University of Richmond
Robins School of Business

Introduction to Corporate Finance

Fin 360: Principles of Financial Management

WHAT IS CORPORATE FINANCE?

Corporate finance is the study of ways to address three basic questions:

❶ What long term investments should the firm take on?
Lines of business? Property needed? Machinery? Factory?

❷ How will the firm obtain long-term financing to pay for these investments?
Borrow? Give up ownership interest and shares for cash?

❸ How will the firm manage everyday financial activities?
Collect from customers and pay suppliers?

Question ❶ is addressed by **capital budgeting**: the process of managing long term investments. The value of the cash flow generated by an investment should exceed its cost. Investments depend on the nature of the business.

Examples:

- Disney purchasing Lucasfilm, building theme parks, or expanding into streaming
- Lego building a manufacturing facility in the United States near Richmond[1]

Capital Structure addresses question ❷. It is the mix of borrowing (debt) and ownership interest (equity) offered to raise long term financing to pay for the firm's assets.

Examples:

- Harley Davidson raises $500 million by selling bonds to investors, promising to pay back that money with interest to investors
- Rivian Automotive raises $13.7 billion by selling ownership interest in its company, and the new owners of the firm as *shareholders* enjoy the benefits of fractional ownership in the firm (i.e., dividends, voting, **residual claim**).[2]

The optimal mix of debt and equity is based on the cost associated with each, such as interest payments or expectations of dividends and market returns.

Question ❸ has to do with the firm's **working capital**, or its current assets and current liabilities.

- How much cash should the firm hold?
- How many days' worth of inventory should be on hand?
- Should the firm purchase on credit from suppliers or pay cash?

Too much cash or inventory on hand may be costly (low returns, storage costs). Too little can leave the firm in a vulnerable position.[3]

? Are the following capital budgeting, capital structure, or working capital decisions? (a) An automobile manufacturer issues bonds to raise money for general corporate purposes, (b) a supplier of pizza boxes agrees to extend a pizzeria's deadline to pay for purchased boxes from 30 days to 45 days, (c) Salesforce acquires communication platform Slack Technologies for $29 billion.

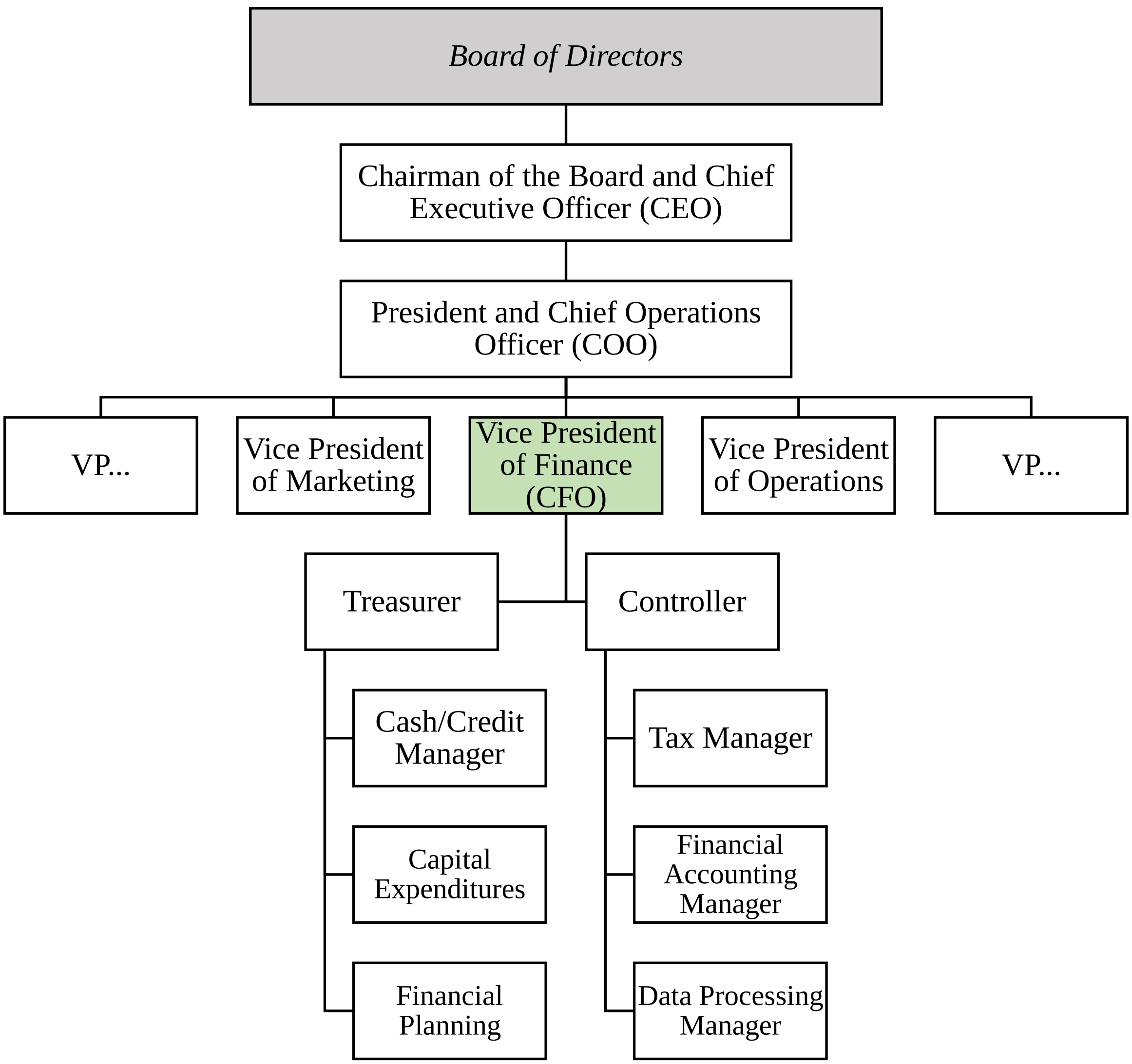
FINANCIAL MANAGER AND FINANCIAL MANAGEMENT DECISIONS

The firm's top *financial manager*, such as the **Vice President of Finance** or **Chief Financial Officer (CFO)**, attempts to address these corporate finance questions. The company's treasurer and controller are also important roles in the firm, often reporting directly to the CFO.

- **Treasurer**: oversees cash and credit management, capital expenditures, and financial planning.

- **Controller**: oversees taxes, cost accounting, financial accounting, and data processing.

Figure 1: Sample Firm Organizational Structure



FORMS OF BUSINESS ORGANIZATION

There are three main types of business organization:

1. **Sole Proprietorship**
2. **Partnership**
3. **Corporation**

SOLE PROPRIETORSHIP

A **Sole Proprietorship** is a business owned by a single individual. The simplest form of organization, the business has no existence apart from its owner.

- Taxed once as income to the individual (no separate corporate tax rate)
- Simple structure: all profits to the single owner
- Limited to the life of the owner, ceasing to exist upon owner's death
- Difficult to raise external money (generally, only through borrowing)
- *Unlimited liability*: business lenders and individuals can go after your personal wealth if your business cannot pay back debts

PARTNERSHIP

A **Partnership** is a business organized much like a sole proprietorship but owned by *two or more* individuals. A *partnership agreement* is important to spell out the rights and duties of each partner.

- **General Partners** are similar to the proprietors of a sole proprietorship and are subject to unlimited liability
- **Limited Partners** may hire general partners to run the business while they themselves have *limited liability*, where the maximum loss is their investment in the firm

Corporation

A **Corporation** is a business created as a *distinct legal entity* composed of one or more individuals or entities. These corporations may have many thousands or millions of owners.

- **C-Corps** (**publicly traded companies** in the United States) must file their **corporate charter** or **articles of incorporation** and **bylaws** that define its purpose, rules, and how directors are elected
  - Most (over half) incorporate in Delaware given its unique legal system, lax corporate laws, and its specialized corporate law court system[4]
- All owners have *limited liability* where only their investment in the firm, not personal wealth, may be lost in bankruptcy
- Transferring ownership is easier (i.e., exchanging ownership shares in markets)
- Raising money is possible through both debt (borrowing) and/or equity (giving up ownership for capital)
- Unlimited life
- Double taxation: the firm, as a separate legal entity pays taxes while owners are taxed on the distributions (i.e., dividends) the firm pays out

Limited Liability Corporations (LLC) is a "hybrid" form of corporation that operates as a sole proprietorship or partnership but retains limited liability and generally avoids double taxation. This form is often recommended for anyone starting a small business. **S-Corps** are "small corps" limited to 100 owners that operate as corporations, but without double taxation.[5]

Start your own business! Visit your state's Secretary of State or Department of State website for necessary forms and to look up a business listing.

THE GOAL OF FINANCIAL MANAGEMENT

What is the goal of a corporation?

- Maximize sales? *But we can incur costs to the point where there are no profits?*
- Maximize profits? Minimize costs? *When? In the short term? Is this at the expense of the future?*
- Survive? *Could this lead to less risk-taking and lower profits?*

> The goal of financial management is to maximize the current value per share of existing shares of ownership (stock) or **maximize the value of the firm.**

By maximizing value to existing shareholders, there's little ambiguity about timing, surviving, or costs. But should maximizing value be done at any cost? What about ethics? What about the firm's **stakeholders**, or the customers, suppliers, employees, and the society that the firm impacts?

THE AGENCY PROBLEM

Now we know *who* the financial manager is, *the questions* they attempt to answer, and their *ultimate goal*. But given ownership of the firm can be spread over a large number of shareholders, a hired manager may have different interests than that of the owners.

Agency Problem: the possibility of conflict between the owners of a firm (**principals**) and the management of a firm (**agents**).

EXAMPLES: A financial manager does not pursue a risky investment opportunity that may pay off for shareholders but cost them their job if it fails. Or perhaps the manager engages in **empire building** by increasing their power in the firm but at the expense of shareholder value. Is the manager's use of the corporate jet necessary?

Overcoming the Agency Problem

- *Compensation*: Firms can align incentives between managers and owners through compensation. The firm can issue **restricted stock units (RSUs)** to a manager that only have value if the manager meets certain performance goals. **Executive or employee stock options** (**ESOs**) allow the manager to pay a low price for shares in the company that they may sell at a much higher price to others in the future.

  Examples:

  - **RSU** – the manager will receive 100 shares of the company in 1 year if the stock performance is above a certain threshold *and* they still work for the firm.

  - **ESO** – the manager will be allowed to buy 100 shares of the company for $20 each even though the shares are worth $70 each.

  Thus, if the company's value increases, the manager's compensation also increases. Cash salary is often only a small part of an executive's compensation. The CEO of Boeing recently earned a salary of $1.4 million and RSU and ESO awards worth $16 million.[6]

- *Monitoring:* Shareholders vote for directors who hire, fire, and monitor managers. However, voting rights are often concentrated among the founders, managers, and CEOs of the firm, implying that small individual investors have little voting power.

Financial Markets and the Corporation

A notable benefit of the corporate form of government is that the firm can raise a large amount of money from a large number of owners. **Financial markets** allow for this (1) raising of capital and for the (2) exchange of ownership.

- **Primary Markets**: when the firm issues equity shares (or bonds and debt) for the first time. Money raised goes to the firm, such as through an **initial public offering** (**IPO**).

- **Secondary Markets**: when investors and owners of the firm trade shares (or bonds and debt) among themselves. The corporation receives no proceeds, but the value of the traded shares establishes the value of the firm.

Secondary markets include (i) **auction markets** (like the **New York Stock Exchange**) where buyers and sellers of securities match with one another after stating their terms and (ii) **dealer markets** (like NASDAQ) where dealers buy and sell shares for themselves "**over the counter**" with other dealers, intending to sell their securities to other investors at a profit later.

Why do managers care about their firm's stock price? The firm's *profitability* is not necessarily affected by its share price, but the *value of the firm* (number of shares × price per share, or its **market cap**) is.

- Compensation and evaluation
- Raising money in the future
- Takeover threat
- Lenders use it to evaluate the health of the firm

In Summary

Corporate finance examines the firm, including its structure, managers, decisions, and organization. Problems arise in the separation of owners and managers, but solutions like effective monitoring and compensation may mitigate these issues.

With this understanding, we will begin to evaluate firm quality and assess their decision making.

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