经济管理学院
The college of Economics and Management

Course Information

Corporate Finance – Fall 2019

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KEYNOTES

- The **goal** of financial management is to maximize the value of the stock.
- We will **learn** how to identify investments and financing arrangements that favorably impact the value of the stock.
- In fact, we could have defined CORPORATE FINANCE as the study of the relationship between business decisions and the value of the stock in the business.

*"However, business of **all** types and sizes need financial management, so the majority of the subjects we discuss bear on **any** form of business."*

付款方式

付款方式	租金	服务费/年	押金
月付	¥6500	¥6240	¥6500
季付	¥6190	¥5942	¥6190
半年付 推荐	¥6190	¥5051 ~~¥5942~~	¥6190
年付 推荐	¥6190	¥4160 ~~¥5942~~	¥6190

Another example

“1000元手机，不用现在出钱，立刻拿走”

“利率8%，三年付清，月付超低”

“总欠款 = 1000+1000*8%*3=1240元”

“每月支付 = 1240/36 = 34.4元”

- 利率算对了吗?
- 类似情形：信用卡分期、车贷分期、抵押贷…

1. 教学

- 课堂：讲授、实例、练习
- 课后：作业、研究、实践

2. 教材

公司理财（精要版）（英文版·原书第10版），斯蒂芬 A. 罗斯，[美]伦道夫 W. 韦斯特菲尔德，布拉德福德 D. 乔丹 著；谭跃，周卉，丰丹 注，机械工业出版社，ISBN：9787111449072

3. 成绩评定

- 平时成绩 50’
  - 出勤、纪律、课堂表现 25’
  - 作业 20’
  - 研究报告 5’
- 期末考试 50’

- **研究报告**的主要目的是鼓励大家进一步学习感兴趣方面
  - 自愿完成，选题范围是讲到章节(见“Corporate Finance schedule.xlsx”)的某一个或几个*Learning Objectives*，具体题目自拟，4000-8000字
  - 报告形式：文献综述、专题报告、实证论文；截止时间：2019.12.27
    - 形式、字数多少符合要求则不分优劣，中英皆可，根据质量评分
    - 优秀=5’，很赞=4’，不错=3’，良好=2’，可以=1’，一般=0’，拼凑=-1’
  - 文献综述：中英文TOP刊物，经典文献和新文献，有逻辑地阐述和评述
  - 专题报告：新数据，图表突出重点， 章节条理清晰，分析有一定深度
  - 实证论文：研究问题明确，样本具有代表性，方法选择合适且使用准确

Lecture 1

Introduction to Corporate Finance

Corporate Finance – Fall 2019

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Prelude

- To begin, we need to address two central issues in this chapter
  - What is corporate finance and what is the role of the financial manager in the corporation?
  - What is the goal of financial management?
- We also introduce the corporate form to describe the financial management environment, and discuss some conflicts that can arise within the corporation.

Learning Objectives

LO1: The basic types of financial management decisions and the role of the financial manager

LO2: The goal of financial management

LO3: The financial implications of the different forms of business organization

LO4: The conflicts of interest that can arise between managers and owners

Chapter Outline

1.1 Corporate Finance and the Financial Manager

1.2 Forms of Business Organization

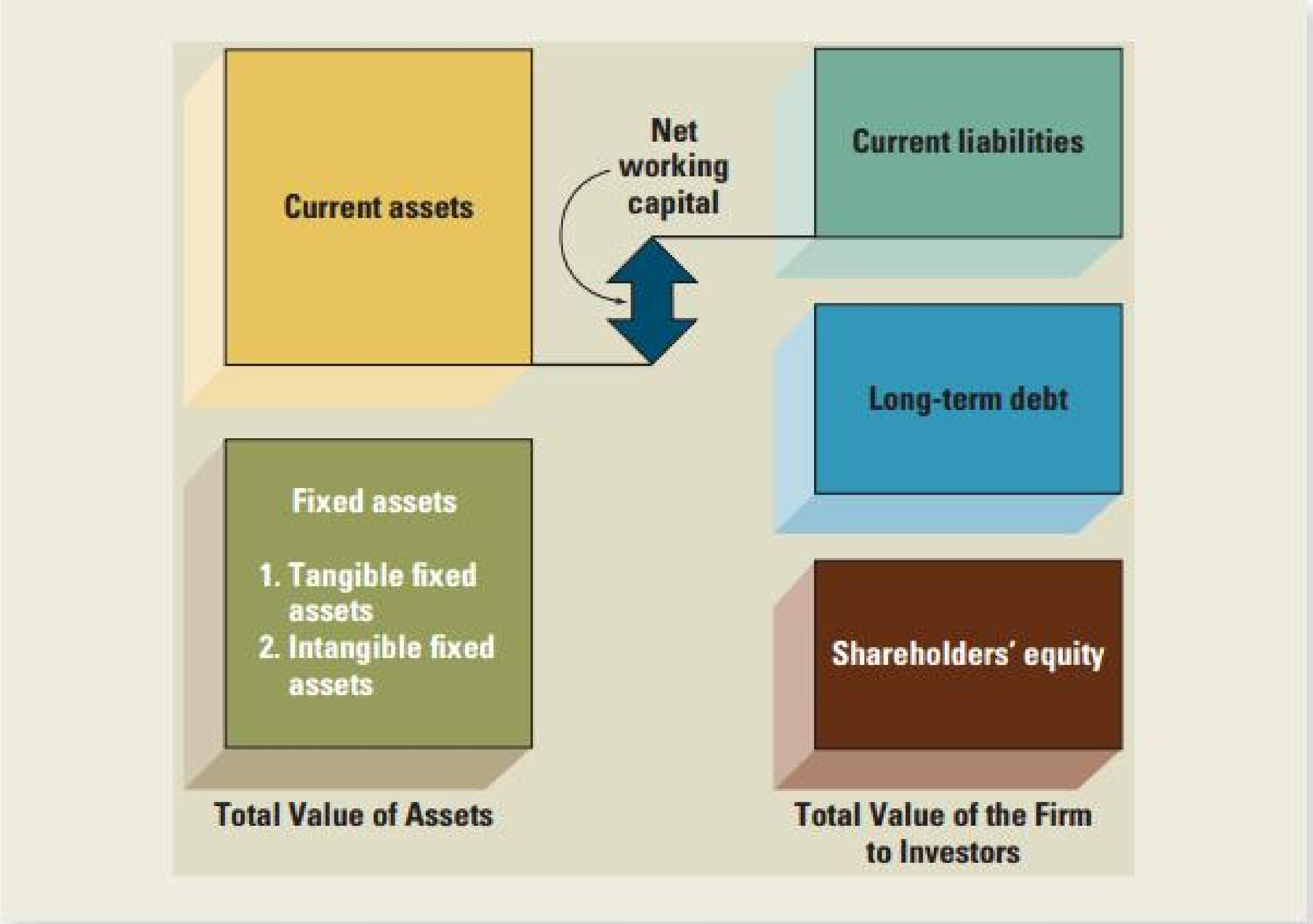
1.3 The Goal of Financial Management

1.4 The Agency Problem and Control of the Corporation

1.5 Financial Markets and the Corporation

1.1 Corporate Finance and the Financial Manager

1.1.1 What is corporate finance?



CORPORATE FINANCE is broadly the study of <u>three questions</u>:

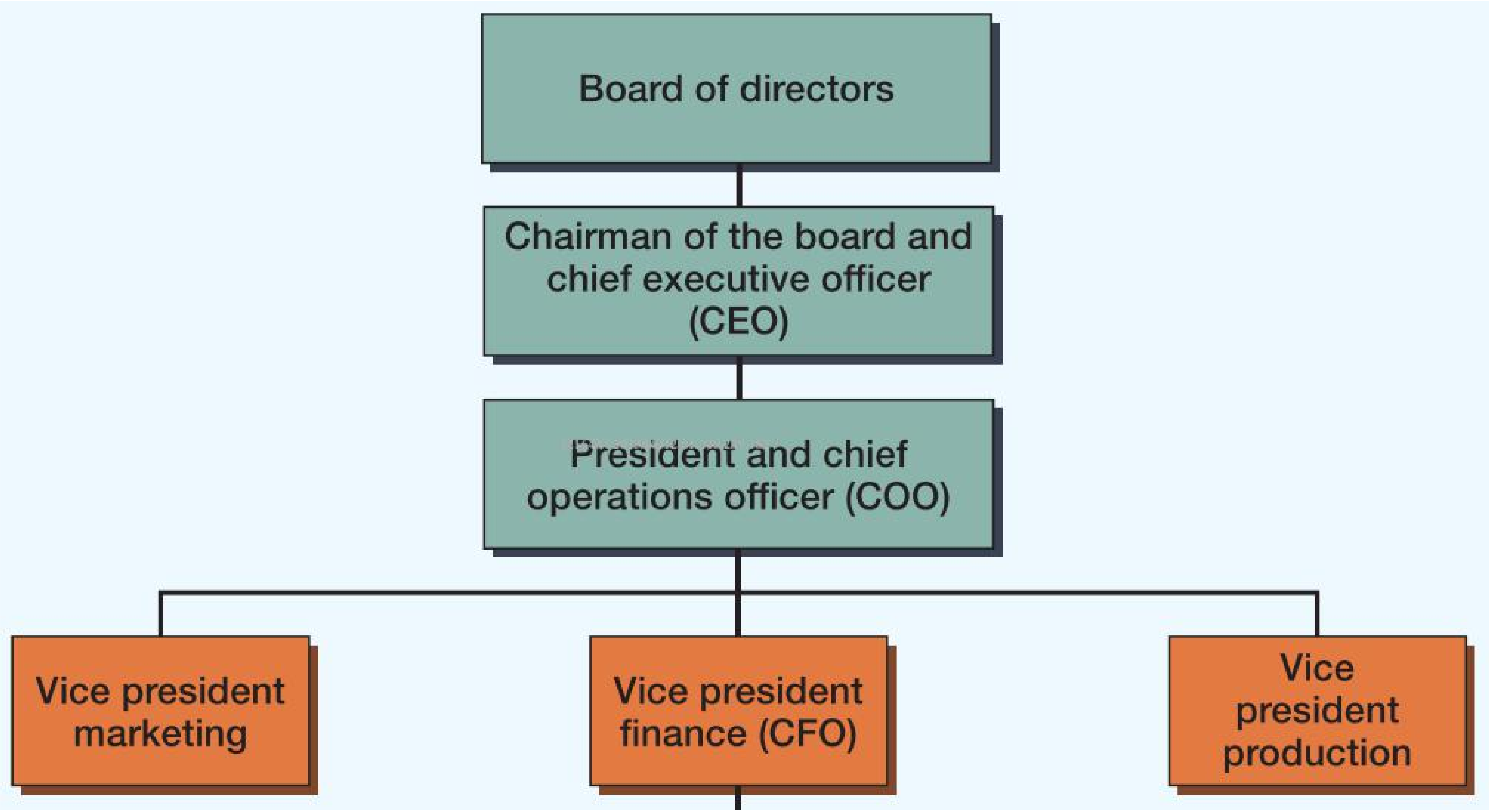
<u>Q1</u>: In what long-lived assets should the firm invest? -> lower left

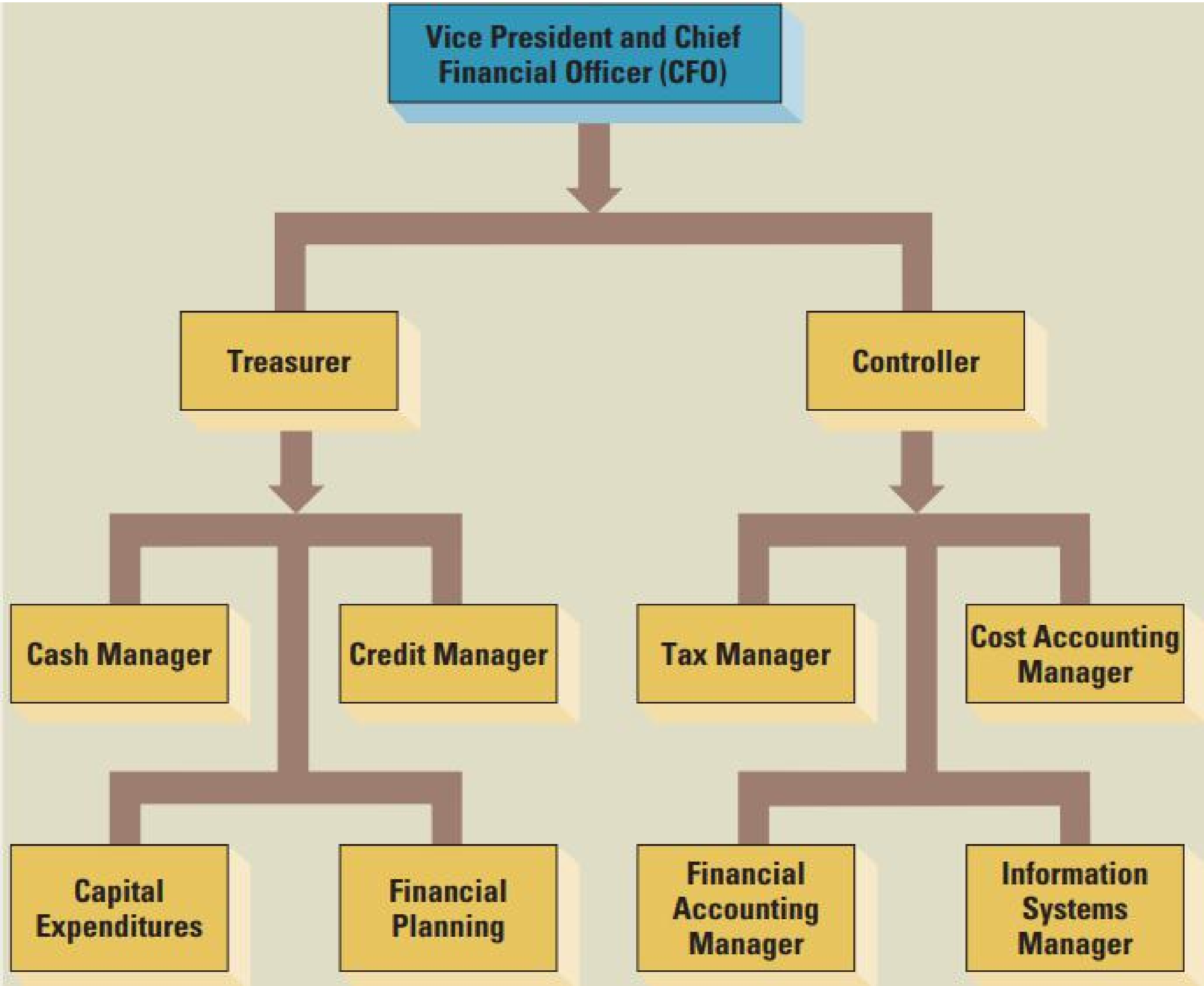
<u>Q2</u>: How can the firm raise cash for required capital expenditures -> right portion

<u>Q3</u>: How should short-term operating cash flows be managed? -> upper portion

1.1.2 The financial manager

- Stockholders are usually not directly involved in making business decisions – they employ managers to make decisions on their behalf.
- In a large company, the financial manager would be in charge of answering the three questions previously listed.
- The financial management function is usually associated with a top officer of the firm, e.g. a vice president of finance or some other chief financial officer (CFO)


Board of directors
Chairman of the board and chief executive officer (CEO)
President and chief operations officer (COO)
Vice president marketing
Vice president finance (CFO)
Vice president production



- The vice president of finance / CFO coordinates the activities of the treasurer and the controller.
- Our study bears mostly on activities usually associated with the treasurer's office.

1.1.3 Financial management decisions

Capital Budgeting

CAPITAL BUDGETING: The process of planning and managing a firm's long-term investments (Q1)

- E.g. Costco decides whether to open a new store in Shanghai

- Identify investment opportunities (long-lived assets):
  - worth to the firm > cost to acquire (the value of cash flow > the cost)
  - Evaluate size (how much), timing (when), and risk (how likely)

Capital Structure

CAPITAL STRUCTURE: The mixture of debt and equity held by a firm (Q2)

- First, how much should the firm borrow? (what mixture is best)
  - The mixture of debt and equity will affect the risk and value of the firm
  - To determine what percentage of the firm's cash flow goes to creditors / shareholders
- Second, what are the least expensive sources of funds for the firm?
  - How and where to raise the money?
  - Evaluate different possibilities carefully

Working Capital Management

WORKING CAPITAL: A firm's short-term assets and liabilities (Q3)

- Working capital management is a day-to-day activity that:
  - Ensures the firm has sufficient resources to continue its operations and avoid costly interruptions
  - Involves a number of activities related to the firm's receipt and disbursement of cash

Notes:

- The three areas of corporate finance are very broad categories
- The following chapters contain greater detail

1.1.4 Course schedule (also see “Corporate Finance schedule.xlsx”)

- Overview of Corporate Finance – CH1, 2
- Financial Statements and Long-Term Financial Planning – CH3, 4
- Valuation of Future Cash Flows – CH5, 6, 7, 8
- Capital Budgeting – CH9, 10, 11
- Risk and Return – CH12, 13
- Cost of Capital and Long-Term Financial Policy – CH14, 15, 16, 17

1.2 Forms of Business Organization

- Large firms in the United States are almost all corporates
- Three different legal forms of business organization
  - Sole proprietorship
  - Partnership
  - Corporation
- Each form has distinct advantages and disadvantages
- As firm grows, advantages of the corporate form > disadvantages

1.2.1 SOLE PROPRIETORSHIP: A business owned by a single individual

- The cheapest business to form -> most common business type
  - No formal charter is required & few government regulations must be satisfied
- The owner of a sole proprietorship keeps all the profits
  - Taxed as individual income (no corporate income taxes)
- Unlimited liability for business debts and obligations
  - No distinction is made between personal and business assets.
- Often unable to exploit new opportunities (insufficient capital)
  - Its life is limited to the life of the sole proprietor
  - The equity money is limited to the proprietor’s personal wealth
- Ownership may be difficult to transfer
  - the transfer requires a entire new owner

1.2.2 PARTNERSHIP: a business formed by two or more individuals or entities

General partnership

- All partners agree to provide some fraction of the work and cash and to share the profits and losses
- Each partner is liable for all of the debts of the partnership, not just some particular share.
- A partnership agreement specifies the nature of the arrangement

Limited partnership

- Permits the liability of some of the partners to be limited to the amount of cash each has contributed to the partnership
- At least one partner be a general partner
- The limited partners do not participate in managing the business

Things about considering a partnership:

1. Partnerships are usually inexpensive and easy to form
2. General partners have unlimited liability for all debts
   - If one general partner is unable to meet his or her commitment, the shortfall must be made up by the other general partners
3. The general partnership is terminated when a general partner dies or withdraws. (A transfer requires that a new partnership be formed.)
   - this is not so for limited partners (may sell their interest in a business)
4. It is difficult for a partnership to raise large amounts of cash
   - Many companies start life as a proprietorship or partnership, but at some point they choose to convert to corporate form
5. Income from a partnership is taxed as personal income to the partners
6. Management control resides with the general partners

Advantage to a sole proprietorship or partnership

- The cost of getting started is low

Disadvantages

- Unlimited liability
- Limited life of the enterprise
- Difficulty of transferring ownership

These three disadvantages lead to:

- **difficulty in raising cash** -> limited ability of business to grow

1.2.3 CORPORATION: A business created as a distinct legal entity composed of one or more individuals or entities

- The most important form of business organization (in terms of size)
- A legal entity has a name and many of the legal powers of natural persons
- Starting a corporation is more complicated
    - must prepare articles of incorporation and a set of bylaws

Advantages

- Ownership in a corporation is represented by shares of stock -> ownership can be readily transferred to new owners
- Managers and stockholders are usually separated in a large corporation -> The corporation has unlimited life
- The shareholders’ liability is limited to the amount invested in the ownership shares
  - The corporation borrows money in tis own name.

- Ease of ownership transfer + Unlimited life + Limited liability

  -> **an enhanced ability to raise cash**

  - E.g. AAPL, 000651

Disadvantages

- Double taxation for shareholders: at both the corporate level and the personal level

  - The federal government taxes corporate income (the states do as well)
  - Personal income tax that shareholders pay on dividend income they receive

	Corporation	Partnership
Liquidity and marketability	Shares can be exchanged without termination of the corporation. Common stock can be listed on a stock exchange.	Units are subject to substantial restrictions on transferability. There is usually no established trading market for partnership units.
Voting rights	Usually each share of common stock entitles the holder to one vote per share on matters requiring a vote and on the election of the directors. Directors determine top management.	Some voting rights by limited partners. However, general partners have exclusive control and management of operations.
Taxation	Corporations have double taxation: Corporate income is taxable, and dividends to shareholders are also taxable.	Partnerships are not taxable. Partners pay personal taxes on partnership profits.
Reinvestment and dividend payout	Corporations have broad latitude on dividend payout decisions.	Partnerships are generally prohibited from reinvesting partnership profits. All profits are distributed to partners.
Liability	Shareholders are not personally liable for obligations of the corporation.	Limited partners are not liable for obligations of partnerships. General partners may have unlimited liability.
Continuity of existence	Corporations may have a perpetual life.	Partnerships have limited life.

1.3 The Goal of Financial Management

1.3.1 Possible goals

- A brainstorming (recall your personal goals)
- Possible goals related to profitability
  - sales, market share, cost control…
- Possible goals related to controlling risk
  - bankruptcy avoidance, stability, safety…
- We need a goal that encompasses both profitability and risk
  - The pursuit of profit normally involves some element of risk
  - It isn’t really possible to maximize both safety and profit
- More important, notice that the financial managers make decisions for the stockholders

1.3.2 The goal of financial management

A more fundamental question: From the **stockholders'** point of view, what is a good financial management decision?

- Assume that stockholders buy stock because they seek to gain financially -> Good decisions increase the value of the stock, and poor decisions decrease the value of the stock
- The financial manager acts in the shareholders' best interests by making decisions that increase the value of the stock.

The **goal of financial management** is to maximize the current value per share of the existing stock.

- No ambiguity in the criterion
- No short-run versus long-run issue

- If the stockholders are winning, everyone else (employees, suppliers, and creditors…) paid their due is winning also
- Managers make decisions that they believe will achieve the highest value -> shareholders will benefit the most
- Managers can receive instantaneous price responses about their decisions from equity investors (the market is efficient to some extent)

CORPORATE FINANCE: the study of the relationship between business <u>decisions</u> and the <u>value</u> of the stock in the business

- We will learn how to identify investments and financing arrangements that favorably impact the value of the stock

1.3.3 A more general goal

<u>Maximize the value of the existing owners' equity</u>

- Sometimes it's difficult to say what the value per share is at any particular time
- The total value of the stock in a corporation is simply equal to the value of the owners' equity
- With this in mind, we don't care whether the business is a proprietorship, a partnership, or a corporation
- No illegal or unethical actions
  - The financial manager best serves the owners of the business by identifying goods and services that add value to the firm
  - These goods and services are desired, legal, and valued in the free marketplace

1.4 The Agency Problem and Control of the Corporation

1.4.1 Agency Relationships

Question: Will management necessarily act in the best interests of the stockholders?

- In large corporations ownership can be spread over a huge number of stockholders -> management effectively controls the firm

AGENCY RELATIONSHIP: The relationship between stockholders and management

AGENCY PROBLEM: The possibility of conflict of interest between the stockholders and management of a firm

- E.g. the sale of a car: flat vs. proportionate commission
- E.g. real estate agents in China

1.4.2 Management Goals

AGENCY COST: the costs of the conflict of interest between stockholders and management

Indirect agency cost is a lost opportunity

- e.g. a firm is considering a new investment. Value preference (the owners of the firm) vs. risk avoidance (management)

Direct agency costs come in two forms:

- A corporate expenditure that benefits management but costs the stockholders
    - e.g. a luxurious and unneeded corporate jet
- An expense that arises from the need to monitor management actions
    - e.g. paying outside auditors to assess the accuracy of financial statement information

Potential goals of management:

1. To maximize the amount of resources over which they have control (corporate power or wealth)
   - This goal could lead to an overemphasis on corporate size or growth
   - Overpayment does not benefit the stockholders of the purchasing company
2. Management may tend to overemphasize organizational survival to protect job security
3. Independence and corporate self-sufficiency
   - management may dislike outside interference

1.4.3 Do Managers Act in the Stockholders' Interests?

It depends on two factors:

- First, how closely are management goals aligned with stockholder goals? (the way managers are compensated)
- Second, can managers be replaced if they do not pursue stockholder goals? (control of the firm)

Managerial Compensation

Management will frequently have a significant economic incentive to increase share value for two reasons:

- First, managerial compensation is usually tied to financial performance in general (often to share value in particular)
  - For example, managers are frequently given the option to buy stock at a bargain price (see an example of Alibaba)
  - The more the stock is worth, the more valuable is this option
- The second incentive managers have relates to job prospects
  - Better performers within the firm will tend to get promoted
  - Managers who are successful in pursuing stockholder goals will be in greater demand in the labor market and thus command higher salaries

Control of the Firm

Control of the firm ultimately rests with stockholders. They elect the board of directors, who, in turn, hire and fire management

Two ways that management can be replaced:

- Proxy fight
  - A group solicits proxies in order to replace the existing board and thereby replace existing management
- Takeover
  - Firms that are poorly managed are more attractive as acquisitions than well-managed firms (because a greater profit potential exists)
  - Avoiding a takeover by another firm gives management another incentive to act in the stockholders' interests

1.4.4 Stakeholders

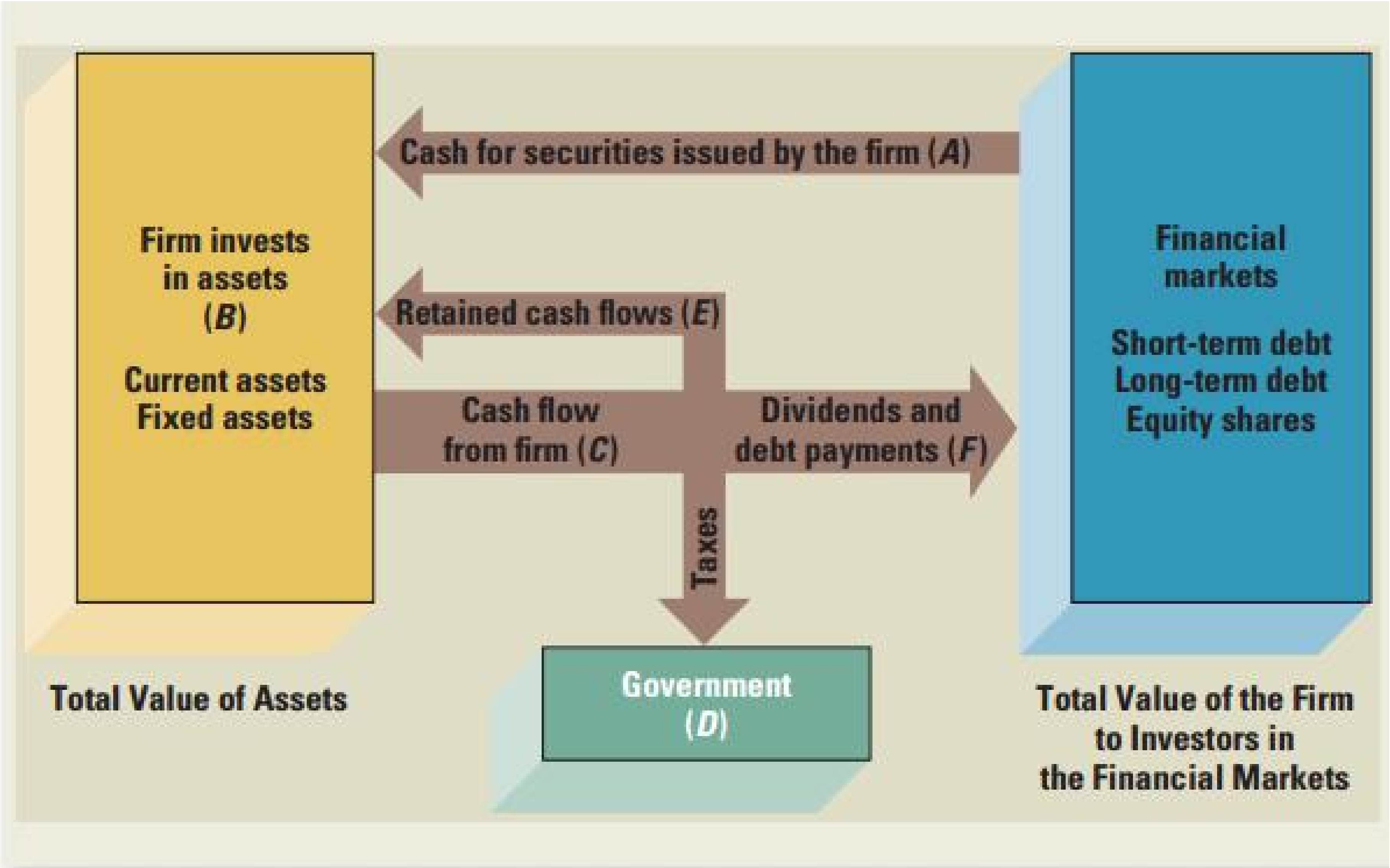
- STAKEHOLDERS: Someone other than a stockholder or creditor who potentially has a claim on the cash flows of the firm
  - E.g. employees, customers, suppliers, and even the government all have a financial interest in the firm
  - Such groups will also attempt to exert control over the firm, perhaps to the detriment of the owners.

1.5 Financial Markets and the Corporation

The advantages of corporate form of organization are significantly <u>enhanced</u> by the existence of financial markets

- Financial markets brings buyers and sellers together
- In financial markets, it is debt and equity securities that are bought and sold
- Financial markets differ in detail:
  - the types of securities that are traded
  - how trading is conducted
  - who the buyers and sellers are

1.5.1 Cash flows to and From the Firm



1.5.2 Primary versus Secondary Markets

- PRIMARY MARKET: the original sale of securities by corporations (or governments)
  - The transaction raise money for the corporation
  - Two types of transactions: public offerings and private placements
- SECONDARY MARKET: securities are bought and sold after the original sale
  - Provide means for transferring ownership of corporate securities
  - Involves one owner/creditor selling to another
  - Secondary markets are also critical to corporations
    - the value of equity, resale ability, …

Dealer versus auction markets

Dealer markets:

- Dealers buy and sell for themselves (at their own risk)
- Dealer markets in stocks and long-term debts are called over-the-counter (OTC) markets
- Usually no central location (connected electronically)
- NASDAQ is a large OTC market for stocks

Auction markets:

- Have physical locations (like Wall Street)
- Match those who wish to sell with those who wish to buy
- The equity shares of most large US firms trade in organized auction markets. The largest such market is NYSE

Epilogue

This chapter mainly focuses on the following issues:

- The three main areas of corporate finance
- The GOAL of financial management
- Three forms of business organization
- Agency problem
- The corporate form and financial markets

Throughout the text, we will always ask the same question: How does the decision under consideration affect the value of the stock?