Introduction
Finance

- Study of allocation of resources over time
  - Income and expenditure matching
  - Retirement planning
  - Mortgage, car, credit card loans
  - Which stock to buy?
  - How Treasury’s borrowing rate is set?
  - Project financing
  - Purchase vs. Lease
  - Replacing old machines or keep maintenance
Personal Finance

• Among major personal finance questions, besides regular budgeting, are:
  1. Income and expenditure matching
     – How to buy a $100,000 house with $50,000/yr income?
  2. Retirement planning
     – How much should you set aside to live comfortably?
  3. Mortgage loans
     – When to refinance? Which kind of mortgage is best?
  4. Consumer loans
     – How to manage credit card debt?
What is Corporate Finance?

Corporate Finance addresses the following three questions:

1. What **long-term investments** should the firm choose?
   - *Which projects are better suited in long run?*

2. How should the firm **raise funds** for the selected investments?
   - *Would issuing stocks better serves the firm or borrowing?*

3. How should **short-term assets** be managed and financed?
   - *How should cash be held? What trade credit we offer?*
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

What *long-term investments should the firm choose?*
The Capital Structure Decision

How should the firm raise funds for the selected investments?

Current Assets

Fixed Assets
1 Tangible
2 Intangible

Current Liabilities

Long-Term Debt

Shareholders’ Equity
Introduction

Short-Term Asset Management

How should short-term assets be managed and financed?

Current Assets

Net Working Capital

Current Liabilities

Long-Term Debt

Fixed Assets

1 Tangible

2 Intangible

Shareholders’ Equity

Current Assets

Long-Term Debt

Net Working Capital

Shareholders’ Equity
The Goal of Financial Management

• What is the correct goal?
  – Maximize revenues?
  – Maximize profit?
  – Minimize costs?
  – Maximize market share?
  – Maximize shareholder wealth?
Value Maximization

- The optimal goal is to: 
  - \textbf{MAXIMIZE SHAREHOLDER WEALTH}
  - Why?

- As residual claimants, shareholders can only get paid if all other constituents (e.g., suppliers, employees, lenders, government, etc.) are optimally dealt with. Otherwise, there’s nothing left for them to enjoy!
What Constitutes Value?

- The fundamentals of valuation:
  In order to maximize the firm’s value, financial managers then have to strive to:
  1. Maximize cash flows
  2. Minimize risk
  3. Optimize timing
The Firm, Claimants, & Markets

Firm issues securities (A)

Retained cash flows (F)

Cash flow from firm (C)

Dividends and debt payments (E)

Taxes (D)

Government

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

Ultimately, the firm must be a cash generating activity.
The Corporate Firm

- The corporate form of business is the standard method for solving the problems encountered in raising large amounts of cash.
  - Colonial ventures in many European powers like Britain and Holland give rise to the modern corporations where the enterprise can last indefinitely but owners are shielded from daily grind of the managing the business (see Wikipedia).

- However, businesses can take other forms.
Forms of Business Organization

- The Sole Proprietorship
  - Profits is not taxed so long as remained in the business
  - No protection of personal assets if business fails

- The Partnership
  1. General Partnership
  2. Limited Partnership
  - Profits is not taxed so long as remained in the business
  - No protection of personal assets if business fails

- The Corporation
  - Profits are taxed like an individual
  - Personal assets are protected if business fails
## A Comparison

<table>
<thead>
<tr>
<th></th>
<th>Corporation</th>
<th>Partnership</th>
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<tbody>
<tr>
<td><strong>Liquidity</strong></td>
<td>Shares can be easily exchanged</td>
<td>Subject to substantial restrictions</td>
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<tr>
<td><strong>Voting Rights</strong></td>
<td>Usually each share gets one vote</td>
<td>General Partner is in charge; limited partners may have some voting rights</td>
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<tr>
<td><strong>Taxation</strong></td>
<td>Double</td>
<td>Partners pay taxes on distributions</td>
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<tr>
<td><strong>Reinvestment and dividend payout</strong></td>
<td>Broad latitude</td>
<td>All net cash flow is distributed to partners</td>
</tr>
<tr>
<td><strong>Liability</strong></td>
<td>Limited liability</td>
<td>General partners may have unlimited liability; limited partners enjoy limited liability</td>
</tr>
<tr>
<td><strong>Continuity</strong></td>
<td>Perpetual life</td>
<td>Limited life</td>
</tr>
</tbody>
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The Agency Problem

While corporations separate ownership from management, they leave room for problems:

- **Agency relationship**
  - Principal hires an agent to represent his/her interest
  - Stockholders (principals) hire managers (agents) to run the company

- **Agency problem**
  - *Conflict of interest between principal and agent;* manager may desire other objectives than those that best serves the owners
Managerial Goals

• Managerial goals may be different from shareholder goals
  – Expensive perquisites
  – Survival
  – Independence
  – Empire building

• Increased growth and size are not necessarily equivalent to increased shareholder wealth
Managing Managers

• Managerial compensation
  – Incentives can be used to align management and stockholder interests
    • One reason why stock options and stock grants are given
  – The incentives need to be structured carefully to make sure that they achieve their intended goal

• Corporate control
  – The threat of a takeover may result in better management (e.g., leveraged buyouts LBOs, tender offers, hostile takeovers, etc.)
    • One reason why private equity supposedly performs better

• Other stakeholders
Financial Markets

• Primary Market
  – Issuance of a security directly to markets
    • Public or private bond offerings for debt capital
    • Initial Public Offerings (IPOs) and Secondary Equity Offerings (SEO) for equity capital

• Secondary Markets
  – Buying and selling of previously issued securities
  – Securities may be traded in either a dealer or auction market
    • NYSE, NASDAQ & other exchanges and marketplaces
Financial Markets

- Firms
- Investors
- Primary Market
- Secondary Market
- Money
- Stocks and Bonds
- Investors securities
- Sue
- Bob
- Money