SMU COX
SCHOOL OF BUSINESS

Lecture 1: Introduction to Financial Management

Financial Manager's Primary Goal and Agency Issues

Presentation to Cox Business Students

FINA 3320: Financial Management

FINA 3320: Finance Concepts - Keys to Success

- Don't get behind!!!
  - Work on the material daily
- Know the language
  - Finance has its own vocabulary
  - Finance uses multiple terms for the same concept
- Ask questions when you don't understand
  - There is no such thing as a bad question, only ignorant people who don't ask questions!
- Educate yourself on current events
  - Start a life-long habit of reading the finance daily journals (e.g., FT and WSJ)
- Talk about finance each day!

The Financial Manager

- This course is about the financial manager and his/her role within the firms
  - Credo: Maximizing the value of the firm
- Who is the financial manager?
  - The person or group of people responsible for making financial decisions within the firm
- During this class, ***YOU*** are the financial manager!
  - Your objective is to learn the requisite concepts and tools necessary to make value enhancing decisions

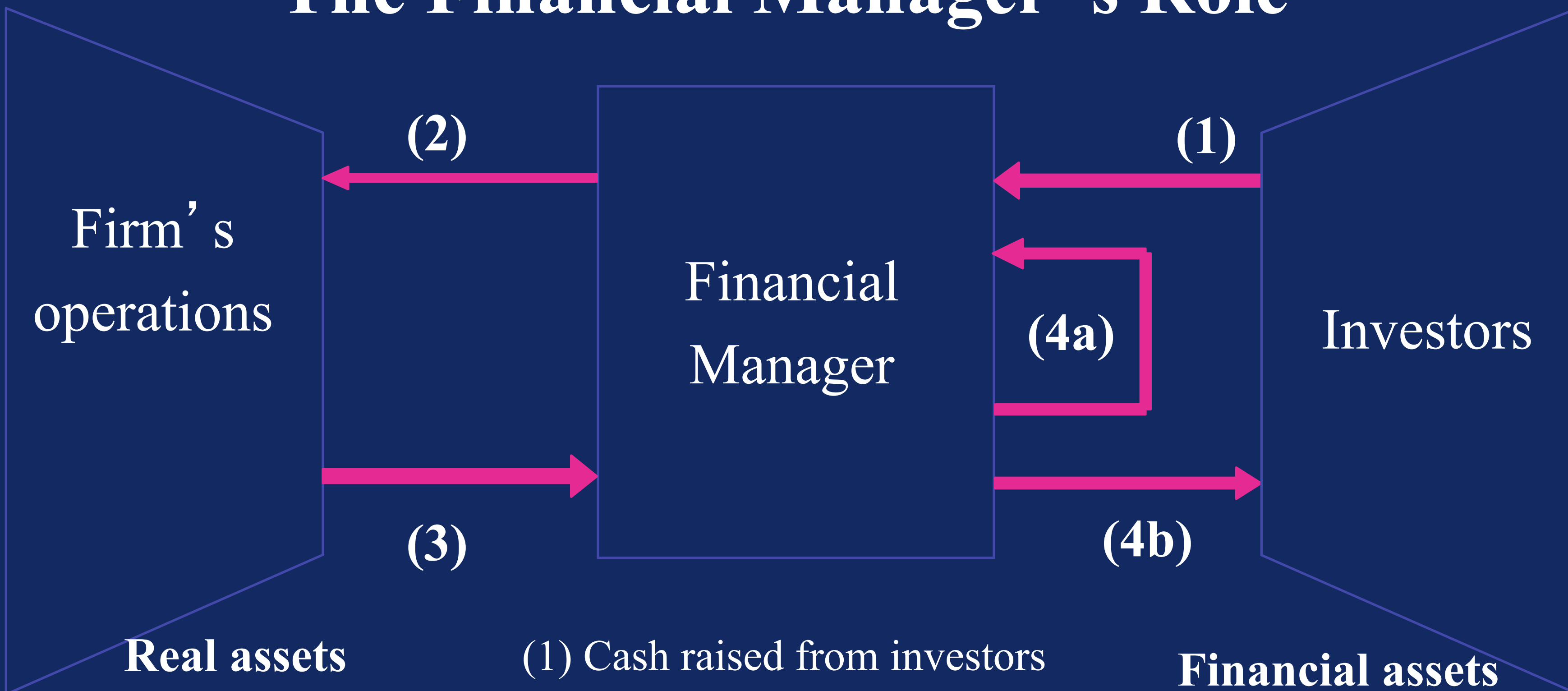
Why is This Course Important?

- Provides a discussion of the types of decisions you will be making as a financial manager
- Begins to develop a framework for actually making these decisions
  - This is not a "how-to" course per se
  - Rather, we will develop your tool-kit for solving real-world problems
- Serves as a foundation for all facets of the finance field

What Decisions?

- Investment decisions
  - How does the firm spend money in hopes of generating a return?
    - Related to real assets (firm's operations), e.g., factories, machines, R&D, advertising, employees, etc.
- Financing decisions
  - How does the firm raise money to invest?
    - Related to financial assets (claims on real assets), e.g., issuing stock, structuring debt, etc.

The Financial Manager's Role



(1) Cash raised from investors

(2) Cash invested in firm

(3) Cash generated by operations

(4a) Cash reinvested

(4b) Cash returned to investors

A Little Context: Organizational Forms

- Sole proprietorship: Single manager/owner (80%# / 13%$)
  - **Advantages**
    - Inexpensive and ease of formation
      - Just start business
    - Fewer government restrictions/regulations
      - Typically only requires obtaining a license
    - Pay personal income taxes (firm is an extension of its owner)
      - Pass-through vehicle
  - **Disadvantages**
    - Unlimited liability
      - Owner is responsible for firm's debts and can be sued personally
    - Limited access to capital
      - Typically inputs startup capital personally and borrows from banks
    - Limited life
      - Firm's life terminated at death of owner

Organizational Forms continued…

- General Partnership: Two or more parties jointly own and typically manage (10%# / 7%$)
  - **Advantages**
    - Inexpensive and ease of formation
      - Typically requires partnership agreement
    - Fewer government restrictions/regulations than corporations
      - Typically only requires obtaining a license
    - Pay personal income taxes (based on percentage ownership)
      - Pass-through vehicle
  - **Disadvantages**
    - Unlimited liability
      - Each partner is responsible for actions of all other partners
    - Limited access to capital
      - Each partner inputs capital personally (may or may not borrow)
    - Limited life
      - Partnership's life may be terminated at death/disability of one partner; however, partnership agreement typically provides for these events

Organizational Forms continued…

- Limited Partnership: Has both general and limited partners
  - **General Partners (GP)**
    - Unlimited liability
      - Each GP is responsible for the debts (actions) of partnership (other GPs)
    - Management control
      - Responsible for the decisions of the partnership (agents)
  - **Limited Partners (LP)**
    - Limited liability
      - Each LP's liability is limited to his/her investment
    - No management control
      - No say in the decision making process (principals)

Organizational Forms continued…

- Corporation: Firm is a legal entity (10%# / 80%$)
  - **Advantages**
    - Limited liability
      - Stockholders' liability limited to their investment
    - Unlimited life
      - Corporation survives the death of stockholders
    - Ease of raising capital
      - Due to ease of transferability of ownership
  - **Disadvantage**
    - Potential double taxation
      - Corporation (C-Corp) pays corporate taxes and stockholders' pay personal taxes on dividends

Organizational Forms continued…

- Types of Corporations:
  - **C Corporations (C-Corps)**
    - Larger corporations
      - Number of shareholders is not limited
    - Double taxation
      - C-Corps pay corporate taxes and stockholders pay personal taxes on dividends
  - **S Corporations (S-Corps)**
    - Smaller corporations
      - Limited to maximum of 75 stockholders (no foreign owners)
    - Avoids double taxation
      - Pass-through vehicle where stockholders are taxed on S-Corps' net profits

Organizational Forms continued…

- Limited Liability Company (LLC): Legal entity where owners are referred to as 'members'
  - **Advantages**
    - Less administrative paperwork and record-keeping than corporation
    - Limited liability similar to that of corporate business form
    - Members elect how income tax is paid on LLC's net profits
      - Can be taxed as sole proprietorship, partnership, S-Corp, or C-Corp
  - **Disadvantages**
    - Newer form of business without a lot of case law
      - Increased uncertainty
    - Some difficulty is raising capital
      - VCs and other investors prefer C-Corps with IPO (Initial Public Offering) potential
    - Some states require payment of franchise or margin tax on LLCs
      - As of 2007, Texas requires payment of the Texas Business Margin Tax by all LLCs

Organizational Forms and the Manager

- Principles discussed in this course will apply to the manager in all organizational forms
- Discussion will generally be in terms of the corporation
- Corporate form results in additional problems and questions that must be dealt with, e.g.:
  - How do we align the interests between the manager and the owners of the firm?
  - Should the corporation issue securities (i.e., stock, bonds) to the general public? If so, how?

The Primary Goal of the Financial Manager

- For whom does the financial manager (agent) work?
  - ***Answer: The owners of the firm (principals)***

- What, then, should be the financial manager's goal in decision-making?
  - ***Answer: Make the owners happy!***

- Simple assumption: Owners' happiness increases as the value of their ownership stake in the firm increases
  - Manager's goal becomes: ***Maximize Shareholder Wealth***
    - Equivalent to maximizing value of common stock
    - Soon we will discuss nuance of ***maximizing firm value***

Maximizing Shareholder Wealth

- Questions asked by financial manager:
  - ***Does a particular decision have the impact of increasing shareholder wealth?***
    - Applies to investment decisions
      - If manager invests in a new project, will this project increase value?
    - Applies to financing decision
      - If manager finances a new project with debt, will this financing increase value?
  - ***What about maximizing profits?***
    - Profits are not well-defined
    - Profits can be manipulated
    - Maximizing profits ≠ maximizing shareholder wealth

Do Financial Managers Maximize Shareholder Wealth?

- Jensen and Meckling (1976)
- Simple case: Single manager/owner
  - If he doesn't, he bears the burden
  - Who cares?
- What happens as the manager's ownership stake decreases?
  - Reaps full benefits of any deviation from shareholder wealth maximization (excess perquisite consumption also known as 'perking and shirking')
  - Only bears a fraction of the costs

Agency Theory

- Principal-Agent Relationships
  - Principal(s)
    - One or more persons who hires another entity (agent) and delegates authority to this entity to perform some service
  - Agent
    - Entity hired by principal(s) to perform some service
    - Fiduciary responsibility

- Principal-Agent Conflicts
  - Arise whenever principal(s) hire an agent to perform some service and agent is more interested in maximizing agent's happiness than in maximizing principals' happiness
    - Stockholders versus Managers
    - Stockholders versus Bondholders

Stockholders Versus Managers

- Stockholders (principals) hire managers (agents)
  - Fiduciary responsibility of managers is to maximize the firm's value
    - Textbook states financial managers goal is to ***maximize shareholders' wealth*** as opposed to ***maximizing firm's value***
    - We will discuss nuance of this difference in the next slide!
  - Potential agency problem arises when managers seek to maximize their own happiness
    - Through perquisites and/or shirking
  - One role of the Board of Directors is to limit this potential agency issue

Stockholders Versus Bondholders

- Bondholders' Wealth Expropriation
  - Stockholders have the ability to either have the bondholders paid off or to have bondholders share in losses
    - If corporation performs well, stockholders will have management pay off bondholders and stockholders receive the residue
    - If corporation performs poorly, bondholders may have to share in the losses
  - Increasing the riskiness of the firm's projects increases both the upside (perform well) and the downside (perform poorly)
    - Bondholders receive a fixed return and won't share in the potential gains from riskier projects, but may share in the losses
  - Stockholders can therefore expropriate value from bondholders by having managers increase riskiness of firm's projects

Shareholder Wealth Versus Firm Value

- Nuance: Which should financial managers maximize: Shareholders' Wealth or the Firm's Value?

  - If the answer is Shareholders' Wealth, then
    - Expropriating wealth from bondholders is a viable end-game strategy

  - If the answer is Firm's Value, then
    - Shifting wealth from bondholders to stockholders does not increase overall value

  - It makes more sense for financial managers to focus their attention on maximizing the overall value of the firm rather than attempting to shift wealth between stakeholders!

Corporate Governance

- Separation of ownership and control
  - Stockholders (principals) own the firm and hire agents to run it
  - Managers (agents) control the firm on behalf of the owners
- Separation can create conflict of interest
- Agency costs: Added costs to the firm resulting from the agency relationship
  - Costs of poor managerial decisions
  - Costs of aligning managers with shareholders
  - Costs of avoiding bondholders' wealth expropriation
- Corporate governance: Set of mechanisms designed to mitigate agency problems

Aligning Managers with Shareholders

- Compensation: Structure to reward good performance and penalize bad performance
  - Do not just pay managers a fixed salary
  - Provide compensation partially in form of equity (shares of stock)

- Stock ownership by managers aligns their interests with those of stockholders
  - Provides incentives for managers to maximize the value of the firm!

- Why not provide 100% of managers' compensation in stock?
  - Some events that impact the firm's stock price are outside the control of managers!

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Aligning Managers with Shareholders continued

- Internal monitoring of managers
  - Board of directors
  - Large shareholders
- External monitoring of managers by markets
  - Possible takeovers
  - Scrutiny when issuing securities
- External monitoring of managers by government
  - Legal and regulatory requirements
- Threat of being fired
  - Follows from many of the above corporate governance factors

Aligning Managers with Shareholders continued

- Sounds simple, doesn't it???
  - Create the proper incentives and managers will maximize the firm's value!!!
- It is not that simple…
- Each of these governance mechanisms has, and possible even creates, its own set of problems!!!

Do Financial Managers Maximize Firm Value?

- Six factors playing a role in ascendancy of firm value
  - (1) Emergence of market for corporate control in the 1980s
    - Prior to 1980s many managers sought to maximize their own happiness rather than the value of the firm
      - This led to hostile takeovers as an effective means of corporate governance
      - Managers learned that if they failed to maximize value, they might be fired!

  (2) Recent large scale corporate corruption and scandals
    - After bubble burst, shareholders, boards of directors, and regulatory agencies started challenging management's decision making
      - Greater discipline imposed on managers to focus on long-term value creation
      - Sarbanes-Oxley created strict requirements for CEO and CFO to attest to validity of financial statements, and to strengthen internal control processes

- (3) Equity-based features in managers' compensation packages
  - In 1970s finance academics became interested in motivation of managers
  - By 2000, estimated value of stock options represented 45% of median pay package for CEO in public corporations
- (4) Increase equity holdings by households
  - In 1975, 25 million people (12% of U.S.) owned equity
  - By 1995, 69 million people (26% of U.S.) owned equity (mutual funds)
- (5) Growing recognition of social security insolvency
  - Growing crisis worldwide of pay-as-you-go retirement systems
  - Solution requires moving to some form of funded system (equity?)
- (6)Stock market trends or fads rather than value creation
  - Asset pricing bubbles – lots of them!! (The "New Economy"!?!?)
  - Fundamental principles of financial economics leads to value creation!
  - ***Investors value cash flows!!!***

So, have these six factors caused financial managers to change their ways and focus on maximizing value?

Some Evidence

From Fortune, September 17, 2001

- From survey responses companies are classified as "aligned" or "non-aligned" based on whether the firm is "pulling for the same things as the shareholders"
- Aligned companies' stocks had twice the returns of the non-aligned group

Characteristics of aligned companies included…

- Focus on cash flow
- Compensation plans that focus on long-term value maximization
  - Multi-year plans that penalize short-term gains with long-term costs
  - No caps on bonuses

Some Evidence continued…

Characteristics of non-aligned companies

- Focus on accounting-based results as opposed to cash flows
- Capped bonuses

Study after study indicate that the market rewards…

- Focus on cash flows
- Long-term value creation

The rest of this course will be dedicated to understanding…

- The financial tools necessary to increase cash flows
- The financial concepts necessary to improve long-term value

Thank You!

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