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International Corporate Finance I

LECTURE 1
Introduction

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Two main issues in corporate finance

1. I the have money. What should I do with it?

- The firm is facing an investment opportunity. Let's take the firm's financial structure as given. The firm should invest or not?
- Topics will include:
  - Present value principle.
  - Weighted Cost of Capital (WACC)
  - Real option.

Two main issues in corporate finance (continued)

2. I know what I want to do. How should finance my project?

- The firm has its business going on. What is the firm's best strategy to finance its business?
- Topics will include:
  - Optimal capital structure.
  - Financing strategy (equity vs debt issue).
  - Dividend policy.

Five things you have to understand

1. Basic accounting.
2. Basic financial instruments of the business firms.
3. Principle of the valuation.
4. Incorporating "risk".
5. The effects of financial problems to the firm's management and organization.

Basic accounting

- Balance sheet
  - *Housekeeping Note* (家計簿) for the business firm.
  - In the next lecture, we will see it using the example of Daikin's 2007 Annual Report .

Firm's financial instruments (1)

- Use cash in hand or getting money from outside.
  - Cash in hand: retained earnings
  - Outside money: equity; debt/borrowing
- Outside money: equity vs debt
- Debt: issuing bond vs bank borrowing

Business corporations in the capitalist economy

- Shareholders are the owners of the corporation.
- Reward for the shareholder.
  - Capital gain (increase of share price)
  - Dividend payment.
- Shareholders as "residual claimants"
  - Other claimants of the firm (stakeholders):
    - Workers, trading partners (account receivables), government (tax)
    - Debt holders.

Firm's financial instruments (2)

- Seniority among outside money
  - Ordinary debt/borrowing.
  - Subordinated debt/borrowing.
  - Preferred stocks
    - In most cases, no voting right.
  - Common stocks
- Limited liability of stock holders.

Valuation of an investment opportunity/project

- Present-value principle (PV)
  - One and only principle.
  - Evaluate expected future profits and losses by their money's worth today. Then, you sum up everything to get net present value (NPV) of the project.
  - Other methodologies are either short cuts (e.g. IRR) or technical sophistication (e.g. real option) of PV principle.

Valuation and risk

Example: R&D of new medicine

- Nature of the project's risk: Purely technical problem.
- Meaning of the project's risk for the entire corporation:
  - The firm's current business might slow down and may not be able to continue to finance R&D activities.
  - Business cycle and macroeconomic environment.
  - Multiple projects might fail simultaneously.
  - Rise of interest increases the cost of outside financing.
- Evaluation of the project's risk as an input for managerial and financial decision making.

Financial problem and governance of organization (1)

- Maximize profits = minimizing costs, including salaries for employees.
- Design of incentive mechanism such that the employees work efficiently.
  - Basic idea: Linking salaries to effort levels.
    - How should we measure individual effort level?
    - By measuring output?
    - How closely tied? How often ?
    - E.g.: bonus payment; employees shareholdings; stock options
  - Based on tenure or based on output?

Financial problem and governance of organization (2)

- Mechanism design such that the manager maximize profits.
  - Incentive mechanism for managers
  - Outside monitors: Auditors, banks, large shareholders.
  - Who monitors outside monitors? Conflict of interests?
  - US: Superpower CEO and a small number of outside directors
  - Japan: Governance by many inside directors
- Company system; spinoff of subsidiaries and etc.