

The Goal of Financial Management



Goal of Corporate Finance

In the old days:

Maximize Profits to Shareholders



Today:

Maximize Wealth of Shareholders



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Profit Maximization:

Advantages:

- *Easy to calculate*
- *Easy to link decision to profitability*

Disadvantages:

- *Emphasizes short-term decisions*
- *Ignores long-term impacts*

As we'll see, we can make decisions that improve profits this year, but reduce profits next year, which will negatively impact stock prices in the long term.

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Example:

You have to decide whether to invest in a new piece of equipment.

The \$1M price tag results in a big hit to this year's profits.

Yet the investment will return \$10M over the next 3 years.

Option 1: Buy the equipment and maximize long-term growth of the business.

Option 2: Don't buy the equipment and maximize this year's profits.

If your annual bonus depends on profitability, what would you do?

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Wealth Maximization:

Advantages:

- *Emphasizes long-term*
- *Recognizes timing of future cash flows*

Disadvantages:

- *Harder to see link between decision and financial outcome*

As an investor, how is your wealth “maximized”?

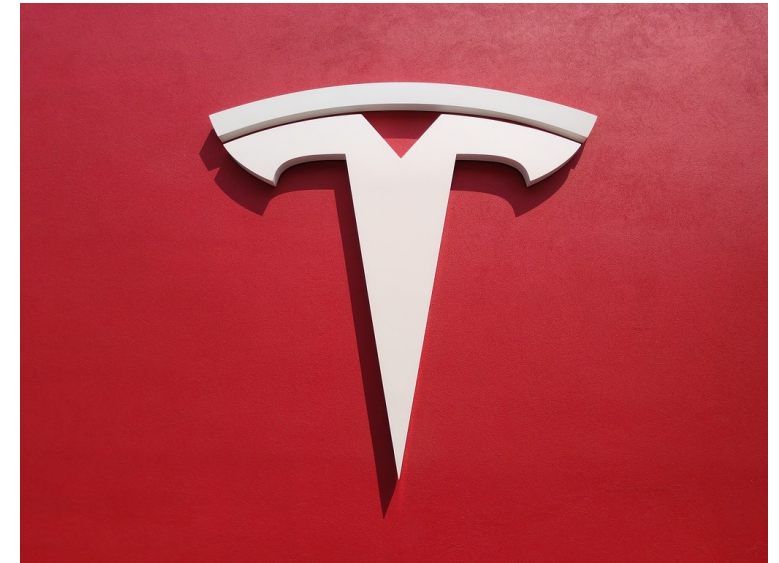
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Wealth Maximization:

You buy 1 share of Tesla stock @ \$1000 per share.

As a shareholder, how does your wealth get maximized?

Financially, your “Wealth Maximization” is all about stock price.



“Wealth Maximization” in a public company is the same - it is all about long-term stock price.

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Wealth Maximization:

What if you work for a private company that doesn't trade in the market?

And you own 10% of the company? How is your wealth “maximized”?

Financially, your “Wealth Maximization” is all about the value of the company.

The more valuable the company, the more your 10% stake is worth.

In this case, the valuation process is a bit more complex, something we'll look at later.

Apple's Stock Price

Apple's Daily Stock Price (AAPL): 2017-2022



Image Source: Yahoo Finance

Starbucks's Stock Price

Starbucks's Daily Stock Price (SBUX): 2017 - 2022



So what is a “Stock”?

Stock represents ownership in a company.

At the company’s inception (and sometimes later in life), the company “authorizes” a specific number of shares of stock.

Some of those shares go to founders of the company, and if lucky, to employees.

The rest are bought and sold by the public (after the company “goes public” after its “Initial Public Offering”, or IPO).

Example. Starbucks has about 1.2 billion shares of stock that trade in the market.

You own 1000 shares of Starbucks. You own a very small % of the company – but you’re still a shareholder!.

Howard Schultz, a founder of Starbucks, owns 33 million shares of Starbucks, or 2.75% of the company, and he’s one of the top 5 shareholders!*



A New Goal of Corporate Finance?

Maximize Stakeholder Value?

Economists and business leaders are starting to recognize that maximizing just shareholder wealth is not the whole picture.

There are many people that contribute to the growth of a company's success:

- Customers
- Employees
- Suppliers
- Communities
- And yes, Shareholders

All Stakeholders should benefit from the company's success too!



This is a major shift in thinking for businesses. We'll see if it really takes hold!

A New Goal of Corporate Finance?

Major companies are shifting their focus...

In 2019, the Business Roundtable, an organization of made up of CEO's from 200 major US companies, issued a statement defining the "Purpose of a Corporation".

It acknowledges "each of our stakeholders is essential."

Many companies now recognize that "Delivering Stakeholder Value" is critical to long-term success.

This is a long way from "the purpose of a corporation is to maximize profits" which drove business for the last 5 decades!



Statement on the Purpose of a Corporation

Americans deserve an economy that allows each person to succeed through hard work and creativity and to lead a life of meaning and dignity. We believe the free-market system is the best means of generating good jobs, a strong and sustainable economy, innovation, a healthy environment and economic opportunity for all.

Businesses play a vital role in the economy by creating jobs, fostering innovation and providing essential goods and services. Businesses make and sell consumer products; manufacture equipment and vehicles; support the national defense; grow and produce food; provide health care; generate and deliver energy; and offer financial, communications and other services that underpin economic growth.

While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders. We commit to:

- Delivering value to our customers. We will further the tradition of American companies leading the way in meeting or exceeding customer expectations.
- Investing in our employees. This starts with compensating them fairly and providing important benefits. It also includes supporting them through training and education that help develop new skills for a rapidly changing world. We foster diversity and inclusion, dignity and respect.
- Dealing fairly and ethically with our suppliers. We are dedicated to serving as good partners to the other companies, large and small, that help us meet our missions.
- Supporting the communities in which we work. We respect the people in our communities and protect the environment by embracing sustainable practices across our businesses.
- Generating long-term value for shareholders, who provide the capital that allows companies to invest, grow and innovate. We are committed to transparency and effective engagement with shareholders.

Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country.

Main Takeaways...

The goal of financial management has changed in the past few decades, from maximizing profits to maximizing the wealth of shareholders.

For companies and shareholders, “wealth maximization” is achieved through growth of the stock price.

Stocks represent ownership in the company. When you own stock, you’re not only a shareholder, but also an owner in the company.

More recently, companies are recognizing there are many stakeholders that support the success of the business, and that they now need to consider “stakeholder value” as their purpose.

Managers make decisions intended to provide long-term growth in the stock price.

How they do that is what this course is all about.

Next Time...

The Capital Allocation Process



How companies acquire money to make their investments!

Credits & References

Slide 1: Business growth concept. Financial report with graphs and arrow by Vitalii Vodolazskyi, Adobe Stock (255882298.jpeg)

Slide 2: Coins on white table with profit graph by andranik123, Adobe Stock (315564205.jpeg). Senior couple walking on the beach in wintertime by goodluz, Adobe Stock (58746038.jpeg).

Slide 6: Tesla logo by Chris Hunkeler, Creative Commons,
<https://www.flickr.com/photos/chrishunkeler/50490972616/in/photostream/> (accessed April 6, 2022).

Slide 8: Apple Stock Price Image Source: Yahoo Finance, 5-Year Interactive Graph (accessed April 6, 2022).

Slide 9: Starbucks Stock Price Image Source: Yahoo Finance, 5-Year Interactive (accessed April 6, 2022).

Slide 10: New York, New York, USA - March 14, 2011: Illuminated Starbucks sign in a Starbucks restaurant on 34th street. By DW labs Incorporated, Adobe Stock (283741591.jpeg). Howard Schultz data from Investopedia,
<https://www.investopedia.com/articles/insights/052416/top-4-starbucks-shareholders-sbux.asp> (accessed April 7, 2022).

Slide 1: Textile cloth factory working process tailoring workers equipment by Ekaterina, Adobe Stock (327690582.jpeg).

Slide 12: Business Roundtable Purpose Statement, downloaded from <https://s3.amazonaws.com/brt.org/BRT-StatementonthePurposeofaCorporationJuly2021.pdf> (accessed April 6, 2022).

Slide 14: Debt financing vs. equity financing by Andrii, Adobe Stock (448221492.jpeg).