

FM 2555A – FALL 2016

CORPORATE FINANCE

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Chapter 1: Topics Covered

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

Corporate Investment and Financing Decisions

1-3

- 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

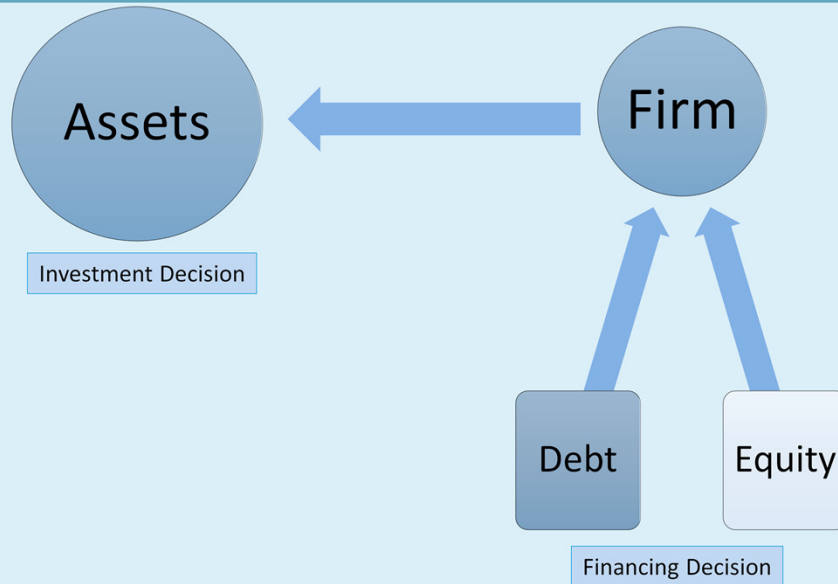
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Capital Budgeting



Corporate Investment and Financing Decisions

1-7



Corporate Investment and Financing Decisions

1-8

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.

This table is taken directly from the book and shows examples of investment and financing decisions. It is highly encouraged to take examples for the current news and add them as topics of discussion in class. Students relate much better when they can reference an event for which they are familiar.

Corporate Investment and Financing Decisions

1-9

Are the following capital budgeting or financing decisions?

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

What is a Corporation?

1-10

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

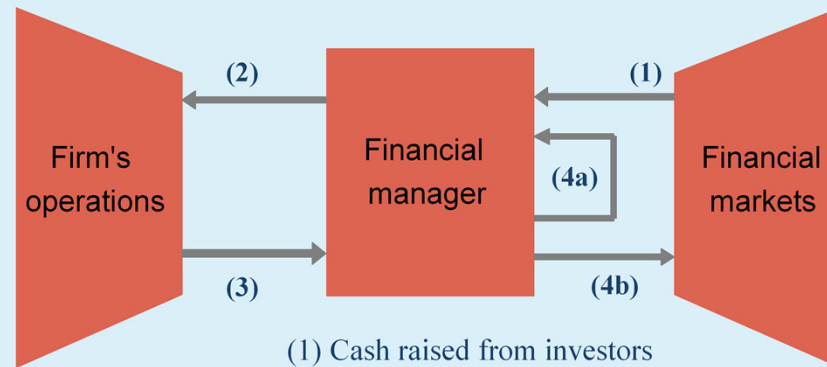
What is a Corporation?

1-11

- **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

1-12



- (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

1-13

- 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

Begin this section with a review of the traditional role of the firm in maximizing the value of stockholders. Spend time pointing out the role and rights of owners of a company to have their goals achieved. It is important to make sure students know the link between ownership of the company and the legitimate desire to maximize stock price.

The Financial Goal of the Corporation

1-14

- 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

Leap from the concept of maximizing stock price to the concept of how it is done. Point out that the natural tendency to achieve high profits may not necessarily accomplish this task. Long-term versus short-term profits can be introduced and maybe even a discussion of the short-term mindset of the capital markets.

The Financial Goal of the Corporation

1-15

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

An excellent follow-up to the debate between shareholders and stakeholders is the debate between shareholders and managers. Here it is worth noting the source of true power. In fact, it is important to highlight the fact that owners of a public corporation have very little power relative to managers. Examples of state corporate law can be presented to show the limited influence shareholders have over managers.

The Financial Goal of the Corporation

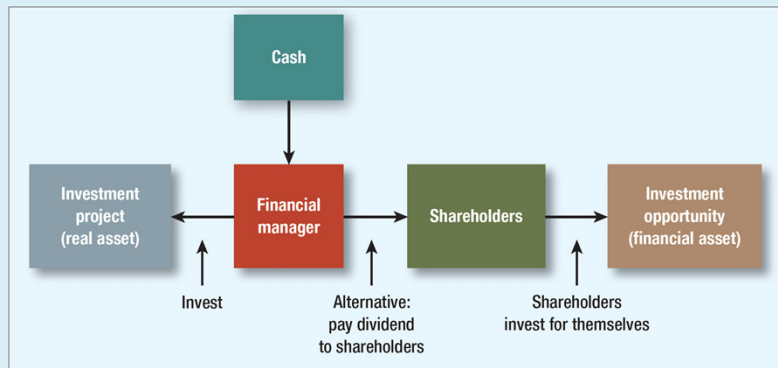
1-16

- 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

Here is an important concept check. While not much is written on this slide, take time to draw out the student's understanding of opportunity cost from their economics course. Some will refer to it as what an investor gives up. Alert students will define it as the value of the next best alternative. Take that definition and explain to them that in the world of finance we add a vital few words, "...at the same level of risk." If you have an example of how companies you know use different hurdle rates, or examples where companies improperly use only one rate for every decision, cite these as dos and don'ts.

The Investment Trade-off

1-17



Taken directly from the book, emphasize the decision managers must make. This shows the flow of cash as determined by the financial manager. Continue to point out that this is a capital budgeting or investment decision. That theme was introduced earlier and should be constantly reinforced.

Agency Problem

1-18

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

Agency Problem

1-19

- 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

1-20

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