Assignment 1:

1. What is the theoretical rational behind the fact that CEOs are commonly paid much higher wages than other workers, including severance deals if dismissed?

1.1.1 Agency Theory

According to agency theory, the fundamental corporate governance problem arises from the separation of ownership and control in modern corporations. Shareholders (the principals) delegate decision-making authority to managers (the agents) to run the company on their behalf. However, because managers may have personal goals and incentives that differ from those of the shareholders, there is an inherent risk of misaligned interests. I.e. agents are expected to be somewhat homo economicus meaning they are assumed to be financially rational, individualistic, opportunistic and seek to maximize their own benefit.

Thus, the primary consequence of agency problems is the emergence of agency costs, which are costs that arise due to conflicts of interest between principals (shareholders) and agents (managers). Thus, to ensure alignment of interests between owners and management, which in this case is the CEO, owners must incentivize CEOs financially. Hence, CEOs are paid much more than other workers.

1.1.2 Behavioral Agency theory

On the contrary, behavioral agency theory (Pepper & Gore, 2012) is a complementary theory to agency theory, and it suggests that; while standard agency theory assumes rational agents motivated primarily by extrinsic, financial rewards, behavioral agency theory challenges this by emphasizing the role of intrinsic motivation, perception, and bounded rationality in shaping CEO behavior.

One key insight is that financial incentives exhibit diminishing marginal utility. In other words, offering a CEO ten times the pay does not result in ten times the effort or value creation. This aligns with prospect theory, which shows that individuals do not evaluate rewards linearly, and that loss aversion, reference points, and risk preferences matter. CEOs may respond more strongly to potential losses (e.g., the threat of reputational damage or demotion) than to additional upside in pay.

Furthermore, behavioral agency theory highlights that intrinsic motivation, such as the desire for achievement, status, purpose, or professional identity, may be more important drivers of executive effort than extrinsic financial incentives, especially at high levels of wealth and responsibility. This explains why many CEOs continue to work hard despite already having significant financial security.

Thus, it can be concluded that part of the reason why CEOs are paid significantly higher than other workers, can be explained by the fact that the separation of ownership and control can lead to agency problems, which are reduced by financial incentive through high pay.

1.1.3 Human Capital Theory

Another theoretical point of view is the Human Capital Theory, which states that CEOs are paid based on their unique competencies. According to this perspective, CEOs earn high salaries because they possess rare and valuable competencies that are difficult to replicate or replace, and which are seen as essential to the firm's performance and competitiveness. These competencies include long tenure and industry specific experience, international management experience, and track record of performance.

In essence, Human Capital Theory explains CEO pay as a market-driven outcome, based on the supply and demand for highly capable executives. Scarcity, substitutability, and proven value are key drivers.

1.1.4 Managerial Power Theory

Managerial Power Theory challenges the traditional agency theory view that CEO pay is primarily a tool to align managerial and shareholder interests. Instead, it suggests that CEO compensation often reflects the CEO’s ability to influence or control the pay-setting process itself, especially in weak governance environments.

According to Bebchuk, Fried, and Walker (2002), high CEO pay is frequently a symptom of concentrated managerial power, not necessarily a reward for performance. When CEOs have significant influence over board composition, internal governance structures, or has had a long tenure, they can extract "rents", i.e., secure higher pay than would be justified under arm’s-length bargaining.

Moreover, the theory argues that while compensation contracts may appear performance-based, they are often designed in ways that reduce actual risk to the CEO, which explains why CEOs are given a large severance package when dismissed, even if it is due to bad company performance.

2. What characterizes CEO pay in publicly traded firms in the Nordic countries, and what can explain this pay level?

1.2.1 Introduction

In publicly listed firms in the Nordics, CEO pay packages are generally moderate, especially when comparing with Anglo-Saxon countries. Further, pay packages tend to reflect a balanced, multi-component structure, which is also quite standard in both continental Europe and in Anglo-Saxon societies. However, the difference between the Nordics and e.g. Anglo-Saxon pay packages is the weight of the different components and the total size of the pay itself, which is significantly higher in the US.

1.2.2 Fixed salary

Firstly, both the Nordics and Anglo-Saxon societies have a fixed pay included in the CEO's pay packages, however, while in the Nordics this typically remains the largest component (or almost the largest component), it is typically the smallest component in Anglo-Saxon countries. This emphasis on fixed pay in the Nordics reflects a cultural and institutional preference for predictability and proportionality.

1.2.3 Short-term incentives (STIs)

Similarly, both Nordic and Anglo-Saxon countries exercise short-term incentives in CEO pay packages, which is often linked to metrics such as earnings before interest and taxes (EBIT), revenue growth, or return on capital. These bonuses are usually capped (significantly lower in the Nordics) and are designed to reward the achievement of short- to medium-term financial and strategic objectives.

1.2.4 Long-term incentives (LTIs)

Lastly, to support alignment with shareholder interests, CEOs may also receive long-term incentive plans, typically in the form of granted shares or stock options. These are often subject to performance conditions (e.g., TSR: total shareholder return) and vesting periods of several years, reinforcing long-term strategic thinking and retention. Again, this is often lower in the Nordics, than in Anglo-Saxon countries.

1.2.5 Conclusion

In conclusion, Scandinavian governance models emphasize transparency and shareholder approval, often requiring say-on-pay votes or public disclosure of remuneration policies. There is also less use of highly leveraged incentive structures compared to Anglo-Saxon countries, and compensation levels remain more closely aligned with social norms around income equity.

Assignment 2:

1. What are the main advantages and disadvantages of the two ownership options?

<u>Option 1: Transition to the third generation and remain a family firm</u>

2.1.1 Advantages

2.1.1.1 Elimination of Agency Problem Type 1

By keeping the company a family firm, the Madsen family will maintain full control of the company, whilst also owning the firm. This will ensure no separation of ownership and control, which will eliminate type 1 agency problems. Thus, information asymmetry that often occurs between owners and managers will also be eliminated. This is particularly the case if Sofie's daughter Clara takes over as CEO. By eliminating type 1 agency problems, the firm also eliminates typical agency costs. These costs include monitoring costs, bonding costs, and residual loss.

2.1.1.2 Long-term focus

Moreover, family-owned firms typically have a more long-term focus in its activities, especially when compared to Private Equity ownership. This ensures modest and stable growth and reduces financial risks of the firm. Additionally, a long-term oriented ownership typically also results in long term investment in non-financial stakeholder focused initiatives. This is typical in Nordic family run firms. By having this mission driven focus, the firm will eliminate type 3 agency problems between stakeholders and owners.

2.1.1.3 Nonpecuniary benefits (Small World Theory (Sinani et al., 2008))

Small Worlds Theory by Sinani et al. (2008), suggests that in small societies like in Denmark, the corporate elite are tight-knit groups that all know each other. This small network of elite corporate people, will tend to favor each other in the corporate world, e.g. by appointing each other in board positions, make favorable deals together, help with access to capital, etc. Moreover, in these so-called small worlds, such as Denmark, governmental influence is also easier accessible, which can be an advantage when running a business. Thus, the theory implies that the family will be better off keeping the firm, since it allows them to have access to these nonpecuniary benefits.

2.1.2 Disadvantages

2.1.2.1 The emergence of agency problem type 2

Morck and Yeung (2003) suggests that family run businesses with concentrated ownership, will lead to agency problem 2, between majority and minority shareholder. In the case of the Madsen family, there are seemingly no majority shareholder per se, however, there are still controlling and non-controlling shareholders, since some members of the family are passive owners. Thus, the risk of agency problem 2 is still possible. Hence, the concentrated control of Madsen Wood A/S by the family members in management can lead to them using company resources for personal use, overpaying themselves and tunneling.

2.1.2.2 The pitfall of family succession

Research on firms with family ownerships performance conducted in Canada (Morck, Stangeland & Yeung, 1998), suggests that family ownership in succession will lead to slower growth. Particularly, the research found that the first generation would be the ones to build the firm and possibly its reputation. Then the second generation would grow the firm large through innovative initiatives and development of the firm. Lastly, the third generation and onwards tended to spend less on innovation and R&D, when compared with similar firms in the same industry, which in most cases lead to the firm falling behind in its respective industry. The first two generations of the Madsen family have been perfect practical examples of the study, thus, it would possibly be a good idea for the family to consider exiting the firm.

<u>Option 2: Sell to Private Equity</u>

2.2.1 Advantages

2.2.1.1 Access to capital and rapid growth

If the Madsen family decides to sell to the Private Equity (PE) firm, then this opens new doors for the firm, since they will have a lot more access to capital, through the PE firm. The PE firm will engage in active ownership and will use leverage along with capital from their limited partners with the goal of growing the company fast. Hence, the PE firm will likely grow the firm quicker than if the family decided to keep the firm.

2.2.1.2 Restructuring and optimization

As mentioned before, PE firms will in most cases engage in active ownership of the firm, thus, they will evaluate every function of the firm and decide if it is necessary/profitable to keep. Moreover, the PE firm will also optimize current activities of the firm, likely increasing the margins of the company. Thus, the fresh perspective of the PE firm will offer valuable changes to the firm, that the family would not have achieved. ´

2.2.1.3 Efficient Governance

Additionally, PE firms are often characterized by implementing efficient governance model based on concentrated active ownership, value-creating boards, financial leverage, and high-powered governance. Thus, by improving every aspect of the company's governance mechanisms, the PE firm will create value in the firm, which would otherwise not be created.

2.2.2 Disadvantages

2.2.2.1 Short term focus

The PE firm will inevitably have a short-term focus; the reason is that their strategy is to keep portfolio companies for 4-6 years and then sell them off for profits. Moreover, since they are investing with leverage and funds provided by limited partners, both of which are interested in getting their committed capital back. Thus, the PE ownership could lead to less job security amongst current employees i.e., increase in agency problem 3, which could damage the firm's reputation, which could hurt the firm financially.

2.2.2.2 Increasing agency costs

When a PE firm takes over a company, they will likely replace management, perhaps keep some of them in the firm, but changes in management is inevitable. The management that PE firms often hire, are professional managers i.e., experienced professionals, that carry human capital, thus, management pay often increases.

Moreover, when PE firms acquire firms, agency problem 1 becomes apparent, since separation of owners and managers happen. Thus, this increases agency costs including monitoring costs, bonding costs, and residual loss.

2.2.2.3 Risk of public scrutiny

Moreover, if the PE firm acquires the firm, it increases the risk of company to lose its reputation, since PE firms have a much larger profit maximization focus, and less of a long-term stakeholder focus, that family firms often have. This increases the risk of type 3 agency problems, between owners and stakeholders, which could lead to public scrutiny, which could impact the firm’s financial performance negatively.

2. If the firm is sold to the Private Equity fund, what changes can be expected in relation to the recruitment of the CEO and the appointment of board members?

2.2.1

The PE firm will likely appoint a new CEO, since having an heir CEO is often not the best choice according to the strategy of a PE firm, which tends to be very short-term focused. The PE firm will likely look for an experienced professional, possibly with experience in other private equity owned firms, to align the focus of both the owner and the CEO. More generally, the PE firm will likely also appoint new managers that can support the rapid growth that the firm is expected to have. However, the PE firm might keep one or some of the family members in the board, to ensure that the company's brand ethos is still strong.

2.2.2 Agency Theory: Control Role

In relation to appointing new board members, the PE firm will likely want to have a person that can have the control role. Since according to agency theory, when there is a separation of ownership and management, then the board must conduct a control role. Currently there is a PE veteran within the board, who could possibly fulfill this role, thus, there will perhaps not be any changes aiming for a control role. However, it is also likely that the PE firm will appoint one of its partners, to the board of the company into the control roll depending on the independence of the current PE veteran. Since if he has been in the board for a long time, he will not be independent and thus, will not be able to fulfill the control role.

2.2.3 Stewardship Theory: Consulting Role

Moreover, according to Stewardship Theory, managers are intrinsically motivated, especially if the PE firm hires an industry professional with experience. This is caused by the fact that these managers often have a very good reputation that they have built up through good management and governance practice. Thus, having the control role in the board becomes less relevant. Instead, the theory suggests that the board should be acting in a consulting role, supporting management with expertise. These board members often have had a long career with executive management experience.

2.2.4 Resource Dependence Theory: Contact Role

Lastly, Resource Dependence Theory suggests that boards should act in a contact role to management. The theory suggests that the board have an important role in connecting managers with important corporate figures to gain a competitive edge in their respective industry. Similarly to the Stewardship Theory, the appointed board members should be experienced executives that can provide a great network to companies to land favorable contracts.