# Valuation And Corporate Finance Transactions

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## Lecture 1

Chapter 2:
Makes the assumption that firms are run properly, efficiently and ethically, which in practice is not the case. The basic principles that stop firms getting into danger by the way they are managed are that the financial manager must be aware of the basic principles in which their company should be run. Without this knowledge they will not be able to make the financial decisions that best fit their company's shareholders.

Chapter 1:
- Corporate finance has 3 main areas of concern
- - capital budgeting: what long term investments should the firm take?
- - capital structure: where will the firm get the long term financing to pay for its investments? Also what mixture of debt and equity should it use to fund operations
- - working capital management: how should the firm manage its everyday financial activities?
- The goal of financial management in a for-profit business is to make decisions that increase the value of the shares or increase the market value of equity.

## Lecture 2

Chapter 12:
- A firm with excess cash can either pay a dividend or make a capital expenditure. Because shareholders can reinvest the dividend in risky financial assets, the expected return on a capital budgeting project should be at least as great as the expected return on a financial asset of comparable risk.
- The expected return on any asset is dependent on its beta. Thus, we showed how to estimate the beta of an equity. The appropriate procedure employs regression analysis on historical returns.
- A project whose beta risk is equal to the firm, who is unlevered, the discount rate is equal ->
- We can generally estimate the projects beta based on the industry average
- A firm can reduce its cost of capital by improving liquidity

Chapter 26:
- Introduced the management of short term finance, involving short lived assets and liabilities. The traces of short term sources appear on firms financial statements. From an accounting perspective, short term finance involves net working capital
- Managing short term cash flows involves the minimization of costs. The two major costs are carrying costs (the interest and related costs incurred by over-investing in short term assets such as cash) and shortage costs (the cost of running out of short term assets). The objective of managing short term finance is to find the optimal trade-off between these costs.
- In an ideal economy a firm could perfectly predict its short term uses and sources of cash and net working capital will be kept at zero. In the real world net working capital provides a buffer that lets the firm meet its ongoing obligations. The financial manager seeks the optimal level of cash of the current assets
- The financial manager can use the cash budget to identify short term financial needs. The cash budget tells the manager what borrowing is required or what lending will be possible in the short term. The firm has a number of possible ways of acquiring funds to meet short term shortfalls, including unsecured and secured loans.

Chapter 7: discussed practical applications of capital budgeting:
- Capital budgeting must be placed on an incremental basis, sunk costs must be ignored whereas both opportunity costs and side effects must be considered.
- You compute NPV by calculating the net cash flow from all sources for each period, then calculating the NPV using those cash flows
- Inflation must be handled consistently. One approach is to express both cash flows and the discount rate in nominal terms. The other approach is to express both cash flows and the discount rate in real terms. Because either approach yields the same result the simpler method should be used, this depends on the type of capital budgeting problem.
- A firm should use the equivalent annual cost approach when choosing between two machines of unequal lives.

## Lecture 3

Chapter 14:
The basic sources of long term debt, preference share and ordinary sh
- We emphasize that ordinary shareholders have residual risk, return, voting rights and limited liability if the corporation elects to default o transfer some or all of its assets to the creditors.
- Long term debt involves contractual obligations set out in indentures kinds of debt but the essential feature is that debt involves a stated repaid. Interest payments on debt are considered a business expe deductible.
- Preference shares have some of the features of debt and ordinary s preference in liquidation and in dividend payments compared to ord
- Firms need financing for capital expenditures, working capital and o Most of the financing is provided from internally generated cash flo
- In Muslim faith standard investment instruments that involve interes acceptable, in response they have developed an alternative.

Chapter 19: how equity is issued
- Large issues have proportionately much lo ones.
- Firm commitment underwriting is far more efforts underwriting. Smaller issues probab uncertainty of these issues. For an offering best efforts underwriting and firm commitm
- Rights issues are cheaper than general ca underpricing, yet most new equity issues a
- Shelf registration is a new method of issuin of shelf issues seem to be substantially low
- Private equity is an increasingly important financing.

## Lecture 4

Chapter 16:
- According to theory, firms should create all-debt capital structures under corporate taxation. Because firms generally employ moderate amounts of debt in the real world, theory must have missed something. The costs of financial distress cause firms to restrain their issuance of debt. These costs are either direct (lawyers and accountants fees in the process of bankruptcy process) or indirect (incentive to take on risky projects or towards underinvestment and impaired ability to conduct business)
- Because financial distress costs are substantial and shareholders hold them, firms have incentives to reduce them. Protective covenants and debt consolidation are common reduction techniques.
- As these costs can be reduced but not eliminated firms will not finance entirely with debt. Firms will select the debt-equity ratio at which firm value is maximized.
- Signalling theory argues that profitable firms are likely to increase their leverage because the extra interest payments will offset some of the pre-tax profits. Rational shareholders will infer higher firm value from a higher debt level.
- The pecking order theory implies that managers prefer internal to external financing. If external financing is required they tend to choose the safest securities, such as debt. Firms may accumulate slack to avoid external equity.

Chapter 17: The beta of the equity of the firm is positively related to the leverage of the firm.

No tax case

Corporate tax case

Chapter 15:
- The particular structure that maximises the value of the firm is also the one that provides the most benefit to the shareholders.
- If the world had no taxes, MM proposition 1 proves that the value of the firm is unaffected by the debt-equity ratio. A firm's capital structure is a matter of indifference. The authors obtain their results by showing that either a high or a low corporate ratio of debt to equity can be offset by homemade leverage. The result hinges on the assumption that individuals can borrow at the same rate as corporations, an assumption we believe to be plausible.
- MM proposition 2 states in a world without taxes: This implies that the expected rate of return on equity is positively related to the firm's leverage. This makes intuitive sense because the risk of equity rises with leverage.
- MM implies that the capital structure decision is a matter of indifference, whereas the decision appears to be a weighty one in the real world. To achieve real-world applicability, we next considered corporate taxes.
- In a world with corporate taxes but no bankruptcy costs, firm value is an increasing function of leverage. $V_L = V_U + T_C B$, the value of a levered firm equals the value of an unlevered firm plus tax leverage

## Lecture 5

Chapter 16 (again):
- Managers owning a small proportion of a firm's equity can be expected to work less, maintain more lavish expense accounts and accept more projects with a negative NPV. Because new issues of equity dilute a managers percentage interest in the firm, such agency costs are likely to increase when a firms growth is financed through new equity rather than new debt.
- The market timing theory suggests there is no pecking order or trade off of capital structure choices. Observed debt ratios are simply a function of past market to book valuations and the timing of funding requirements. Firms will have more equity if they needed funding when market to book valuations were high. Conversely, if financing was required during low market to book periods, debt would tend to dominate.
- Significant equity financing can be explained by real growth and inflation, even in a world of low bankruptcy costs.
- The factors that determine debt-equity ratios are taxes (firms with a high taxable income should rely more on debt than firms with low taxable income), types of assets (firms with a higher percentage of intangible assets such as research and development should have low debt, but firms with primarily tangible assets should have a higher debt) and uncertainty of operating income (firms with high uncertainty should rely on mostly equity)

## Lecture 6

Chapter 18:
- The dividend policy of a firm is irrelevant in a perfect capital market because the shareholder can effectively undo the firms dividend strategy. If a shareholder receives a greater dividend than desired, they can reinvest the excess. If they receive less they can sell extra shares of equity. This is due to MM and is similar to their homemade leverage concept.
- Shareholders will be indifferent between dividends and share repurchases in a perfect capital market.
- Because dividends are taxed, companies should not issue equity to pay out a dividend.
- Also because of taxes, firms have an incentive to reduce dividends. For example, they might consider increasing capital expenditures, acquiring other companies, or purchasing financial assets. However, due to financial considerations and legal constraints, rational firms with large cash flows will likely exhaust these activities with plenty of cash left over for dividends.
- In a world with personal taxes, a strong case can be made for repurchasing shares instead of paying dividends.
- There are a number of justifications for dividends even in a world with personal taxes. Investors in no-dividend equities incur transaction costs when selling off shares for current consumption. Behavioural finance argues that investors with limited self-control can meet current consumption needs via high-dividend equities while adhering to a policy of 'never dipping into principal'. Managers, acting on behalf of shareholders, can pay dividends to keep cash from bondholders. The board of directors, also acting on behalf of shareholders, can use dividends to reduce the cash available to spendthrift managers.
- The stock market reacts positively to increases in dividends (or an initial payment) and negatively to decreases in dividends. This suggests that there is information content in dividend payments.
- High (low) dividend firms should arise to meet the demands of dividend-preferring (capital gains preferring) investors. Because of these clienteles, it is not clear that a firm can create value by changing its dividend policy.
- Time-varying demand for dividends means that in some periods companies that pay dividends are traded at a premium and in other cases they are not. Managers will time their divided policies to take advantage of this premium.

## Lecture 7

## Lecture 8

Chapter 28:
- One firm can acquire another in several different ways. The three legal forms of acquisition are merger and consolidation, acquisition of equity and acquisition of assets. Mergers and consolidations are the least costly from a legal standpoint, but they require a vote of approval by the shareholders. Acquisition by equity does not require a shareholder vote and is usually done via a tender offer. However, it is difficult to obtain 100% control with a tender offer. Acquisition of assets is comparatively costly because it requires more difficult transfer of asset ownership.
- The synergy from an acquisition is defined as the value of the combined firm (Vab) less the value of the two firms as separate entities. Vab - (Va + Vb) = synergy. The shareholders of the acquiring firm will gain if the synergy from the merger is greater than the premium.
- The benefits from an acquisition are revenue enhancement, cost reduction, lower taxes and reduced capital requirements.
- Shareholders may not benefit from a merger that is done only to achieve diversification or earnings growth. And the reduction in risk from a merger may actually help bondholders and hurt shareholders.
- A merger is said to be friendly when the managers of the target support it. A merger is said to be hostile when the target managers do not support it. Some of the most colourful language of finance stems from defensive tactics in hostile takeover battles. Poison pills (the target company attempts to make its stock less attractive to the acquirer), golden parachutes (agreement between a company and an employee (usually upper executive) specifying that the employee will receive certain significant benefits if employment is terminated), crown jewels (creating anti-takeover clauses which compels the sale of their crown jewels if a hostile takeover occurs) and greenmail (buying enough shares in a company to threaten a takeover, forcing the owners to buy them back at a higher price in order to retain control).

# Lecture 1