Corporate Finance and Financial Strategy

Optimising corporate and shareholder value

Tony Davies
Ian Crawford

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TONY DAVIES

and

IAN CRAWFORD

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Brief contents

Contents *vii*
Features *xvii*
Preface *xxiii*
Guided tour *xxvii*
Acknowledgements *xxxi*

Part I
CORPORATE FINANCE *1*

Introduction to Part I *2*

1 The financial environment *5*
2 Corporate objectives *51*
3 Corporate governance *87*
4 Risk, return, and portfolio theory *171*
5 Capital structure and the cost of capital *213*
6 Capital investment decisions *251*
7 Sources of finance and the capital markets *307*
8 Financial analysis *373*
9 Financial planning *443*
Case Study I: Gegin Ltd *477*
10 Management of working capital *481*
11 International operations and investment *541*
12 Financial risk management *577*
Case Study II: Millpot Ltd *625*

Part II
FINANCIAL STRATEGY *631*

Introduction to Part II *632*

13 The business life cycle and financial strategy *633*
14 Financial strategies from start-up to growth *663*
Case Study III: Derlex Ltd *691*
Case Study IV: Bircom plc *692*
15 Financial strategies from growth to maturity to decline *695*
Case Study V: Kite Ltd *726*
16 Mergers and acquisitions (M&As) *729*
17 Financial strategies in M&As *773*
18 Reorganisations and restructuring *805*
Case Study VI: Chamberlain plc *832*

APPENDICES

Present value tables *837*
Solutions to selected chapter-end exercises *841*
Index *913*

Contents

Features *xvii*
Case studies *xvii*
Press extracts *xvii*
Figures *xviii*
Preface *xxiii*
Guided tour *xxvii*
Acknowledgements *xxxi*

Part 1 CORPORATE FINANCE *1*

Introduction to Part I ***2***

1 The financial environment ***5***

Learning objectives *6*
Introduction *6*
Corporate finance and financial strategy *7*
Types of business entity *10*
Business organisational structures *16*
Financial statements *22*
Accountability and financial reporting *34*
Managing corporate finance *38*
Underlying principles of corporate finance *39*
Summary of key points *42*
Glossary of key terms *43*
Questions *47*
Discussion points *47*
Exercises *48*

2 Corporate objectives ***51***

Learning objectives *52*
Introduction *52*
Strategic management *52*
Corporate objectives *54*

Financial strategy 59
Efficient market hypothesis 63
Shareholder value 67
Strategic financial decisions 73
The agency problem 74
Summary of key points 79
Glossary of key terms 80
Questions 83
Discussion points 83
Exercises 84

3 Corporate governance 87

Extracts from Johnson Matthey Plc's report and accounts 2012 88
Learning objectives 133
Introduction 133
Corporate governance codes of practice 134
The audit and the role of auditors 146
Directors' responsibilities 150
Insolvency 158
Wrongful trading 159
Fraudulent trading 160
Disqualification of directors 160
Summary of directors' obligations and responsibilities 162
Actions to ensure compliance 163
Summary of key points 164
Glossary of key terms 165
Questions 167
Discussion points 167
Exercises 167

4 Risk, return, and portfolio theory 171

Learning objectives 172
Introduction 172
The relationship between risk and return 173
Investor attitudes to risk 176
Business risk and financial risk 177
The impact of risk on financing 178
Systematic and unsystematic risk 179
Diversification 180
Risk measurement 181
Portfolio risks and returns 186
Markowitz's portfolio theory 193
Risk-free investments 197

Capital market line (CML) 198
Investors' preferences 199
The return on the market portfolio 204
Summary of key points 207
Glossary of key terms 207
Questions 209
Discussion points 209
Exercises 209

5 Capital structure and the cost of capital **213**

Learning objectives 214
Introduction 214
Capital asset pricing model (CAPM) 214
Cost of equity 219
Simple dividend growth model 220
Cost of debt 221
Weighted average cost of capital (WACC) 223
Capital structure 227
Gearing – debt and equity 228
Optimal capital structure 234
Traditional approach to capital structure (or financial structure) 235
Miller and Modigliani (I) net income approach to capital structure 236
Miller and Modigliani (II) market imperfections approach to capital structure 237
Further approaches to capital structure 238
Summary of key points 241
Glossary of key terms 242
Questions 243
Discussion points 243
Exercises 243

6 Capital investment decisions **251**

Learning objectives 252
Introduction 252
What is an investment? 253
Future values, present values, perpetuities, and annuities 254
Investment appraisal methods 259
Advantages and disadvantages of the five investment appraisal methods 274
Other factors affecting investment decisions 276
Risk and uncertainty and decision-making – sensitivity analysis 284
Equivalent annual cost (EAC) 294
Capital budgeting 295
Control of capital investment projects 299
Summary of key points 300

Glossary of key terms *301*
Questions *302*
Discussion points *302*
Exercises *302*

7 Sources of finance and the capital markets ***307***

Learning objectives *308*
Introduction *308*
Sources of finance internal to the business *309*
Short-term external sources of finance *312*
Long-term external sources of finance *314*
The capital markets *338*
Financial institutions *345*
Islamic banking and Islamic finance *348*
The global financial crisis *357*
Summary of key points *363*
Glossary of key terms *364*
Questions *366*
Discussion points *367*
Exercises *367*

8 Financial analysis ***373***

Extracts from Johnson Matthey Plc report and accounts 2012 *374*
Learning objectives *378*
Introduction *378*
The performance review process *379*
Limitations of the performance review process *383*
Economic performance measurement *384*
Ratio analysis *385*
Return on equity (ROE), return on assets (ROA), and the Du Pont system *406*
Horizontal analysis *411*
Vertical analysis *413*
Segmental reporting *414*
Cash versus profit, and EBITDA, EVA™, and MVA *419*
Predicting corporate financial failure *428*
Summary of key points *432*
Glossary of key terms *433*
Questions *435*
Discussion points *435*
Exercises *436*

9 Financial planning ***443***

Learning objectives *444*

Introduction 444
The strategic view 445
The purpose of financial planning 449
The financial planning process 450
Financial modelling 452
The role of forecasting 459
Cash flow forecasting and planning 460
Planning for growth 462
Financing growth 464
Strategic performance assessment 465
Summary of key points 471
Glossary of key terms 471
Questions 472
Discussion points 473
Exercises 473

Case Study I: Gegin Ltd 477

10 Management of working capital 481

Learning objectives 482
Introduction 482
Working capital and working capital requirement 483
Working capital management as a strategic tool 488
Working capital policy 494
Inventories management 496
Just in time (JIT), materials requirement planning (MRP), and optimised production technology (OPT) 503
Trade receivables and credit management 505
Trade payables management 510
Operating cycle performance 518
Cash improvement techniques 520
Short-term cash flow improvement 521
Long-term cash flow improvement 526
Cash management 527
Summary of key points 531
Glossary of key terms 532
Questions 534
Discussion points 535
Exercises 535

11 International operations and investment 541

Learning objectives 542
Introduction 542

Internationalisation 543
Why companies undertake international operations 546
Types of international operation 547
International investment appraisal 553
International investment cost of capital 566
Financing international investment 569
Risk and international investment 570
Summary of key points 572
Glossary of key terms 572
Questions 573
Discussion points 573
Exercises 574

12 Financial risk management 577

Learning objectives 578
Introduction 578
Risk and uncertainty 579
Types of financial risk 582
Exchange rate equivalency model 585
Interest rate risk 589
Exchange rate risk 590
Financial risk management 594
Hedging financial risks 595
The use of derivatives 598
Financial risk management strategy 610
Behavioural finance 612
Summary of key points 616
Glossary of key terms 617
Questions 620
Discussion points 620
Exercises 621

Case Study II: Millpot Ltd 625

PART 2 FINANCIAL STRATEGY 631

Introduction to Part II 632

13 The business life cycle and financial strategy 633

Learning objectives 634
Introduction 634
Product life cycle (PLC) 635

Boston Consulting Group (BCG) matrix 637
The business life cycle (BLC) 639
Business risk and the life cycle 643
Financial risk and its inverse correlation with business risk 646
eps and net cash flow and the life cycle 648
Sources of funding and the life cycle 649
Dividends and the life cycle 651
Shareholders' returns and the life cycle 652
Price/earnings (P/E) ratio, the share price, and the life cycle 656
Summary of key points 658
Glossary of key terms 659
Questions 659
Discussion points 660
Exercises 660

14 Financial strategies from start-up to growth 663

Learning objectives 664
Introduction 664
A profile of start-up businesses 665
Sources of support for a start-up business 666
Venture capitalists (VCs) 666
Risk and return in start-up 669
A profile of growth businesses 672
The transition from start-up to growth 675
A change in the profile of investors 675
Risk and return in growth 676
Types of capital market 680
The flotation of a company – initial public offering (IPO) 682
Financing new projects 684
Rights issues 685
Summary of key points 687
Glossary of key terms 687
Questions 688
Discussion points 688
Exercises 688

Case Study III: Derlex Ltd 691
Case Study IV: Bircom plc 692

15 Financial strategies from growth to maturity to decline 695

Learning objectives 696
Introduction 696
The turbulence phase of the business life cycle 696

A profile of mature businesses 697
The transition from growth to maturity 698
Risk and return in maturity 699
Debt financing in maturity 699
Dividends – why are they paid? 700
Dividend policy and payment of dividends 703
Dividend policy – some practical issues 711
The dividend argument – relevancy and irrelevancy 712
Takeover targets 712
A profile of declining businesses 713
Risk and return in decline 714
Strategies to delay decline 716
Reducing the debt ratio 718
Summary of key points 721
Glossary of key terms 721
Questions 722
Discussion points 722
Exercises 723

Case Study V: Kite Ltd 726

16 Mergers and acquisitions (M&As) *729*

Learning objectives 730
Introduction 730
What are mergers, acquisitions, amalgamations, and takeovers? 730
Underlying principles of M&As 731
Types of M&A 732
Reasons and justifications for M&As 737
Financial motives in M&As 745
Managerial motives in M&As 747
Target company valuation 747
Other reasons for share valuation 758
Some further share valuation models 758
Summary of key points 764
Glossary of key terms 765
Questions 765
Discussion points 765
Exercises 766

17 Financial strategies in M&As *773*

Learning objectives 774
Introduction 774
Financing acquisitions 774

Debt versus equity in financing acquisitions 780
Financial strategy in acquisitions 781
Takeover pre-bid defences 788
Takeover post-bid defences 793
The position of shareholders, managers, employees, and financial institutions in M&As 798
Summary of key points *799*
Glossary of key terms *800*
Questions *801*
Discussion points *801*
Exercises *801*

18 Reorganisations and restructuring *805*

Learning objectives *806*
Introduction *806*
Reasons for reorganisations and restructuring 807
Reorganisation – financial strategies in response to internal issues 807
Reorganisation – financial strategies in response to external issues 814
Demergers 814
Privatisation – sale by government 817
Privatisation – return to private ownership 817
Management buy-outs (MBOs) 818
Management buy-ins (MBIs) 826
Problems with MBOs and MBIs 827
Summary of key points *828*
Glossary of key terms *828*
Questions *829*
Discussion points *829*
Exercises *829*

Case Study VI: Chamberlain plc *832*

APPENDICES *835*

Present value tables *837*
Solutions to selected exercises *841*

Index *913*

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Features

Case studies

Case study I	Gegin Ltd	*477*
Case study II	Millpot Ltd	*625*
Case study III	Derlex Ltd	*691*
Case study IV	Bircom plc	*692*
Case study V	Kite Ltd	*726*
Case study VI	Chamberlain plc	*832*

Press extracts

Chapter 1	Financial management in action	*23*
Chapter 2	How an inappropriate financial strategy can destroy shareholder value	*60*
Chapter 3	A new chapter in English law on corporate manslaughter?	*157*
Chapter 4	Diversify to give a clearer picture	*181*
Chapter 5	Companies ignore the risk of high gearing at their peril	*229*
Chapter 6	The impact of high UK costs on investments by large foreign companies	*283*
Chapter 7	Floating on the AIM	*344*
	The growth of Islamic financing	*348*
Chapter 8	The past is not a good predictor of the future	*384*
	Companies that fail to pay suppliers on time	*384*
Chapter 9	How realistic are financial plans?	*446*
Chapter 10	The problem of too much inventory	*498*
Chapter 11	From trading links to direct overseas presence	*552*
Chapter 12	Derivatives – beware!	*611*
	Predicting human behaviour – a racing certainty?	*612*
Chapter 13	The choice between dividends and capital growth	*655*
Chapter 14	A growing breed of venture capitalist	*667*
	Difficulties in setting the right price for an IPO	*683*
Chapter 15	Mature takeover target	*713*
Chapter 16	How successful are M&As?	*739*
Chapter 17	Illumina poison pill	*790*
	The real value of a company's assets	*795*
	Jousting match for white knight	*797*
Chapter 18	A successful deep discount rights issue	*810*
	A badly timed deep discount rights issue	*811*
	The difficulties in debt restructuring	*813*

Punch without spirit 814
Pfizer spins off 815
A Jersey-based MBO 820
MBI Moss injection to make Wasps buzz 827

Figures

1.1 The framework of corporate finance and financial management 8
1.2 Types of business entity 11
1.3 The finance function within a company's organisation 16
1.4 Features of useful financial information 18
1.5 Branches of accounting and finance 19
1.6 The main elements of the balance sheet 24
1.7 The main elements of the income statement 26
1.8 The main elements of the statement of cash flows 28
1.9 Users of financial and accounting information 33
2.1 The strategic management process 53
2.2 The stakeholders of a business 54
2.3 Surrogate objectives of a company 55
2.4 An illustration of the relationship between risk and return 68
2.5 The variables that affect shareholder wealth 68
3.1 The business community 135
3.2 The context of corporate governance 136
4.1 The relationship between perceived risk and required return 174
4.2 Factors relating to business risk 177
4.3 Levels of financial risk for the investor and the company 178
4.4 Available portfolios of risk/return combinations 195
4.5 Available portfolios of risk/return combinations 196
4.6 The envelope curve of investor choices of portfolios 197
4.7 The capital market line (CML) 198
4.8 Investor's indifference curve 199
4.9 Indifference curve comparison 200
4.10 Indifference curves and the CML 201
4.11 CML example 203
4.12 The risk premium on required returns from a portfolio 205
5.1 The capital asset pricing model (CAPM) 216
5.2 Sources of external finance 228
5.3 Capital structure – traditional approach 235
5.4 Capital structure – MM(I) approach 236
5.5 Capital structure – MM(II) approach 237
5.6 Capital structure – WACC approach 239
6.1 The five main investment appraisal criteria methods 260
6.2 Present value of £100 using a discount rate of 5% per annum 264
6.3 Interpolation of the internal rate of return (IRR) 268
6.4 Extrapolation of the internal rate of return (IRR) 269
6.5 Advantages and disadvantages of the five investment appraisal methods 275
6.6 Australian companies' capital budgeting evaluation techniques in 2011 276

6.7	Project appraisal factors used in sensitivity analysis	*284*
7.1	Internal sources of finance	*310*
7.2	External sources of short-term finance	*313*
7.3	External sources of long-term finance	*314*
7.4	Some of the main characteristics and rights of equity capital compared with debt capital	*315*
7.5	London Stock Exchange new issues of securities on the Main Market 2000 to 2011	*343*
7.6	London Stock Exchange selected further issues on the Main Market 2000 to 2011	*343*
7.7	The range of financial institutions	*346*
7.8	USA, UK and EU household debt as a percentage of GDP 1987 to 2007	*359*
7.9	USA mortgage loan defaults 2005 to 2010	*360*
7.10	UK average house prices February 2002 to February 2012	*361*
7.11	UK debt as a percentage of GDP by type of borrower 1987 to 2007	*362*
8.1	The stages of performance review	*380*
8.2	An example of a SWOT analysis – Ryanair 2010	*381*
8.3	Flatco plc balance sheets as at 31 December 2011 and 2012	*386*
8.4	Flatco plc income statements for the years ended 31 December 2011 and 2012	*387*
8.5	Flatco plc additional information to the financial statements 2012	*387*
8.6	Flatco plc cash generated from operations for the years ended 31 December 2011 and 2012	*388*
8.7	Flatco plc statement of cash flows for the years ended 31 December 2011 and 2012	*388*
8.8	Flatco plc analysis of cash and cash equivalents and bank overdrafts as at 31 December 2011 and 2012	*389*
8.9	Profitability ratios	*389*
8.10	Efficiency ratios	*395*
8.11	Liquidity ratios	*399*
8.12	Investment ratios	*401*
8.13	Financial ratios	*405*
8.14	Johnson Matthey Plc sales revenue 2012	*417*
8.15	Johnson Matthey Plc sales revenue 2011	*417*
8.16	Johnson Matthey Plc sales revenue 2012 and 2011	*418*
8.17	The advantages and disadvantages of using cash flow as a measure of company performance	*419*
8.18	The advantages and disadvantages of using earnings per share (eps) as a measure of company performance	*420*
8.19	BT plc EBITDA and free cash flow for 2006 to 2010	*422*
9.1	The strategic planning process	*447*
9.2	The strategic planning relationship with budgeting	*448*
9.3	Financial planning income statement flow diagram	*451*
9.4	Financial planning balance sheet flow diagram	*452*
9.5	Supportex year 1 simple income statement and balance sheet	*453*
9.6	Supportex year 1 and year 2 simple income statement and balance sheet	*453*

9.7 Supportex year 1 and year 2 simple income statement and balance sheet, with additional funding *454*
9.8 Supportex year 1 detailed income statement and balance sheet *455*
9.9 Supportex year 1 and year 2 detailed income statement and balance sheet *456*
9.10 Supportex five-year plan income statement and balance sheet *457*
9.11 Excel five-year planning model for Supportex *458*
9.12 Supportex five-year plan external funding requirement and debt/equity ratios *458*
9.13 Dubai Dreams three-month cash forecast *462*
9.14 An example of the balanced scorecard *469*
10.1 The cash operating cycle *485*
10.2 Supportex working capital 50% of sales revenue *490*
10.3 Supportex working capital 30% of sales revenue *491*
10.4 Consequences of Supportex's working capital reduction to 30% of sales revenue *492*
10.5 Supportex working capital 70% of sales revenue *493*
10.6 Consequences of Supportex's working capital increase to 70% of sales revenue *494*
10.7 Illustrations of the range of working capital ratios in the construction, chemical, and supermarket industrial sectors *496*
10.8 Example of an aged accounts receivable report *509*
10.9 Example of an aged accounts payable report *518*
10.10 Balance sheet items that impact on short-term and long-term cash flow *521*
11.1 The international financial marketplace *545*
11.2 Types of international operation *547*
11.3 Additional factors to consider in international financing *570*
12.1 US$/£ sterling average exchange rate 1980 to 2011 *584*
12.2 Exchange rate equivalency model *586*
12.3 Exchange rate equivalency model equations *587*
12.4 Euro/£ sterling forward exchange rates at 14 June 2012 *591*
12.5 Example of euro/£ sterling forward exchange rates *591*
13.1 Examples of the product, industrial sector, and industry level *635*
13.2 The product life cycle (PLC) *636*
13.3 The Boston Consulting Group (BCG) box *637*
13.4 Levels of business risk that may be faced by a company during its life cycle *644*
13.5 Levels of financial risk that may be faced by a company during its life cycle *647*
13.6 The likely cash flows of a business at different stages of its life cycle *649*
13.7 Sources of possible funding during a company's life cycle *650*
13.8 Dividend payout levels likely during a company's life cycle *651*
13.9 Shareholder returns likely during a company's life cycle *653*
13.10 Example of shareholders' returns throughout a company's life cycle *654*
13.11 P/E (price/earnings) ratio and share price likely during a company's life cycle *657*
14.1 Profile of a start-up business *665*
14.2 Profile of a growth business *673*
14.3 Functions facilitated by a primary capital market *681*
14.4 Functions facilitated by a secondary capital market *681*
15.1 Profile of a mature business *697*
15.2 Reasons for paying dividends *700*

15.3	Profile of a declining business	*714*
16.1	The ways in which mergers and acquisitions (M&As) may take place	*733*
16.2	Announced mergers and acquisitions in Europe 1995 to 2011	*737*
16.3	Justifications supporting the reasons for M&As	*742*
16.4	Asset-based business valuation approaches	*748*
16.5	Earnings-based business valuation approaches	*750*
16.6	The elements of free cash flow	*756*
16.7	Further business valuation approaches	*759*
16.8	Tesco plc consolidated balance sheet as at 25 February 2012	*761*
16.9	Tesco plc consolidated income statement for the year to 25 February 2012 and Note 27 to the accounts	*762*
17.1	Methods used to finance M&As	*775*
17.2	Risk, return, and financing	*780*
17.3	Identification of suitable acquisition targets	*782*
17.4	Takeover pre-bid defences	*789*
17.5	Takeover post-bid defences	*793*
18.1	Financial strategies for a company with too little debt	*807*
18.2	Next share price performance July 2008 to January 2012	*808*
18.3	Financial strategies for companies with too much debt	*809*
18.4	The stages of an MBO deal financed by venture capitalists	*822*

This book is dedicated to
Frances Davies

Preface

Coverage of financial issues by the press and media increases almost daily in both volume and complexity. The importance and media coverage of these issues has escalated enormously since the beginning of the so-called 'credit crunch', the global financial crisis that began in 2008. This includes topics such as debt, interest rates, corporate financial fraud, stock market performance, investment and growth, mergers and acquisitions, venture capitalists and private equity, derivatives, and foreign currency exchange rates. Each of these topics is in some way concerned with the risks faced by government organisations and individuals, and by financial institutions, banks, manufacturing and service companies, and their shareholders and lenders, and the corresponding cash returns that they expect to receive in reward for acceptance of such risks.

Corporate finance is concerned with all these financial issues, which impact on us all in one way or another and are forever changing in their composition and focus. The discipline of corporate finance is about:

- the way in which financial resources are acquired
- how these resources are most effectively used
- the control of these activities.

The topicality and critical importance of these topics therefore makes their study exciting and very relevant to a better understanding of the performance of countries' economies and businesses, and the decisions and problems they face.

This new textbook is called *Corporate Finance and Financial Strategy* because it includes not only the theory and key areas of corporate finance and the range of techniques that may be used and applied in practice, but also the appropriate financial strategies that may be adopted in order to optimise the use of the scarce resource of money (or cash flow).

One of the main objectives in writing this book was to produce a clear and user-friendly text, which embraces both the core principles and practice of corporate finance and also financial strategy. This book uses a comprehensive set of learning features, illustrative worked examples and assessment material to support and reinforce your study. It is aimed primarily at students who are undertaking a degree or diploma in accounting, finance, economics or business management, which includes a course in corporate finance or financial strategy, or both. It is also aimed at students undertaking postgraduate finance and business masters degrees, MBA students, and students pursuing professional accounting and finance courses.

Content and structure

The content and structure of the text have been carefully researched to follow closely the typical requirements of most introductory corporate finance and financial strategy courses at both undergraduate and postgraduate levels. This text assumes no prior knowledge of the subject:

we start at square one and take you step-by-step through the concepts and application of techniques, with clear explanations and numerous examples.

The text comprises 18 chapters, and is structured into two parts: corporate finance, and financial strategy:

Corporate finance is broadly concerned with the effective acquisition and use of financial resources in creating corporate value, and its translation into shareholder value. It includes a wide range of strategic financial management techniques and decision-making relating to capital investment; capital structure; working capital; the management of financial risk; financial planning; international operations and investment. It also covers accountability of company directors and their relationships with shareholders and other stakeholders.

Financial strategy decisions in general relate to the levels of:

- investment in the assets of the business, and the choice of types of asset
- most appropriate methods of funding – debt or equity
- profit retention
- profit distribution
- gearing, or capital structure of the business
- management of financial risk,

with the aim of maximisation of shareholder wealth.

Financial strategy is concerned with the creation of corporate value, but also how this is then reflected in increased shareholder wealth through creation of shareholder value consistent with levels of perceived risk and the returns required by investors.

Each of these areas and their component chapters are outlined in the introductory section to each part of the text.

A further key objective in writing this text was to provide a flexible study resource. There is a linkage between each of the chapters, which follow a structure that has been designed to facilitate effective learning of the subject in a progressive way. However, each chapter may also be used on a standalone basis; equally, chapters may be excluded from study if they relate to subjects that are not essential for a specific course. Therefore, the text is intended to be suitable for modules of either one or two semesters' duration.

Each chapter aims to help students understand the broader context and relevance of corporate finance and financial strategy in the business environment, and how these may assist in improving both corporate value and shareholder value. To put each topic in context we have provided numerous examples and commentary on company activity within each chapter, including at least one extract from the press and financial media; companies featured include Nestlé, Tesco, Barclays Bank, Ericsson, Next, Punch Taverns and BT. In addition, the book includes extracts and analysis of the actual Report and Accounts 2012 of Johnson Matthey, a major UK plc.

Using this book

To support your study and reinforce the topics covered, we have included a comprehensive range of learning features and assessment material in each chapter, including:

- learning objectives
- introduction
- highlighted key terms

- mini cases about real companies
- fully worked examples
- integrated progress checks
- key points summary
- glossary of key terms
- questions
- discussion points
- exercises.

Within each chapter we have also included numerous diagrams and charts that illustrate and reinforce important concepts and ideas. The double-page Guided Tour that follows on pages xxvii–xxviii summarises the purpose of these learning features and the chapter-end assessment material. To gain maximum benefit from this text and to help you succeed in your study and exams, you are encouraged to familiarise yourself with these elements now, before you start the first chapter.

It is easy, but mistaken, to read on cruise control, highlighting the odd sentence and gliding through the worked examples, progress checks and chapter-end questions and exercises. Active learning needs to be interactive: if you haven't followed a topic or an example, go back and work through it again; try to think of other examples to which particular topics may be applied. The only way to check you have a comprehensive understanding of things is to attempt all the integrated progress checks and worked examples, and the chapter-end assessment material, and then to compare with the text and answers provided. Fully worked solutions are given immediately after each example, and solutions to around 45% of the chapter-end exercises (those with their numbers in colour) are provided in Appendix 2. Additional self-assessment material is available in the student centre of the book's accompanying website (see page xvi).

Case studies

Throughout the book there are six case studies that may be tackled either individually or as a team. The case studies are a little more weighty than the chapter-end exercises and integrate many of the topics covered in the book. Each case study therefore gives you an opportunity to apply the techniques and knowledge gained, and to develop these together with the analytical skills, judgement, and strategic approach required to deal with real-life business problems. Additional cases are provided on the accompanying website.

We hope this textbook will enhance your interest, understanding and skills. Above all, relax, learn and enjoy!

Guided tour

Learning objectives at the beginning of each chapter enable you to focus on what you should understand after using each section of the book.

Learning objectives

Completion of this chapter will enable you to:

- Explain financial planning as part of the strategic management process.
- Outline the purpose of financial planning.
- Describe the financial planning process.
- Use financial modelling to plan the long-term activities of a business.
- Identify the ways in which a company may use alternative forecasting methods.
- Prepare a cash flow forecast as part of the financial planning process to determine a company's funding requirements.
- Explain the ways in which a business may plan for its future growth.
- Consider the financing options that a company may use to fund its future growth.
- Outline the ways in which a company's performance may be measured against its plans.
- Explain the ways in which the balanced scorecard may be used to translate a company's strategic plans into operational terms.

The **Introduction** gives you a brief overview of the content and aims of each chapter, and how it links to the previous chapter.

Introduction

Many companies have started up with very good ideas and good intentions with regard to their development and future sales growth. However, the corporate graveyard is full of companies that have been unsuccessful in these endeavours because they have failed to plan for such growth in terms of its impact on costs and planned levels of investment and funding.

This chapter considers financial planning, which is an important part of the strategic management process, concerned not with the absolute detail but taking a look at the big picture of the company as a whole. Strategic financial planning is not short term, but is concerned with periods of more than one year, and looks at expected levels of a company's sales growth and how it may be financed.

In order to produce forecast long-term financial statements, financial plans are prepared based on the company's planned growth rate, and its financial ratios relating to costs, working capital, tax, dividends, and gearing. Forecasts are not plans or budgets but are predictions of what may happen in the future. There are a variety of techniques, both qualitative and quantitative, which are used to forecast growth rates. Quantitative methods include use of the statistical techniques of exponential smoothing and regression analysis.

Cash flow forecasting is one part of the financial planning process and is used to determine a company's future funding requirements on a monthly and yearly basis. The company may use its own resources of retained earnings to support its plans for future sales growth. In some circumstances, additional external funding is necessary for a company planning future growth.

Key terms are highlighted the first time they are introduced, alerting you to the core concepts and techniques in each chapter. A full explanation is given in the Glossary section at the end of the chapter.

purposes to influence improved business unit and departmental performance. Monitoring of actual performance against plans is used to provide feedback in order to take the appropriate action necessary to reach planned performance, and to revise plans in the light of changes.

The role of financial planning is crucial to any business and it is important to be as accurate as possible. As the Thomas Cook press extract below indicates, the impact of a failure to accurately **forecast** the costs of long-term projects can have serious consequences for a company's financial stability.

Currently, many companies are taking the view that the traditional planning and annual budgeting systems are unsuitable and irrelevant in rapidly changing markets. Further, they believe that budgets fail to deal with the most important drivers of shareholder value such as intangible assets like brands and knowledge. Some of these companies, like Volvo, Ikea, and Ericsson, have already revised their need for annual budgets as being an inefficient tool in an

Press extracts feature real company examples from the press, including commentary that highlights the practical application of corporate finance in the business environment.

Mature takeover target

Sadly, there is still plenty of action in Afghanistan. But for investors in Inmarsat – the UK satellite company that provides phones and internet services to ships, aircraft and soldiers in such remote places – some action in the boardroom would be welcome. Over the past year, the company's share price has fallen by two-fifths as a stalled shipping industry and cutbacks in military activity hurt business. Is this a perfect moment to make a bid?

Inmarsat's shares jumped 4 per cent yesterday on speculation that it may be a takeover target. EADS and General Electric have been aired as possible candidates. The Franco-German aerospace group bought Vizada, one of Inmarsat's main distributors, last year for €1bn and adding Inmarsat may open some prospect of synergies. Cost savings are less obvious for GE, though.

That said, Inmarsat's tepid medium-term outlook could be a turn-off for a publicly listed acquirer. Its earnings before interest, tax, depreciation and amortisation in 2012 are forecast to fall by 4 per cent and there is little prospect of growth in 2013. That perhaps opens the door for private equity. In a leveraged buy-out scenario, if a buyer paid, say, £2.5bn – or £5.54 per share, a 30 per cent premium to Inmarsat's undisturbed share price – funded half with debt, then even assuming no ebitda growth over five years, it could produce an internal rate of return of 12 per cent. Not bad.

Boosting Inmarsat's appeal is that its long-term future looks favourable. It has yet to materially tap into emerging markets and its new global broadband satellites could boost its military business revenues late next year. Current investors may be fed up with the lack of action but a private buyer with a longer-term perspective should be able to find value in the business. For Inmarsat's long-suffering shareholders, that would be a relief.

Source: Inmarsat, Lex column (2012), Financial Times, 9 February.
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Numerous **Worked examples** throughout the book provide an application of the learning points and techniques included within each topic. By working through the step-by-step solutions, you have an opportunity to check your knowledge at frequent intervals

Worked example 11.6

Martin plc, a UK multinational company, has equity with a market value of £150m and debt capital with a market value of £100m. The company's current cost of equity is 12%, and its after-tax cost of debt is 7%.

Martin plc has secured a contract worth Aus$80m to supply and install plant and equipment for a company in Australia. The payment terms of the contract set by Martin plc, which are non-negotiable, are:

- Aus$20m payment to be made on completion of stage one of the contract at the end of year one
- Aus$24m payment to be made on completion of stage two of the contract at the end of year two
- Aus$36m payment to be made on completion of stage three of the contract at the end of year three

The estimated cost of the supply and installation of the plant and equipment is Aus$70m.

Project cash outflows in respect of the project are expected to involve three currencies – Aus$, £ sterling, and euro – and cash flows are estimated as follows:

Year	**0**	**1**	**2**	**3**
Inflows				
Aus$	0	20	24	36
Outflows				
Aus$	6	3	7	4
UK £	3	3	1	3
€	3	3	4	5

The current exchange rates at the start of the project are:

£ = Aus$2.50
€ = Aus$1.67

Progress checks allow you to check and apply your understanding of each key topic before you move on.

Progress check 11.7

Explain the significance of the choice of discount rate in international investment appraisal.

Mini case boxes provide a real-world context for key topics.

Mini case 17.2

One of the benefits of using a rights issue to fund an acquisition lies in the opportunity to maintain the same profile of shareholders after the funds have been raised without increasing the gearing of the company outside normal levels.

In September 2009 Balfour Beatty plc, a UK engineering and construction company, announced the acquisition of the US professional services business Parsons Brinckerhoff in a $626m (£380m) takeover.

Balfour Beatty plc offered a 3 for 7 rights issue at 180 pence per ordinary share (a discount of 48%) to raise approximately £353m, net of issue expenses. The outcome was that existing shareholders bought 97% of 199.5m new shares, with the remaining 6m shares bought by other investors.

After the acquisition, the overall spread of shareholders therefore altered only marginally, and the gearing ratio remained at a level acceptable to the company.

Balfour Beatty plc gearing 2006 to 2010

2010	2009	2008	2007	2006
115%	140%	104%	158%	160%

A **Summary of key points** features at the end of each chapter. This allows you to check that you understand all the main points covered before moving on to the next chapter.

Summary of key points

- Internationalisation, with regard to the increasing geographical dispersion of economic, cultural, social, educational, technological, and political activities across national borders, has an increasing impact on the role of the financial markets and the activities of international companies.
- The international financial marketplace is an interrelated network of buyers and sellers in which exchange activities occur in the pursuit of profit and reward, and has obvious significance for international companies.
- Companies may wish to undertake overseas operations for a variety of reasons, but particularly to gain access to overseas markets by enabling them to get closer to their customers.
- Companies may engage in various types of international operations, for example through exporting, use of agents, licensing, franchising, or the establishment of a branch, joint venture, or an overseas subsidiary.
- International companies may consider foreign direct investment (FDI) in terms of investments in new or expanded facilities overseas.
- There are additional, unique features associated with international investment appraisal in a multi-currency, overseas environment, compared with the appraisal of domestic investment projects, for example taxation, foreign currency cash flows, overseas interest rates, transfer prices, royalties, management fees, exchange controls, and country risk.
- The evaluation of international investment using NPV requires the choice of a suitable cost of capital as a discount rate, the most appropriate of which may be the required return specific to the individual investment.
- The choice of financing for international investments requires the consideration of currency risk, interest rate risk, taxation, gearing, and country risk.
- Country risk, which is also called political risk, is the exposure a company faces as a consequence of a change in government action, against which it may protect itself through, for example, insurance, negotiation, development of close relationships, establishment of a local presence, and the use of local financing.

At the end of each chapter a **Glossary of key terms** in alphabetical order provides full definitions of any key terms that have been introduced. The numbers of the pages on which key term definitions appear are high-lighted in the index.

Glossary of key terms

arbitrage This is the act of exploiting the price differences in financial instruments, or other assets, in different markets by simultaneously buying and selling the assets to make a profit from the price difference. It exists because there are market inefficiencies but it also provides a means of ensuring that prices do not remain different for long periods and that an equilibrium price is finally reached.

cost of debt The annual percentage rate of return required by long-term lenders to a company (loans and bonds), generally expressed net of tax as a cost to the company.

cost of equity The annual percentage rate of return required by the shareholders of a company.

dividend growth model (or Gordon growth model) A method of calculating cost of equity that assumes a direct link between the share price and expected future dividends and recognises the expected rate of dividend growth (G) achieved through reinvestment of retained earnings.

dividend model A method of calculating the cost of equity that divides the current dividend by the current share price, which is based on the notion that shareholders may value shares by the value of their expected dividends.

Short narrative-type **Questions** encourage you to review and check your understanding of all the key topics. There are typically 7 to 10 of these questions at the end of each chapter.

Questions

Q17.1 Why is the method of financing important in M&As?

Q17.2 In what ways does a cash purchase of a business differ from a vendor placing?

Q17.3 How may eps be enhanced from a takeover?

Q17.4 Describe the various forms of equity restructuring that may be used by a target company to avoid its being taken over.

Q17.5 How may profit announcements, and changes in dividend policy, be used by target companies to provide defences after a takeover bid has been made?

Q17.6 Describe and explain the range of defence strategies used by companies facing a hostile takeover bid.

Q17.7 Outline the types of problem faced by employees and managers after their company has been taken over.

A **Discussion points** section typically includes 2 to 4 thought-provoking ideas and questions that encourage you to critically apply your understanding and/or further develop some of the topics introduced in each chapter, either individually or in group discussion.

Discussion points

D17.1 'Takeovers merely satisfy the inflated egos of power-hungry company bosses.' Discuss.

D17.2 'The ways in which M&As are financed do not have any influence on their subsequent success.' Discuss.

D17.3 'There is no real defence against a takeover bid from a determined predator company.' Discuss.

D17.4 'The position of shareholders, managers, and employees in M&As is largely disregarded by both predator and target companies.' Discuss.

Exercises provide comprehensive examination-style questions which are graded by their level of difficulty, and also indicate the time typically required to complete them. They are designed to assess your knowledge and application of the principles and techniques covered in each chapter. Full solutions to the colour-highlighted exercise numbers are provided in Appendix 2 to allow you to self-asses your progress

Exercises

Solutions are provided in Appendix 2 to all excercise numbers highlighted in colour.

Level I

E2.1 *Time allowed – 15 minutes*

Identify the components of shareholder wealth and explain how the strategic financial decisions made by a company impact on each of them.

E2.2 *Time allowed – 15 minutes*

Explain what is meant by shareholder value and consider the value-creating alternatives. Outline three ways of measuring shareholder value.

E2.3 *Time allowed – 30 minutes*

Explain how alternative methods may be used to measure shareholder value and give your view as to which may be the most appropriate measure.

Level II

E2.4 *Time allowed – 30 minutes*

At a recent board meeting the managing director of Angel plc announced that the company's directors had been awarded substantial cash bonuses and share options, despite the company incurring substantial losses during the last financial year. Explain why the above represents an agency problem within a company between the directors and the shareholders, and the ways in which it may be resolved.

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Tables

Table 11.1 from 'Foreign Direct Investment flows by region in 2010', UNCTAD World Investment report 2011, United Nations Publication ISBN 978-92-1-1 112828-4 © United Nations 2011.

Text

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Part I

CORPORATE FINANCE

Part contents

1 The financial environment 5
2 Corporate objectives 51
3 Corporate governance 87
4 Risk, return, and portfolio theory 171
5 Capital structure and the cost of capital 213
6 Capital investment decisions 251
7 Sources of finance and the capital markets 307
8 Financial analysis 373
9 Financial planning 443
Case Study I Gegin Ltd 477
10 Management of working capital 481
11 International operations and investment 541
12 Financial risk management 577
Case Study II Millpot Ltd 625

Introduction to Part I

Part I of this book is about corporate finance, which is concerned with the effective use of financial resources in creating corporate value. It looks at the financial environment in which businesses operate, their financial aims and objectives, and includes a wide range of financial management techniques related to financial decision-making. These include, for example, capital investment, capital structure, working capital, the management of financial risk, financial planning, and international operations and investment. It also considers the ways in which compliance with various corporate governance guidelines broadly supports the achievement of business objectives in determining the responsibilities and accountability of company directors and their relationships with shareholders and other stakeholders.

In Chapter 1, Figure 1.1 provides the framework of strategic corporate finance on which this book is based. The topics included in each of the shaded areas in Figure 1.1 are covered in Chapters 1 to 12, except for financial strategy, which is covered in Chapters 13 to 18 in Part II of this book.

Part I is concerned primarily with the creation of corporate value and its translation into shareholder value. Part II of this book is about the use of appropriate financial strategies, as distinct from business strategies. This looks at what companies may do to ensure not only the creation of corporate value, but also that the performance of the business is reflected in the maximisation of shareholder value. Companies may do all the right things in terms of creating value from investments in value-creating projects. However, if this performance is not translated into and reflected in optimal shareholder value through dividend growth and an increasing share price then the primary objective of the business – maximisation of shareholder wealth – is not being achieved.

The providers of the capital for a business, its shareholders and lenders, require appropriate returns on their investments from dividends, interest, and share price increases, commensurate with the levels of risk they are prepared to accept associated with the type of businesses and industrial sectors in which they invest. The directors or managers of a company have the responsibility for pursuit of the objective of shareholder wealth maximisation. Faced with different types and levels of risk at each stage in a company's development, directors' responsibilities therefore include not only ensuring that value is added to the business, that is corporate value, through making 'real' investments in projects that return the highest possible positive net present values of cash flows, but also ensuring that appropriate financial strategies are adopted that reflect this in the value created for shareholders, that is shareholder wealth.

These 'real' investment types of decision and their financing are dealt with in Part I. Part II looks at how companies are exposed to varying levels of financial risk at each of the different stages in their development, and in response to these how they may apply the techniques dealt with in Part I. Part II also considers how the creation of corporate value by companies at each stage of their development may then be reflected in increased shareholder value through the use of appropriate financial strategies and exploitation of market imperfections. We will explore how different financial strategies may apply at different stages in the development of a company. Shareholder value is provided in two ways: from increases in the price of shares; and the payment of dividends on those shares.

In Part II we look at the ways in which strategic financial decisions may be made relating to the levels of:

- investment in the assets of the business, and the types of assets
- most appropriate methods of funding – debt or equity
- profit retention
- profit distribution
- gearing, or capital structure of the business,

with the aim of maximisation of shareholder wealth through creation of shareholder value consistent with levels of perceived risk and returns required by investors and lenders.

To provide a framework for Part II in which to consider these decisions we will use a simplified, theoretical 'business life cycle' model, the BLC, which describes the stages through which businesses may typically progress from their initial start-up through to their ultimate decline and possible demise. The financial parameters particular to each stage of this simplified business life cycle will be identified and appropriate financial strategies will be discussed that may be used to exploit the specific circumstances in order to create shareholder value.

Chapter 1 looks at the financial environment in which businesses operate and their financial aims and objectives. This chapter provides the framework of corporate finance.

Chapter 2 considers the objectives of businesses. A business raises money from shareholders and lenders to invest in assets, which are used to increase the wealth of the business and its owners. The underlying fundamental economic objective of a company is to maximise shareholder wealth.

In Chapter 3 we provide an introduction to corporate governance. This topic has become increasingly important, particularly since 2008 and the unacceptable behaviour of banks and other financial institutions, and as the responsibilities of directors continue to increase. We look at the ways in which compliance with the various corporate governance guidelines broadly supports the achievement of the aims and objectives of companies in determining the responsibilities and accountability of company directors and their relationships with shareholders and other stakeholders. The burden lies with management to run businesses in strict compliance with statutory, regulatory, and accounting requirements, so it is crucial that directors are aware of the rules and codes of practice that are in place to regulate the behaviour of directors of limited companies.

Chapter 4 examines the relationship between risk and return and how diversification may be used to mitigate and reduce risk. It considers the impact of diversification and looks at the portfolio theory developed by Markowitz.

Chapter 5 considers the way in which a company's average cost of capital may be determined from the costs of its various types of capital financing. The average cost of a company's capital is an important factor in determining the value of a business. In theory the minimisation of the combined cost of equity, debt, and retained earnings used by a company to finance its business should increase its value. The average cost of a company's capital may also be used as the discount rate with which to evaluate proposed investments in new capital projects. Chapter 5 considers whether an optimal capital structure is of fundamental importance to its average cost of capital and looks at the various approaches taken to determine this.

Chapter 6 considers how businesses make decisions about potential investments that may be made in order to ensure that the wealth of the business will be increased. This is an important area of decision-making that usually involves a great deal of money and relatively long-term commitments. It therefore requires appropriate techniques to ensure that the financial objectives of the company are in line with the interests of the shareholders.

Chapter 7 deals primarily with long-term, external sources of business finance available for investment in businesses. This relates to the various types of funding available to a business, including the raising of funds from the owners of the business (the shareholders) and from lenders external to the business. Chapter 7 closes with an introduction to the fast-growing area of Islamic banking and Islamic finance.

Chapter 8 is headed *Financial analysis*. The three main financial statements provide information about business performance. Much more may be gleaned about the performance of a business through further analysis of the financial statements, using financial ratios and other techniques, for example trend analysis, industrial and inter-company analysis. Chapter 8 looks at the analysis and interpretation of the published accounts of a business. It uses the Report and Accounts for the year ended 31 March 2012 of Johnson Matthey Plc to illustrate the type of financial and non-financial information provided by a major UK public company. The chapter closes with a look at some of the measures that approximate to cash flow, for example earnings before interest, tax, depreciation, and amortisation (EBITDA), and economic value added (EVA), that may be used to evaluate company performance.

Chapter 9 deals with the way in which businesses, as part of their strategic management process, translate their long-term objectives into financial plans. This chapter includes consideration of the role of forecasting, financial modelling, and planning for growth.

In Chapter 10 we look at one of the sources of finance internal to a business, its working capital, and the impact that its effective management has on cash flow, profitability, and return on capital. Working capital comprises the short-term assets of the business, inventories, trade receivables, and cash, and claims on the business – trade payables. This chapter deals with how these important items may be more effectively managed. We are now living in a global economy in which businesses trade internationally, and may also have a presence in a number of overseas countries.

In Chapter 11 the implications of internationalisation are discussed with regard to companies' involvement in overseas operations, directly and indirectly, and it considers the appraisal and financing of international investments.

Chapter 12 looks at financial risk faced by businesses resulting from the variation in interest rates, and currency exchange rates, from one period to another. We consider the different ways in which these risks may be approached by companies, and the techniques that may be used to manage such risks. We consider the development of derivatives and look at examples of their use by companies (and their misuse, which we have seen over the past ten years or so). Finally, we explore the relatively newly developed topic of behavioural finance that aims to understand and explain the sometimes seemingly irrational behaviour of investors.

1

The financial environment

Chapter contents

Learning objectives	*6*
Introduction	*6*
Corporate finance and financial strategy	*7*
Types of business entity	*10*
Business organisational structures	*16*
Financial statements	*22*
Accountability and financial reporting	*34*
Managing corporate finance	*38*
Underlying principles of corporate finance	*39*
Summary of key points	*42*
Glossary of key terms	*43*
Questions	*47*
Discussion points	*47*
Exercises	*48*

Learning objectives

Completion of this chapter will enable you to:

- Outline the framework of corporate finance and its link with financial strategy.
- Illustrate the different types of business entity: sole traders, partnerships, private limited companies, public limited companies.
- Explain the role of the finance function within a business organisational structure.
- Explain the nature and purpose of financial statements.
- Consider the issues of accountability and financial reporting.
- Describe what is meant by accounting and corporate finance.
- Outline how the corporate finance function is managed to meet business objectives.
- Explain the underlying principles of corporate finance.

Introduction

This chapter explains why finance is such a key element of business life. For aspiring finance directors, finance managers, and accountants, and those of you who may not continue to study finance and accounting, the underlying principles of finance are important topics. A broad appreciation will be useful not only in dealing with the subsequent text, but also in the context of the day-to-day management of a business.

The chapter begins by explaining how the discipline of corporate finance was established and developed. It provides the framework on which each of the subsequent chapters is based. It also explains the links between corporate finance and strategy, and how the financial models and techniques covered in the first part of the book are used in the adoption of appropriate financial strategies by companies at different stages in their development.

The owners or shareholders of the range of business entities may be assumed to have the primary objective of maximisation of their wealth. Directors of the business manage the resources of the business to meet shareholders' objectives. Directors and managers are responsible for running businesses, and their accountability to shareholders is maintained through their regular reporting on the activities of the business.

The finance function plays a crucially important part in all organisations. Its responsibilities include both accounting and corporate finance, the latter relating to the management and control of the financial resources at its disposal. The effective management of corporate finance is essential in ensuring that the business meets its primary objective of maximisation of shareholder wealth. This chapter introduces the fundamental concepts and principles of corporate finance.

A large number of financial terms are used throughout this book, the definitions of which may be found in the glossaries of key terms at the end of each chapter.

Corporate finance and financial strategy

The business environment comprises companies that have just started up or are in various stages of their development. Each has its own reason for being in business and each has its own financing requirements. In the early part of the 20th century when new industries and technologies were emerging there was a growing requirement for new financing, particularly from external sources. This requirement saw increasing interest in various types of securities, particularly equity shares, and also led to the establishment of finance as a discipline separate from economics, in which it had its origins.

The growth in equity shareholdings increased (and has continued to increase up to the present day) but confidence was drastically dented during the economic depression and as a result of the financial scandals of the 1930s. As bankruptcy became a real possibility more attention began to be focused on companies' liquidity and financial structure, and there was a need for increased disclosure of financial information and its analysis. The 1940s saw an increase in financial analysis of cash flow, planning, and methods of control. In the 1950s capital budgeting emerged together with the financial management of assets, and an awareness of how financial decision-making impacted on the value of businesses. This all led to the establishment of the discipline of corporate finance in the early 1960s supported by the publication of a number of academic papers on topics such as the capital markets and share prices, which had previously been considered only in the areas of economics and statistics.

Corporate finance continues to be developed from its beginnings at the start of the 20th century, as do the techniques used in the management of corporate finance, and with an increasing emphasis on international aspects of trade, investment and financing. This book covers all the main areas of corporate finance and its management (financial management).

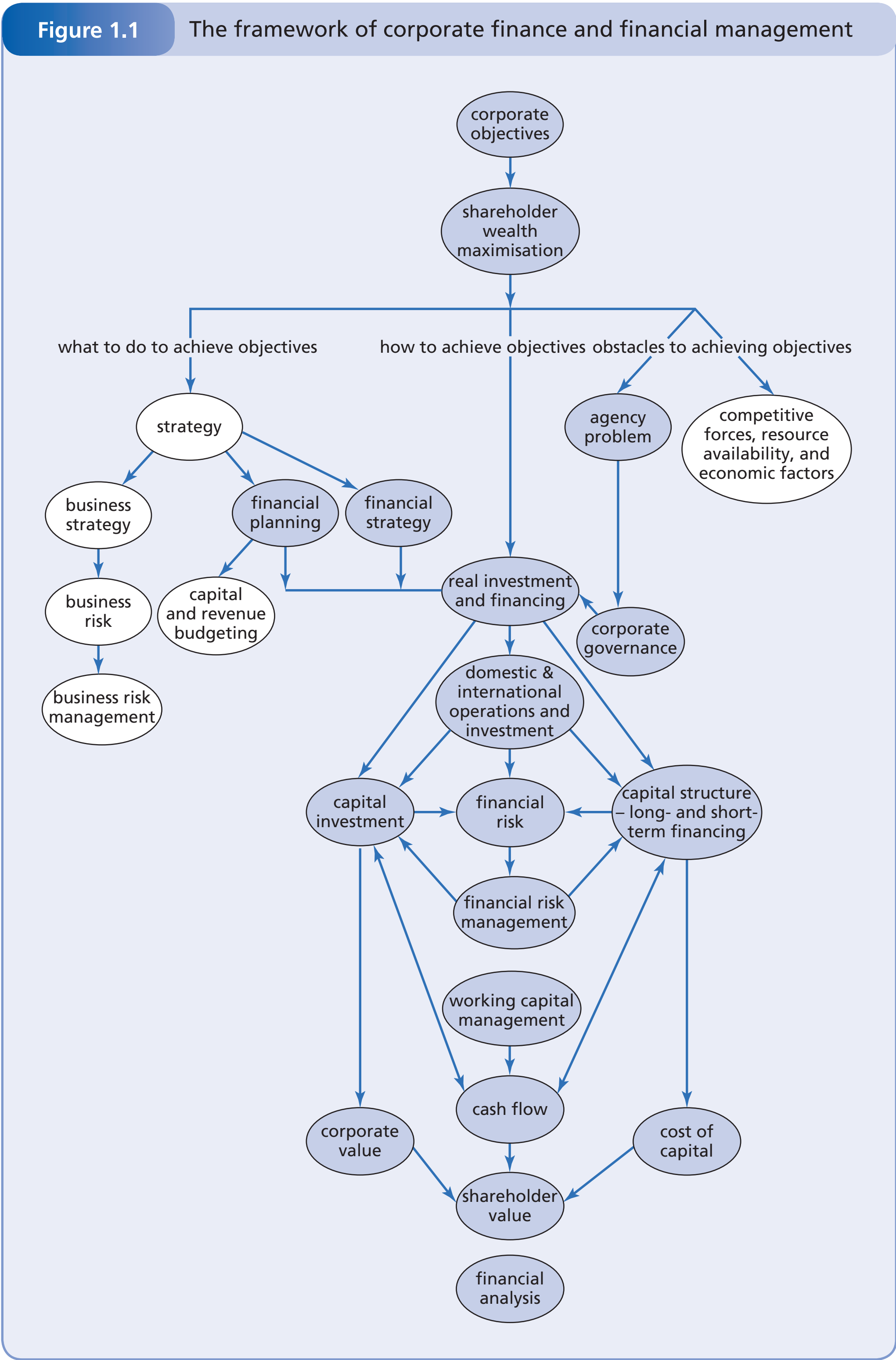
Let's consider each of the elements of the chart in Figure 1.1, which provides the framework on which this book is based. It is not strictly a flow chart but contains the topics, roles, and techniques covered in this book (and the relationships between them), which are represented by the elements of the chart that are shaded.

Corporate objectives (see Chapter 2) are formulated by a business, in alignment with its underlying mission and company policy, and may include for example profit maximisation, or market share maximisation. Its mission is the company's general sense of purpose or underlying belief. Its policy is a long-lasting, usually unquantified, statement of guidance about the way in which the company seeks to behave in relation to its stakeholders. A company normally has social and environmental responsibilities, responsibilities to its employees, and responsibilities to all its other stakeholders. However, this should not be inconsistent with its primary responsibility to its shareholders. We are assuming that the aim of a business is to add value for its shareholders with the primary objective of maximising shareholder wealth. Shareholder wealth comprises the dividends paid to shareholders on the shares they hold, and the gains achieved from the increase in the market price of their shares.

The directors of a business are appointed by the shareholders to manage the business on their behalf. The directors are responsible for developing appropriate strategies that determine *what* the company is going to do to achieve its objectives, with the primary aim of maximising shareholder wealth. A strategy is a course of action that includes a specification of resources required to achieve a specific objective; it is *what* the company needs to do long term to achieve its objectives, but it does not include *how* to achieve them.

A company's strategy includes its business strategy, which establishes the type of business, its location, its products and services, its markets, its use of resources, and its growth objectives. These areas are assessed with regard to the risks associated with them for which

Figure 1.1 The framework of corporate finance and financial management



appropriate risk management techniques may be put in place. The company's business strategy is quantified for the long term (typically three years, five years, or ten years) through its financial planning function (see Chapter 9). The short term is quantified in the company's six-monthly or yearly budgets.

A company's strategy also includes financial strategy. This book links corporate finance and financial management with financial strategy. Chapters 1 to 12 discuss the various aspects, models, and hypotheses relating to the discipline of corporate finance, and the techniques and methods used in the financial management of a business. Chapters 13 to 18 deal with the various stages of development of a business, and each chapter considers the most appropriate financial strategies that may be adopted by companies with regard to their current stage of development. 'Most appropriate financial strategies' means those financial strategies that result in the optimisation of the value of the business, with the aim of maximising shareholder wealth. An example of such a strategy is a company that may buy insurance to cover the risks relating to the achievement of its commercial objectives. The high cost of the insurance premiums means that the short-term profits of the company are reduced, but the long-term value of the business to the shareholders will be increased because of the removal of uncertainty about the company's future earnings.

At the heart of corporate finance are two broad areas that deal with *how* the company will achieve its objectives, and specifically its financial objective of maximisation of shareholder wealth. The first area relates to the allocation and use of financial resources for real capital investment (see Chapter 6) in, for example, new product development, land and buildings, and plant and equipment (as distinct from the popular meaning of investment in securities, stocks and shares). The second area relates to the financing of such investments, which may be internal to the company from the retained earnings of the business or from improvements in its management of working capital (see Chapter 10) or from external financing. External financing broadly comprises loans and equity share capital provided to companies by investors and which may be acquired and traded in capital markets like, for example, the London Stock Exchange (see Chapter 7).

Capital investments may be made by companies in their own domestic countries, but companies are also now becoming increasingly involved in international operations and investment (see Chapter 11), and international financing (see Chapter 7). Domestic and international investment, and domestic and international financing, all face various types of risk (see Chapter 4), including financial risk, the management of which is discussed in Chapter 12.

If good decisions are made by a company's managers and directors, which result in investments that add value then corporate value will be increased and reflected in increased cash flow. It is crucially important to appreciate that it is cash flow (in real terms) and not profits, which reflects the true value of a business. If good decisions are made with regard to financing then the capital structure of the company will result in the cost of capital of the company being at a level that will also enhance its corporate value (see Chapter 5). However, an increase in corporate value may not necessarily result in an increase in shareholder value. That will depend partly on how much of the cash flow that has been generated has been used to pay out dividends (or retained for future investment), and partly in the increase (or not) in the share price. The share price will depend on the market's perception of the financial health of the business, and the demand for and level of trading in the company's shares. The analysis of the financial performance and the financial position of a business is considered in Chapter 8.

In theory, the creation of value through adoption of appropriate strategies, and making the right decisions, looks simple and straightforward. In practice, there are of course many obstacles in the way to prevent a company from achieving its objectives. There are competitive