

Lecture 1 - Overview of Corporate Finance

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HEC MONTRÉAL

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Course information

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 - ▶ Office Hours: By appointment

- ▶ Location & Calendar:
 - ▶ Decelles 3032
 - ▶ Every Wednesday 8:30-11:30, September 3 - December 3
 - ▶ No class: October 15, 22
 - ▶ Midterm: October 17, 13:30-16:45
 - ▶ Final: December 15, 13:30-16:45

Course Information (Contd.)

- ▶ Required:
 - ▶ **Fundamentals of Corporate Finance** by Ross, Westerfield, Jordan, and Roberts, 6th Canadian edition, McGraw-Hill Ryerson
 - ▶ Slides and lecture notes

- ▶ A laptop or financial calculator will be required for the exams
 - Texas Instruments BAII PLUS (recommended)

- ▶ Grade Distribution:
 - ▶ Quiz: 10%
 - ▶ Midterm exam: 30%
 - ▶ Final exam: 40%
 - ▶ Assignment: 20%

Course Information (Contd.)

- ▶ **Review Session on Financial Mathematics:**
 - ▶ a 2-3 hours help session designed specifically for students taking Basic Corporate Finance
 - ▶ Monday, September 8th, 15:30-17:30
 - ▶ registration required at:
<http://technopedagogie.hec.ca/inscription/cam/>

Outline

- ▶ What is Finance?
- ▶ What is a Corporation?
- ▶ Who is the Financial Manager?
- ▶ What is the Role of the Financial Manager?
- ▶ Separation of Ownership and Management
- ▶ Financial Markets
- ▶ Financial Institutions
- ▶ Financial Statements

What is Finance?

- ▶ The study of managing money
- ▶ 3 Main **Areas** of Study:
 - ▶ Financial Markets and Institutions
 - ▶ Investments
 - ▶ Corporate Finance
- ▶ Corporate finance is a specific area of finance that analyzes the financial decisions of corporations
- ▶ The **Financial System**
 - ▶ Lenders
 - ▶ Borrowers
 - ▶ Financial Intermediaries
 - ▶ Financial Markets

What is a Corporation?

- ▶ 3 **Forms** of Business Organization:
 - ▶ Sole Proprietorship
 - ▶ Partnership
 - ▶ Corporation

Sole Proprietorship

- ▶ An **unincorporated** business owned by one individual
- ▶ The owner has **sole and unlimited liability** of all company's obligations
- ▶ Advantages:
 - ▶ easily and inexpensively formed
 - ▶ subject to very few government regulations
 - ▶ avoids corporate income taxes
- ▶ Disadvantages:
 - ▶ difficult to finance
 - ▶ unlimited personal liability for business' debts
 - ▶ the life of the business is limited to the life of the owner

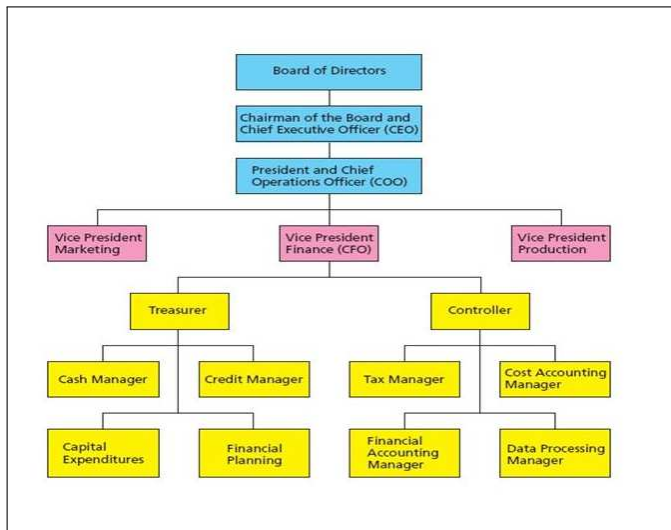
Partnership

- ▶ Two or more individuals associate to conduct a business
- ▶ The partners are personally **liable** for all company's obligations
- ▶ The partners **pay personal income tax** on their share of the business
- ▶ Advantages:
 - ▶ easily and inexpensively formed
 - ▶ subject to very few government regulations
 - ▶ avoids corporate income taxes
- ▶ Disadvantages:
 - ▶ difficult to finance
 - ▶ unlimited personal liability for the business' debts
 - ▶ difficulty in transferring ownership

Corporation

- ▶ **Legal entity**
- ▶ Resident of the country/province
- ▶ Separate and distinct from its owners and managers
- ▶ Owners (shareholders) have **limited liability**
- ▶ Advantages:
 - ▶ unlimited life
 - ▶ easy transferability of ownership interests
 - ▶ limited liability to the amount invested
 - ▶ more access to funds
- ▶ Disadvantages:
 - ▶ corporate earnings may be subject to double taxation
 - ▶ lots of regulations

Who is the Financial Manager?



What is the Role of the Financial Manager?

- ▶ Maximizing profits is **NOT** his primary goal
- ▶ **Maximizing shareholders' wealth IS** his primary goal
 - ▶ **maximizing the value** of the firm
 - ▶ **maximizing the stock price** which benefits all stakeholders (consumers, employees)
- ▶ The financial manager needs to make decisions about the future of the firm:
 - ▶ **Investment** (capital budgeting) decision
 - ▶ **Financing** (capital structure) decision
 - ▶ **Working Capital** management decision

Separation of Ownership and Management

- ▶ A distinctive feature of the corporations:
 - ▶ Stockholders
 - ▶ Board of Directors
 - ▶ Management
- ▶ **Agency relationship:** the principal (stockholder) hires another person - agent (manager) to represent his interests.
- ▶ **Agency problem:** the manager does not act in the best interest of the shareholders, but in his own interest
 - ▶ imposes **agency costs:** direct and indirect
- ▶ Need to **align** the interests of the managers with the interests of the shareholders

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 goal
- ▶ **Corporate control:**
 - ▶ The threat of a takeover may result in better management
- ▶ **Other stakeholders** (creditors, clients, suppliers, etc)

Financial Markets

- ▶ A way of bringing buyers and sellers together
- ▶ The **Initial Public Offering** (IPO)
- ▶ The **Seasoned Equity Offering** (SEO)
- ▶ Financial markets:
 - ▶ **Primary** markets: the original sale of securities take place
 - ▶ **Secondary** markets: securities are traded after the original sale
- ▶ Trading takes place in:
 - ▶ **Centralized** / Organized Stock Exchanges: TSE, NYSE, AMEX, LSE, CBOE
 - ▶ **Non-Centralized** / Over-the-Counter Exchanges: OTC exchange (NASDAQ)

Over-the-Counter

- ▶ OTC traders: **dealers**
- ▶ Sophisticated telecommunications network
- ▶ **Bid** price
- ▶ **Ask** price
- ▶ OTC can be both a primary and a secondary market
- ▶ Corporate Debt is traded Over-the-Counter

The Roles of Financial Markets

- ▶ To help establish **equitable prices** for securities:
 - ▶ the high volume of trades
 - ▶ the standardization of securities
 - ▶ the concentration of traders
- ▶ To provide **liquidity**
 - ▶ dealers
 - ▶ financial markets that are big and deep enough to absorb large transactions
- ▶ To minimize **transaction costs**
 - ▶ economies of scale
 - ▶ rules to ensure the safety of the traders
 - ▶ standardization
 - ▶ reduced search costs

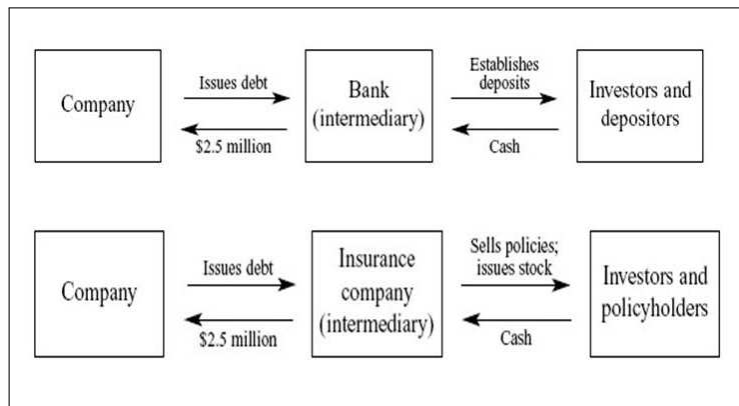
Types of Markets

- ▶ **Primary markets & Secondary markets**
- ▶ **Private markets & Public markets**
- ▶ **Money markets & Capital markets**
- ▶ Physical asset markets & Financial asset markets
- ▶ Spot markets & Futures markets
- ▶ Mortgage markets & Consumer credit markets
- ▶ World, national, regional, & local markets
- ▶ Dealer markets & Auction markets

Financial Institutions

- ▶ Financial intermediaries between investors (funds suppliers) and firms raising funds
- ▶ Can be chartered banks or other depository institutions:
 - ▶ trust companies
 - ▶ credit unions
 - ▶ investment dealers
 - ▶ insurance companies
 - ▶ pension funds
 - ▶ mutual funds

Bank vs. Insurance Company



Financial Statements - Balance Sheet (CAN)

	Dec. 31, 2005	Dec. 31, 2006	Dec. 31, 2007
ASSETS			
CURRENT ASSETS	104,0	119,0	137,0
Cash	6,0	12,0	8,0
Accounts Receivable	44,0	48,0	56,0
Inventories	52,0	57,0	72,0
Prepaid Expenses	2,0	2,0	1,0
NONCURRENT ASSETS	56,0	51,0	53,0
Financial assets & intangibles	0,0	0,0	0,0
Property, plant, & equip. (net)	56,0	51,0	53,0
Gross value	90,0	90,0	93,0
Accumulated depreciation	(34,0)	(39,0)	(40,0)
TOTAL ASSETS	160,0	170,0	190,0
LIABILITIES & OWNERS' EQUITY			
CURRENT LIABILITIES	54,0	66,0	75,0
Short-term debt	15,0	22,0	23,0
Owed to banks	7,0	14,0	15,0
Current portion of long-term debt	8,0	8,0	8,0
Accounts payable	37,0	40,0	48,0
Accrued expenses	2,0	4,0	4,0
NONCURRENT LIABILITIES	42,0	34,0	38,0
Long-term debt	42,0	34,0	38,0
OWNERS' EQUITY	64,0	70,0	77,0
TOTAL LIABILITIES & OWNERS' EQUITY	160,0	170,0	190,0

Financial Statements - Income Statement (CAN)

	2005		2006		2007	
		% of Sales		% of Sales		% of Sales
Net Sales	390,0		420,0		480,0	
Cost of goods sold	(328,0)		(353,0)		(400,0)	
Gross Profit	62,0	15,9%	67,0	16,0%	80,0	16,7%
Selling, general, & admin. expenses	(39,8)		(43,7)		(48,0)	
Depreciation expenses	(5,0)		(5,0)		(8,0)	
Operating profit	17,2	4,4%	18,3	4,4%	24,0	5,0%
Extraordinary items	0,0		0,0		0,0	
Earnings before interest & tax (EBIT)	17,2	4,4%	18,3	4,4%	24,0	5,0%
Net Interest Expense	(5,5)		(5,0)		(7,0)	
Earnings before tax (EBT)	11,7	3,0%	13,3	3,2%	17,0	3,5%
Income tax expense	(4,7)		(5,3)		(6,8)	
Earnings after tax (EAT)	7,0	1,8%	8,0	1,9%	10,2	2,1%
Dividends	2,0		2,0		3,2	
Retained Earnings	5,0		6,0		7,0	