Aswath Damodaran 1

THE OBJECTIVE IN CORPORATE FINANCE

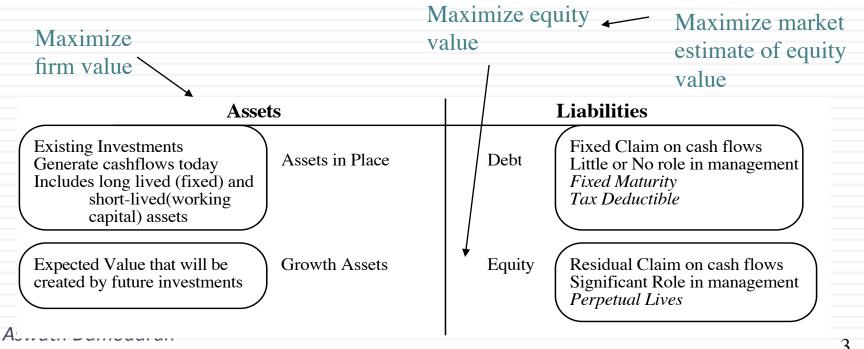
"If you don't know where you are going, it does'nt matter how you get there"

First Principles

Maximize the value of the business (firm) **The Investment Decision The Dividend Decision** The Financing Decision If you cannot find investments Invest in assets that earn a Find the right kind of debt return greater than the that make your minimum for your firm and the right acceptable rate, return the cash minimum acceptable hurdle mix of debt and equity to to owners of your business rate fund your operations The hurdle rate How much The return How you choose The optimal The right kind should reflect the should reflect the cash you can to return cash to mix of debt of debt riskiness of the magnitude and return the owners will matches the and equity investment and the timing of the depends upon depend on maximizes firm tenor of your the mix of debt cashflows as well current & whether they value assets and equity used as all side effects. potential prefer dividends to fund it. investment or buybacks opportunities

The Objective in Decision Making

- In traditional corporate finance, the objective in decision making is to maximize the value of the firm.
- A narrower objective is to maximize stockholder wealth. When the stock is traded and markets are viewed to be efficient, the objective is to maximize the stock price.



Maximizing Stock Prices is too "narrow" an objective: A preliminary response

- Maximizing stock price is not incompatible with meeting employee needs/objectives. In particular:
 - Employees are often stockholders in many firms
 - Firms that maximize stock price generally are profitable firms that can afford to treat employees well.
- Maximizing stock price does not mean that customers are not critical to success. In most businesses, keeping customers happy is the route to stock price maximization.
- Maximizing stock price does not imply that a company has to be a social outlaw.

Why traditional corporate financial theory focuses on maximizing stockholder wealth.

- Stock price is easily observable and constantly updated (unlike other measures of performance, which may not be as easily observable, and certainly not updated as frequently).
- If investors are rational (are they?), stock prices reflect the wisdom of decisions, short term and long term, instantaneously.
- The objective of stock price performance provides some very elegant theory on:
 - Allocating resources across scarce uses (which investments to take and which ones to reject)
 - how to finance these investments
 - how much to pay in dividends

The Classical Objective Function

STOCKHOLDERS Maximize Hire & fire stockholder managers wealth - Board - Annual Meeting No Social Costs Lend Money Managers • BONDHOLDERS/ - \rightarrow SOCIETY **LENDERS** Protect All costs can be bondholder traced to firm Interests Reveal Markets are information efficient and assess effect on honestly and on time value FINANCIAL MARKETS

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