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FM 2555A – FALL 2016 CORPORATE FINANCE

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Chapter 1: Topics Covered

- Corporate Investment and Financing Decisions
- The Financial Goal of the Corporation
- Preview of Coming Attractions

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Corporate Investment and Financing Decisions

- Real assets
 - Assets used to produce goods and services.
- Financial assets
 - Financial claims to the income generated by the firm's real assets.

Corporate Investment and Financing Decisions 1-4

- Investment decision
 - Purchase of real assets
- Financing decision
 - Sale of financial assets
- Capital structure
 - Choice between debt and equity financing

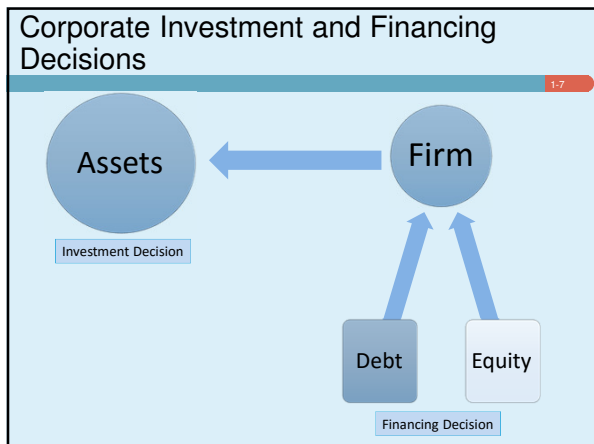
Corporate Investment and Financing Decisions 1-5

- Capital budgeting decision
 - Decision to invest in tangible or intangible assets
 - Also called the investment decision
 - Also called capital expenditures or (CAPEX)

Corporate Investment and Financing Decisions 1-6

Capital Budgeting

<u>Tangible Assets</u>	<u>Intangible Assets</u>
Expand Stores	New Drug R&D
@ \$800 million	@ \$800 million



Corporate Investment and Financing Decisions

Company	Recent Investment Decisions	Recent Financing Decisions
Facebook (U.S.)	Acquires WhatsApp for \$22 billion.	Pays for the purchase with a mixture of cash and Facebook shares.
Fiat Chrysler (Italy)	Announces plans to spin off its Ferrari luxury car unit.	Repays €2.5 billion of medium term debt.
GlaxoSmithKline (U.K.)	Spends \$6.6 billion on research and development for new drugs.	Raises \$5 billion by an issue of bonds in the United States.
LVMH ² (France)	Acquires Clos des Lambrays, one of the most prestigious vineyards in Burgundy.	Raises an additional €1.1 billion by short-term borrowing.
Procter & Gamble (U.S.)	Spends about \$9.7 billion on advertising.	Reinvests \$4 billion of profits.
Tesla Motors (U.S.)	Spends \$250 million largely on manufacturing facilities for a new model of electric car.	Raises over \$300 million by the sale of new shares.
Union Pacific (U.S.)	Announces spending plans of \$3.9 billion, including the purchase of 200 new locomotives.	Pays \$1.5 billion as dividends.
Vale (Brazil)	Sets aside \$2.6 billion to develop its huge coal mine in Mozambique.	Maintains credit lines with its banks that allow the company to borrow any time up to \$5 billion.
Walmart (U.S.)	Plans to invest \$1.2 to \$1.5 billion in e-commerce and digital initiatives.	Buys back \$6.7 billion of its shares.
Exxon Mobil (U.S.)	Commits about \$7 billion to develop oil sands at Fort McMurray in Alberta.	Reinvests \$17.8 billion of profits.

Corporate Investment and Financing Decisions

Are the following capital budgeting or financing decisions?

- Intel decides to spend \$1 billion to develop a new microprocessor.
- Volkswagen borrows 350 million euros (€350 million) from Deutsche Bank.
- Royal Dutch Shell constructs a pipeline to bring natural gas onshore from a production platform in Australia.
- Avon spends €200 million to launch a new range of cosmetics in European markets.
- Pfizer issues new shares to buy a small biotech company.

What is a Corporation?

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- Corporation
 - A business organized as a separate legal entity owned by stockholders
- Types of Corporations
 - Public companies
 - Private corporations
 - Limited liability corporations (LLC)

What is a Corporation?

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- Types of business organisations
 - Sole proprietorships
 - Partnerships
 - Corporations
 - Limited liability options
 - ✓ Limited liability partnerships
 - ✓ Limited liability corporations
 - ✓ Professional corporations
- Limited liability:
 - The owners of a corporation are not personally liable for its obligations.

Role of The Financial Manager

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graph LR; FM[Financial manager]; FO[Firm's operations]; FMkt[Financial markets]; FM -- (1) --> FMkt; FMkt -- (2) --> FM; FO -- (3) --> FM; FM -- (4a) --> FO; FM -- (4b) --> FMkt;
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(1) Cash raised from investors
(2) Cash invested in firm
(3) Cash generated by operations
(4a) Cash reinvested
(4b) Cash returned to investors

The Financial Goal of the Corporation

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- Stockholders want three things
 - To maximize current wealth
 - To transform wealth into most desirable time pattern of consumption
 - To manage risk characteristics of chosen consumption plan

The Financial Goal of the Corporation

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- Profit maximization
 - Not a well-defined financial objective
 - ✓ Which year's profits?
 - Shareholders will not welcome higher short-term profits if long-term profits are damaged
 - ✓ Company may increase future profits by cutting year's dividend, investing freed-up cash in firm
 - Not in shareholders' best interest if company earns less than opportunity cost of capital

The Financial Goal of the Corporation

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- Shareholders desire wealth maximization
- Managers have many constituencies, "stakeholders"
- "Agency problems" represent the conflict of interest between management and owners

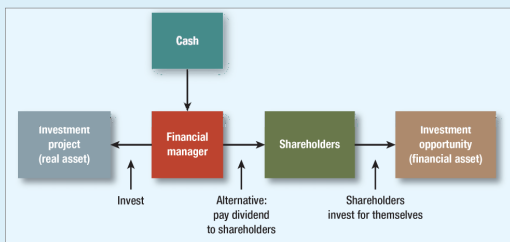
The Financial Goal of the Corporation

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- The investment trade-off
 - Hurdle rate/cost of capital
 - ✓ Minimum acceptable rate of return on investment
 - Opportunity cost of capital
 - ✓ Investing in a project eliminates other opportunities to use invested cash

The Investment Trade-off

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Agency Problem

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- Do managers maximize shareholder wealth or manager wealth?
- Managers have many constituencies “stakeholders”
- Stakeholder
 - Anyone with a financial interest in the corporation

Agency Problem

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- Agency problem
 - Managers are agents for stockholders and are tempted to act in their own interests rather than maximizing value
- Agency cost
 - Value lost from agency problems or from the cost of mitigating agency problems

Agency Problem

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- Corporate governance
 - The laws, regulations, institutions, and corporate practices that protect shareholders and other investors
