

Introduction to Corporate Finance: Overview

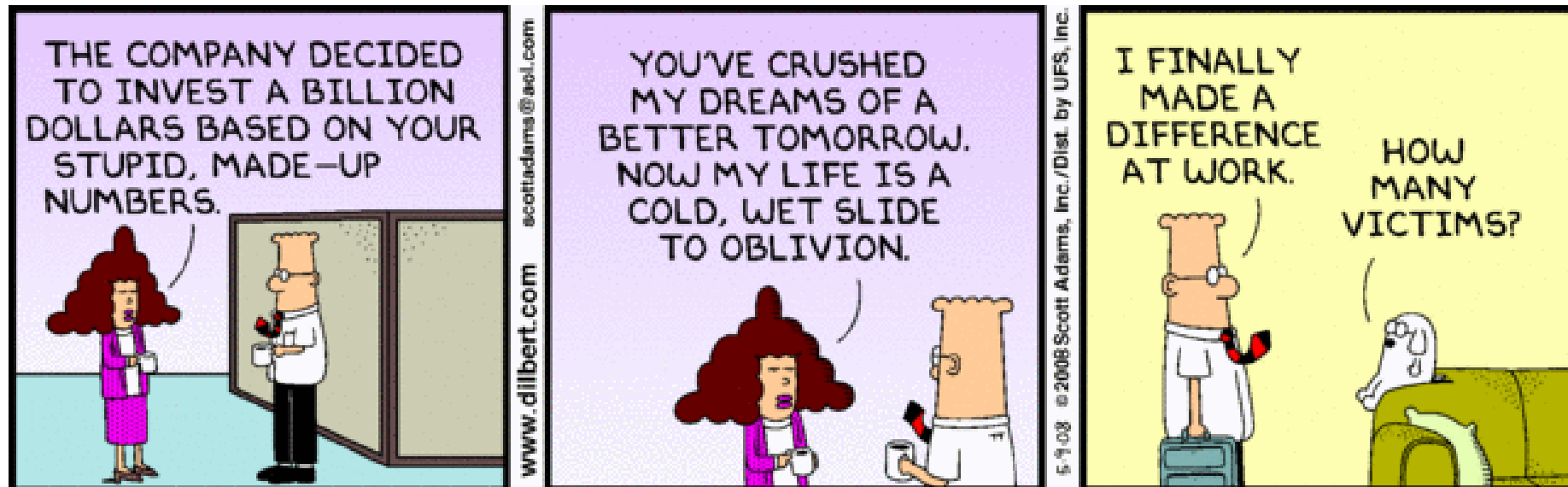
Readings:

Hillier et al., Chapters 1 & 2

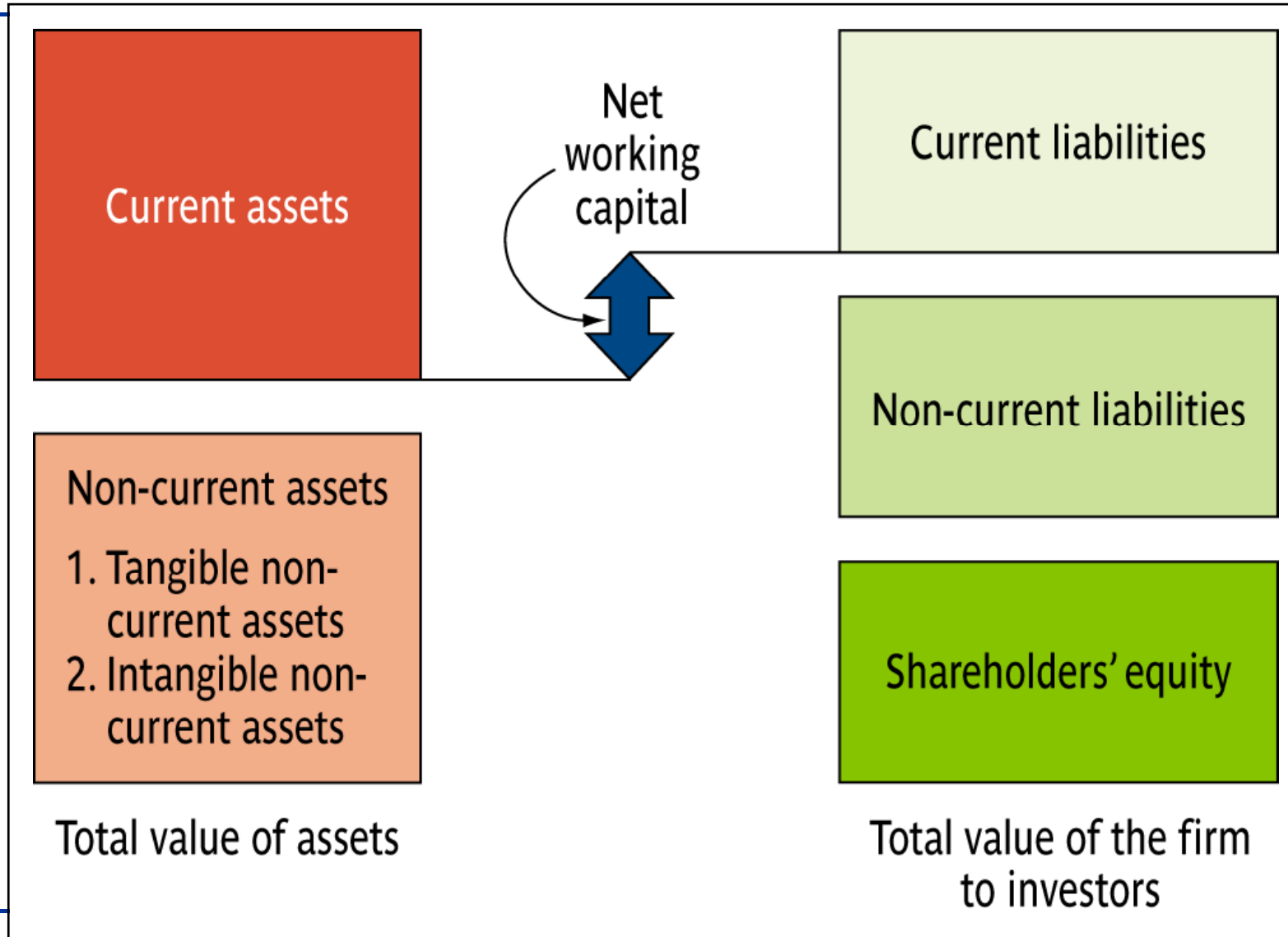
Overview of Lecture

- What is Corporate Finance?
- The Goal of Financial Management
- Financial Markets
- Corporate Finance in Action: Google
- Corporate Governance
- The Agency Problem

What Is Corporate Finance?



The Balance Sheet Model of the Firm



Example: The Balance Sheet Model

- On 4 March, 2008, Admiral Group plc, a British motor insurer, announced its financial results for the year 2007:
 - Tangible non-current assets: £7.7 million
 - Intangible non-current assets: £69.0 million
 - Current assets: £793.6 million
 - Current liabilities: £632.7 million
 - No non-current liabilities
- What is the balance sheet model?

Example: The Balance Sheet Model

Current assets
£793.6 million

Current liabilities
£632.7 million

Net working capital:
 $£793.6 \text{ million} - £632.7 \text{ million}$
 $= £160.9 \text{ million}$

Non-current assets
Tangible:
£7.7 million
Intangible:
£69.0 million

Shareholders'
equity:
£237.6 million

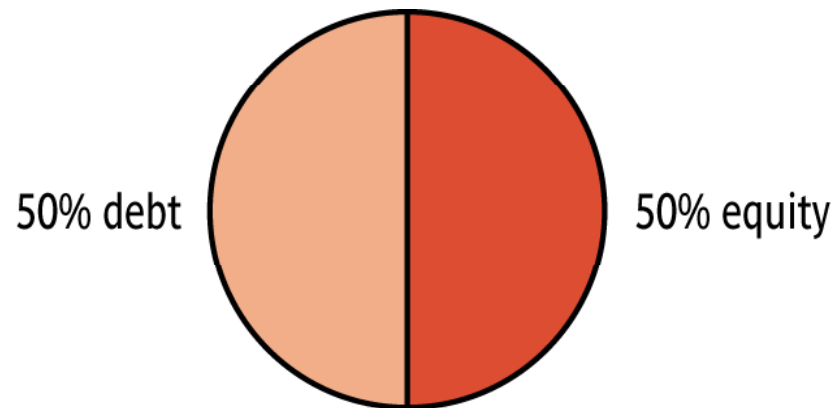
Total value of assets:
£870.3 million

Total value of firm to
investors: £870.3 million

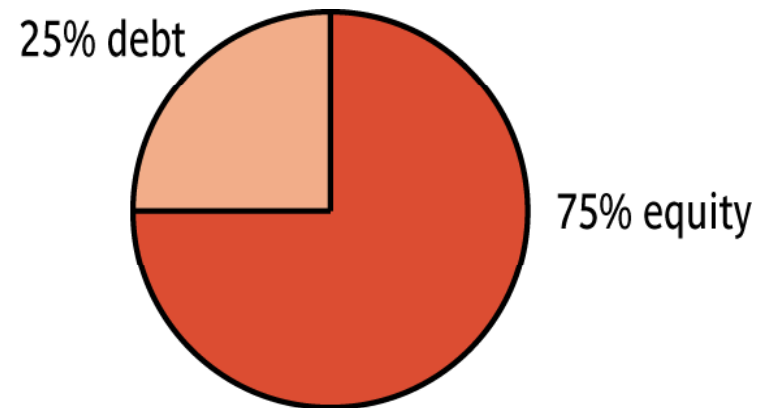
Capital Structure: The Firm as a Pie



$$\text{Value of Firm} = \text{Value of Debt} + \text{Value of Equity}$$



Capital structure 1



Capital structure 2

The Financial Manager

Responsible for
Investment
Decisions

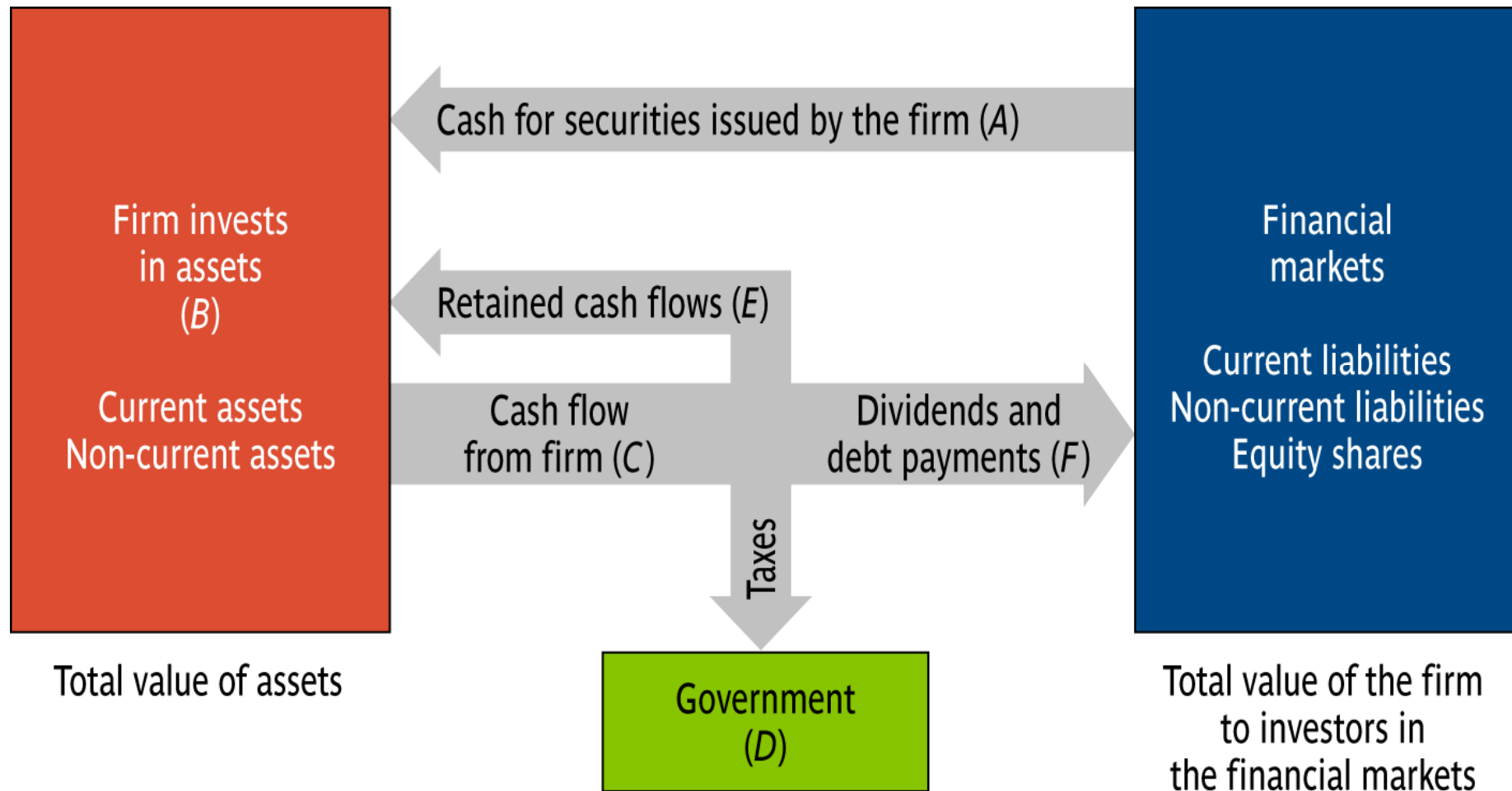
Responsible for
Financing
Decisions

Responsible for
Short-Term
Financial
Planning

Oversee
Accounting and
Audit Function
in Firm

Ensure the
Financial
Welfare of the
Firm

How Cash Flows...



Accounting Flow vs Cash Flow

Midland plc is an Irish firm that refines and trades gold. At the end of the year, it sold 2,500 ounces of gold for €1.67 million. The company had acquired the gold for €1 million at the beginning of the year. The company paid cash for the gold when it was purchased. Unfortunately it has yet to collect from the customer to whom the gold was sold.

Accounting Flow:

The Midland plc Accounting View Income Statement Year End December 31

Sales	€1,670,000
- Costs	- €1,000,000
Profit	€ 670,000

Cash Flow:

The Midland plc Financial View Income Statement Year Ended December 31

Cash inflow	€ 0
- Cash outflow	- €1,000,000
	- €1,000,000

Timing of Cash Flows

The Italian firm, Montana SpA, is attempting to choose between two proposals for new products. Both proposals will provide additional cash flows over a four-year period and will initially cost €10,000. The cash flows from the proposals are as follows:

Year	New Product A	New Product B
1	€ 0	€ 4,000
2	0	4,000
3	0	4,000
4	<u>20,000</u>	<u>4,000</u>
Total	€20,000	€16,000

Which is the best?

The Risk of Cash Flows

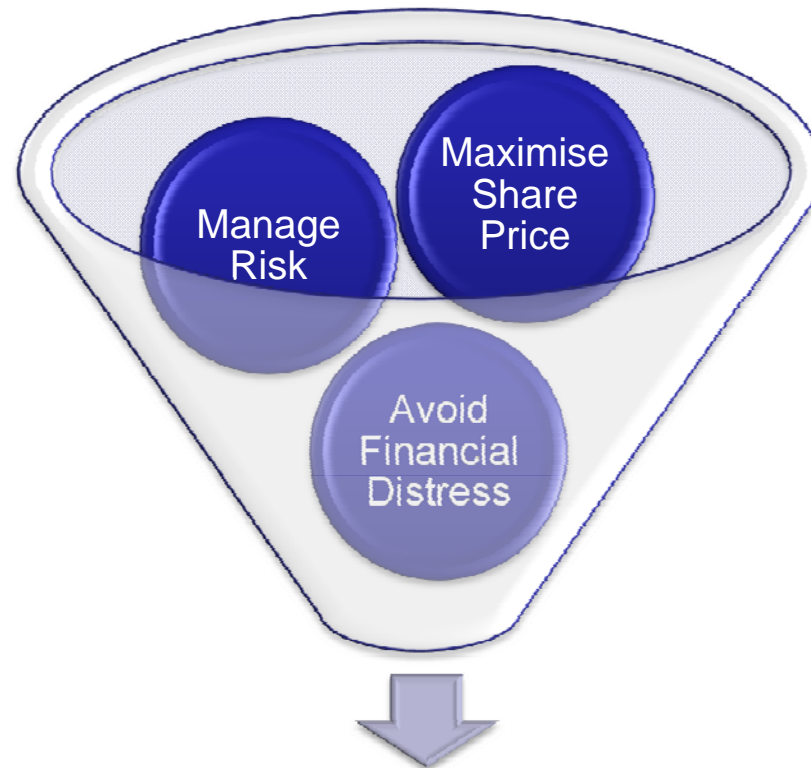
The Norwegian firm, Fjell ASA, is considering expanding operations overseas, and it is evaluating the Netherlands and South Africa as possible sites. The Netherlands is considered to be relatively safe, whereas operating in South Africa is seen as considerably more risky. In both cases the company would close down operations after one year.

After undertaking a complete financial analysis, Fjell has come up with the following cash flows (in NOK) of the alternative plans for expansion under three scenarios – pessimistic, most likely, and optimistic:

	Pessimistic	Most Likely	Optimistic
Netherlands	750,000	1,000,000	1,250,000
South Africa	0	1,500,000	2,000,000

Which is the best?

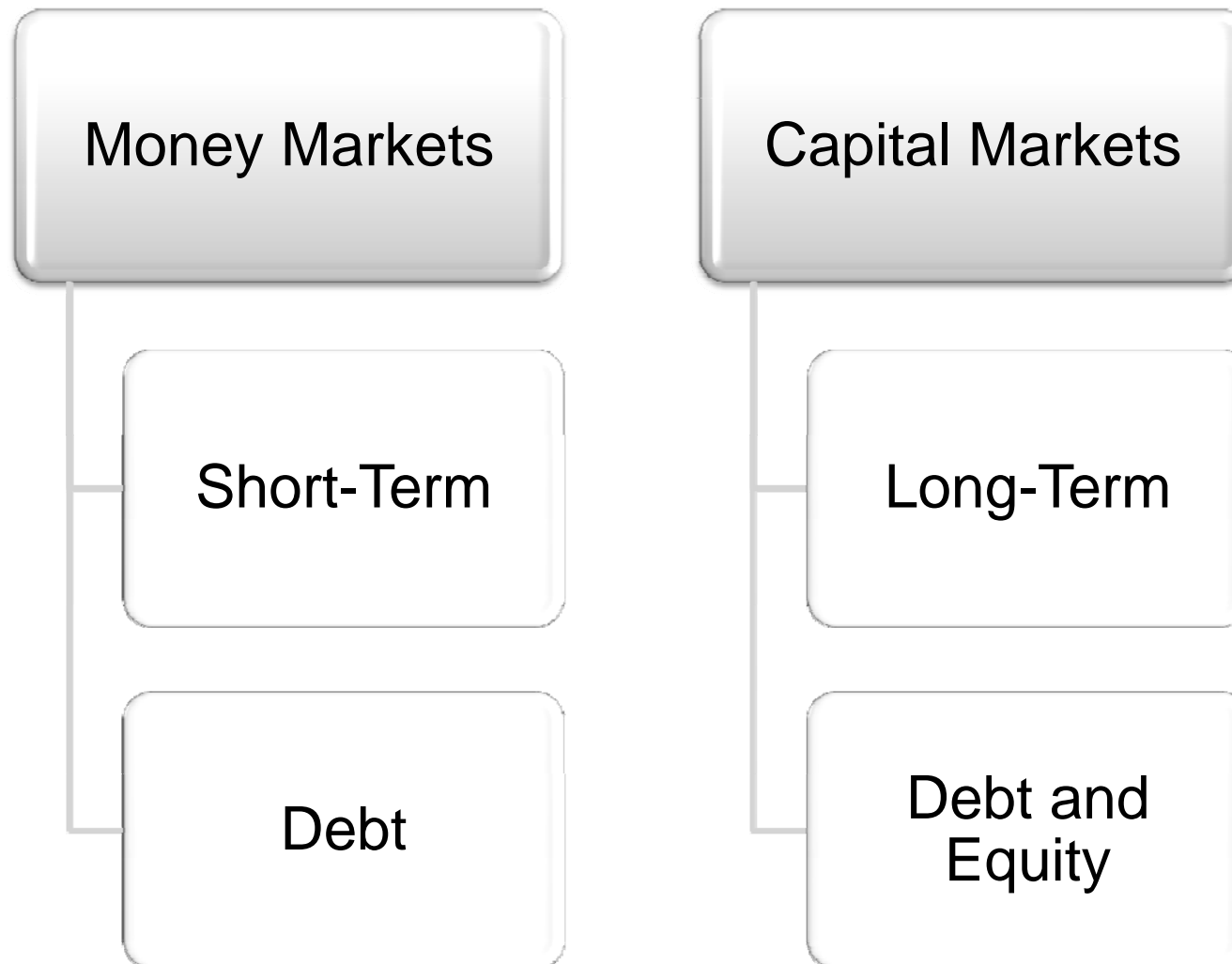
The Goal of Financial Management



Maximise value of owner's equity
("Shareholder value")

➤ And what about „stakeholder value“?

What are the Financial Markets?



Primary vs Secondary Markets

Primary Markets

Securities are sold to investors

Money that is raised goes to issuing firm

First share issue is called an Initial Public Offering

Second share issue is called a Seasoned Offering

Secondary Markets

Investors trade securities with each other

Money that is raised goes to seller of securities

Share prices

Corporate Finance in Action: Google

Early Days

Great Idea

Received Funding



The Share Issue

Needed to Expand Further

Stock Market Listing



Google Now

Multinational Company

A Class and B Class Shares

So What Is Corporate Finance?

Investment

- Capital Budgeting:
Choose best projects

Financing

- Capital Structure:
Choose source of financing for
investment

Liquidity

- Short-Term Financial Planning:
Ensure you have enough cash and
inventory

“Corporate Governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. How do the suppliers of finance get managers to return some of the profits to them? How do they make sure that managers do not steal the capital they supply or invest it in bad projects? How do suppliers of finance control managers?”

(Shleifer/Vishny, *Journal of Finance* 1997, p. 737)

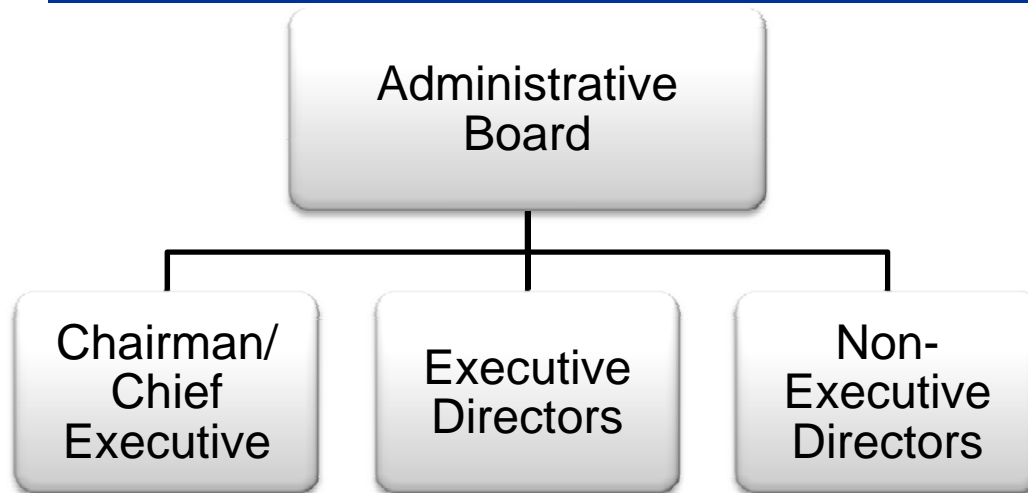
The Corporate Firm

Sole
Proprietorship

Partnership

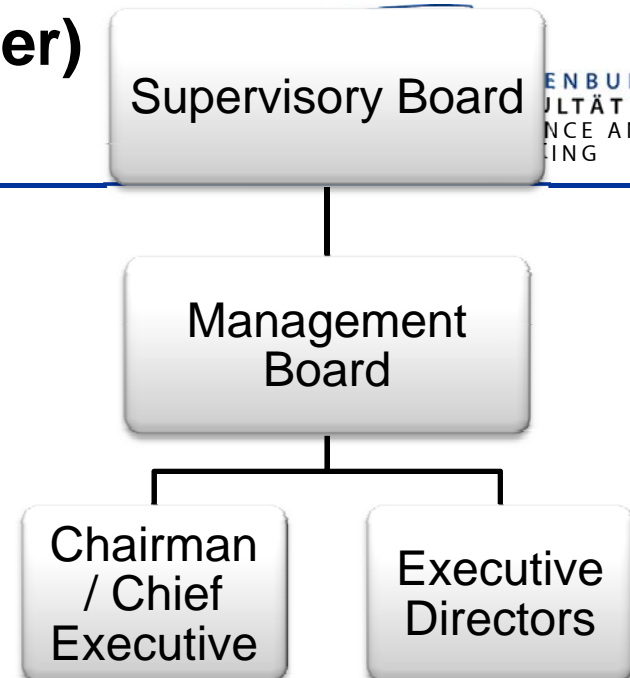
Limited
Corporation

Unitary (Single-Tier) vs Dual (Two-Tier) Board Structures



Single-Tier

- Shareholders elect directors at annual general meeting
- Administrative board reports to shareholders



Two-Tier

- Shareholders elect members of supervisory board at AGM
- Supervisory board elects executive directors
- Management board reports to supervisory board

Partnerships vs Corporations

Liquidity and Marketability

- Partnership: Restricted Trading
- Corporation: Traded more easily, sometimes on exchange

Voting Rights

- Partnership: Partners have control
- Corporation: Each share gives a voting right

Taxation

- Partnership: Profits taxed at personal tax rate
- Corporation: Profits taxed at corporate tax rate

Reinvestment and Dividend Payout

- Partnership: All profits allocated to partners
- Corporation: Total freedom in dividend decisions

Liability

- Partnership: General Partners have unlimited liability
- Corporation: Shareholders have limited liability

Continuity of Existence

- Partnership: Limited life
- Corporation: Unlimited life

Bank-Based Versus Market-Based Financial Systems

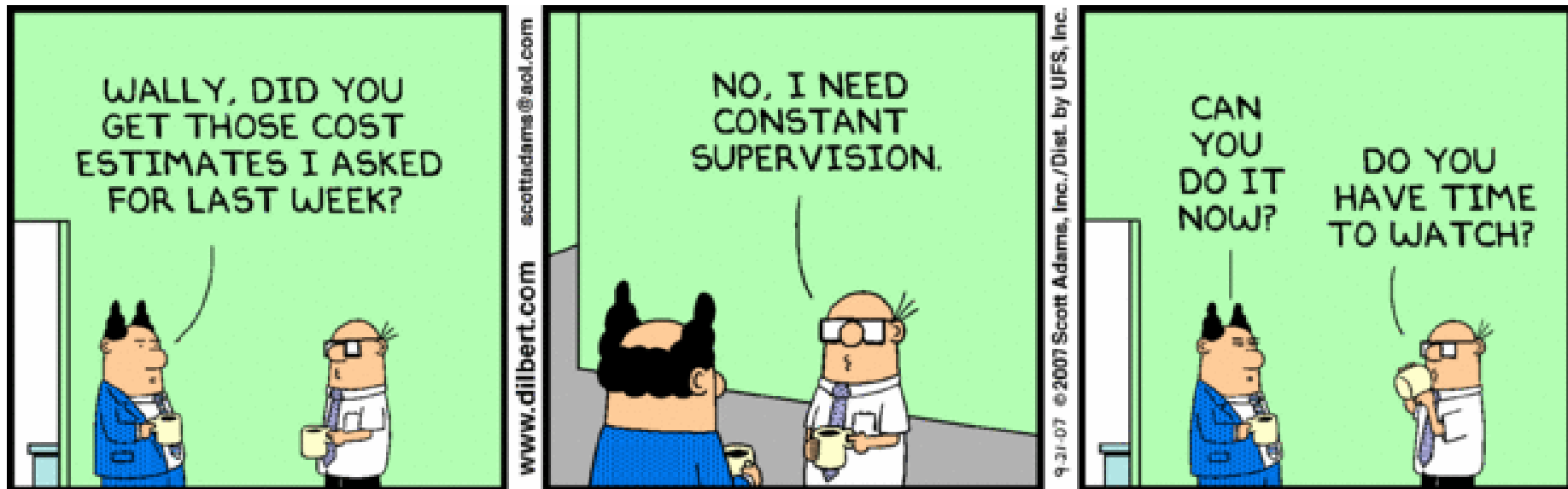
Bank Based Systems

- Banks are central to the process of moving funds between demanders and suppliers of capital
- More active monitoring
- Germany and Japan are examples

Market Based Systems

- Securities markets are as important and can be significantly more important
- External market discipline
- US and UK are examples

The Agency Problem



- If someone (the principal) hires someone else (the agent) to do something, the latter might pursue his or her own goals
- There might be a conflict between these goals and those of the principal
- Thus, the principal has to make sure that the agent only acts in the principal's best interest

The Agency Problem

- Typical agency relationships:
 - Relationship between management and shareholders
 - Relationship between large shareholders and minority shareholders
 - Relationship between shareholders and debtholders

The Agency Problem



- How can we make sure that managers act in the interests of shareholders?
 - Align management's incentives with shareholders' goals (e.g., management compensation)
 - Exercise control (e.g., vote at the AGM)

⇒ Agency Theory

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