

FINM 2001 NOTES

INTRODUCTION TO CORPORATE FINANCE

FINANCIAL DECISIONS

- Major financial decisions are:
 - Investment decisions — decisions that determine the asset profile of a business (amount and composition of investments)
 - Financing decisions — how the assets are to be funded (debt and/or equity).
 - Financing decisions also involve dividend decisions
 - Dividend decisions — whether to pay a dividend to shareholders (and if so, what size) or maintain the funds within the firm for internal growth

INVESTMENT DECISIONS

- Firms need to decide whether their investment decisions will lead to maximizing shareholder's wealth
 - To do this, companies weigh up the cost and benefits of their decisions
 - $\text{Benefit} > \text{Cost} = \text{Good Decision}$
 - $\text{Benefit} < \text{Cost} = \text{Bad Decision}$
 - However many issues arise from this, namely
 - How to quantify the costs and benefits
 - How to quantify the risk and uncertainty
- Also called Capital Budgeting
 - The planning and control of cash outflows in the expectation of deriving future cash inflows from investments in non-current assets
 - Involves evaluating the:
 - Size of future cash flows
 - Timing of future cash flows
 - Risk of future cash flows
- More difficult to quantify the risk and uncertainty of a financial decision
 - For example:
 - There may be a high level of uncertainty in the effectiveness of the equipment
 - The cost of the equipment may change over time
 - Is it better to wait to purchase the equipment later?
 - The cost of borrowing may change over time

BUSINESS STRUCTURES

- Sole proprietorship
 - Business owned by one person
 - Unlimited liability

- Partnership
 - o Business owned by two or more people acting as partners
 - o Unlimited liability
- Company
 - o Separate legal entity formed under the *Corporations Act 2001*
 - o Limited liability
 - o Ownership may be transferred without disrupting the businesses daily activities
 - o Subject to extensive regulation

MAJOR ROLES OF FINANCIAL MANAGER – THE FINANCIAL FUNCTION

- Project evaluation
- Dividend and share repurchase decisions
- Dividend distributions
- Collection and custody of cash and payment of bills
- Management of investments in current assets
- Assessing the viability of growth through acquisitions
- Planning the future development of the business
- Interest rate and exchange rate risk management
- Development and implementation of financial policies

A COMPANY'S FINANCIAL OBJECTIVE

- The maximisation of shareholders' wealth (market value of a company's shares times number of shares)
 - o Maximise Equity
 - Share price x number of shareholders

BASIC CONCEPTS OF FINANCE

Firm Value

- The value of a company (V) on the financial markets may be expressed as:
 $V = D + E$ where D = value of debt and E = value of equity
- Financial markets will value debt and equity, taking into account the risk and expected return from investing in these securities

Nominal and Real Amounts

- The cost of an asset expressed as the number of dollars paid to acquire the asset is the nominal price
- However, due to inflation and deflation, the purchasing power of money changes
- Real amounts: Nominal amounts adjusted for inflation

Arbitrage

- Two identical assets (or perfect substitutes) being traded in the same market must have the same price (assuming no transaction costs)
- Otherwise, a risk-free profit could be made by simultaneously purchasing at the lower price and selling at the higher price

- This arbitrage eliminates the price difference
- $\text{Price}(\text{security}) = \text{PV}(\text{all CF paid by the security})$
- Law of one price

Market Efficiency and Asset Pricing

- Market efficiency means that we should expect securities and other assets to be fairly priced, given their expected risks and returns.
- Trade-off between risk and expected return can be captured in a quantitative model, e.g. the capital asset pricing model (CAPM)

Agency Relationships

- Where one party, the principal, delegates decision-making authority to another party, the agent.
- In a company setting:
 - o The agents are usually managers
 - o The principals are usually shareholders
- The separation of ownership and control gives rise to what is known as the agency conflict.
- How does this happen?
 - o Negative impact on investment, financing and dividend decisions
 - o Reduced value due to managers acting in their own rather than shareholders' best interests
 - o Costs associated with monitoring managers
 - o Bonding costs: costs of incentive and remuneration schemes that align the interests of managers with those of shareholders.
- To ensure manager act in the shareholders best interest they can:
 - o Pay employees with company stock and/or stock options
 - o Ensure underperforming managers are fired (monitor performance)
 - o Write contracts that ensure the interests of managers and shareholders are aligned – Set goals and targets
 - o Mount hostile takeovers – Vote out the 'old' management

FISHER'S SEPARATION THEOREM

- Also called Two Period Certainty Model
- Addresses the question of how management deals with diverse preferences for dividends and investment in a company with more than one shareholder

Assumptions:

- Perfect certainty – Know future cash flows
- Perfect capital markets
- Rational investors
- Borrowing and lending interest rates are equal

The Company

- The company is endowed with a fixed amount of resources at Time 1

- Managers must decide how much to invest and how much to pay out as dividends
- The level of investment at Time 1 determines:
 - The residual resources at Time 1, available as a dividend at Time 1
 - The resources that will be available to be paid as dividends at Time 2
- These opportunities can be summarised in a production possibilities curve (PPC)

Production Possibilities Curve

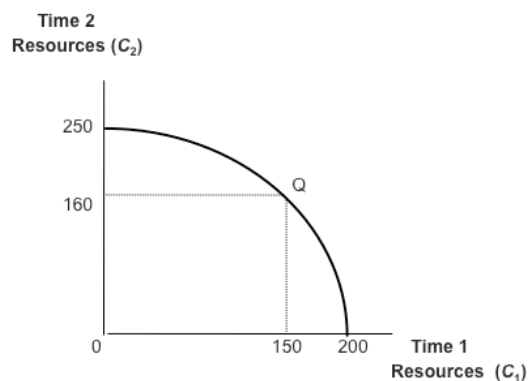


Figure 2.1: Production possibilities curve

The Shareholders

- Forgo current consumption by investing in a company at Time 1 in order to earn a return that increases consumption opportunities at Time 2.
- A person's preference for consumption at Time 1 or 2 can be represented by indifference curves — all combinations of Time 1 and Time 2 consumption on the same indifference curve make the consumer equally well off.
- Convex shape of indifference curves shows that a consumer's desire to increase consumption at a given time decreases as the level of consumption at that time increases (decreasing marginal utility).
- Would prefer a point to the right of the indifference curve – Prefer more to less
 - Indifferent to any choice on the line

FIGURE 2.2 Indifference curves of a representative shareholder

