CHAPTER 1: CORPORATE FINANCE, WHAT IS IT?

Well, this class is going to be given by professor Damodaran. Most of the thing are obvious and logical, but at least we need to hear it once.

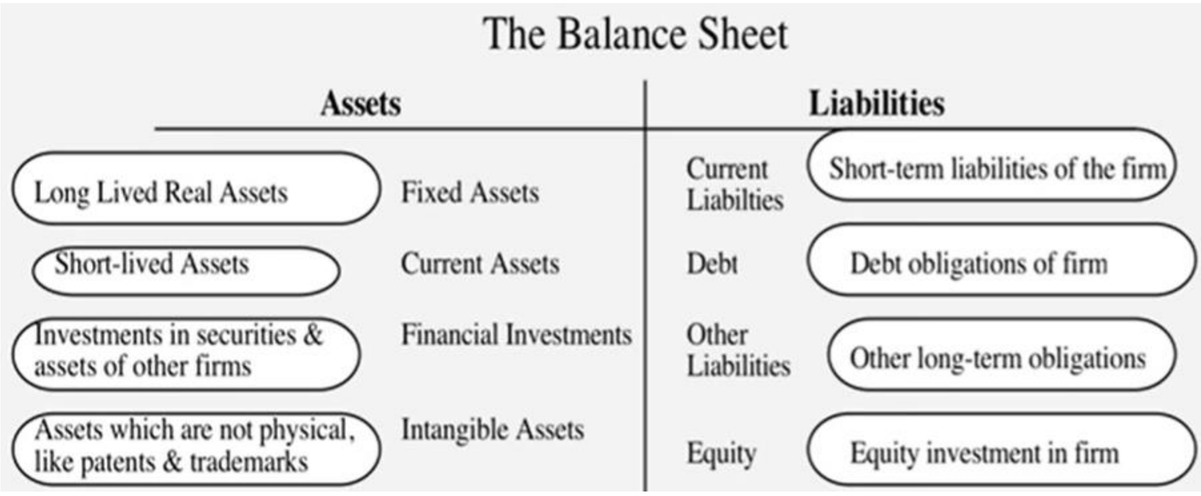
Definition.

Corporate Finance involves every decision that is made in a business. That is because the decisions made will have **financial implications.**

In consequence, Marketing, Sells, Branding, Accounting are just pieces of a puzzle in a bigger picture which is corporate finance.

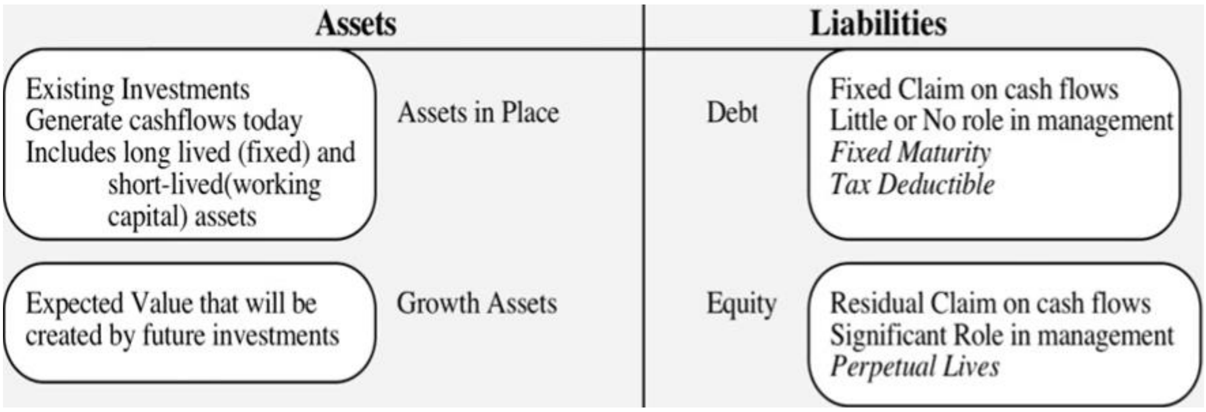
Difference in Balance Sheet.

Accounting.



I am not going to explain anything about this as we all should be familiar with it. Just saying that this balance sheets only explains what the company has **now** and not the **future perspectives.**

Finance.



This one is different, and it has some characteristics we are going to discuss.

Characteristics:

- **Assets:** Things that the company has or rights about them.
  - **Assets in Place:** All the investments you have already made as a company. **Ex.:** Buildings, factory… (We get it from the total amount of assets in the balance sheet).
  - **Growth Assets:** Value attached to what is expected to do on the future. They are supposed to be growth opportunities which derive into a possible **creation of value. Ex.:** Buying another company in the future. (We get it from doing D + E – A)
- **Liabilities:** You can either **borrow** the money or use your **own** money.
  - **Debt:** That is when you **borrow the money**. Also, they are the one's you have to **pay first** when you earn and the ones who are **first on claiming** the assets when you go bankrupt. But they have very **little management** of the company. **Ex.:** A credit from the bank. (We get it from the total liabilities we have)
  - **Equity:** It is your **own money**. They have more **power over management**, but they always get what is **left over**. **Ex.:** Capital. (We get it from the share price multiply per number of shares).

3 Principles that govern corporate finance.

At first, we have to think that the **main goal** of a firm is to increase at its maximum **the value/price of the stock/wealth of the stockholders**.

The Investment Decision/Principle.

Concept.

When you make an investment in assets as a business, make sure you have a greater return than a minimum acceptable of **hurdle rate.**

Key points.

- **Hurdle Rate:** It should reflect the **risk** of the investment and **founding** used for it. So, the mix of debt and equity used to make it happen.
- **Return:** It should reflect the **magnitude** and the **timing** of the cashflows as well as all side effects. **Note:** You want to have more money coming in than money coming out from the investment, as well as receiving before paying.

The Financing Decision/Principle

Concept.

It tries to define which is the optimal **mix** between **debt** and **equity** that allows a **maximization of the firm's value.** In order to do so, we need to know:

- **What do we have:** As the magnitude of the assets and their value.
- **Time characteristics:** See if the assets are long term or short term (in order to pay the debt).

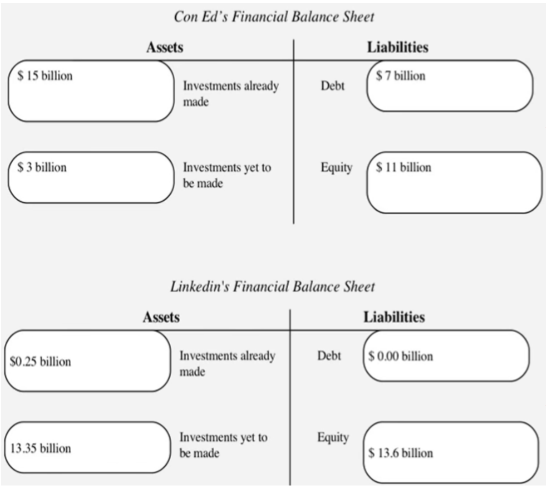
Note: We want the lowest hurdle rate for our business, so we need a mix that gets that.

The Dividend Decision/Principle.

This principle states that you are most of the times serving your stockholders and because of it you need to give the highest **value of the firm** you can. At the same time, sometimes you will have to give dividends. But at last, if you do not find money for your investments, it is key that you do not push your luck and return the money to the investors from the business.

Characteristics of Corporate Finance.

1. **Common Sense:** It is common sense, you do not need to study this if you use your common sense. **Ex.:** Found your company at a 6 % rate, not 9%.
2. **Focus:** The purpose is to maximize the value of the firm. Because of it, we should try to focus on one objective that ends on that purpose.
3. **Know your state in the Life Cycle:** Know at what state your company is at on the Life Cycle. Thanks to this, you will be able to make decisions. **Ex.:**



Mature Company, value on the investment already made. (Dividends, mix debt equity, lot of assets)

Growth Company, value on the investment yet to be made. (No dividends, equity +++, little assets)

4. **Universal:** It is for all kinds of business, doesn't matter its characteristics.
5. **We need to follow the principles:** If we do not follow the principles, we are going to go down, so we need to stablish the first principles.

Jokes:

- My wife is mad at the fact that I have no sense of direction. So I packed up my stuff and right.
- I am reading a book about gravity. Is impossible to put down!
- What do you call someone with no body and no nose? Nobody knows.

Main Goal.

Maximize the value of the stock prices. It is not the only goal but is the main goal, as it is saying that you should try to maximize the value of the firm.

Situation.

On this chapter we are going to base our assumptions in this utopian situation, so we can demonstrate the main goal we have described.

Characteristics.

1. **Stockholders:** They have power over managers, and they can hire or fire them. Because of it, managers want to keep them happy.
2. **Bondholders or Lenders:** They are not going to get played, even if they do not protect themselves against the company. Managers, as they will need them, they won't play them.
3. **Financial Markets:** They reveal honestly the information of the company. Markets are rational, they do not act out of sentimental and anger.
4. **Society:** They are no social cost.

This is utopian, so it is not real, but it is made so we can show why should we increase the stock price.

Joke.

- If you see a robbery in an Apple store, does that makes you an iWitness?

Relationships.

Stockholders – Managers.

In order to access the power the stockholders have over managers they have:

- **Annual meeting:** Proxis if they are not voted, they do protect the manager, leaving the manager with maybe **50 %** of the shares just because others didn't show up. They also select the board of directors.
- **Board of Directors:** They should control the CEO. Most times is the CEOs who decides who is on the board. Normally it should be 10 tops.

When the power is taken from the stockholders to the managers, they usually put their own interest in front of the owners. They can do:

- ✓ **Greenmail:** The company offers a much higher price than the one offered by the hostile takeover, so they do not loose their job.
- ✓ **Golden Parachutes:** Correct your contract in order to protect managers if there is a hostile takeover.
- ✓ **Poison Pills:** They acquire the rights of the cashflow to "defend" the company from a hostile takeover.
- ✓ **Shark Repellents:** Anti-takeover amendments which need the approve of the annual meeting, which is taken by the CEO.
- ✓ **Overpaying in takeovers:** Acquisitions which make no sense but the ego of the CEO makes it done.

Hostile Takeover (OPA).

A competitor wants to buy someone company, against the vision of the managers. Then, the managers can difficult the acquisitions.

Managers – Bondholders.

When banks lend money to companies and they do not protect themselves, usually companies put more debt on themselves so they can improve the value of the stock. Unfortunately, themselves increase their hurdle rate, which is unfortunate for the first lender who has characteristics when it was less risky.

Remember that if a company goes bankrupt, no money is payed back.

Managers – Society.

Social cost is a real thing, like pollution.

Managers – Financial Markets.

The people react from bad news because of it, markets are not rational at all.

This is driven because of the misleading information that companies provide, coming with delay and sometimes even lying. If you are a small company, you depend on trust for your financial.

Note.

Before looking at the numbers, you look at who is controlling the company. The shareholders get affected from what the CEO does.

Reality.

Now what we are looking is how can we solve the problems that we explained in the previous pages.

Solutions to problems.

1. **Different Governance:** We could assign the responsibility of keeping an eye on the managers to others.

We have the examples of Japan and Germany.

Germany.

The banks were the ones who overlooked what the managers were doing. And also the enterprise were looking on the banks.

The problematic is the same that Japan.

Japan.

They use the term **keiretsus,** which means the companies have shares of the other companies. Thanks to this, other companies were the ones looking on what the others were doing wrong.

The problem came when most of the companies were doing a bad job and, as the bad managed companies had the power, they fire the other who were doing a good job.

2. **Different Objective rather than increase the firm's value:** Pick some other objective that is not maximizing the value of the firm.

Maximizing growth, sells or others could be some clear examples of what we are seeing here. Unfortunately, they should be temporary goals, which shouldn't be at the eye of the company for long periods.

Example.

If your main goal was maximizing the sells, you might lower the price even under cost so you can get that sales, nevertheless, you will go bankrupt, but you will have achieved your goal. This is the problematic and that is why they are only temporary.

3. **Reduce the potential problems we might have:**

This is the third and most effective way. When markets make mistakes, they correct themselves, either later or earlier, but they do. The concept is **self-correcting.**

Stockholders – Managers.

When there are imperial managers, there will be a day when the proxis that are given to the CEOs because other people do not show up, they do show up. And then, they choose another manager.

Even, they do a hostile acquisition.

Managers – Bondholders.

They make special requirements and conditions to lend money. Now, bondholders protect themselves, so the company doesn't play them. With the use of clauses, they do not allow an increase in debt acquisition.

Managers – Financial Markets.

When you lie to the market, when the truth comes out, the stock price drowns, collapses. Even when the things go better for the company, you lose your credibility, making the price at lows.

Growth companies should never lie.

Managers – Society.

Usually, when you are crossing the line of social cost, most of the times the society targets you and drowns you. **Ex.:** Tobacco companies.

Example.

The board of directors of Disney.

Questions

¿What is a Captive Board?

A captive board is when many managers and CEO are members of the board, they do not overlook or control the CEO. That is when you usually reach an **imperial CEO.**

¿What is a conflict of interest?

It is when someone has his decisions influence because of the positive relation it has with that which is being affected on the decision.

¿What is an agency problem?

It is a problem between the Managers and the Shareholders, having different interest.

¿What is the problem of having profit as an objective?

It relies on the income statement, so what is going to happen is that there is incentive to manipulate it. Remember than the managers make it. Also, the main goal is forgotten.

Jokes.

There 3 unwritten rules in life.

1.
2.
3.

The end.

This might not be funny for some, but it is to me, so, I hope you like it.

https://youtu.be/gbxSpLDQehg