Week 1: Introduction to Corporate Finance

- **Corporate finance** → concerned with the financial decisions of corporations
- Corporations need to invest in real assets (tangible such as machines and intangibles such as R & D) to generate cash inflows and income
- Acquisition of real assets need to be financed (i.e. paid for) by an array of different methods such as borrowing (debt), retaining & reinvesting cash inflows, and by selling shares (equity)
- Therefore, key decisions in corp finance:
    - **The Investment Decision**→ concerned with the acquisition of real assets that are used to produce goods and services and generate cash flows/income
    - **The financing Decision** → concerned with different methods of acquiring funds for investment

The investment trade-off

- The fundamental objective of a financial manager is to **maximize shareholder value** or the market value of the corporation. This is in the best interest of the shareholders.
- However, when the CFO has a large cash inflow, should he/she reinvest that into real assets or pay out cash to shareholders as extra dividends?
- This decision depends on the rate of return on the investment and the rate of return stockholders can earn by investing in financial markets
- If **ROR investment project > ROR shareholders external investing** in financial markets themselves → they will vote for the investment. If it is the contrary, they will oppose the investment.
- E.g. assume Walmart's decision to invest on 200 new stores is just as risky as the US stock market. If the US stock market has an expected return of 10% while Walmart's new project would generate a 20% return, investors would vote for the project. (If it was 5%, they would be better off with cash and investing in the stock market)
- **Hurdle rate/cost of capital** → This is the minimum rate of return on investment acceptable e.g. for Walmart's scenario above, it would be 10%.
- It is essentially the **opportunity cost of capital** as the hurdle rate depends on investment opportunities available to investors in financial markets. That is, investing in a project eliminates other opportunities to invest cash/funds.
    - This is also affected by the risk of each investment (not merely the interest rate)

Corporate objective of a public company

- The primary objective in conventional corporate finance is to **maximise the value of the firm**
- Each stockholder wants three things:
    1. To be as rich as possible, that is, to maximise his or her current wealth
    2. To transform that wealth into the most desirable time pattern of consumption either by borrowing to spend now or investing to spend later
        - Crucial assumption for this is a **well-functioning, competitive capital market** e.g. if G (from appendix) could not borrow against his future income, in one year, of $121,000 today, he would just spend the $100,000 he has today, rather than investing. If he invested, with IR at 10%, and getting 21% return on his friend's business, he would be able to borrow PV=(121,000)/(1.10)= $110,000 today. Thus he would be able to spend $10,000 extra.
    3. To manage the risk characteristics of that consumption plan
- Financial managers acting in shareholders' interests cannot help with 2 or 3 – therefore, their purpose is narrowed to only 1 → increase market value of the firm and increase share price → increase shareholders' wealth

- The value of a company is measured through **market capitalization**
  - This is the number of issues shares x price of shares
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NO. ISSUED (m)	LAST SALE PRICE	MARKET CAP. ($b)
2,238	24.20	54.17

Maximise Profit Vs Maximise Wealth

- Maximising profit does not necessarily result in wealth maximisation
- Wealth maximisation refers to the long term wealth or value of the firm, rather than short term profits
- If a manager quickly raises profits for one term through various mechanism, but fails to sustain it, they do not maximise wealth → Al Dunlap and Sunbeam (cut work force by 50% + 80% of products + 'presell' to raise profit → resulted in share prices rose a lot, but they crashed soon after, with share prices plummeting from $53 to $6 → wealth was definitely not maximised in this case)

Conflict of interest and the Agency Problem

- Managers, owners, debt holders and other stakeholders such as customers may have conflicting objectives
- An agency problem exists where the principal has to entrust their interest to an agent who acts on their behalf
- **Agency problem→** managers, acting as agents for stockholders, may act in their own interest rather than maximising value
- Ownership vs Management:
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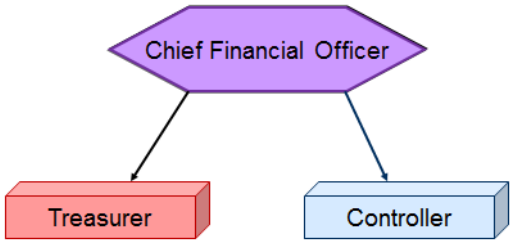
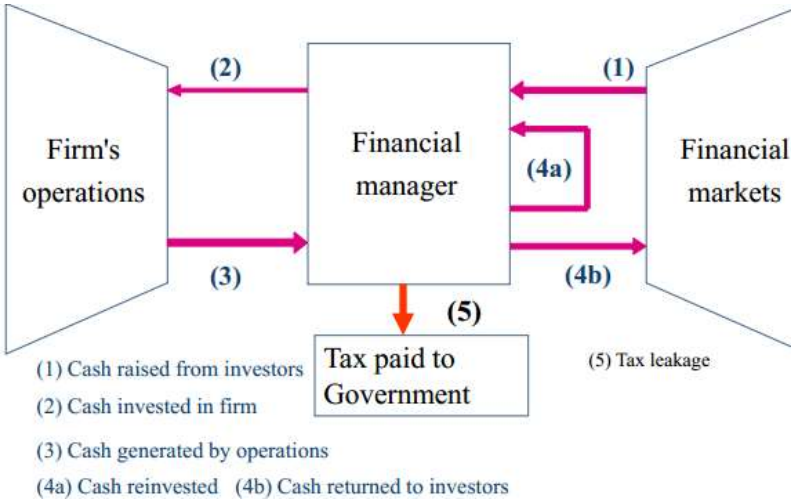
Difference in Information	Different Objectives
▪ Stock prices and returns	▪ Managers vs. stockholders
▪ Issues of shares and other securities	▪ Top mgmt vs. operating mgmt
▪ Dividends	▪ Stockholders vs. banks and lenders
▪ Financing	

- **Agency costs** are incurred when:
  - Managers do not attempt to maximise firm value e.g. a manager avoids attractive but 'risky' investments to improve their own job security or buys an unnecessary private jet for his company travels
  - Shareholders incur costs to monitor the managers and constrain their actions
- **Agency problem and Corporate governance solutions:**
  - **Legal and regulatory requirements→**
    - Corporations Act and ASIC→ to prevent managers from doing things against shareholder interest and protect investors
  - **Compensation plans→** create a structure such that the manager is finally rewarded for increasing shareholder value
    - E.g. linking bonuses with profit rises. However, this can create complications as managers, propelled by their own interests, might engage in acts that increase short term profits to earn bonuses, but damage the company's wealth, i.e. long term profits (creative accounting + focus on short term goals)
    - A more effective way is executive options → buying shares → align the manager's financial interest with the shareholders (option of buying shares has to be calculated properly, the exercise price (buying) shouldn't be too high or low)
  - **Board of directors →** Are a second set of agents of the shareholders and they oversee management on behalf of the shareholders. (Non executive and executive BoDs)

- **Monitoring** → Most significant are financial statements which show what the management is doing with shareholder funds and how the company is being managed → auditing etc
- **Takeovers** → Poor management → company struggles and loses value → threats from direct competitors for a take over
- **Shareholder pressure** → Replace board and management under the shareholder's consent e.g. through voting during AGM
- **Reputation** → managers don't want a bad reputation as it is harder to find a job later (only in tute)

The financial manager

- The financial manager (CFO) is responsible for major corporate financial decisions.
  - This involves both investments into the firm's operations (investment decision) and raising capital for those investments (financing decision) → seeks to maximise the firm's value and address the issues relating to 'the investment decision' and the 'financing decision'
  - 

  - These three are collectively known as the financial manager
- Essentially, the financial manager stands between the firm and outside investors
- 

- As above, the CFO raises capital from financial markets (1) (bank loans or securities sold in financial markets), then reinvests these in the firm's operations (2). Cash flow generated from real assets through business operation (3). The CFO then decides, within contractual constraints e.g. bank loan interests must be paid, whether to reinvest it back into the business (4a), repay money to financial markets (4b) and pay mandatory tax to government (5).