

CHAPTER 1

An Overview of Financial Management and the Financial Environment

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Topics in Chapter

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

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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.

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Business Organization from Start-up to a Major Corporation

- Sole proprietorship
- Partnership
- Corporation

(More . .)

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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

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Starting as or Growing into a Partnership

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

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Becoming a Corporation

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

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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

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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

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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.

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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.

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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

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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)

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Free Cash Flows (FCF)

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

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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

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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:

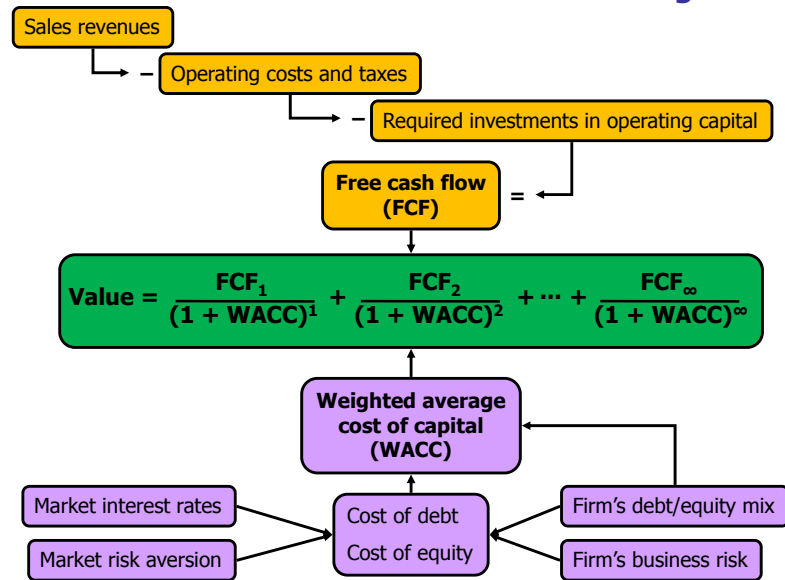
$$\text{Value} = \frac{FCF_1}{(1 + WACC)^1} + \frac{FCF_2}{(1 + WACC)^2} + \dots + \frac{FCF_\infty}{(1 + WACC)^\infty}$$

See "big picture" diagram on next slide.

(More . .)

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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

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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).

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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

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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.

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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

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Typical Rates of Return

<u>Instrument</u>	<u>Rate (January 2009)</u>
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 . .)

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Typical Rates (Continued)

<u>Instrument</u>	<u>Rate (January 2009)</u>
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%

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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

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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

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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.

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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)

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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

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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.

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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.”

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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.

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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).

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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

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