Introduction To Corporate Finance

Why take this course?

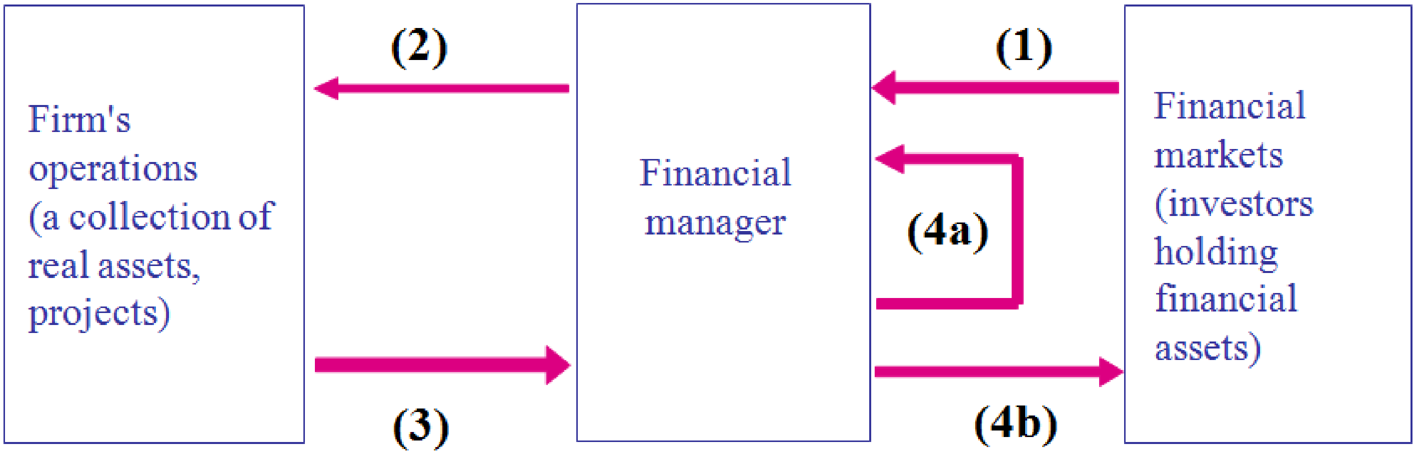
Lecture Outline

- Financial Management Decisions
- Forms of Business Organization
- The Goal of Financial Management
- The Agency Problem and Control of the Corporation
- Financial Markets and the Corporation

Financial Management Decisions

- Working capital management
  - How do we manage the day-to-day finances of the firm?
  - Daily net cash position
- Capital budgeting (Investment decision)
  - What long-term investments or projects should the business take on?
- Capital structure (Financing decision)
  - How should we pay for our assets?
  - Should we use debt or equity?

Financial Management Decisions

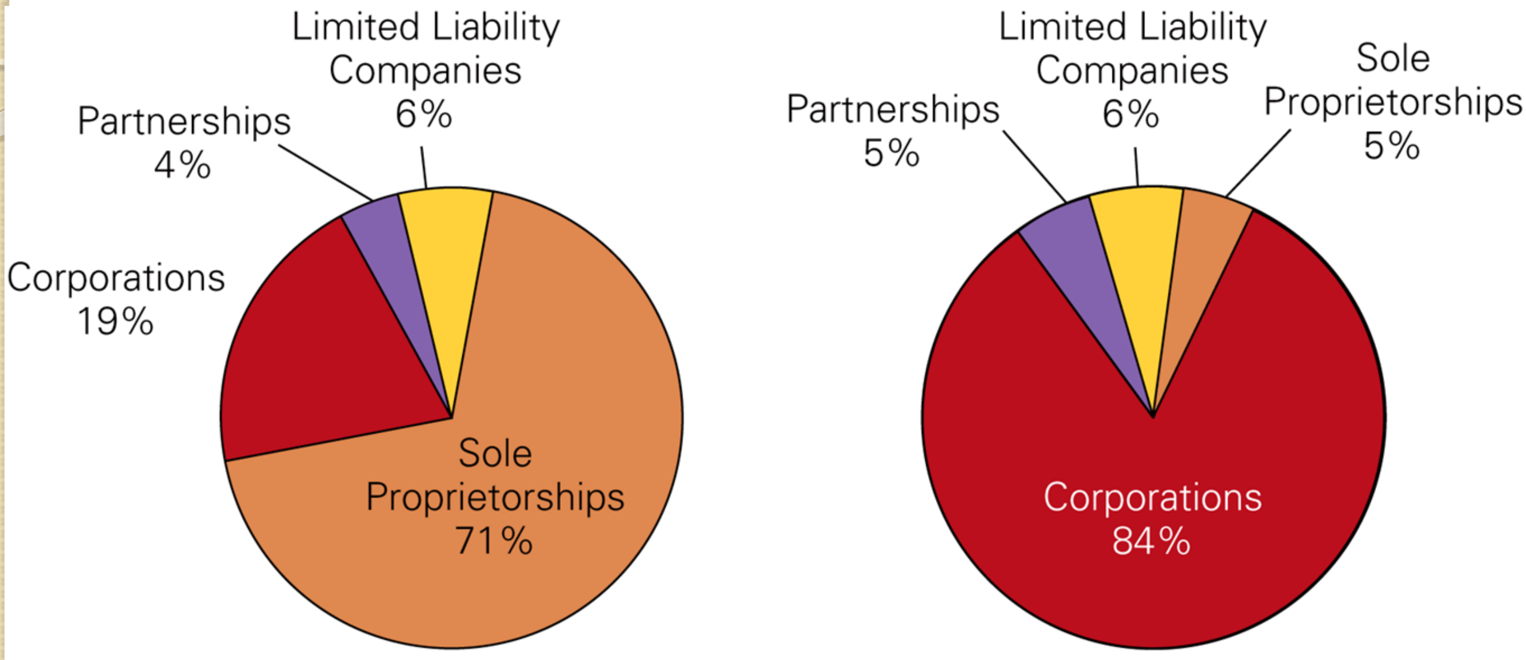


- (1) Cash raised from investors (Financing or capital structure decision)
- (2) Cash invested in firm (Investment decision, or capital budgeting decision)
- (3) Cash generated by operations
- (4a) Cash reinvested
- (4b) Cash returned to investors (Dividend and payout decisions)

What is a Corporation?

- Corporate finance perspective
  - A firm is a collection of projects. A project is anything that generates cash flows
- Legal perspective: Business Forms
  - Sole proprietorship
  - Partnership
    - General Partners
    - Limited Liability Partnerships
  - Limited Liability Company
  - Corporation

Four Types of Firms



(a) Percentage of Businesses **(b)** Percentage of Revenue

Sole Proprietorship

- Advantages
  - Easiest to start
  - Least regulated
  - Single owner keeps all the profits
  - Taxed once as personal income
- Disadvantages
  - Limited to life of owner
  - Equity capital limited to owner's personal wealth
  - Unlimited liability
  - Difficult to sell ownership interest

Partnership

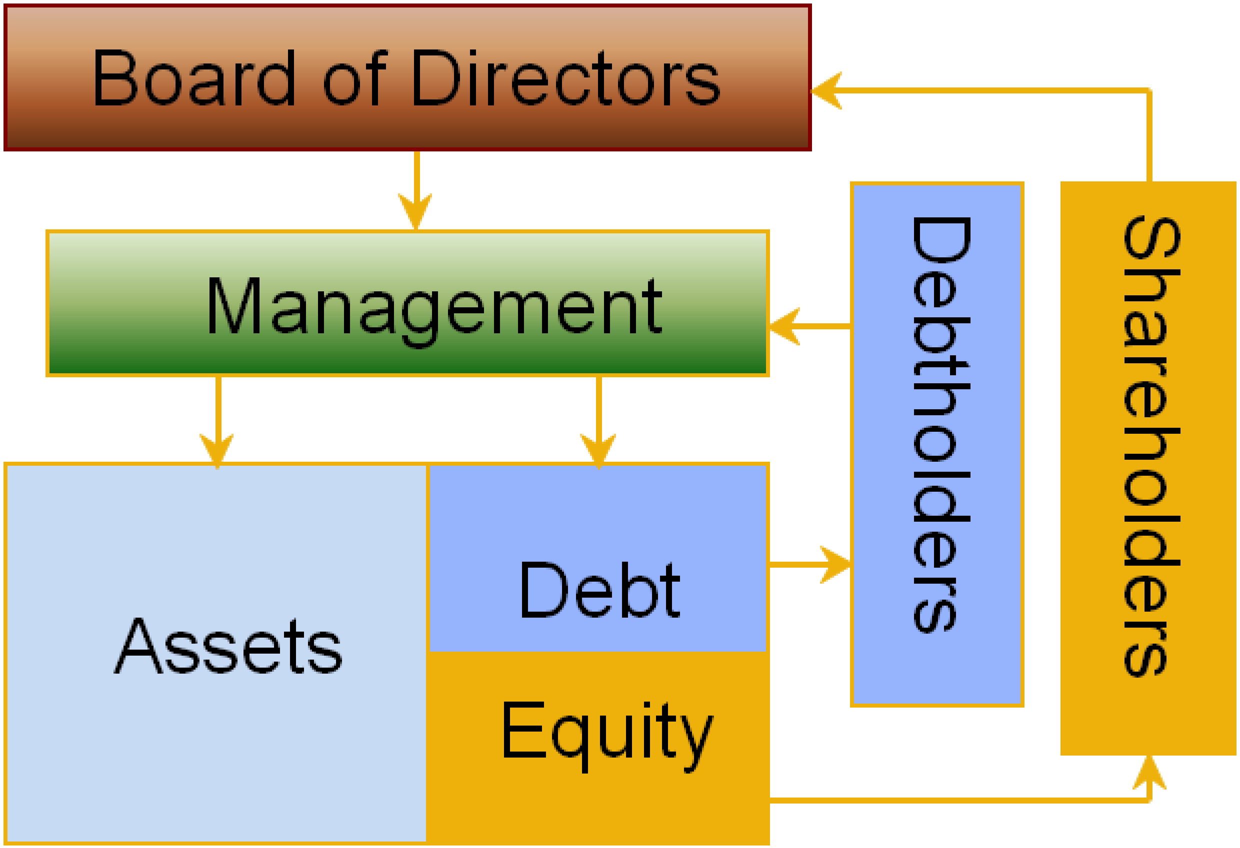
- Advantages
  - Two or more owners
  - More capital available
  - Relatively easy to start
  - Income taxed once as personal income

- Disadvantages
  - Unlimited liability
    - General partnership
    - Limited partnership
  - Difficult to raise capital
  - Limited life - Partnership dissolves when one (general) partner dies or wishes to sell
  - Difficult to transfer ownership

Corporation

- Advantages
  - Limited liability
  - Unlimited life
  - Separation of ownership and management
  - Easy transfer of ownership
  - Easier to raise capital
- Disadvantages
  - Separation of ownership and management
  - Double taxation (in the USA)
  - Cost of set-up and report filing

Anatomy of a Corporation



Goal Of Financial Management

- What should be the goal of a corporation?
  - Maximize profit?
  - Minimize costs?
  - Maximize market share?
  - Maximize the current value of the company's stock?

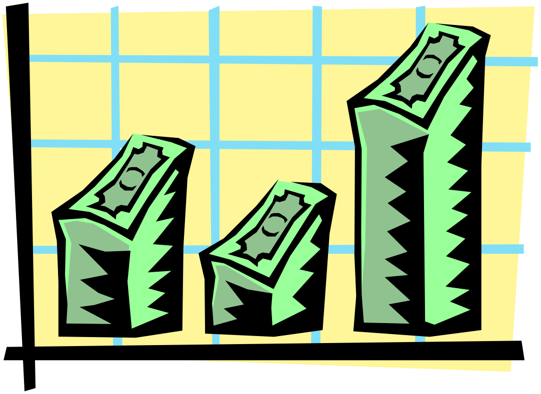
Goal Of Financial Management

- The primary financial goal is *shareholder wealth maximization*, which translates to maximizing stock price.

Is stock price maximization the same as profit maximization?

- No, despite a generally high correlation amongst stock price, EPS, and cash flow.
- Current stock price relies upon current earnings, as well as future earnings and cash flow.
- Some actions may cause an increase in earnings, yet cause the stock price to decrease (and vice versa).

Factors that affect stock price



- Projected cash flows to shareholders
- Timing of the cash flow stream
- Riskiness of the cash flows

$$\text{Value} = \frac{CF_1}{(1+k)^1} + \frac{CF_2}{(1+k)^2} + \cdots + \frac{CF_n}{(1+k)^n}$$

$$= \sum_{t=1}^{n} \frac{CF_t}{(1+k)^t}.$$

Quick Quiz

- What are the three types of financial management decisions and what questions are they designed to answer?
- What are the three major forms of business organization?
- What is the goal of financial management?

The Agency Problem

- Agency relationship
  - Principal hires an agent to represent their interest
  - Stockholders/Creditors (principals) hire managers (agents) to run the company
  - Agency Problem due to Conflict of interests

Agency Problem

- Within a corporation, agency problems exist between:
  - Shareholders and Managers
  - Shareholders and Creditors (bondholders)
  - Creditors (bondholders) and Managers

Shareholders versus Managers

- Managers are naturally inclined to act in their own best interests.
- But the following factors affect managerial behavior:
  - Managerial compensation plans
  - Direct intervention by shareholders
  - The threat of firing
  - The threat of takeover

Shareholders versus Creditors

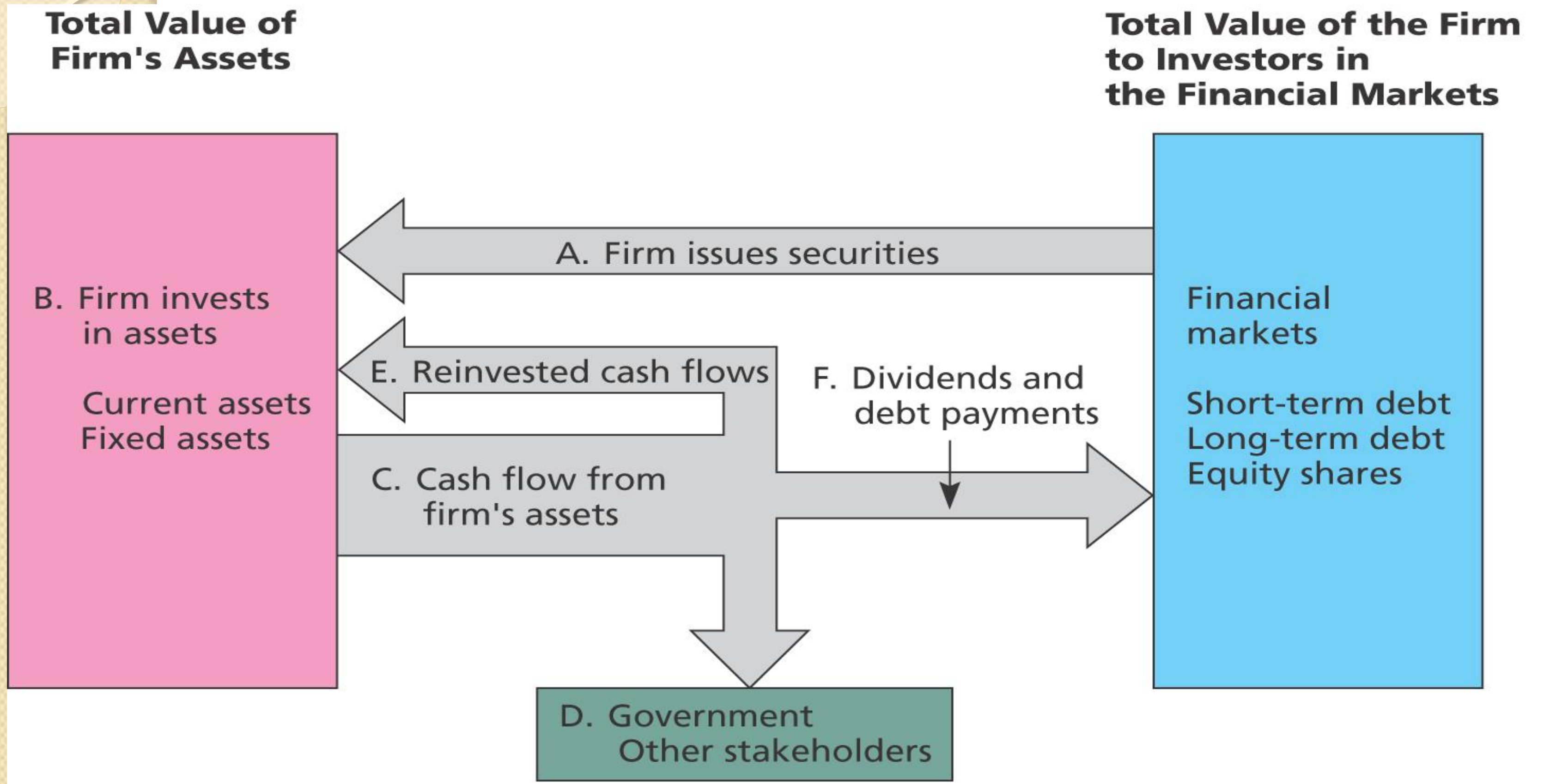
- Shareholders (through managers) could take actions to maximize stock price that are detrimental to creditors.
- New Investment Opportunities
- Dividend versus Retained Earnings
- In the long run, such actions will raise the cost of debt and ultimately lower stock price.

Creditors (bondholders) & Managers

- Financing Decision
- Senior versus Junior bond

What is a Financial Market?

- A market is a venue where goods and services are exchanged.
- A financial market is a place where individuals and organizations wanting to borrow funds are brought together with those having a surplus of funds.
- Cash flows to the firm
- Primary vs. Secondary Markets



A. Firm issues securities to raise cash.
B. Firm invests in assets.
C. Firm's operations generate cash flow.
D. Cash is paid to government as taxes. Other stakeholders may receive cash.
E. Reinvested cash flows are plowed back into firm.
F. Cash is paid out to investors in the form of interest and dividends.

Quick Quiz

- What are agency problems and why do they exist within a corporation?
- What is the difference between a primary market and a secondary market?

End of Lesson