CORPORATE FINANCE

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Meaning of Business Finance

- In general, finance may be defined as the provision of money at the time it is wanted.
- “Business finance is concerned with the acquisition and conservation of capital funds in meeting financial needs and overall objectives of a business enterprise.” ---------Wheeler.

Broadly defined :

- “It is an activity concerned with planning, raising, controlling and administering of the funds used in the business. ---------Guthman & Dougall
- The term Business Finance involves, raising of funds and their effective utilization keeping in view the overall objective of the firm.
- “Financial management is that managerial activity which is concerned with the planning and controlling of the firm’s financial resources.”
- Effective utilization of money utilized in the business.

- “Financial Management is concerned with the managerial decisions that result in the acquisition and financing of long term and short-term credits for the firm. As such it deals with the situations that require selection of specific assets, the selection of specific liabilities as well as the problem of size and growth of an enterprise. The analysis of these decisions is based on the expected inflow and outflow of funds and their effects upon managerial objectives.” -------Phillippatus.

OBJECTIVE OF FINANCIAL MANAGEMENT

Objective : To ensure that the various financial decisions are taken in such a way that they result in the maximization of shareholders' wealth.

1. Profit Maximization
2. Wealth maximization
3. Ensuring a fair return to the shareholders
4. Building up reserves for growth and expansion
5. Ensuring maximum operational efficiency
6. Ensuring financial discipline in the organization
7. Keeping the expenses under limit and maximize the return or at least optimize the return.

Finance Function

- The three major financing decisions are:

  (a) Investment Decision

  (b) Financing Decision

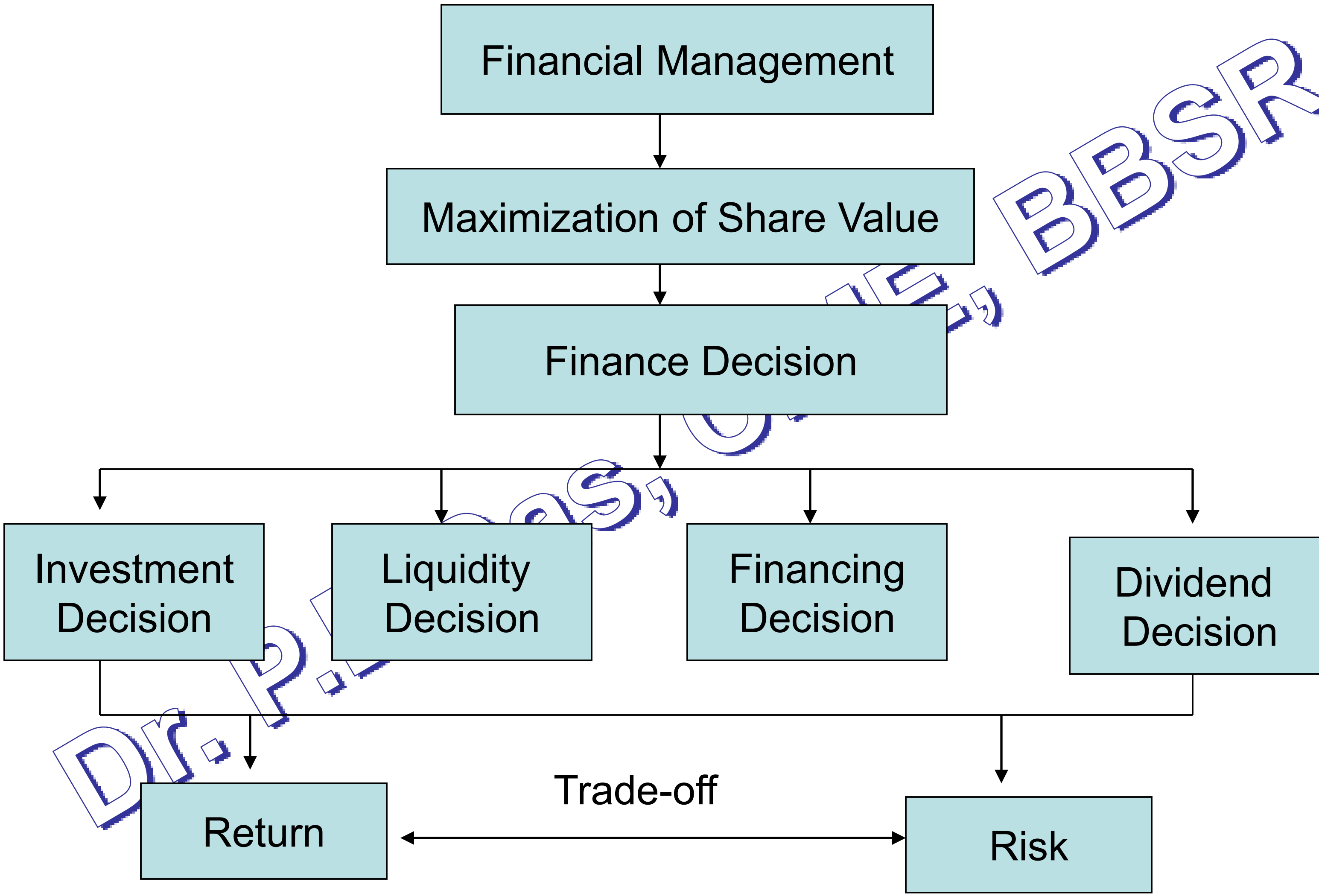
  (c) Dividend Decision and

  (d) Liquidity Decision

FUNCTIONS OF A FINANCE MANAGER

- To explore profitable avenues for investment.
- Mobilization of funds
- To ensure proper deployment of funds and control over the use of funds
- To achieve the right balance between risk and return.
- To decide the optimal dividend payout ratio
- To ensure that the liquidity of assets is maintained.

An Overview of Financial Management



Scope of Financial Management

The areas in which FM is required or the functional areas of FM :

1. Estimating financial requirements
2. Deciding sources of finance
3. Deciding capital structure
4. Selecting a pattern of investment
5. Proper Cash Management
6. Implementing Financial Control (equilibrium between the requirement and the utilization)
7. Proper Utilization of Surplus (after meeting the requirement whatever is left is surplus)

Traditional Approach about Financial Management

Corporate Finance: In the narrow sense of procurement of funds raised externally.

i. Institutional arrangement in the form of financial institution which comprises the organisation of Capital Markets.

ii. The financial instrument through which funds are raised.

iii. The legal and accounting relationship between the firm and its source of funds.

The Modern Approach

- Can be said to be:

1. How large should an enterprise be and how fast should it grow?
2. In what form should it hold assets?
3. What should be the composition of liabilities?

- **3 major decisions:**

1. The investment decisions
2. The Financing decisions
3. The Dividend Policy decisions.

A. Investment Decisions

- **Capital Budgeting:** Probably most crucial decision. Relates to selection of an asset or investment proposal or course of action which benefits are expected over a period of time. Whether an asset will be accepted or not will depend upon relative benefits and returns.

  The **second** element is the analysis of risk and uncertainty.

  Extends into future – accruals are uncertain and to be examined under various assumptions of sales & prices.

  Thirdly, the evaluation of the worth of a long term project implies a certain norm or standard against which the benefits are to be judged (Cost of capital)

B. Financing Decisions

- Concerns with financing mix or capital structure.

  Capital structure refers to the proportion of Debt and Equity.

- Two aspects of Financing Decisions: Optimum capital Structure (in what proportions funds are raised to maximise return to share holders) & to drawing up of Appropriate Capital Structure.

C. Dividend Policy Decisions

- Profits can be distributed or they can be retained in the business itself.
- Dividend Pay-out Ratio: Balancing act between meeting the growth objective and keeping the stake holders happy.

In what proportion of net profit should be paid out to share holders.

Interface between finance & other Functions

- **Common factor**: use of resources obtained in exchange for money and ensuring that the investment is effectively utilised through control functions
- **Marketing – Finance Interface**: Pricing, Product Promotion & Advt, choice of product mix, distribution policy. Understanding of impact of credit extended to customers.
- **Production – Finance Interface**: Production manager – Controls large part of investment in the form of equipment, material and men. Optimum inventory – minimum stoppage in process – evaluation of additional resources – cost & utility analysis.
- **Top Management** – Finance Interface. Use of financial reports to assess the trend and overall effectiveness of the organisation.

Basic inputs for management control and strategic decisions.

Financial Goals

- Profit maximization (profit after tax)
- Maximizing earnings per share
- Wealth maximization

Profit Maximization

- Maximizing the rupee income of firm
  - ✓ Resources are efficiently utilized
  - ✓ Appropriate measure of firm performance
  - ✓ Serves interest of society also

Objections to Profit Maximization

- It is Vague
- It Ignores the Timing of Returns
- It Ignores Risk
- Assumes Perfect Competition
- In new business environment profit maximization is regarded as
  - Unrealistic
  - Difficult
  - Inappropriate
  - Immoral

Maximizing Profit after Taxes or EPS

- Maximising PAT or EPS does not maximise the economic welfare of the owners.
- Ignores timing and risk of the expected benefit
- Market value is not a function of EPS.
- Maximizing EPS implies that the firm should make no dividend payment so long as funds can be invested at positive rate of return—such a policy may not always work.

Shareholders' Wealth Maximization

- Maximizes the net present value of a course of action to shareholders.
- Accounts for the timing and risk of the expected benefits.
- Benefits are measured in terms of cash flows.
- **Fundamental objective**—maximize the market value of the firm's shares.

Importance of Managerial Finance

- Finance deals with decisions concerning cash inflows and cash outflows.
- Emphasis is on cash flows rather than income because most liabilities—that is, debts—must be paid with cash.

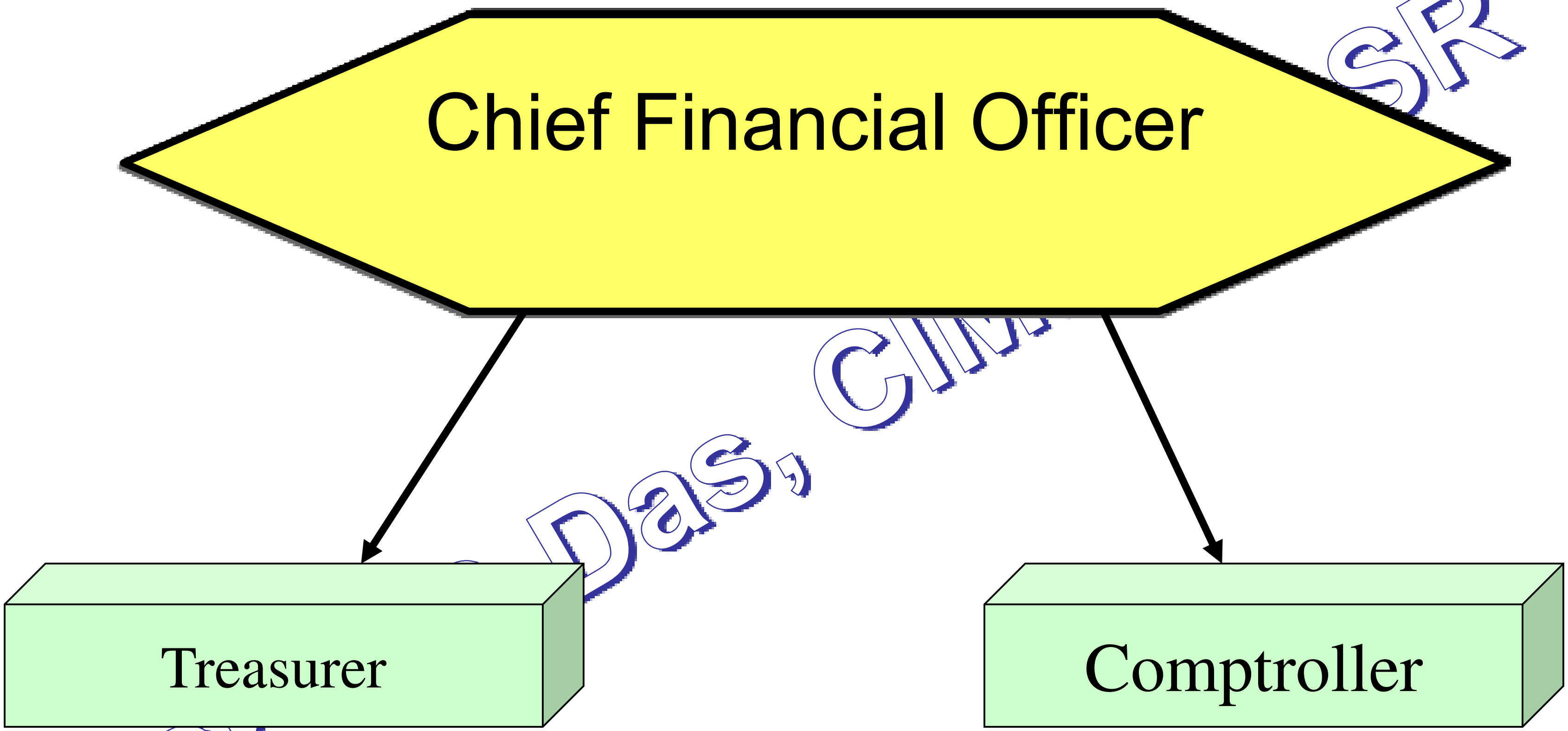
Importance of Managerial Finance in Non finance Areas

- Most decisions cannot be made without considering the impact on the financial well-being of the firm.
- Must determine whether the funds needed to implement decisions are available.

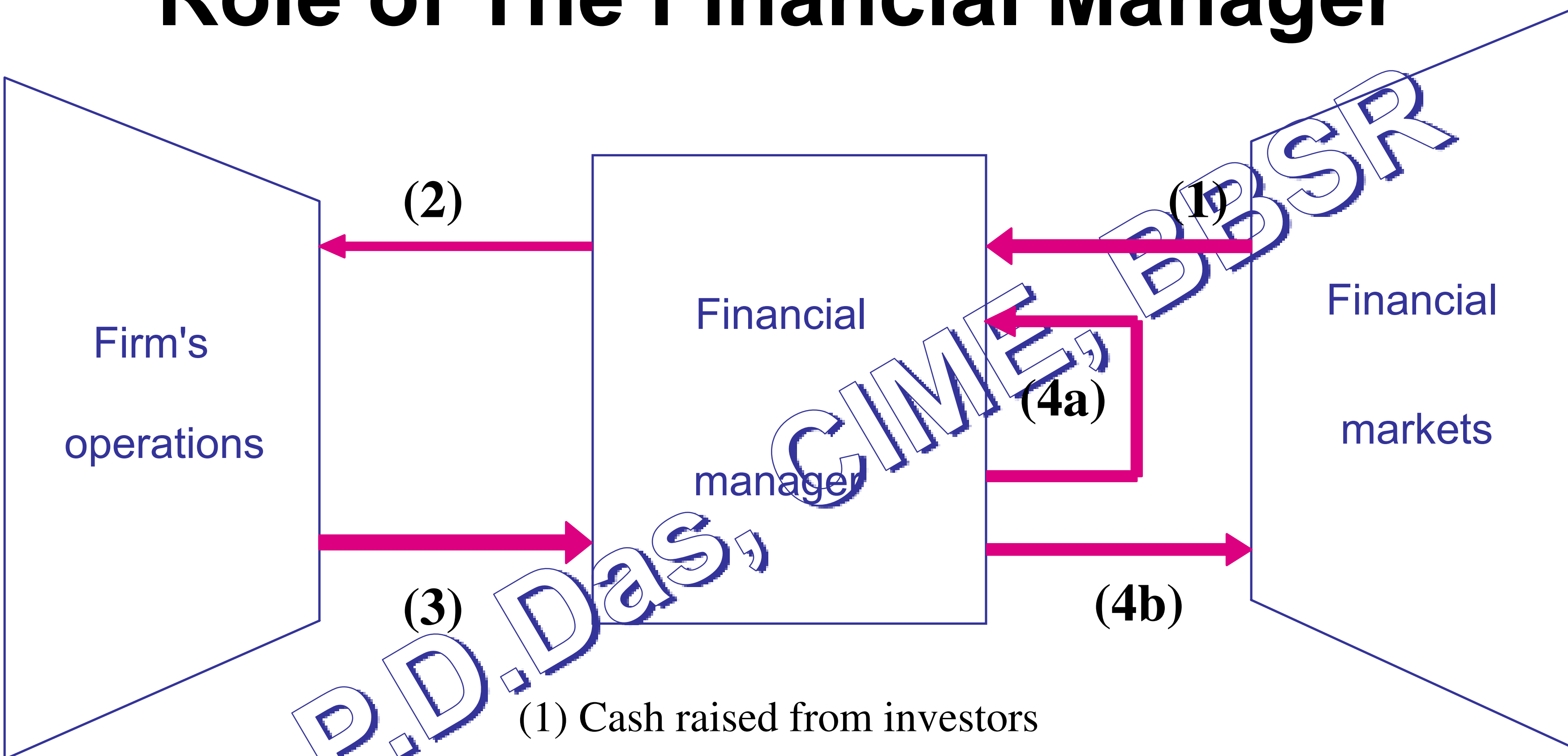
Why is corporate finance important to all managers?

- Corporate finance provides the skills managers need to:
  - Identify and select the corporate strategies and individual projects that add value to their firm.
  - Forecast the funding requirements of their company, and devise strategies for acquiring those funds.

Who is The Financial Manager?



Role of The Financial Manager



(1) Cash raised from investors

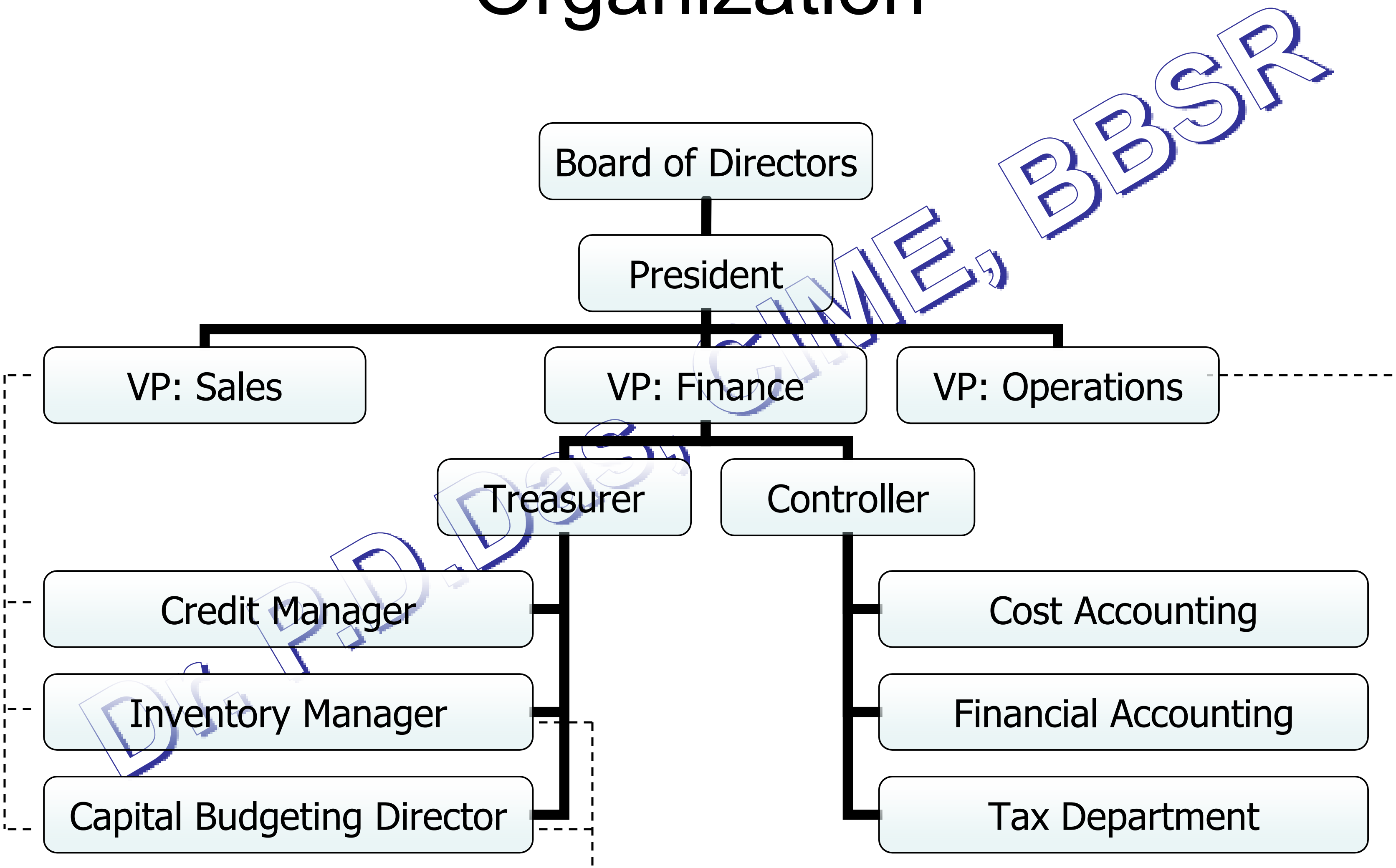
(2) Cash invested in firm

(3) Cash generated by operations

(4a) Cash reinvested

(4b) Cash returned to investors

Role of Finance in a Typical Business Organization



Financial Manager's Responsibilities

- Forecasting and Planning—financial decisions impact the future of the firm.
- Investment and Financing Decisions—determine which assets to purchase and how to finance them.
- Coordination and Control—financial decisions must be made in coordination with other functional areas, such as marketing, accounting, and so forth.
- Dealing with Financial Markets—the firm must go to the financial markets to raise needed funds.

Goals of the Corporation

- Maximize wealth—should be the primary goal of the financial manager.
- Social Responsibility—firms should be socially responsible at the same time they earn "normal" profits.
- Wealth Maximization/Social Responsibility—actions that maximize the value of the firm also are beneficial to society; wealth maximization improves the standard of living.

Why Stock Price Maximization Works

Stockholders hire managers to run their firms for them

Because stockholders have absolute power to hire and fire managers

Managers set aside their interests and maximize stock prices

Because markets are efficient

Stockholder wealth is maximized

Because lenders are fully protected from stockholder actions

Firm Value is maximized

Because there are no costs created for society

Societal wealth is maximized

Managerial action to Maximize Shareholder Wealth :

- What type of action can managers take to maximize shareholder wealth ?

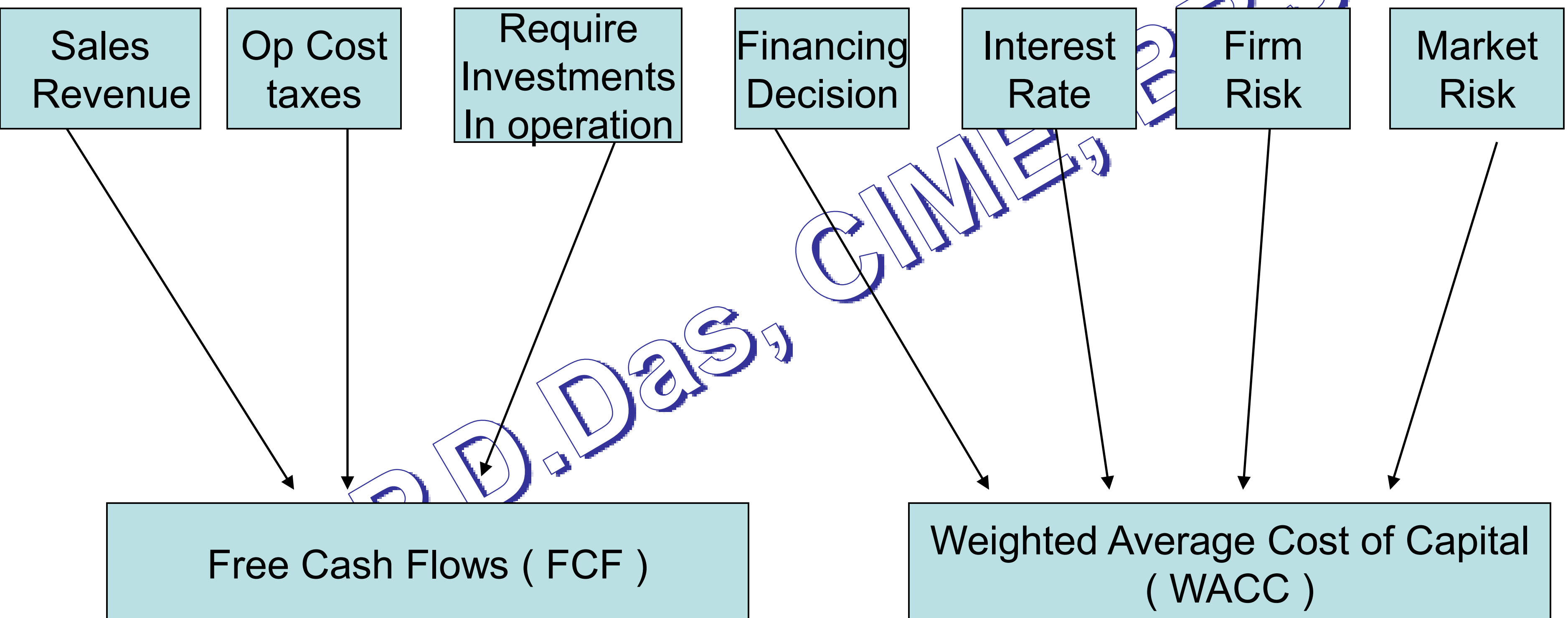
To answer this question, we first need to ask

- “ What determines a firm’s value ?”

Answer

- It is a company’s ability to generate cash flows now and in the future.

Determinants of a Firm’s Value :



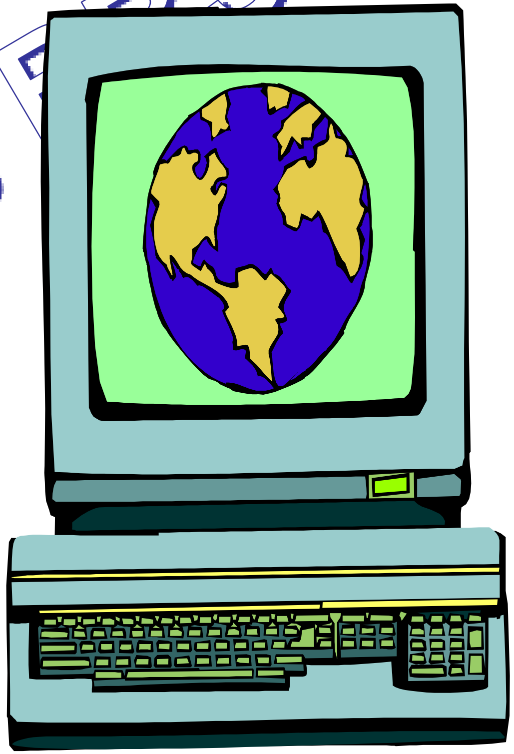
Managerial Finance in the 20th Century

- Pre-1960s—mostly descriptive in nature.
- 1960s—became more analytical with greater emphasis on valuation.
- 1980s—inflation, regulation/deregulation, information technology, and globalization were important factors to consider.
- 1990s—technological innovation, deregulation, and globalization were important factors to consider.
- 2000s—globalization, IT, regulatory attitude of the government are important factors to consider.

Financial Management Issues of the New Millennium

--The effect of changing technology

--The globalization of business



Emerging challenges faced by the financial manager

- **MICRO FINANCE & SHGs**
  - One third of rural people are not served by banks.
  - They are considered, individually, as un-bankable due to lack of collateral security.
  - With innovative savings & loan products –considered bankable.
  - The innovative routes are through mFIsand SHGs.

- **MICRO FINANCE & SHGs**
  - MF is mobilize savings and extend micro credit.
  - Banks open deposit accounts of these mF Is and also extend loans to meet the shortfall in their lending program.
  - Result : the poor remain mostly dependent on mFIs.
- MICRO FINANCE & SHGs
  - SHGs –banks open their deposit accounts and provide credit as a multiple of the group fund.
  - Result : It leads to empowerment of the poor people. After sometime, SHGs need no external support to continue with their activities.

- **EVOLUTION OF SHGs IN INDIA**
- Banking rests on collaterals for giving loan.
- Poor cannot give collaterals.
- They remained outside the purview of banks.
- For overall economic development, the grass root level economy can't be ignored.
- Therefore, a way out to provide the poor with savings and credit services from the formal banking sector was evolved.
- Asian & Pacific Regional Agricultural Credit Association at its 5thGA held in Bangkok in 1984 and Kathmanduin 1986 signed among its members to study the existing SHGs of the rural poor –to initiate a project to link them.
- India set up the Task Force headed by Add. Sec., MoA, GoIas its Chairman.
- NABARD led the team. Presented draft report at 8thExecutive Committee Session of APRACA at N. Delhi in 1987.

- **EVOLUTION OF SHGs IN INDIA**
- Published the report in 1989.
- Launched Pilot Project for linking 500 groups of SHGs in 1992.
- In 1996 (KC), RBI directed banks to include linking of SHG as its mainstream activity.
- In 1998, GoIawarded a national priority through its recognition in Union Budget 1998-99.

- **SHGs LINKAGE MODELS ADOPTED**
- Model I –SHGs formed and financed by banks.
- Model II –SHGs formed by NGOs and formal agencies, but directly financed by bank.
- Model III -SHGs financed by banks using NGOs and other agencies as financial intermediaries.

Agency Problems:

Managers Versus Shareholders' Goals

- **There is a Principal Agent relationship between managers and shareholders.**
- In theory, Managers should act in the best interests of shareholders.
- In practice, managers may maximise their own wealth (in the form of high salaries and perks) at the cost of shareholders.

Agency Problems:
Managers Versus Shareholders' Goals

- Managers may perceive their role as reconciling conflicting objectives of stakeholders. This stakeholders' view of managers' role may compromise with the objective of SWM.

- Managers may avoid taking high investment and financing risks that may otherwise be needed to maximize shareholders' wealth. Such "satisfying" behaviour of managers will frustrate the objective of SWM as a normative guide.

- ***This conflict is known as <u>Agency problem</u> and it results into <u>Agency costs</u>.***

Agency Costs

- Agency costs include the less than optimum share value for shareholders and costs incurred by them to monitor the actions of managers and control their behaviour.

END OF SESSION

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