

2-208-97 Basic Corporate Finance
Professor Iwan Meier

Introduction to Corporate Finance

1. Administration
2. Introduction
3. Overview of Corporate Finance

Course Organization

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Readings

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- Required
 - “Fundamentals of Corporate Finance”, by Ross, Westerfield, Jordan, and Roberts, fifth Canadian edition, *McGraw-Hill Ryerson*.
 - The financial press (e.g. The Wall Street Journal, The Economist, Globe and Mail Report on Business, etc.)
 - Course web site.
- Suggested
 - Study guide for use with “Fundamentals of Corporate Finance”, by Jeannette Switzer, *McGraw-Hill Ryerson*.

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How the Course Works

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- This course is designed to provide
 - Knowledge of the basic concepts that are specific to the finance field.
 - Foundations that will be used in later finance courses.
- To get the most out of this course, understand the parts and their purpose through
 - Lectures
 - Books (text and study guide)
 - Exercises (in the text and study guide)
 - CD-ROM
 - Other stuff (internet sites, market simulations, financial press...)

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Course Grade

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- Mark distribution:
 - Quiz (fifth class): 10%
 - Mid term exam: 30%
 - Assignment (due last class): 20%
 - Final exam: 40%
- All questions will be in English, but you may answer in English or French.
- A laptop or financial calculator will be required for the exams.

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Introduction to Corporate Finance

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Roadmap for today:

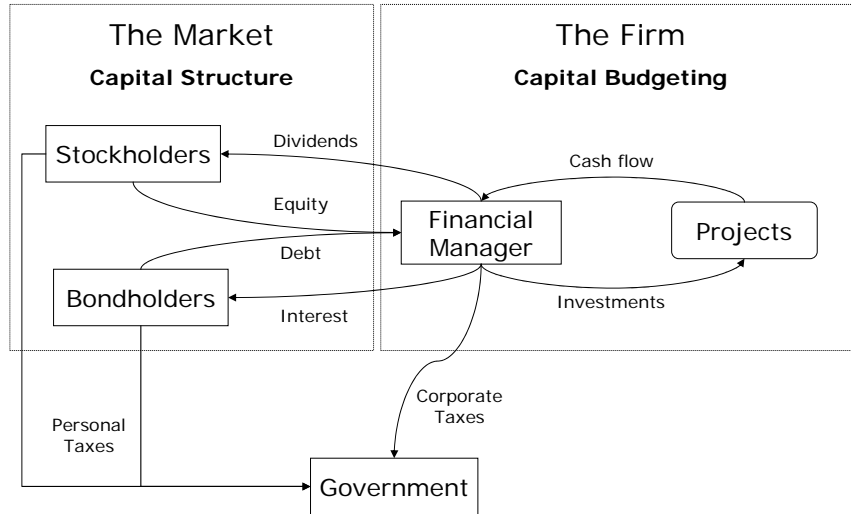
- What is corporate finance?
- Role of the financial manager
- Financial management decisions:
 - ① Capital budgeting
 - ② Capital structure
 - ③ Working capital management

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Course in a Nutshell



Century of Capital Decision Making

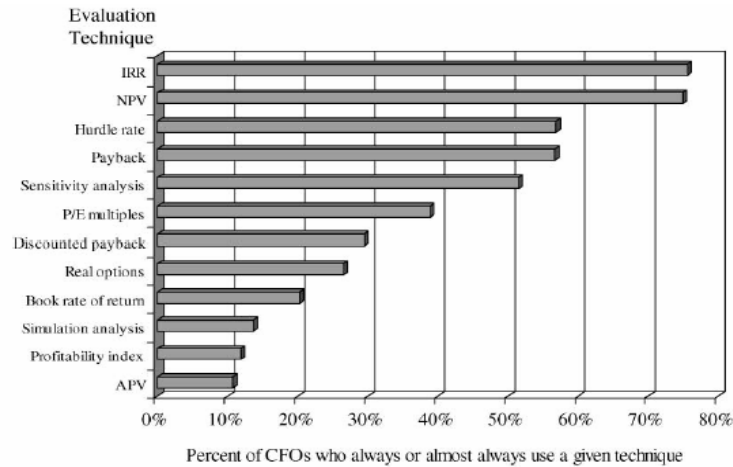


DEARBORN, Mich. - Ford Motor Co.'s \$2 billion revival of the sprawling River Rouge complex — a risky endeavor while the company battled financial problems — has transformed a gritty piece of American history into a modern model of environmental responsibility and manufacturing flexibility.



Developed between 1917 and 1928, the Rouge was an automotive "ore to assembly" complex. Henry Ford's idea was to achieve "a continuous, nonstop process from raw material to finished product, with no pause even for warehousing or storage."

Capital Budgeting Tools



Source: Graham and Harvey (2001), "The Theory and Practice of Corporate Finance: Evidence from the Field", *Journal of Financial Economics* 60, 187-243.

We Also Learn About Personal Finance

Cash Back or Low APR?

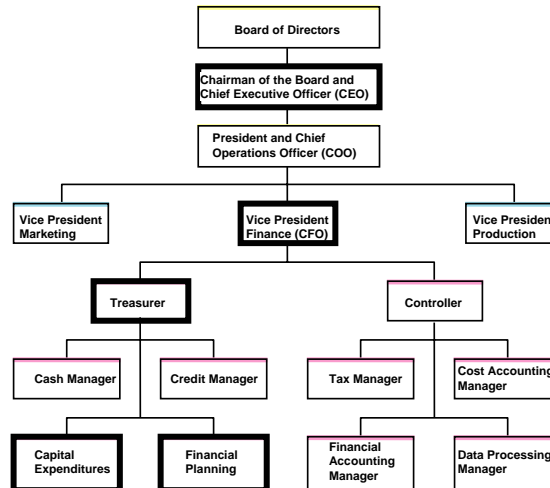
By [Aleksandra Todorova](#)

IN THE MARKET FOR a new car? If you were hoping for 0% APR, you just might be too late. Manufacturers have started to shy away from such generous offers, says Jesse Toprak, director of pricing analysis at [Edmunds.com](#), an automotive information Web site. The reason? Economic recovery. Those 0% financing deals were considered a necessary evil during the bear market, when manufacturers felt they needed to provide added enticement to keep cars moving off the lot. But that doesn't mean they plan to offer these deals any longer than necessary. "They don't want to keep spending money unless they have to," Toprak says.

Source: www.smartmoney.com

A Simplified Organizational Chart

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Source: "Fundamentals of Corporate Finance", by Ross, Westerfield, Jordan, and Roberts, 5th Canadian edition, McGraw-Hill Ryerson.

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Forms of Business Organization

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We look at three different legal forms:

- ① Sole proprietorship
- ② General or limited partnership
- ③ Corporation

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Sole Proprietorship

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Examples:

- Your own lemonade stand.
- A professional in private practice.

- Easy to setup.
- No distinction between owner and business:
 - Unlimited liability
 - Profits are personal income
 - Difficult to transfer

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Partnership

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Example:

- Law firm.

- Similar to a proprietorship, but
 - Shared resources, revenues and responsibilities.
 - One partner can act on behalf of others.
- Two types of partnership agreements:
 - General: Everything shared.
 - Limited: Some partners have limited liability.

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Corporation

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Example:

- Most businesses, ranging from an individual plumber to a multi-national.
- Separate legal entity:
 - Taxed separately from the individual → double taxation
 - Limited liability → owner only liable for investment
 - Unlimited lifespan, transferable ownership
 - Ownership can be separated from management
- Slightly complicated to setup
 - Articles of incorporation
 - Bylaws

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Advantages and Disadvantages

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- Which is better for:
 - Getting a small business started quickly without much hassle (e.g. lemonade stand)?
 - Obtaining a bank loan to finance a startup business?
 - Protecting the owner of a risky business?
 - Attracting outside investors?
 - Selling a business?
 - Minimizing taxes? (How are dividends taxed?)
- Businesses require both skill and capital, but they need not come from the same person.

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The Goal of Financial Management

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- When making financial decisions, what should be the enterprise's goal?

Should it maximize

- market share?
- sales revenue?
- profits?
- lifetime of business (avoid bankruptcy)?

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Goal in a For-Profit Business

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- Balance earning profits and controlling risk.

Managers work for the board of directors, who represent shareholders. Shareholders are better off when the value of the stock is high.

- ❶ Managers should maximize the value of the firm's equity.

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What About These Goals?

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- Maximize customer satisfaction.
- Environmental responsibility.
- Ethical behavior.

Therefore:

- ② In the real world, management must balance this against many other factors, but we will usually ignore those for the purpose of simplicity.

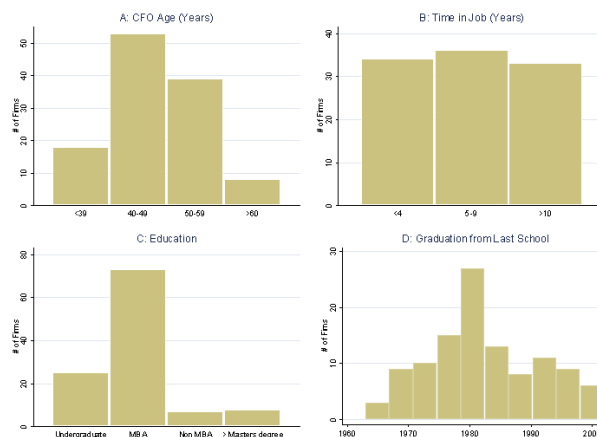
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Chief Financial Officer (CFO) Profiles

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Source: Meier and Tarhan (2003). Results for the 124 responding CFOs in the survey.

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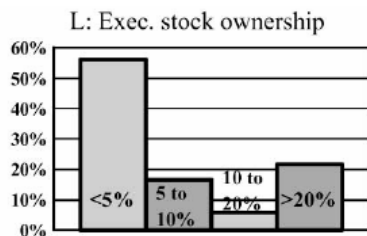
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Agency Problems

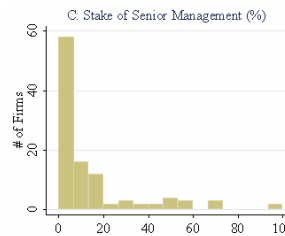
- Knowing the goal of the shareholders, how do we get the managers to work towards that goal?
- Definition of agency problem:
Conflicts of interest between the shareholders and management of a firm.
- Agency costs:
 - Direct: Corporate expenditure that benefits the manager, monitoring costs.
 - Indirect: Foregone investment opportunities or excessive investment.

What is the Stake of Senior Management?

- The equity stake of top management in the firm is 5% or less for half of the firms.



Source: Graham and Harvey (2001): The top three executives own at least 5% of the common stock of their firm in 44% of the sample.



Source: Meier and Tarhan (2003): The equity stake of senior management in the firm is 5% or less for half of the respondents (53.3%), and 1% or less for 13.1% of the firms.

Solutions to Agency Problem

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- ① Compensation plans tied to increases in firm value.
- ② Control (monitoring and corporate takeovers).
- ③ Long-term relationships.

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Financial Markets and Institutions

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- What types of financial institutions are there and what do they do?
- Financial markets
 - Money markets versus capital markets.
 - Primary markets versus secondary markets.

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Comparison Accounting and Finance

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- Accounting and finance worry about different goals:
 - Accounting worries about control of funds and accountability.
 - Finance worries about decision making and creating value.
- This means that accountants and financial managers might want to record and report the firm's performance differently.
- Two recurring differences:
 - Book value versus market value.
 - Cash flow versus income.

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Finance – Market Value

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- In finance, something is valuable only to the degree that someone is willing to pay for it.
- Market value is defined as the most that someone is willing to pay.
- We use market value for financial decisions.

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Accounting – Book Value

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- Based on historic value (purchase price) and depreciation
- Much less subjective than market value
- Changes less frequently than market value
- Therefore easier to track and better for accounting

- Book value is close to market value when the asset is more
 - Liquid
 - Short-term
 - Example: cash

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Income versus Cash Flow

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- How do we measure whether a firm is profitable?
Examples:
 - We make a big sale today but allow the customer to pay in 24 months. When should we record the revenue?
 - We buy a delivery truck that will last us ten years. When should we record the expense?
- Cash flow
 - Simple to measure.
 - Highly variable and hence not a good measure of profitability.
- Income
 - Income and expense accrual and matching principles.
 - Non-cash items (e.g. depreciation expense).

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What We Know Now

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- The three main areas of corporate finance.
- Basic forms of business organization:
 - Differences between a sole proprietorship and a corporation.
 - Advantages and disadvantages of each.
- Goals of financial management
- Agency problems in achieving those goals.
- Financial markets and institutions.
- Accounting versus finance:
 - Book value versus market value.
 - Income versus cash flow.