Chapter 13

Introduction to Corporate Finance and Governance

Topics Covered

- Creating Value with Financing Decisions
- Common Stock
- Preferred Stock
- Corporate Debt
- Convertible Securities
- Patterns of Corporate Financing

Creating Value with Financing Decisions

- Companies regularly find competitive advantages, but there are few protected niches in financial markets
- The corporations seeking funds and the investors investing play zero-sum games, so there are little chances that corporations could consistently trick investors into overpaying for its securities
- Therefore, in an efficient capital market all securities are fairly priced given the information available to investors
- Many different kinds of securities (p.350 table 13-1)

Common Stock

Treasury Stock (issued but not outstanding)

Stock that has been repurchased by the company and held in its treasury

Issued Shares

Shares that have been issued by the company

Outstanding Shares

Shares that have been issued by the company and held by investors

Common Stock

Authorized Share Capital

Maximum number of shares that the company is permitted to issue, as specified in the firm's articles of incorporation

Par Value

Value of security shown on certificate

Additional Paid-in Capital

Difference between issue price and par value of stock. Also called capital surplus

Retained Earnings

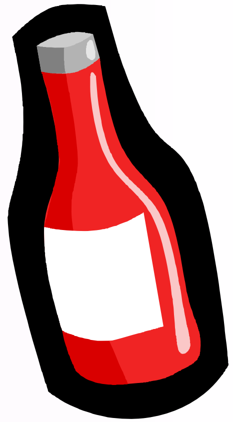
Earnings not paid out as dividends

Common Stock

Example - H.J. Heinz Book Value vs. Market Value (4/2004)

Total shares outstanding = 352 million

Common Shares ($.25 par)	108
Additional paid in capital	403
Retained earnings	4,857
Treasury shares at cost (79 mil.)	-2,928
Other	-546
Net common equity (Book Value) (mil.)	1,894

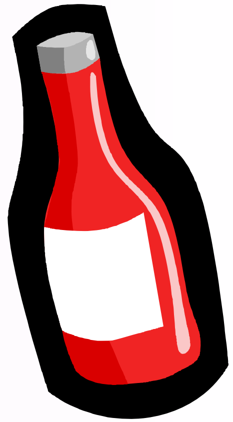


Common Stock

Example - H.J. Heinz Book Value vs. Market Value (4/2004)

Total Shares outstanding = 352 million

January 2001 Market price =	$38/sh
# of shares	x 352
Market Value	$13,376 million



Common Stock

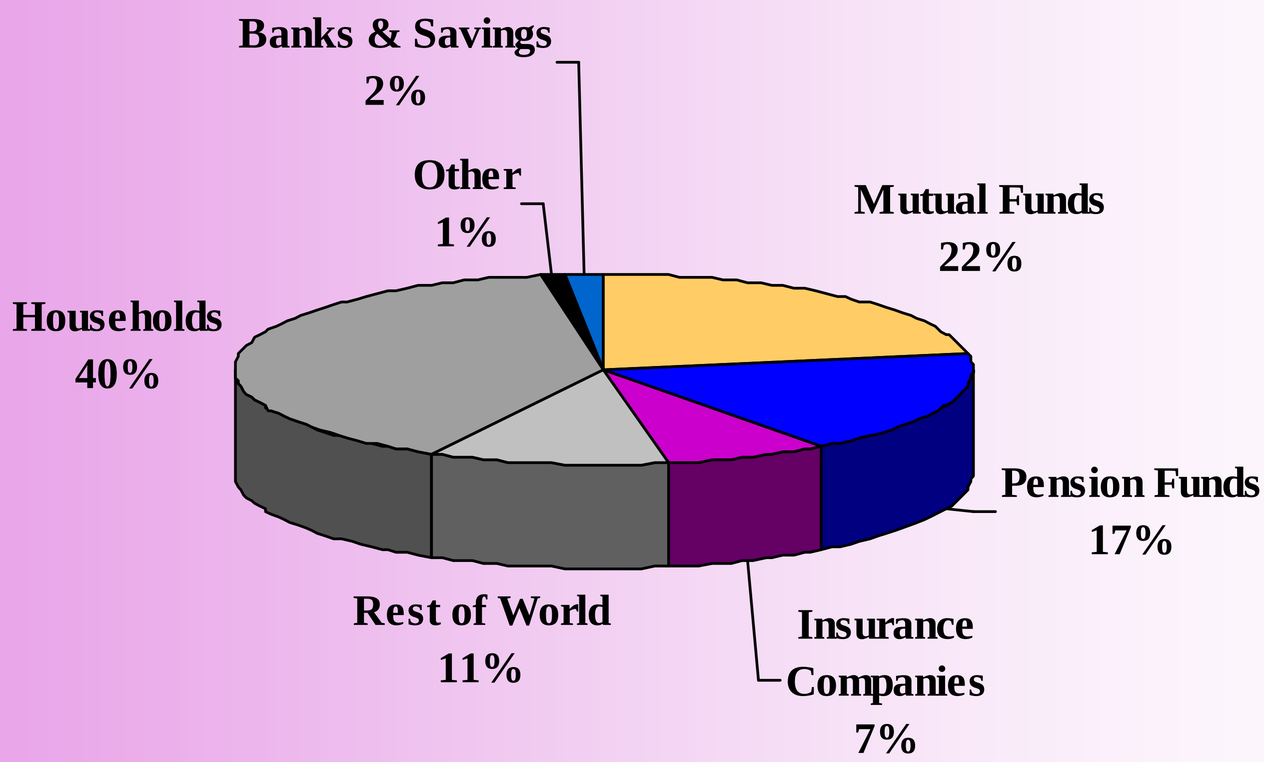
Book Value vs. Market Value

Book value is a backward looking measure. It tells us how much capital the firm has raised from shareholders in the past. It does not measure the value that shareholders place on those shares today

The market value of the firm is forward looking, it depends on the future dividends that shareholders expect to receive.

Common Stock

Corporate Equity Holdings



Common Stock

- Ownership of the Corporation
  - Stockholders owe the corporation
  - Stockholders are entitled to what ever profits are left over after lenders have received their entitlement
  - Stockholders have "residual claim"
  - Shareholders have the ultimate control over how the company runs (they have the right to vote on appointments to the board of directors)
  - Majority vs. Cumulative voting (p.353)
  - Proxy contest

Preferred Stock

Preferred Stock - Stock that takes priority over common stock in regards to dividends

Net Worth - Book value of common shareholder’s equity plus preferred stock

- ★ Preferred stocks are rarely with voting right, except about the issues that affects their place in the queue
- ★ Preferred stocks are similar to corporate bonds, but companies cannot deduct preferred dividends when they calculate taxable income
- ★ For company-investors, only 30% of the dividends of the common and preferred stocks is taxed, that means the effective tax rate is 30% x 35% = 10.5%

Floating-Rate Preferred - Preferred stock paying dividends that vary with short term interest rates

Corporate Debt

- When companies borrow money, they promise to make regular interest payments and to repay the principal
- Debt has the unique feature of allowing the borrowers to walk away from their obligation to pay, in exchange for the assets of the company
- "Default Risk" is the term used to describe the likelihood that a firm will walk away from its obligation, either voluntarily or involuntarily
- "Bond Ratings" are issued on debt instruments to help investors assess the default risk of a firm

Corporate Debt

Prime Rate - Benchmark interest rate charged by banks

Funded Debt - Debt with more than 1 year remaining to maturity

Sinking Fund - Fund established to retire debt before maturity (When there is a sinking fund, investors are prepared to lend at a lower rate of interest.)

Callable Bond - Bond that may be repurchased by firm before maturity at specified call price (p.359 Figure 13-2)

Corporate Debt

Subordinate Debt - Debt that may be repaid in bankruptcy only after senior debt is repaid.

Secured Debt - Debt that has first claim on specified collateral in the event of default.

Investment Grade - Bonds rated Baa or above by Moody's or BBB or above by S&P.

Junk Bond - Bond with a rating below Baa or BBB.

Corporate Debt

Eurodollars - Dollars held on deposit in a bank outside the United States

Eurobond - Bond that is marketed internationally

Private Placement - Sale of securities to a limited number of investors without a public offering

Protective Covenants - Restrictions on a firm to protect bondholders

1. Restrict the amount of extra debt
2. Prevent others from being ahead in the queue in trouble
3. Limit the size of the dividend paid

Lease - Long-term rental agreement.

Corporate Debt

Indexed Bonds – Whose payments rise in line with some index, like inflation, commodity price, weather condition, etc.

Asset-Backed Bonds – The borrower sets aside a group of assets and the income from these assets is then used to service the debt

Reverse Floaters – Floating-rate bonds that pay a higher rate of interest when other interest rates fall and a lower rate when other rates rise are called reverse floaters. They are riskier than normal bonds.

Convertible Securities

<u>Warrant</u> - Right to buy shares from a company at a stipulated price before a set date

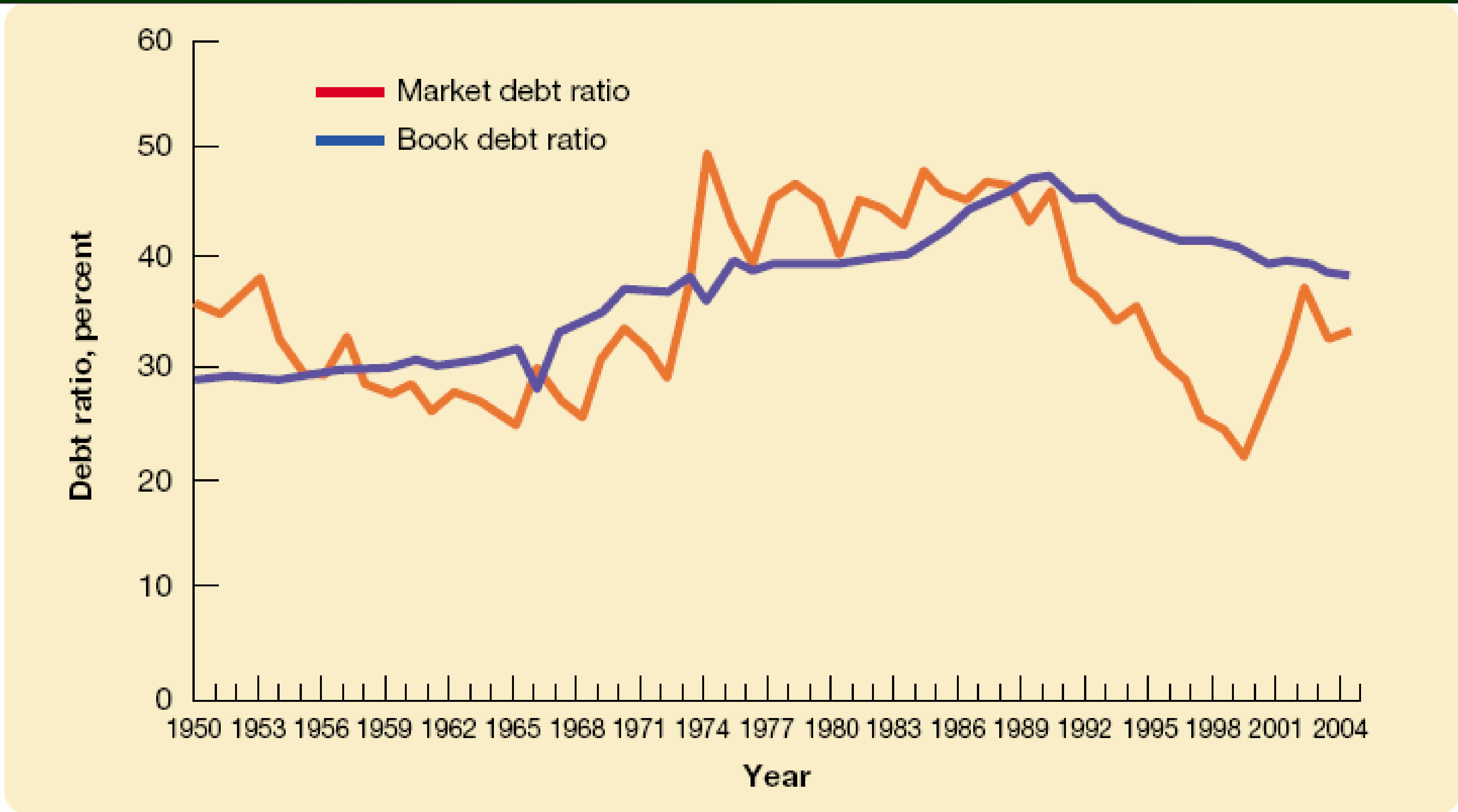
<u>Convertible Bonds</u> - Bonds that the holder may exchange for a specified amount of another security

- ➔ Convertibles are a combined security, consisting of both features of a bond and a call option
- ➔ However, the value of a convertible bond does not equal to the sum of the prices of the bond and the call option

Patterns of Corporate Financing

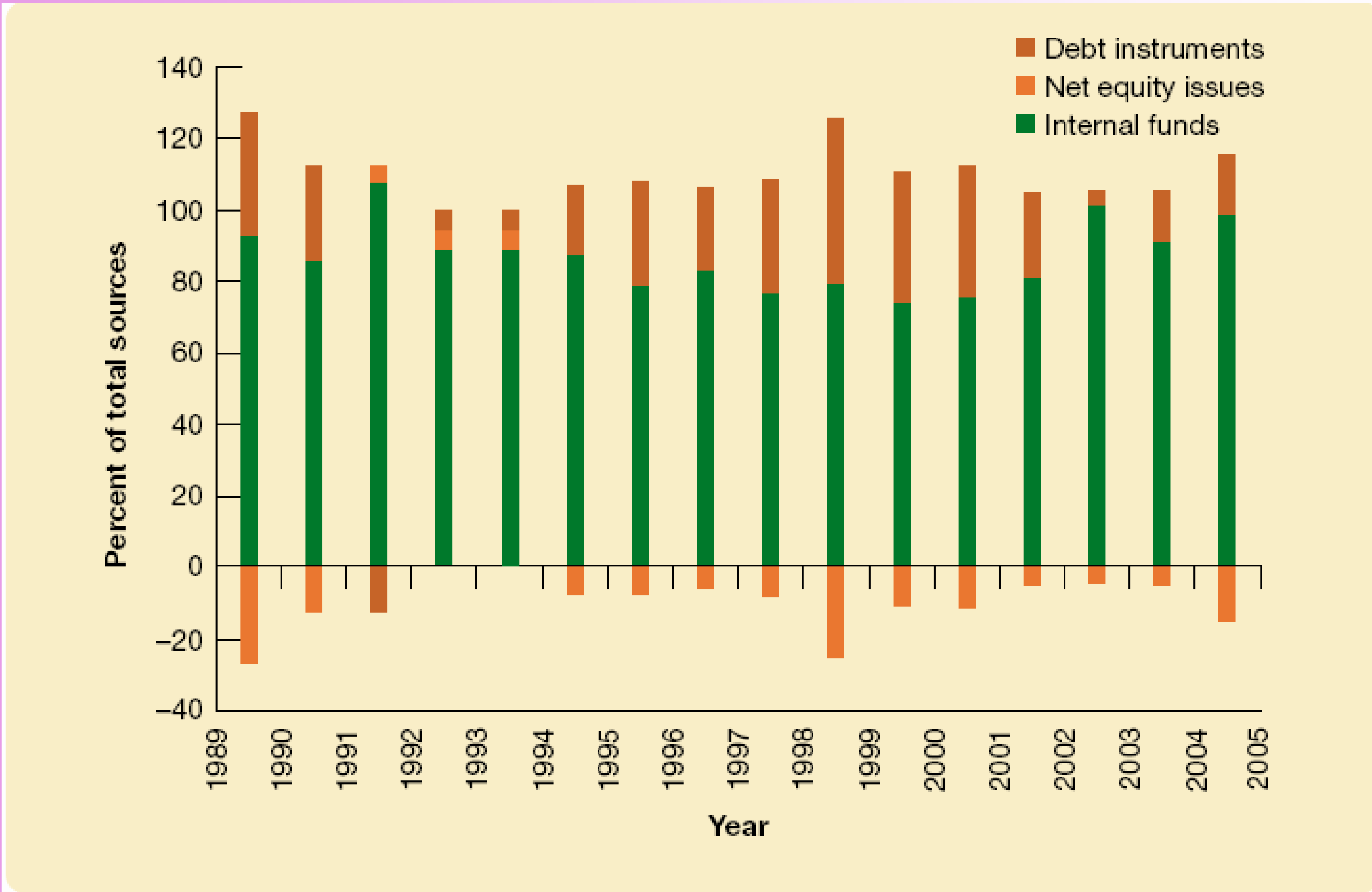
- Firms may raise funds from external sources or plow back profits rather than distribute them to shareholders
  - Internally generated funds: Cash reinvested in the firm, including depreciation plus earnings not paid out as dividends
  - External sources of capital: Either sell new equity or borrow
  - Financial deficit: Difference between cash the companies need and the amount generated internally

Patterns of Corporate Financing



Source: Board of Governors of the Federal Reserve System, Division of Research and Statistics, "Flow of Funds Accounts," Table B.102 at **www.federalreserve.gov/releases/z1/current/data.htm.**

Patterns of Corporate Financing



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