

LM02 · CORPORATE ISSUERS · CFA LEVEL I

Investors and Other Stakeholders

How capital providers divide a firm's cash flows — and the other parties who affect corporate decisions

What This Reading Covers

A corporation's cash flows are split between two core capital providers — **lenders** (debtholders) and **shareholders** (equity) — with very different legal claims, risk profiles, and incentives. Beyond those providers, a wider set of **stakeholders** (directors, managers, employees, customers, suppliers, governments, communities) also have a vested interest in the firm. LM02 introduces how these claims and interests interact, and how **ESG factors** (environmental, social, governance) are incorporated into issuer analysis.

Learning Outcome Statements

- LOS a** Compare the financial claims and motivations of lenders and shareholders
- LOS b** Describe a company's use of debt financing (effect on ROE, risk, and dilution)
- LOS c** Describe a company's stakeholder groups and compare their interests
- LOS d** Describe environmental, social, and governance factors of corporate issuers considered by investors

Exam Tip: The two "must-know" numbers in LM02 come from the worked example: Revenue = 100, Costs = 70, interest rate on debt = 20%. From that simple setup, you should be able to compute ROE for both an all-equity firm and a levered firm — and show how the levered firm's ROE is both higher and more sensitive to revenue shocks.

LOS A · FINANCIAL CLAIMS & MOTIVATIONS

Lenders vs. Shareholders — Two Very Different Claims

A single set of corporate cash flows gets split between capital providers with very different legal rights, risk appetites, and return profiles.

FEATURE	DEBTHOLDERS (LENDERS)	EQUITY INVESTORS (SHAREHOLDERS)
Capital provided	Finite maturity (temporary)	Permanent capital
Payment obligation	Issuer <i>must</i> make scheduled interest & principal payments	No commitment to future dividends or repayments
Priority of claim	Priority (senior) claim — paid before equity	Residual claim — own what is left after all other payments
Decision-making	No decision-making power within the corporation	Voting rights on key decisions
Contractual protections	Debt contracts may impose financial covenants or legal claims on certain assets	Cash distributions at the discretion of the board
Tax treatment (issuer)	Interest is tax deductible	Dividends are not tax deductible
Risk for investor	Lower risk	Higher risk
Cost of capital to issuer	Cheaper	Costlier

The one-line summary

Interest is paid before distributions to equity investors. Debtholders hold a priority claim; shareholders hold a residual claim. That single fact drives every other difference in the table.

Why debt is riskier for the *issuer*

Although debt is cheaper and lower-risk for the investor, issuing debt is *riskier* for the company. If the company fails to meet its contractual interest or principal payments, it may be forced into bankruptcy and

liquidation. Equity carries no such obligation — which is why debt "increases risk for equity investors" too.

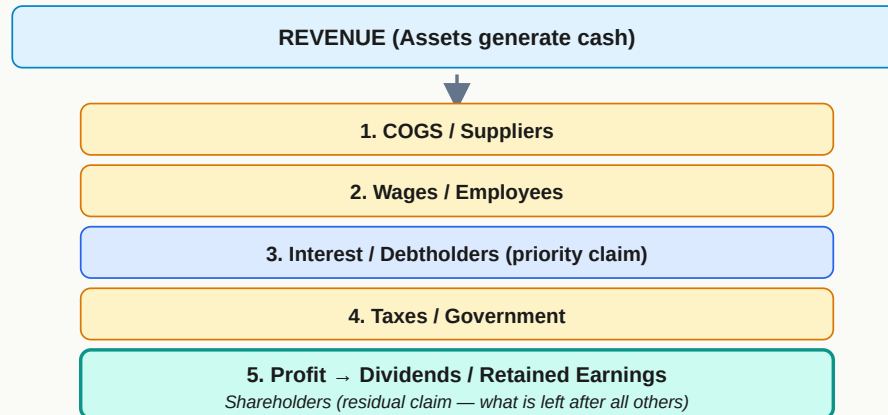
LOS A · RISK-RETURN PROFILES & PRIORITY OF CLAIMS

Payoff Asymmetry & the Priority Waterfall

Because lenders are paid first (and only their promised amount), their upside is **capped**. Shareholders are paid last (whatever is left over) — their upside is **unlimited**, but so is their exposure to losses on their investment.

PRIORITY OF CLAIMS ON CORPORATE CASH FLOW

Revenue flows through the firm — each layer must be paid before the next



Payoff Asymmetry

DEBTHOLDER PAYOFF

Capped upside: the most a lender can earn is the contractual interest plus principal. Returns do not rise with the firm's success.

Downside: if the firm defaults, lenders can lose part or all of principal. Maximum loss = amount of debt held.

Motivation: maximize the likelihood of timely payments. Lenders get *no benefit* from increased risk or higher leverage.

SHAREHOLDER PAYOFF

Unlimited upside: as the firm grows, residual cash flows to equity can rise without ceiling.

Downside: shareholders can lose 100% of their investment, but not more (limited liability).

Motivation: maximize residual cash flows — take more risk, use more debt, pay dividends.

Exam Tip: A residual claim with unlimited upside and a priority claim with capped upside is the single most-tested idea in LM02. Expect a question that describes one and asks you to identify the claim type.

LOS B · USE OF DEBT — EFFECT ON ROE & RISK

How Debt Changes ROE (and Risk)

The worked example below shows how adding debt to a firm's capital structure raises ROE in good times, *and* makes ROE far more sensitive to revenue shocks. This is the mechanical source of **financial leverage**.

WORKED EXAMPLE

Impact of Debt on Equity Returns (ROE)

◆ GIVEN

Revenue = 100 · Expenses = 70 · Interest rate on debt = 20% · taxes ignored

Two firms, each with Assets = 100:

- **All-Equity firm:** Debt = 0, Equity = 100
- **Levered firm:** Debt = 75 (financial leverage), Equity = 25

? FIND

ROE for each firm at base revenue, and after a $\pm 20\%$ change in revenue (costs unchanged).

SOLUTION

► SOLUTION

1

Base case (Revenue = 100)

$$\text{All-equity: ROE} = (100 - 70) / 100 = 30 / 100 = 30\%$$

$$\text{Levered: ROE} = (100 - 70 - 0.20 \times 75) / 25 = (30 - 15) / 25 = 15 / 25 = 60\%$$

Debt boosts ROE because equity (the denominator) shrinks faster than interest shrinks the numerator — as long as the firm earns more than the interest rate on assets.

2

Good year — Revenue +20% (= 120, costs unchanged)

$$\text{All-equity: ROE} = (120 - 70) / 100 = 50 / 100 = 50\%$$

$$\text{Levered: ROE} = (120 - 70 - 15) / 25 = 35 / 25 = 140\%$$

3

Bad year — Revenue -20% (= 80, costs unchanged)

All-equity: $ROE = (80 - 70) / 100 = 10 / 100 = 10\%$

Levered: $ROE = (80 - 70 - 15) / 25 = -5 / 25 = -20\%$

= ANSWERS & ROE RANGE

All-equity ROE (bad → base → good)

10% → 30% → 50%

Levered ROE (bad → base → good)

-20% → 60% → 140%

Swing in ROE (good – bad)

40 pp vs. 160 pp

★ TAKEAWAY

Debt financing increases both ROE and risk. The levered firm earns more in good times and loses more in bad times. Its ROE swings 4× as much as the all-equity firm's for the same ±20% revenue shock.

This is also why "debt increases risk for equity investors" — even though the lender's cash flows are fixed, the equity holder absorbs a bigger swing in residual cash flows.

QUIZ 1 · CHECKPOINT

Test Your Understanding: Claims, Payoffs & Leverage

Q1. Which of the following best describes a shareholder's claim on a company's cash flows?

Q2. All else equal, issuing debt rather than equity is *most likely* to:

Q3. Using the LM02 example (Revenue 100, Costs 70, Debt 75 at 20%, Equity 25, no taxes), if revenue *falls* by 20% to 80 with costs unchanged, the levered firm's ROE is closest to:

Q4. A debtholder and a shareholder most likely disagree about how a company should be managed because:

LOS B · WHY FIRMS USE DEBT & MANAGE DILUTION

Why Firms Use Debt — and the Dilution Trade-off

If debt increases risk, why do firms use it? Two answers from the source:

1. Debt is cheaper than equity

Lenders bear less risk (priority claim), so they demand a lower return. Interest is also **tax deductible**, which further reduces its after-tax cost.

2. Equity issuance causes dilution

Issuing additional shares **reduces existing shareholders' fractional ownership** (= dilution). Firms can offset dilution by generating incremental profit on the new capital.

Conflict Between Capital Providers

The firm has one set of cash flows to be split between two capital providers with very different incentives:

PARTY	OBJECTIVE	PREFERRED ACTIONS
Shareholders	Maximize residual cash flows (unlimited upside)	Take risks to earn higher returns · maximize debt use · pay dividends
Bondholders	Maximize likelihood of timely payments (limited upside)	No benefit from extra risk · no benefit from extra leverage · want stable cash flows

Mechanism to bridge the conflict — contractual restrictions (covenants)

Debt contracts typically include restrictions to protect lenders from shareholder-driven risk-taking. The two classic examples from the source:

- **Minimum cash flow coverage** — e.g., EBITDA must cover interest by at least X times
- **Maximum leverage** — e.g., debt-to-EBITDA must stay below some ceiling

LOS C · COMPANY STAKEHOLDER GROUPS

Stakeholders — The Broader Set of Interested Parties

"Stakeholders depend on the company and the company depends on them." A stakeholder is **any party with a vested interest in a company**. Stakeholders may compromise or enhance a company's ability to maximize shareholder return.

STAKEHOLDER WHEEL — THE CORPORATION AT THE CENTRE



Two Competing Philosophies

SHAREHOLDER THEORY OF GOVERNANCE

Stakeholders are considered *only to the extent* they affect shareholder value. The board's job is to maximise shareholder return.

STAKEHOLDER THEORY OF GOVERNANCE

Corporate governance should consider *all* stakeholder interests. ESG should be an explicit objective of the board.

Practical tensions with the stakeholder approach

How do you balance multiple objectives? How do you define and measure non-shareholder objectives?

How do you compete globally with rivals who face no such constraints? And what is the cost of doing so?

The source flags these as open questions, not solved problems.

LOS C · PRIMARY STAKEHOLDER GROUPS (DETAILS)

Stakeholder Groups in Detail

Investors — Shareholders & Debtholders

Shareholders and debtholders are covered above. Note the split in the debt universe:

PRIVATE DEBTHOLDERS	PUBLIC DEBTHOLDERS (BONDHOLDERS)
Often hold debt to maturity	Hold tradeable securities
Direct access to management & non-public information	Rely on public information & financial statements
Critical lenders may have real influence	Little to no influence (except during restructuring)
Wide variation in risk appetite — may engage in distressed investing	Influence concentrated in a few holders only if debt is being restructured

Board of Directors

Elected by shareholders to advance their interests. Major stock exchanges require corporate-governance standards (e.g., the London Stock Exchange requires at least 50% of directors to be independent).

Inside Directors

Have links to the company (founders and current or former managers).

Independent Directors

No material relationship with the company. May better represent the interests of minority shareholders.

Two-tier structure: a separate supervisory board (independent directors) oversees the board of directors.

Staggered boards: groups of directors are elected in consecutive years — this limits the ability of shareholders to effect a major change of control but allows for continuity.

Other Primary Stakeholder Groups

GROUP	PRIMARY INTEREST / RELATIONSHIP
Managers	Led by the CEO; determine and implement strategy and day-to-day operations. <i>Stock-based incentive plans align their interests with shareholders.</i>
Employees	Corporations rely on their human capital. May have equity via compensation; may form unions to negotiate pay and conditions.

Customers	Require products that satisfy needs at a reasonable price, meet quality and safety standards, and may need ongoing support. Major customers can exert influence; retail-customer satisfaction is often correlated with revenue growth. Environmental and social impact of products is of growing importance.
Suppliers	Primary interest is being paid on time. Long-term stability matters when they provide specialised products.
Government & Regulators	Governments advance the interests of their constituencies. Regulators have an interest in compliance; governments like tax revenue.
Community	Local communities bear environmental and social effects of operations (jobs, pollution, infrastructure).

LOS A & C · CONFLICTS AND ALIGNMENT

Conflicts Between Stakeholder Groups — and How They Are Aligned

The same cash flows can't satisfy every stakeholder at the same time. The table below collects the key conflicts that appear in the reading, together with the alignment mechanisms typically used.

CONFLICT	WHY IT EXISTS	ALIGNMENT MECHANISM
Shareholders vs. Debtholders	Shareholders want more risk / more leverage / more dividends; debtholders want stable cash flows and downside protection.	Debt covenants — minimum cash flow coverage, maximum leverage, restrictions on dividends or asset sales.
Shareholders vs. Managers	Managers may prefer empire-building, perks, or job security over maximizing shareholder value.	Stock-based incentive plans (shares, options, performance units) align managers' payoff with the share price.
Controlling vs. Minority shareholders	Majority holders can favour decisions that don't serve minority holders.	Independent directors on the board may better represent minority interests. Exchange rules (e.g., LSE 50% independence requirement) support this.
Shareholders vs. Employees / Community	Cost cutting or plant closures may serve shareholders but harm employees or the surrounding community.	Labour law, unions, ESG policies, and stakeholder-theory governance frameworks.
Short-term vs. Long-term investors	Short-horizon holders may pressure the firm into actions that hurt long-term value.	Staggered boards and board continuity rules slow hostile change-of-control activity.

Exam Tip: The CFA text frames these conflicts consistently as *priority vs. residual* (lender vs. shareholder) and *agency* (shareholder vs. manager, majority vs. minority). Memorize the mechanism that pairs with each: covenants for lenders, stock-based pay for managers, independent directors for minority holders.

QUIZ 2 · CHECKPOINT

Test Your Understanding: Stakeholders & Conflicts

Q5. Which group of debtholders is *most likely* to hold debt to maturity and have direct access to management and non-public information?

Q6. The primary function of debt covenants is best described as:

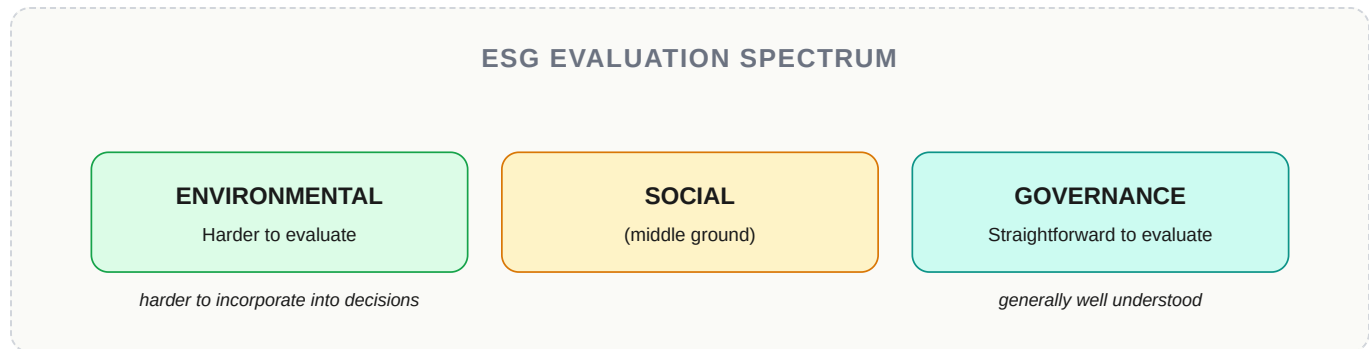
Q7. A staggered board is *most likely* to:

Q8. Stock-based incentive plans are *most directly* designed to:

LOS D · ESG — WHY & WHEN IT MATTERS

Environmental, Social & Governance Factors

ESG factors sit on a spectrum of how easy they are to evaluate:



Why ESG Has Grown in Importance

- 1 The **financial impact** of ESG factors has risen — e.g., environmental disasters now have direct P&L consequences.
- 2 Investor **interest in E and S issues** has grown (particularly among younger investors).
- 3 **ESG regulation** is increasing.

Companies are being forced to treat environmental and social impacts as **internal costs** rather than *negative externalities* that they can ignore.

Materiality & Investment Horizon

Materiality refers to ESG issues that can have a significant impact on a company's operations, financial performance, or the valuation of its securities. *Materiality varies across industries* — natural-resource-intensive industries face a direct, material effect on operations.

Analysts also consider their **investment horizon**: some ESG factors affect performance in the short term, others only in the long term — so they matter differently for a 2-year bond versus a 10-year bond or long-dated equity.

LOS D · E / S / G FACTORS IN DETAIL

E · S · G — Specific Factors

ENVIRONMENTAL

- Climate change
- Air and water pollution
- Biodiversity
- Deforestation
- Energy efficiency
- Waste management
- Water scarcity

SOCIAL

- Customer satisfaction
- Data protection & privacy
- Gender and diversity
- Employee engagement
- Community relations
- Human rights
- Labor standards

GOVERNANCE

- Board composition
- Audit committee structure
- Bribery and corruption
- Executive compensation
- Lobbying
- Political contributions
- Whistleblower schemes

Environmental — Climate-Change Considerations

Physical Risks

Damage and destruction from climate events — floods, storms, wildfires, long-term sea-level change.

Transition Risks

Losses related to the transition to a lower-carbon economy — e.g., **stranded assets**: emission-intensive reserve assets that become unviable.

Social

Practices concerning — and the impacts of the company on — **employees and human capital, customers, and communities**. *Minimizing social risk can also lower costs* (higher productivity, lower employee turnover).

Governance

Governance analysis is usually found in the issuer's **proxy statements and annual reports**. Classic governance topics include board composition and independence, audit committee structure, executive compensation design, and policies on bribery, lobbying, and whistleblowers.

LOS D · EVALUATING ESG RISKS & OPPORTUNITIES

How Analysts Incorporate ESG into Valuation

The process is similar for both equity and debt analyses. Once a material factor is identified, its impact must be **quantified** — how will future cash flows be affected — and then reflected in the valuation of the firm's securities.

Differential impact on equity vs. debt

- A **significant long-term adverse ESG event** affects equity *immediately and disproportionately* — equity claims can see a sharp decline in share prices.
- **Fixed obligations (debt)** are less affected — unless the company's ability to make interest and principal payments is compromised.
- The effect on debt also depends on **maturity**: e.g., a 10-year bond carries long-horizon ESG exposure that a 2-year bond does not.

Tool of Choice — Sensitivity & Scenario Analysis

Analysts should evaluate ESG factors with **sensitivity / scenario analysis** — flexing discount rates or cash flow assumptions to reflect ESG-driven outcomes.

Examples from the source:

- *Lower discount rate* for a food company moving to sustainable sources (lower perceived risk).
- *Increase employee turnover* assumption (raising operating costs) for a hotel chain facing bad publicity about working conditions.

Exam Tip: A common LM02 trap: "ESG events affect debt more than equity because debt has priority claims." *False*. Equity is hit first and hardest by long-term adverse ESG events (residual claim absorbs the shock). Debt is only hit if payment capacity is threatened.

QUIZ 3 · CHECKPOINT

Test Your Understanding: ESG

Q9. Of the three ESG pillars, which is typically the *most straightforward* to evaluate, and where is it usually disclosed?

Q10. "Stranded assets" are *best* classified as an example of:

Q11. Compared with an equivalent equity security, a 2-year bond of the same issuer is *most likely* to be:

Q12. When analysts incorporate ESG factors into valuation, they *most commonly*:

MODULE COMPLETE

Your Scorecard

0 / 12

LM02 Key Takeaways — Exam-Ready Cheat Sheet

Claims & Motivations

- 1 **Lenders hold a priority claim** — capped upside, lower risk, cheaper for issuer, interest is tax deductible.
- 2 **Shareholders hold a residual claim** — unlimited upside, higher risk, costlier for issuer, dividends at board's discretion.
- 3 **Issuer risk:** debt is cheaper than equity but riskier for the firm (missed payments → bankruptcy).

Debt Financing & Leverage

- 4 **Worked example (Rev 100, Cost 70, Debt 75 @ 20%, Equity 25):** ROE = 30% (all-equity) vs. 60% (levered). After -20% revenue: 10% vs. -20%. After +20%: 50% vs. 140%.
- 5 **Debt increases both ROE and risk.** Equity issuance avoids that risk but causes *dilution* of existing shareholders.
- 6 **Covenants** bridge shareholder/lender conflict: minimum cash-flow coverage, maximum leverage.

Stakeholders & Alignment

- 7 **Primary stakeholder groups:** shareholders, debtholders (private vs. public), board of directors (inside vs. independent), managers, employees, customers, suppliers, government/regulators, community.

- 8 **Alignment mechanisms:** covenants (lenders) · stock-based pay (managers) · independent directors (minority shareholders) · staggered boards (continuity).
- 9 **Shareholder vs. stakeholder theory of governance** — narrow (only affect shareholder value) vs. broad (all stakeholders, ESG as board objective).

ESG

- 10 **E / S / G spectrum:** E = hardest to evaluate; G = most straightforward; S sits in between.
- 11 **Climate risks:** physical (damage/destruction) vs. transition (lower-carbon economy; *stranded assets*).
- 12 **Equity vs. debt:** long-term adverse ESG events hit equity *immediately and disproportionately*; debt is affected only if payment capacity is threatened, and less so for short maturities.
- 13 **Method:** sensitivity / scenario analysis — flex discount rate or cash flow assumptions (e.g., lower discount rate for sustainable food producer; higher turnover assumption for hotel with labour issues).

Last-Minute Exam Checklist

Priority claim (lender, capped upside) vs. **residual claim** (shareholder, unlimited upside)

Debt is cheaper for the issuer (+ tax deductible) but **riskier** (bankruptcy)

Levered ROE swings 4× more than all-equity ROE in the MM example

Covenants = minimum coverage, maximum leverage · **Stock-based pay** aligns managers with shareholders

Private vs. public debtholders — access to information and influence differs

Stranded assets = transition risk (not physical) · **Equity** hit first & hardest by long-term ESG shocks