

Corporate Finance: What Can We Learn?

- How to select profitable projects for investment?
(Budgeting decisions)
- How to finance the investments efficiently?
(Financing decisions)
- What to do with the profits?
(Payout Policy)
- What is the value of the firm?
(Valuation for IPOs, M&A, equity analysis)

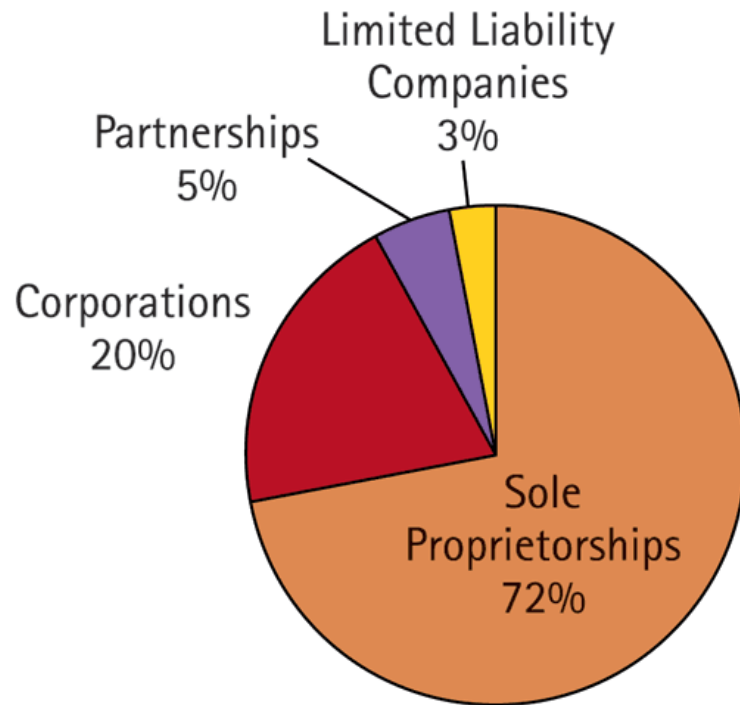
Lecture 1. Intro to Corporations

- The Four Types of Firms
- Ownership versus Control of Corporations

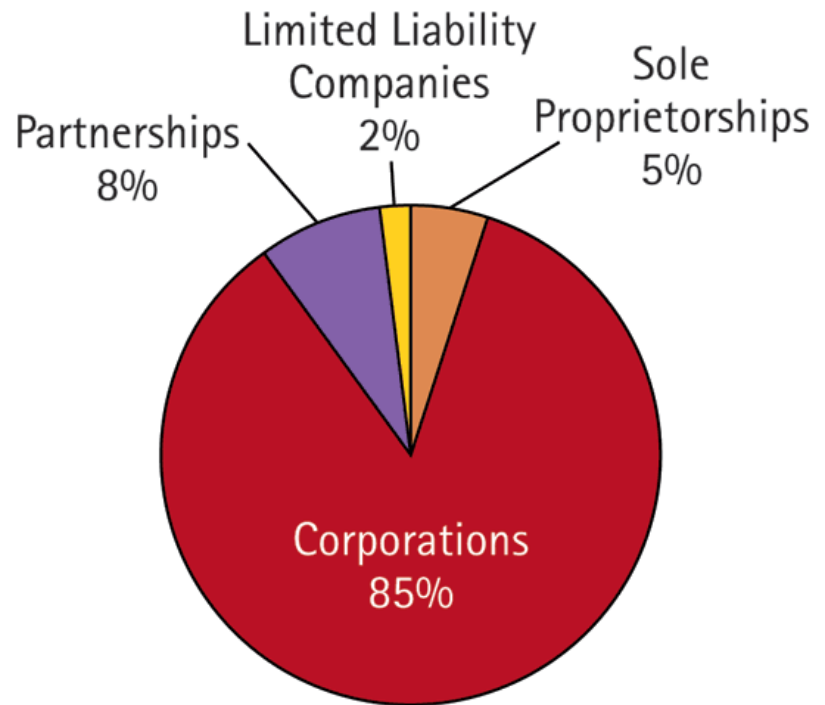
The Four Types of Firms

- Sole Proprietorship
- Partnership
- Limited Liability Company
- Corporation

Types of U.S. Firms



(a) Percentage of Businesses (2000)



(b) Percentage of Revenue Generated (2000)

The Four Types of Firms (cont'd)

1. Sole Proprietorship

- Business is owned and run by one person
- Typically has few, if any, employees
- Advantages
 - Easy to create
 - Few gov't regulations
 - Income is not subject to corporate taxation – pay only individual income tax
- Disadvantages
 - Unlimited personal liability for business debts
 - Limited life – if the owner dies, his/her heirs receive the assets, but have to start a new business.

The Four Types of Firms (cont'd)

2. Partnership

- Similar to a sole proprietorship, but with more than one owner.
- General partnership
 - All partners are personally liable for each other's and the firm's debts. A lender can require any partner to repay all of the firm's outstanding debts.
 - The partnership usually ends with the death or withdrawal of any single partner, even if other partners want to continue the business.

The Four Types of Firms (cont'd)

- Limited Partnership: solves the problem of personal liability
 - Limited Partnership has two types of owners.
 - General Partners
 - Have the same rights and liability as partners in a general partnership
 - Typically run the firm on a day-to-day basis
 - Limited Partners
 - Have limited liability and cannot lose more than their initial investment
 - Have no management authority and cannot legally be involved in the managerial decision making for the business
 - Problem with LP
 - Limited partners' decision-making ability can pierce their protection.

The Four Types of Firms (cont'd)

3. Limited Liability Company (LLC in U.S., LLP in BC, UK)
 - All owners have limited liability *and* can manage the business
 - like a general partnership, but each partner is not liable for other partners.
 - New in the U.S., Canada (BC allowed it in 2004), but 100+ years elsewhere (GmbH). Canada's LLPs can be formed only by lawyers, accountants, etc., but BC allows any partnership to become LLP.
 - It usually faces LP-like taxation -- pays no corporate tax and income/losses are passed-through to the owners. However, different states and provinces often have additional LLC taxes or fees, which causes some uncertainty.
- Weakness of all types of partnerships and LLCs: difficult to raise capital for new investments and growth
 - i.e., relatively difficult to borrow (debt) or sell membership interest (equity).

The Four Types of Firms : Corporation

4. **Corporation:** A legal entity separate from its owners

- Has many of the legal powers individuals have, such as the ability to enter into contracts, own assets, and borrow money
- Limited liability. The corporation is solely responsible for its own obligations. Its owners are not liable for any obligation the corporation enters into.
- Other advantages:
 - Unlimited life.
 - Easy transferability of ownership through shares. In partnerships, each asset has to be individually transferred.
 - Losses are fully tax-deductible for a corporation, whereas in other company types an individual must prove there was a profit motive before deducting losses.
 - Credit rating is separate from the owners.

Corporation (cont'd)

- *Corporation: Formation*
 - Corporations must be legally formed. The corporation files a charter with the state it wishes to incorporate in. The state then “charters” the corporation, formally giving its consent for the company to be recognized as a legal entity.
- Articles of incorporation (the charter) include: Company name, Location of registered office, Classes and authorized shares, Share transfer restrictions (if any), Directors, Business restrictions
 - Due to its attractive legal environment for corporations, Delaware is a popular choice for incorporation in the U.S..
 - When partnerships grow, they are often transformed into corporations, e.g. MSFT in 1981, GS in 1999.

Corporation (cont'd)

- Corporation: Ownership
 - Represented by shares of stock, i.e. shareholders are the owners of a corporation.
 - There is no limit to the number of shareholders and, thus, the amount of funds a company can raise by selling stock.
 - Profits can be distributed via dividends to many investors, without giving up the controlling stake.

Corporation : Disadvantages

- Tax Implications: **Double Taxation**, i.e. corporate and individual
 - Note: There are “S” Corporations (U.S. only) – a way around double tax
 - Firm’s profits are not subject to corporate income tax, but instead are allocated directly to the shareholders.
 - But: restrictions on stock ownership (no foreign owners, at most 75 shareholders)
- Costs. Registration and ongoing admin costs (annual report, accounting, higher bank fees) are the same regardless of firm size and, thus, can be a burden for smaller businesses. A corporation usually must be represented by an attorney in court.

Ch. 1.3 Goals of The Corporation

- Shareholders desire **wealth maximization** (*firm value* is or can eventually be distributed to shareholders)
- Net Present Value (NPV) of an investment

$$NPV = PV(\text{Benefits}) - PV(\text{Costs})$$

- In a corporation, there may be thousands of shareholders, many with different priorities.
- Maximizing the sum of the firm's investment NPVs satisfies *all* shareholders

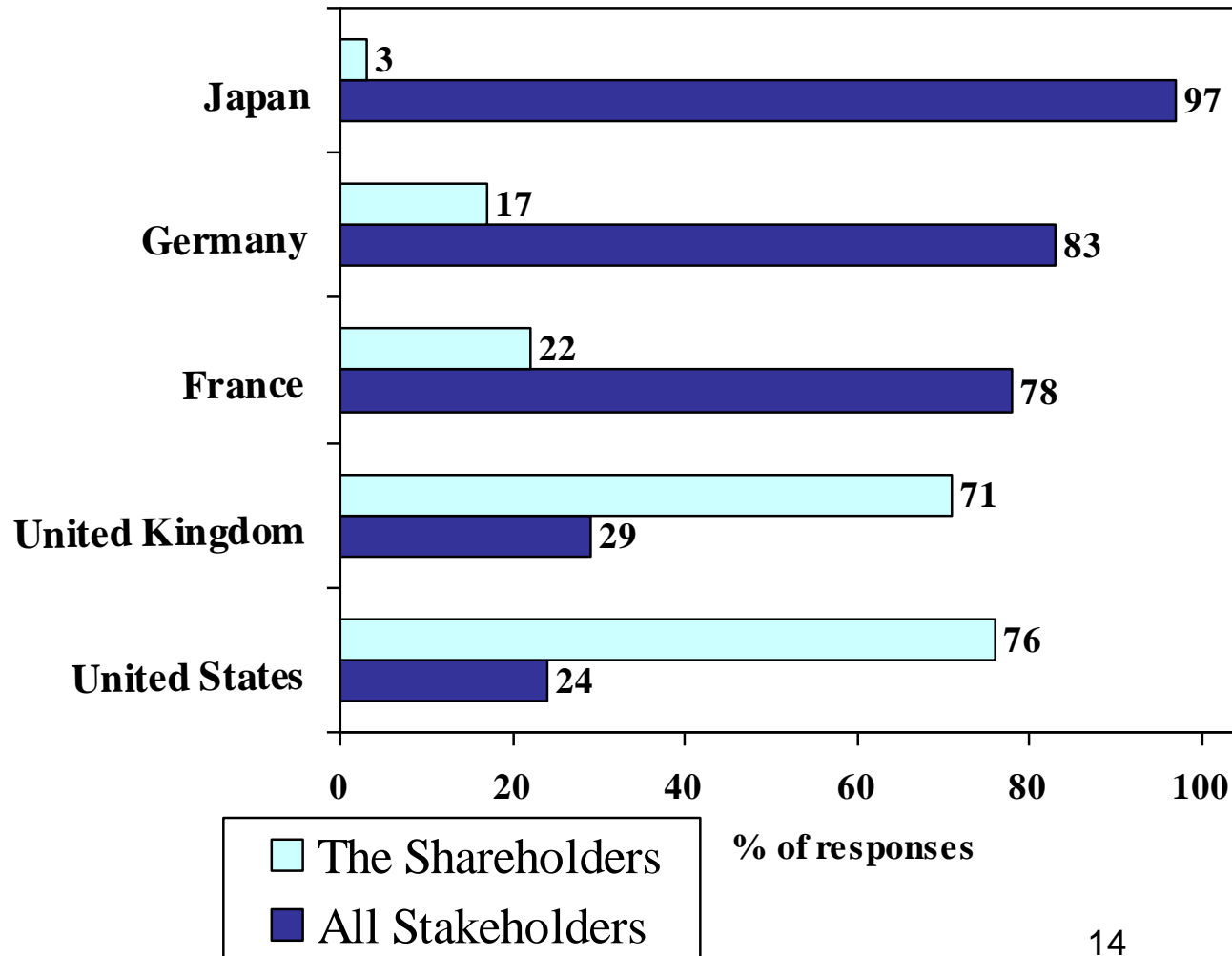
Whose Company Is It?

- Do managers maximize just shareholder wealth or other stakeholders' interests?

Stakeholder examples:

employees,
bondholders,
environment

Survey of 378 managers from 5 countries



1.3 Goals of The Corporation

- In defense of stock price maximization:
 - Owners of stock are the society now - through pension plans, mutual funds, and directly (unlike in the first half of the 20th century)
 - Successful corporations grow and hire new employees, thereby benefiting the society.
 - Fortune magazine's main criterion to put a firm in the list of Most Admired companies is the company's ability to attract, develop and retain talented people.

Ch 1.4. Ownership versus Control of Corporations (Important)

- Corporate Management Team
 - ownership and control are *separate*:
 1. Shareholders
 - Elect directors – members of the **Board of Directors**, which controls the firm
 - Vote on big issues (e.g., merger, charter amendments) directly
 - Classes of shares (e.g., common vs. preferred) determine shareholder rights
 2. Board of Directors
 - Has ultimate decision-making authority
 - Appoints and oversees the CEO
 3. Chief Executive Officer (CEO) and managers
 - Responsible for day-to-day decision making

Ownership versus Control of Corporations (cont'd)

- Principal-Agent Problem

- The corporation is “the principal” that hires the manager who is “the agent”.
- The agency problem is that managers may act in their own interest, rather than in the best interest of the shareholders.
- The Board of Directors has a duty before shareholders that managers run the company well, i.e. maximize its value.
- Managers’ effort is not observable
- One potential solution is to tie executive compensation to firm performance.
- How should performance be measured?
 - Stock price (most common)
 - Economic value added (EVA, BMA ch.13), earnings growth, etc.

Agency Problems and Incentives (p. 290-292)

Agency Problems in Capital Budgeting

- Reduced effort
- Perks
- Empire building
- Entrenching investment
- Avoiding risk

The last three lead to a violation of the NPV maximization rule

Ownership versus Control of Corporations (cont'd)

- Why is the stock price (returns) a good measure of CEO Performance?
 - If a CEO is performing poorly, shareholders can express their dissatisfaction by selling their shares. The selling pressure will drive the stock price down. The CEO can be replaced.
 - However, stocks can be mispriced temporarily, so that the fundamental (intrinsic) price, rather than current mkt price, must be maximized and looked at.
 - Hostile Takeover can circumvent the problem of managerial entrenchment
 - Low stock prices may entice a Corporate Raider to buy enough stock, so that it gains enough control over the seats on the Board of Directors to vote and replace current management. The stock price will rise after the new management team “fixes” the company.

Ownership versus Control of Corporations (cont'd)

- *Corporate Bankruptcy* can also lead to management replacement; it can even replace the owners of the firm
 - Reorganization and Ownership transfer to debt-holders
 - Liquidation
 - of unprofitable units or complete shutdown