Introduction to Corporate Finance

Lecture Objectives

- This lecture will provide an introduction to corporate finance.
- Explain where career opportunities are found within the three interrelated areas of finance.
- Identify some of the forces that will affect financial management in the future.
- Briefly explain the responsibilities of the financial staff within an organization.
- State the primary goal in a publicly traded firm, and explain where social responsibility and business ethics fit in.
- Define an agency relationship, give some examples of potential agency problems, and identify any possible solutions.
- Identify major factors that determine the price of a company's stock, including those which managers have control over and those which they do not.

What is Finance?

Finance is the art and science of managing financial and real assets.

The processes, institutions, markets, and instruments involved in the transfer of money between individuals, businesses, and governments form the foundation of the study of finance.

Career Opportunities in Finance

There are three areas of the opportunity for finance graduates.

Financial Institutions

Banks, Insurance Companies, Mutual Funds, and Investment Banks

The following skills are important:

- Valuation techniques
- Interest rate models
- Regulations
- Types of financial instruments
- General business administration
- Communications

A common entry-level position is bank officer trainee.
This include learning teller operations
Cash management operations
Making loans
May become a branch manager or a specialist in one of many areas.

Investments

Often starting in brokerage houses in

Sales
Security Analyst
Financial Planning

Others work in banks, mutual funds, insurance companies, or financial consulting firms.

The main functions are sales, security analysis, and management of investment portfolios

Financial Management

This is the largest area of the 3 with opportunities in financial institutions, industrial and retail firms. Also, there are opportunities in government and non-profit organizations.

Responsibilities include deciding credit terms level of inventory level of cash merger and acquisition analysis and dividend policy.

Capital Budgeting
Investment Analysis
Financial Forecasting and Planning
Cash Management
Credit Administration
Funds Procurement
Financial Risk Management

Regardless of which area of finance majors enter into, he or she will need knowledge of all three.

Modern Corporate Finance

In the early 1900s Financial Management emphasized the legal aspects of mergers, the formation of new firms, and the various types of Securities that firms could issue to raise capital. In the 1930s the emphasis shifted to bankruptcy and reorganization, to corporate liquidity, and to the regulation of security markets. During the 1940s and early 1950s finance continued to be taught as a descriptive, institutional subject, viewed more from the standpoint of an outsider rather than
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and from that of management. However, a movement toward theoretical analysis began during the late 1950s, and the focus shifted to managerial decisions regarding the choice of assets and liability so as to maximize the value of the firm.

Every Firm must answer three questions

♦ What long-term investments should we make?
♦ Where will we get the financing to pay for the investment?
♦ How will we manage our everyday financial activities?

Corporate finance, broadly speaking is the study of ways to answer these three questions.

We will examine these issues over the semester.

Importance of Financial Management

Old Way

Marketing forecast product sales
Engineering and production staff would determine the required assets.
Financial managers would raise the required capital.

New Way

Now the process is much more coordinated. Financial managers usually head up this effort. It is much more important to coordinate decisions.

The Financial Manager's Responsibilities

1. Forecasting And Planning

   The financial manager must work with others as the organization looks ahead. Financial managers assure all participants are using the same assumptions on common inputs.

2. Major Investment And Financing Decisions

   Financial managers determine the optimal sales growth rate, what assets to buy, and how to finance the investments (debt (long or short-term) or equity). Dividend policy is determined by the investment opportunities of the firm.

3. Coordination And Control

   Financial managers ensure efficient operations. All business decisions have financial implications which need to be considered.

4. Dealing With The Financial Markets

   Financial managers interact with capital markets.
5. Risk Management

All businesses face risks: floods, fires, and other natural disasters, commodity price, equity price, interest rate, and foreign exchange risks. The financial manager is responsible for identifying the relevant risks and how to manage the firm's exposure.

Finance in the Organizational Structure of the Firm

How are large corporations structured?

In general, the owners are not directly involved in making business decisions. The owners hire managers to represent the owners’ interests and make decisions on their behalf.

The financial manager would be in charge of answering the three questions raised earlier. The top financial manager is the CFO or VP of Finance.

CFO or VP of Finance reports to the President or CEO.

Treasurer

Capital Budgeting

The process of planning and managing a firm’s long-term investments. The financial analysts in the Treasury department identify positive NPV projects. Some projects depend on the firm’s business, others do not.

Capital structure decisions

A firm’s capital structure refers to the proportion of debt and equity the firm uses to finance its operations. There are two concerns:

How much should the firm borrow? or What combination of debt and equity is best? This will affect the value and risk of the firm.

What are the least expensive sources of funds for the firm?

Firms have much flexibility in choosing a capital structure. Whether one capital structure is better than another is the heart of the capital structure issue.

Financial managers must decide where and how to raise the needed funds. They must consider the expenses.

There are a wide variety of lenders and ways to structure the instruments.

Raising capital

Corporate Pension Plans

Risk Management

Working Capital Management

The management of the firm’s short-term assets and liabilities

Short-term assets:   Cash
Marketable Securities
Inventory
Short-term Liabilities: A/P
Notes payable
Accruals

Issues:
How much cash and inventory should we have on hand?
How should we obtain short-term credit? Will we purchase supplies on credit or pay cash?

Credit Management
Should we sell on credit? On what terms? To whom?

Controller

Accounting
Taxes.

The goal of financial management is to maximize the current value of existing stock

Managerial incentives to maximize shareholder wealth

In large corporations the owners and typically numerous and widely dispersed. It is hard to tell if managers are trying to maximize shareholder wealth.

Social responsibility

Are corporations responsible for employee welfare, customers, and the communities in which they operate?

Stock price maximization and social welfare

Is stock price maximization good or bad for society?

In general, it is good because stock price maximization requires firms:

1. To operate in an efficient and low-cost manner.
2. To develop new products.
3. To provide in an efficient and courteous service.
Managerial Actions to Maximize Shareholders Wealth

To determine the actions required to maximize shareholder wealth, we must first establish the factors that determine a firm’s value. Simply stated, a firm’s value is a function of the firm’s ability to generate current and future cash flows. We currently know three things:

1. The value of any asset is valuable only to the extent that it generates cash flows. This includes a firm’s stock.
2. The level and timing of the cash flows are important.
3. Investors are risk adverse.

All managers should work to increase cash flows. We are talking about cash flow from assets or free cash flows. Remember the following equation. It is from Fin 311.

Cash Flow from Assets = OCF – NCS – ΔNWC

or

Free Cash Flow (FCF) = (Revenues – Costs)(1 – TC) – CapEx – ΔNWC + (Dep)(TC)

Any action a manager can undertake that will increase revenues, reduce operating costs and taxes, or investments in operating capital will increase the FCF and the value of the firm.

Strategic Policy Decisions:

1. Types of Products
2. Production Methods
3. R & D efforts
4. Capital Structure
5. Dividend Policy
6. Other

Business ethics

Business ethics is a company’s attitude and conduct toward its employees, customers, communities, and stockholders.

A firm’s commitment to business ethics can be measured by the tendency of the firm and its employees to adhere to laws and regulations relating to such factors as:

- product safety and quality
- fair employment practices
fair marketing and selling practices
the use of confidential information for personal gain
community involvement
bribery
illegal payments to foreign governments to obtain business.

Chemical Bank suggests that ethical behavior can increase profits:

1. Avoids fines and legal expenses.
2. Builds public trust.
3. Attracts customers who appreciates and supports its policies
4. Attracts and retains high caliber employees
5. Supports the economic viability of the communities in which it operates.

It is not always clear which course of action is the best when ethical issues arise.

It is imperative for top management to support and be openly committed to ethical behavior.

**Agency Relationships**

When someone (the principal) hires another (the agent) to represent the principal’s interests. In business the principals are the stockholders and the agents are the managers.

In all agency relationships there is a possibility of conflict of interest between the agent and principal.

**Agency conflicts**

Agency conflicts are very important in large corporations. The firm's managers generally own a small portion of the stock. This can lead to situations where shareholder wealth maximization is not the first priority.

For example managers may try to maximize the firm's size.

- Increased job security because a hostile takeover is less likely
- Increase their power, status, and salaries.
- Create more opportunities for their lower and middle-level managers.

**Agency costs**

To reduce agency conflicts, shareholders must incur agency costs. These are the costs necessary to induce managers to maximize shareholder wealth.
Three major categories

1. Monitoring costs (audits)
2. Organizational structure (appoint outside directors)
3. Opportunity costs (stockholder votes on certain issues)

The objective is to balance the monitoring costs with the additional benefits of monitoring.

Managerial incentives

Performance-Based Incentive Plans

These plans tie a manager's compensation to the company's performance.

1. Provide incentives for manages to maximize shareholder wealth
2. Attract and retain managers willing to stake their financial future on their abilities.

Direct Intervention by Shareholders

Institutional ownership has changed agency issues. In the past institutions would just sell their shares if they disagreed with the management of the firm. Now institutions cannot sell their holdings without adversely affecting the stock price. This has lead to an increased willingness to talk with management and offer suggestions. In addition, stockholders can sponsor a proposal that must be voted on at the stockholder's meeting. Although these proposals may not be binding, they do get the attention of management.

The Threat of Firing

This option is being used more often.

Takeovers

Hostile takeovers are most likely to occur when the firm's stock is undervalued relative to its potential because of poor management. Incumbent management is seldom kept after a takeover. This is not used as often when compared to the past.

Another agency conflict: stockholders versus creditors

Creditors have a claim on part of the firm's earnings (interest & principle) but stockholders have control over the decisions affecting the firm's profitability and risk.

The cost of debt (interest rate) is based on:

1. The riskiness of the firm's existing assets.
2. The expected risk of future assets.
3. The firm's existing capital structure.
4. The expected capital structure

If the firm takes on a project with greater than expected risk, the required return on the firm's debt will increase. This will lead to a decrease in the value of the firm's outstanding debt. If the project is successful, all of the benefits go to the stockholders. If the project fails, the debtholder may have to share in the losses.

Is this ethical? Creditors will protect themselves in the future with covenants, which restrict the debtholder's actions. The creditors may decide not to deal with the firm or charge higher interest rates. All of these actions tend to increase the cost of future debt and lower the value of the stock.

The External Environment

Stock prices are affected by factors that are external to the firm. Some of the factors are:

- Legal constraints such as Anti-trust Laws
- Level of economic activity
- Tax laws
- Level of the stock market
- Environmental Regulations
- Production and Workplace regulations
- Employment Practices Rules
- Federal Reserve Policy
- International Rules

Within a set of legal constraints, management makes a set of long-run strategic policy decisions. These decisions are affected by the level of the economic activity and tax policies, which affect the timing, and riskiness of cash flows. This affects the dividend policy. These factors, profitability, timing, risk, and dividend policy along with the general market conditions affect the stock price.