Class 7

UG3F14
Corporate Finance

Class 7 Topics and Content

- Sources of Capital: Equity or Debt Financing

- Equity: Introduction and types of Equity
- Equity Valuation (Common Stock)
- Debt: Introduction, Types of Debt (Loans and Bonds)
- Bonds Valuation and the Interest Rates
- Debt or Equity Financing?

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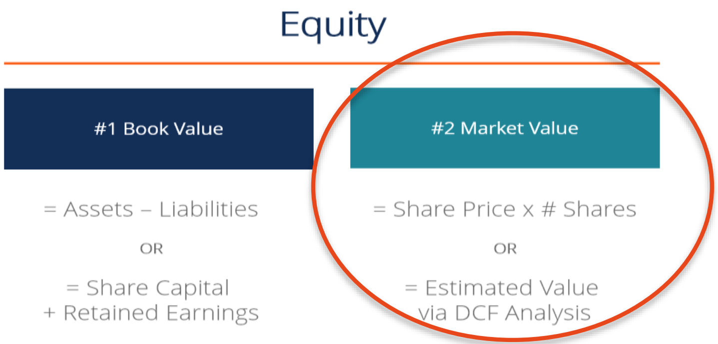
- Sources of Capital: Equity or Debt Financing:

- Equity: Introduction
  - ✓ In finance and accounting, equity is the value attributable to the owners of a business
  - ✓ It can be computed by:
    - The business book value of equity or the difference between assets and liabilities on the company’s balance sheet – net worth or shareholder’s equity
    - The market value of equity (public) is based on the current share price or a value that is determined by investors or valuation professionals.



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- Sources of Capital: Equity or Debt Financing:

- Equity: Types of Equity
  - ✓ Common Stock or Equity
    - Is a security that represents equity ownership in a corporation
    - Provides voting rights, and entitles the holder to a share of the company's success in the form of dividends and any capital appreciation in the value of the security
    - Common stockholders are residual owners of the firm - they earn a return only after all other security holder claims (debt and preferred equity) have been satisfied in full
    - Dividends on common stocks are neither fixed nor guaranteed. A company can choose to reinvest all profits and pay no dividends
  - ✓ Preferred Stock
    - Preferred stock is also referred to as a hybrid security as it has features of both common stock and bonds
    - Preferred stock is similar to common stocks in that it has no fixed maturity date, the nonpayment of dividends does not result in bankruptcy of the firm, the dividends are not deductible for tax purposes

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- Sources of Capital: Equity or Debt Financing:

- Equity: Types of Equity
  - ✓ Preferred Stock
    - Preferred stock is similar to corporate bonds in that the dividends are typically a fixed amount, and there are no voting rights.
    - Is an equity security that has preference with regard to:
      - Dividends: They are paid before the common stockholders
      - Claim on assets: They are paid before common stockholders if the firm goes bankrupt and sells or liquidates its assets

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- Sources of Capital: Equity or Debt Financing:

- Equity: Valuation
  - ✓ Common stock valuation is a method of determining the intrinsic value (or theoretical value) of a stock
  - ✓ The importance of valuing stocks is the fact that the intrinsic value of a stock is not attached to its current price, and by knowing a stock's intrinsic value, an investor may determine whether the stock is over- or under-valued at its current market price
  - ✓ The holder of one share in a company that has one million shares outstanding is the owner of one-millionth of the company
  - ✓ The value of that share should represent that percentage of the company's worth
  - ✓ Stock valuation methods can be are two types: absolute and relative methods
    - Absolute method relies on the company's fundamental information:
      - ▪ The analysis of financial information found in the business financial statements
      - ▪ The method techniques involves the company's cash flows, dividends, and growth rates like:
        1) Dividend discount model (DDM): based that the intrinsic value of the company's stock price equals the present value of the company's future dividends

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- Sources of Capital: Equity or Debt Financing:

- Equity: Valuation
  - Absolute method relies on the company’s fundamental information:
    1) Dividend discount model (DDM): based that the intrinsic value of the company’s stock price equals the present value of the company’s future dividends

The formula to calculate DDM is: Present value of stock or P = D1/(Re – G)
D1 = Next year’s estimated dividend
Re = Cost of equity
G = Expected growth rate of dividends based on historical increases

Example DDM: Company ABC paid a dividend of ₤1.80 per share this year, the business expects dividends to grow at 5% per year constant, and the company's cost of equity capital is 7%

$D_1 = D_0$ x (1 + g) = ₤ 1.80 x (1 + 5%) = ₤ 1.89
Company ABC price per share = D1 / (r - g) = ₤ 1.89 / (7% - 5%) = ₤ 94.50

If the stock is currently selling in the NYSE at ₤ 93.50 is undervalue and a good buy

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- Sources of Capital: Equity or Debt Financing:

- Equity: Valuation
    - Absolute is based on the company's fundamental information:
        - The analysis of financial information found in the business financial statements
        - The method techniques involves the company's cash flows, dividends, and growth rates like:

            2) Discounted cash flow model (DCF): the intrinsic value of a stock is calculated by discounting the company's free cash flows to its present value - sophisticated

    - Relative method is based on comparing the investment with similar companies by calculating key financial ratios using comparable companies analysis

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- Sources of Capital: Equity or Debt Financing:

- ➢ Debt: Introduction, Type of Debt Sources, and the Bond Market
  - ✓ Is when a company borrows money to be paid back at a future date with interest, and can be in the form of:
    - Bank borrowing: loans, notes, or bills
    - Bonds:
      - ✓ Bonds are interest-only fixed-income loan (the borrower will pay the interest every period, but none of the principal will be repaid until the end of the loan) securities issued by corporations and governments to raise capital
      - ✓ The bond issuer borrows capital from the bondholder and makes fixed payments to them at a fixed (or variable) interest rate for a specified period

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- Sources of Capital: Equity or Debt Financing:

- Debt: Type of Bonds
  - Bonds:
    - ✓ Conventional Corporate Bonds
    - ✓ Corporate bonds with unusual features like FLOATING-RATE BONDS with adjustable coupon payments - tied to an interest rate index such as the Treasury bill interest rate or the London Interbank Offered Rate (LIBOR)

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- Sources of Capital: Equity or Debt Financing:

- ➢ Debt: Introduction, and the Bond Market
  - Bonds:

For example, Beck Corporation wants to raise $1,000 for 30 years to fund the plant expansion, the interest rate on similar debt issued by similar corporations is 12%. Beck will pay $120 (0.12 × $1,000) in interest every year for 30 years to the bondholders, and at the end of 30 years, Beck will repay the $1,000

✓ Bond Market: The bond market is a financial market where participants can issue new debt, known as the primary market, or buy and sell debt securities, known as the secondary market. This is usually in the form of bonds, but it may include notes, bills, and so for public and private expenditures

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- Sources of Capital: Equity or Debt Financing:

- Bond: Valuation
  - ✓ YIELDS - Interest rates change in the marketplace while cash flows from a bond stay the same (coupon); therefore, the value of the bond fluctuates
    - If interest rates rise, the present value of the bond’s remaining cash flows declines, and the bond is worth less
    - If interest rates fall, the bond is worth more
    - Yield is a figure that represents the return from a bond, if the price change due to changes interest rates, yields will change

Example: An investor buys a bond at its ¥1,000 par value with a 10% coupon, if it is held to maturity, the issuer (corporation) pays the investor ¥ 100 a year for 10 years, and in year 10, pays back the ¥1,000 on the scheduled date

Yield = coupon amount/price

Yield = 10% (¥ 100/ ¥ 1000)*100%

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- Sources of Capital: Equity or Debt Financing:

- Bonds and Interest Rates and Yield (YTM)
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- Sources of Capital: Equity or Debt Financing?

Debt (Bonds) vs Equity (Stock) Financing – which is best for a particular business and why?

- ✓ The decision relies on factors such as the current economic climate, the business' existing capital structure, or the business' life cycle stage
- ✓ The Cost of Equity is generally higher than the Cost of Debt since equity investors take on more risk when purchasing a company's stock as opposed to a company's bond
- ✓ The Cost of Debt is usually lower than the cost of equity, but taking on too much debt will cause the cost of debt to rise above the cost of equity
- ✓ The biggest factor influencing the cost of debt is the loan interest rate
- ✓ Other considerations when making a financing decision:
  1. **Flotation costs**: If investment banks are charging a lot to issue new stock, issuing debt will be cheaper and vice versa
  2. **Interest rates**: High interest rates will require the business to offer high coupon bonds in order to be an attractive investment. This will be more costly for the business, thus issuing equity will be cheaper and vice versa.
  3. **Business growth**: If the company is young and is making significant investments in R&D in order to support growth, it may be wiser to reduce monthly claims on cash flows by issuing equity and vice versa.

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- ***Sources of Capital: Equity or Debt Financing?***

Debt (Bonds) vs Equity (Stock) Financing – which is best for a particular business and why?

- Debt and equity financing are two very different ways of financing businesses

Pros and Cons of Debt Financing

Pros:

- Doesn’t dilute owner’s portion of ownership
- Lender doesn’t have claim on future profits
- Debt obligations are predictable and can be planned
- Interest is tax deductible
- Debt financing offers flexible alternatives for collateral and repayment options

Cons:

- Debt must be repaid
- Can be difficult to qualify for, depending on financial status and credit score
- Some debt instruments restrict businesses from pursuing alternative financing options
- Higher debt-equity ratios increase the financial risk of the company
- Assets could be seized in case of default

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- ***Sources of Capital: Equity or Debt Financing?***

Debt (Bonds) vs Equity (Stock) Financing – which is best for a particular business and why?

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Pros and Cons of Equity Financing

Pros:

- No obligation to pay dividends on equity
- Possible industry experience and connections from right investors
- Investors’ money doesn’t have to be returned if business fails
- Improves financial health of business by reducing leverage

Cons:

- Having to give up a portion of ownership
- Higher equity issuing costs
- Attracting investors can be harder than getting a loan

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The decision between debt or equity financing depends on the type of business and whether the advantages outweigh the risks, but most companies use a mix of both types of financing, in which case you can use a formula called the weighted average cost of capital, or WACC, to assess the cost of debt and equity financing.