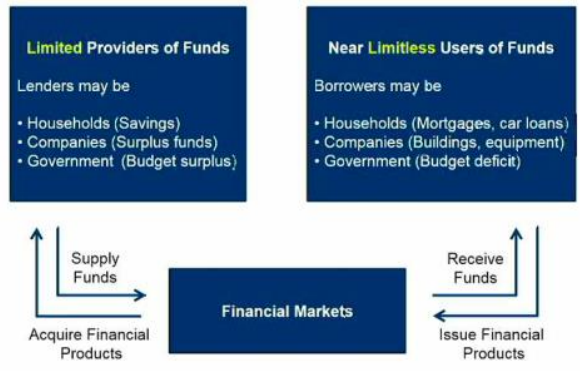
FINC2011 Final Exam Notes



Role of the financial manager

1. *Investment decision (capital budgeting)*
    a. What long term investments should the firm take on?
2. *Financing decision (capital structure)*
    a. Where will we get the long term financing to pay for the investment?
3. *Dividend decision*
    a. How are returns distributed to equity holders?

The investment decision

purchase of real assets

- Real assets: assets that can be put to productive use to generate a return (e.g. machinery and equipment)
- The type of assets the firm should use
- How many assets it needs to run its business
- Deciding when to shutdown and dispose of assets
- The purchase of more intangible assets (e.g. patents or shares in another company)
- Capital budgeting evaluation (week 5)

The financing decision

sale of financial assets

- Financial assets: assets that represent a claim to a series of cash flows against an economic unit (e.g. corporate bond)
- How should the firm raise funds to purchase real assets?
- How does the firm choose its gearing ratio?
- What are the costs of each diff source of finance?
- Should the firm issue short term or long term securities?

Dividend decision

- Dividend policy refers to the decision by companies to pay out net profit after tax or retained earnings to shareholders (as dividends) or alternatively reinvest these profits (retained earnings)

Goal of financial management

Goal: maximise shareholder wealth i.e. minimise profit, market share, etc. minimise costs.

Market capitalisation

Owner wealth is measured by 'market capitalisation' of securities

- For shares this is the total market value of all the shares of a company on issue

$$MCap = Price * Shares\ Outstanding$$

Forms of business organisations

Sole proprietorship/ trader	Partnership	Company

• Business owned and controlled by one person Advantages • Easy to start, lightly regulated, single owner keeps all profits Disadvantages • Unlimited liability, equity capital limited to owner's personal wealth, limited to life of owner, difficult to sell ownership	• A business formed by two or more individuals/entities Advantages • More capital available, relatively easy to start Disadvantages • Unlimited liability, partnership dissolves when one partner dies or wishes to sell, difficult to transfer ownership, difficult to raise capital	• Business created as a distinct legal entity owned by one or more individuals or entities • Can be publicly listed or a private company Advantages • Limited liability, unlimited life, separation of ownership and management, transfer of ownership is easy, easier to raise capital Disadvantages • Agency costs

Agency problems

- Principal hires an agent to represent their interest
  - Shareholders (principals) hire managers (agents) to run the company
- Agency problem
  - Conflict of interest between principal and agent
- Why does this conflict exist?
  - Because there is a separation of ownership and control

How can we align shareholder and management interests?

- Legal and regulatory requirements
- Managerial compensation (e.g. stock options and performance- based options)
- Shareholders elect the Board of Directors, who are responsible for monitoring management
- Proxy fight to replace existing management
- Threat of takeover

Asset valuation

  - TVOM is derived from the fact that interest can be earned on an alternative investment opp
  - The interest rate is referred to as the OC of buying the asset or the OC of capital

Functions of a financial system

- Comprises a range of financial institutions, financial instruments and financial markets which interact to facilitate the flow of funds
  - Overseen by a central bank (RBA)
  - Supervised by prudential regulator (APRA)
- Key functions
  - **Encourage savings and allocate them to the most efficient users of funds**
  - **Provide economic and financial info to the markets**
  - **Important component of monetary policy**

Encourage savings and allocate these savings to the most efficient users of funds

- Surplus entities can invest their savings through the purchase of financial assets. Assets (real and financial) can be thought of as a package of four main attributes:
  - <u>Return or yield</u>
    - Total financial benefit received (interest and capital) from an investment; expressed as %
  - <u>Risk</u>
    - Possibility or probability that an actual outcome will vary from the expected outcome; uncertainty
  - <u>Liquidity</u>
    - Access to cash and other sources of funds to meet day-to-day expenses and commitments
  - <u>Time pattern of cash flows</u>
    - Frequency of periodic cash flows (interest and principal) associated with a financial instrument
- Financial instruments should possess diff combinations of the 4 attributes to encourage savings
- Financial markets should ensure that savings are directed to the most efficient users of funds
- Financial institutions like commercial banks, finance companies, insurance companies, super funds and managed funds help bring together those who have money (savers) and those who need money (borrowers)

Provide economic and financial info to the markets

- Info affects price and investment decisions
- Types of info
  - Macroeconomic announcements
  - Stock info (ASX)
  - Company info (e.g. audited annual reports)

Important component of monetary policy

RBA

- Developed in 1960, functions and powers based on *reserve bank act 1959*
- Duty is to contribute to stability of the currency, full employment and economic prosperity and welfare of Aus people. Does this by setting cash rate to agreed inflation target (2-3%)

Monetary policy

- Actions of central bank that influence level of interest rates in order to achieve economic outcomes
- The primary target is inflation

Financial institutions

1. **Depository financial institutions**

Accept deposits and provide loans to customers
E.g. CBA, Westpac

2. **Investment banks and merchant banks**

Specialist providers of financial and advisory services to corporations, high net worth individuals and govt
E.g. JP Morgan, Goldman Sachs

3. **Contractual savings institutions**

Offer financial contracts such as insurance and superannuation
E.g. AMP, ING Direct

4. **Finance companies and general financiers**

borrow funds direct from markets to provide loans and lease finance to customers
E.g. building societies (Aussie home loans - now owned by CBA, RAMS home loans - now owned by Westpac)

5. **Unit trusts**

Investors buy units issued by the trust, pooled funds invested
E.g. colonial first state - owned by CBA

Financial instruments

1. Equity

Ownership interest; going concern; voting rights; residual claim
E.g. ordinary share or common stock

2. Debt

Interest and principal payments; finite life; first claim
E.g. bond

3. Hybrid securities

Characteristics of debt and equity
E.g. preference shares, convertible bonds

4. Derivatives

Value derived from underlying asset/security, mainly used to manage risk

- **Forward contract**
  - Contract to trade at a future date at a price determined today
- **Futures contract**
  - Standardised forward contract
- **Option contract**
  - Right to buy or sell at a future date at a price determined today
- **Swap contract**
  - Agreement to exchange future cash flows

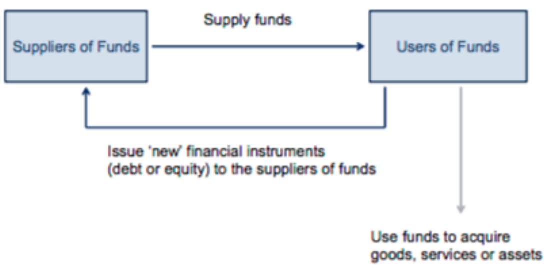
5. Financial markets

Matching principle

- Short-term assets should be funded w short term liabilities
- Longer term assets should be funded by longer term liabilities and equity

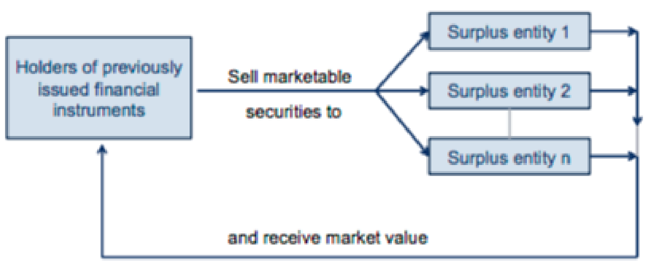
Primary market transaction

- Occurs when a new financial instrument is issued in the money or capital market
- New capital is raised in this process
- E.g. an IPO



Secondary market transaction

- Involves transaction involving existing financial instruments
- No new capital is raised in this process
- E.g. purchasing shares on ASX



Direct vs intermediated finance

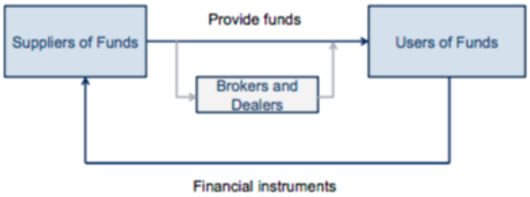
Issue of new financial instruments can occur in 2 ways:

1. *Direct finance*

Funding obtained direct from the money markets and capital markets

Broker: an agent who carried out instructions of a client

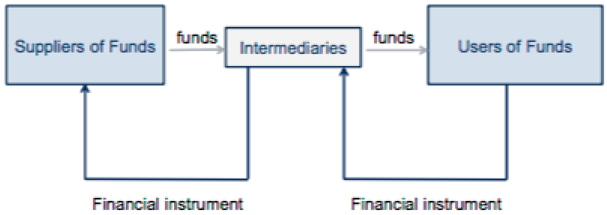
Dealer: makes a market in a security by quoting both buy (bid) and sell (ask) prices



Advantages	Disadvantages
-Removes financial intermediary -Diversification of funding sources -Greater flexibility -Enhanced profile	-Mismatching of preferences and maturity structure -Liquidity and marketability of the direct finance instrument -High search and transaction costs -Difficult to assess risk - particularly default risk

2. *Intermediated finance*

- Financial transaction conducted w a financial intermediary
- Distinguished by separate contractual arrangements



Advantages

- Asset transformation
- Maturity transformation
  - Liability mgmt
- Credit risk diversification and transformation
- Liquidity transformation
- Economies of scale

Wholesale vs retail markets

Wholesale market

- Direct financial flow transaction between institutional investors and borrowers
- Large scale transaction

Retail market

- Financial transaction conducted with financial intermediaries mainly by individuals and small to med-sized (SMEs) businesses
- Principally w financial intermediaries
- Price takers

Money markets

Wholesale markets in which short term securities are issues and traded

Comprises a no. of submarkets

Central bank: system liquidity and monetary policy

- Reserve Bank Info and Transfer System (RITS)

Inter-bank market

Bills market

- Bank Accepted Bills (BABs)

Commercial paper market

- No acceptor

Negotiable certificates of deposit market

Capital markets

- Markets for LT funding for businesses, individuals and govt's
- Equity market (ASX)
- Corporate debt market
  - Term loans, commercial property finance, debentures, unsecured notes, subordinated debt, lease arrangements and securitisation
  - International capital markets
- Govt debt market
- Foreign exchange market
- Derivatives market