

Some pending matters about corporate finance (II)

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The Enron, WorldCom and Parmalat scandals that took place during the last decade led to governments to take legislative measures for protecting investors. Initially, the corporate governance reforms have been voluntary but then become compulsory in many countries. The most scandalous affair was that of Sarbanes-Oxley, the United States legislative reform which is compulsory for every company that intends to be listed in their markets. Since Sarbanes-Oxley began to be applied, only one European company started its listing in the United States due to the high cost.

If good governance is so expensive, does it mean it is a value source for investors? In other words, is it greater the return of companies with a better corporate governance? If this is not the case, the adoption of corporate governance should be questioned. Toyota, the Japanese company, is a good example of unprotected investors. It is an astonishing case of 'bad governance': its board is made up of 26 members when everybody knows a board must be made up of 10-11 members to be effective. There are few independent directors. However, the company's profits have risen an average 8 per cent per year in 1999-2005. The benefits of its rival General Motors (a good example of good governance) fell 23 per cent per year on the same period.

By the way, there are no empirical evidence to conclude that those firms protecting investors are the most profitable firms. El Corte Inglés is not listed and does not publish financial reporting. However, in 2005 the company reported a 15.855 million euros turnover, a figure few Spanish companies can match.

The financial analysts role

Corporate finance departments devote a lot of time and efforts to minimizing the capital cost of companies. This allows firms to grow and make a profit giving value to investors. However, a study carried out by Tom Copeland and published in the Journal of Applied Corporate Finance showed corporate earnings have no relation with return on stock. So, increases in earnings per share can predict only a 4,5 per cent of return on stock. However, the best variable for predicting returns is changes in analysts recommendations .

The above has two important consequences. Firstly, investor relations departments have more weight than corporate finance ones. Secondly, since analysts recommendations are biased, companies markets prices will be even more biased. Scott Richardson, from Wharton School, has recently shown analysts are too optimistic and

recommend buying before selling. Besides, Chris Malloy, from London Business School, has shown analysts tend to give more favourable recommendations to firms closer to them geographically. One could think this is due to they receive better information. Nothing could be further from the truth: buying recommendations on companies closer to analysts are in fact the wrongest ones.

The question researchers try to answer is why markets pay so much attention to analysts recommendations when their bias is so evident.

Risks planning

From the famous options valuation formula by Black and Soles, financial derivatives markets have developed quickly to meet coverage needs of companies and investors. Now we can count with products which reduce interest rate, exchange rate, credit rate or market rate risk. However, the real risk sources which have caused financial crisis and bankruptcies cannot be removed: terrorism, natural disasters (tsunami, Katrina...), pandemics (SARS). A policy insurance is the best solution for these events. But it is not enough: just think about the IIS effect on airlines.

This is the reason why risk policies attention has shifted from simple management (with derivative products) to planning (risk assesment). The last techniques, such as Entreprise Risk Management (ERM), analyses from all points of view the effects of a sudden event (terrorist attacks) in companies which try to minimize its impact trhough business strategies. That is why rental car companies, for instance, have increased its presence in urban areas to the detriment of airports. That is why so many companies are diversifying its products and its geography to avoid being exposed to political and legal changes or natural disasters.

The challenge for corporate finance research is providing tools for companies to manage those risks efficiently. The researching on social studies is undervalued, except maybe History. I think financial products, investors and companies financial strategy and valuation techniques have been developed from academic innovations. And the other way round, researchers keep on working to solve problems that investors, companies and governments cannot tackle. Of course, this list is not thorough and we could talk about the public or private firms debate, how to measure the capital cost in international markets, why companies must be funded with capital if debt is cheaper and so on. As you can see, our agenda is full for the next decades.