CHAPTER 1

An Overview of Financial Management and the Financial Environment

Topics in Chapter

- Forms of business organization
- Objective of the firm: Maximize wealth
- Determinants of fundamental value
- Financial securities, markets, and institutions

Why is corporate finance important to all managers?

- Corporate finance provides the skills managers need to:
  - Identify and select the corporate strategies and individual projects that add value to their firm.
  - Forecast the funding requirements of their company, and devise strategies for acquiring those funds.

Business Organization from Start-up to a Major Corporation

- Sole proprietorship
- Partnership
- Corporation

(More . .)

Starting as a Proprietorship

- Advantages:
  - Ease of formation
  - Subject to few regulations
  - No corporate income taxes
- Disadvantages:
  - Limited life
  - Unlimited liability
  - Difficult to raise capital to support growth

Starting as or Growing into a Partnership

- A partnership has roughly the same advantages and disadvantages as a sole proprietorship.

Becoming a Corporation

- A corporation is a legal entity separate from its owners and managers.
- File papers of incorporation with state.
  - Charter
  - Bylaws

Advantages and Disadvantages of a Corporation

- Advantages:
  - Unlimited life
  - Easy transfer of ownership
  - Limited liability
  - Ease of raising capital
- Disadvantages:
  - Double taxation
  - Cost of set-up and report filing

Becoming a Public Corporation and Growing Afterwards

- Initial Public Offering (IPO) of Stock
  - Raises cash
  - Allows founders and pre-IPO investors to "harvest" some of their wealth
- Subsequent issues of debt and equity

Agency Problems and Corporate Governance

- Agency problem: managers may act in their own interests and not on behalf of owners (stockholders)
- Corporate governance is the set of rules that control a company's behavior towards its directors, managers, employees, shareholders, creditors, customers, competitors, and community.
- Corporate governance can help control agency problems.

What should be management's primary objective?

- The primary objective should be shareholder wealth maximization, which translates to maximizing the fundamental stock price.
  - Should firms behave ethically? YES!
  - Do firms have any responsibilities to society at large? YES! Shareholders are also members of society.

Is maximizing stock price good? (Continued)

- Consumer welfare is higher in capitalist free market economies than in communist or socialist economies.
- *Fortune* lists the most admired firms. In addition to high stock returns, these firms have:
  - high quality from customers' view
  - employees who like working there

What three aspects of cash flows affect an investment's value?

- Amount of expected cash flows (bigger is better)
- Timing of the cash flow stream (sooner is better)
- Risk of the cash flows (less risk is better)

Free Cash Flows (FCF)

- Free cash flows are the cash flows that are available (or free) for distribution to all investors (stockholders and creditors).
- FCF = sales revenues - operating costs - operating taxes - required investments in operating capital.

What is the weighted average cost of capital (WACC)?

- WACC is the average rate of return required by all of the company's investors.
- WACC is affected by:
  - Capital structure (the firm's relative use of debt and equity as sources of financing)
  - Interest rates
  - Risk of the firm
  - Investors' overall attitude toward risk

What determines a firm's fundamental, or intrinsic, value?

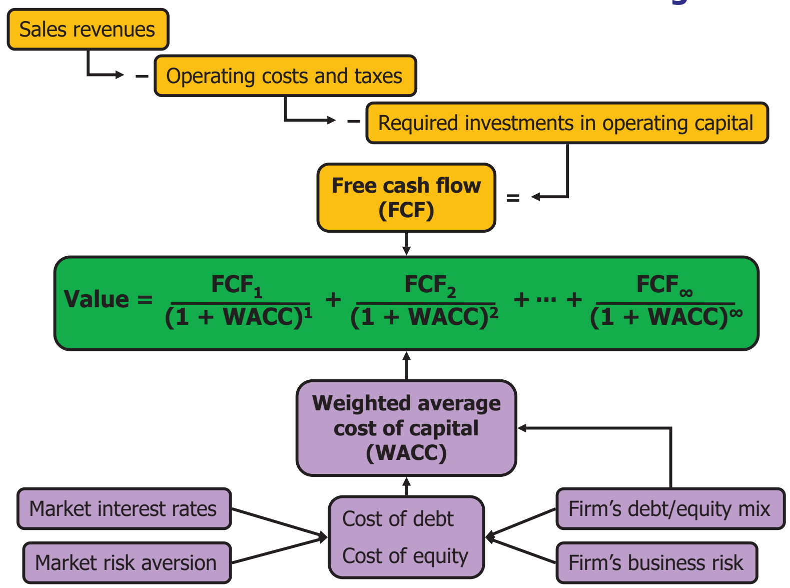
Intrinsic value is the sum of all the future expected free cash flows when converted into today's dollars:

$$\text{Value} = \frac{FCF_1}{(1 + WACC)^1} + \frac{FCF_2}{(1 + WACC)^2} + \ldots + \frac{FCF_\infty}{(1 + WACC)^\infty}$$

See "big picture" diagram on next slide.

(More . .)

Determinants of Intrinsic Value: The Big Picture



Who are the providers (savers) and users (borrowers) of capital?

- Households: Net savers
- Non-financial corporations: Net users (borrowers)
- Governments: U.S. governments are net borrowers, some foreign governments are net savers
- Financial corporations: Slightly net borrowers, but almost breakeven

Transfer of Capital from Savers to Borrowers

- Direct transfer
  - Example: A corporation issues commercial paper to an insurance company.
- Through an investment banking house
  - Example: In an IPO, seasoned equity offering, or debt placement, company sells security to investment banking house, which then sells security to investor.
- Through a financial intermediary
  - Example: An individual deposits money in bank and gets certificate of deposit, bank makes commercial loan to a company (bank gets note from company).

Cost of Money

- What do we call the price, or cost, of debt capital?
  - The interest rate
- What do we call the price, or cost, of equity capital?
  - Cost of equity = Required return = dividend yield + capital gain

What two factors lead to exchange rate fluctuations?

- Changes in relative inflation will lead to changes in exchange rates.
- An increase in country risk will also cause that country's currency to fall.

Financial Securities

	Debt	Equity	Derivatives
Money Market	•U.S. T-Bills •CDs •Eurodollars •U.S. Fed Funds		•Options •Futures •Forward contract
Capital Market	·T-Bonds ·Agency bonds ·Municipals ·Corporate bonds	• Common stock • Preferred stock	•LEAPS •Swaps

Typical Rates of Return

Instrument	Rate (January 2009)
U.S. T-bills	0.41%
Banker's acceptances	5.28
Commercial paper	0.28
Negotiable CDs	1.58
Eurodollar deposits	2.60
Commercial loans:	
Tied to prime	3.25 +
or LIBOR	2.02 +

(More . .)

Typical Rates (Continued)

Instrument	Rate (January 2009)
U.S. T-notes and T-bonds	3.04%
Mortgages	5.02
Municipal bonds	4.39
Corporate (AAA) bonds	5.03
Preferred stocks	6% to 9%
Common stocks (expected)	9% to 15%
Government Treasury bills	1.2%

What are some financial institutions?

- Commercial banks
- Investment banks
- Savings & Loans, mutual savings banks, and credit unions
- Life insurance companies
- Mutual funds
  - Exchanged Traded Funds (ETFs)
- Pension funds
- Hedge funds and private equity funds

What are some types of markets?

- A market is a method of exchanging one asset (usually cash) for another asset.
- Physical assets vs. financial assets
- Spot versus future markets
- Money versus capital markets
- Primary versus secondary markets

Primary vs. Secondary Security Sales

- Primary
  - New issue (IPO or seasoned)
  - Key factor: issuer receives the proceeds from the sale.
- Secondary
  - Existing owner sells to another party.
  - Issuing firm doesn't receive proceeds and is not directly involved.

How are secondary markets organized?

- By "location"
  - Physical location exchanges
  - Computer/telephone networks
- By the way that orders from buyers and sellers are matched
  - Open outcry auction
  - Dealers (i.e., market makers)
  - Electronic communications networks (ECNs)

Physical Location vs. Computer/telephone Networks

- Physical location exchanges: e.g., NYSE, AMEX, CBOT, Tokyo Stock Exchange
- Computer/telephone: e.g., Nasdaq, government bond markets, foreign exchange markets

Types of Orders

- Instructions on how a transaction is to be completed
  - Market Order– Transact as quickly as possible at current price
  - Limit Order– Transact only if specific situation occurs. For example, buy if price drops to $50 or below during the next two hours.

Auction Markets

- Participants have a seat on the exchange, meet face-to-face, and place orders for themselves or for their clients; e.g., CBOT.
- NYSE and AMEX are the two largest auction markets for trading U.S. stocks.
- NYSE is a modified auction, with a "specialist."

Dealer Markets

- "Dealers" keep an inventory of the stock (or other financial asset) and place bid and ask "advertisements," which are prices at which they are willing to buy and sell.
- Often many dealers for each stock
- Computerized quotation system keeps track of bid and ask prices, but does not automatically match buyers and sellers.
- Examples: Nasdaq National Market, Nasdaq SmallCap Market, London SEAQ, German Neuer Markt.

Electronic Communications Networks (ECNs)

- ECNs:
  - Computerized system matches orders from buyers and sellers and automatically executes transaction.
  - Low cost to transact
  - Examples: Instinet (US, stocks, owned by Nasdaq); Archipelago (US, stocks, owned by NYSE); Eurex (Swiss-German, futures contracts); SETS (London, stocks).

Over the Counter (OTC) Markets

- In the old days, securities were kept in a safe behind the counter, and passed "over the counter" when they were sold.
- Now the OTC market is the equivalent of a computer bulletin board (e.g., Nasdaq Pink Sheets), which allows potential buyers and sellers to post an offer.
  - No dealers
  - Very poor liquidity