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

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.

Maximize firm value

Maximize equity value

Maximize market estimate of equity value

Assets			Liabilities
Existing Investments Generate cashflows today Includes long lived (fixed) and short-lived(working capital) assets	Assets in Place	Debt	Fixed Claim on cash flows Little or No role in management *Fixed Maturity* *Tax Deductible*
Expected Value that will be created by future investments	Growth Assets	Equity	Residual Claim on cash flows Significant Role in management *Perpetual Lives*

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