Introduction to Corporate Finance

Basic Areas of Finance

• Corporate Finance
• Investments
• Financial Institutions
• International Finance
What is Corporate Finance?

Corporate finance focuses on 3 questions:

1. What should we invest in?
2. How do we finance those investments?
3. How do we manage the day-to-day operations of the firm?

The Balance Sheet Model of the Firm

• Balance Sheet Identity:
Capital Budgeting

• What is capital budgeting?
  – The process of ______________________ the firm’s ____________________________.

• How do we do it?
  1. Estimate cash flows.
  2. Estimate the cost of those cash flows.
  3. Discount the cash flows.

Capital Structure

• What is capital structure?
  – The ____________________________ describing how the firm is financed.

• Does capital structure matter?
• How do taxes affect this decision?
• How does this relate to the goal of the financial manager?
Short-Term Cash Flow Management

- What does short-term cash flow management entail?
  - Net Working Capital =
  - Cash Management
  - Credit Management

The Firm and the Financial Markets

Ultimately, the firm must be a cash generating activity.

The cash flows from the firm must exceed the cash flows from the financial markets.
Debt and Equity as Contingent Claims

- Debt is ______________________________.
- Equity gets ________________________.

A corporation has $100 in debt.
If the value of the firm’s assets is…
- $75, debtholders get _____ and stockholders get _____.
- $100, debtholders get _____ and stockholders get _____.
- $200, debtholders get _____ and stockholders get _____.
- $1,000,000, debtholders get _____ and stockholders get ________.
Sole Proprietorship

• Pros
  – Easy startup.
  – Taxed as personal income.

• Cons
  – ________________________.
  – Life limited to that of owner.
  – Equity limited to owner’s wealth.
  – Difficulty in transferring ownership.

Partnership

• General vs. Limited Partners
• Pros
  – Easy startup.
  – Taxed as personal income.

• Cons
  – ________________________.
  – Life limited to that of the owners.
  – Equity limited to owners’ combined wealth.
  – Difficulty in transferring ownership.
Corporation

- **Corporation**: *A business created as a distinct legal entity composed of one or more individuals or entities.*

- Separation of Ownership and Control
  - Shareholders
  - Directors
  - Managers

Corporation

- **Pros**
  - ________________________.
  - Easy transfer of ownership.
  - Unlimited life.
  - Equity is not limited.

- **Cons**
  - Difficult to startup.
  - ________________________.
The Goal of the Firm

What does that mean?

Agency Conflicts

- What is a principal-agent relationship?

- *Agency Problem/Conflict*: The possibility of conflict of interest between the stockholders (the principal) and management (the agent) of a firm.
Agency Conflicts

- *Agency Costs*: The costs of the conflict of interest between stockholders and management.
  - Direct agency costs:
    - 
    - 
  - Indirect agency costs
    - 

How do we control agency conflicts?

- Managerial Compensation

- Control of the Firm
  - 
  - 
  - 
Chapter 1 Suggested Problems

• Concepts Review and Critical Thinking Questions:
  – 3, 6, 7, and 8