CHAPTER

1

Introduction to Corporate Finance

McGraw-Hill/Irwin

Key Concepts and Skills

- Know the basic types of financial management decisions and the role of the Financial Manager
- Know the financial implications of the various forms of business organization
- Know the goal of financial management
- Understand the conflicts of interest that can arise between owners and managers
- Understand the various types of financial markets and various regulations

Chapter Outline

1.1 What is Corporate Finance?

1.2 The Corporate Firm

1.3 The Importance of Cash Flows

1.4 The Goal of Financial Management

1.5 The Agency Problem and Control of the Corporation

1.6 Financial Markets and Regulations

1.1 What is Corporate Finance?

Corporate Finance addresses the following three questions:

1. What long-term investments should the firm choose? (Investment or Capital Budgeting Decision)
2. How should the firm raise funds for the selected investments? (Financing or Capital Structure Decision)
3. How should short-term assets be managed and financed? (Operating or NWC Investment Decision)

Balance Sheet Model of the Firm

Total Value of Assets:

Current Assets

Fixed Assets

1 Tangible

2 Intangible

Total Firm Value to Investors:

Current Liabilities

Long-Term Debt

Shareholders' Equity

The Capital Budgeting Decision

Current Assets

Fixed Assets

1 Tangible

2 Intangible

What long-term investments should the firm choose?

Current Liabilities

Long-Term Debt

Shareholders' Equity

The Capital Structure Decision

Current Assets

Fixed Assets

1 Tangible

2 Intangible

How should the firm raise funds for the selected investments?

Current Liabilities

Long-Term Debt

Shareholders' Equity

Short-Term Asset Management

Current Assets

Net Working Capital

Current Liabilities

Long-Term Debt

Fixed Assets

1 Tangible

2 Intangible

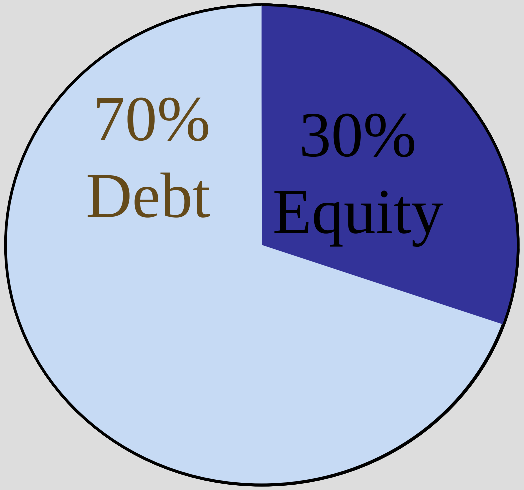
How should short-term assets be managed and financed?

Shareholders' Equity

Capital Structure

The value of the firm can be thought of as a pie.

The goal of the manager is to increase the size of the pie, mainly through the investment decision.
The Capital Structure decision can be viewed as how best to slice the pie.



If how you slice the pie affects the size of the pie, then the capital structure decision matters.

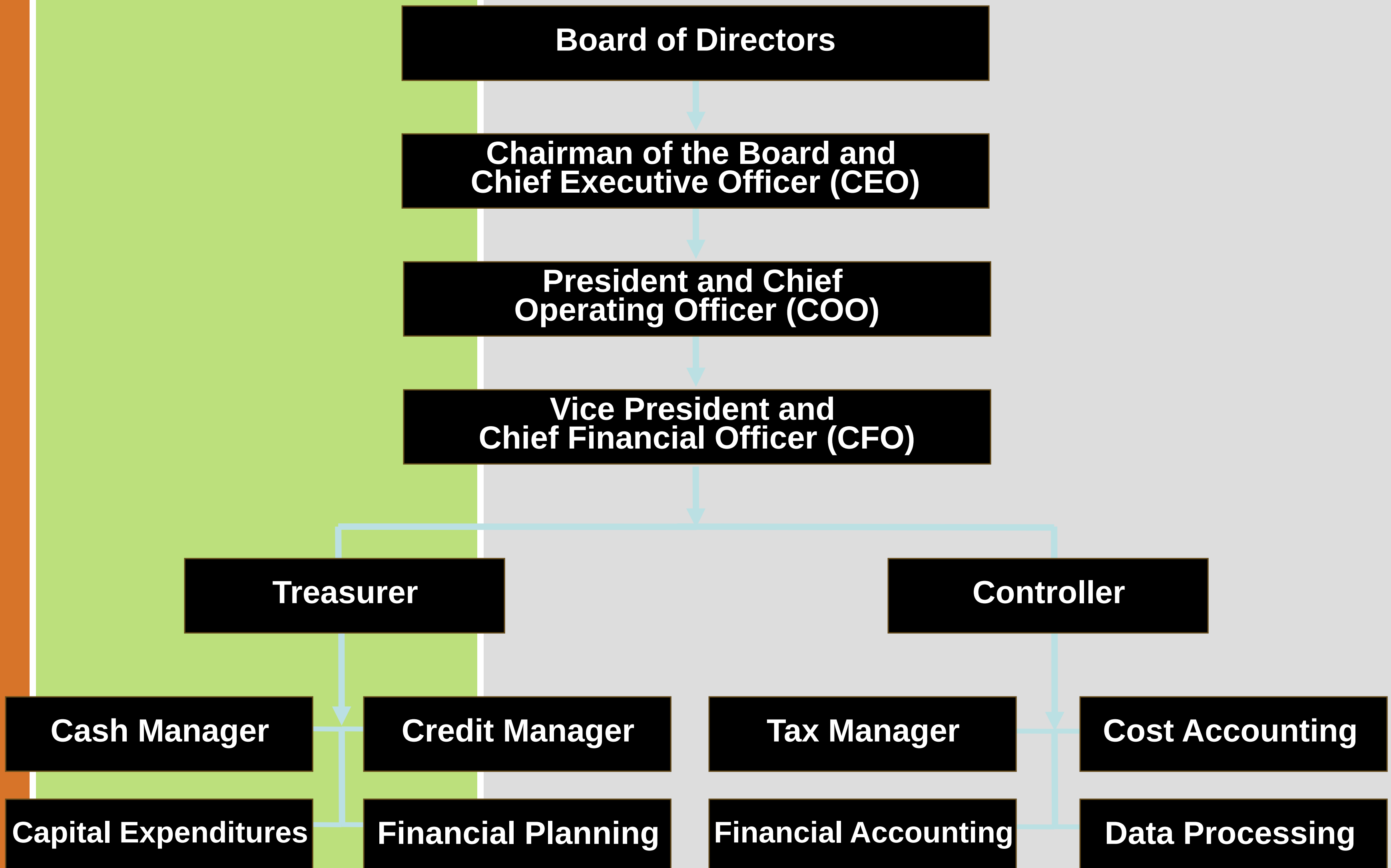
The Financial Manager

The Financial Manager's primary goal is to increase the value of the firm by:

1. Selecting value creating projects
   -- Buy assets that generate more cash than they cost
2. Making smart financing decisions
   -- Sell financial instruments (e.g., bonds and stocks) that raise more cash than they cost

Smart financial decisions are ones that generate more cash than what they cost!

Hypothetical Organization Chart



1.2 The Corporate Firm

- The corporate form of business is the standard method for solving the problems encountered in raising large amounts of cash.
  - Corporation is a legal entity
    - Assets are what a corporation owns
    - Liabilities and Equity are what a corporation owes

However, businesses can take other forms.

- Sole Proprietorship and Partnership.

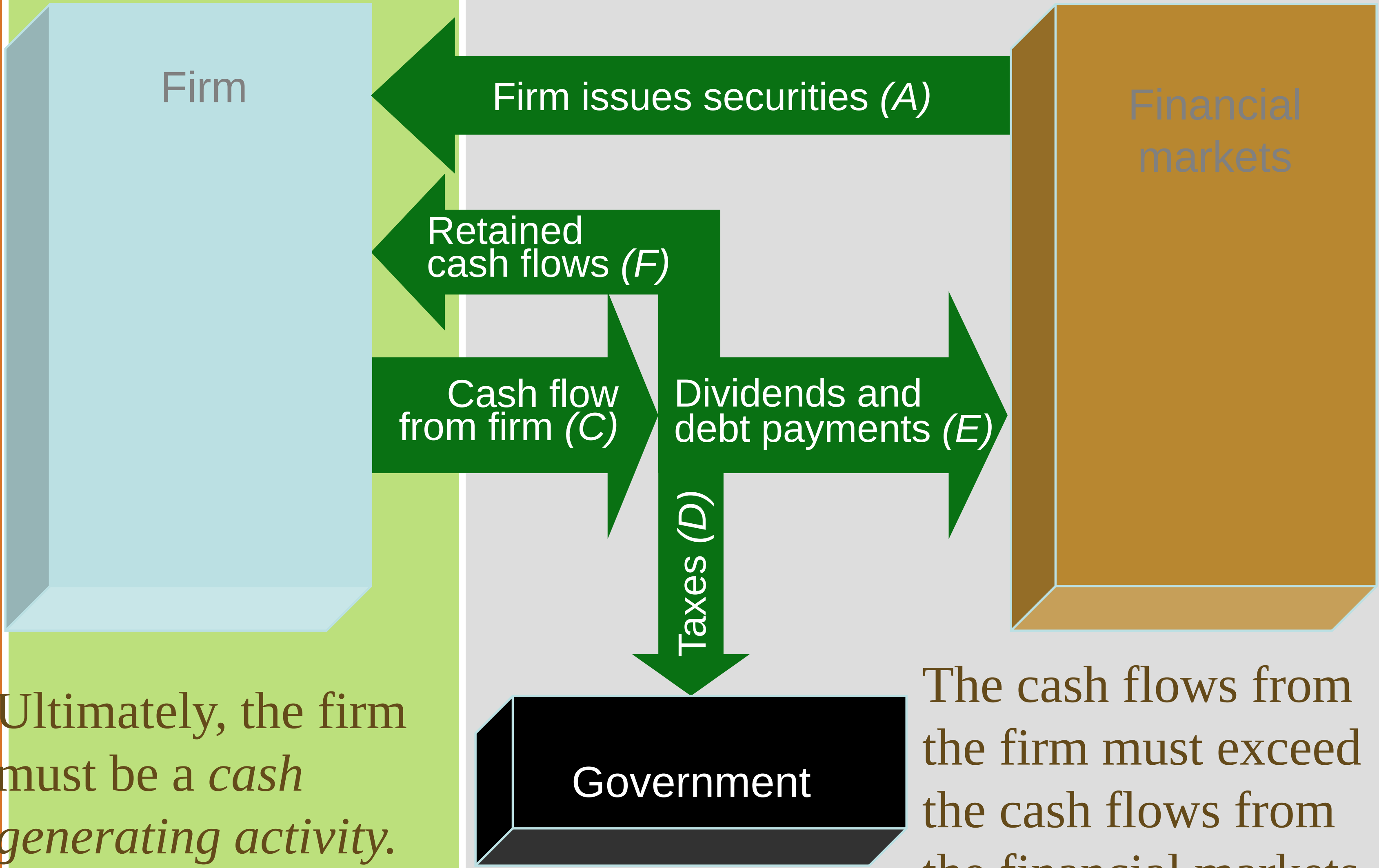
Forms of Business Organization

- The Sole Proprietorship
- The Partnership
  - General Partnership
  - Limited Partnership
- The Corporation
- Advantages and Disadvantages
  - Liquidity and Marketability of Ownership
  - Control
  - Liability
  - Continuity of Existence
  - Tax Considerations
  - Costs of Going Public and Compliance

A Comparison

	Corporation	Partnership
Liquidity	Shares can be easily exchanged	Subject to substantial restrictions
Voting Rights	Usually each share gets one vote	General Partner is in charge; limited partners may have some voting rights
Taxation	Double, i.e., both corporate and personal income taxes	Partners pay personal income taxes on distributions
Reinvestment and dividend payout	Broad latitude	All net cash flows are distributed to partners
Liability	Limited liability	General partners have unlimited liability; limited partners enjoy limited liability
Continuity	Perpetual life	Limited life

1.3 Importance of Cash Flows



Ultimately, the firm must be a *cash generating activity.*

The cash flows from the firm must exceed the cash flows from the financial markets.

1.4 The Goal of Financial Management

- What is the correct goal?
  - Maximize profit?
  - Minimize costs?
  - Maximize market share?

  - **Maximize Long-Term Firm Value!**
    - Equivalently, shareholder wealth maximization and stock value maximization.
    - 3 aspects of after-tax cash flows that determine firm value:
      - Size/Amount – larger, better!
      - Timing – sooner, better!
      - Riskiness –safer, better!

Jensen (JACF 2001) - Highlight

Concern/Issue –

-- Why do we focus on the interests of shareholders but not those of other stakeholders? Why don't we try to satisfy the interests of all stakeholders as our objective?

-- Need to have a single-valued objective that drives decision making and supports an independent measure of performance.

Expanded/Enlightened Long-Term Firm Value Maximization Objective (esp. w/ dispersed ownership)

-- Value creation as the criterion for making required tradeoffs among stakeholders while considering their interests in decision making, i.e., a pro-stakeholder approach.

-- Maximizing firm value by producing products/services that generate more value (and benefits) to the society than what is put into the production.

1.5 The Agency Problem

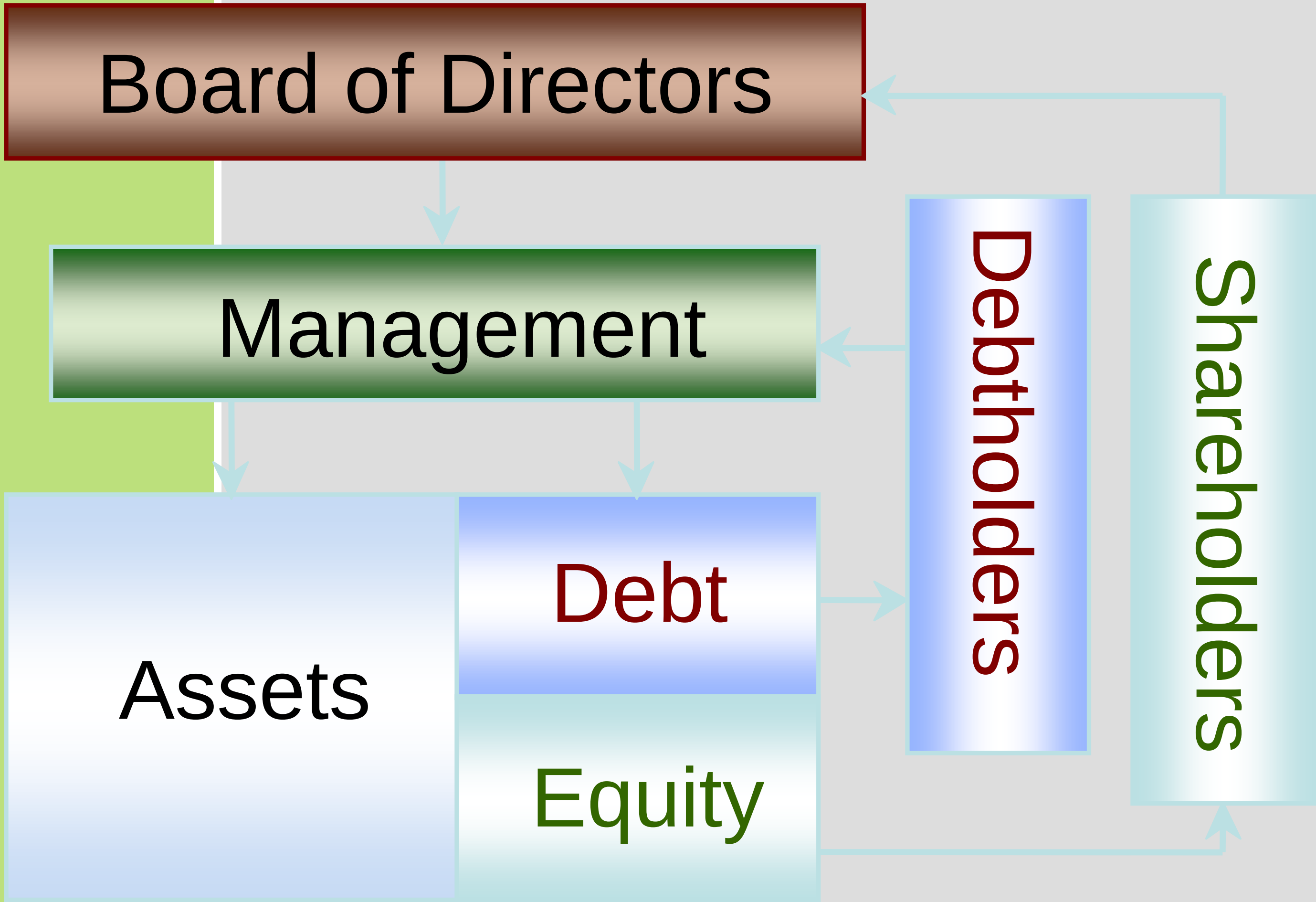
- The firm can be viewed as a set of contracts, and one of them is between stockholders and managers.
- Agency relationship
  - Stockholders (principals) hire managers (agents) to represent his/her interest in running the company
- Agency problem (key condition)
  - Conflict of interests between principal and agent
- Agency costs
  - The costs of devising incentive compatible contracts and monitoring the behaviors of managers

Managerial Goals

- Managerial goals may be different from shareholder goals, i.e., conflict of interests
  - Expensive perquisites
  - Survival
  - Independence
- Increased growth and size are not necessarily equivalent to increased shareholder wealth

Separation of Ownership and Control

•



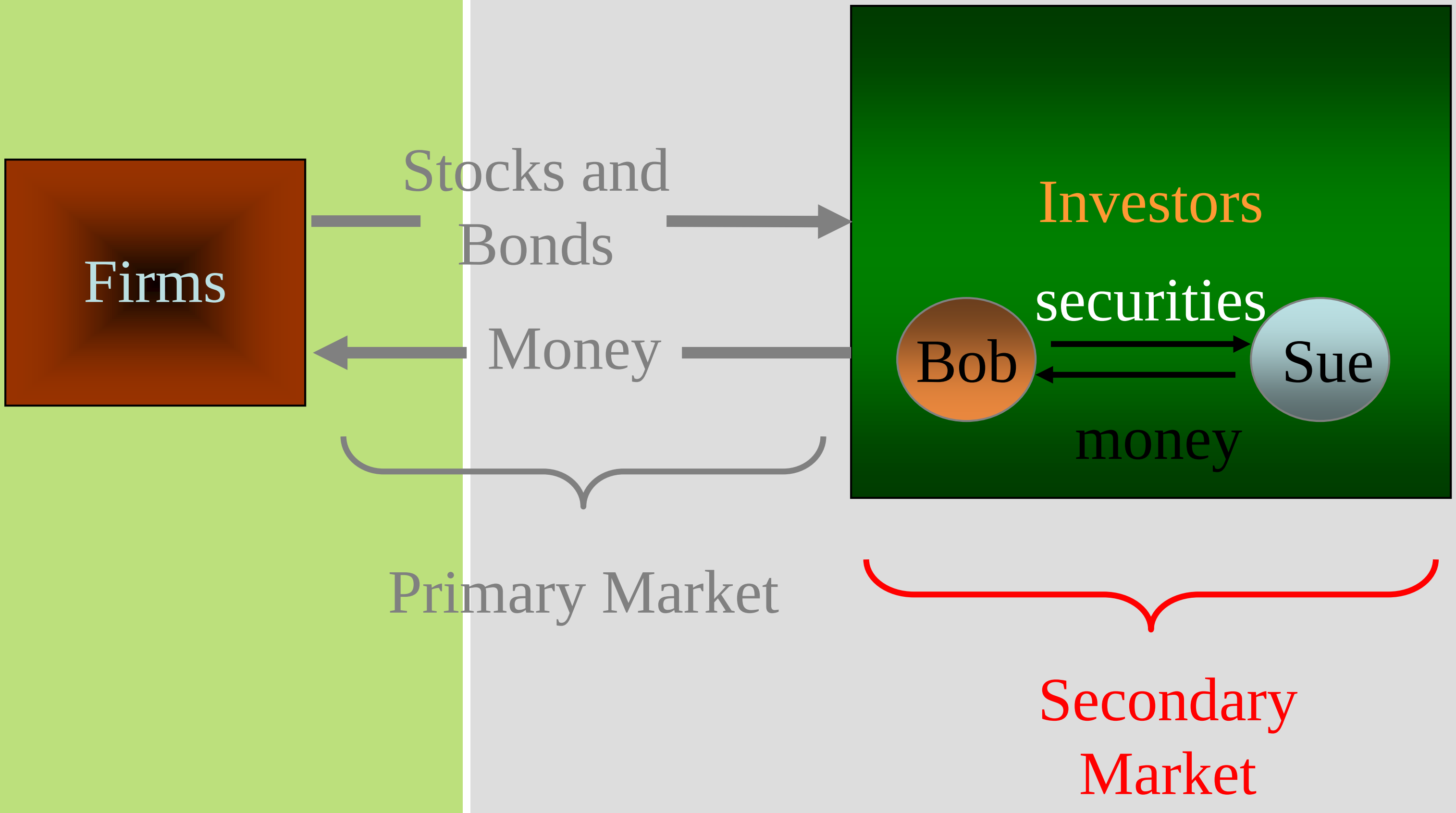
Managing Managers

- Managerial compensation
  - Incentives can be used to align management and stockholder interests
  - The incentives need to be structured carefully to make sure that they achieve their intended goal
- Corporate control (Capital market discipline)
  - The threat of a takeover may result in better management
- Human capital market discipline
  - The threat of being fired and the associated negative impact on human capital
- Other stakeholders
  - Customers, employees, suppliers, community, government, etc.

1.6 Financial Markets and Regulations

- Primary Market
  - Issuance of a security for the first time
- Secondary Markets
  - Buying and selling of previously issued securities
  - Securities may be traded in either a dealer or auction market
    - NYSE
    - NASDAQ

Financial Markets



Regulations

- The Securities Act of 1933 and the Securities Exchange Act of 1934
  - Issuance of Securities (1933)
  - Creation of SEC and reporting requirements (1934)
- Sarbanes-Oxley (“Sarbox”/SOX; 2002/2004)
  - Increased reporting requirements and responsibility of corporate directors
- Financial Regulatory Reform (2010)
  - Expand the scope of federal banking and securities regulations to a broad category of segments in financial markets and system.

Quick Quiz

- What are the three basic questions Financial Managers must answer?
- What are the three major forms of business organization?
- What is the goal of financial management?
- What are agency problems, and why do they exist within a corporation?
- What is the difference between a primary market and a secondary market?
- What major regulations impact public firms?