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Cambridge University Press
978-1-108-48696-5 — Corporate Finance
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CHAPTER 1

Corporate Finance

A Conceptual Introduction

Our goal is to make finance the servant, not the master, of the real economy.

—Alistair Darling

Tata Motors Limited (TML) has a capacity to produce 790,000 cars annually. Based on the projected growth of the economy, it must estimate the future demand and decide whether to add another half a million to its capacity. The additional half million vehicles will require substantial investment. If the economy grows at the rate projected by the company's corporate planning department, the investment will prove extremely lucrative. On the other hand, if the growth slackens and other factors do not turn out to be favourable, it can spell doom for the company.

A decision to go ahead with the project would necessitate arrangement of funds for investment. The funds may be raised through either equity or debt. The debt can be short term, to be rolled over on maturity, or for a longer duration. Alternatively, the company can mobilize funds through instruments that are a combination of both debt and equity, as it had done in 1991 by issuing partially convertible bonds. The company can either directly approach a financial institution or it can undertake a public issue whereby it invites the public at large to participate in the financing. There are numerous options available and a choice must be made regarding the best possible combination with which the project can be financed.

An appropriate dividend policy is critical to the company's future success. Shareholder earnings comprise dividends as well as capital gains. Shareholders keenly look forward to receiving dividends from the company. At the same time, the distribution of dividend reduces the cash flows available with the company for investment, besides its implications for capital structure and valuation. A long-term policy must be established that balances the desire of the shareholders to receive dividends on the one hand and the cash flow requirements of the company on the other.

Credit to dealers constitutes a significant proportion of the working capital. Should TML insist on payment on delivery from the dealers, or let them pay only after a vehicle has been sold to the eventual customer? What should be the inventory of vehicles to be stocked with the dealers and in TML's own factory, in addition to the inventory of components it must maintain?

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Payment terms negotiated with component suppliers are a crucial determinant of the working capital. Credit, inventory and payables have a bearing on the investment required for working capital, significantly impacting the cash flow position as well as the return on investment of TML.

The Indian economy has recently been going through tough times, with growth having plummeted from 8.2 per cent during 2015–16 to below 5 per cent annualized in the first nine months during 2019–20. Lower growth has quite naturally dented the demand for commercial vehicles as well as passenger cars, the two main segments that TML operates in. Profitability of its operations has declined. It is imperative that the company critically analyses its recent performance and devises ways to improve profitability and generate sufficient cash flows.

- Is it possible to push sales higher by giving dealers longer term credit?
- Can inventories be optimized by reducing the number of suppliers?
- Has the company compromised on margins in order to push sales and whether has this hurt profitability?
- Have the company's cash flows been compromised?
- Does the company's cost of production compare favourably with that of competitors?
- Has tax outgo increased due to reduced investments? Can this be optimized?

Some years back, the iconic Jaguar Land Rover Limited (JLR) was bleeding financially and was up for grabs. Tata Motors decided to acquire it, and JLR now constitutes a significant part of TML's business. Its impact on the overall performance of TML is significant. Mergers and acquisitions (M&As) can be game changers for any company in the long run.

Tata Motors Ltd generates substantial cash flows from its business operations every year which need to be invested efficiently to ensure safety, returns and liquidity. Termed 'treasury management', companies can generate significant returns from the cash flows they have accumulated over the years.

Some of the machinery for the expansion will be imported from Europe, requiring payment in euros. A decision needs to be taken whether to raise funds in the domestic market and convert the rupees into euros at the time of actual payment or to source funds in euros through an issue of global depository receipts or external commercial borrowing. The company also has the option of raising funds in a different currency, such as the US dollar, and then swapping it with the euro. The foreign exchange rates are in a constant state of flux, and the company must decide whether to ride the volatility in foreign exchange rates or hedge its requirements of euros through various derivative instruments such as futures, forwards, options and longer-term swaps.

TML today is a global entity with production, sales and imports in many countries. It has to deal in several currencies on a daily basis. While its sales in China and the United Kingdom (UK) lead to inflows in yuan and pound, investment in a new plant in Mexico requires funds in Mexican peso. Taking care of inflows and outflows of funds in different currencies is a complex task.

The aforementioned are some of the decisions that the chief financial officer (CFO) of TML must take, in conjunction with other departments of the company. Evidently, these decisions have a significant bearing on the company's performance and are all a part of what the CFO of TML handles on a daily basis, constituting what we study as corporate finance.

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The Financial Markets

Understanding and interfacing with financial markets is integral to the functioning of a CFO. The CFO relies considerably on financial markets to achieve the company's objectives. As we will discuss later, a company's objective is to maximize its value and, therefore, the pricing of its equity and bonds is critical. The CFO must have expert knowledge of how prices are determined in financial markets. He needs to constantly access the financial markets for satisfying the requirement for funds. Other functions such as treasury investments, risk management, acquisitions and dividends also require deep knowledge of and experience in financial markets. The CFO must communicate effectively with investors. In fact, investor relations have become a priority with most companies today.

While we will discuss financial markets in much greater detail in the next chapter, it is useful to point out its impact on individuals and corporates briefly.

Financial markets enable an individual's earnings pattern and his corresponding spending pattern to be different over his lifespan. Without financial markets, the consumption and earnings pattern must correspond, wherein the individual is able to consume only what he earns during a given period of time.

When a person starts earning, he may wish to save, either for a rainy day or for his post-retirement days. Alternatively, he may be like the generation 'Y', which believes in consumption today rather than in some uncertain future time period; they borrow now against future income to acquire a house, an automobile, an expensive mobile handset or even an exotic holiday abroad. After finishing your MBA and securing a well-paying job, you are unlikely to wait for years to buy your favourite car or a house of your own. The financial markets enable you to borrow to fund the purchase. The borrowing will be paid off from your future income. This implies an exchange of your future income for present consumption. This is unlike the author, who, being at the end of his employment, is consuming less than his current income to pay for past borrowings as well as save for his post-retirement needs.

Mortgage Financing

Ownership of a house was a difficult proposition for people of my generation. Financial institutions lending for purchase of a house were non-existent. The only option was to accumulate sufficient savings, which took a lifetime. Severe shortage of housing ensured that property prices rose faster than accumulation of savings. It was a very frustrating catch-up game.

The establishment of HDFC Limited in the 1980s and its subsequent growth ushered in the mortgage industry in India. Three decades later, the mortgage sector growth shows no sign of abating. Borrowing long term to buy a house is a simple proposition in today's developed financial markets.

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Similar to individuals, companies also need not depend only on internally generated cash flows to finance their long-term investments; they can raise money from the financial markets. They may borrow or sell new equity to raise funds that can be paid off through future income. Reliance Infrastructure Limited had huge plans for investment in the mid-2000s. Its internally generated cash flows were insufficient, but it was able to access the financial markets in different ways—public issue of its shares, bank loans, external commercial borrowing amongst others—to finance the projects. On the other hand, there are companies which generate cash flows in excess of what they need. Hindustan Unilever Limited (HUL), with established brands and an extensive distribution network, generates large cash flows every year. Being a mature company, its investment requirements are limited. Hindustan Unilever Limited makes use of the financial markets to park its excess cash flows in financial securities, to be used later when required.

Consumption Choices

Without the existence of financial markets, an individual's consumption is limited by his earnings. Financial markets enable him to save from his current income, earn a return and consume more in the future. Alternatively, an individual can borrow against his future earnings by taking a loan from banks and financial institutions.

Assume that Mr A earns ₹100 each in the current as well as in the subsequent year. If the financial market provides a return of 10 per cent for one year, Mr A can invest his current year earnings of ₹100 at 10 per cent to obtain ₹110 next year. Together with the earnings of ₹100 next year, he can consume ₹210. Alternatively, Mr A can borrow ₹90.91 and pay it back with interest from the next year's earnings of ₹100. His choices, thus, broaden to

- ₹210 next year and nothing in the current year, or
- ₹190.91 now and nothing next year.

In fact, Mr A can enjoy a consumption pattern of any combination represented by Figure 1.1.

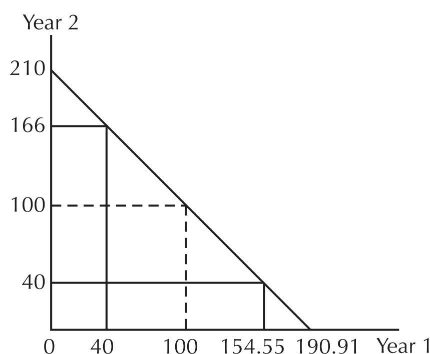

FIGURE 1.1 Consumption choices

Source: Author.

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In the real world, Mr A can manoeuvre his choices over his entire lifespan (and not just for the two years, as in the example), depending on expectations of his earnings, applicable interest rate and expected lifespan. Such choices are enabled by the existence of vibrant financial markets.

It is the existence of a vibrant, developed and well-regulated financial market which facilitates an interchange between earnings and consumption and enables individuals as well as corporates to plan their consumption and investment patterns over time to suit their own preferences. Financial market enables both individuals and companies to enjoy spending and investment quite different from their earnings patterns.

There are two distinguishing characteristics of the discussed financial decisions. First, investment decisions entail costs and benefits, usually spread over a long period of time. Spending more than earnings leads to borrowing from the financial markets and paying interest on the borrowings. On the other hand, if the earnings are greater than the expenditure, the surplus can be invested in financial instruments to earn a return on investments.

Second, the associated costs and benefits are not known with certainty. Returns depend on the choice of investments and may neither be fixed nor known in advance. An investor may decide to invest in the equity of a software venture whose returns and cash flows will depend on multiple factors, namely the growth of the US economy, the rupee–dollar exchange rate and several others, which cannot be predicted with certainty. Return on equities for an investor can be very volatile and unpredictable. Markets were booming for a long period of time until 2007. Unbridled optimism all around raised stock prices to dizzying levels. The subsequent crisis witnessed decline in prices by over 50 per cent and destroyed huge wealth. Booms and busts have characterized stocks throughout history, leading to overnight riches or extensive wealth destruction.

Return is what the investor gets from his investment; risk of these investments is what he has to bear. Usually, there is a direct relationship between risk and return; the higher the risk of an investment, the higher is the return and vice versa. The financial markets offer a wide spectrum of risk–return choices. Investors take a decision based on which return and risk combination suits them best.

In making such decisions on where and how to invest/raise funds, economic entities use the financial system in the country and even globally. The financial system refers to the set of markets and institutions which enables 'financial contracting and the exchange of assets and risks' (Zvie and Merton 2000). The financial system comprises the following:

1. Financial markets: markets for trading financial securities such as shares, bonds and financial derivatives.
2. Regulatory bodies that govern the players and the markets: the Reserve Bank of India; the Securities and Exchange Board of India (SEBI); the Insurance Regulatory Development Authority; and the Securities and Exchange Commission, United States of America (USA), amongst others.
3. Financial services firms: investment banks, financial advisory firms, institutional advisory firms.

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4. Financial intermediaries: banks, non-banking finance companies, mutual funds, hedge funds, insurance and pension funds.

While there are many reasons for studying finance, in this book we will focus on finance for the corporate sector. An MBA course is designed to prepare students to take up managerial responsibilities in the corporate sector. We will concentrate on financial theory required for the management of a business entity and focus on the company as an organizational form, to the exclusion of say a non-governmental organization (NGO), a start-up entrepreneurial venture or household finance.

Types of Business Organizations

A business enterprise can be organized in three forms. The simplest is the sole proprietorship wherein a single person, the sole proprietor, owns the business in its entirety and has exclusive responsibility of the assets and liabilities of the firm. If the business is unable to pay its dues, the sole proprietor is legally bound to pay from his own personal resources. Technically, the owner has unlimited liability. Thus, his liability is not limited to the amount he has invested in the venture but extends to the overall commitment of the business.

Unlimited liability also characterizes partnership, which is the second form of organizing a business enterprise. A partnership is a business organization owned by two or more partners who share the profits generated by the partnership. Partnership firms in India are governed by the Indian Partnership Act, 1932. In accordance with the Act, there must be a contract between two or more partners who agree to carry on the business with the objective of sharing profits in the partnership. As in the case of sole proprietorship, all partners have unlimited liability. Provision exists in the law, however, to constitute a business as a limited liability partnership.

Both sole proprietorship and partnership have limitations as business organizations. As business grows in size and becomes more complex, it is difficult to raise the large amount of capital that may be required. A limited number of partners cannot be expected to provide the funding that the growth of the business enterprise may necessitate. That is why virtually all large business organizations are structured as corporate entities.

A corporation, also referred to as a limited liability company, is a legal entity distinct from its owners. Being a separate legal entity, it can borrow, own property and enter into contracts on its own. It can sue and be sued. Tax provisions applicable to a company are different from those applicable to other forms of business organizations. In India, companies are incorporated and governed under the Companies Act, 1956.

A company is a legal entity separate from its owners, and funds raised from investors, in the form of either debt or equity, are a liability of the company, something it owes to those investors.

A corporate form of organization has several advantages.

1. A company is a permanent entity which is not impacted by the death of any of its owners. Equity ownership merely passes on to the heir of the deceased. This gives stability to the organization, which is missing in the other forms. Ownership may change on a daily basis, with investors buying and selling shares of the company, without in any way impacting its working. Managers similarly may come and go, without disrupting operations. Many

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companies exist today that are more than a hundred years old. Tata Steel Limited, for example, was founded in 1907 and continues to be a vibrant business entity.

2. A company can have an unlimited number of equity shareholders and thus is in a position to raise a vast amount of capital. It is inconceivable that modern business and economy could have grown in the manner and to the extent they have without the corporate structure of organization. Larsen & Toubro (L&T) Ltd, for example, is valued at over ₹1,750,000 million. No single individual or a set of partners could have contributed this vast sum of money. The company has millions of investors who have together put in the required funds, facilitated, of course, by the corporate structure of organization.
3. A corporate structure of organization, with its distinguishing feature of limited liability, is the earliest means of risk management known to investors. Certain in the knowledge that they cannot be asked to pay for the liability of the firm from their own personal assets, their obligation being limited to the investment they have made, investors can leave the management of the company in more competent hands. Limited liability enables investors to diversify their resources by investing in multiple businesses. Portfolio diversification becomes possible. Thus, the corporate form of organization helps the investor in managing the risks of their investments.

   Kingfisher Airlines (KFA) became bankrupt in 2012. The company had in the past raised funds from the public through issue of equity and borrowings from financial institutions including banks. Debt provided by banks and other financial institutions has now become what is technically termed 'non-performing asset'. With the resources it now has, KFA will find it difficult to pay back all the liabilities and the lenders will have to take a hit. At the same time, limited liability safeguards the shareholders of Kingfisher, who cannot be asked to pay the liabilities of the firm from their personal assets. Their losses are limited to the amount they have already invested in the equity of the company. The payment of any liability of the firm is the sole responsibility of the company and not of its shareholders. The two are separate entities.
4. Separation of ownership and management is a significant characteristic feature of the corporate structure. The owners or equity investors, large in numbers and widely dispersed, appoint competent managers to run the business. You do not necessarily need to own a business you are managing. Nor do you have to manage a business you own.

L&T and Britannia

On 5 June 2017, 1,270,946 shares of L&T Ltd exchanged hands, representing a change in ownership of 0.14 per cent of the total shares. It had no impact on the ordinary business of the company, which continued to engage in its regular operations.

On 3 June 2003, Britannia Industries Limited asked its managing director to leave with immediate effect due to differences over strategic issues and replaced him with a new one. The company continued to function normally, of course, with a different strategy.

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Objectives of a Company

In order to effectively manage a company, it is essential that all stakeholders agree on and work towards the objectives the company seeks to accomplish. It is widely believed that companies must maximize profits. However, that would be a flawed metric to try and achieve for various reasons.

1. Profits can be easily manipulated, as they sometimes are. Accountants have this wonderful knack of generating the specific profit figure that will please the management. Widely divergent figures can be made to represent a 'true and fair' picture of a company's performance under a broad interpretation of the generally accepted accounting principles (GAAP).
2. For it to be an effective metric, the period over which the company maximizes profits needs to be specified. For instance, if the objective is to maximize profits in the current year, there are many ways of achieving this at the cost of profits in later years. A pharmaceutical company can easily reduce expenditure on research and development (R&D) to inflate immediate profits. Similarly, a fast-moving consumer goods (FMCG) company may show a better picture of earnings by reducing investments in brands in the current year. The management usually has considerable leeway in manipulating profits over different years.

   Such practices are not healthy for business, and such companies are unlikely to survive for long. Companies have been known to declare profits that are always in line with expectations of investors, irrespective of the actual performance. We have often witnessed a new chief executive officer (CEO) 'clean up the books' by recognizing all past losses and liabilities, attribute the same to the previous CEO and start afresh. Cleaning up the books would, of course, not have been undertaken if the previous CEO had continued in his position.
3. It is important to factor in the investments required to generate a certain level of profit. Absolute profit by itself is meaningless. Company A's ₹100 million profit is better than ₹200 million profit by company B if the investment in company A is less than half the amount invested in company B. It is the return on investment which is more significant than just the absolute amount of profit.
4. Finally, the risk assumed to generate the given profit is critical. A higher profit may not be desirable if the company has been exposed to excessive risk in generating that profit. Not only can the profits disappear in the future, such risks can jeopardize the very existence of the company. Risk will be discussed in detail later in the book.

Earnings per share (EPS) is another measure that analysts sometimes look at, especially stock investors. It takes into account the investments required to generate profits. But it suffers from the other three weaknesses mentioned earlier.

The objectives of a company must be well established and unambiguous, have a long-term perspective and be able to guide the management in decision-making. Profit maximization and similar objectives fail these criteria. Value maximization or shareholder wealth maximization has over time been considered, in financial literature, to be the right metric for a company to aim for, despite somewhat successful attacks on it in recent times.

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First, the value of a company is market driven, in fact, market determined; it equals the sum of its equity and debt value. The equity and debt values are based on the price of the company's shares and bonds, established by way of purchase and sale by millions of investors in the market. To that extent, the value is not left to the whims and fancies of an accountant, nor to the vagaries of varied interpretations of the GAAP.

Even if a company is not publicly traded, or its price is not otherwise available, it is possible to determine value by applying standard well-known valuation methods. Based on well-established principles of free cash flow, time value of money, discounting, risk, required rate of return and so forth, the model takes into consideration future cash flows of the company rather than accounting-based methods that look at the past.

Second, value maximization leads to efficient allocation of resources. Financial markets facilitate or intermediate funds transfer between households and the corporate sector. Based on value maximization, the financial markets transfer funds to projects that provide the highest possible return on investments commensurate with their risk, resulting in maximization of the growth of the economy. The Government of India invests large amounts regularly in Air India and other unviable businesses owned by it, thereby dampening economic growth. Given a choice, the financial markets will quite evidently decide against such value-destroying investments.

Third, starting a business venture is quite risky, the risk being primarily borne by equity shareholders. If a company does not perform well or becomes bankrupt, it is the shareholders who stand to lose the most. They have the last priority over the assets and the cash flows of the company. The revenues generated by the company are first used to pay the salaries of employees, the cost of raw materials to suppliers and to meet other operating expenses. The cash flow that remains after meeting these expenses, called operating profits, is distributed as interest to lenders and as corporation tax to the government. Only the balance that remains after all these payments have been made accrues to the shareholders. Technically, the claims of the shareholders are inferior to the claims of other stakeholders and thus, the shareholders are exposed to the highest possible risk.

What motivates equity investors to bear such high risk? Clearly, it is the expectation that companies will maximize their wealth in normal times by pursuing value maximization. New ventures would be very unlikely if the risk bearers (the equity investors) are not appropriately rewarded.

Fourth, a company has numerous stakeholders—people who are impacted by what the company does—the customers, the suppliers, the employees, the lenders, the government, the society and, of course, the shareholders. Ideally, the company must maximize the benefits to all the stakeholders. Such a scenario, while highly desirable, is possible only under ideal conditions and is not quite practical. Good intentions are not only suspect but are also difficult to implement. Often, the gains to one stakeholder will be at the expense of other stakeholders. All stakeholders' claims need to be balanced, a task difficult to define, let alone achieve. Moreover, such a balancing act provides no guidance to managers in their decision-making.

Maximizing shareholder wealth automatically implies that other stakeholders' interests have already been taken care of, since their claims are ahead of and superior to that of the shareholders, who are considered the residual owners of the company. Achieving wealth

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maximization implies that cash flows accruing to the company have already been satisfactorily distributed to other stakeholders, before the shareholders can claim their share. Shareholder wealth maximization thus becomes the single metric that a firm can aim for and be sure of to satisfy all stakeholders. Value maximization should thus be the one objective guiding all decision-making by the company.

Companies have, for long, been stating this as an explicit policy and thus, shareholder wealth maximization becomes the critical metric to achieve. The iconic Coca-Cola Company stated in its annual report a long time back, 'Our mission is to maximize share-owner value over time.'

Lloyds TSB and Value Maximization

Lloyds TSB had a long time back accepted value maximization as its stated goal and explicitly provided a well-argued defence. According to the company,

> putting value creation first can bring huge benefits, not only to the company but to society as a whole. No company can survive for long unless it creates wealth. A sick company is a drag on society. It cannot sustain jobs nor adequately serve customers. It cannot give to philanthropic causes.
>
> We believe there is no better way for us to serve all our stakeholders—not just our shareholders, but our customers, fellow employees, business partners and the community at large—than by creating value over time for those who employ us. It is our success in value creation that has enabled the Lloyds TSB group to become a leader in charity.

Indian companies too have understood the importance of value creation and actively seek to achieve value maximization. As far back as 1999, EID Parry had stated in its annual report, 'At EID Parry, value creation is central to our operations. It is the force that drives our highly focused agenda for growth. It is the insight to find better, more effective ways of doing business. Maximizing value is more than a slogan. It is the cornerstone of our culture.'

Value maximization thus becomes the guiding mantra for managers in decision-making. Should the company

1. invest in a new packaging project or a cement plant?
2. issue bonds or access equity from a private equity investor for its foray into a software project?
3. lower its price to thwart a new entrant or competitor?
4. offer employee stock option plans (ESOPs) to its managers?

All these decisions can be taken by managers keeping in mind the need to maximize the value of the company by explicitly answering three questions:

1. What is the expected return of the decision? Impacts cash flows.

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