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

(page 14 of your textbook)
Financial Markets

Firms

Stocks and Bonds

Money

Investors

securities

Bob

Sue

money

Primary Market

Secondary Market

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

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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