Conflicts of interest between managers owners and creditors finance essay

Profession, Manager

Managers, owners and creditors usually have the same fundamental objective that is to see the business prosper in the companies. But when companies are in financial distress, conflicts of interest between managers, owners and creditors arise. The reason to answer this problem is just because managers have different goals from owners and creditors.

As we know, managers are usually hired to run a business of companies on behalf of owners. Thus, some problems can arise between managers and owners because interest of ownership is separated from interest of control especially when companies fall into financial distress. Managers may pursue some goals that bring benefits to them but may not be beneficial to the owners. Owners have their own shares and they think that their shares value will be increased. They have right to indirectly control of the operating decisions that influence the companies' cash flows and others. Besides, creditors are the party who provide capital to companies at rates based on the riskiness of companies' assets and on companies' capital structure of debt and equity financing. Conflict of interest between owners and creditors is that owners want to borrow money at the lowest rate whereas creditors decide the rate based on the risks of companies' investment projects and companies themselves. The more risks companies have, the more required rate on the firm's debt will be paid. When a company faces financial distress and may be going to bankruptcy, there are usually two solutions to settle. The first solution is reorganization and continuation as a going concern. Managers usually like this solution as they can exercise control over what goes on during the company. The second solution is liquidation and selling off of the assets of the company. Managers usually do not like this solution

and may resist whereas creditors like this solution as they stand to get their money from the liquidation value first. However, managers may not want this to happen and they may seek to “ bribe” the creditors with a promise of getting more money than they should if the latter agree to the first solution. This is not in the interest of the owners.

Conflicts of interest between managers, owners and creditors always exist even when the company is profitable. Therefore, the company has a cash surplus. Managers would want this money as a financial bonus and the shareholders would want this money as a stock dividend whereas creditors get paid a fixed amount and they get paid before the owners get paid.

II: In a personal financial situation, give an example of opportunity cost.

In a personal financial situation, opportunity cost of any investment is the return one could earn on the next best alternative. A simple way, we can understand that opportunity is the benefit you could have received by taking an alternative action.

All investments of a company involve opportunity cost. A dollar today is worth more than a dollar in one year because the dollar today can be invested and will increase more than a dollar in one year. The dollar you can get after one year carries an opportunities cost equal to the return on the forgone investment. Thus, opportunity cost is the forgoing cost and when there are a number of business alternatives. The decision makers always select the alternative which has the highest opportunity cost because if the decision maker selects any other alternative he or she has lost the

opportunity. Companies usually use opportunity cost to evaluate a capital Investment project. The company can compare between the projected return and the return it would earn on the highest yielding alternative investment involving similar risk. For example, a company has a free amount of money in the bank that earning interest 10% after 1 year. If this company uses this amount of money to invest a project, it will get 15% profit after 1 year. In this example, opportunity costs of this company are 5% (15%-10%).

Decision makers of a company always have to consider choosing the way which can give them the maximum benefit that can cover all costs. They use opportunity cost to analyze a project and the simplest way to estimate the opportunity cost is to compare the present choice with the next best alternative that could be made. However, it is not easy to make comparison because many alternatives do not have a market price or very difficult to calculate into money.

Question III: In America, Vietnam or any other country, what is appropriate question to ask when evaluating an investment opportunity? Explain why.

When evaluating an investment opportunity in America, Vienam or any other country, the appropriate question that company usually concern is " what is the discount rate?"

The discount rate is rate of return that recognizes the time value of money. It is calculated based on cash flow expected in future from the investment. Management of a company always compares the discount rate of many projects to choose which projects with maximum return or wealth for the

company's stockholders. The discount rate is also related to a risk factor that recognizes the uncertainty associated with achieving future profit forecasts. The risky projects can bring high discount rate to investors. However, it is not easy to determine the appropriate discount rate because it is calculated by using discounted cash flow techniques. Besides, the appropriate discount rate is influenced by some main factors. The first factor is related to macroeconomic conditions such as inflation, interest rates and country risks…Vietnam has higher country risks than America because Vietnamese policies can be changed very fast. The second factor is matter of the industry such as average of profit ratio in the industry… The third factor is the company policy which related to capital structure. Otherwise, there are some factors related to projects themselves. Evaluating the factors helps investors define discount rate and therefore they have an overview of the investment opportunity. Besides, management have to foresee the estimated future benefits are large enough to justify the current expenditure as well as the proposed investment based on capital budgeting. It is the most cost-effective way to achieve their goals.

The discount rate to be applied can be based on the facts and circumstances of a particular case as well as the analysis of the likelihood of achieving forecasted lost profits. Companies have to assess the relevant factors in determining an appropriate discount rate that help them build a stronger case in support of their damage position.

Question IV: Discuss the true economic cost to Daimler-Benz (Mercedes) when it purchased Chrysler in 1998. How did that workout?

In May, 1998, Daimler-Benz and Chrysler Corporation, two of the world's leading car manufacturers, agreed to combine their businesses. Daimler-Benz purchased the Chrysler Corporation at $37. 3 billion. The former Chrysler Corporation was given autonomy to manufacture mass-market cars and trucks while the Germans firm continued to build luxury cars. Thus, purposes of this business for Daimler-Benz is to access to the North American market for automobiles without diluting the image of its Mercedes-Benz brand. Otherwise, with acquiring Chrysler they can get production capacity outside Germany and opportunity to learn from Chrysler's envied process of making decisions quickly and bringing new vehicles to market promptly. However, the true cost to purchase the Chrysler is not $37. 3 billion because the Chrysler has $15. 5 billion in interest-bearing debt that makes the total price to purchase is $52. 8 billion ($37. 2 million + $15. 5 million). Thus, Chrysler's assets need to make future cash flow worth at least $52. 8 billion.

Therefore, the true economic cost to Daimler-Benz when it purchased Chrysler is over $52. 8 billion. After purchasing Chrysler, Daimler-Benz firm had to bear many extra expenses related to changes in many factors such as leaderships, business strategy, culture clash and management styles. The Daimler is different from the Chrysler different in businesses. The Daimler's core competency is high-valued, technically advanced cars and focuses on development of luxury cars whereas Chrysler focused on mass market and

considered as a very cost – effective company. Moreover, European culture is far different from American style and there may appear conflict of management style in a short time. Thus, it is difficult to the business and cash flow for DaimlerChrysler in the future. Therefore, DaimlerChrysler faced failures in operating. Despite significant short and medium term expected synergies, DaimlerChrysler has been negative profits after the deal. In 2001, DaimlerChrysler got loss of $5. 8 billion which was the biggest loss in German business history. In 2007, The Chrysler was bought of 80. 1% (about $7. 4 billion) by Cerberus Capital Management LP. This price is much cheaper than the price ($37. 3 billon) when Daimler purchased Chrysler in 1998. After 9 years, this deal marked the divorce of Daimler and Chrysler.

Question V: A sporting good manufacturer has decided to expand into a related business. Management estimates that to build and staff a facility of the desired size and to attain capacity operations would cost $275 million in present value terms. Alternatively, the company could acquire an existing firm or division with the desired capacity. One such opportunity is the division of another company. The book value of the division’s asset is $140 million and its earnings before interest and tax are presently $30 million. Publicly traded comparable companies are selling a narrow range around 12 times current earnings. The companies have debt-to-asset ratios averaging 40 percent with an average interest rate of 10 percent.

Using a tax rate of 34 percent, estimate the minimum price the owner of the division should consider for its sale.

Multiple = Market Value / EBIT (1-tax)

Therefore, Market value = Multiple x EBIT (1-tax)

Market value = 30 (1-0. 34) x 12 = $237. 6 million

Market value = D + E

D = 40% x $140 million = $ 56 million.

E = Market value – D = $237. 6 million – $ 56 million = $181. 6 million.

With calculation above, the minimum price the owner of the division should consider for its sale is the value of its equity (E). The minimum price is $181. 6 million.

b. What is the maximum price the acquirer should be willing to pay?

The maximum price the acquirer should be willing to pay is the market value. In this case, it is $237. 6 million

c. Does it appear that that an acquisition is feasible? Why or why not?

Because the companies have debt-to-asst ratios averaging 40 percent with an average interest rate of 10 percent, the price will be:

$237. 6 million + ($237. 6 million x 40%) x 10% = $247. 104 million

The price above is less than $275 million. If the managements build and staff a facility, they have to pay $275 million. Thus, this acquisition is feasible. Otherwise, the company can utilize staff and facility.

d. Would a 25 percent increase in stock prices to an industry average price-to-earnings ratio of 15 change your answer to (C)? Why or why not?

In this situation, Market Value = $237. 6 million x 1. 25 = $297 million.

The price in this situation is more than $275 million. If the managements build and staff a facility, they have to pay $275 million. Thus, with 25% increase in stock prices to an industry average price-to-earnings ratio of 15%, my answer to (c) will be changed.

e. Referring to the $275 million price tag on the replacement value of the division, what would you predict would happen to acquisition activity when market values of companies and divisions rise above their replacement values?

When market values of companies and divisions rise above their replacement value and related to the $275 million price tag on the replacement value of the division, I predict that the company will acquire existing firm or division with the desired capacity instead of building and staffing new facility.

Question VI:

What does it mean when a company's free cash flow is negative in one or more years?

Free cash flow always measures how much money a company generates after deducting maintenance capital expenditure, but before capital expenditure on expansion. Free cash flow is important for any company because it a company can pursue opportunities that increase shareholder

value with free cash flow. It is difficult for a company to launch new products, make any acquisition, pay dividends and reduce debt without enough cash.

In theory, Free Cash Flow = Net Income + Amortization/Depreciation- Changes in Working Capital – Capital Expenditures. Thus, if the free cash flow is negative in one or more years, company may have large investments. If these investments get a high return, profits that a company attains are more than costs to be paid. Otherwise, a profitable business or in some particular industries may have negative cash flow especially in the beginning of investments. In these cases, negative free cash flow of a company can be accepted in a short time but not in a long time.

b. Do negative values of free cash flow in way alter or invalidate the notion that a company's fair market value equals the present value of its free cash flows discounted at the company's weighted average cost of capital?

Free cash flow is the amount of cash a company has after expenses, debt service, capital expenditures, and dividends. The higher the free cash flow of a company, the stronger the company's Balance Sheet. Free cash flow can affect the value of a firm. Negative free cash flow can not define the value and it has no sense. However, negative values of free cash flow invalidate the notion that a company's fair market value equals the present value of its free cash flows discounted at the company's weighted average cost of capital. Some divisions of a company may accept loss in order to increase free cash flow of a company in the future.

c. Suppose a company’s free cash flows were expected to be negative in all future periods. Can you conceive of any reasons for buying the company’s stock?

Free cash flow is the most important number to be needed to know about a company before buying its stock. Big companies usually throw off large sums of free cash flow whereas young or growing companies may have a negative free cash flow. We can buy the company’s stock if the company’s free cash flow in the short time. However, if a company’s cash flow were expected to be negative in all future periods, we should not buy their stock because the company’s finance situation is not good. The company may get troubles in sales, heavy debt, ineffective investments or other causes in operation that result to a cash flow with higher expenditures than income. With negative cash flow in all periods, the company may have to bankruptcy. Therefore, there is no reason for buying its stock.

However, if we know that the company has some big projects and will get high return in the long time, we can consider buying the company’s stock because large investments can make the company having negative cash.