

Corporate Finance

Introduction to Corporate Finance

Chapter 1

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- Some important questions:
 - What long-term investments should the firm take on?
 - Where will the firm get long-term financing to pay for the investments?
 - How will the firm manage everyday financial activities of the firm?
- Financial managers try to answer some, or all, of these questions.
- The top financial manager is usually the Chief Financial Officer (CFO).
 - *Treasurer* oversees cash management, credit management, capital expenditures, and financial planning;
 - *Controller* oversees taxes, cost accounting, financial accounting, and data processing.

Corporate Organisation Chart

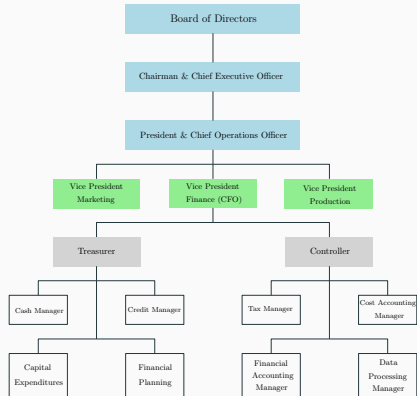


Figure 1: A Simplified Organisational Chart

Financial Management Decisions

- Capital Budgeting
 - What long-term investments or projects should the business take on?
- Capital Structure
 - How should we pay for our assets?
 - Should we use debt or equity?
- Working Capital Management
 - How do we manage the day-to-day finances of the firm?

Forms of Business Organization

- Three major forms:
 - Sole Proprietorship
 - Partnership
 - General;
 - Limited.
 - Corporation
 - S Corporation (S Subchapter);
 - Limited Liability Company.

- A legal “person” distinct from owners and a resident of a state.
- Advantages
 - Limited liability;
 - Unlimited life;
 - Separation of ownership and management;
 - Transfer of ownership is easy;
 - Easier to raise capital.
- Disadvantages
 - Agency problem;
 - Double taxation.

International Corporate Forms

- All of the following forms feature public ownership and limited liability:

Company	Country	Type of Company
BMW	Germany	<i>Corporation</i>
Shell UK Ltd.	United Kingdom	<i>Public Limited Company</i>
Unilever NV	Netherlands	<i>Limited Liability Company</i>
Saab AB	Sweden	<i>Joint Stock Company</i>

Table 1: International Corporations

Goal of Financial Management

- Maximise the current value per share of the company's existing stock;
- Maximise the market value of the existing owners' equity.
- Does this mean we should do anything and everything to maximise owner wealth?
 - Outsourcing?
 - Off-shoring?
 - Enron?
 - Corporate support of charities?

Goal of Financial Management Cont'd

- Why does traditional corporate finance theory focus on maximising stockholder's wealth?
 - Stock price is easily observable and constantly updated;
 - If investors are rational, stock prices reflect the wisdom of decisions, short term and long term, instantaneously.
 - The objective of stock price performance provides some very elegant theory on:
 - Allocating resources across scarce uses;
 - How to finance these investments;
 - How much to pay in dividends.

Stockholders Interests versus Management Interests

- The stockholders have significant control over management. The two mechanisms for disciplining management:
 - The annual meeting;
 - The board of directors.
- Neither mechanisms is effective in disciplining management as theory posits.

- Sarbanes-Oxley Act (2002)
 - Driven by corporate scandals (Enron, Tyco, WorldCom, Adelphia).
 - Intended to strengthen protection against accounting fraud and financial malpractice.
 - Compliance very costly: firms driven to go public (outside the country) or go private (go dark).

The Agency Problem

- Agency Relationship
 - Principal hires an agent to represent its interests;
 - Stockholders (principals) hire managers (agents) to run the company.
- Agency Problem
 - Conflict of interest between principal and agent;
- Management goals and agency costs.

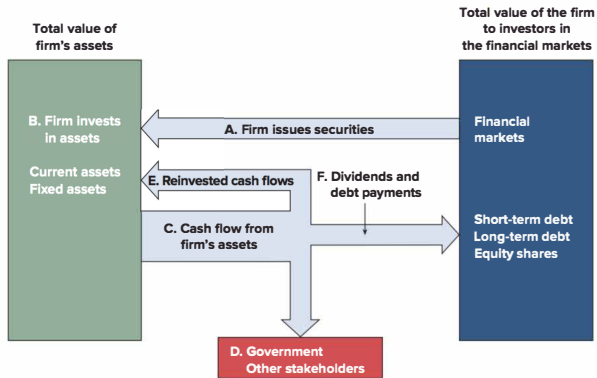
Do Managers Act in the Shareholders' Interests?

- The primary financial goal of management is shareholder wealth maximisation, which translates to maximising stock price.
 - Value of any asset is present value of cash flow stream to owners.
 - Most significant decisions are evaluated in terms of their financial consequences.
 - Stock prices change over time as conditions change and as investors obtain new information about a company's prospects
- Managers recognise that being socially responsible is not inconsistent with maximizing shareholder value.

- Financial markets are efficient.
 - Managers convey information honestly;
 - Financial markets make reasoned judgements of the effects of this information on true value.
- There are some holes in the 'Efficient Markets' assumption.

- Financial markets play important role in corporate finance:
 - Cash flows to the firm.
 - Primary versus secondary markets:
 - Dealer versus auction markets;
 - Listed versus over-the-counter securities (NYSE, NASDAQ)

Cash Flows Between the Firm and the Financial Markets



- A. Firm issues securities to raise cash.
- B. Firm invests in assets.
- C. Firm's operations generate cash flow.
- D. Cash is paid to government as taxes. Other stakeholders may receive cash.
- E. Reinvested cash flows are plowed back into firm.
- F. Cash is paid out to investors in the form of interest and dividends.

Figure 2: Cash Flows Between the Firm and the Financial Markets