Corporate Finance

Final Report

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Why Corporate Finance??

In any business enterprise, the important functional areas are production, finance, marketing and personal activities. Out of these, financial activities have the utmost importance.

Almost everyone in today's world needs the knowledge of corporate world and how its run as someday or other we need to be in the corporate atmosphere as entrepreneurs or as individuals working in a company. To bring out maximum value for the company, one should have deep insights into how the company is being run, what factors are affecting the growth, how to increase growth, how to bring maximum output from the available limited resources. For these questions to be effectively answered one should know about corporate world and corporate finance is the answer to the corporate world.

Good knowledge of corporate finance helps in good decision-making regarding running finances in any company, thus making corporate finance a very important knowledge to have.

Contents

1 Introduction

1.1 Corporate Finance

Corporate Finance broadly covers the following aspects-

a) Time Value of Money

b) Sources of Funds

c) Mergers and Acquisitions

d) Capital Structure

e) Raising Capital in International Markets

f) Financial Derivatives

g) Capital Budgeting

For a business corporate finance plays a key role in its success or failure as it a part of or an extension of financial accounting/financial modelling but a it is not that easy to run a business.
To start and run a business the prerequisites are-

a) Feasible Ideas

b) Skills

c) Money

Corporate Finance is an area of finance that discusses about sources of funds, application of funds and the strategic decisions that financial manager take to increase the value of stake holders.
Here, application of funds implies the way the funds are being utilised.

1.2 Goals of Corporate Finance

The goal of corporate finance is very different from that of the business. The goal of business is to focus on its ideology and make money out of it. Whereas, the goals of a corporate finance are-

a) Minimisation of costs

b) Survival of the business

c) Beating the competition

d) Maximising the sales

e) Maximising the market share

Thus, the goal of corporate finance is firstly the survival of the business rather than profit making, which comes secondary. Corporate Finance provides a method to **"Maximise"** the value of the Stakeholders.

2 Some Important Terms

2.1 Stakeholders

a) a) Stakeholders are the people who are interested directly or indirectly in the business, those who have active or inactive roles in the business.

b) b) This person maybe internal or external to the business.

2.1.1 Internal Stakeholders

Internal Stakeholders are the key people comprising of the post holders such as shareholders, board of directors, employees, auditors, legal consultant etc.

2.1.2 External Stakeholders

External Stakeholders are the costumers, suppliers, creditors, investors, taxation authorities, media, government agencies etc.

2.2 Opprtunity Cost

The Opportunity cost of a particular activity option is the loss of value or benefit that would be incurred by engaging in that activity, relative to engaging in an alternative activity offering a higher return in value or benefit.

Opportunity cost is the cost incurred by the company by taking a particular project. Had the company not accepted this project then what else should it had have done with the money. The money could've been used in various other ways like investing somewhere, buying machinery, adding assets etc.

Thus, opportunity cost analysis helps the company come up to the most beneficial use of the money and investments it has, to bring out the best outcomes for the growth.

2.3 Dividend Pay-out Plan

Dividend Pay-out plan is the plan that the company makes to how pay out the investors the dividend. Whether the really wants to pay out money or wants to make profit for the investors using the money.

2.4 Difference between 'Dividend' and 'Dividend Pay-out'

The dividend yield compares the amount of the dividend paid to the share price of the company's stock. The dividend pay-out instead compares the dividend amount of the company's earnings per share.

2.5 Microeconomics

Microeconomics is the branch of mainstream economics that studies the behaviour of individuals and forms in making decisions regarding the allocation of scarce resources and the interactions among these individuals and firms.

2.6 Depreciation

This is the reduction in the value over the year of any article or product due to the natural wear and tear.

To calculate depreciation, we assume the initial price of product to be Rs. X and its life to be Y years. In such case, the value of the product decreases by X/Y per year making the value 0 after Y years.

2.7 Amortization

This is the technique used to periodically lower book value of a loan or an intangible asset (asset which is not in the physical form like machine but those which do not have any physical form, for example patents, copyrights etc.) over a set period of time.

Thus, amortization is similar to depreciation but on intangible assets or loans.

2.8 Cash Conversion Cycle (CCC)

It is a metric that expresses the time (in days) it takes a company to convert its investments in inventory and other resources into cash flows from sales.

This metric takes into account how much time the needs to sell its inventory, how much time it needs to collect receivables and in how much time it has to pay bills. It is one of the several quantitative measures which help evaluate efficiency of a company's operation and management.

$$\text{CCC} = \text{DIO} + \text{DSO} - \text{DPO}$$

DIO: Days of Inventory Outstanding **DSO:** Days of Sales Outstanding **DPO:** Days of Payable Outstanding

$$DIO = \frac{\text{Avg. Inventory}}{COGS} \times 365 \text{ Days}$$

where:

$$\text{Avg. Inventory} = \frac{1}{2} \times (\text{BI} + \text{EI})$$

$$\text{BI} = \text{Beginning inventory}$$

$$\text{EI} = \text{Ending inventory}$$

Low DIO implies rapid sales.

$$DSO = \frac{\text{Avg. Accounts Receivable}}{\text{Revenue Per Day}}$$

where:

$$\text{Avg. Accounts Receivable} = \frac{1}{2} \times (\text{BAR} + \text{EAR})$$

$$\text{BAR} = \text{Beginning AR}$$

$$\text{EAR} = \text{Ending AR}$$

Low DSO implies company is able to collect capital in short time.

$$DPO = \frac{\text{Avg. Accounts Payable}}{COGS \text{ Per Day}}$$

where:

$$\text{Avg. Accounts Payable} = \frac{1}{2} \times (\text{BAP} + \text{EAP})$$

$$\text{BAP} = \text{Beginning AP}$$

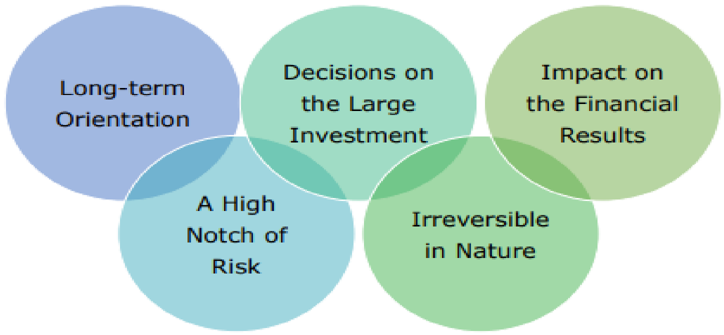
$$\text{EAP} = \text{Ending AP}$$

$$COGS = \text{Cost of Goods Sold}$$

High DPO implies that the company holds on to the cash longer, thus increasing the investing potential of the company.

It is good to have a lower CCC. The lower the CCC, faster the company earns.

3 Corporate Finance Decisions



Corporate Finance decisions depend mainly on the following factors-

a) Capital Investment

b) Capital Financing

c) Dividend Pay-out

Not all business opportunities are to be accepted by a company. Proper analysis should be done before accepting the business opportunity.

For an investment to result fruitful outcomes, the investments must be recovered as early as possible because the future is very ascertained.

To analyse whether or not to invest in a company, capital budgeting techniques can be used.

3.1 Capital Budgeting Techniques

3.1.1 Payback Period

This depends on the time period by which the invested money is returned back and is calculated by adding up the projected amount the company is able to return per annum.

Its shortcomings are-

a) This ignores the time value of money

b) There is no risk consideration taken into account

3.1.2 Net Present Value (NPV)

Net Present Value (NPV) is the difference between the present value of cash inflows and the present value of cash outflows over a period of time. NPV is used in capital budgeting and investment planning to analyse the profitability of a projected investment or project. NPV is the result of calculations used to find today's value of a future stream of payments.

The formula of NPV is as follows-

$$\mathrm{NPV} = \sum_{t=0}^{T} \frac{\mathrm{CF}_t}{(1+r)^t}$$

$$\mathrm{NPV} = -\mathrm{CF}_0 + \frac{\mathrm{CF}_1}{(1+r)^1} + \frac{\mathrm{CF}_2}{(1+r)^2} + \cdots + \frac{\mathrm{CF}_T}{(1+r)^T}$$

NPV is used to calculate the current total value of a future stream of payments.

The decision whether or not to invest in a/an business/investment opportunity depends upon its NPV as follows-

a) If NPV ¿ 0: We can accept the business/investment opportunity

b) If NPV ¡ 0: We should reject the business/investment opportunity

c) If NPV = 0: We can accept or reject the business/ investment opportunity based on our own analysis

3.1.3 Internal Rate of Return (IRR)

Internal Rate of Return is the rate at which the present value of cash inflow is equal to the present value of cash outflow.

IRR is also called hurdle rate and discount rate.

In other words, the IRR is a hurdle rate/discount rate that makes NPV zero. We can use trial and error method to arrive at the rate.

3.1.4 Break-Even Analysis

The Break-even Point **(BEP)** is a level of sales or output at which the total costs will be equal to the total revenues and consequently, there will be *neither profit nor loss*.

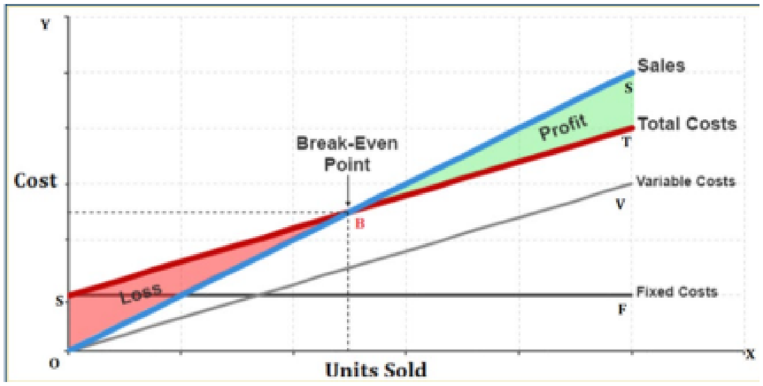
To know more about BEP, we need to know about-

a) **Fixed Cost:** It is a cost or an expense that does not change with the change in the level of output.

b) **Variable Cost:** These are the costs that vary in proportion to the volume of output.

c) **Revenue:** It is the amount that a business generates from its operation during a period.

d) **Contribution Margin:** Contribution margin indicates the quantity of business revenue will be contributing towards the fixed cost.



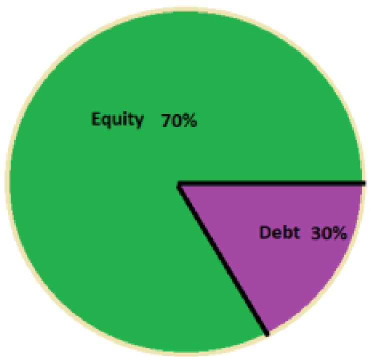
Y
Sales
S
Total Costs
T
Profit
Break-Even
Point
Cost
Variable Costs
V
B
Loss
S
Fixed Costs
F
O
Units Sold
X

4 Capital Structure

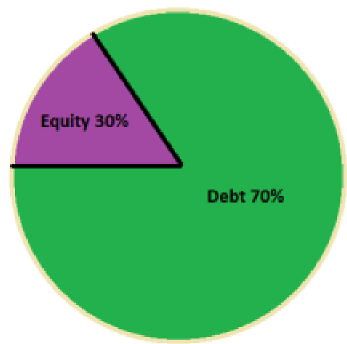
Businesses can be based on-

a) **Equity Capital:** Major part of money comes from equity.

b) **Debt Capital:** Major part of money comes from debt.



Equity Capital



Debt Capital

4.1 Debt Capital

4.1.1 Pros

a) Have lower interest rates

b) Good for short term needs

c) Have tax advantages such as interest paid on loans is tax-deductible

d) Simple loan repayment

4.1.2 Cons

a) There is a repayment risk in case of failure

b) Bankruptcy risk

c) Might have impact on credit rating

d) One needs collateral for loans

It is suitable under the following circumstances-

a) When one is ready to make regular repayments

b) One has good credit score

c) One possesses collateral

4.2 Equity Capital

4.2.1 Pros

a) Equity capital aims for long-term orientation

b) Risk is shared with equity holders

c) It brings additional value

d) Does not require regular payment to the investors.

4.2.2 Cons

a) Profit needs to be shared

b) Ownership gets diluted

c) There are chances of conflicts among various stakeholders

d) Costs company higher cost (can be assumed as higher rate of interest for analogy)

It is suitable under the following circumstances-

a) When creditworthiness of company is an issue

b) If company is ready to share profit and control of the company.

c) The company is not confident of earning profits

d) The company is ready to share decision making control with equity partners

4.3 Factors Influencing Capital Structure Decisions

4.3.1 Economic Specific Factor

a) **Nature of Business:** For example- FMCG has quicker CCC, thus can go for debt capital.

b) **Stock Market:** When company is listed with stocks, generally company has equity orientation.

c) **Taxation:** When company wants to enjoy tax benefits, they go debt capital so that they can save tax on interest as the interest paid on taxes are tax-deductible.

d) **Rate of Interest:** When the company wants to enjoy low Rate of Interest, it goes for debt capital, whereas if the company wants to reduce risk it has to go for equity capital where it gives higher interests.

e) **Credit Policy:** This depends on how much time the company gives its distributors/middlemen for repayment. For example, NET 30 means a period of 30 days is given for the repayment.

4.3.2 Industry Specific Factors

a) **Seasonality:** For businesses that are season dependent go for debt capital

b) **Competition:** In case of high competition, companies prefer going for equity orientation as it reduces the risk by sharing it among the equity holders.

c) **Life Cycle of Industry**

4.3.3 Company Specific Factors

a) **Age and size of the company:** If the company is young and ambitious and is small in size it goes for equity capital as they do not want to take the risk. Whereas, a company at its saturation level i.e. a company is doing well and does not aspires much will go for debt capital so that it has to pay minimum rate of interest.

b) **Form of the Company:** A company could be singly owned, venture, partnership etc. and in each case the capital structure depends on the management and their policies.

c) **Stability of Earning:** A company which is stable will go for debt capital as it knows that being stable it can save money by paying less rate of interest on debts. Whereas, a company with unstable earning will opt for equity capital to prevent any non-repayment of interest in case the company fails to make money.

d) **Credit Standing:** A company with good credit standing (or creditworthiness) can go for debt capital but a company with poor credit standing has to go for equity capital.

e) **Management Philosophy:** The decision of capital structure also depends upon the management. If the management is willing to share control of the company it will go for equity capital, otherwise it will have to go for debt capital.

4.4 Dividend Decisions

When someone invests some money in a company, they expect-

a) Dividend

b) Capital Gain

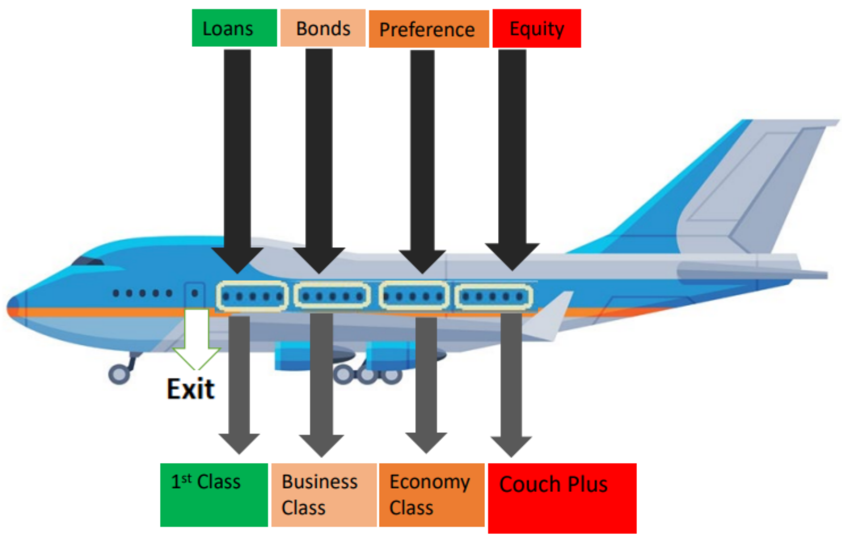
Some companies keep giving out dividends regularly so as to keep the costumers happy and satisfied that their money is in safe hands and is being used to generate profits.

Some companies do not pay dividend on regular interval so that they have money to invest in case some good investment opportunity passes by. Thus, they tend to reinvest the money to make higher profits and when they don't foresee any investment opportunity coming, they distribute the dividend among the share holders.

5 How Secured Are You??

In case a company falls under a crisis, money is distributed in the following preference order-

1) Loan Providers
2) Bond Holders
3) Preference Equity Holders
4) Equity/share Holders



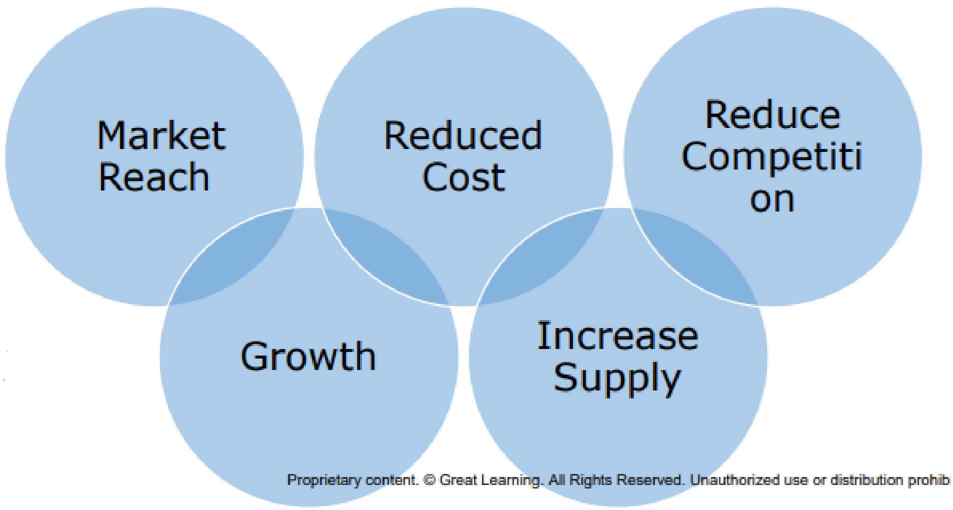
After paying to any top preference, if any money is remaining then it is distributed to the lower preference. Thus, it seems like the Equity/share holders have the maximum risk of losing money, but they also make the highest profit in case the company booms. Thus, *higher the risk, higher the reward.*

6 Mergers & Acquisitions

6.1 Merger

It is the process in which two or more business entities come together to form a new entity. In this process, both pre-merger business entities cease to exist.

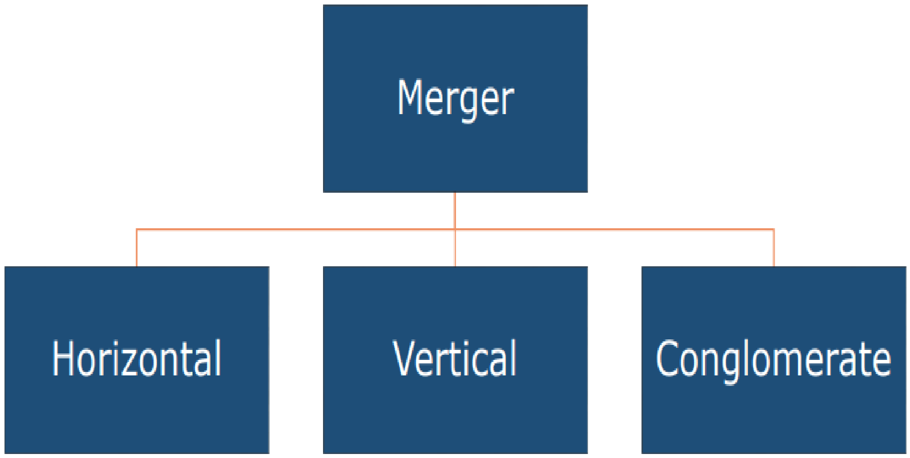
6.1.1 Reason for Merger



After merger the performance of the combined entity becomes more than the sum of their individual performance when working alone. This is called *synergy*. Examples of recent mergers-

1. Vodafone-Idea merger
2. Flipkart's acquisition of eBay India
3. Tata and Bharti Airtel
4. Disney acquired entertainment assets of Fox
5. Verizon-Yahoo deal
6. Google buying HTC's smartphone business
7. Cisco acquired BroadSoft
8. Johnson Johnson acquired Actelion

6.1.2 Classification of Merger



a) **Horizontal Mergers:** Merger of two business entities operating within the same industry yet competitors to each other.
For example- Merger of Bank of Madura with ICICI Bank (in 2000), Merger of Centurion Bank with HDFC Bank

b) **Vertical Mergers:** Merger of two business entities in different stages of production processes.
For example- Tata motors acquired an 80% stake in Trilix Srl, an Italian design and engineering firm (in 2010).

c) **Conglomerate Mergers:** In a Conglomerate Merger, there is no relationship between the production process in the acquiring company and the acquired firm.
For example- Merger of Tata and Sky (in 2009). In this example, 'Tata' is an automobile company and 'Sky' is a content distribution company.

6.2 Acquisitions

An acquisition is a process of one business entity acquiring another. In this process, the acquired company cease to exist while the acquiring company continue to exist.

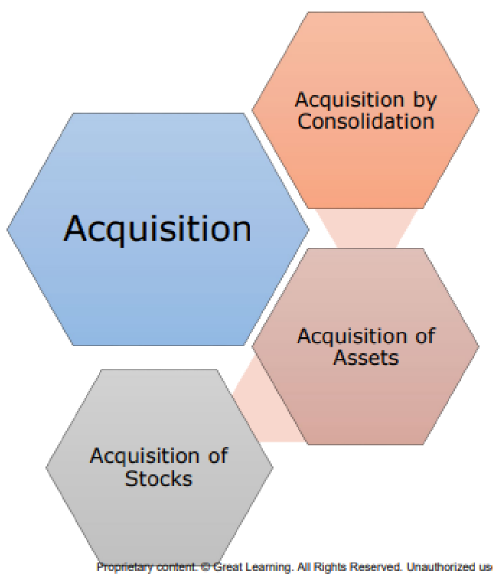
6.2.1 Reason for Acquisition

a) To obtain a specific product (Software companies)

b) To increase size of the company

c) To obtain control over a critical resource/market

6.2.2 Classification of Acquisitions



a) **Acquisition by consolidation:** Combination of assets and liabilities of two companies.
For example- A France based IT company Capgemini has acquired NASDAQ listed IT company iGate for INR 2500 million in 2015.

b) **Acquisition of Stock:** By acquiring the stocks a business can earn the control over the business.
For example- Singapore Based GIC acquired 63.9% of stake in Mumbai based Nirlon Ltd. The value of the deal was INR 128 million.

c) **Acquisition of Assets:** In acquisition of assets, the bidder acquires all the assets of the target firm. The bidder may prefer acquisition of assets to avoid the target firm's liabilities.
For example- Ola Cabs acquired TaxiforSure for INR 120 million

6.3 Advantages of Mergers & Acquisitions

a) Increase the market share

b) Reduce the cost

c) Economies of Scale. Production in larger quantities reduces cost

d) Access to new talent and technology

e) Helps company to face competition

f) Access to new market places

g) Tax Benefits

6.4 Limitations of Mergers & Acquisitions

a) Creates Cultural Gap

b) Job Loss

c) Exhaustive Re-skilling

d) Uncertain Results

7 Alternate for Merger & Acquisitions

The possible alternatives for Merger & Acquisitions are-

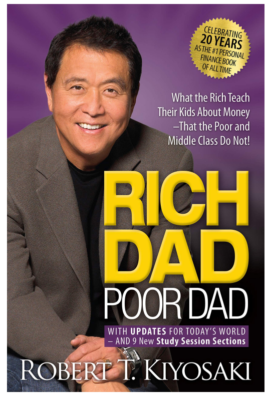
a) **Joint Venture:** It is the *best* alternative for merger & acquisitions. In such an arrangement, companies come together for a specific reason for a limited period.
For example- State Bank of India (SBI) and Bharti Airtel have announced a joint venture to offer banking services to consumers.

b) **Informal arrangement:** Parties agree to co-operate without the need of an equity component.
For example- ICICI Securities enters into strategic alliance with AM Capital (in 2015)

c) **Leveraged buy-out (LBO):** Purchase of a company by a small group of investors, and is financed largely by debt.
Its purpose is tTo raise the necessary funds to acquire control from the existing shareholders by issuing debt. As a result of the purchase, control is left with the small group of investors and the ownership of the company changes from public to private.
For example- The Leveraged Buy Out Deal Of Tata Tetley (in 2000). This deal was the biggest ever cross-border acquisition and also the first-ever successful leveraged buy-out by an Indian company.

8 Rich Dad Poor Dad

This is the **No. 1** Personal Finance Book written by **Robert T. Kiyosaki**



8.1 Chapter One: 'The Rich Don't Work for Money'

Through this chapter author tells us that he had the chance to see the world of money through two very different views, one of his poor dad and other of his rich dad.

The first thing rich dad taught the author was to avoid the rat-trap. Rat-trap according to the rich dad is the fear of not having money, job insecurity etc. They don't react logically rather emotionally to these situations. When they get some bucks in their hands, they are overjoyed as their emotions of joy, desire and greed take over. Here again they react instead of thinking.

They fear so they go to work hoping that working will earn them money and solve their problems. Fear keeps them I their trap of working. Money governs their lives and emotions but they fail to confront this truth.

Next, the rich dad taught them to see what others cannot. He told them to forget about pay check as soon as possible to make your life easier. One should keep using their brain, work for free, and soon the brain will start thinking of ways of making money more than anybody else could pay you.

There are enormous number of opportunities present but we fail to see them as we are not actually looking for them but pay checks.

8.2 Chapter Two: 'Why Teach Financial Literacy?'

For one to become rich he/she must be financially literate irrespective of the academic qualifications have. Without having financial literacy and trying to become rich is like building a skyscraper on a weak foundation, which would soon fall.

One must have knowledge of accounting. It is no doubt boring and confusing but crucial for financial success. One must be able to understand numbers and not fear from them.

To start with financial literacy, one must be able to clearly distinguish between an **asset** and **liability**. Once the difference is clear then you must only buy assets. This understanding is not as easy as it seems mostly because people have been educated differently by bankers, financial planners and others. For example, they use the value of liabilities to add up to the net worth which actually don't have any value.

According to the author, whatever adds money to your pocket is an asset whereas what takes money out of pocket is a liability. One should make a balance sheet and add up of assets and liabilities. Now the goal is to balance liabilities with assets with assets being equal or more than the liabilities.

Next one has to make an income statement comprising of two columns namely-

a) Income

b) Expenses

Assets add to the income column whereas liabilities add to the expense column. When one increases the asset column, they tend to generate more money. Once this money is generated, most people tend to buy liabilities from this money but instead if one buys assets, he/she will generate more income. Thus, one who understands difference between assets and liabilities grows richer.

Now how do we know when a person is wealthy? For this the author uses the following definition- *"Wealth is the measure of the cash flow from the asset column compared with the expense column. When one's assets generate enough income to cover one's expenses, one is wealthy, even when they are not rich."*