Class 1

UG3F14
Corporate Finance

Class 1

I. ***Module Introduction***

II. ***Overview of Corporate Finance:***

1. The Concept of Corporate Finance
2. The Purpose of Business Finance
3. Corporate Finance Activities
4. The Corporate Firm
5. Role of the Finance Manager in a Corporation: Types of financial decisions:
   - Long-Term Financial Planning and Decision Making:
     a. Investment Decisions
     b. Financing Decisions
     c. Dividend Decisions
   - Short-Term Finance Decisions

6. The Agency Problem

Class 1

I. Module Introduction

Description:

- This is an introduction to the study of the principles of corporate finance and their application to the usual financial issues and decision-making of business enterprises.
- By the end of the unit, you will be familiar with financial vocabulary, understand aspects of financial theory, and appreciate the underlying financial mind-set as well as incentives involved when solving problems of finance.
- Students will learn how to determine risk and make financial decisions, and how to value an investment as a potential financial opportunity.

Activities:

- Lectures
- Online Debates and Discussions
- Case Studies
- Article Discussion
- Individual Work
- Research Project
- Practical Sessions
- Collaborative Classroom Exercises

Class 1

I. Module Introduction

Competences – at the end of the module the learner will have acquired the responsibility and autonomy to:

- Take responsibility for identifying, analysing and solving unpredictable problems in diverse areas of business finance;
- Develop a critical awareness of the time value of money, risk, future returns and the capital investment decisions;
- Make informed, reasoned and sustainable decisions on capital investment projects;
- Demonstrate administrative design by using analytical techniques related to financing operations and valuation of organisations and investment opportunities.

Skills – at the end of the module the learner will have acquired the following skills:

- Apply knowledge and understanding of corporate finance, in a manner that indicates a professional approach, to interpret different criteria used to evaluate proposed investments, to determine the cost of capital, and to calculate relevant costs of capital for an investment project;
- Demonstrate theoretical and practical responses to applying several valuation methods to value investment opportunities, projects and companies;

Class 1

I. Module Introduction

Skills – at the end of the module the learner will have acquired the following skills:

- Estimate an optimal capital structure, the effects of financial leverage, bankruptcy, and the role of taxes;
- Gather and interpret relevant financial data and use it to achieve business objectives.

Judgment Skills and Critical Abilities – at the end of the module/unit the learner will have acquired the following judgement skills and critical abilities:

- Make professional judgments on the role and effects of the capital markets;
- Critically analyse and propose reasoned solutions to questions of capital allocation, retention and distribution;
- Evaluate corporate finance decision-making techniques and apply them in relevant internal and external situations;
- Make professional judgments on strategies employed by managers to maximise shareholder wealth.

Class 1

I. Module Introduction

Sessions:

- 18 30min sessions

Assessment: The assessment consists of Formative and Summative assessment activities listed, and described:

<table>
<tr><th colspan="2">Online Learning 100%</th></tr>
<tr><td>Formative</td><td>Summative</td></tr>
<tr><td>21 hours</td><td>14 hours</td></tr>
<tr><td>Case Study</td><td>Case Study (1500 words) – 50%</td></tr>
<tr><td>Group Report Formative Submission</td><td>Report (2000 words) – 50%</td></tr>
</table>

<table>
<tr><th>Formative</th><th>Summative</th></tr>
<tr><td colspan="2">Set Exercise/Case Study: Throughout the unit, students practice the application of knowledge, analytical, problem-solving or evaluative skills and receive timely feedback. As a result, students will be ready to provide a practical analytical solution (1500 words) to various problems presented in the unit by using skills and knowledge acquired.</td></tr>
<tr><td>Report Formative Submission: Students will have an opportunity to receive feedback on a partial submission of the group report.</td><td>Report: Students are working to apply valuation methods to value a project/business and provide recommendations to managers and/or potential investors.</td></tr>
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Class 1

I. Module Introduction

Assessment:

1. Formative Assessments: Refer to the Module Syllabus for the specific activities and dates
- Prefinal grade is based on the Formative Assessment activities, and it is not a part of a module final grade
- Students should have more than 50 points of the prefinal grade to be allowed to submit summative assessment activities which represent module final grade

2. Summative Assessment Activities: Refer to the Module Syllabus for the guidelines, general rules for written assignment and rubric.
- Assessment 1: Case Study due week 10
- Assessment 2: Group Report + Oral Presentation due week 11

The passing grade for the module is 60%

Class 1

I. Module Introduction

Module Requirements
Core Readings List

- Ross, S. et al. (2019). *Essentials of Corporate Finance (10th ed.)* McGraw-Hill Education.
- Brealey, R., Myers, S., Allen, F. (2019). *Principles of Corporate Finance (13th ed.).* McGraw-Hill Education.
- Koller, T. et al, (2020). *Valuation: Measuring and Managing the Value of Companies.* Wiley.

Supplementary Reading List

- Berk J, DeMarzo P. (2019). *Corporate Finance (5th ed.)* Pearson.
- Booth, L., Cleary, W. S., & Rakita, I. (2020). *Introduction to Corporate Finance*. John Wiley & Sons.
- Asquith, P., & Weiss, L. A. (2019). *Lessons in corporate finance: A case studies approach to financial tools, financial policies, and valuation*. John Wiley & Sons.
- Pinto, J. E. (2020). *Equity Asset Valuation.* John Wiley & Sons.
- Rosenbaum, J. et al. (2020). *Investment Banking.* Wiley.

Other Business and Finance Resources: Please refer to the module syllabus for recommended websites

Class 1

II. Overview of Corporate Finance:

1. The Concept of Corporate Finance:

- Corporate finance is the area of finance that relates to:
  - ➢ How corporations deal with funding sources
  - ➢ The actions management takes to increase income (revenues), and the value of a firm
  - ➢ Corporate finance departments are charged with governing and overseeing their firms' financial activities and capital investment decisions
- The primary goal of corporate finance is to **maximize shareholder value** thru long and short term financial planning and strategies

2. The Purpose of Business Finance:

- Provide tools, and information to support businesses to make effective and efficient decisions for:
  - ➢ Financial Planning
  - ➢ Proposals of investment decision
  - ➢ Managing of liabilities, assets and capital investments
  - ➢ Business financial monitoring & control
  - ➢ Risk management

Class 1

II. Overview of Corporate Finance:

2. The Purpose of Business Finance:

- Provide information to answer some of the strategic and tactical questions like:
  - ➢ In what long-lived assets should the firm invest?
  - ➢ How can the firm raise cash for required capital expenditures?
  - ➢ How should short-term operating cash flows be managed?

3. Corporate Finance Activities - in general terms:

Corporate Finance Activities

Capital Investments	Capital Financing	Dividends & Return of Capital
Decide what projects / acquisitions to invest in Earn the highest possible risk-adjusted return	Determine how to fund capital investments Optimize the firm's capital structure	Decide how and when to return capital to investors

https://corporatefinanceinstitute.com/resources/knowledge/finance/corporate-finance-industry/

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II. Overview of Corporate Finance:

4. The Corporate Firm:

- The firm is a way of organizing the economic activity
- A basic problem of the firm is how to raise cash
- Legal forms of organizing firm to raise cash- businesses can take a form of:
  - a) Sole proprietorship: The business owned by one person.
    - ✓ The least expensive business to form, no formal charter is required, and few government regulations must be satisfied for most industries
    - ✓ No payment of corporate income taxes - profits are taxed as individual income
    - ✓ Unlimited liability for business debts and obligations - no distinction is made between personal and business assets
    - ✓ The life of the sole proprietorship is limited by the life of the sole proprietor
    - ✓ Equity is based on the sole proprietor’s personal wealth
    - ✓ Examples: small businesses such as, a local grocery store, a local clothes store, an artist, freelance writer, IT consultant, or freelance graphic designer

EBay, Walmart, and Marriott Hotels are some examples of sole proprietorships that grew into multi-million dollars corporations

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II. Overview of Corporate Finance:

4. The Corporate Firm:

b) Partnership: Any two or more people can get together and form a partnership

- ✓ Partnerships fall into two categories: general partnerships and limited partnerships
- ✓ In a general partnership all partners agree to provide some fraction of the work and cash and to share the profits and losses, each partner is liable for all of the debts of the partnership
- ✓ Limited partnerships permit the liability of some of the partners to be limited to the amount of cash each has contributed to the partnerships
- ✓ A partnership agreement specifies the nature of the arrangement
- ✓ Partnerships are usually inexpensive and easy to form
- ✓ It is difficult for a partnership to raise large amounts of cash. Equity contributions are usually limited to a partner's ability and desire to contribute to the partnership

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II. Overview of Corporate Finance:

4. The Corporate Firm:

b) Partnership: Any two or more people can get together and form a partnership

- ✓ Income from a partnership is taxed as personal income to the partners
- ✓ Management control resides with the general partners
- ✓ It is difficult for large business organizations to exist as sole proprietorships or partnerships
- ✓ The disadvantages are unlimited liability, limited life of the enterprise, difficulty of transferring ownership, and in raising cash.

Apple, Inc. was crated by Steve Jobs and Steve Wozniak in 1,976 as a partnership, and 1,977 they choose to convert to corporate form

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II. Overview of Corporate Finance:

5. The Corporate Firm:

c) Corporation: It is a distinct legal entity. As such, a corporation can have a name and enjoy many of the legal powers of natural persons like acquire and exchange property, enter contracts and may sue and be sued.

- ✓ The most important for of business enterprise, and more complicated than starting a proprietorship or partnership
- ✓ The incorporators must prepare articles of incorporation and a set of bylaws including the intended life of the corporation
- ✓ Comprises three sets of distinct interests: the shareholders (the owners), the directors, and the corporation officers (the top management)
- ✓ Ownership in a corporation is represented by shares of stock, and can be readily transferred to new owners with no limit to the transferability of shares as there is in partnerships
- ✓ The corporation has unlimited life, and the shareholders’ liability is limited to the amount invested in the ownership shares

Walmart, Inc., Microsoft Corporation, Amazon.com, Inc., or Inditex

Class 1

II. Overview of Corporate Finance:

5. The Role of the Finance Manager- The Importance of the Cash Flows:

- The most important job of a financial manager is to create value from the firm's capital budgeting, financing, and net working capital activities
- To create value the firm must create more cash flow than it uses:
  - ✓ Buy assets that generate more cash than they cost
  - ✓ Sell bonds and stocks and other financial instruments that raise more cash than they cost
  - ✓ Financial goals: Business sustainability, avoid financial distress and bankruptcy, maximize sales and market share, minimize costs, maximize profits

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II. Overview of Corporate Finance:

5. The goal of a financial manager:

A finance manager has to find answers and provide advisory, and solutions to:

- What should be the size of firm?
- In which assets / projects funds should be invested?
- Investments in which assets / projects should be reduced or discontinued?
- Balance Risk-Return Trade-Off – The higher the risk, higher the return and the lower the risk, lower the return
- A finance manager seeks to select projects / assets which: Minimize the risk for given level of return or maximize return for given degree of risk

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II. Overview of Corporate Finance:

5. The goal of a financial manager:

1. Long Term Financial Planning and Decision Making
   - Importance of Long-Term Investment Decisions:
     - ➢ They directly affect the profitability or earning capacity of the business
     - ➢ They affect the size of assets, scale of operations and competitiveness of business
     - ➢ They involve important amount of investment which remains blocked in the fixed assets for a long period of time
     - ➢ Most of the investments are irreversible, and if reversible, it will be at a high cost

Class 1

II. Overview of Corporate Finance:

5. The goal of a financial manager:

1. Long Term Financial Planning and Decision Making:
   - *Capital budgeting & Investments Decisions:*
     - ➢ Long term investments / planning – select the criteria for finding of projects
     - ➢ What long-term investments should the firm take?
     - ➢ Decision-making process that companies follow with regard to which capital-intensive projects they should pursue
     - ➢ Planning where to place the company's long-term capital assets in order to generate the highest returns with the lowest risk
     - ➢ Deciding whether or not to pursue an investment opportunity through extensive financial analysis
     - ➢ Examples of capital budgeting decisions: Investment in plant and machinery, Purchase or takeover of an existing business firm, Starting a new factory or sales office or Introducing new product line

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II. Overview of Corporate Finance:

5. The goal of a financial manager:

1. Long Term Financial Planning and Decision Making:
   - Factors Affecting Capital Budgeting & Investments Decisions:
     - ✓ Cash flows of the project- The series of cash receipts and payments over the life of an investment proposal should be considered and analyzed for selecting the best proposal.
     - ✓ Rate of return- The expected returns from each proposal and risk involved in them should be taken into account to select the best proposal.
     - ✓ Investment criteria involved- The various investment proposals are evaluated on the basis of capital budgeting techniques. Which involve calculation regarding investment amount, interest rate, cash flows, rate of return etc. It is to be considered which technique to use for evaluation of projects.

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II. Overview of Corporate Finance:

5. The goal of a financial manager:

1. Long Term Financial Planning and Decision Making
   - *Capital Financing Decisions*:
     - ➢ Corporation has two primary capital sources for investment purposes:
       - ✓ Self-generation of capital thru revenue streams /income which takes time and resources
       - ✓ External capital funding sources like bank loans or issuing debt (bonds) that will increase debt rations and liabilities in the balance sheet, affecting the business cash flows, and raising cash thru equity capital (selling stock) which is less risky but dilutes the value of the stock, and earnings to shareholders
     - ➢ Capital Financing and Structure decisions involves decisions on:
       - ✓ How to optimally finance the capital investments through the business
       - ✓ Where will the funding come: bank, bonds, equity or a blend
       - ✓ Find the optimal mix in debt/equity to fund investments

Class 1

II. Overview of Corporate Finance:

5. The goal of a financial manager:

1. Long Term Financial Planning and Decision Making
   - Factors Affecting Financing Decision:
     - ✓ Cost-The cost of equity is more than the cost of debts. The least costly source should be selected
     - ✓ Financial Risk- More risk is associated with borrowed funds as compared to owner’s fund
     - ✓ Flotation cost- The cost involved in issuing securities such as broker’s commission or underwriter’s fees. The higher the flotation cost, less attractive is the source of finance.
     - ✓ Cash flow position of the business- In case the cash flow position of a company is good enough then it can easily use borrowed funds.
     - ✓ Control considerations- In case the existing shareholders want to retain the complete control of business then finance can be raised through borrowed funds
     - ✓ 6. State of capital markets- During boom period, finance can easily be raised by issuing shares but during depression period

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II. Overview of Corporate Finance:

5. The goal of a financial manager:

1. Long Term Financial Planning and Decision Making
   - *Dividends & Return of Capital Decisions*:
     - ➢ Concerned with deciding how much of the profit earned by the company should be distributed among shareholders (dividend) and how much should be retained for the future contingencies (retained earnings)
     - ➢ Dividend refers to that part of the profit which is distributed to shareholders
     - ➢ The decision regarding dividend should be taken keeping in view the overall objective of maximizing shareholder s wealth

Class 1

II. Overview of Corporate Finance:

5. The goal of a financial manager:

1. Long Term Financial Planning and Decision Making
   - Factors Affecting Dividends & Return of Capital Decisions:
     - ✓ Earnings - Company having high and stable earning could declare high rate of dividends as dividends are paid out of current and past earnings.
     - ✓ Stability of dividends- Companies generally follow the policy of stable dividend. The dividend per share is not altered in case earning changes by small proportion or increase in earnings is temporary in nature.
     - ✓ Growth prospects - In case there are growth prospects for the company in the near future then, it will retain its earnings and thus, no or less dividend will be declared.
     - ✓ Cash flow positions- Dividends involve an outflow of cash and thus, availability of adequate cash is a requirement for declaration of dividends.
     - ✓ Preference of shareholders- In case shareholders desire for dividend then company may go for declaring. The amount of dividend depends upon the degree of expectations of shareholders.

Class 1

II. Overview of Corporate Finance:

5. The goal of a financial manager:

2. Short Term Financial Decision Making - Working Capital Decisions:
   - Funds used in its day-to-day operations to ensure liquidity position of a firm to avoid insolvency
   - Working capital deals with currents assets and current liabilities
   - Key areas of working capital decisions: How much inventory to keep?, deciding ratio of cash and credit sales, proper management of cash, effective administration of bills receivables and payables, or investment of surplus cash
   - The principle of effective working capital management focuses on balancing liquidity and profitability

Class 1

II. Overview of Corporate Finance:

6. The Agency Problem and Control of the Corporation:

- ➢ Agency Relationship: The relationship between stockholders and management
  - ✓ In corporate finance, the agency problem refers to a conflict of interest between a company's management and the company's stockholders
- ➢ Control of the Corporation:
  - ✓ Financial manager acts in the best interests of the stockholders by taking actions that increase the value of the stock
  - ✓ Corporations has many stakeholders
  - ✓ Management effectively controls the firm - will they necessarily act in the best interests of the stockholders? Or pursue its own goals at the stockholders' expense?
  - ✓ Reasons for Agency Problems: Conflict of interest and agents tend to have more information than principals

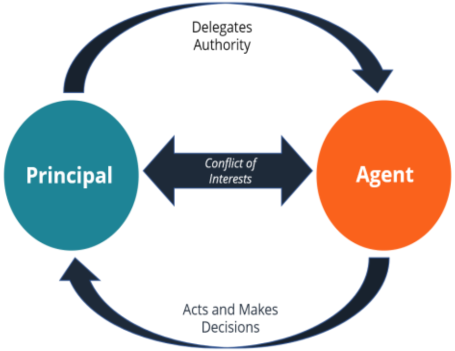
Class 1

II. Overview of Corporate Finance:

6. The Agency Problem and Control of the Corporation:

- To mitigate the agency problem, it should require:
  - ✓ Corporate governance
  - ✓ Full transparency
  - ✓ Placing restrictions on the agent's capabilities
  - ✓ Invest in monitoring
  - ✓ Tying the compensation structure to the well-being of the principal

Example of Principal - Agent Problem: Issuers (principal) and rating agencies



https://corporatefinanceinstitute.com/resources/knowledge/other/principal-agent-problem/

Class 1

II. Overview of Corporate Finance:

6. The Agency Problem and Control of the Corporation – Case: Enron Corporation

- ➢ Enron Corporation was an American energy, commodities, and services company based in Houston, Texas. It was founded in 1985 with 29,000 employees and $74billion in losses due to fraud – ceased 2007
- ➢ Enron's: management hiding losses from shareholders and the general public through accounting fraud

https://www.britannica.com/event/Enron-scandal

Other Cases:

- Goldman Sachs and the Real Estate Bubble

https://fortune.com/2016/04/11/goldman-sachs-doj-settlement/

- The Boeing Buyback

https://www.newsweek.com/boeing-airlines-under-fire-90-billion-share-buybacks-stoke-controversy-bailout-pleas-least-1493934

- Executive Compensation and WorldCom

https://www.nytimes.com/2005/01/06/business/10-exdirectors-from-worldcom-to-pay-millions.html