BAF231: CORPORATE FINANCE
COURSE OUTLINE/LECTURE NOTES
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Course Outline

1. Nature of the firm
2. Corporate objectives
3. Capital budgeting
4. Investment evaluation criteria
5. Leasing
6. Mergers and acquisition
7. Issuance of new shares
8. Cost of capital
9. Capital structure
10. Financing decisions

Lecture Notes

NATURE OF THE FIRM

A business firm or business organization is an economic entity or agent which produce the varieties of goods and services necessary for human survival and economic welfare. Business organisations do not exist in a vacuum, they exist in an environment and are part of a structure or network of organizations or entities that constitute the economy.

The finance functions in any organization is affected by factors both within and outside the organization and financial management can only be fully appreciated in the context of the economic, political, legal and socio-cultural environment in which its operates.

Inorder to satisfy our common needs, people engage in various kinds of jobs that is producing all kinds of things like foods, clothing, housing, etc. that people need to be happy, satisfied and fulfilled. The coordinated effort of all these producers are together referred to as ‘’ECONOMIC ACTIVITIES’’.

Money and finance are simply the means of settlement for the transactions to facilitate the process of production, distribution and exchange of these products and to keep track of the movement of the goods and services produced in a country.

The term ‘BUSINESS’ may be understood as a complex field of commerce and industry including basic processing, manufacturing, and distribution and a network of ancillary services such as banking, insurance, transportation, tele-communication,etc., which serve to facilitate the process of production and distribution of goods and services.

The term business firm, business enterprise or business organisation are interchangeably used to describe specialized forms of organisations, specifically designed to participate in the process of production and exchange of goods and services.

Hahns (1981) defines a business firm as an economic unit, an entity, or a basic building block of the economy conceived to transform inputs into outputs in the production of goods and services required to satisfy the wants of a given society.

In the traditional society, there are no organizations specifically designed for the production of goods and services isolated from the rest of the social system. Work was shared out in a community so that each individual has his role. People tend to specialize in what they can do best and each exchanges the surplus to get what he needs. This is what economists call specialization, division of labour and exchange. Typically a business firm develop as a result of man's effort to combat or improve upon the resources of nature and for better management of available resources.

In our modern society, we depend largely on variety of organisation to provide all types of goods and services. Organizations are said to be UBIQUITOUS which means they are to be found everywhere in the society. Examples of organizations include schools, churches, hospitals, banks, small, medium, and large scale enterprises. specialization and division of labour are better practiced in modern organizations, combining its various resources (human, financial, physical) to serve the various needs of a society in a more effective manner.

BUSINESS AND CREATION OF VALUE

In many societies, the term business has been erroneously interpreted to mean making money by any means. But from a purely economic point of view business organizations exist to satisfy human needs and make profit, i.e., to create surplus of income over the cost incurred in the process of producing goods and services. There is no doubt that the universal use of money, the free market competition and technological improvement in production methods, transportation and telecommunication etc. has resulted in large scale production, commercialization of business and acceleration of acquisition of private wealth by the owners of capital rather than simply to sustain life.

Levitt (1960) affirmed that, the purpose of every business is to serve the society , and that it is the purpose for which a business exists that gives its legitimacy. He observes that the presence of such social eye sores as lack of adequate food, housing ,medical care, power supply, transportation and telecommunication facilities, etc. are indications of our failure to use business opportunities to provide for the basic needs of society. In providing or satisfying the needs of the society, the businessman would not only create wealth for himself but also contribute effectively to the growth of the economy.

However, most of the businessmen in our society prefer to “reap where they did not sow” and indulge in excessive gambling, speculation and even outright fraud in the name of business. The failure of businesses in our country today is as a result of lack of strong ethical culture. Ethics go beyond the law, they are standard of behavour which are expected of a good citizen (be it individual or corporate citizen) of a country. Ethics define for the people what is normally right or wrong.

Business ethics requires business managers to answer moral questions concerning the value they have created in their effort to maximize profit. The reason why we are in business is very important, the real truth about money is that it has no real value in/ and of itself except in the goods and services we produce as a people (Adam Smith, 1870).

CAPITAL BUDGETING DECISIONS

Capital budgeting decision is also known as investment decision or capital expenditure decision. It is a firm’s decision to invest its current funds most efficiently in long term asset in anticipation of expected flow of benefit over a series of years. The firm’s investment decisions would include expansion, acquisition, modernization and replacement of long term assets.

EXPANSION refers to the acquisition of additional assets by a firm to increase its production capacity. Before a firm considers expansion, it checks its present profitability status first or may decide to float new shares for equity capital or use debt funds. If your company is truly profitable, retained earnings could be used in funding expansion of the company. Retained earnings is the portion of the company’s profit not distributed to shareholders as dividend but kept aside for investment purposes.

The combination of equity and debt in a company’s capital used to fund profitable investments in order to maximize the wealth of shareholders is called CAPITAL MIX.

Cost of Equity: Dividend + floatation cost

Cost of Debt: Interest

ACQUISITION: refers to the acquisition of new long-term fixed assets for production. In doing this, a company may raise funds from the capital market through issuance of shares or floatation of bonds or debentures.

MODERNIZATION: Modernization could be necessary due to technological changes, the nature and grade of machineries used in production, improving the quality and efficiency in production and operation. In today’s world, operations of firms have shifted from analogue to digital in nature. Thus, an existing company must follow the trend to remain in business and perform well.

REPLACEMENT: replacement is important when some of the long term assets of a company have worn-out overtime and their efficiency would reduce. For example, a machine used over time would become less efficient and breaks down regularly resulting in a high maintenance cost. Hence, it is important to replace such old assets with new ones.

Types of Investments

The types of investments include, replacement, expansion of business, modernization. The explanations are as stated above.

Classification of Investments

Investments are classified into three categories, namely, mutually exclusive investment, independent investment and contingent investment.

MUTUALLY EXCLUSIVE INVESTMENT: It serves the same purpose and compete with each other. Therefore, if one investment is undertaken, others would have to be excluded. E.g., a company may either use a more labour intensive, semi automatic machine or a more capital intensive, highly automatic machine for production. Choosing a semi automatic machine disqualifies the acceptance of the highly automatic machine.

INDEPENDENT INVESTMENT: It serves different purposes and do not compete with each other. For instance, a flour manufacturing company may consider expansion of its plants capacity to manufacture salt. Depending on the profitability of both business and availability of funds the company can take on both investments.

CONTINGENT INVESTMENT: Contingent investments are dependent project, choosing one of the investment necessitates undertaking one or more other investments. For example, if a company decides to establish a university in a remote or rural area, it may have to invest in houses, hospitals, roads, etc. for both staff and students. Therefore, establishing a university also requires investments in facilities for staff and students. The total expenditure is treated as a single investment.

INVESTMENT EVALUATION CRITERIA

A number of investment evaluation criteria are used in practice. These are grouped into two main categories as follows:

A. Discounted cash flow [DCF] criteria; it include:

- **i.** Net present value (NPU)
- ii. Internal rate of return (IRR)
- iii. Profitability index (PI)

B. Non discounted cash flow criteria; it include

- i. pay back period (PBP)
- ii. Discounted payback period (DPP)
- iii. Accounting rate of return (ARR)

Net Present Value Method (NPV)

NPV method is a discounted cash flow technique that explicitly recognizes the time value of money. It states that cash flows arising at different time periods differs in value and are comparable only when its equivalent present values are found.

The following are steps involved in calculation of NPV:

1) Cash flows of the investment project should be forecasted based on the realistic assumptions.
2) Appropriate discount rate should be identified to discount the forecasted cash flows. The appropriate discount rate is the project's opportunity cost of capital which is equal to the return expected by investors on investment of equivalent risk.
3) Present value of cash flows should be calculated using the opportunity cost of capital as the discount rate.
4) Net present value should be found by subtracting present value of cash outflows from present value of cash inflows. The project should be accepted if NPV is positive(NPV > 0).

NPV ACCEPTANCE RULE:

1. Accept the project when NPV is positive (NPV > 0)
2. Reject the project when NPV is negative(NPV < 0).
3. May or may not accept the project when NPV is zero (NPV = 0).

Profitability Index (PI)

This is another time adjusted method of evaluating proposals. It is the ratio of the present value of cash inflows, at the required rate of return, to the initial cost outlay of the investment. It is a benefit - cost (b/c) technique.

ACCEPTANCE RULE FOR PI:

1. Accept the project if PI is greater than one (PI>1).
2. Reject the project when PI is less than one(PI<1).
3. May or may not accept the project when PI is equal to one.

Payback Period

This is the number of years required to recover the initial capital invested in a project. It is categorized into two, namely:

1. payback period with even cash inflows
2. payback period with an uneven cash inflows.

The formula for calculating pp with even cash inflow is PB=Co/C

Where Co = initial investment or capital outlay ,C = annual cash flow.

Accounting Rate of Return (ARR)

ARR is the ratio of the average profit after tax to average investment. It is also known as returns on investment.

COST OF CAPITAL

Cost of capital is also known as opportunity cost of capital. It is the cost incurred in raising capital to fund an investment or business.

The opportunity cost of capital is the discount rate for discounting the cash flows of a project. The project's cost of capital is the minimum required rate of return on funds committed to the project, which depends on the riskiness of the cash investment. Since investment project undertaken by a firm may differ in risk, each one of them will have its own unique cost of capital.

The firm represent the aggregate of investment projects undertaken by it, therefore the firm's cost of capital is the overall or average required rate of returns on the aggregate of investment project. Thus, the firm's cost of capital is not the same as the project's cost of capital.

SIGNIFICANCE OF THE COST OF CAPITAL

The cost of capital is used as a standard for:

1. Evaluating investment decisions

2. Designing a firms policy
3. Appraising the financial performance of top management.

EVALUATING INVESTMENT DECISIONS: This is concerned with analysing the project with positive NPV and undertaking the most profitable ones.

DESIGNING A FIRM'S POLICY: The firm's policy would consider whether the firm should use only equity or debt, or combination of both in funding its business and at what rate; whether to use more of equity or more of debt or equal proportion of both.

APPRAISING THE FINANCIAL PERFORMANCE OF TOP MANAGEMENT : The cost of capital serves as an indicator of the efficiency of top management as applying the optimum capital structure for a firm increase its profitability.

Weighted Average Cost of Capital

A firm obtains capital from various sources, due to the risk differences and the contractual agreement between the firm and the investors, the cost of capital of each source of capital differs. The cost of capital of each source of capital is known as component or specific cost of capital. The combined cost of all sources of capital is called overall or average cost of capital. Thus, the overall cost is also called THE WEIGHTED AVERAGE COST OF CAPITAL (WACC).

The various sources of capital are related to each other. The firm's decision to use debt in a given period reduces its future debt capacity as well as increases the risk of shareholders. The shareholders will require a higher rate of return to compensate for the increased risk. Similarly, the firm's decision to use equity capital would enlarge its potential for borrowings in the future. On the long-run, the firm is expected to maintain a balance between debt and equity. The mix of debt and equity is called the firm's CAPITAL STRUCTURE because of the connection between the source of capital and the firms desire to have a large target capital structure in a long run. It is generally agreed that the cost of capital should be closed in the composite, overall sense, i.e., in terms of the weighted average cost of capital.

FINANCING DECISION

Financing decision is the use of both debt and equity in funding a business. It is also known as capital structure decision. Debts are fixed charge sources of fund. Equity is owner' equity. Preference share is similar to debt because it has fixed charge (dividend). The difference between preference shares and debt is that a company is not compelled by law to pay preference dividend if it does not make profit. However, in the case of debt, the company is compelled to pay interest on debt irrespective of making profit or not. The way a company handles its debt-equity mix affects its market value.

Ordinary share is also known as owners' equity. Ordinary shareholders are the real owners of the firm or company compared to the preference shareholder. Ordinary shareholders, being the owners of the business get whatever is left after tax deduction, payment of dividend to preference shareholders.

It is possible to use dividend decision as financing decision. In this case, the company retains its dividend in order to use in financing new investment opportunities. The company may fully retain the profit or retain part or a proportion of the profit and distribute the remaining proportion of the profit to shareholders as dividends. Dividends has two forms - cash dividends and bonus shares.

Capital gain is the difference between the selling price of the share and the cost price of the shares.

FINANCIAL LEVERAGE

The use of fixed charges sources of funds such as debt and preference capital along with owners equity in the capital structure is called financial leverage or gearing or trading equity. The use of the term trading on equity is derived from the fact that it is the owners equity that is used as a basis to raise debt, that is, it is the equity that is traded upon. The supplier of debt has limited participation in the companies profit and therefore he will insist on protection in values represented by the owners equity.

LEASING

Leasing is a contract between the lessor and the lessee in which the lessor gives the right to the use of asset(s) to the lessee over an agreed period of time for a consideration called the lease rental. The lessor is the owner of the property while the lessee is the user of the property.

LEASE RENTAL is the fee charged for the use of the property over an agreed period of time. The lessee pays the rental to the lessor as regular fixed payments over a period of time at the beginning or end of the month, quarter, half year or a year. Although generally fixed, the amount and timing of payments of lease rentals can be followed according to the lessee’s profit or cash flows. In up-fronted leases, more rentals are charged in initial years and less in the later years of the contract. The opposite happens in back-ended leases. At the end of the lease contract, the asset reverts back to the lessor who is the legal owner of the asset. As the legal owner it is the lessor not the lessee who is entitled to claim depreciation on the leased asset.

EVALUATING FINANCIAL LEASE

Leasing is a two step decision for the lessee firm (the firm using the asset): first it has to evaluate the economic viability of the asset as an investment. If the asset has a positive NPV the company should proceed to acquire the asset. Once it has decided to do so, the firm can compare the cost of financing the asset through leasing with that of normal sources of financing.

HIRE PURCHASE

There are three parties to a hire purchase financing include:

a. The manufacturer
b. The hirer
c. The hiree

The hiree may be a manufacturer or a finance company. The manufacturer sells asset(s) to the hiree who sells it to the hirer in exchange for the payment to be made over a specified period of time.

A hire purchase agreement between the hirer and the hiree involves the following three agreement:

1. The owner of the asset (the hiree or manufacturer with an understanding that the hirer will pay agreed installments over a specified period of time.
2. Ownership of the asset will transfer to the hirer on the payment of all installment.
3. The hirer will have the option of the agreement anytime between the transfer of the asset

MERGERS AND ACQUISITION

It is one of the constituents of corporate restructuring. The other constituents include: takeovers, spine-offs, leverage buy-out, buy-back of shares, capital reorganization , sale of business units and assets.

A merger is said to occur when two or more companies combine into one company. One or more company may merge with an existing company or they may merge to form a new company. In merger, there is a complete amalgamation of the assets and liabilities as well as share holders' interest and businesses of emerging companies. There is yet another mode of merger in which one company may purchase another company without giving proportionate ownership to the shareholders of the acquired company or without continuing the business of the acquired company . In India, merger is also known as amalgamation.

Merger or amalgamation may take two forms:

1. Merger through absorption
2. Merger through consolidation

Merger through Absorption: This is the combination of two or more companies into an existing company. All companies except one losses their identity in a merger through absorption.

Merger through Consolidation: This is the combination of two or more companies. In these form of merger all companies are legally dissolved and a new company emerged, the acquired companies transfer their assets, liabilities and shares to the new company for cash or exchange of shares.

FORMS OF MERGER

There are three forms of merger, namely:

1. Horizontal merger: This is a combination of two or more firms in similar type of production, distribution or area of business, e.g., the combination of two book publishers to gain dominant market share.
2. Vertical merger: This is a combination of two or more firms involved in different stages of production or distribution, e.g., joining a TV manufacturing company with a TV marketing company.
3. conglomerate merger: This is a combination of firms engaged in unrelated line of business activities, e.g., merging a cement manufacturing firm with a fertilizer manufacturing firm.

Acquisition

An acquisition may be defined as an act of acquiring effective control over asset or management of a particular company by another company without any combination of business or companies.

An acquisition occurs when an acquiring firm acquires a substantial quantity of shares or voting rights of the target company. Therefore, in acquisition two or more companies involved may remain independent, separate legal entity or they may be a change in control of the acquired company.

TAKE OVER: A take over occurs when an acquiring firm takes over control of the target firm. It does not necessarily entail full legal control.