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Corporate governance analysis

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Abstract
Corporate Governance Analysis, Stockholder Analysis, Risk and Return. Dividend Policy, and Valuation of a publicly traded company with at least three years of trading history by the end of 2014 with annual financial statements, potential conflicts of interest, separation of ownership and management: implications for risk – taking behaviour, leverage, profit margin, stable growth model, value of equity, 2 – stage growth model and 3 – stage growth model, etc. were all discussed in this research.

Keywords: corporate governance analysis, stockholder analysis, stable growth model, value of equity, 2 – stage growth model and 3 – stage growth model.

1. Introduction

The common theme is Industry Sector – Land and Property. The researcher will be writing on Property Development PLC which is a quoted public company. It is on trading history that the company has traded publicly for at least three years. This company was selected based on the market capitalization as at the end of 2014 and financial performance for the past three years. It should be noted that 2012, 2013 and 2014 were the years considered, as well as their annual reports. It is a quoted public company with limited liability incorporated in Sri Lanka on 15 October, 1980. The company was re-registered under the Companies Act No. 07 of 2007 on 13th December, 2007. It has eight directors of which one out of the eight directors is the Chairman. The company's management is made up of Chief Executive Officer, Manager Finance, Manager Maintenance, and Senior Administration Executive. The company has registered office, a subsidiary and secretaries in Sri Lanka. Ernst & Young Chartered Accountants and Kreston MNS & Company Chartered Accountants are the company's auditors. The company is banking with Bank of Ceylon. Now that the company has being fully introduced, let us now go to the conceptualization terminologies.

2. Conceptualization Terminologies

In order for this work to be useful and well understood, some conceptual terms have to be defined. such terms are: Analysis, Corporate Governance Analysis, Social Obligation, Financial Market, Financial Statement, Stockholder Analysis, Marginal Investor, Risk and Return, Risk, Risk Profile, Cost of Equity, Cost of Debt, Cost of Capital, Dividend Policy, Valuation, Stable Growth Model, 2 – Stage Growth Model, 3 – Stage Growth Model, Value of Equity, Market Value, Profit Margin, Leverage, Value, and Growth, etc. below are their definitions as well as the answers to the questions that were attached to the conceptual terms.

2.1 Analysis

It simply means the detailed examination of the elements or structure of something.

2.2 Corporate governance analysis

The framework of rules and practices by which a board of directors ensures accountability, fairness, and transparency in a company's relationship with all its stakeholders which are the financiers, customers, management, employees, government, and the community.

2.3 Social Responsibility

Social responsibility is an ethical framework and suggests that an entity, be it an organization or individual, has an obligation to act for the benefit of society at large. Social responsibility is a duty every individual has to perform so as to maintain a balance between the economy and the ecosystems. The firm's social obligation as well as its image management in the society depends in the governance of the Company's affairs, and the Board to strike balance in the interests of the Company, its shareholders, employees and other stakeholders. The Board is finally responsible for the Company's financial performance.

2.4 Financial Market

A financial market is a market in which people trade financial securities, commodities, and other fungible items of valu at low transaction costs and at prices that reflect supply and demand. Securities include stocks and bonds, and commodities include precious metals or agricultural products.

2.5 Financial Statement

A financial statement (or financial report) is a formal record of the financial activities and position of a business, person, or other entity. Relevant financial information is presented in a structured manner and in a form easy to understand.

2.6 Stockholder Analysis

Stockholder analysis is a tool for clearly defining key stakeholders for a project or other activity, understanding where stakeholders stand, and developing corporation between the stakeholders and the project team. The main objective is to ensure successful outcomes for the project or the changes to come.

2.7 Marginal Investor

Marginal Investor is a representative investor whose actions reflect the beliefs of those people who are currently trading a stock. It is the marginal investor who determines a stock's price. The marginal investor is also known as the *Last Investor*. Here the marginal investor who is also the last investor is the shareholder who invested last in the shares of Company ABC. Let us now look at risk and return.

2.8 Risk and Return

Higher risk is associated with greater probability of higher return and lower risk with a greater probability of smaller return. This trade off which an investor faces between risk and return while considering investment decisions is called the risk return trade off. I will earn dividends as my return for investing in this company's stock. Yes, I would have outperformed the market. More than 70% performance can be attributed to the management.

2.9 Risk Profile

A risk profile is an evaluation of an individual or organization's willingness to take risks, as well as the threats to which an organization is exposed to. A risk profile identifies: 1. The acceptable level of risk an individual or corporation is prepared to accept. According to 2014 Annual Report of Property Development PLC, the Risk Profile of this company is the market risk, credit risk and liquidity risk. The overall risk in this firm is equal to the overall property investment that the company has invested in. The risk is coming from the market. The reason is because; the price or value of the property the company has invested in might not be the same with the market price or value of the same property. The risk profile changes as time progresses.

2.10 Cost of Equity

The cost of equity is the rate of return required by the company's ordinary shareholders in order for that investor to bear the risk of holding that company's shares. The return consists both of dividend and capital gains.

$$\text{Cost of Equity} = \frac{\text{(EACS)}}{\text{Equity}}$$

$$Ke = \frac{3,538,274,000}{4,335,751,099}$$

Ke = 0.8161
Ke = 81.61%

Note: EACS means Earnings Available to Common Shareholders.

The riskiness of this firm equity is that the Earnings Available to Common Shareholders is on a close range with the value of equity. The company's cost of equity is 81.61% or 0.8161.

2.11 Cost of Debt

Cost of debt is the interest a company pays on its borrowings. It is expressed as a percentage rate. In addition, cost of debt can be calculated as a before-tax rate or an after-tax rate. Because interest is deductible for income taxes, the cost of debt is usually expressed as an after-tax rate.

$$\text{Cost of Debt} = \frac{\text{Interest}}{\text{Debt}}$$

$$Kd = \frac{161,031,297}{480,620,207}$$

Kd = 0.3350
Kd = 33.50%

The riskiness of this company's debt is that the interest on the debt is very high. The company's cost of debt is 33.50% or 0.3350.

2.12 Cost of Capital

Cost of capital refers to the opportunity cost of making a specific investment. It is the rate of return that could have been earned by putting the same money into a different investment with equal risk. Thus, the cost of capital is the rate of return required to persuade the investor to make a given investment.

$$\text{Cost of Capital} = \frac{\text{Equity}}{\text{Equity + Debt}} \text{ x } Ke + \frac{\text{Debt}}{\text{Equity + Debt}} \text{ x } Kd\,(1 - Tc)$$

$$WACC = \frac{3,438,612,945}{4,018,894,2047} \text{ x } 81,61\% + \frac{480,620,207}{4,018,894,2047} \text{ x } 3.50\%\,(1\text{-}28\%)$$

WACC = 0.8556 x 0.8161 + 0.1196x 0.3350 (1 – 0.28)
WACC = 0.6983 + 0.1196 x 0.3350 (0.72)
WACC = 0.6983 + 0.0289
WACC = 0.7272
WACC = 72.72%

This company's current cost of capital is 72.72% or 0.7272.

2.13 Risk

Is a situation exposing one to uncertainty; is to expose (someone or something of valued) to danger, harm or loss.

2.14 Dividend Policy

A dividend policy is a company's approach to distributing profits back to its owners or stockholders. If a company is in a growth mode, it may decide that it will not pay dividends, but rather re-invest its profits (retained earnings) in the business. According to 2014 Annual Report of Property Development PLC, the firm has returned cash to its owners through first and final dividends payment. The firm has paid dividends.

Rs. 173,795,511 is the cash the firm has accumulated over time. If the firm has excess cash, and they don't have any profitable investment to invest the excess cash into, I will recommend they return the excess cash as dividends to stockholders who might have investments where they will invest the money into.

2.15 Valuation

This simply means an estimation of the worth of something, especially one carried out by a professional valuer. It also means the monetary worth of something, especially as estimated by a valuer.

2.16 Stable Growth Model

The Gordon growth model is used to determine the intrinsic value of a stock based on a future series of dividends that grow at a stable rate, because the model simplistically assumes a constant growth rate. It is generally only used for companies with stable growth rates in dividends per share.

2.17 Stage Growth Model

The two – stage model has an unstable initial growth rate, and can be either positive or negative. This initial phase lasts for a specific time and is followed by stable growth which lasts forever. The problem with this model is that the growth rate from the initial phase is assumed to change to the stable growth rate overnight.

The two-stage dividend discount model takes into account two stages of growth. This method of equity valuation is not a model based on two cash flows but is a two-stage model where the first stage may have a high growth rate and the second stage is usually assumed to have a stable growth rate.

The two-stage model can be used to value companies where the first stage has an unstable initial growth rate and there is a stable growth in the second stage which lasts forever. The first stage may have a positive, negative, or a volatile growth rate and will last for a finite period while the second stage is assumed to have a stable growth rate for the rest of the life of the company. In this model, it is assumed that the dividend paid by a company also grows in the exact way i.e. in two such stages. Let us now look at the 3-Stage Growth Model.

2.18 Stage Growth Model

The three-stage dividend discount model is much like its simple counterparts, the Gordon Growth Model, the two-stage model, and the H model. In fact, it is essentially a combination of these three models that aims to eliminate some of the shortcomings intrinsic to those formulas.

The three-stage model incorporates elements of all three models: an initial period of very aggressive or paltry growth followed by a period of incremental increase or decrease that eventually stabilizes at a more moderate growth rate that is assumed to continue for the life of the company. Because of the complexity of this formulae and the numerous growth rates it can accommodate, it is the most likely of ll the models to accurately reflect the value of a stock based on actual dividend data. Of course, a stock's price is not the product of its dividend valuation alone, so even the most precise model may not align perfectly with market values. Instead, the three-stage model has an initial phase of stable high growth that lasts for a certain period. In the second phase the growth rate declines linearly until it reaches the final stable growth rate. This model improves upon both previous models and can be applied to nearly all firms.

I will pick the 3 – stage growth pattern for this firm.

The high growth will lasts for a certain period.

2.19 Value of Equity

Equity value is the value of a company available to owners or shareholders. It is the enterprise value plus all cash and cash equivalents, short and long term investments, and less all short-term debt, long-term debt and minority interests.

The value of equity in this firm is Rs. 3,538,274.

In other words, the value of equity in this firm is Rs. 52.10 compared to the market value which is Rs. 98.00.

2.20 Market Value

Is the amount for which something can be sold on a given market.

2.21 Profit Margin

Is simply the amount by which revenue from sales exceeds costs in a business. I will choose the path of profit margin when hired to enhance value of this firm.

2.22 Leverage

It simply means the ratio of a company's loan capital (debt) to the value of its ordinary shares (equity); gearing. It is used borrowed capital for (an investment), expecting the profits made to be greater than the interest payable.

2.23 Value

It's simply the regard that something is held to deserve; the importance, worth, or usefulness of something. It is the principles or standards of behaviour; one's judgment of what is important in life. It means the estimating of the monetary worth of something. It means to consider (someone or something) to be important or beneficial; have a high opinion of.

2.24 Growth

Is the process of increasing in size. It means something that has grown or is growing. The key variable driving this value is growth.

3. Separation of ownership and management: implications for risk-taking behaviour

Stock companies employ the standard corporate form; while mutual merge the customer and owner functions. However, this simple distinction masks a more complex reality. Within the category of stock insurers, tremendous variation in ownership structure exists. At one extreme, stock ownership can be fully concentrated in the hands of management; and at the other extreme, the stock ownership can be widely dispersed when the stock company is ultimately owned by a mutual parent. These ownership structures manifest various degrees of separation of ownership from management. Specifically, as explained later in the paper, the degree of separation of ownership from management increases as one moves across the ownership structures, from companies closely-held by management, to companies closely-held by others (i.e. parties other than management0, to widely-held stock insurers, to mutual-owned stock insurers, and finally to mutual insurers.

Price findings has shown that mutual and stock ownership structures are significantly different from each other, and that such differences have important implications for inserers' distribution choices, CEO compensation, and other aspects of insurers' operations (e.g., Mayers and Smith, 1981; Mayers and Smith, 1988; Mayers and Smith, 1992; Kim, Mayers and Smith, 1996); Pottier and Sommer, 1997; Regan and Tzeng, 1999). The difference between mutual and stock ownership structures also has important implications for insurers' risk-taking behaviour; including decisions related to business mix and investment strategies (Lamm-Tennant and Starks, 1993; Lee, Mayers and Smith, 1997). The results of existing studies are consistent with greater separation of ownership and management being associated with less risk taking.

As a result of separation between management and ownership in Property Development PLC, the best way for the management to respond to stockholders is in their corporate governance. In its governance of the Company's affairs, the Board strives to balance the interests of the Company, its shareholders, employees and other stakeholders. The Board is finally responsible for the Company's Financial Performance (Nwokwu, Dharmadasa, & Rathnasingha, 2018; Nwokwu, Atapattu, & Azeez, 2019; Nwokwu, 2018; Nwokwu, Rathnasingha & Pradeep, 2019) [10, 8, 9, 7].

4. Potential conflicts of interest

A potential conflict of interest involves a situation that may develop into an actual conflict of interest. It is important to note that a conflict of interest exists whether or not decisions are affected by a personal interest; a conflict of interest implies only the potential for bias, not likelihood. If not well handled by the firm, potential conflicts of interest may arise between the management and the stockholders on whether to reinvest the stockholders dividends or to issue their dividends to them. The firm interacts with the financial markets through their quarterly and annually data they released and published in the Colombo Stock Exchange. The markets get information on the firm through their quarterly and yearly publications in the Colombo Stock Exchange.

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