

Corporate Finance: an Introduction

SMN 224 – Corporate Finance

Week 1

Contents

1. What is a corporation?
2. What is corporate finance?
3. What is the role of the financial manager?
4. What are/should be the goals of the financial manager?

1. What is a corporation?

- ▶ Many possible definitions
- ▶ In particular...
 - a) Legal definition
 - b) Accounting / financial definition
 - c) Sociological / political definition
- ▶ “Textbook corporate finance” (implicitly) relies on the accounting / financial definition
- ▶ This has implications for our valuation of firms’ behaviour and performance

a) Legal definition

- ▶ The corporation is a business organization that is owned by stockholders who hold shares in the business
 - ▶ Question: do shareholders really own the firm (see discussion in section 4)?
- ▶ Characteristics
 - ▶ Distinct legal entity with its own “Constitution” (the articles of association) and laws (the memorandum of association)
 - ▶ Shareholders’ liability is limited to the amount invested in the equity – hence the name “limited company” (Ltd.) or “public limited company” (plc.) in the UK
- ▶ Different from other business forms (sole proprietorship & partnerships)

A comparison

	Corporation	Partnership
Liquidity	Shares can be easily exchanged	Subject to substantial restrictions
Voting Rights	Usually each share gets one vote	General Partner is in charge; limited partners may have some voting rights
Taxation	The corporation is taxed (“double taxation”)	Partnership not taxed. Partners pay taxes on profits.
Reinvestment and dividend payout	Broad latitude	All net cash flow is distributed to partners
Liability	Limited liability	General partners may have unlimited liability; limited partners enjoy limited liability
Continuity	Perpetual life	Limited life

Articles of Association & Memorandum of Association (in the UK)

Memorandum of Association

- Agreement to form a company
- Initial allocation of share capital
- Names of shareholders
- Since 2009, no mention of name, purpose...

Articles of Association

- Issuing of shares and allocation of voting rights
- Appointment of directors
- Directors' meetings
- Special voting rights
- Dividend policy...



Costs & benefits of incorporation

- ▶ **Costs of the corporation**

- ▶ More costly to set up
- ▶ More burdensome to manage

- ▶ **Benefits of the corporation**

- ▶ Transferable ownership
- ▶ Limited liability
- ▶ Continuity (unlimited life)

- ▶ **All of these characteristics give the corporation an easier access to cash**



b) Accounting / Financial definition

The corporation is a balance sheet

Consists of assets and liabilities

Assets may represent the investments made by the firm while liabilities may represent sources of financing

Assets and liabilities are differentiated according to their **degree of liquidity** (i.e. the easiness and speed at which they can be transformed in cash)

Current vs. fixed assets

Current liabilities vs. long-term debt

Shareholders' equity = residual

Balance Sheet Model of the Firm

Total Value of Assets:

Current Assets

Fixed Assets
1 Tangible
2 Intangible

Total Firm Value to Investors:

Current Liabilities

Long-Term Debt

Shareholders' Equity

c) Sociological / political definition

The corporation is (obviously) an organization...

A set of relationships

... But also, (less obviously) an *entity*

Biondi et al. , *The Firm as an Entity* (2007)

By contrast with a contractual view of the firm represented, in particular, in the mainstream corporate finance literature

Implication: the firm cannot be reduced to ownership of assets by shareholders

Yet another approach: the corporation as

Its life, its goals are shaped by the interactions between its members

Individuals and groups

2. What is corporate finance?

Three key questions / three kinds of decisions

- a) How should the firm raise funds for the selected investments?

Capital structure decision

- b) How should short-term assets be managed and financed?

Management of short-term cash flows (net working capital)

- c) What long-term investments should the firm choose?

Capital budgeting decision

a) The capital structure decision

Current Assets

Fixed Assets
1 Tangible
2 Intangible

How should the firm raise funds for the selected investments?

Current Liabilities

Long-Term Debt

Shareholders' Equity



Financing the firm

To pay for the firm's investments, the firm needs to raise money

It does that by selling financial securities

Claims on the firm's real assets and on the cash those assets will generate

Two kinds of financial securities: **debt** and **equity**

Debt

All financial securities that consist in fixed claims on future payments are called debt

Holders of those kind of financial securities are called creditors

Priority claims

Equity

- ▶ All financial securities that involve variable claims on future payments AND ownership are called equity
- ▶ Holders of equity shares are called shareholders (or stockholders)
- ▶ Residual claims on the firm's assets

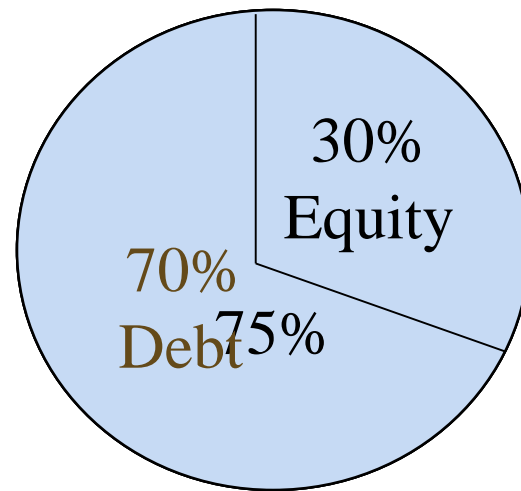
Capital Structure

The value of the firm can be thought of as a pie.

The goal of the manager is to increase the size of the pie.

The capital structure decision can be viewed as how best to slice the pie.

If how you slice the pie affects the size of the pie, then the capital structure decision matters.



Example 1.1

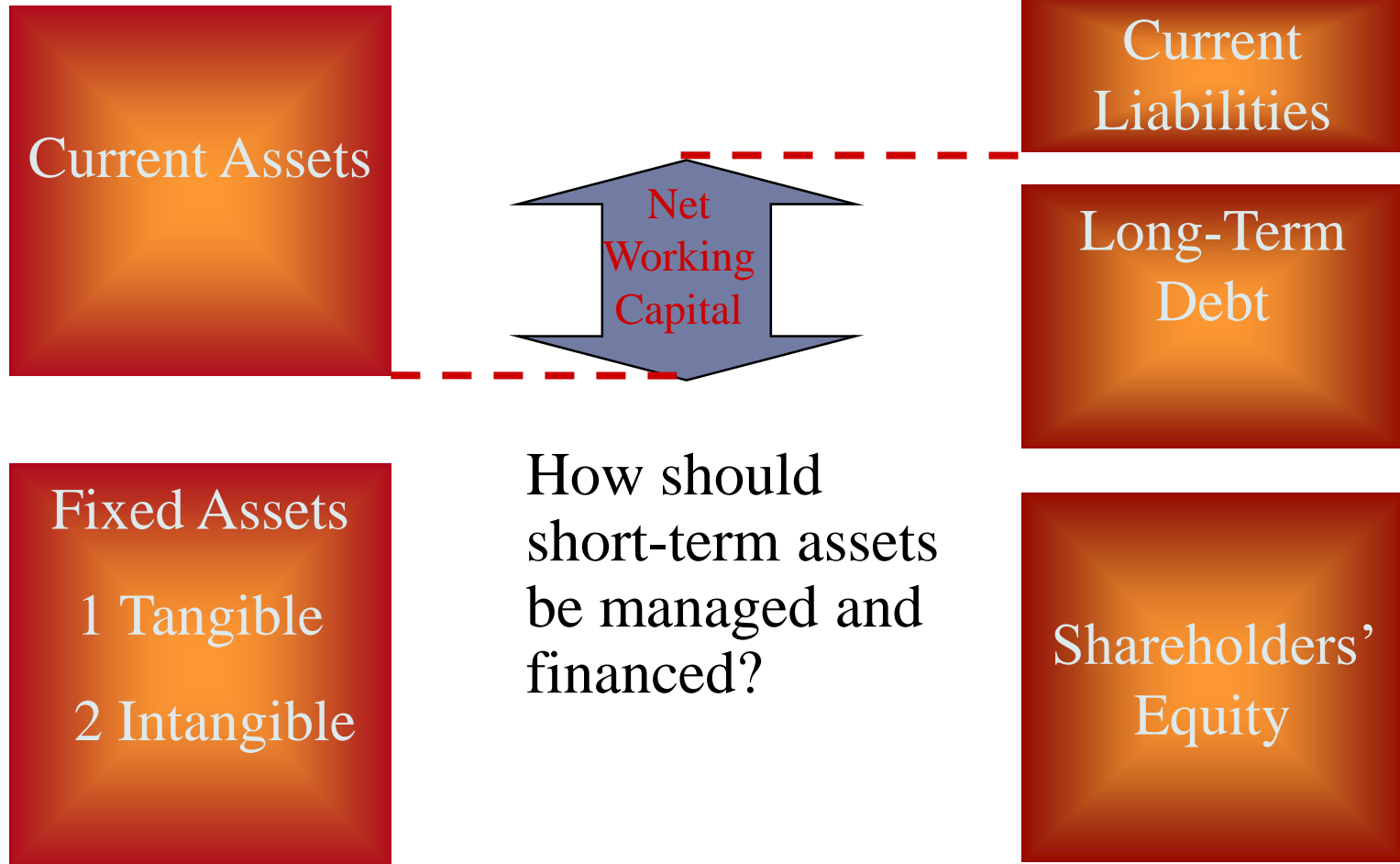
On 18 September 2014, Alibaba Group Holding issued IPOs on New York Stock Exchange at \$68 per share

Why an IPO?

To raise funds / cash windfall for early investors

Capital structure decision

b) Short-term asset management



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- ▶ **Net working capital** = current assets – current liabilities
 - ▶ Problems arise when there is a **gap in cash flow, which** might be due to
 - ▶ A mismatch between current assets and current liabilities
 - ▶ Amount / timing of operational cash flows are not known with certainty
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Example 1.2

In 2012, Crédit Agricole SA, the second-largest French bank, announced it would “*strengthen its balance sheet*” by cutting short-term debt 15% within a few months.

Why? Two reasons

Long-term financing more accessible in last year’s context

Reliance on money markets’ funding perilous

c) The capital budgeting decision

Current Assets

Current
Liabilities

Long-Term
Debt

Fixed Assets

1 Tangible

2 Intangible

What long-term
investments
should the firm
choose?

Shareholders'
Equity

Capital budgeting

- ▶ All the decisions pertaining to making and managing investments in long-lived assets
 - ▶ Real vs. financial assets
 - ▶ Tangible & intangible
 - ▶ Intangible assets are assets that derive their value from the rights and privileges granted to their owner, are long-term in nature, and lack physical substance
 - ▶ Acquisitions



Example 1.3

In September 2013, PUMA announced the renewal of a sponsorship deal with Usain Bolt

\$9 million per season until 2017

\$4 million per year later as a “Puma ambassador”

This is a capital budgeting decision by Puma

Investment into an intangible, long-term asset

Other key decisions in corporate finance

Mergers and acquisitions

Payouts and dividends

Debt restructuring



3. What is the role of the financial manager?

- ▶ One of the top managers of the firm
- ▶ In large corporations, the top financial manager is called the **Chief Financial Officer**
 - ▶ Usually also a member of the Board of directors
 - ▶ Usually a Vice-President of the firm
- ▶ Reporting to the CFO are the **Treasurer** and the **Controller**



Chief Financial Officer

Responsible for:

- Financial policy
- Corporate planning

Treasurer

Responsible for:

- Cash management
- Raising capital
- Banking relationships

Controller

Responsible for:

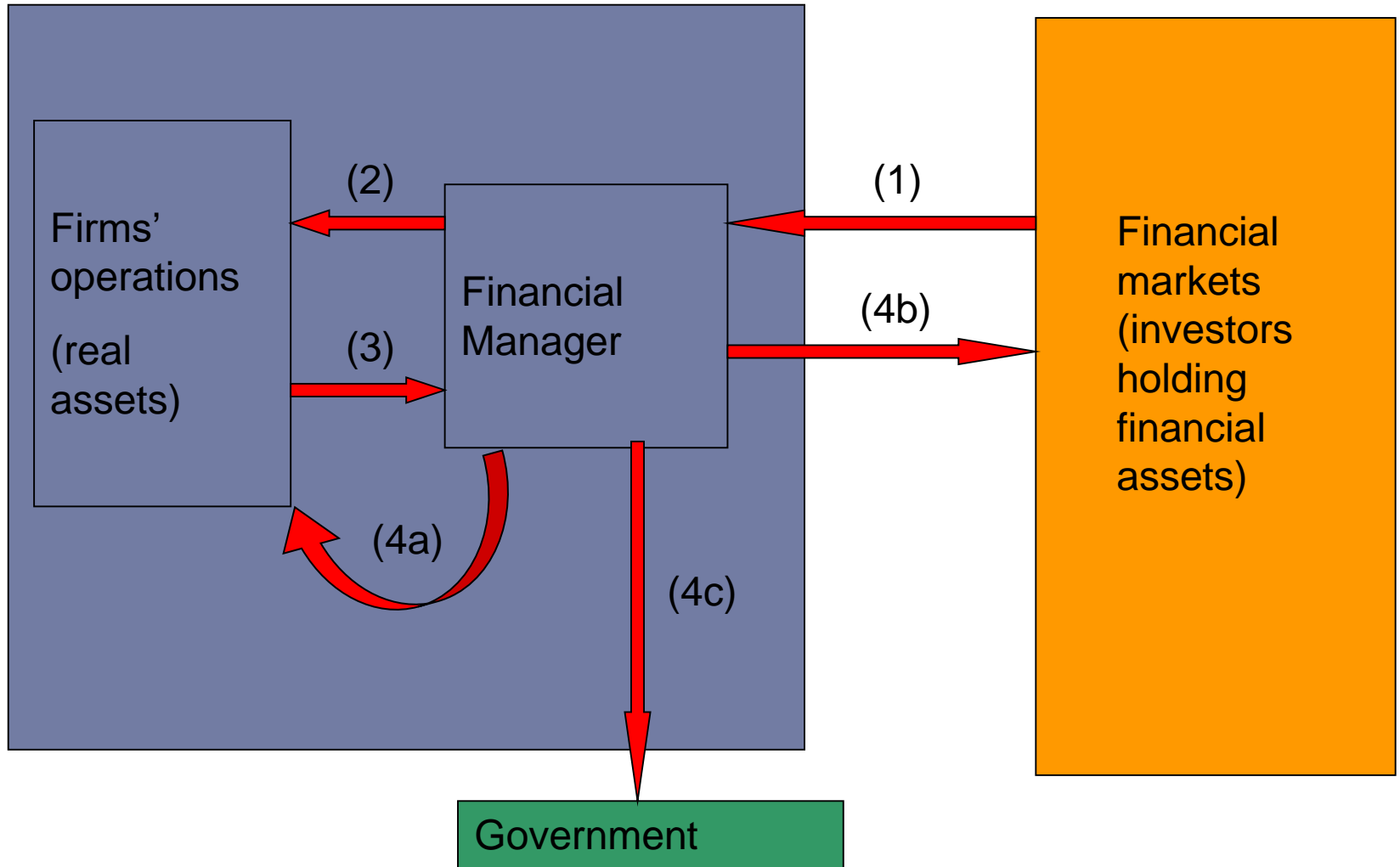
- Preparation of financial statements
- Accounting
- Taxes



Financial managers and financial markets

- ▶ The financial manager stands at the cross-roads of all cash-flows coming in and going out of the firm
 - ▶ Between the firm's operations and **financial markets**

Cash flows in and out of the firm



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- (1) Cash raised by selling financial assets to investors
 - (2) Cash invested in the firm's operations & used to purchase real assets
 - (3) Cash generated by the firm's operations
 - (4a) Cash reinvested
 - (4b) Cash returned to investors
 - (4c) Taxes

What should the financial manager do?

The Financial Manager's primary goal is to increase the value of the firm by:

1. Selecting value creating projects
2. Making smart financing decisions



4. The goals of financial management

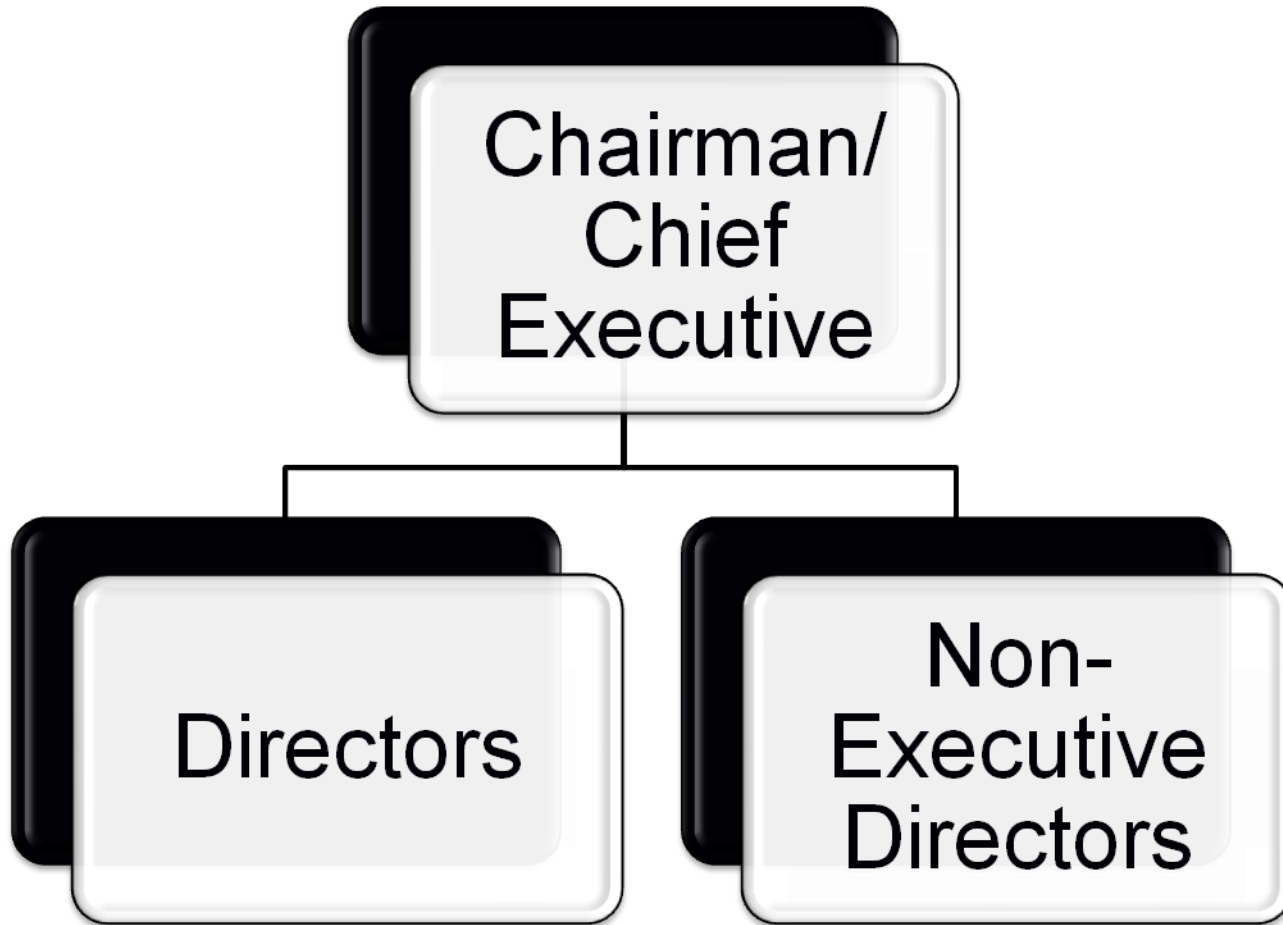
- ▶ There are many possible goals for the financial manager:
 - ▶ Maximize profit
 - ▶ Minimize costs
 - ▶ Maximize market share
 - ▶ Avoid bankruptcy
 - ▶ Survive
 - ▶ Maintain steady earnings growth...
- ▶ Which goal should he/she choose?
- ▶ And perhaps more importantly, whose goals are we talking about? Managers? Shareholders? Others?



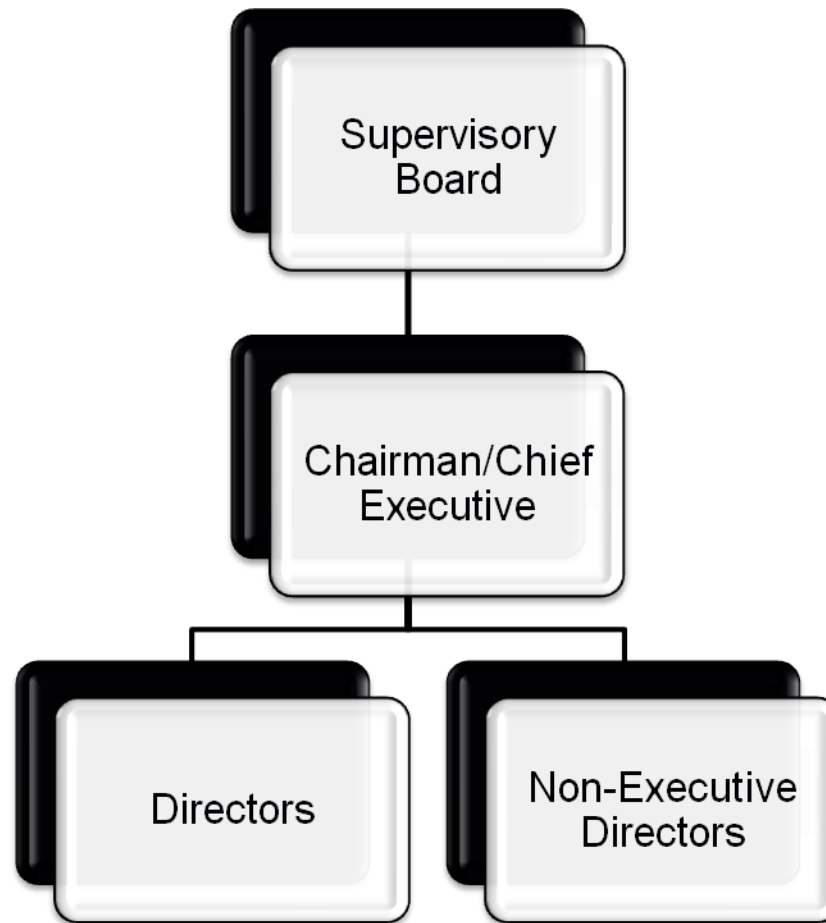
The Agency Problem

- ▶ **Agency relationship**
 - ▶ Principal hires an agent to represent his/her interest
 - ▶ Stockholders (principals) hire managers (agents) to run the company
 - ▶ **Agency problem**
 - ▶ Conflict of interest between principal and agent
 - ▶ **Separation of ownership and management**
 - ▶ In modern, large companies, management and ownership are separated
 - ▶ Differences in the degree of separation (single vs. two-tier board structures)
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Single-tier boards of directors



Two-tier Boards



A UK-Germany comparison



Unitary

- Board Reports to Shareholders
- Shareholders elect directors at AGM



Two-Tier

- Board reports to supervisory board
- Supervisory board elects directors
- Supervisory board consists of representatives from banks, government, trade unions, other stakeholders



Managerial Goals

- ▶ Managerial goals may be different from shareholder goals
 - ▶ Expensive perquisites
 - ▶ Survival
 - ▶ Independence
- ▶ Increased growth and size are not necessarily equivalent to increased shareholder wealth



Managing Managers

- ▶ **Managerial compensation**
 - ▶ Incentives can be used to align management and stockholder interests
 - ▶ The incentives need to be structured carefully to make sure that they achieve their intended goal
- ▶ **Corporate control**
 - ▶ The threat of a takeover may result in better management
- ▶ **Other stakeholders**



Questioning shareholder value

- ▶ Maximizing shareholder value: the right objective for the firm?
 - ▶ The mainstream theory
 - ▶ Shareholders are residual claimants
 - ▶ Maximizing shareholder value will benefit all stakeholders
 - ▶ Good for the firm in the long-run
 - ▶ Legal duty
 - ▶ The facts
 - ▶ Legal duty to maximize shareholder value = myth (Stout, 2012)
 - ▶ Maximizing shareholder value might not benefit everyone
 - ▶ Might lead to excessive focus on short-term results (share prices)