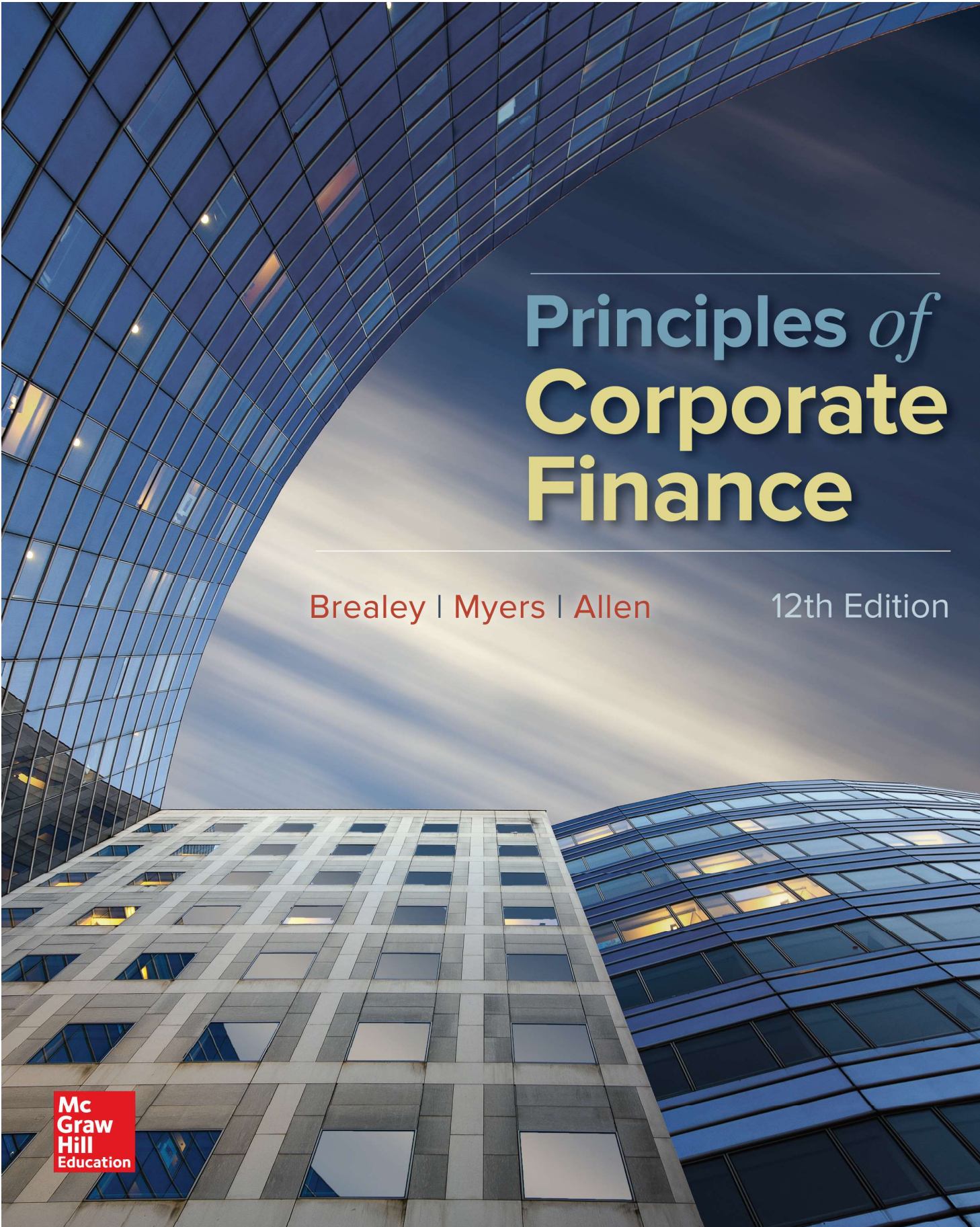




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1-1 Corporate Investment and Financing Decisions

To carry on business, a corporation needs an almost endless variety of **real assets**. These do not drop free from a blue sky; they need to be paid for. The corporation pays for the real assets by selling claims on them and on the cash flow that they will generate. These claims are called **financial assets** or **securities**. Take a bank loan as an example. The bank provides the corporation with cash in exchange for a financial asset, which is the corporation's promise to repay the loan with interest. An ordinary bank loan is not a security, however, because it is held by the bank and not sold or traded in financial markets.

Take a corporate bond as a second example. The corporation sells the bond to investors in exchange for the promise to pay interest on the bond and to pay off the bond at its maturity. The bond is a financial asset, and also a security, because it can be held and traded by many investors in financial markets. Securities include bonds, shares of stock, and a dizzying variety of specialized instruments. We describe bonds in Chapter 3, stocks in Chapter 4, and other securities in later chapters.

This suggests the following definitions:

Investment decision = purchase of real assets

Financing decision = sale of financial assets

But these equations are too simple. The investment decision also involves managing assets already in place and deciding when to shut down and dispose of assets if profits decline. The corporation also has to manage and control the risks of its investments. The financing decision includes not just raising cash today but also meeting obligations to banks, bondholders, and stockholders that contributed financing in the past. For example, the corporation has to repay its debts when they become due. If it cannot do so, it ends up insolvent and bankrupt. Sooner or later the corporation will also want to pay out cash to its shareholders.¹

Let's go to more specific examples. Table 1.1 lists 10 corporations from all over the world. We have chosen very large public corporations that you are probably already familiar with. You have probably used Facebook to connect with your friends, shopped at Walmart, or used Crest toothpaste.

Investment Decisions

The second column of Table 1.1 shows an important recent investment decision for each corporation. These investment decisions are often referred to as **capital budgeting** or **capital expenditure (CAPEX)** decisions, because most large corporations prepare an annual capital budget listing the major projects approved for investment. Some of the investments in Table 1.1, such as Vale's coal mine or Union Pacific's new locomotives, involve the purchase of tangible assets—assets that you can touch and kick. However, corporations also need to invest in intangible assets, such as research and development (R&D), advertising, and marketing. For example, GlaxoSmithKline and other major pharmaceutical companies invest billions every year on R&D for new drugs. Similarly, consumer goods companies such as Procter & Gamble invest huge sums in advertising and marketing their products. These outlays are investments because they build brand recognition and reputation for the long run.

Today's capital investments generate future cash returns. Sometimes the cash inflows last for decades. For example, many U.S. nuclear power plants, which were initially licensed by

¹We have referred to the corporation's owners as "shareholders" and "stockholders." The two terms mean exactly the same thing and are used interchangeably. Corporations are also referred to casually as "companies," "firms," or "businesses." We also use these terms interchangeably.