TOPIC 1: WHAT IS FINANCE?

FINANCE – raising of money (capital)

CAPITAL – money used for investment

INVESTMENT – making of money, using capital

HOW DO WE FINANCE?

1. Existing funds of owners
2. Sharing ownership (selling part of business to public)
3. Borrow money

TYPES OF CAPITAL

- Equity
- Debt

HOW DO WE INVEST?

Capital raised used to buy assets that make money (generate a return).

- Assets bought depend on the type of business being run
- The process of using capital to buy assets is called **Capital Budgeting**

Investment Decision		Financing Decision	
ASSETS		**LIABILITY (DEBT)**	
E(R) > 5%		K_d = 5%	$50
		EQUITY	
E(R) > RRoR		K_e = 5%	$50
	$100		$100
		Cost of Capital (RRoR) = 5%	

Overall Cost of Capital = $\frac{50}{100} * 5\% + \frac{50}{100} * 5\% = 5\%$

K_d = Cost of Debt
K_e = Cost of Equity
RRoR = Required Rate of Return
E(R) = Expected RoR

COST OF CAPITAL
How much (%) needs to be paid for debt and equity.

WEIGHTED AVERAGE COST OF CAPITAL (WACC)
Measure of the cost of capital, using a weighted average of debt and equity costs.
- WACC is a RRoR

REQUIRED RATE OF RETURN (RRoR)
Minimum % needed to be earned on capital invested. Also called *Hurdle Rate.*

EXPECTED RATE OF RETURN (E(R))
What is forecasted to be earned (%) on assets.

$$E(R)_{Assets} > RRoR_{Capital}$$

CAPITAL STRUCTURE
The partition of capital b/w debt and equity.

- Knowing the capital structure provides the weights used to calculate WACC.

FLOW OF FUNDS
Is where capital is transferred from surplus units to deficit units in an economy.

Deficit units – need more capital
Surplus units – have more capital than need

This is important as it enables money to be transferred from those who have excess capital to those who need it.

A **well-functioning** and **developed** financial system allows for the efficient flow of funds.

There are 3 ways for the flow of funds to occur in an economy:
1. Direct transfer b/w surplus and deficit units
2. Indirect transfer; using an investment bank
3. Indirect transfer; using a financial intermediary

The efficient flow of funds means:
- Capital is mispriced (over-priced/under-priced; depends on whether buying or selling)
- Surplus & deficit units have liquidity (can raise capital they need and to meet needs)
- There is sufficient depth of financial markets