

Chapter 2

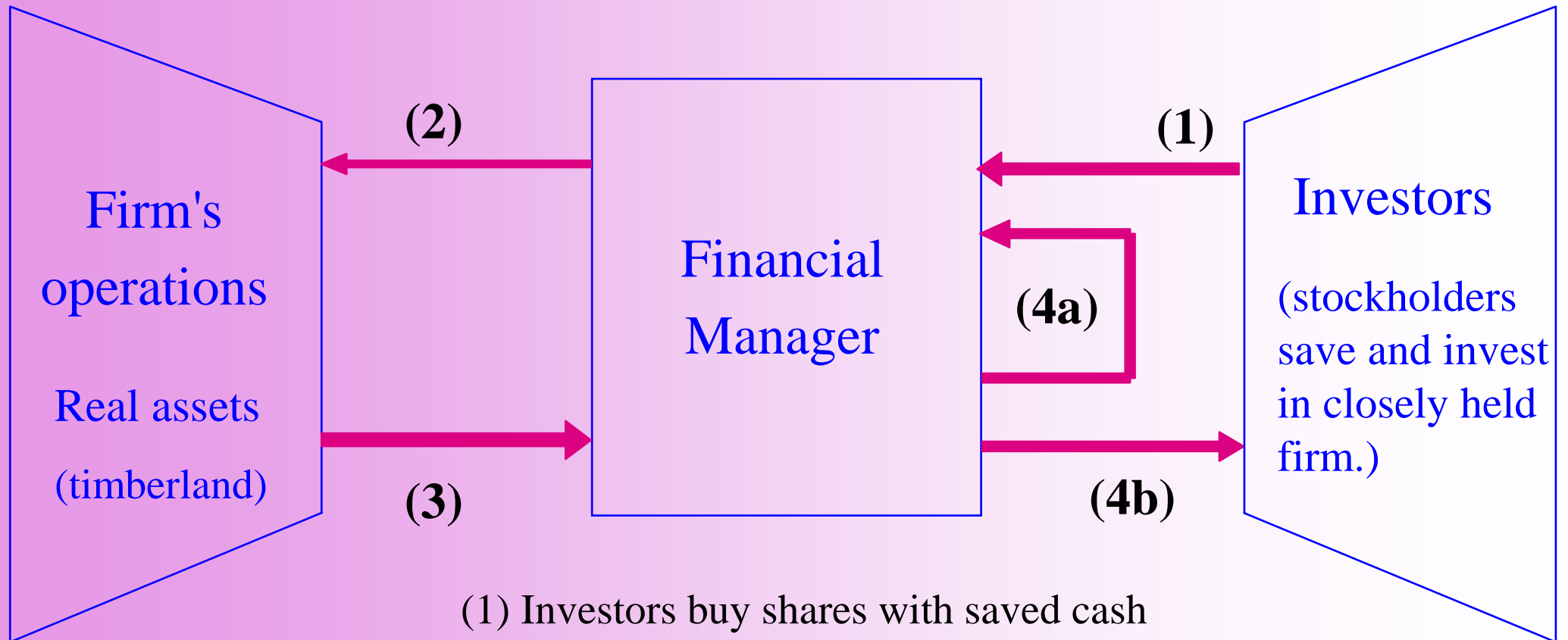


Why Corporations Need Financial Markets and Institutions

Topics Covered

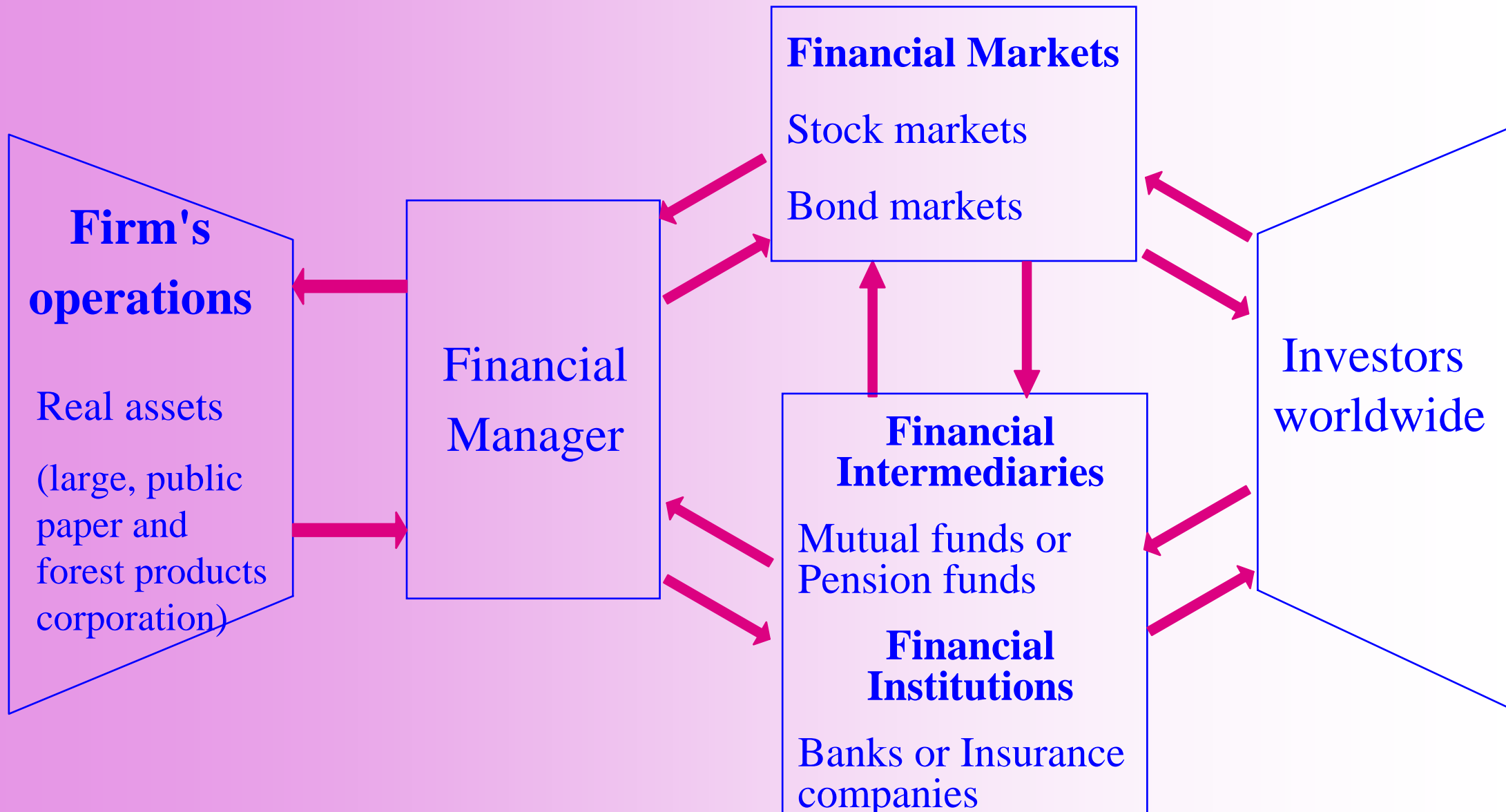
- ➡ Financing Decisions do matter (Apple Computer, Table 2-1, p. 29)
- ➡ The Flow of Savings to Corporations
- ➡ Functions of Financial Markets and Financial Intermediaries
- ➡ Value Maximization and the Cost of Capital

The Flow of Savings to Corporations

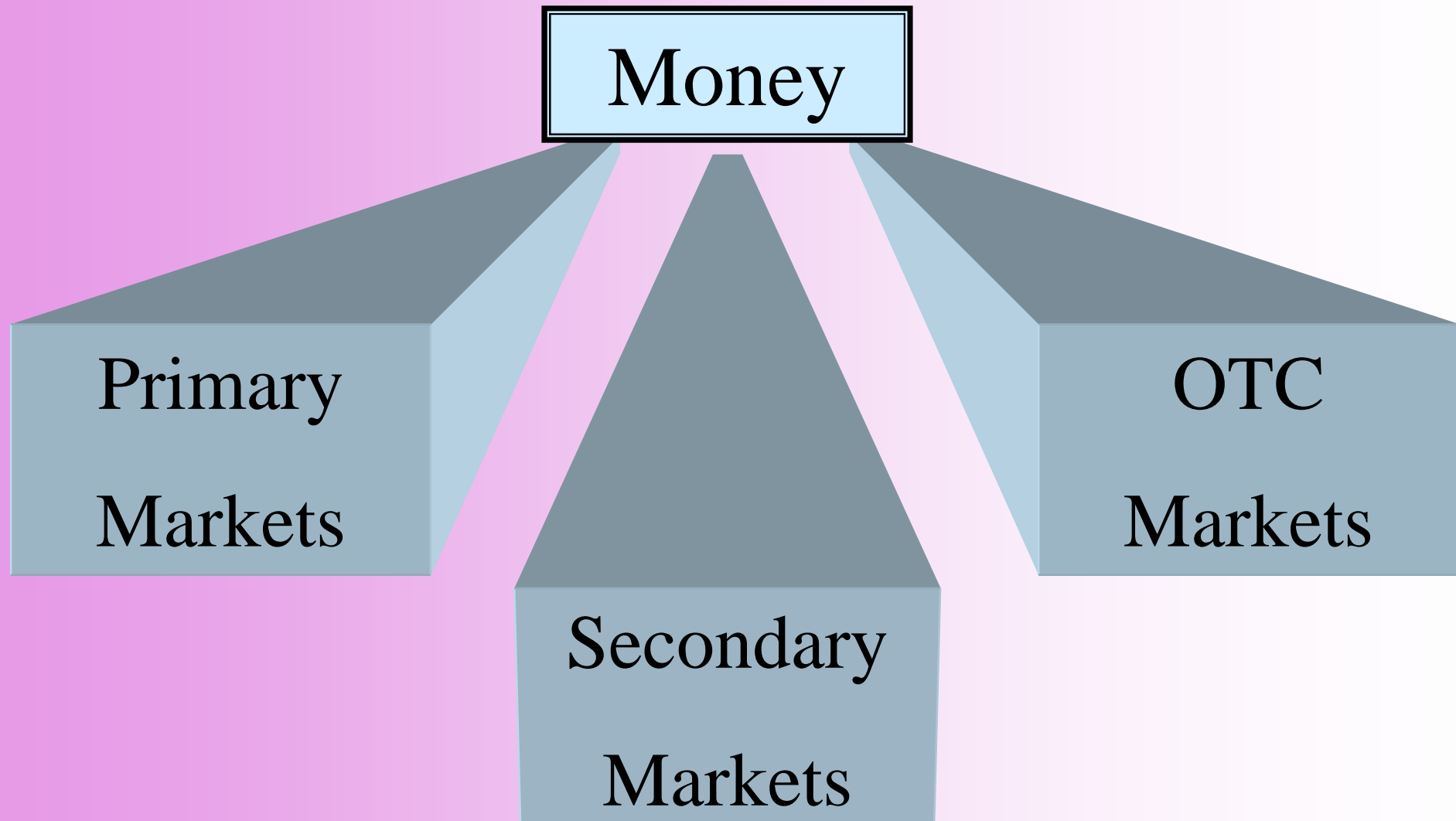


- (1) Investors buy shares with saved cash
- (2) Cash is invested
- (3) Timber harvest generates cash
- (4a) Cash reinvested
- (4b) Cash returned to investors

The Flow of Savings to Corporations



Stock Markets



Other Financial Markets

⇒ Fixed-income market

- Capital market (long-term financing)

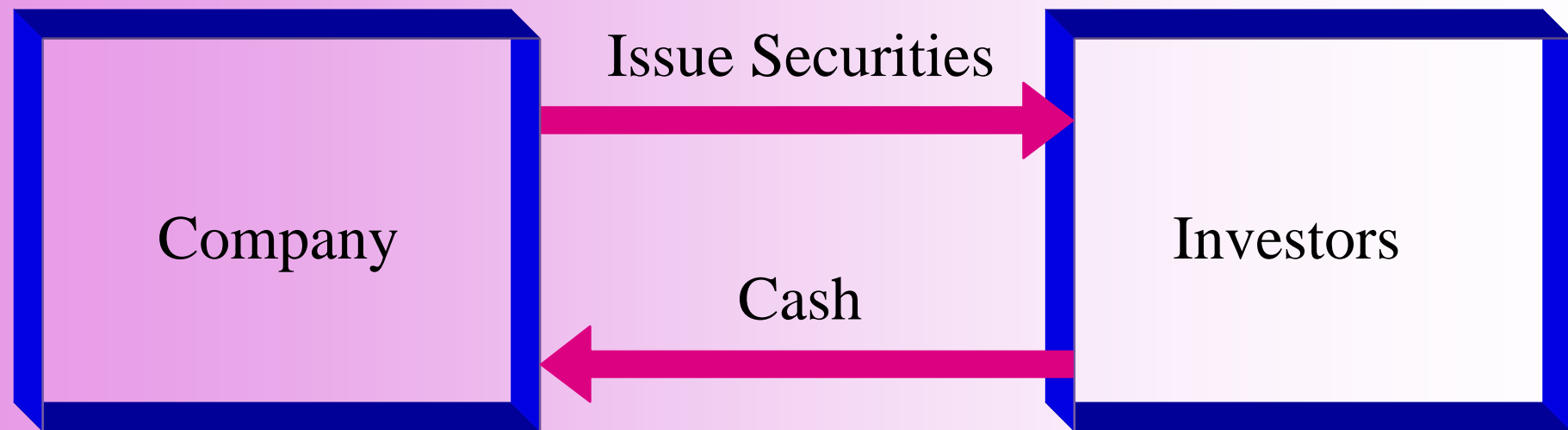
- Money market (short-term (< 1 year) financing)

⇒ Foreign-exchange market

⇒ Commodity market

⇒ Markets for options and other derivatives

Financial Intermediaries



Financial Intermediaries

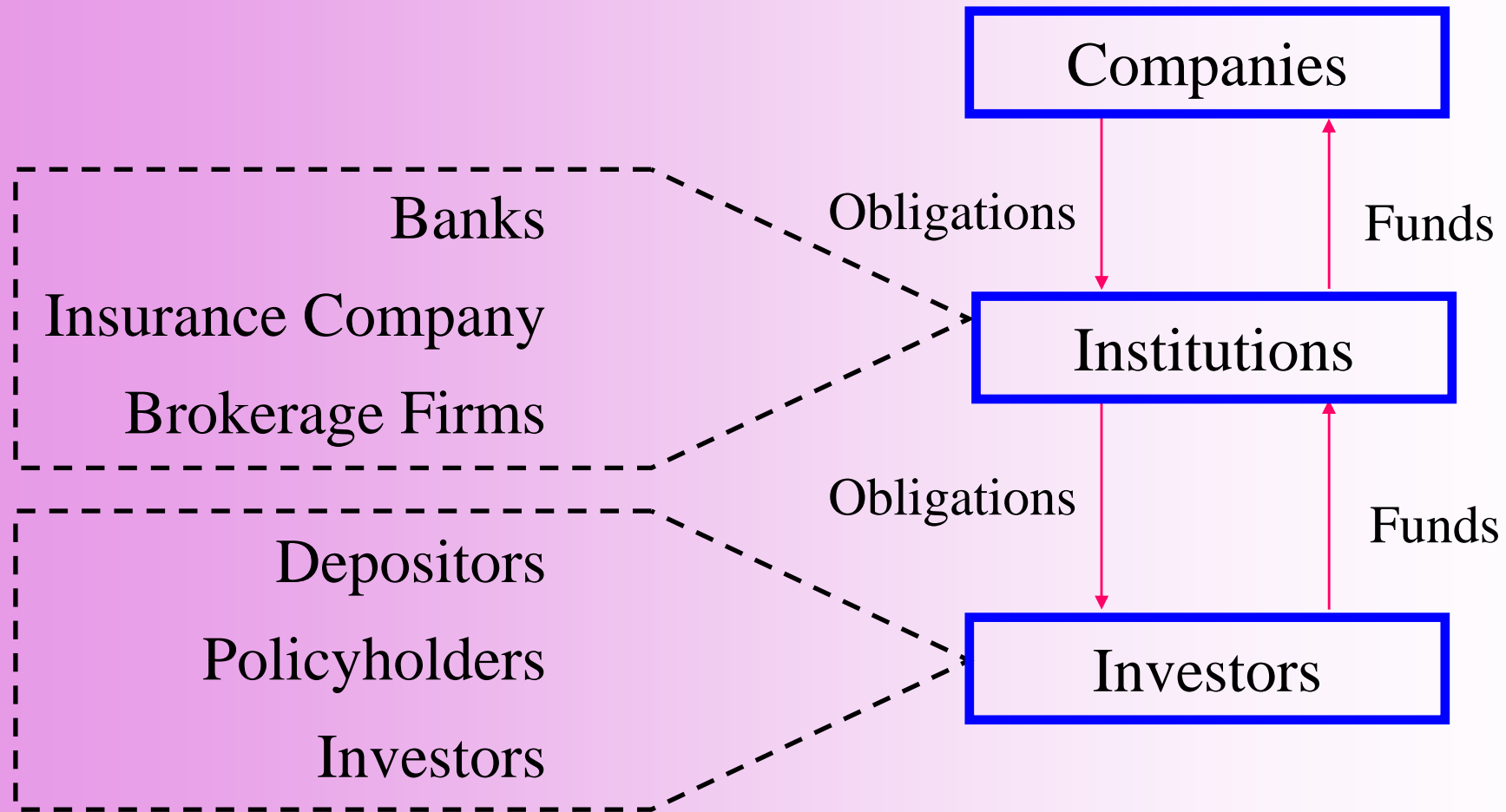


*Mutual funds pools the savings of many investors and invests in a portfolio of securities

*Usually, fees and expenses absorbed by mutual funds are about 0.5 % per year

*Pension fund: Investment plan set up by an employer to provide for employee's retirement

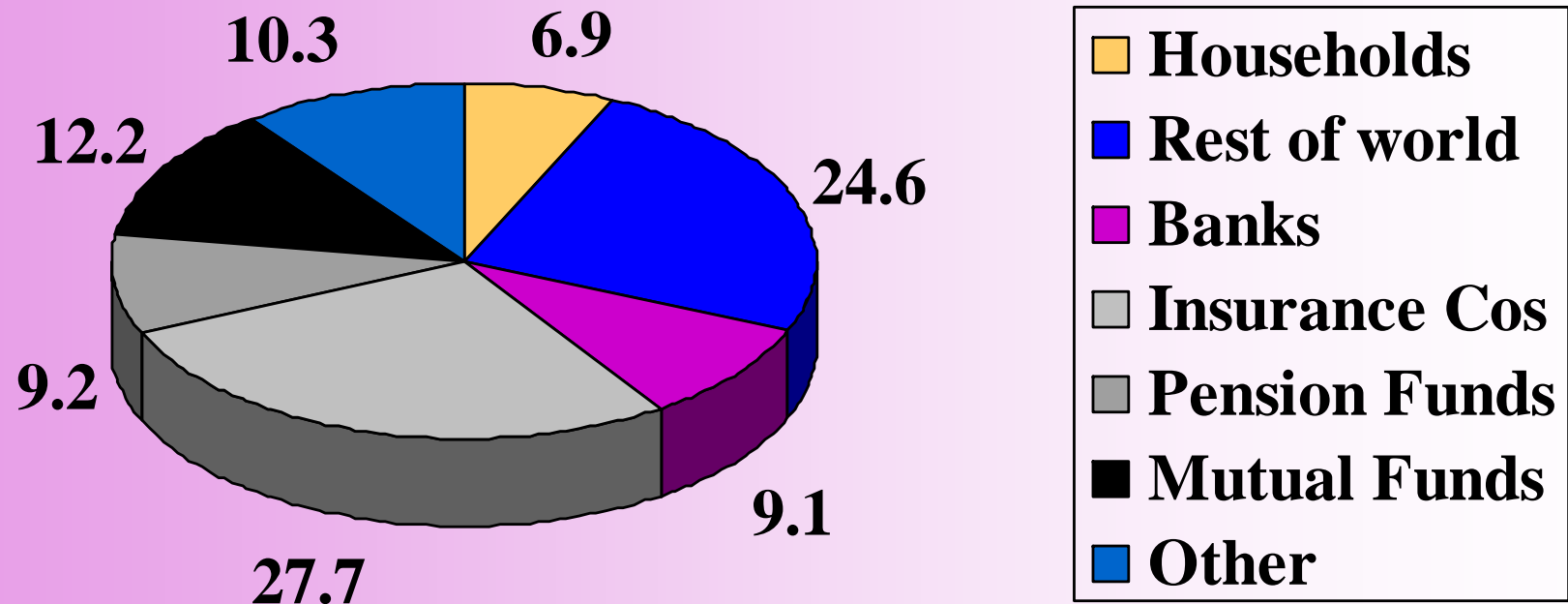
Financial Institutions



*Financial institutions are intermediaries that do more than just pool and invest saving

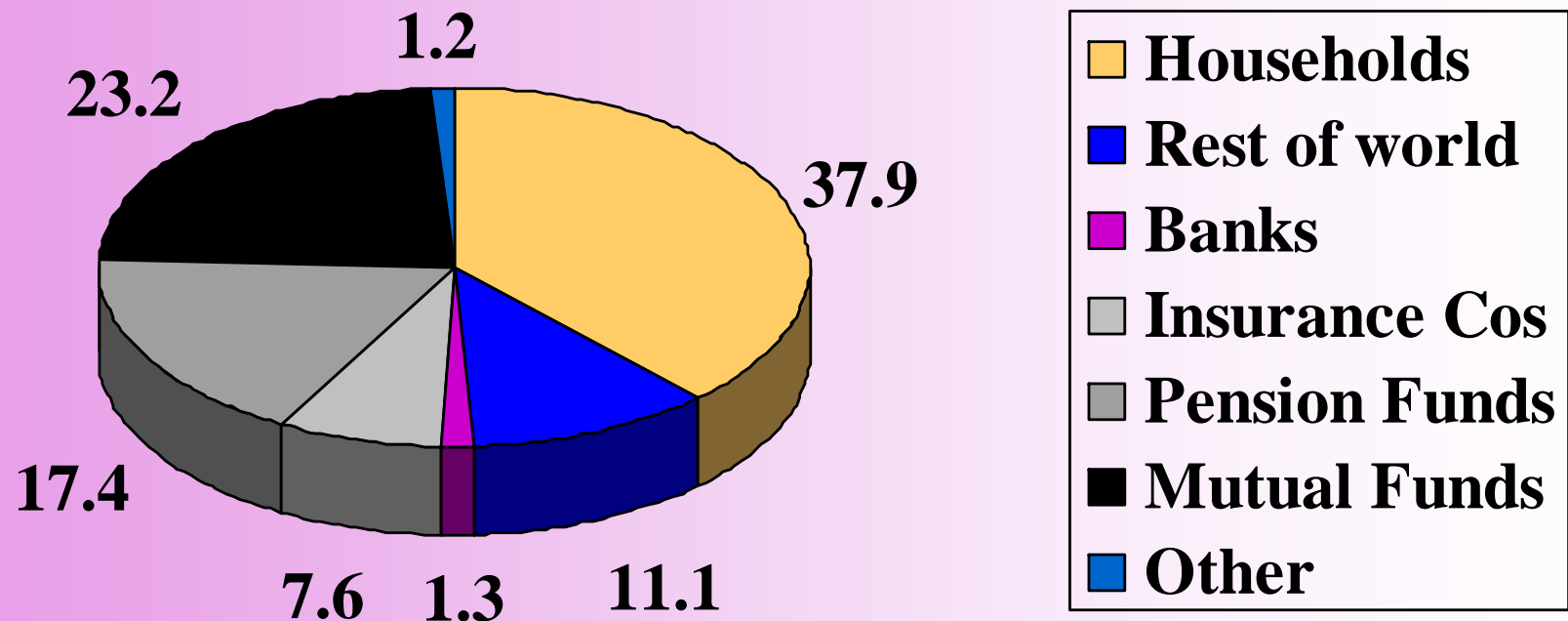
Total U.S. Financing

% Holdings of Corporate and Foreign Bonds (Qtr 1, 2005)



Total U.S. Financing

% Holdings of Corporate Equities (Qtr 1, 2005)



Functions of Financial Markets and Intermediaries

- ➡ Channel Savings to Corporate Investment
- ➡ Match up Borrowers and Lenders (Sellers and Buyers)
- ➡ Transporting Cash across Time (smooth consumption)
- ➡ Risk Transfer and Diversification
- ➡ Liquidity Provided
- ➡ The Payment Mechanism (Checking Accounts or Credit Cards)
- ➡ Information Provided (Quotation)
 - ➔ Commodity Prices, Interest Rates (maturities and credit ratings), Stock Prices or Company Values, etc.

Value Maximization and the Cost of Capital

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- ➡ The cost of capital is the minimum acceptable rate of return for capital investment
 - ➔ Investment projects offering rates of return higher than the cost of capital, the value of firm is added
 - ➔ Investment projects offering rates of return less than the cost of capital, the projects should be not undertaken
- ➡ The cost of capital for corporate investment is set by the rates of return on investment opportunities in financial markets (see the figure in the next page)
- ➡ The (opportunity) cost of capital depends on the riskiness of the project and is different from the real financing cost

Value Maximization and the Cost of Capital

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Figure 2-5, p. 43

