



INTERNATIONAL
BUSINESS SCHOOL

The financing needs of corporations

Principles and Practices of
Business Finance

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Agenda

1. What Is a Corporation?
2. Forms of Business Organization
3. What is Capital?
4. Financing & Investment decisions
5. Internal financing
6. External Financing
7. Relationship between risk and return
8. The paradox of the cheap external funds

What Is a Corporation?

- A business organized as a separate legal entity owned by stockholders.
- The corporation's owners are called shareholders or stockholders.
- The owners of a corporation are not personally liable for its obligations, this called limited liability.
- The goal is always to increase the value of the company, in other words to **increase the wealth of the owners**
 - **Short term goal: profit**
 - **Long term goal: increase wealth**

Forms of Business Organization

Corporation

- A legal entity separate and distinct from its owners and managers.
- Having unlimited life
- Easy transferability of ownership
- Limited liability

Non-Corporation

- Sole Proprietorships: one person
- Partnerships
- Limited Liability Companies LLC

Most companies begin their lives as a sole proprietorship or partnership before converting to corporation through a process of Going Public

Forms of Business Organization

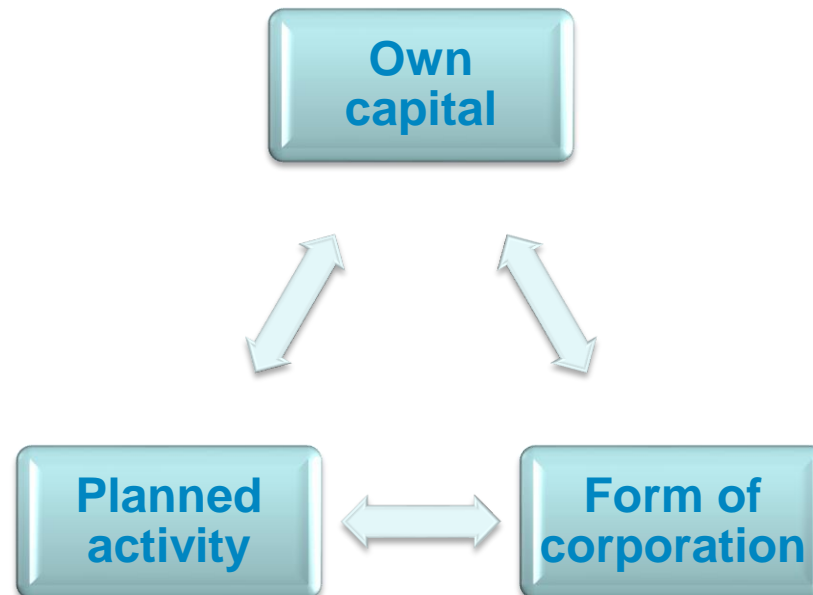
	Sole Proprietorships	Partnerships	Limited Liability	Corporation
Number of owners	One	Unlimited	Unlimited	Unlimited
Liability for Debts	Yes	Yes	No	No
Owners manage the firm	Yes	Yes	Yes	No
Ownership Change dissolves firm	Yes	Yes	No	No
Taxation	Personal	Personal	Personal	Double*

What is Capital?

Many different definitions depending on the context

- "Wealth in the form of money or other assets owned by a person or organization or available for a purpose such as starting a company or investing" (Oxford Dictionary)
- "While money is used simply to purchase goods and services for consumption, capital is more durable and is used to generate wealth through investment." (Investopedia)

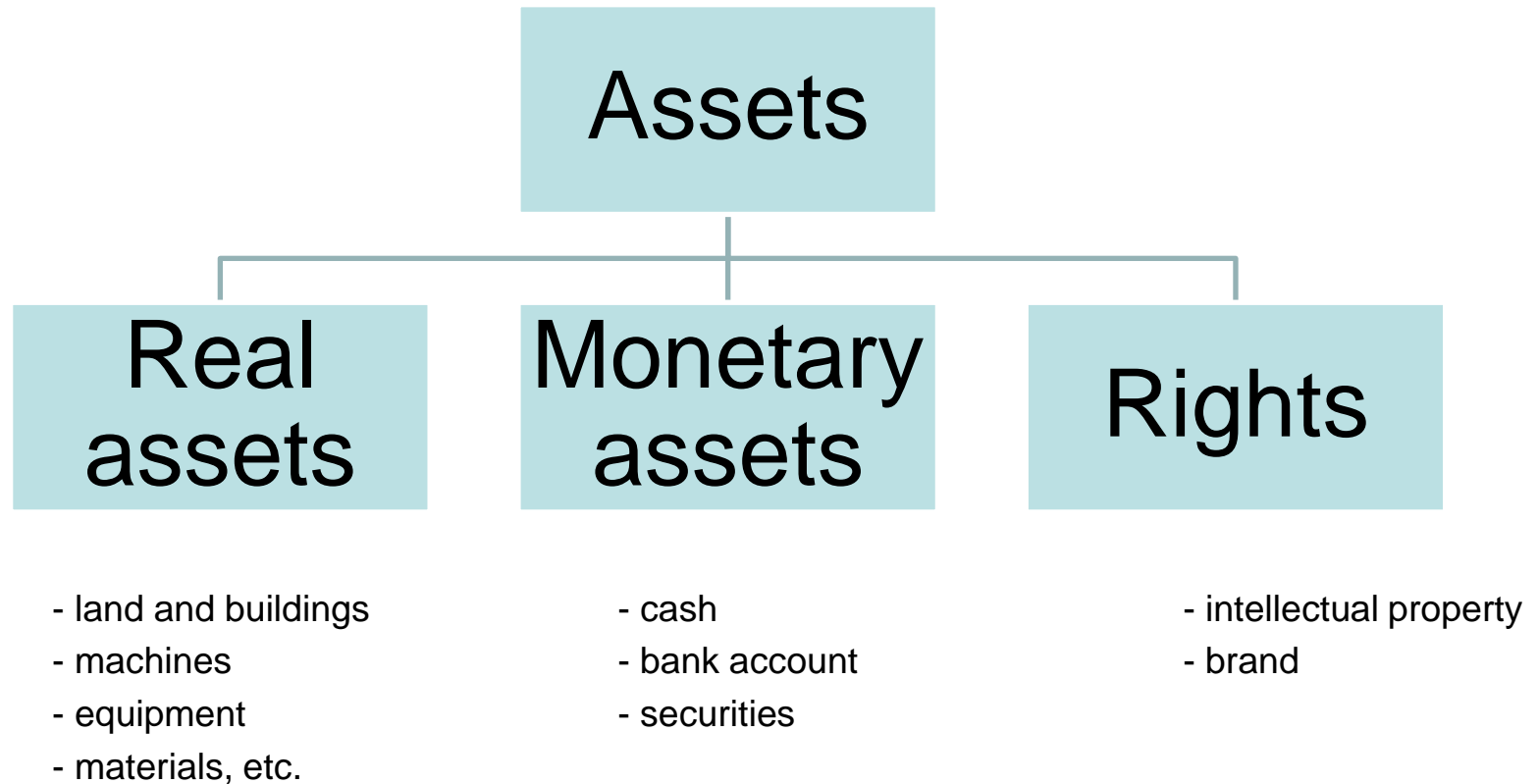
A strong relationship between the amount of own capital, the planned activity and the form of the organization.



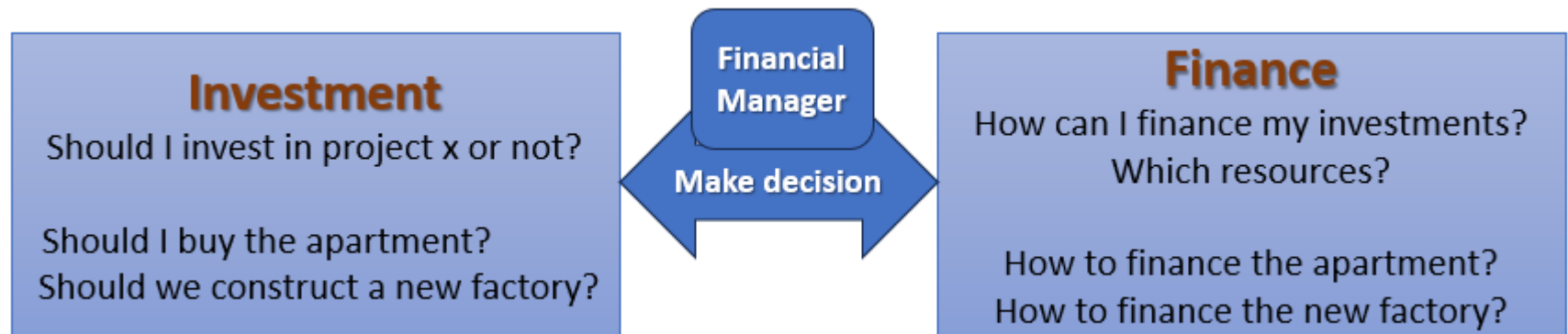
Examples for the relationships:

- Starting an airline determines that the capital necessary will be large and that the way it's functioning requires a corporation.
- On the other hand, a small consulting firm that gives financial advices can be launched with little capital and even as a sole proprietorship.

With your capital, You need to buy assets to start a company



Financing & Investment decisions



Facebook Spent \$700 million to acquire Instagram, the privately owned photo-sharing company.

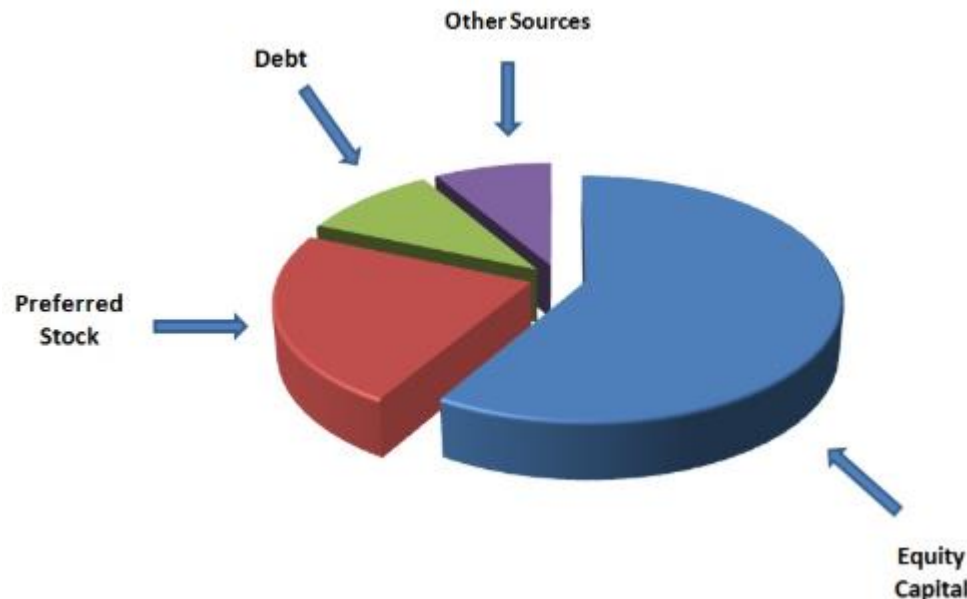
Raised \$6.8 billion by issuing shares in an initial public offering (IPO).

Corporation Financial resources



Funds come from **internal and external** sources, forming the capital structure of the company.

The capital structure = the ratio and composition of the different funding forms within a



Own/Internal financing

- **Owner's Capital (Equity Capital):** *paid-in by the owners in the form of shares. The shareholders are considered as the owners of the business.*
- **Profit from this year** *(profit that could still be paid out in dividends in the coming months)*
- **Retained earnings:** *profit that was not paid out to the owners in the form of dividends in the past and is now at the disposal of the company)*

External Financing

Long term financing

DEBT THAT NEEDS TO BE REPAYED IN THE LONG TERM (>1 YEAR)

- **Investment loans** (*mostly from banks and other financial institutions*)
- **Leasing:** Companies lease assets rather than buy them
- **Selling bonds to the public** (*like a loan, but not from a bank*)

External Financing

Short-term financing

DEBT THAT NEEDS TO BE REPAID IN THE SHORT TERM (<1 YEAR)

- **Overdrafts:** *Loans from your bank on your bank account*
- **Loans** *to finance your current production*
- **Loans** *to finance the execution of a contract*
- **Loans that are backed by some valuable assets**
(usually bonds or similar assets, the bank can take those assets in case the company doesn't repay its loan)
- **Trade loans:** *when suppliers sell goods on credit giving the company a credit period to pay its invoice.*

Internal Vs. External Financing?

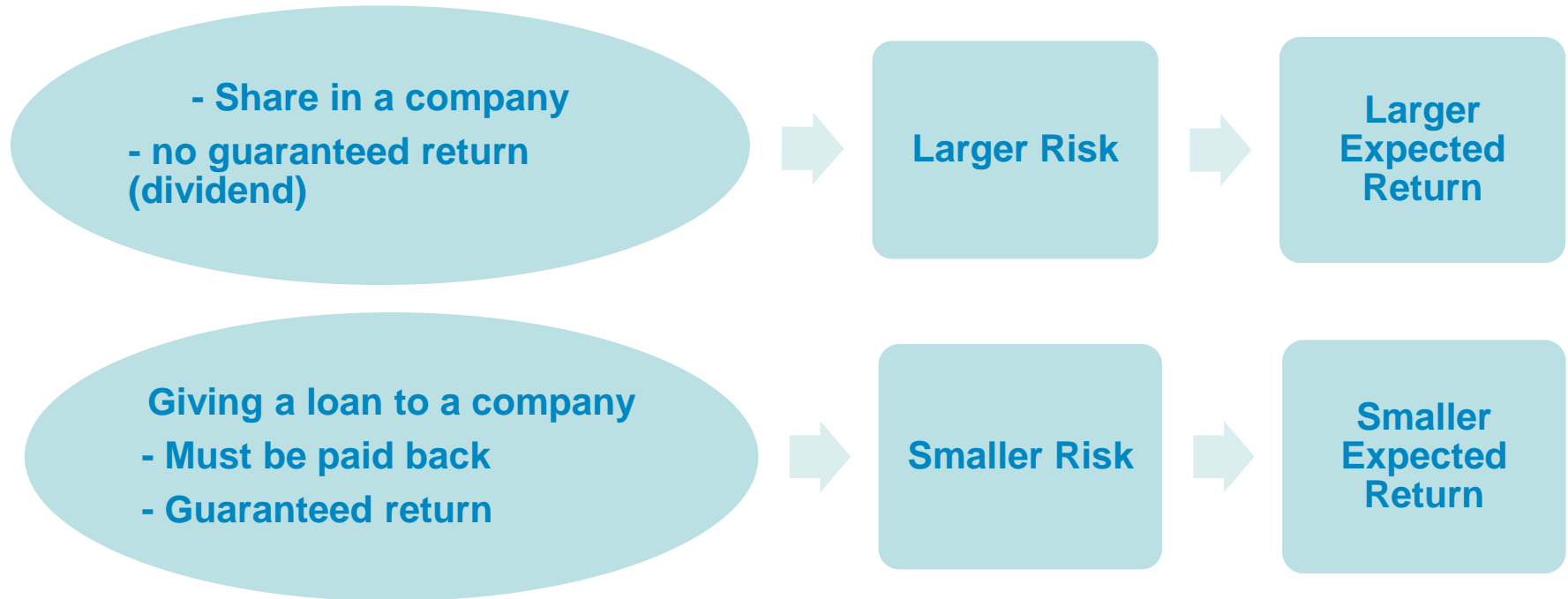
Internal financing (Shares) get dividends

External financing sources get interest

What is cheaper, the own funds or the external ones?

Think about this question from the risk point of view

Relationship between risk and return



Price of own funds

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Price of external funds

No risk Minimal return expected (*risk of the government bonds*)

Investors are willing to accept more risk if (and only if!!) that means that their investment will potentially bring a larger income.

Financing Decision dilemma – Internal financing

- **advantages**

- The funds are there for ever (provides stability)
- All the income generated by the company stays with the owners of the company
- If there is no payment of the price (no dividends), then the company grows

disadvantages

- Difficult to get access, the process is lengthy and expensive
- Not flexible
- Expensive source of funding

Financing Decision dilemma – External financing

advantages

- Access is relatively quick (sometimes automatic)
- Size can be flexibly adjusted to needs of company
- Relatively cheap source of funds
- Interest is accounted for as a cost and reduces the basis on which the taxes due to the government are calculated

disadvantages

- Not available for ever, must be paid back
- Company must share its revenues with the lenders
- Increasing the leverage might lead to serious financial difficulties

The paradox of the cheap external funds

