Key to Quiz C: 3/21/12

Quiz: Assume that yesterday Firms A, B and C were identical and that all three were privately-owned firms where the founder and CEO owned 100% of the firm's stock.

a. Assume that as a result of an initial public offering this morning, Firm B's founder (who will remain the firm's CEO) now only owns 5% of that firm's outstanding shares. Based on the information in chapter 16, what differences would you expect to see in the future decisions made by the CEOs of Firms A and B? What is the reason (or reasons) for each of these differences?

b. Assume that this morning Firm C undertook an initial public offering of shares that also resulted in the founder (who will remain the CEO) of Firm C owning only 5% of the firm's outstanding shares. However Firm C also issued a significant amount of debt at the same time it undertook the initial public offering. Based on the information in chapter 16, what differences would you expect to see in the future decisions made by the CEOs of Firms B and C? What is the reason (or reasons) for each of these differences?

a. Firm B's CEO will be more likely to:

1) not work as hard as Firm A's CEO

Reason: the CEO of Firm A gets all the benefit of his or her effort while the CEO of Firm B shares the benefit with the firm's shareholders

2) work to increase his pay and perks relative to Firm A's CEO

Reason: the CEO of Firm A bears the cost of these pay and perks while the CEO of Firm B shares these costs with the firm's shareholders

3) diversify Firm B more than the CEO of Firm A will diversify Firm A

Reason: a firm's management is not generally well diversified while the firm's stockholders will be. As a result, diversifying the firm benefits the firm's management but not the firm's stockholders

Notes:

a) since stockholders are indifferent to the firm's diversification, they are only hurt by this decision if the firm incurs costs as it diversifies

b) if all of the shares sold in the IPO were owned by the founder and all of the proceeds of the IPO went to the founder, then he or she is likely to have invested the proceeds in a well-diversified portfolio. However, if the funds are used to expand the firm, then he or she will remain undiversified.

23 = 50
19 = 46
17 = 46
13 = 44

12 = 42
8 = 40
6 = ~~40~~ 39
4 = 37

3 = 35
1 = 30

4) engage in empire building

Reason: management of larger firms tend to have larger salaries, more pay and perks, more power, and less risk

Problem: this harms stockholders if the firm expands by investing in negative NPV projects

b. Compared to the CEO of Firm B, Firm C's CEO will be less likely to:

1) slack off

Reasons:

a) the threat of bankruptcy motivates management to work harder

b) creditors help monitor the firm's management

2) engage in empire building

Reason: surplus cash that would be used for empire building now goes to debt service

3) increase pay and perks

Reasons:

a) surplus cash that could have been used for pay and perks now goes to debt service

b) through their monitoring of management, creditors will reduce the chance of excess pay and perks