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TOPIC :INTRODUCTION TO CORPORATE FINANCE

Introduction to Corporate Finance

What is Corporate Finance?

- Every decision that a business makes has financial implications, and any decision which affects the finances of a business is a corporate finance decision.
- Defined broadly, everything that a business does fits under the rubric of corporate finance.
- Regardless of whether you work for a corporation or are an external party with an interest in a particular corporation, understanding and being able to analyze corporate decisions is important

- We examine in-depth the decisions that a financial manager has to make
- We discuss basic valuation models that allow us to value a firm

The Three Major Decisions in Corporate Finance

- The investment decision
  - Why are managers asked to make choices amongst potential investments?
  - What makes for a good investment?

The Three Major Decisions in Corporate Finance

- The financing decision
- Where do firms raise/acquire the funds for value-creating investments?

- What mix of owner's money (equity) or borrowed money(debt) should the firm use?

The Three Major Decisions in Corporate Finance

- The dividend decision
  - How much of a firm’s funds should be reinvested in the business and how much should be returned to the owners?

First Principles of Corporate Finance

- Invest in projects that yield a return greater than the minimum acceptable hurdle rate with adjustments for project riskiness.
- Choose a financing mix that minimizes the hurdle rate.
- If there are not enough investments that earn the hurdle rate, return the cash to stockholders.
- These decision criteria will be consistent with the objective of the firm: **Maximize the Value of the Firm**

Valuation

- Some of the issues we will address:
  - How does a particular decision affect firm value?
  - "The link between these decisions and the firm value can be made by recognizing that *the value of a firm is the present value of its expected cash flows, discounted back at a rate that reflects both the riskiness of the projects of the firm and the financing mix used to finance them." page 6*
  - What are the prominent valuation methods?

Corporate Governance and Managerial Decisions

- Managers making decisions that are consistent with the firm objective of firm value maximization is predicated on the assumption that managers will act in the best interest of shareholders

- Corporate governance addresses the relationships between the various stakeholders in the firm

Finance is not a science…

- Often times, decision inputs are subjective
- Experience allows us to become more confident about our inputs

Am I Ever Going to Use This Stuff?

- Survey of 392 CFOs in 1998/99 about:
  - Capital budgeting, capital structure decisions

- Firms covered a broad spectrum of companies

"Theory and Practice of Corporate Finance: Evidence from the Field," Journal of Financial Economics, Vol. 60 by J. Graham and C. Harvey

Am I Ever Going to Use This Stuff?

- Capital Budgeting
  - How often do you use particular techniques?
    - NPV - 75%
    - IRR - 76%
    - Payback period – 57%
  - NPV and IRR more used by:
    - Large firms
    - Highly levered firms

Am I ever going to use this stuff?

- Capital Budgeting (contd.)
  - Cost of capital
    - CAPM (for cost of equity) – 74%
    - Company-wide rate -60%
    - Risk-adjusted rate – 51%

Am I Ever Going to Use This Stuff?

- Capital Structure
  - Do companies set target debt-equity ratio?
    - Strict target – 44%
    - Flexible target – 37%

Review concepts

- Time value terminology:
  - Annuity: Stream of equal, periodic cash flows for a fixed period of time
  - Perpetuity: Stream of equal, periodic cash flows forever
  - Growing perpetuity: Stream of periodic cash flows that grows at a constant rate forever (dividend discount model used to value equity is one example of a growing perpetuity)
- Capital Asset Pricing Model (CAPM)
  - Can be used as the discount rate to value equity
  - Represents the required rate of return for equity investors
- NPV and IRR models for discounted cash flow