Finance I

Introduction to Corporate Finance

1 Corporate Finance and the Financial Manager

What is Corporate Finance?

Corporate finance is concerned about three main problems:

1. Planning and managing long-term investments (Capital Budgeting).
   Open a new store, develop a new software, acquire new equipments, etc...

2. How to obtain and manage the financing needed to support the long-term investments (Capital Structure).
   How and where to raise the money? Debt vs equity.

3. How to manage short-term assets (Working Capital Management).
   How to manage day-to-day activity (inventory, money owed to suppliers, accounts receivable) in order to avoid costly interruptions.

In large corporations, the owners (shareholders) are not directly responsible for the firm's business decisions. Managers are hired to represent the shareholders' interests. More specifically, the financial manager has to provide solutions to the above problems. The vice president of finance, or CFO, is the top officer associated with financial management. The CFO reports to the president, or COO. The CFO coordinates the activities of the treasurer (cash, financial planning, capital expenditures) and the controller (accounting, tax, information systems). See Figure 1.1 in Ross, Westerfield....

2 Legal Forms of Business Organization

Sole proprietorship: Business owned by one person.

Characteristics: Simple to form (+), subject to few regulations (+), profits are taxed like personal income (+, −), unlimited liability of the owner (−), limited ability to raise equity (−), limited life (−), difficult to transfer ownership (−).

Partnership: Business owned by many partners.

Characteristics: In a general partnership, all partners have unlimited liability. In a limited partnership, the general partners run the firm for the limited partners. General partners are fully involved and have unlimited liability. The limited partners do not actively participate in the business and have limited liability. Except for limited partners' liability, the advantages and disadvantages of this form of business are similar to those of the sole proprietorship.

Corporation: Legal entity separate and distinct from its owners.

Characteristics: A corporation has many of the rights and obligations of a person. Complex to form (−), double taxation of income (−), owners have limited liability (−), firm has unlimited life (+), easy to transfer ownership (+), relatively easy to raise equity (+).

3 The Goal of Financial Management

What is best? Survive in business? Avoid bankruptcy? Maximize sales? Maximizes profits? Minimize costs?

Maximizing profits seems a good answer but it is not clear what it means. If we are talking about this year's profits, then cutting Research & Development expenses might do it, which may not be a good thing for the future.

A good decision from the financial manager should benefit the shareholders. Hence goods decisions should have a positive impact on shareholders' equity. For a publicly traded company, this means that *the goal of financial management is to maximize the current value per share of existing stock.* For the stock price to be an accurate measure of the financial manager's performance, we need capital markets to do their pricing job correctly. That is, we need capital markets to be *efficient.* In an *efficient capital market*, all available information is incorporated into stock prices, and thus what the financial manager knows, the shareholders know it, too.

Should managers do anything (illegal or unethical actions) to increase the stock price?

4 The Agency Problem and Control of the Corporation

In large corporations, ownership can be spread over a huge number of shareholders.

Does management act in the best interests of all the shareholders or does it pursue its own goals (or the goals of minority of shareholders)?

An agency relationship is such that someone (namely the principal) hires someone else (the agent) to work for him, or represent his interests, but the principal cannot verify everything the agent does. If not provided with the right incentives, the agent will pursue his own goals instead of the principal's goals. This problem is circumvented with contractual arrangements that align the agent's objectives with that of the principal.

The conflict of interests between management and shareholders creates agency costs. An agency cost may be the purchase of goods that benefit management but not shareholders as, for instance, a luxurious jet. Another agency cost would be the expenses incurred in order to monitor management actions.

There may be other agency costs, such as loss opportunities. That is, management may not dare to undertake some risky project that could benefit shareholders because of the possibility that they lose their job if the project fails.

Management may also be too avid of growth, as they could develop a taste for corporate control. This could lead them to overpay for acquisitions, which does not benefit shareholders.

How to solve this problem?

- *Managerial compensation*: Tying managers' compensation to the stock price can be a solution if it is done correctly. Stock options or shares at bargain prices? Somehow managers have incentives to satisfy shareholders since this gives them more value on the labour market and thus allows them to command higher wages.

- *Control of the firm*: Bad managers eventually lose their job since the latter are hired (and fired) by the board of directors, elected by shareholders. Moreover, firms with bad management are often takeover targets. If the takeover succeeds, bad managers will be replaced.

- *Stakeholders*: A stakeholder is anybody with a claim on the cash flows of the firm, such as creditors, employees, and shareholders, of course. Somehow stakeholders may push for higher costs to the firms, such as employee benefits, social and environmental considerations. Firms nevertheless need to take account of these considerations.

5 Financial Markets and the Corporation

Financial markets facilitate the flow of cash to and from the firm. Different markets have different purposes. Money markets (short-term debts, dealer markets) versus capital markets (long-term debts and shares of stock, dealer and auction markets). Primary markets versus secondary markets (third and fourth markets)

6 Financial Institutions

Financial institutions act as intermediaries between funds suppliers and funds demanders. Chartered banks, trust companies, insurance companies, credit unions, investment dealers, pensions funds, mutual funds. Intermediaries benefit from economies of scale and specialization. Competition to offer financial services should lead to an efficient allocation of funds.

Financial institutions profit from *direct* and *indirect* finance.

Direct finance: The institution charges a fee for a service (banker's acceptance fee). In direct finance, the funds do not flow through the institution.

Indirect finance: In this case, the funds flow through the institution and the institution benefits from the spread between interest rates, bid-ask prices, etc.

7 Trends in Financial Markets and Financial Management

Financial engineering: Borrowers and savers' needs lead to the creation of innovative investment vehicles, especially derivatives securities. Asset-backed securities are an example.

The rise of information technology influences the way firms do business.

Markets become more and more deregulated.

We observe the demutualization of insurance companies.