Corporate Finance

BY

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Abstract

Every decision made in a business has financial implications, and any decision that involves the use of money is a corporate financial decision. Defined broadly, everything that a business does fits under the rubric of corporate finance. It is, in fact, unfortunate that we even call the subject corporate finance, because it suggests to many observers a focus on how large corporations make financial decisions and seems to exclude small and private businesses from its purview. A more appropriate title for this discipline would be *Business Finance*, because the basic principles remain the same, whether one looks at large, publicly traded firms or small, privately run businesses. All businesses have to invest their resources wisely, find the right kind and mix of financing to fund these investments, and return cash to the owners if there are not enough good investments.

INTRODUCTION

The definition of “corporate finance” varies considerably across the world. In the US, for example, it is used in a much broader way than in the UK – to describe activities, decisions and techniques that deal with many aspects of a company’s finances and capital.
In the UK, the terms “corporate finance” and “corporate financier” tend to be associated with transactions in which capital is raised in order to create, develop, grow or acquire businesses.
It is often associated in the UK with some degree of change of ownership in a business, connected to a corporate transaction that leads to the creation of a new equity structure or shareholder base, and the related issue, underwriting, purchase or exchange of equity (and related warrants) or debt.
The financial activities related to running a corporation.

A division or department that oversees the financial activities of a company. Corporate finance is primarily concerned with maximizing shareholder value through long-term and short-term financial planning and the implementation of various strategies. Everything from capital investment decisions to investment banking falls under the domain of corporate finance.

Investment Analysis and Capital Budgeting

Investment analysis (or capital budgeting) is the planning of value-adding, long-term corporate financial projects relating to investments funded through and affecting the firm's capital structure. Management must allocate the firm's limited resources between competing opportunities (projects), which is one of the main focuses of capital budgeting. Capital budgeting is also concerned with the setting of criteria about which projects should receive investment funding to increase the value of the firm, and whether to finance that investment with equity or debt capital. Investments should be made on the basis of value-added to the future of the corporation. Projects that increase a firm's value may include a wide variety of different types of investments, including but not limited to, expansion policies, or mergers and acquisitions. When no growth or expansion is possible by a corporation and excess cash surplus exists and is not needed, then management is expected to pay out some or all of those surplus earnings in the form of cash dividends or to repurchase the company's stock through a share buyback program.

Capital budgeting is a long term planning for replacement of an old inefficient equipment and /or additional equipment or physical plant when growing business conditions warrant. Capital budgeting will determine when the organization is able to afford the purchase of the equipment. Capital budgeting involves setting aside moneys each year for large investments that night need to be made. For example, purchasing costly equipment or machines, expanding or relocating the business premise, instituting a complete internal reorganization, developing and launching a new product. Therefore, planning, evaluating budgetary alternatives is very important. Here are some important “money concepts” to keep in mind:

- firm’s capital is always limited
- money borrowed for capital expenditures will cost more money
- today’s dollar is worth one dollar-plus, in the sense that it can be held in a bank account and draw interest
- tomorrow’s dollar will probably be worth one dollar-minus
- money assigned to capital expenses may sometimes be out to different, more productive uses

Capital Investments are made for two basic reasons:

1) to lower operating costs, or 2) to increase sales. Any major commitment of your firm’s funds warrants due caution and consideration on your part. Indeed, a common mistake of many small businesses is to put too many dollars into capital assets, thereby precipitating a cash crisis that can immobilize operations and even cause bankruptcy. Of course, such investments can be made directly from the company treasury through borrowed or equity capital and long-term leasing.

Whatever the approach (or combination thereof), you will find the following procedure of value making decisions of this nature:

- List all of the alternatives on a sheet of paper. Remember also to list the one alternative that's always present in such situations: Do nothing.
- Work up all the costs involved for each of the choices. Be sure to include estimates of details like the cost of borrowing additional sum of money if you don't have enough, and the value of leaving your firm's current dollars untouched and earning interest in a savings account.
- Estimate the most likely results (outcomes), in dollars and cents, of each pf the alternatives.

Capital structure:

A mix of a company's long-term debt, specific short-term debt, common equity and preferred equity. The capital structure is how a firm finances its overall operations and growth by using different sources of funds. Debt comes in the form of bond issues or long-term notes payable, while equity is classified as common stock, preferred stock or retained earnings. Short-term debt such as working capital requirements is also considered to be part of the capital structure.

A company's proportion of short and long-term debt is considered when analyzing capital structure. When people refer to capital structure they are most likely referring to a firm's debt-to-equity ratio, which provides insight into how risky a company is. Usually a company more heavily financed by debt poses greater risk, as this firm is relatively highly levered.
Capital structure describes how a corporation finances its assets. This structure is usually a combination of several sources of senior debt, mezzanine debt and equity. Wise companies use the right combination of senior debt, mezzanine debt and equity to keep their true cost of capital as low as possible. Depending on how complex the structure, there may in fact be dozens of financing sources included, drawing on funds from a variety of entities in order to generate the complete financing package. Capital structure is what describes the relationship of these financing sources as they appear on the corporation's balance sheet.

Corporate Financial Decisions, Firm Value, and Equity Value

If the objective function in corporate finance is to maximize firm value, it follows that firm value must be linked to the three corporate finance decisions outlined—investment, financing, and dividend decisions. The link between these decisions and firm value can be made by recognizing that the value of a firm is the present value of its expected cash flows, discounted back at a rate that reflects both the riskiness of the projects of the firm and the financing mix used to finance them. Investors form expectations about future cash flows based on observed current cash flows and expected future growth, which in turn depend on the quality of the firms

projects (its investment decisions) and the amount reinvested back into the business (its dividend decisions). The financing decisions affect the value of a firm through both the discount rate and potentially through the expected cash flows.

This neat formulation of value is put to the test by the interactions among the investment, financing, and dividend decisions and the conflicts of interest that arise between stockholders and lenders to the firm, on one hand, and stockholders and managers, on the other. We introduce the basic models available to value a firm and its equity, and relate them back to management decisions on investment, financial, and dividend policy. In the process, we examine the determinants of value and how firms can increase their value.

Equity value is the value of a company available to owners or shareholders. It is the enterprise value plus all cash and cash equivalents, short and long-term investments, and less all short-term debt, long-term debt and minority interests.

Equity value accounts for all the ownership interest in a firm including the value of unexercised stock options and securities convertible to equity.

From a mergers and acquisitions academic perspective, equity value differs from market capitalization or market value in that it incorporates all equity interests in a firm whereas market capitalization or market value only reflects those common shares currently outstanding.

The enterprise value (EV) measures the value of the ongoing operations of a company. It attempts to measure the value of a company's business instead of measuring the value of the company. It is the measure for calculating how much it would cost to buy a company's business free of its debts and liabilities. It can be thought of as a theoretical takeover price of a company's business.

The enterprise value is used as an alternative to market capitalization. It is a more accurate estimate of the takeover price of a company than the market capitalization. The enterprise value is calculated by the following formula:

Enterprise Value = Market Capitalization +Debt +Preferred Share Capital + Minority Interest - Cash and cash equivalents

Let's discuss these components individually and the reasons why they are included in the calculation of enterprise value.

Valuation:

Knowing what an asset is worth and what determines that value is a pre-requisite for intelligent decision making -- in choosing investments for a portfolio, in deciding on the appropriate price

to pay or receive in a takeover and in making investment, financing and dividend choices when running a business. The premise of valuation is that we can make reasonable estimates of value for most assets, and that the same fundamental principles determine the values of all types of assets, real as well as financial. Some assets are easier to value than others, the details of valuation vary from asset to asset, and the uncertainty associated with value estimates is different for different assets, but the core principles remain the same. This introduction lays out some general insights about the valuation process and outlines the role that valuation plays in portfolio management, acquisition analysis and in corporate finance. It also examines the three basic approaches that can be used to value an asset.

A philosophical basis for valuation

A postulate of sound investing is that an investor does not pay more for an asset than it is worth. This statement may seem logical and obvious, but it is forgotten and rediscovered at some time in every generation and in every market. There are those who are disingenuous enough to argue that value is in the eyes of the beholder, and that any price can be justified if there are other investors willing to pay that price. That is patently absurd. Perceptions may be all that matter when the asset is a painting or a sculpture, but we do not and should not buy most assets for aesthetic or emotional reasons; we buy financial assets for the cashflows we expect to receive from them. Consequently, perceptions of value have to be backed up by reality, which implies that the price we pay for any asset should reflect the cashflows it is expected to generate. Valuation models attempt to relate value to the level of, uncertainty about and expected growth in these cashflows.

There are many aspects of valuation where we can agree to disagree, including estimates of true value and how long it will take for prices to adjust to that true value. But there is one point on which there can be no disagreement. Asset prices cannot be justified by merely using the argument that there will be other investors around who will pay a higher price in the future. That is the equivalent of playing a very expensive game of musical chairs, where every investor has to answer the question, "Where will I be when the music stops before playing. The problem with investing with the expectation that there will be a bigger fool around to sell an asset to, when the time comes, is that you might end up being the biggest fool of all.

Inside the Valuation Process

There are two extreme views of the valuation process. At one end are those who believe that valuation, done right, is a hard science, where there is little room for analyst views or human error. At the other are those who feel that valuation is more of an art, where savvy analysts can manipulate the numbers to generate whatever result they want. The truth does lies somewhere in the middle and we will use this section to consider three components of the valuation process that do not get the attention they deserve – the bias that analysts bring to the process, the uncertainty that they have to grapple with and the complexity that modern technology and easy access to information have introduced into valuation.

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