Eighth Edition

CORPORATE FINANCE AND INVESTMENT

Decisions and Strategies

Richard Pike, Bill Neale and Philip Linsley

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Preface

We are very pleased that the textbook is now in its eighth edition. It is unusual for a textbook to have such longevity and there are a series of people who need thanking – our publishers, who continue to support us in our endeavours to produce a contemporary and informative text, academics who recommend the book, and students who purchase the book and use it in their studies.

Corporate finance and the financial world continue to develop and change at a rapid rate, and the dynamic nature of financial markets is evident in movements in share prices and stock indices across the world. The financial crisis that commenced in 2007–8 is still having fundamental repercussions and making headlines. The crisis fully illustrates that finance should be studied and the potential consequences of financial decisions need to be understood. Futher, the crisis demonstrates that what happens in finance can have important ramifications for governments and individuals as well as businesses. Risk has always been a key facet of finance and financial markets, but now seems to have even greater significance. As a consequence, risk management has risen in prominence.

These considerations reinforce our view that finance should be about developing, explaining and, above all, *applying* key concepts and techniques to a broad range of contemporary management and business policy concerns and challenges. It is becoming more appropriate, certainly at the undergraduate level, to demonstrate the role finance has to play in explaining and shaping business development rather than concentrating on rigorous, quantitative aspects.

The focus of the eighth edition, as in previous ones, is distinctly corporate, examining financial issues from a managerial standpoint. To simplify greatly, we have tried, wherever possible, to present the reader with the question 'OK, but how does this help the managerial decision-maker?' and also to provide a few answers, or at least pointers.

Some might say we should include chapters on other financial issues deemed to have a degree of importance equivalent to those covered here. Yet we believe, as ever, that there is a trade-off between comprehensiveness and manageability. This edition is directed at those issues, which in our experience are regarded as the central issues in finance.

Distinctive features

The eighth edition retains a set of distinctive features, including the following:

- *A strategic focus*. Students often regard financial management as a subject quite distinct from management and business policy. We attempt to relate the subject to these matters, emphasising the integration of the finance function within the context of managerial decision-making and corporate planning, and to the wider external environment.
- *A practical approach*. Financial theory increasingly dominates some texts. Theory has its place, and this text covers an appreciable amount; however, we seek to blend theory and practice: to ask why they sometimes differ, and to assess the role of less-sophisticated financial approaches. In other words, we do not elevate theory above common sense and intuition.

- *A clear and accessible style*. Personal experience and feedback suggest that much of our target readership prefers a more descriptive, rather than heavily mathematical, approach but appreciates worked examples and illustrations. There is a place for formulae, proofs and quantitative analysis; however, where possible, an alternative narrative explanation is provided.
- *An international perspective*. Although emanating from the UK, our text continues to use, where appropriate, examples drawn from other regions and countries, especially mainland Europe and the USA.

Teaching and learning features

A range of teaching and learning features is provided, including the following:

- *Mini case studies*. Topical cameos, applying financial management principles to well-known companies, are presented at the start of chapters and elsewhere within the text.
- *Learning objectives*. Specified at the outset of each chapter, these highlight what the reader should achieve in terms of concepts, terminology and skills.
- *Worked examples*. Integrated throughout the text to illustrate the key principles.
- *Extracts from the press*. Each chapter includes at least one article mainly from either the *Financial Times* or *The Economist*, focusing on one of the key issues addressed in the chapter.
- *Key revision points*. Provided at the end of each chapter to summarise the main concepts covered.
- *Annotated further reading*. At the end of each chapter, a number of key books and articles are suggested to offer additional perspectives and enable subjects to be studied in more depth. Full details of all books and articles are given in the References at the end of the book.
- A quick reference *glossary* of simple definitions.

Assessment features

Flexible study and assessment is facilitated by a variety of activities:

- *Self-assessment activities (SAAs)*. These include both short questions and simple numerical exercises designed to reinforce a point made in the text or to encourage the reader to pursue a particular line of thought. Questions are inserted in the text at appropriate points and the answers are packaged together at the end of the book in Appendix A.
- *Questions*. These test a mix of numerical, analytical and descriptive skills, offering a spread of difficulty. A selection of solutions is also provided in Appendix B at the end of the text, making these suitable for self-assessment, tutorial or examination purposes.
- *Practical assignments*. These provide the opportunity to look beyond the confines of the text to consider the application of concepts to a company or organisation, or to published financial reports and data, and are suitable where group or individually assessed coursework is set.

Readership

The text has proved successful both for newcomers to finance and also for students with a prior knowledge of the subject. It is particularly relevant to undergraduate,

MBA and other postgraduate and post-experience courses in corporate finance or financial management. Students seeking a professionally accredited qualification will also find it especially relevant to the financial management papers of the Association of Chartered Certified Accountants, Institute of Chartered Secretaries and Administrators, Certified Diploma in Finance and Accounting, Chartered Institute of Management Accountants and the Institute of Chartered Accountants in England and Wales.

Changes to the eighth edition

As with previous editions, our revisions are based on extensive market research, including reviewers' questionnaires and direct feedback from adopters and users. Feedback, while always interesting and helpful, was sometimes contradictory. Hopefully, we have achieved a balance between academic rigour and practical application.

In preparing this edition, we have battled with two opposing forces. We wanted to avoid expanding the text to an unmanageable size, yet we have been aware of several gaps in our coverage in previous editions, and the need for 'infill'.

The main changes to this edition in structure and in content are summarised below.

Structural changes

In the seventh edition we introduced more discussion of topics related to risk. We have built on this in the eighth edition and further extended these discussions on risk management and real options. We have also tried to make the text more accessible by 'breaking up' the chapters through the incorporation of additional self-test questions.

Structure and outline

An outline of the text is given below; however, a further description of the purpose and content of each section is given in the introduction to each.

Part I considers the underlying framework for corporate financing and investment decisions; key aspects of this part are the financial objectives of business, the financial environment within which firms operate, the time-value of money and the concept of value.

Part II addresses investment decisions and strategies within firms. Emphasis is placed on evaluation procedures, including treatments of taxation, inflation and capital rationing. Because, in practice, investment decision-making often bears little relationship to the theoretical approaches outlined in some texts, we persist in our attempt to promote an understanding of the practical evaluation of investment decisions by firms.

The importance of value, risk and the expected rate of return are examined in Part III, with six chapters devoted to this theme. Here we consider the investment project in isolation, including the rapidly developing and exciting field of options analysis. Other chapters view risk and return more from a shareholder perspective. Fundamental to this section are the rate of return on investment required by shareholders and the valuation of the enterprise.

Part IV discusses the short-term financing decisions and policies for acquiring assets. It covers treasury and working capital management.

Part V addresses long-term strategic financing and policy issues. What are the main sources of finance? How much should a company pay in dividends? How much

should it borrow? The culminating chapter focuses on corporate restructuring, with particular reference to acquisitions.

Part VI examines international financial management issues. It explains the operation of the foreign currency markets and how firms can hedge against adverse foreign exchange movements, and sets out the principles underpinning firms' evaluation of foreign investment decisions.

A concluding chapter reviews developments in corporate finance, with specific focus on market efficiency and behavioural finance.

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All textbooks include 'acknowledgements' but, on reflection, this seems too weak a word to use when assistance has so often been so freely given. *Roget's Thesaurus* offers as a synonym, 'the act of admitting to something', suggesting rather grudging recognition!

Our recognition of the wide range of people and organisations is anything but grudging. We extend our warm appreciation of the helpful comments provided by you over the years, and also for consent to use your material.

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Part I

A FRAMEWORK FOR FINANCIAL DECISIONS

Business financial decisions are not made in a vacuum. An 'obvious' decision may often have to be tempered by an appreciation of the restrictions imposed by the prevailing environment. Although it is beyond our scope to consider the full social, political and economic complexity of the financial decision-making context, we provide an overview of the key features of the UK financial and economic system. A sound grasp of the framework for financial decisions is essential if the reader is to appreciate fully the issues discussed in subsequent chapters of this book.

Part I provides an introduction to the scope and the fundamental concepts of financial management. Chapter 1 provides a broad picture of the subject and the important role it plays in business. It examines the nature of financing and investment decisions, the role of the financial manager and the fundamental objective for corporate financial management. This leads on, in Chapter 2, to consideration of the financial and tax environment in which businesses operate. Particular attention is devoted to the characteristics and operation of the London Stock Exchange, which provides a barometer of the success of financial decisions via the market's valuation of the company's shares. The extent to which any market can provide 'accurate' valuations is also considered.

Central concepts in financial management are the time-value of money and present value, which are discussed in Chapter 3. The chapter also provides an understanding of the valuation of bonds and shares. Concepts of value and its measurement play important roles in subsequent chapters, where investment, financing and other key decisions are discussed.

1 An overview of financial management 3

2 The financial environment 23

3 Present values, and bond and share valuation 54

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1 An overview of financial management

Working for shareholders

Tesco and Walmart are two of the world's largest and best known retailers. Tesco was founded in the UK and Walmart in the USA, and both companies now have a significant international presence. The overlap between the two companies is not restricted to their competing in the same market sector. The two companies also have the same primary focus on shareholder value:

> Everything we are doing reflects my determination to deliver shareholder value, an appropriate balance between investing for future growth, and delivering sustainable returns for our shareholders.
>
> (Tesco 2013 Annual report)

> Delivering strong returns to shareholders remains a top priority for Walmart.
>
> (Walmart 2013 Annual report)

Sources: http://www.tescoplc.com, http://stock.walmart.com

Learning objectives

By the end of this chapter, you should understand the following:

- What corporate finance and investment decisions involve.
- How financial management has evolved.
- The finance function and how it relates to its wider environment and to strategic planning.
- The central role of cash in business.
- The goal of shareholder wealth creation and how investors can encourage managers to adopt this goal.

1.1 INTRODUCTION

The objectives of Tesco and Walmart, summarised at the start, suggest that management has a clear idea of its purpose and key objectives. The mission is to deliver economic value to shareholders in the form of dividend and capital growth. Organisations such as Tesco and Walmart understand the importance of meeting the requirements of the **shareholders** – the owners of the business who need to be rewarded for their investment risk. Their objectives, strategies and decisions are all directed towards creating value for them.

One of the challenges in any business is to make investments that consistently yield rates of return to shareholders in excess of the cost of financing those projects and better than the competition. This book centres on that very issue: *how can firms create value through sound investment decisions and financial strategies?*

This chapter provides a broad picture of financial management and the fundamental role it plays in achieving financial objectives and operating successful businesses. First, we consider where financial management fits into the strategic planning process. This leads to an outline of the finance function and the role of the financial manager, and what objectives he or she may follow. Central to the subject is the nature of these financial objectives and how they affect shareholders' interests. Finally, we introduce the underlying principles of finance, which are developed in later chapters.

Starting a business: Brownbake Ltd

Ken Brown, a recent business graduate, decides to set up his own small bakery business. He recognises that a clear business strategy is required, giving a broad thrust to be adopted in achieving his objectives. The main issues are market identification, competitor analysis and business formation. He identifies a suitable market with room for a new entrant and develops a range of bakery products that are expected to stand up well, in terms of price and quality, against the existing competition.

Brown and his wife become the directors of a newly-formed limited company, Brownbake Ltd. This form of organisation has a number of advantages not found in a sole proprietorship or partnership:

- *Limited liability*. The financial liability of the owners is limited to the amount they have paid in. Should the company become insolvent, those with outstanding claims on the company cannot compel the owners to pay in further capital.
- *Transferability of ownership*. It is generally easier to sell shares in a company, particularly if it is listed on a stock market, than to sell all or part of a partnership or sole proprietorship.
- *Permanence*. A company has a legal identity quite separate from its owners. Its existence is unaffected by the sale of shares or death of a shareholder.
- *Access to markets*. The above benefits, together with the fact that companies enable large numbers of shareholders to participate, mean that companies can enjoy financial economies of scale, giving rise to greater choice and lower costs of financing the business.

Brown should have a clear idea of why the business exists and its financial and other objectives. He must now concentrate on how the business strategy is to be implemented. This requires careful planning of the decisions to be taken and their effect on the business. Planning requires answers to some important questions. What resources are required? Does the business require premises, equipment, vehicles and material to produce and deliver the product?

The key to industrial capitalism: limited liability

Shares, or 'equities', were first issued in the 16th century, by Europe's new joint-stock companies, led by the Muscovy Company, set up in London in 1553, to trade with Russia. (Bonds, from the French government, made their debut in 1555.) Equity's popularity waxed and waned over the next 300 years or so, soaring with the South Sea and Mississippi bubbles, then slumping after both burst in 1720. Share-owning was mainly a gamble for the wealthy few, though by the early 19th century, in London, Amsterdam and New York, trading had moved from the coffee houses into specialised exchanges. Yet the key to the future was already there. In 1811, from America, came the first limited-liability law. In 1854, Britain, the world's leading economic power, introduced similar legislation.

The concept of limited liability, whereby the shareholders are not liable, in the last resort, for the debts of their company, can be traced back to the Romans. But it was rarely used, most often being granted only as a special favour to friends by those in power.

Before limited liability, shareholders risked going bust, even into a debtors' prison maybe, if their company did. Few would buy shares in a firm unless they knew its managers well and could monitor their activities, especially their borrowing, closely. Now, quite passive investors could afford to risk capital – but only what they chose – with entrepreneurs. This unlocked vast sums previously put in safe investments; it also freed new companies from the burden of fixed-interest debt. The way was open to finance the mounting capital needs of the new railways and factories that were to transform the world.

Source: Based on *The Economist*, 31 December 1999.

Once these issues have been addressed, an important further question is: how will such plans be funded? However sympathetic his bank manager, Brown will probably need to find other investors to carry a large part of the business risk. Eventually, these operating plans must be translated into financial plans, giving a clear indication of the investment required and the intended sources of finance. Brown will also need to establish an appropriate finance and accounting function, to keep himself informed of financial progress in achieving plans and ensure that there is always sufficient cash to pay the bills and to implement plans. Such issues are the principal concern of financial management, which applies equally to small businesses, like Brownbake Ltd, and large multinational corporations, like Tesco and Walmart.

1.2 THE FINANCE FUNCTION

In a well-organised business, each section should arrange its activities to maximise its contribution towards the attainment of corporate goals. The finance function is very sharply focused, its activities being specific to the financial aspects of management decisions. Figure 1.1 illustrates how the accounting and finance functions may be structured in a large company. This book focuses primarily on the roles of finance director and treasurer.

It is the task of those within the finance function to plan, raise and use funds in an efficient manner to achieve corporate financial objectives. Two central activities are as follows:

1. Providing the link between the business and the wider financial environment.
2. Investment and financial analysis and decision-making.

■ Link with financial environment

The finance function provides the link between the firm and the financial markets in which funds are raised and the company's shares and other financial instruments are traded. The financial manager, whether a corporate treasurer in a multinational

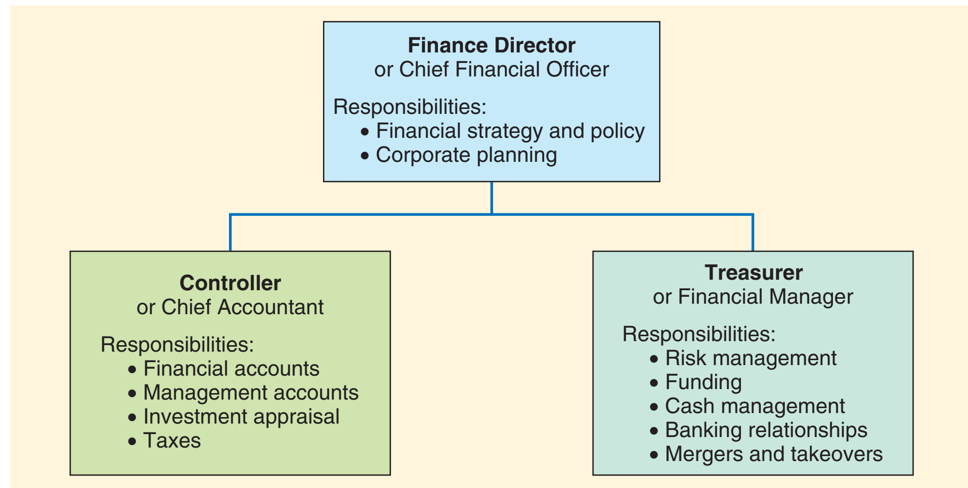

Figure 1.1 The finance function in a large organisation

company or the sole trader of a small business, acts as the vital link between financial markets and the firm. Corporate finance is therefore as much about understanding financial markets as it is about good financial management within the business. We examine financial markets in Chapter 2.

1.3 INVESTMENT AND FINANCIAL DECISIONS

Corporate finance is primarily concerned with investment and financing decisions and the interactions between them. These two broad areas lie at the heart of financial management theory and practice. Let us first be clear what we mean by these decisions.

The *investment decision*, sometimes referred to as the capital budgeting decision, is the decision to acquire assets. Most of these assets will be *real assets* employed within the business to produce goods or services to satisfy consumer demand. Real assets may be tangible (e.g. land and buildings, plant and equipment, and stocks) or intangible (e.g. patents, trademarks and 'know-how'). Sometimes a firm may invest in *financial assets*. Such investment does not form part of trading activity and may be in the form of short-term securities and deposits.

The basic problems relating to investments are as follows:

1. How much should the firm invest?
2. In which projects should the firm invest (fixed or current, tangible or intangible, real or financial)? Investment need not be purely internal. Acquisitions of other companies represent a form of external investment.

The *financing decision* addresses the problems of how much capital should be raised to fund the firm's operations (both existing and proposed), and what the best mix of financing is. In the same way that a firm can hold financial assets (e.g. investing in shares of other companies or lending to banks), it can also sell 'claims' on its own **real assets**, by issuing shares, raising loans, undertaking lease obligations, etc. A financial security, such as a share, gives the holder a claim on the future profits in the form of a dividend, while a bond (or loan) gives the holder a claim in the form of interest payable. Financing and investment decisions are therefore closely related.

real assets
Assets in the business (tangible or intangible)

Self-assessment activity 1.1

Take a look at the statement of financial position of Brownbake Ltd.

Assets employed	£
Machinery and equipment	15,000
Vehicles	8,000
Patents	12,000
Stocks	10,000
Debtors	3,000
Cash and bank deposit	4,000
	52,000
Liabilities and shareholders' funds	12,000
Trade creditors	8,000
Loans	32,000
Shareholders' equity	52,000

Identify the tangible real assets, intangible assets and financial assets. Who has financial claims on these assets?

(Answer in Appendix A at the back of the book)

1.4 CASH – THE LIFEBLOOD OF THE BUSINESS

Central to the whole of finance is the generation and management of cash. Figure 1.2 illustrates the flow of cash for a typical manufacturing business. Rather like the bloodstream in a living body, cash is viewed as the 'lifeblood' of the business, flowing to all essential parts of the corporate body. If, at any point, the cash fails to flow properly, a 'clot' occurs that can damage the business and, if not addressed in time, can prove fatal!

Good cash management therefore lies at the heart of a healthy business, and the major sources and uses of cash for a typical business are depicted in Figure 1.2.

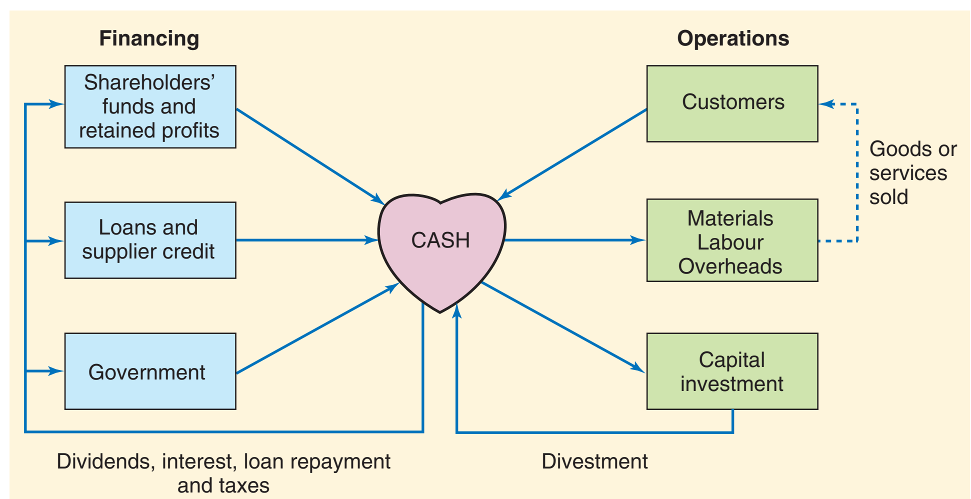

Figure 1.2 Cash – the lifeblood of the business

Sources and uses of cash

Shareholders' funds

shareholders' funds or equity capital
Money invested by shareholders and profits retained in the company

The largest proportion of long-term finance is usually provided by shareholders and is termed **shareholders' funds** or **equity capital**. By purchasing a portion of, or shares in, a company, almost anyone can become a shareholder with some degree of control over a company.

Ordinary share capital is the main source of new money from shareholders. They are entitled both to participate in the business through voting in general meetings and to receive dividends out of profits. As owners of the business, the ordinary shareholders bear the greatest risk, but enjoy the main fruits of success in the form of dividends and share price growth.

Retained profits

For an established business, the majority of equity funds will normally be internally generated from successful trading. Any profits remaining after deducting operating costs, interest payments, taxation and dividends are reinvested in the business (i.e. ploughed back) and regarded as part of the equity capital. As the business reinvests its cash surpluses, it grows and creates value for its owners. The purpose of the business is to do just that – create value for the owners.

Loan capital

debt finance/loan capital
Capital raised with an obligation to pay interest and repay principal

Corporate bonds
Medium- to long-term borrowing by a company

gearing
Proportion of the total capital that is borrowed

Money lent to a business by third parties is termed **debt finance** or **loan capital**. Most companies borrow money on a long-term basis by issuing loan stocks (or **corporate bonds**). The terms of the loan will specify the amount of the loan, rate of interest and date of payment, redemption date, and method of repayment. Loan stock carries a lower risk to the investor than equity capital and, hence, offers a lower return.

The finance manager will monitor the long-term financial structure by examining the relationship between loan capital, where interest and loan repayments are contractually obligatory, and ordinary share capital, where dividend payment is at the discretion of directors. This relationship is termed **gearing** (known in the USA as leverage).

Government

Governments and the European Union (EU) provide various financial incentives and grants to the business community. A major cash outflow for successful businesses will be taxation.

We now turn from longer-term sources of cash to the more regular cash flows from business operations as shown in Figure 1.2. *Cash flows from operations* comprise cash collected from customers less payments to suppliers for goods and services received, employees for wages and other benefits, and other operating expenses. The other major cash flow is long-term expenditure on capital investment.

1.5 THE EMERGENCE OF FINANCIAL MANAGEMENT

While aspects of finance, such as the use of compound interest in trading, can be traced back to the Old Babylonian period (*c.* 1800 BC), the emergence of financial management as a key business activity is a far more recent development. During the 20th century, financial management evolved from a peripheral to a central aspect of corporate life. This change was brought about largely through the need to respond to the changing economic climate.

With continuing industrialisation in the UK and much of Europe in the first quarter of the last century, the key financial issues centred on forming new businesses and raising capital for expansion and acquisitions.

As the focus of business activity moved from growth to survival during the depression of the 1930s, finance evolved by focusing more on business liquidity, reorganisation and insolvency.

Successive Companies Acts, Accounting Standards and corporate governance mechanisms have been designed to increase investors' confidence in published financial statements and financial markets. However, the US accounting scandals in 2002, involving such giants as Enron and Worldcom, have dented this confidence.

The 2007 credit crisis brought huge turmoil into the financial markets. This crisis resulted from banks expanding lending to sub-prime (i.e. riskier) borrowers and developed into a worldwide financial crisis that prompted comparisons with the Great Depression of the late 1920s and 1930s. The extent of the crisis resulted in significant financial support being provided to banks by governments, and, in 2009, the Bank of England reported that if 'all the facilities offered by central banks and governments were fully called upon, the scale of support to banking systems in the United Kingdom, the United States and euro area would exceed US$14 trillion' (Bank of England, 2009). This crisis has continued to have significant repercussions for governments, businesses and individuals. New banking regulations have been created, businesses have found it more difficult to access finance and individuals have found household budgets more difficult to manage.

Recent years have seen the emergence of financial management as a major contributor to the analysis of investment and financing decisions. The subject continues to respond to external economic and technical developments:

1. Successive waves of merger activity over the past 40 years have increased our understanding of valuation and takeover tactics. With governments committed to freedom of markets and financial liberalisation, acquisitions, mega-mergers and management buy-outs have become a regular part of business life.
2. Technological progress in communications and the liberalisation of markets have led to the globalisation of business. The single European market has created a major financial market with relatively unrestricted capital movement. Modern computer technology not only makes globalisation of finance possible, but also brings complex financial calculations and financial databases within easy reach of every manager.
3. Complexities in taxation and the enormous growth in new financial instruments for raising money and managing risk have made some aspects of financial management highly specialised. The causes of the 2007 credit crisis stem, in part, from the risk management practices of the banks and the use of certain forms of **derivative** instruments.

derivative
A financial instrument whose value derives from an underlying asset

4. Deregulation in the City is an attempt to make financial markets more efficient and competitive, although the lack of regulation in the banking sector was also judged a major factor in the 2007 banking crisis.
5. Greater awareness of the need to view all decision-making within a strategic framework is moving the focus away from purely technical to more strategic issues. For example, a good deal of corporate restructuring has taken place, breaking down large organisations into smaller, more strategically compatible businesses.

1.6 THE FINANCE DEPARTMENT IN THE FIRM

The organisational structure for the finance department will vary with company size and other factors. The board of directors is appointed by the shareholders of the company. Virtually all business organisations of any size are limited liability companies, thereby reducing the risk borne by shareholders and, for companies whose shares are listed on a stock exchange, giving investors a ready market for disposal of their holdings or for making further investment.