



Universidad del Desarrollo
Universidad de Excelencia

Finance I

Fall 2012

Session 2:

Introduction to Finance

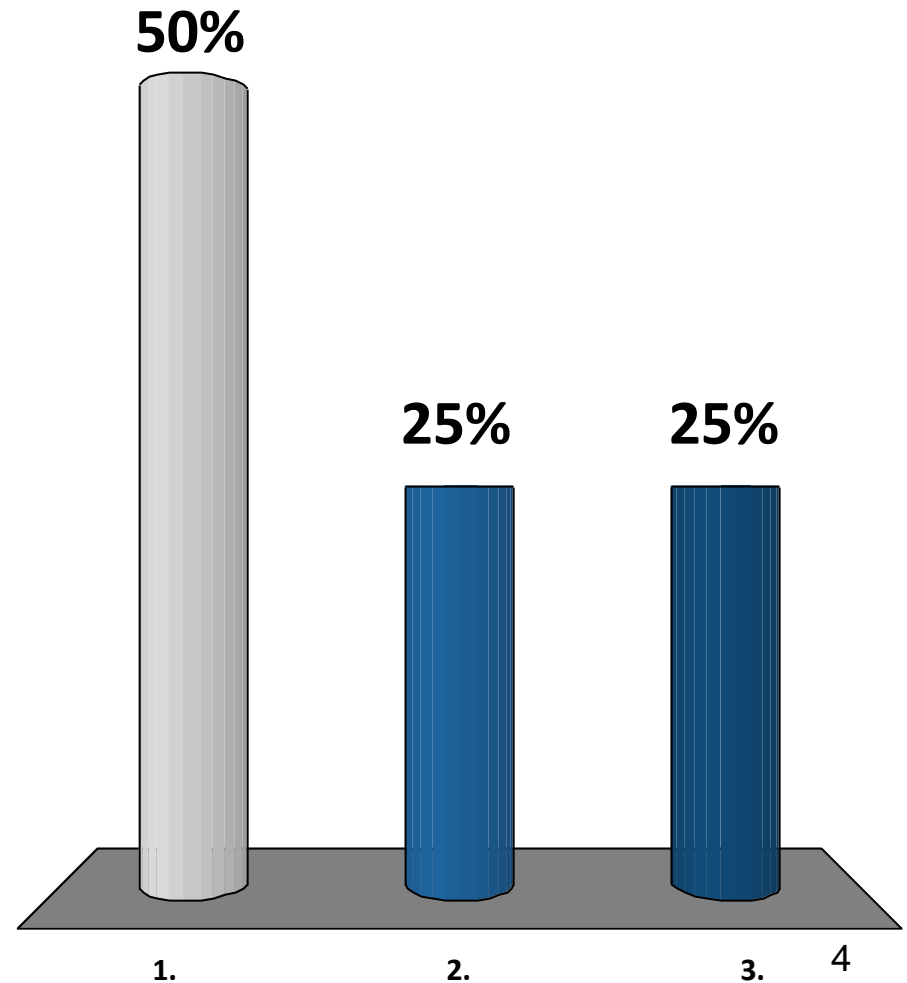


1. **Use of clickers**
2. **Recap of syllabus**
3. **Introduction to Finance**
4. **Closing**

- ▶ **Grab a clicker / button pad**
- ▶ **Pay attention to the instructions**
- ▶ **In the future, I'll assign a specific clicker to each student (see number on the back).**

Select accordingly to your current status

1. UDD student, registered in the class
2. Exchange student, registered in the class
3. Students not registered in the class



- ▶ **Classes are not lectures, they're guided discussions and analysis of PREVIOUSLY STUDIED material**
 - Participation is highly encouraged... you **MUST** contribute to the class to keep your grade (7.0.- 10% of final grade)
 - 75% minimum attendance to pass
 - You may leave the class after signing the attendance list
 - You may not enter the class after the attendance list has been signed: Don't be late
 - Keep your phones OFF... or else

- ▶ **Individual assignments are mandatory (online). They will help you prepare for the quizzes.**
 - Maximum grade on quiz is proportional to assignment completion (100% complete => max grade 7.0; 0% completion => max grade 4.0)

- ▶ **Quizzes, during class best 6 out of 8 represent 20% of final grade**
 - **No class on March 21st => online quiz instead**

- ▶ **Group assignments will take a lot of your time, but it'll be worth the effort.**
 - You will learn in the process
 - Your classmates will thank your efforts as it'll help them study
 - Your teammates will thank or penalize your effort by deciding your grade
 - 3 videos (2 book lectures and 1 cases resolution)
 - Best 2 (group grades/not individual grades) out of 3 represent 10% of final grade

- ▶ **Midterms are only 15% (each) of final grade**

- ▶ **Final exam is worth 30% of final grade**
 - Minimum exam grade to pass is 3.0

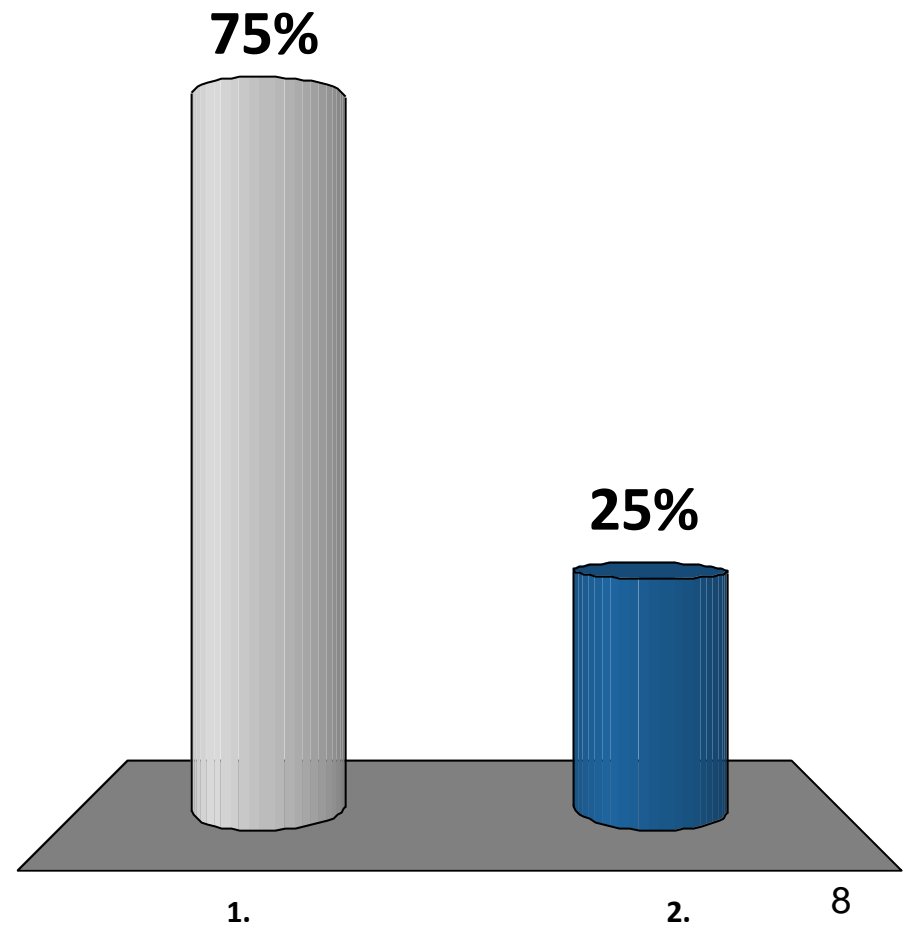
- ▶ **Final grade required to pass: 4.0 (3.96 for those who like to play on the edge)**

► What is a corporation?

- Legal entity created for a determined purpose.
- In general, the term applies to companies in which the owners have limited liability on the company's debt. In Chile it refers to: Sociedad Anonima Abierta y Cerrada, Sociedad de Responsabilidad Limitada, Sociedad por Acciones, Empresa Individual de Responsabilidad Limitada, etc.
- Each has MANY differences regarding legal and tax requirements, but for our interests in Corporate Finance, we can treat them all as Corporations:
 - Limited liability to owners
 - Possible separation between ownership and management

If you were an entrepreneur, would you rather create a:

1. Limited liability company
2. Non limited liability company



3. Introduction to Finance

► Role of the financial manager:

- Manage the interaction between sources and uses of funds (money)
- To create value for the company...
- ...and to maximize his/her own utility (agency problem)

► Sources of funds (where do I get the money)

- Own funds (generated by the company / withhold dividends)
- External funds (shareholders, partners, banks, capital markets, providers, clients, employees, etc.)
- Choose the best source.... (obvious right?)
- ... based on direct cost, risk, tax, legal, business strategy, market, etc.... Not so easy!!!

3. Introduction to Finance

▶ Uses of funds (what do I do with the money)

- Assets (real, intangible, financial)
- Choose the best use.... (obvious right?)
- ... based on direct cost, risk, tax, legal, business strategy, market, etc.... Not so easy!!!

▶ In the literature, the decision of investment is separated and independent of the financing decision.

- In real life, both are strongly related (some projects can be financed by debt, others by equity, etc.)

▶ Many topics of corporate finance are drifting away from reality. Just as in Economics, the theory is constructed on models that simplify reality.

- This doesn't mean that theory is wrong, it's just incomplete.

3. Introduction to Finance

▶ Agency Theory.... Broad subject, many books

- Our interest will be the “agency problem”

▶ Simplest way to understand the agency problem: Each individual wants to maximize their own benefit.

- Owners benefit from greater company value
- Managers benefit from greater salary and lower workload
- Both interests go opposite ways
- If manager gets paid a lot and does little work, he is happy but the company lowers its value thus the owner is not happy
- If manager gets paid little and does lots of work, he is unhappy but the company increases its value thus owner is very happy

▶ Agency cost includes:

- Costs derived from lower effort (less than optimal work load) by the manager
- Costs derived from monitoring the manager and incentives to motivate the manager to achieve the optimal work load

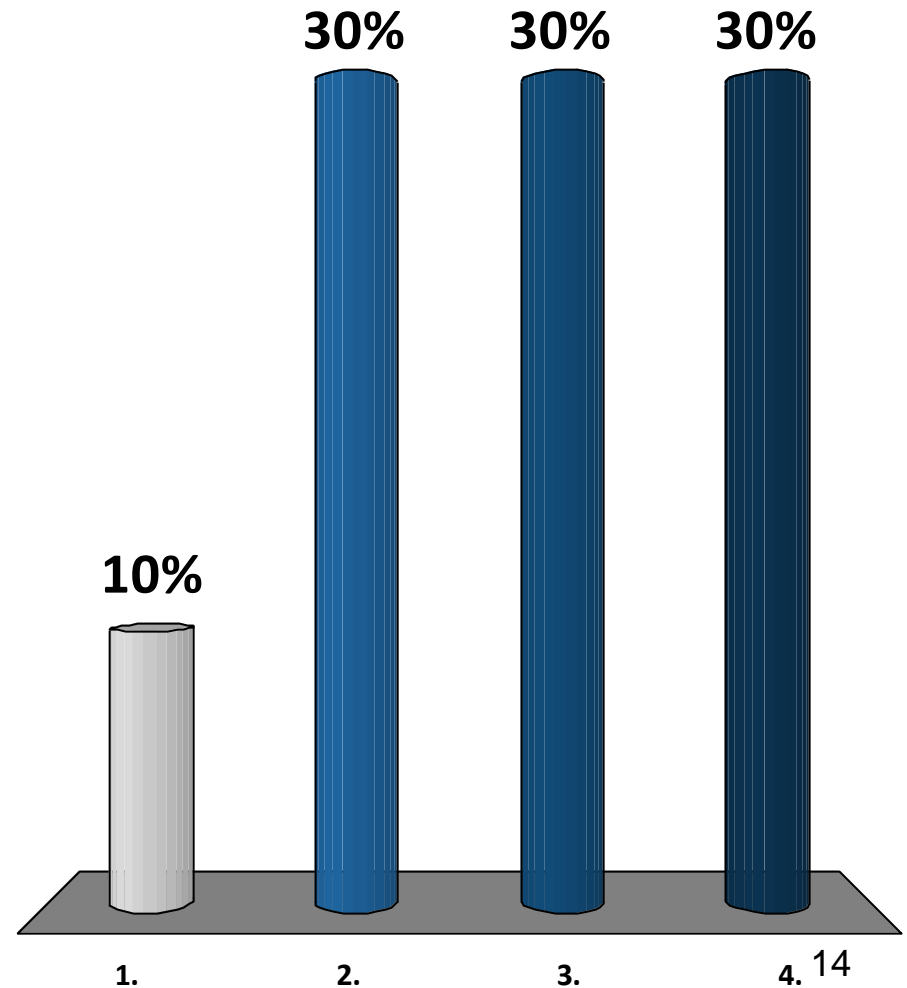
▶ Other examples of agency problems?

- Lenders / Borrowers
- Investment Managers / Investors
- Politics / voters ?

- ▶ **One of the main topics within Finance is Value (the amount and its determinants)**
 - Value of physical assets (tangible and intangible)
 - Value of financial assets

What's the value of something?

1. Its cost
2. Its market price
3. The maximum amount someone is willing to pay for it
- ✓ 4. None of the above



- ▶ **In Spanish, we frequently speak of value (valor) as a synonym of price (precio)**
 - In English, not so much. English speakers will get the difference
 - Value and Price mean completely different things
 - In real life, Value and Price are almost always different

▶ Value: from Latin *valere* (to be worth)

- The quality (positive or negative) that renders something desirable or valuable
- The degree of importance you give to something.
- The amount (of money or goods or services) that is considered to be a fair equivalent for something else

▶ Characteristics

- Quantifiable and therefore comparable
- Inherent to the characteristics of the person performing the valuation therefore SUBJECTIVE
- Dynamic
- Financial value: the maximum amount that I'm willing to pay to own it OR the minimum amount that I'm willing to receive to sell it.

3. Introduction to Finance

▶ Price: from Latin *pretium* (money spent)

- The cost required to gain possession of something.
- The cost of an action or deed.

▶ Characteristics

- Quantifiable and therefore comparable
- OBJECTIVE, is observable in every transaction
- Dynamic

3. Introduction to Finance

▶ How do they compare?

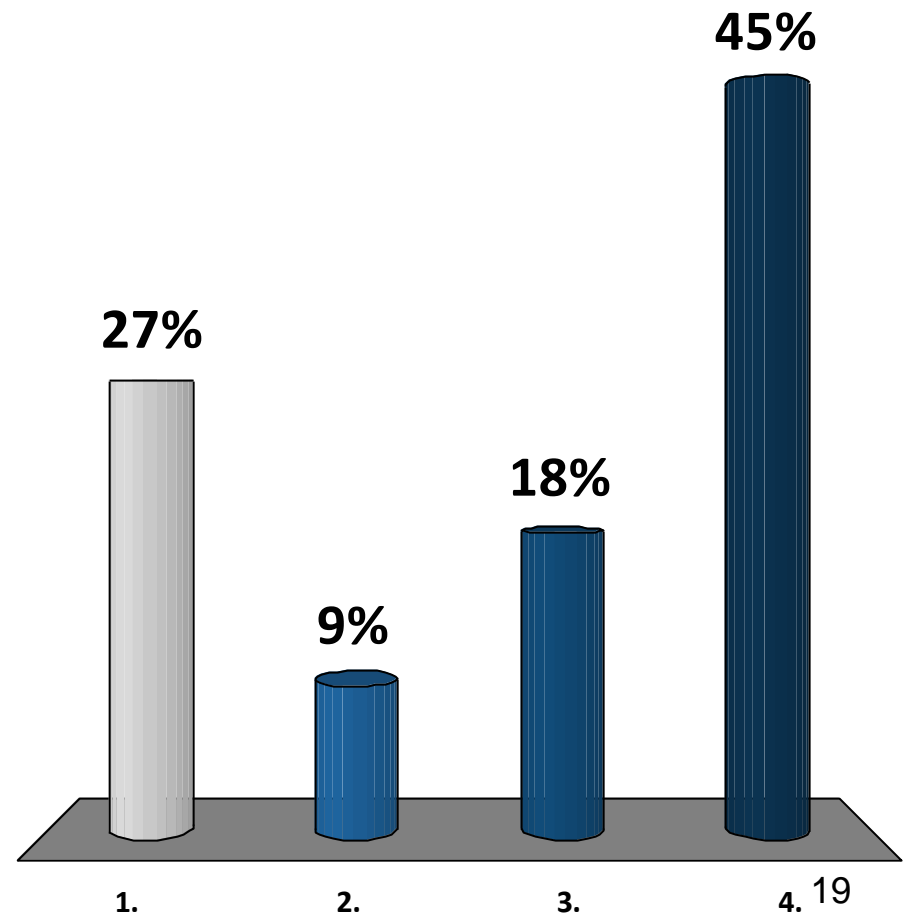
- If you sell something, it's because its value is less than its price
- If you buy something, it's because its value is more than its price

▶ In a transaction, there are two different values and one price

- unless both seller and buyer are indifferent, which is an economic theoretical rationality but unrealistic as we'll see during this course

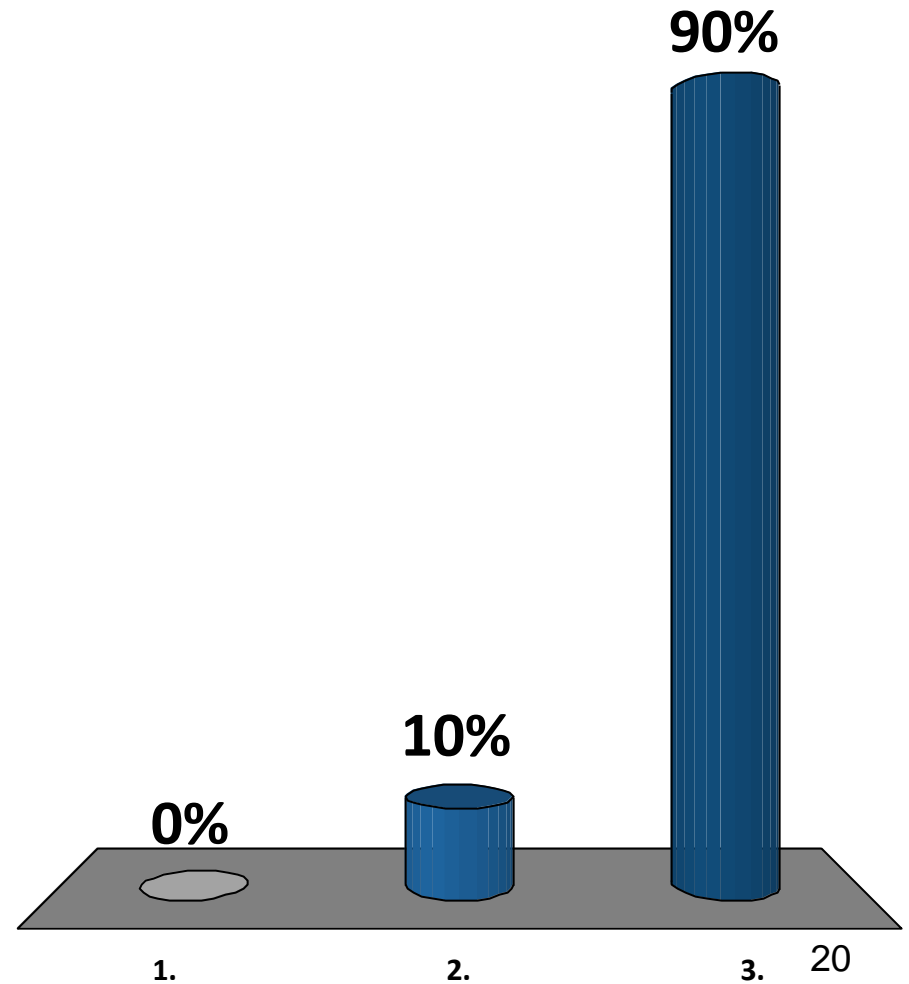
What is the real value?

1. The Buyer's
2. The Seller's
3. The Price
- ✓ 4. None of the above



Which one are we interested in?

1. Value
2. Price
- ✓ 3. Both



3. Introduction to Finance

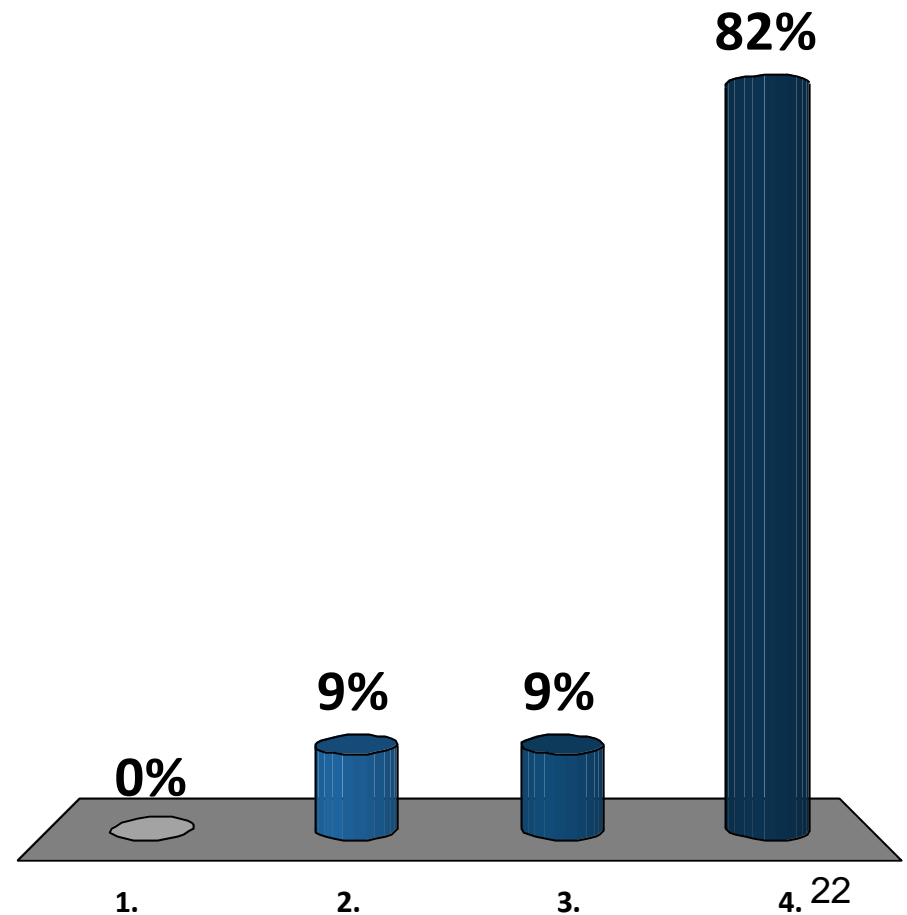
- ▶ **As mentioned earlier, theoretical models simplify the real world, therefore for this course we'll mostly assume both value and price are the same number**

- ▶ **Why? Because under common assumptions as:**
 - Rationality and equal risk aversion of individuals,
 - full access and comprehension of all existing information
 - availability of financial markets
 - => the value is equal for everyone, hence the price is equal to the value

- ▶ **If we have time, we'll discuss some paradoxes from behavioral finance**

What is the value of the world?

1. 1 million dollars
2. 100 billion dollars
3. 100 trillion quadrillion quintillion dollars
4. Impossible to determine



Usuarios que responden más rápido (en segundos)

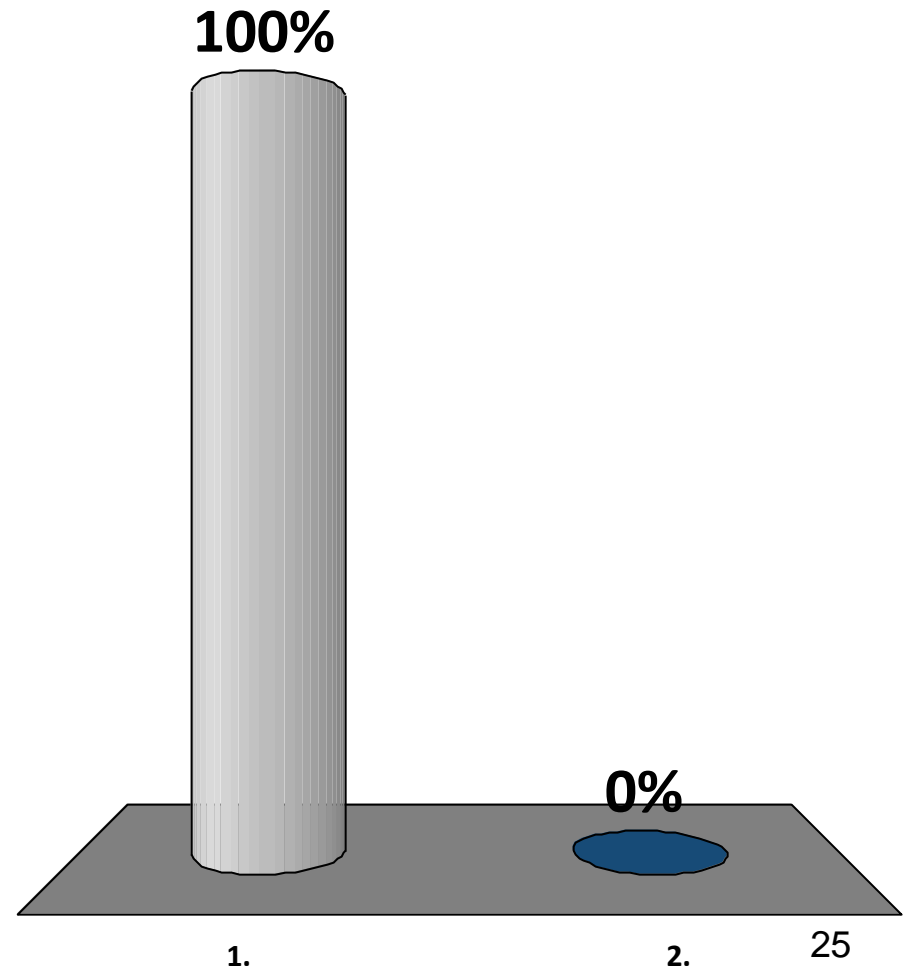
5,28	Participante 591829		
11,91	Participante 5916EA		
17,55	Participante 5916B0		
17,6	Participante 58CAF0		
17,81	Participante 5916A5		

Puntuaciones de participantes

45	Participante 59177E		
40	Participante 591829		
35	Participante 58CB92		
35	Participante 5917FE		
30	Participante 5916A5		

Will you register in the class

1. Yes
2. No



► Next class:

- Study chapter 2 BMA
- Bring a friend and convince him/her to join the course. 1 contribution point for you and your friend as reward
- Get to know your classmates and evaluate potencial fit for your team