CHARTA LEARNING · LESSON NOTES

Stakeholders, governance, covenants and sustainability

CFA Level I · Corporate Issuers

You will learn: Who a company answers to, the governance tools that keep it accountable, how to read a debt covenant test, what lenders and shareholders are each entitled to, and how material environmental and social issues enter a valuation.

Running example: Examples use made-up figures: a company with 100 shares and 5 board seats, two identical firms paying 60 next year, a firm with debt of 500 under covenant tests, and a firm owing lenders 100.

1. Stakeholders and the agency problem

- Governance is the system of rules, checks and people that makes sure a company is run in the interests it is meant to serve. It closes the gap between owners and the managers who run the business.
- A stakeholder is anyone affected by the company or with a claim on it: shareholders, creditors, employees, customers, suppliers, regulators. Shareholders are only one group.
- Control runs from shareholders, who elect the board, to the board, which hires and watches management. Creditors are protected by the loan contract and covenants, staff, customers and suppliers by their contracts, and regulators by law and disclosure.
- Each group wants something different. Shareholders want the residual return; creditors want safe repayment; employees want fair pay and secure jobs; customers want quality at a fair price; suppliers want prompt payment; regulators want the rules followed and the truth told. Governance settles the trade-offs.
- The agency (principal agent) problem: the owner is the principal, the manager the agent, and the agent has own goals (pay, comfort, empire). Tools to reduce it: a strong board, honest audits, voting rights, pay that rewards the right things, and disclosure.

2. Governance tools: board, votes, audit and takeover

- The board is elected by owners and oversees management. Good signs: independent directors (no close business or personal tie to the company or its managers, which does not mean owning no shares) and a chair who is a different person from the chief executive.
- Committees: audit (accounts and the outside auditor), remuneration (executive pay) and nomination (new directors). They should be mostly or wholly independent.
- One share, one vote is the norm. Dual class shares, where insiders hold extra votes, usually weaken governance. An external auditor gives an independent opinion on the accounts. The takeover threat (the market for corporate control) disciplines weak management.
- Cumulative voting lets a minority pool its votes on one candidate. A holder with more than 100 ÷ (seats + 1) of the shares can guarantee a seat.

100 SHARES, 5 SEATS; HOLDERS OWN 80 AND 20 SHARES

Straight voting: small holder	loses every seat vote 80 to 20	**0 seats**
Cumulative votes: large holder	80 shares × 5 seats	**400 votes**
Cumulative votes: small holder	20 shares × 5 seats	**100 votes**
Large holder needs to win all 5	more than 5 × 100	**500+ votes**
Share needed to guarantee a seat	above 100 ÷ (5 + 1)	**16.7%**

Watch out: Thinking an independent director owns no shares.

3. Conflicts of interest and what good governance is worth

- Three classic clashes: shareholders against managers (perks and empire building); shareholders against creditors (risk taking with borrowed money, where owners keep the upside and lenders carry the downside); controlling against minority shareholders (related party deals).
- Managing relationships well brings cheaper debt, loyal staff and customers, and few fines. Neglect brings tight terms from lenders, strikes or lost talent, lost customers and fines.
- If governance makes investors nervous, the required return rises and value falls.

Value = cash flow next year ÷ (required return − growth rate)

IDENTICAL FIRMS, CASH FLOW 60, GROWTH 3% (ILLUSTRATION)		
Firm A, good governance	60 ÷ (0.09 − 0.03)	**1,000.00**
Firm B, weak governance	60 ÷ (0.10 − 0.03)	**857.14**
Value lost by B	1,000.00 − 857.14	**142.86 (14.3%)**

4. Debt covenants

- A debt covenant is a rule in a loan contract that the borrower agrees to follow, in return for cheaper credit. They limit risk shifting from shareholders to lenders.
- Affirmative covenants say what the borrower must do (audited accounts, insurance, taxes, keeping ratios). Negative covenants say what it must not do (extra debt above a limit, asset sales, big dividends).
- Two ratios are tested most. Leverage (debt ÷ EBITDA, earnings before interest, tax, depreciation and amortisation) must stay below a maximum. Interest cover (EBIT ÷ interest, EBIT being earnings before interest and tax) must stay above a minimum.
- A breach is usually an event of default, even if every payment is on time, because a covenant measures the borrower's health.
- The lender may demand the loan back at once (acceleration) but usually negotiates: a waiver for a fee, or an amendment with a higher rate, tighter terms or more collateral. Cross default can spread to other loans.

Leverage = Debt ÷ EBITDA (stay below limit); Interest cover = EBIT ÷ Interest (stay above limit)

DEBT 500, INTEREST 40, DEPRECIATION 50; LIMITS: LEVERAGE AT MOST 3.5×, COVER AT LEAST 3.0×		
Year 1 (EBITDA 200): leverage	500 ÷ 200	**2.50× (passes)**
Year 1 interest cover	150 ÷ 40	**3.75× (passes)**
EBITDA that hits the cover limit	40 × 3.0 + 50	**170, headroom (200 − 170) ÷ 200 = 15.0%**
Year 2 (EBITDA 130): leverage	500 ÷ 130	**3.85× (breach)**
Year 2 interest cover	(130 − 50) ÷ 40	**2.00× (breach)**
Interest actually paid	on time, in full	**40**

Watch out: Treating a covenant as only a late payment problem; getting the direction wrong.

5. Lenders and shareholders: two different claims

- Lenders hold the fixed claim: interest and principal only, paid before shareholders if the firm is wound up. Shareholders hold the residual claim: whatever is left, with unlimited upside and, by limited liability, loss capped at their stake.
- A lender asks whether it will be paid and focuses on the downside. A shareholder asks how big this can get. Owners may like risk that lenders dislike, so lenders protect themselves with covenants, collateral and a higher required return.
- The shape resembles a call option on the firm, with the debt as its strike. Risk shifting: a riskier project with the same average firm value moves value from lenders to owners, which is why covenants exist.

Lender gets min(V, D); Owners get max(0, V − D)

DEBT OWED 100; FIRM VALUE V AT THE END

V = 60	lenders min(60, 100); owners 0	**lenders 60, owners 0**
V = 150	lenders 100; owners 150 − 100	**lenders 100, owners 50**
V = 200	lenders 100; owners 200 − 100	**lenders 100, owners 100**
Debt 80: safe project (V = 100)	lenders 80; owners 100 − 80	**owners 20**
Debt 80: risky project (160 or 40, equally likely)	lenders average of 80 and 40; owners average of 80 and 0	**lenders 60, owners 40**
Value moved to owners	40 − 20 = 80 − 60	**20**

Watch out: Forgetting that the shareholder and lender conflict is about risk.

6. Environmental and social factors (ESG)

- ESG is environmental, social and governance. These factors matter to an investor not for ethics alone, but when they change the money a company earns or the risk it carries: they are then financially material.
- Materiality depends on the business. A carbon cost is a high factor for a coal power station, a low one for a software firm; water scarcity is high for a drinks maker, low for a law firm.
- A factor can bring opportunities as well as risks. Analysts ask which factors can move this company's revenue, costs or risk.
- Uses, from light touch to deep: negative screening (excludes sectors or companies), best in class (sector leaders), thematic investing (clean energy, water), full integration (ESG in forecasts and discount rate). Engagement uses meetings and votes to push for change. Rating providers often disagree.
- Integration is not exclusion. Do not double count: if a risk is in the cash flows, do not also lift the discount rate for it.

A CARBON COST: CASH FLOW 100, GROWTH 2%, REQUIRED RETURN 8% (ILLUSTRATION)

Base value	100 ÷ (0.08 − 0.02)	**1,666.67**
Cash flow route: cash flow cut to 90	90 ÷ 0.06	**1,500.00 (down 10.0%)**
Rate route: required return 9%	100 ÷ (0.09 − 0.02)	**1,428.57 (down 14.3%)**

Key takeaways

- Shareholders are one kind of stakeholder; governance tools (independent board, committees, votes, audit) reduce the agency problem.
- Poor governance raises the required return and lowers value.
- Covenants are loan rules: leverage must stay below its limit, interest cover above its limit.
- A covenant breach is usually a default even if every payment was made.
- Lenders get min(V, D); owners get max(0, V − D), which is why owners may favour risk.
- ESG enters a valuation where it is material, through cash flows or the discount rate, never both for the same risk.

Quick check

1. Covenant: debt ÷ EBITDA at most 3.0. Debt is 450 and EBITDA falls to 140. Breach?
   Answer: Yes. 450 ÷ 140 = 3.21 is above 3.0, even if all interest was paid.
2. A firm owes lenders 100 and ends up worth 80. What do lenders and owners get?
   Answer: Lenders 80, owners 0.
3. A material carbon cost: two ways into a valuation, and what to avoid?
   Answer: Cut cash flow or raise the rate, never both for the same risk.

Summary notes for the Charta whiteboard lesson. Examples use made-up figures. Watch the full lesson at charta-learning.com.