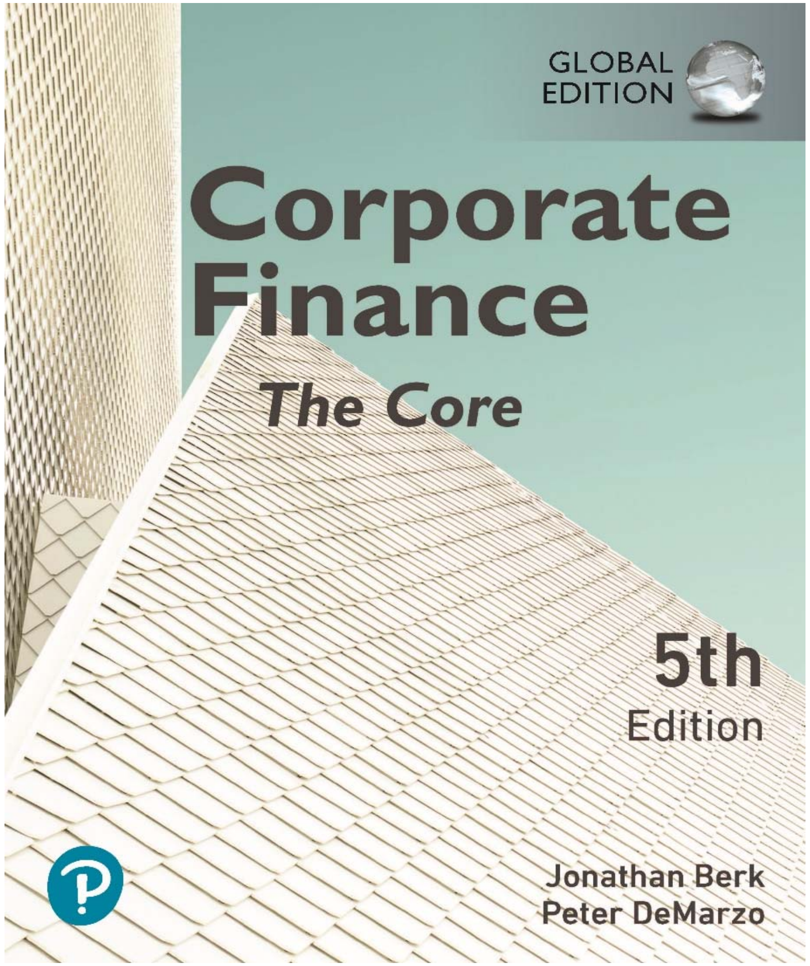
Corporate Finance: The Core

Fifth Edition, Global Edition



Chapter 1

The Corporation and Financial Markets

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Chapter Outline

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Learning Objectives (1 of 3)

- List and define the four major types of firms in the United States; describe major characteristics of each type, including the means for distributing income to owners.
- Distinguish between limited and unlimited liability, and list firm types that are subject to each type of liability.
- Describe the taxation consequences for C and S corporate forms.

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Learning Objectives (2 of 3)

- Discuss the division of corporate ownership into shares of stock; evaluate the implications of that division for corporate decision making.
- Explain how corporate bankruptcy can be viewed as a change in firm ownership.
- Compare and contrast the characteristics of shares that are publicly traded and those that are not.

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Learning Objectives (3 of 3)

- Describe the major changes that stock markets have gone through in the last decade.
- Differentiate between trading on an exchange and trading in a dark pool.
- Describe the impact of various types of Fintech, such as telecommunications, security, automation, and big data on the field of finance.

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1.1 The Four Types of Firms

- Sole Proprietorship
- Partnership
- Limited Liability Company
- Corporation

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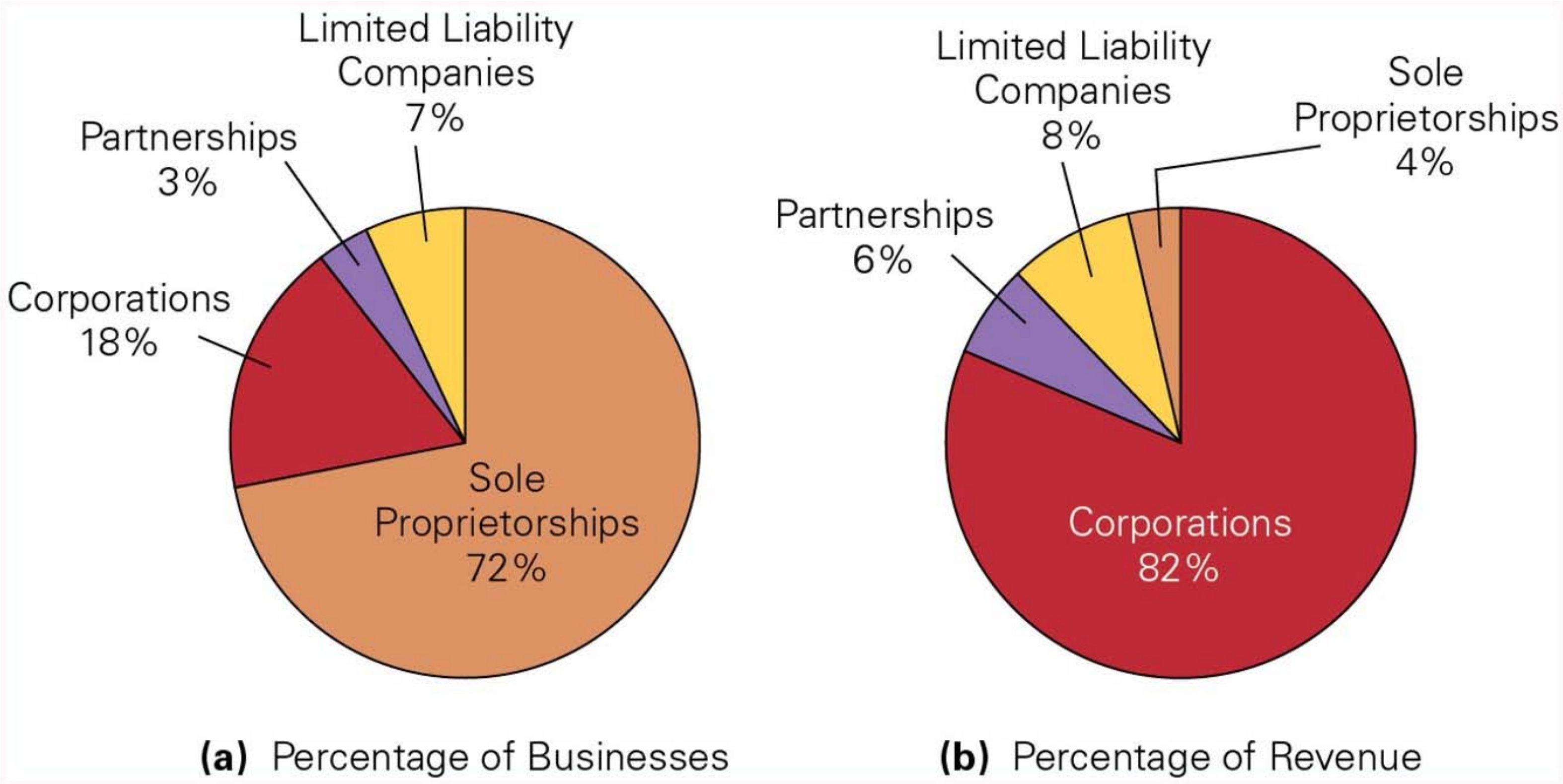
Figure 1.1 Types of U.S. Firms



Source: www.irs.gov

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Sole Proprietorship

- Business is owned and run by one person.
- Typically has few, if any, employees.
- Advantage
  - Easy to create
- Disadvantages
  - No separation between the firm and the owner
  - Unlimited personal liability
  - Limited life

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Partnership (1 of 2)

- Similar to a sole proprietorship, but with more than one owner
- All partners are personally liable for all of the firm's debts. A lender can require any partner to repay all of the firm's outstanding debts.
- The partnership ends with the death or withdrawal of any single partner.

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Partnership (2 of 2)

- Limited Partnership has two types of owners.
  - General Partners
    - Have the same rights and liability as partners in a "regular" partnership
    - Typically run the firm on a day-to-day basis
  - Limited Partners
    - Have limited liability and cannot lose more than their initial investment
    - Have no management authority and cannot legally be involved in the managerial decision making for the business

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Limited Liability Companies (LLC)

- All owners have limited liability, but they can also run the business.
- Relatively new business form in the United States

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Corporation (1 of 3)

- A legal entity separate from its owners
  - Has many of the legal powers individuals have such as the ability to enter into contracts, own assets, and borrow money.
  - The corporation is solely responsible for its own obligations. Its owners are not liable for any obligation the corporation enters into.

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Corporation (2 of 3)

- Formation
  - Corporations must be legally formed. The corporation files a charter with the state it wishes to incorporate in. The state then "charters" the corporation, formally giving its consent to the incorporation.
  - Due to its attractive legal environment for corporations, Delaware is a popular choice for incorporation.

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Corporation (3 of 3)

- Ownership
  - Represented by shares of stock
  - Owner of stock is called
    - Shareholder
    - Stockholder
    - Equity Holder
  - Sum of all ownership value is called equity.
  - There is no limit to the number of shareholders and, thus, the amount of funds a company can raise by selling stock.
  - Owner is entitled to dividend payments.

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Tax Implications for Corporate Entities

- Tax Implications
  - Double Taxation
- "S" Corporations
  - Firm's profits are not subject to corporate income tax, but instead are allocated directly to the shareholders.

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Textbook Example 1.1 (1 of 2)

Taxation of Corporate Earnings

Problem

You are a shareholder in a corporation. The corporation earns $8 per share before taxes. After it has paid taxes, it will distribute the rest of its earnings to you as a dividend.

The dividend is income to you, so you will then pay taxes on these earnings. The corporate tax rate is 25% and your tax rate on dividend income is 20%. How much of the earnings remains after all taxes are paid?

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Textbook Example 1.1 (2 of 2)

Solution

First, the corporation pays taxes. It earned \$8 per share, but must pay $0.25 \times \$8 = \$2$ to the government in corporate taxes. That leaves \$6 to distribute. However, you must pay $0.20 \times \$6 = \$1.20$ in income taxes on this amount, leaving $\$6 - \$1.20 = \$4.80$ per share after all taxes are paid. As a shareholder you only end up with \$4.80 of the original \$8 in earnings; the remaining $\$2 + \$1.20 = \$3.20$ is paid as taxes. Thus, your total effective tax rate is $3.20/8 = 40\%$.

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1.2 Ownership Versus Control of Corporations

- Corporate Management Team
  - In a corporation, ownership and direct control are typically separate.
  - Board of Directors
    - Elected by shareholders
    - Have ultimate decision-making authority
  - Chief Executive Officer (CEO)
    - Board typically delegates day-to-day decision making to CEO.

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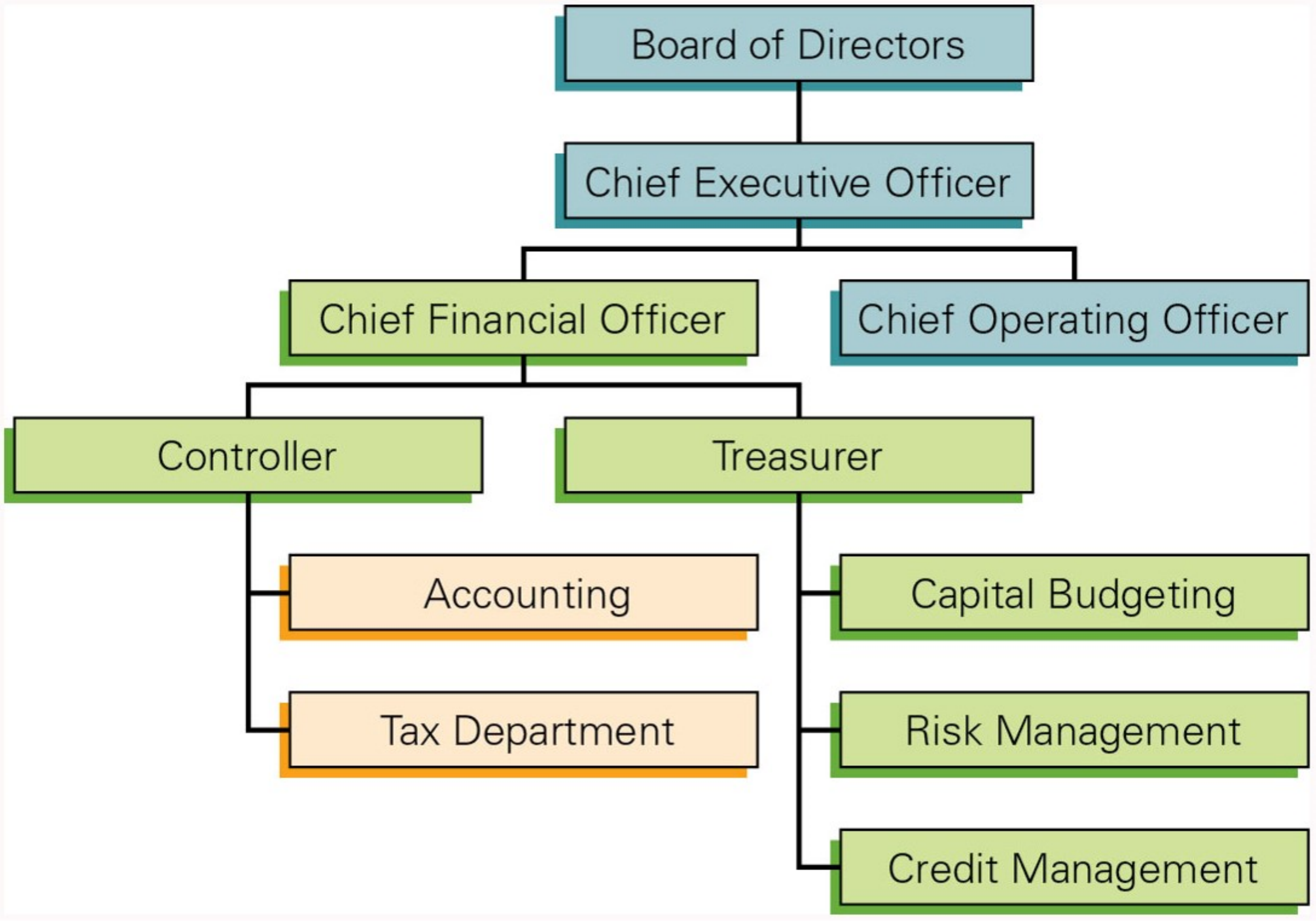
Figure 1.2 Organizational Chart of a Typical Corporation



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Financial Manager

- Responsible for
  - Investment Decisions
  - Financing Decisions
  - Cash Management

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Goal of the Firm

- Shareholders will agree that they are better off if management makes decisions that maximize the value of their shares.

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The Firm and Society

- Often, a corporation's decisions that increase the value of the firm's equity benefit society as a whole.
- As long as nobody else is made worse off by a corporation's decisions, increasing the value of the firm's equity is good for society.
- It becomes a problem when increasing the value of the firm's equity comes at the expense of others.

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Ethics and Incentives Within Corporations (1 of 3)

- Agency Problems
  - Managers may act in their own interest rather than in the best interest of the shareholders.
  - One potential solution is to tie management's compensation to firm performance.
  - How should performance be measured?

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Ethics and Incentives Within Corporations (2 of 3)

- CEO Performance
  - If a CEO is performing poorly, shareholders can express their dissatisfaction by selling their shares. This selling pressure will drive the stock price down.
  - Hostile Takeover
    - Low stock prices may entice a Corporate Raider to buy enough stock so they have enough control to replace current management. The stock price will rise after the new management team “fixes” the company.

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Ethics and Incentives Within Corporations (3 of 3)

- Corporate Bankruptcy
  - Reorganization
  - Liquidation

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1.3 The Stock Market (1 of 2)

- The stock market provides liquidity to shareholders.
  - Liquidity
    - The ability to easily sell an asset for close to the price at which you can currently buy it

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1.3 The Stock Market (2 of 2)

- Public Company
  - Stock is traded by the public on a stock exchange.
- Private Company
  - Stock may be traded privately.

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Primary and Secondary Stock Markets

- Primary Markets
  - When a corporation itself issues new shares of stock and sells them to investors, they do so on the primary market.
- Secondary Markets
  - After the initial transaction in the primary market, the shares continue to trade in a secondary market between investors.

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Traditional Trading Venues

- New York Stock Exchange (NYSE)
  - Market Makers/Specialists
    - Each stock has only one market maker.
- NASDAQ
  - Does not meet in a physical location
  - May have many market makers for a single stock
- Bid Price Versus Ask Price
  - Bid-Ask Spread
    - Transaction cost

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New Competition and Market Changes (1 of 2)

- In 2005, the NYSE and NASDAQ exchanges accounted for over 75% of all trade in U.S. stocks.
- Today, due to increased competition from new fully electronic exchanges and alternative trading systems, handle more than 50% of all trades.

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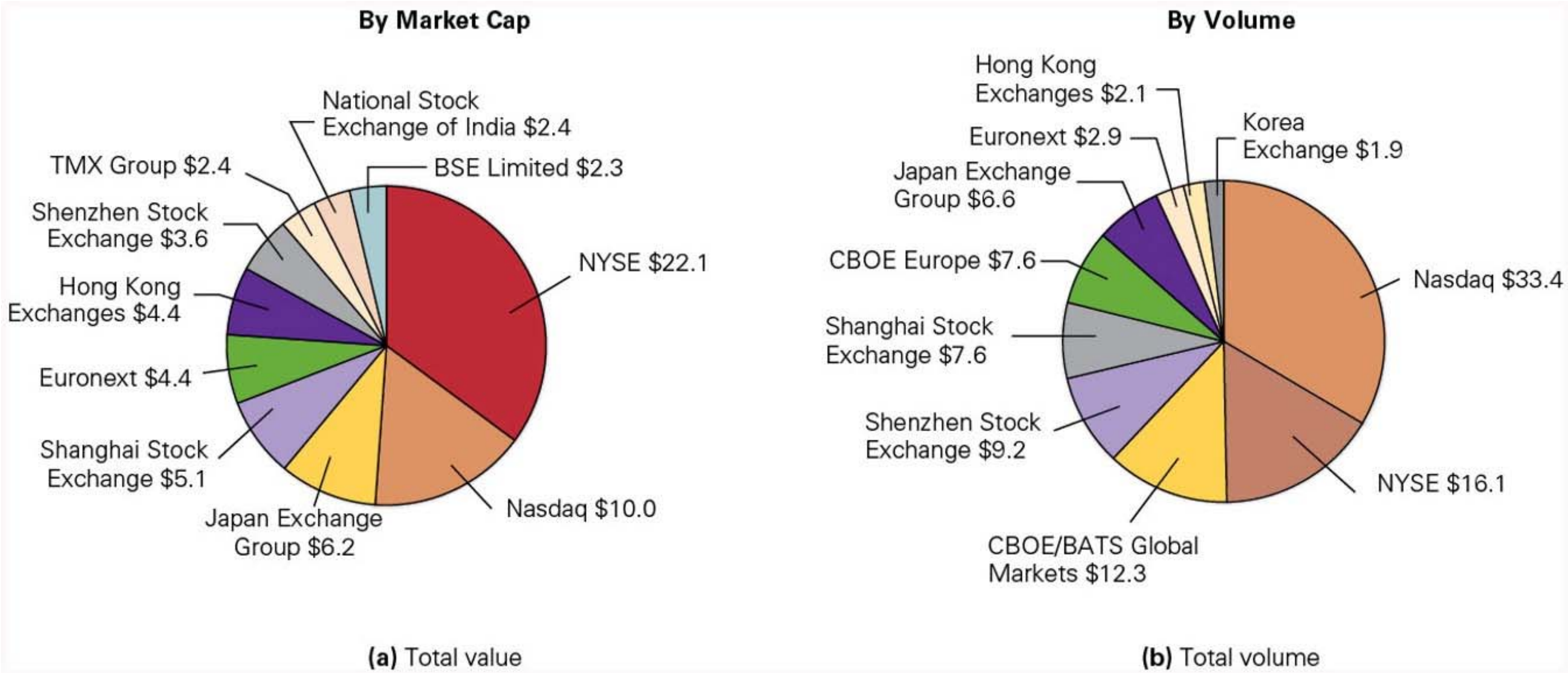
Figure 1.3 Worldwide Stock Exchanges Ranked by Two Common Measures



Source: www.world-exchanges.org

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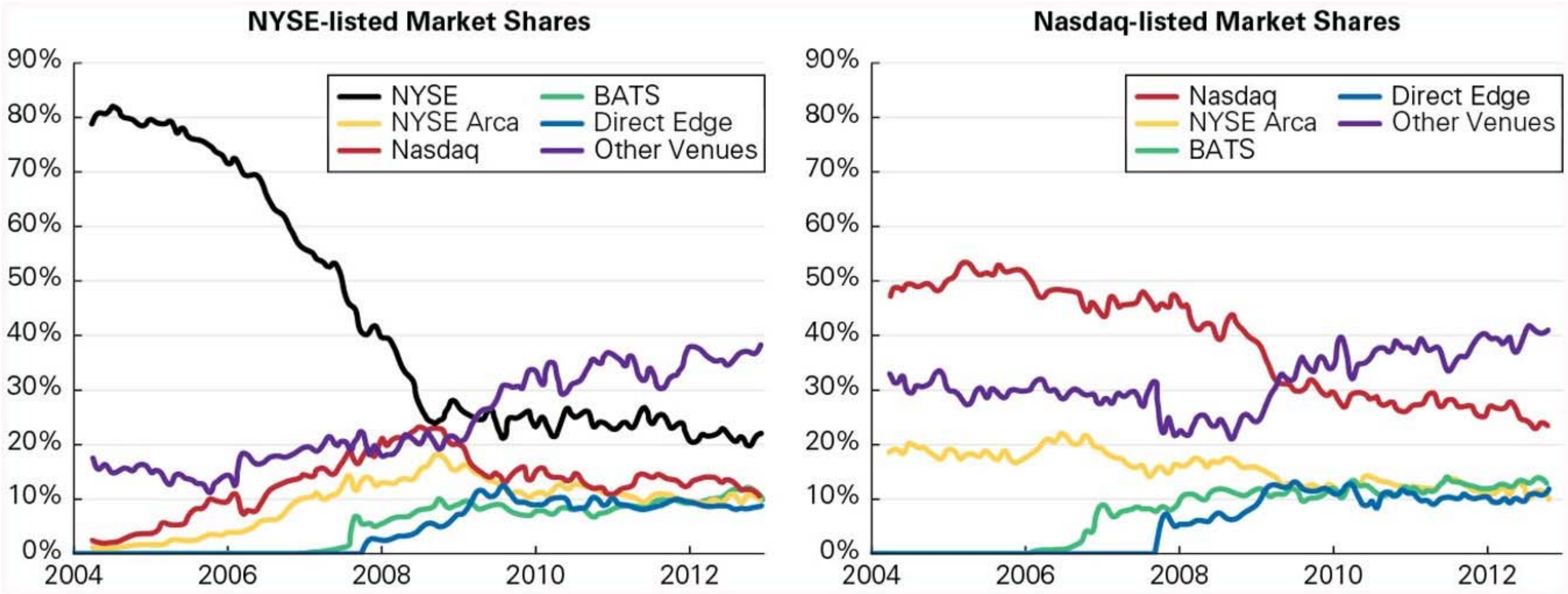
Figure 1.4 NYSE and NASDAQ Market Share



Source: J. Angel, L. Harris, and C. Spatt, "Equity Trading in the 21st Century: An Update," **Quarterly Journal of Finance** 5 (2015): 1–39.

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New Competition and Market Changes (2 of 2)

- New Competition and Market Changes
  - Limit Order
    - An order to buy or sell a set amount at a fixed price
  - Limit Order Book
    - The collection of all limit orders
  - Market Orders
    - Orders that trade immediately at the best outstanding limit order
  - High Frequency Traders (HFTs)
    - A class of traders who, with the aid of computers, execute trades many times per second in response to new information

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Dark Pools

- With exchange trading, the limit book orders are public, allowing investors to trade at the current bid or ask price, and transactions are visible to all traders when they occur.
- Dark pools do not make their limit order books visible.
- Instead, they offer investors the ability to trade at a better price with the tradeoff being that their order might not be filled if an excess of either buy or sell orders is received.

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1.4 Fintech: Finance and Technology

- Fintech refers to the relation between financial innovation and technical innovation.

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Telecommunications

- Because the same financial securities are often traded on markets that are physically far apart, finance professionals have always been amongst the first adopters of improved communication technologies.

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Security and Verification

- Blockchain
  - A technology that allows a transaction to be recorded in a publicly verifiable way without the need for a trusted third party to certify the authenticity of the transaction
- Cryptocurrency
  - A currency whose creation and ownership is determined via a public blockchain

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Automation of Banking Services

- Robo-Advisors
  - Computer programs that are intended to replace the work of financial advisors by providing detailed and customized investment recommendations

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Big Data and Machine Learning

- Financial organizations have long recognized the importance of collecting data and using it in decision making.
- The availability of data has enabled companies throughout the economy to better target their products to consumers, and financial services companies are no exception.

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Competition

- Technological advances have opened the way for non-finance organizations to provide financial services.

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