**Lecture 1 Review**

**Intro to Finance**

The 3 Main Categories of Traditional Finance:

1. Money and Banking

* The role of a bank is to bring borrowers and lenders together
* On the local level, a bank is thought of as an economic engine (creates mortgages and facilitates commercial lending)
* At the corporate level, we think of investment banking, which brings companies together

1. Investments

* Involves analyzing and evaluating investment opportunities
  + Advisory jobs = certified financial planner, broker, wealth manager (fee of 1% of assets)
  + Analysts examine financials and value assets

1. Financial Management \*\*\*

* Dealing with the finances of a firm
* Typical issues facing a financial manager are…
  + What projects should the firm invest in?
  + How do we finance the projects?
    - Financing could be cash or debt
  + Daily financing activities of the business
    - Pricing, exchange rate contracts, inventory, etc.

The 5 Guiding Principles of Finance:

1. Maximize wealth

* Maximization of wealth is the creation of as much wealth as possible with the available resources
* Not all firms maximize wealth
  + Ex: non-profit businesses
  + Even for-profit firms have a charitable side

1. TVM \*\*\*

* TVM is the opportunity cost of tying up funds in projects, stocks, or other assets
* RULE: A dollar today is worth more than a dollar tomorrow because that dollar today can earn interest
* Opportunity cost is the right to spend money today
  + If I invest today, I cant consume today
  + Investors want compensation for their time

1. Risk vs. return

* Risk: the chance that an outcome is different than expected (uncertainty)
* The expected risk vs. return trade off is the concept that greater risk should be rewarded with a higher return
  + The greater the risk, the greater the reward
* Examples of Low Risk:
  + Bank CD (less than 1% interest)
  + US govt bond (1% - 4% interest)
  + Large company stock (6% - 8% interest)
* Examples of High Risk:
  + Startups (funded by venture capitalists that want close to a 30% return)
  + Junk bonds
* In-Class example of risk vs. return:
  + Mechanical Technology sold bulletin board stock, meaning it’s not traded on Wall Street. Pope could have bought the stock for $2/share and made a great return because it later sold for $40/share.

1. Leverage

* Leverage is the concept of how much debt a firm issues for its projects
  + Leverage is the percent of debt on the balance sheet
* For a firm, a greater percentage of debt means they have to make greater interest payments, which increases risk for shareholders

1. Diversification

* Diversification is the idea of removing risk from a portfolio of stocks or other investments
  + Don’t put all your eggs in one basket
* If you invest in multiple assets, you reduce your overall risk
  + Ex: many people, especially employees, got screwed with Enron

The 3 Basic Forms of Business Organizations:

1. Sole Proprietorship (1 owner)

* Roughly 80% of all businesses in the US are sole proprietorships

1. Partnership (2+ owners)
2. Corporation (many owners/shareholders)

* Roughly 90% of all business is conducted by corporations

Sole Proprietorships

* Sole Proprietorship: an unincorporated business owned by one individual
* 3 advantages to a sole proprietorship:

1. Easy to start
2. You’re your own boss and subject to fewer regulations
3. Single tax

* 3 disadvantages to a sole proprietorship:

1. Unlimited liability
2. Difficult to raise capital
3. Life of business

Partnerships

* Partnership: two or more persons associate to conduct a non-corporate business
* There are 2 basic forms of a partnership:

1. General (riskier)
2. Limited (exposed to less risk and no decision making)

* 2 advantages to partnerships:

1. Easy to start
2. Single tax

* 4 disadvantages to partnerships

1. Unlimited liability
2. Difficult to raise capital
3. Life of business
4. Partnership issues can destroy a business

* Ex: ATL Spirit Grove – one free agent signing wrecked the company

Corporations

* Corporation: a legal entity created by a state; separate and distinct from its owners and managers
* 3 advantages to corporations:

1. Limited liability
2. Easier access to capital (easier to get money)
3. Liquidity: ability to convert something to cash

* Easy transfer of ownership
* 2 disadvantages to corporations:

1. Double taxation
2. More regulation

* The value of a business might be maximized as a corporation rather than one of the other business forms because:
  + Firms need capital (cash) to grow and corps have easier access to capital
  + Investors like limited liability

How do firms raise capital?

* Through debt and equity

Debt

* Debt: a contract between a borrower and a lender to repay principle with interest
* Debt has 6 basic characteristics:

1. No ownership for investors
2. No voting rights or control for investors

Good for borrower

1. Maturity date
2. Interest is tax deductible
3. Set payment dates plus a required payment
4. First claim for investors

Equity

* While debt represents a loan to the firm, equity, or CS or shares, is an ownership claim in the issuer
  + CS is a variable income security
    - Variable income security: investments that provide their owners with a rate of return that is dynamic and determined by market forces
* Equity has 5 basic features:

1. Ownership for investors
2. Voting rights for investors

* Board of Directors

1. Dividends

* Not required to pay, though (investors may not get paid anything)

1. Residual Claim

* Last in line 🡪 riskier

1. Preemptive Right: as an existing shareholder, you have the right to participate/buy any new shares

* Ex: Social Network
  + Movie about the founding of fb
  + Cofounder had a 30% share and only paid $18000 for his share
  + After time away, he then only had a 0.3% share, which violates preemptive right because you can’t dilute investors
  + Settled with $900 million in lawsuit