Introduction to Corporate Finance

Chapter 1

Outline

1. Types of Firms
2. Definition of Corporate Finance
3. The Financial Manager
4. The Goal of Financial Management
5. The Agency Problem
6. Financial Markets

Forms of Business Organization

Forms of Business Organization

There are 3 major forms of business organization, each with its pros and cons.

1. Sole Proprietorship
2. Partnership
3. Corporation

Sole Proprietorship

A business owned by a single individual. In general, the business has no existence apart from its owner: its life is limited to the proprietor's own life span.

Sole Proprietorship

Pros:

- Easy to start & simple structure

Cons:

- Unlimited liability from creditors
- Equity raised is limited to the proprietor's personal wealth

Partnership

A business much like a sole proprietorship, but formed by two or more owners.

Partnership

Pros:

- Easy to start & simple structure

Cons:

- Unlimited liability from creditors for general partners
- Difficult to transfer ownership

Corporation

A business created as a distinct legal entity composed of one or more individuals or entities.

Corporation

Pros:

- Limited liability for owners
- Easy transfer of ownership and raising of equity financing
- Unlimited life

Cons:

- Double taxation
- Relatively more difficult to establish

Other Forms of Business Organization

We will focus on corporations, but other forms include:

S-corp

A corporation, but without double taxation, limited to about 100 shareholders

LLC

A limited liability corporation, operates as a sole proprietorship or partnership but retains limited liability and generally avoids double taxation

Start a Business!

To begin filing paperwork, visit the Kentucky Secretary of State's website.

Explore business listings as well.

To Summarize

The forms of business organization each have pros and cons. Unlimited liability to creditors can be a significant drawback for sole proprietorships and partnerships.

What is Corporate Finance?

Corporate Finance Answers 3 Questions

1. What long-term investments should the firm take on?
2. Where and how will the firm secure long-term financing?
3. How will the firm manage everyday financial activities?

Long-Term Investments

- The process of planning and managing a firm's long term investments is known as capital budgeting.
- The value of the cash flow generated by an investment should exceed its cost.

Investment Opportunities

Depend on the nature of the business:

- The Walt Disney Company expanding Disneyland Paris theme park or acquiring 20th Century Fox.
- Uber pulling out of south-east Asia.

Long-Term Financing

- Financing is needed to support long term investments
- The firm can borrow (debt) or use funds generated by selling ownership of the firm to investors (equity)

Long-Term Financing Examples

- Tesla raised $1.8 billion by promising to pay back funds in the future (debt)
- Snapchat raised $3.4 billion by selling ownership shares of the company (equity)

Capital Structure

The mixture of debt and equity that comprises the firm.

- If the firm is a pie, the *capital structure* is how it is sliced
- The optimal mix of debt and equity is based on the costs associated with each
- Sources and timing of long-term financing is important

Everyday Financial Activities

Working Capital refers to a firm's short-term (or current) assets and liabilities.

- How much cash should be kept on hand for a particular firm?
- How many days worth of inventory should that firm hold?
- Should that firm purchase on credit from suppliers or obtain financing and pay cash?

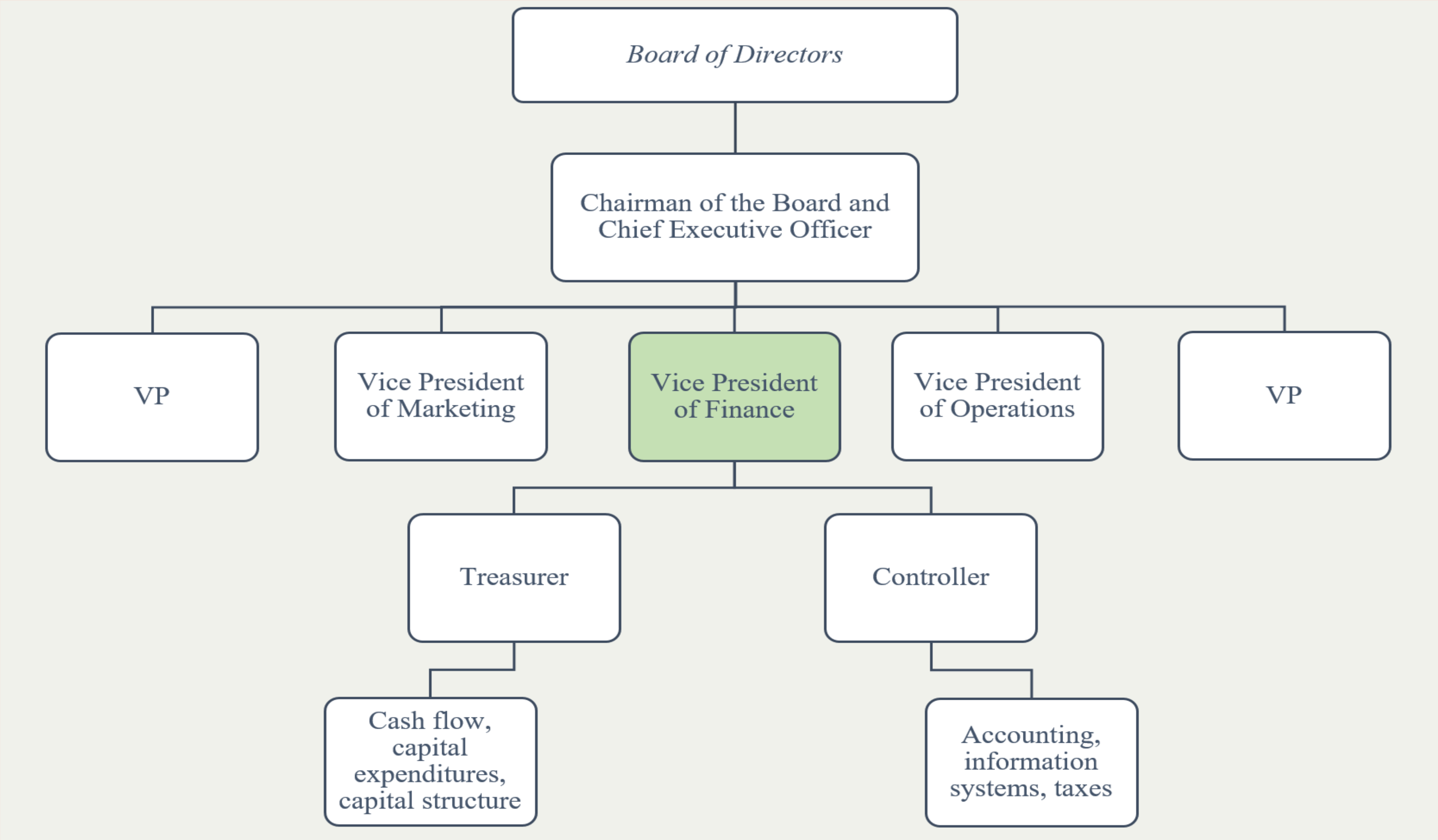
To Summarize

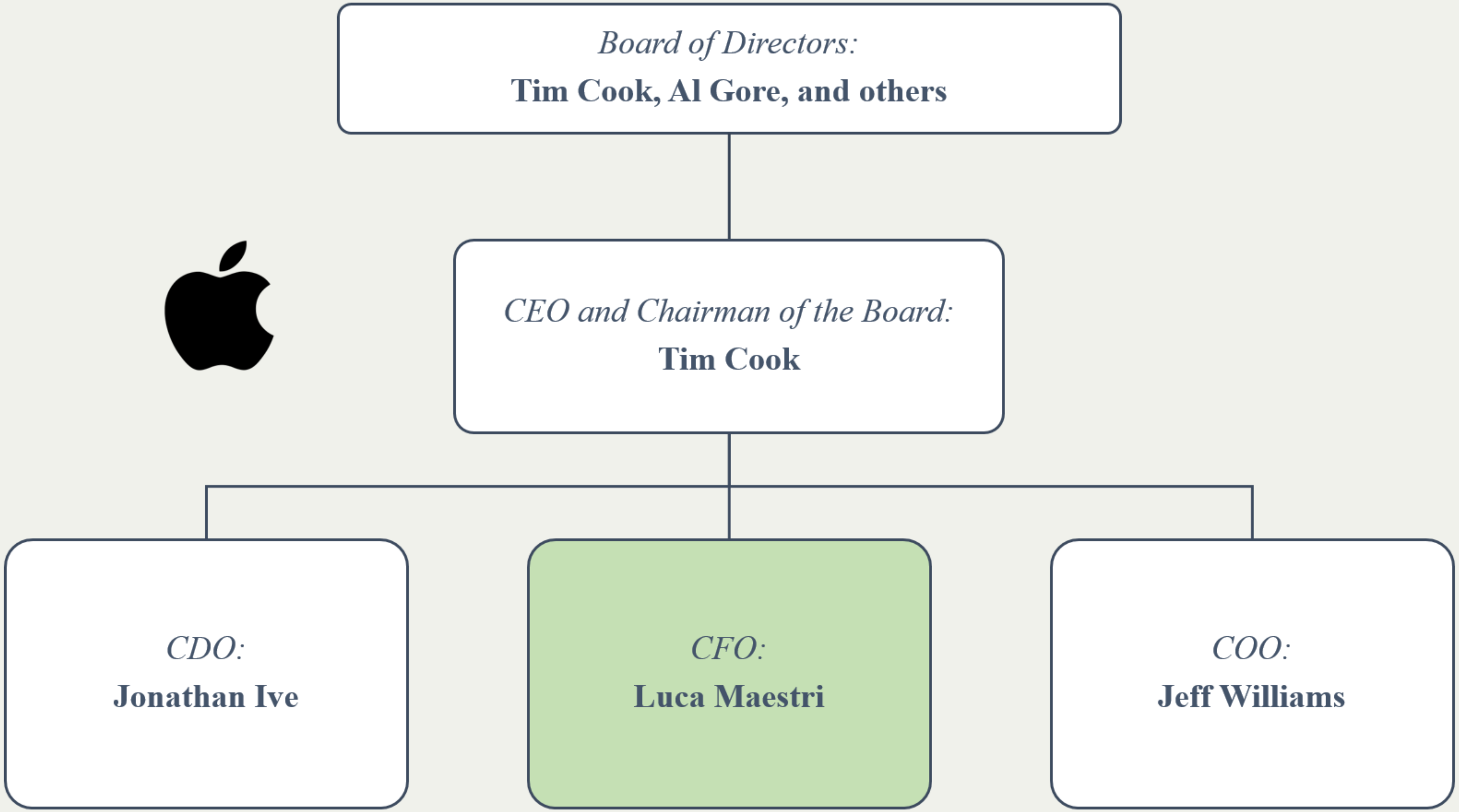
Corporate Finance seeks to answer questions regarding long-term investments, financing, and the capital structure of the firm.

The Financial Manager

The Financial Manager

In corporations, tasked with answering those three broad corporate finance questions we've discussed.


Board of Directors
Chairman of the Board and Chief Executive Officer
VP
Vice President of Marketing
Vice President of Finance
Vice President of Operations
VP
Treasurer
Controller
Cash flow, capital expenditures, capital structure
Accounting, information systems, taxes


Board of Directors:
Tim Cook, Al Gore, and others
CEO and Chairman of the Board:
Tim Cook
CDO:
Jonathan Ive
CFO:
Luca Maestri
COO:
Jeff Williams

The Goal of Financial Management

POSSIBLE GOALS OF THE FINANCIAL MANAGER

Maximize Sales?

But we can incur costs to the point where we make no profits.

Maximize Profits?

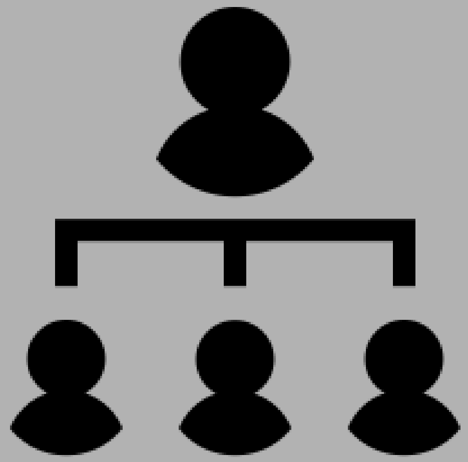
When? Now? Is this at the expense of the future?

Survive?

This could lead to less risk-taking and lower profits.

The Goal of Financial Management

To maximize the current value per share of existing stock.



The Agency Problem

Separation of Ownership and Management

The financial manager should seek to maximize value for the shareholders, not pursue their individual interests at the shareholders' expense.

The Agency Problem

The possibility of conflict between the owners (stockholders) of a firm and the management of a firm.

<u>Examples</u>:

- An investment isn’t pursued because failure would cost the manager their job
- A manager only pursues certain investments so that they control more (empire building)

Potential Solutions

1. Tie manager performance to the performance of the firm (stock options)
2. Shareholder monitoring through voting at company elections

To Summarize

The separation of owner and manager leads to the rise of the agency problem, but there are ways to minimize this issue.

Financial Markets & The Corporation

Financial Markets

Allow for the raising of capital or exchange of ownership.

Primary & Secondary Markets

1. *Primary Markets*: raise capital through public offerings or private placements (i.e., Snapchat's IPO)

2. *Secondary Markets*: trading ownership of a corporation; these transactions help to establish the value of the firm (i.e., buying and selling stock)

WHY MANAGERS CARE ABOUT THE STOCK PRICE

A public company doesn't profit or lose money when its share price fluctuates in the secondary market. But the price matters for a number of reasons:

1. Compensation
2. Raising capital in the future
3. Creditors
4. Takeover target
5. Use of shares to acquire other firms

To Summarize

Financial markets matter for raising capital and assessing the health of the firm.

Takeaways

TAKEAWAYS

1. Three main forms of business organization, each with pros and cons.
2. Limited liability is an important feature of corporations and LLCs, encouraging entrepreneurship.
3. Corporate finance seeks to answer 3 main questions regarding investing, financing, and daily activities.
4. The financial manager deals with these questions and seeks to maximize the value of the firm.
5. But agency problems exist.
6. Financial markets allow for raising of capital and exchange of ownership, and managers care about the secondary markets.

END.