



# Business Finance

BA 2nd Year - 01/10/2019

# Course Plan

ISTITUTO MARANGONI - Business Finance - 2019 / 2020				
Course n°	Date	Time	Duration (H)	Section content
1			2,5	Introduction to Finance Financial securities Financial markets
2			2,5	Financial markets : Stock exchange markets and IPO, Equity markets. Facts & figures IPO What is free float ?
3			2,5	The Time Value of Money Timeline Simple interest and compound interest Conventions for interest rates
4			2,5	Three Rules of Time Travel Future value Present value
5			2,5	Discounted Cash Flows (DCF) and Useful Shortcut PV of an uneven cash flow stream Annuities and perpetuities
6			2,5	NPV and Stand-Alone Projects Applying actualisation to make decisions IRR : Internal Rate of Return
7			2,5	Capital Budgeting Decision & Cash flow forecast I Major investment appraisal methods
8			2,5	Capital Budgeting Decision & Cash flow forecast II Cash flow forecasting Cash management
				Assessment period
				Assessment period



**Business Finance : course n°1**  
**Introduction to Finance**  
**Financial securities**  
**Financial markets**

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# Outline

1. Financial securities
2. Financial markets

# 1 - Financial securities

# Financial securities

- Financial securities (or instruments) are similar to “goods” for investment purposes.
- In particular, a **financial security** is a paper which is a claim on an issuer’s future income and/or assets (issuers : governments, corporations, etc).

# Financial securities

Some examples of financial securities :

- **Bonds and stocks**
- **Commodities** (oil, gold...traded via futures contracts)
- **Derivatives** (used to hedge risk)
- **Foreign exchange** (USD/Euro) involve currencies, which are not financial securities *stricto sensu*

# Financial securities: bonds

- A **bond** is a debt security that promises to make payments periodically for a specified period of time (one year, 10 year, etc).



- Bonds can be either **zero-coupon bonds** (i.e. without intermediate cash flows), or **coupon-paying bonds** (i.e. with intermediate cash flows).

# Financial securities: stocks

- A **stock** (or equity) is a financial security that is a share of ownership of a corporation.
- It is a claim on the earnings and assets of a corporation (ex: Facebook, Apple, Total).
- Depending on the corporate policy, market participants investing in stocks (called **stockholders**) may receive dividends.

# Stock certificate

**10808**

THIS CERTIFICATE NOT VALID  
UNLESS COUNTERSIGNED BY  
TRANSFER AGENT.

**\*1400\***

Countersigned and Registered even date  
By: *[Signature]*  
Transfer Agent & Registrar  
Salt Lake City, Utah

**SILVER STANDARD MINING COMPANY**  
INCORPORATED UNDER THE LAWS OF THE STATE OF UTAH  
CAPITAL STOCK \$250,000.00 5,000,000 SHARES PAR VALUE 5 CENTS  
Non-Assessable

This Certifies that FREDA G. BURLEIGH is the  
registered holder of \*\*\*ONE THOUSAND FOUR HUNDRED\*\*\* Shares  
OF SILVER STANDARD MINING COMPANY  
transferable only on the books of the Corporation by the holder hereof in  
person or by Attorney upon surrender of this Certificate properly endorsed.  
In Witness Whereof, the said Corporation has caused this Certificate to be signed  
by its duly authorized officers and its Corporate Seal to be hereunto affixed  
this 19th day of April A.D. 1957

*[Signature]* SECRETARY *[Signature]* PRESIDENT

**SILVER STANDARD MINING COMPANY**  
CORPORATE SEAL  
SALT LAKE CITY, UTAH

© 5053 366

# Bonds vs stocks

- There are several important differences between stocks and bonds:
  - (i) Bonds do not promise share of ownership, stocks represent share of ownership.
  - (ii) Bonds have fixed maturity,  
Stocks do not have maturity.
  - (iii) Bonds generate contractual payments,  
Stocks do not have contractual payments.

# Bonds vs stocks

- In particular, bondholders and stockholders are rewarded in different ways.
- Bondholders receive interest, which is contractual.
- Stockholders may receive dividends and benefit from an increase in stock price.

# Bonds vs stocks

- For stockholders : dividends and future stock prices are NOT contractual.
- A corporation may pay dividends if it had enough earnings and wants to redistribute part of those earnings to shareholders.
- The stock price of a company depends on the fluctuations in the market ie : demand and supply for this stock in the market.
- Stock have no maturity, they are perpetual. Most bonds have a maturity date (even if some can be perpetual).

## 2 - Financial markets

# Financial markets

- A **Financial market** is a place in which investors can buy and sell financial securities (e.g. bonds, stocks).
- The main role of financial markets is to channel funds between lenders (who have excess cash and want to invest their money) and borrowers (who need capital).

# Financial markets

- The functioning of financial markets is important because they permit businesses and governments to transfer funds within the financial system.
- While firms can finance their activities by issuing stocks and/or bonds, governments finance their expenditures by issuing debt.

# Financial markets

- We usually make the following distinctions among financial markets :
- **Primary** markets vs. **secondary** markets
- **Organized exchanges** vs. **over-the-counter (OTC)** markets
- **Money** markets vs. **capital** markets

# Primary vs secondary

- **Primary market** is a financial market in which new issues of securities are sold to initial buyers. = *market for newly-issued securities*
- **Secondary market** is a financial market in which securities which have already been issued are exchanged. = *market for “second-hand” securities*

# Organized exchange vs OTC

- In an **exchange-traded market**, buyers and sellers meet in one central location for trading activities (e.g. NYSE). They may access this central location via computers. All trades are centralized and observable.
- In an **over-the-counter (OTC) market**, trade is conducted through computer-linked network or telephone. Each investor has its private network and trades in a non-transparent way. OTC market can be considered as an intangible organization.

# Organized exchange

NYSE is an exchange-traded market



# Organized exchange

## Euronext Paris : Supervision room



# Money market vs capital market

- Financial markets can be further classified based on the maturity of the securities.
- **Money market** is a financial market in which short-term (less than one year) debt securities are traded.
- **Capital market** is a financial market in which long-term debt (more than one year) and equity securities (= stocks) are traded.

# Examples of money market securities

- **US Treasury bills** : short-term debt of the US government to finance the activities of the federal government. They are among the most liquid financial securities.
- **Commercial paper** : short-term debt securities issued by large banks and corporations.

# Examples of capital market securities

- **Stocks** : issued by large corporations.
- **Government bonds** : long-term debt securities issued by governments to finance long-term projects.
- **Corporate bonds** : long-term debt securities issued by corporations to finance long-term projects and business plans.

# Prices in financial markets

- Demand coming from the buyers and supply provided by sellers determine the price of the financial securities in financial markets.
- The prices of the financial instruments can increase or decrease over time, depending the buy-sell actions of the investors.

# Direct finance vs indirect finance

- There are two fundamental mechanisms through which funds can get transferred within a financial system :
- **direct finance**
- **indirect finance**

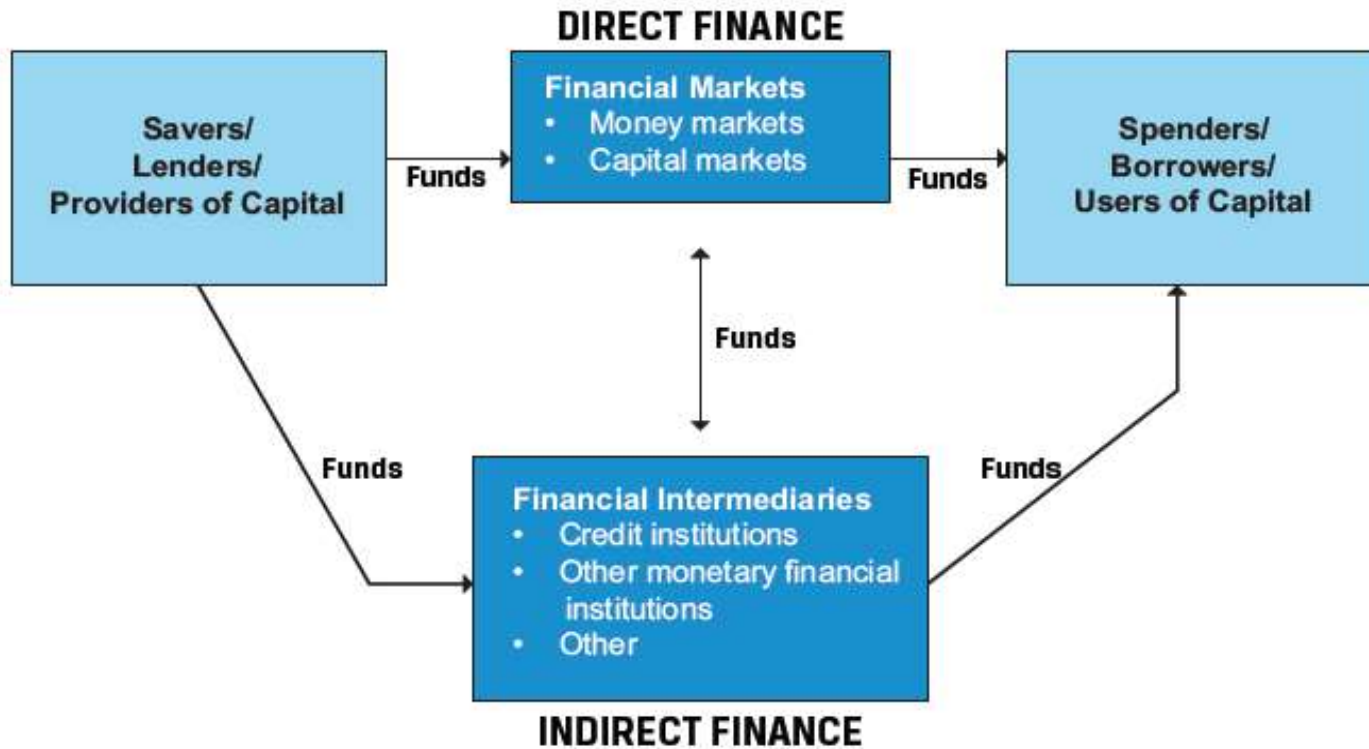
# Direct finance

- In direct finance, funds get transferred directly between lenders and borrowers.
- For example, an investor can invest directly in the stock market by buying stocks on the NYSE.
- An investor can also lend money directly to a business he trusts.

# Indirect finance

- In indirect finance, funds get transferred indirectly between lenders and borrowers.
- Between lenders and borrowers stands a middleman which is a financial institution (banks, mutual funds, insurance companies...)
- Financial institutions connect savers/investors to spenders/borrowers.

# Direct and indirect finance



*Source:* Based on data from the European Central Bank (<http://www.ecb.int/mopo/eaec/structure/html/index.en.html>).

# Financial Institutions

- Financial institutions, such as banks, collect the funds from those who have money and transfer the funds to agents who need them.
- Lenders and borrowers can be households, governments, business firms and foreigners.

# Financial institutions

- Financial institutions are important for the well functioning of financial markets.
- The absence of financial institutions creates several problems within a financial system.
- These problems are related to **inefficiency, transaction costs, and information.**

# Financial institutions

- In a financial system without financial institutions, indirect finance does not function. This situation leads to several complications:
- First, lenders (or savers) who have available funds may not find borrowers who need money. The funds transferring becomes a prolonged process, which in turn, promotes **inefficiency**.

# Financial institutions

- Second, transferring funds between savers and borrowers becomes costly. These costs are called **transaction costs**.
- Finally, without financial institutions, lenders cannot acquire enough information about borrowers. This leads to the problem of **asymmetric information**.
- Thus, financial institutions enable financial markets to function efficiently by reducing asymmetric information and transaction costs.

# Asymmetric information

Asymmetric information can be in two forms



- **Adverse selection** : occurs before the transactions are completed. **Georges Akerlof : Lemon market.** Because of information asymmetry (only the seller knows if the car is good), prices tend to be low, and then good « lemons » tend to quit the market.
- **Moral hazard** : occurs after the transactions or contracts are completed, when one party in the financial system cannot observe the actions of the other counterparties (e.g. debt contracts).



# Financial intermediation

- To reduce such asymmetric information problems, financial institutions should be able to obtain funds from lenders and transfer to borrowers.
- This process is called **financial intermediation**.
- Financial intermediation is crucial:
  - To help financial markets function efficiently,
  - To eliminate asymmetric information,
  - To reduce transactions costs.