CORPORATE FINANCE LECTURE NOTE PACKET 2 CAPITAL STRUCTURE, DIVIDEND POLICY AND VALUATION

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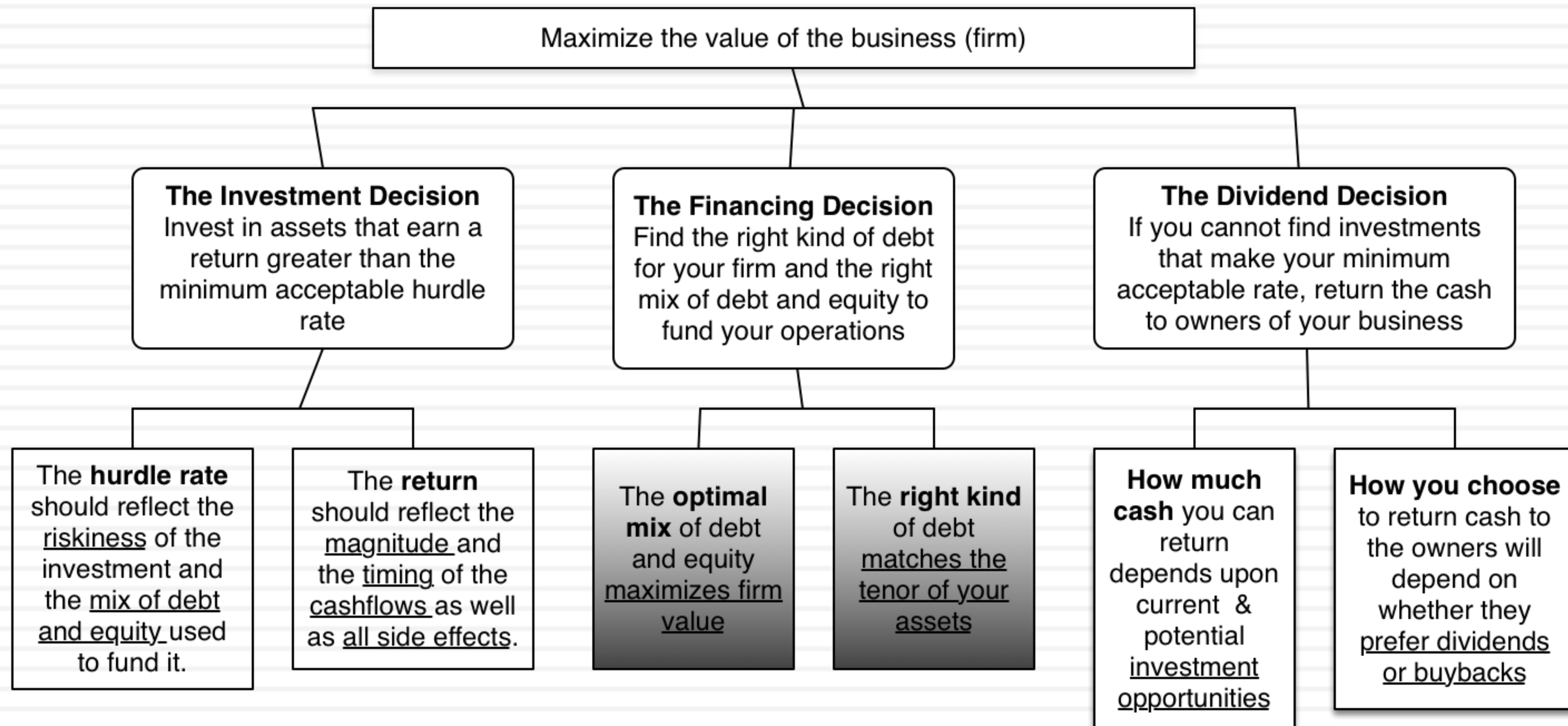
CAPITAL STRUCTURE: THE CHOICES AND THE TRADE OFF

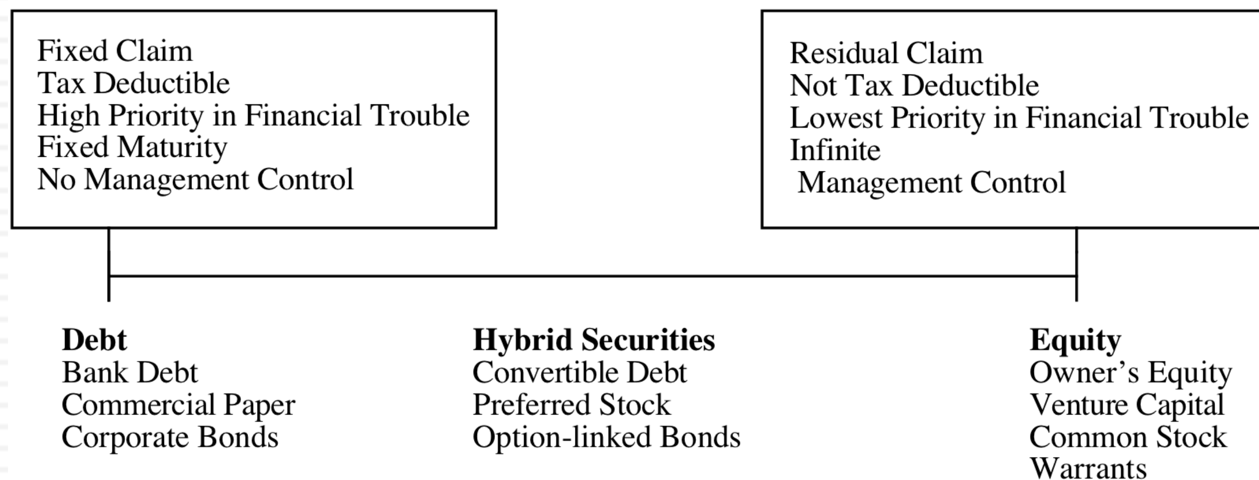
"Neither a borrower nor a lender be"
Someone who obviously hated this part of corporate finance

First principles

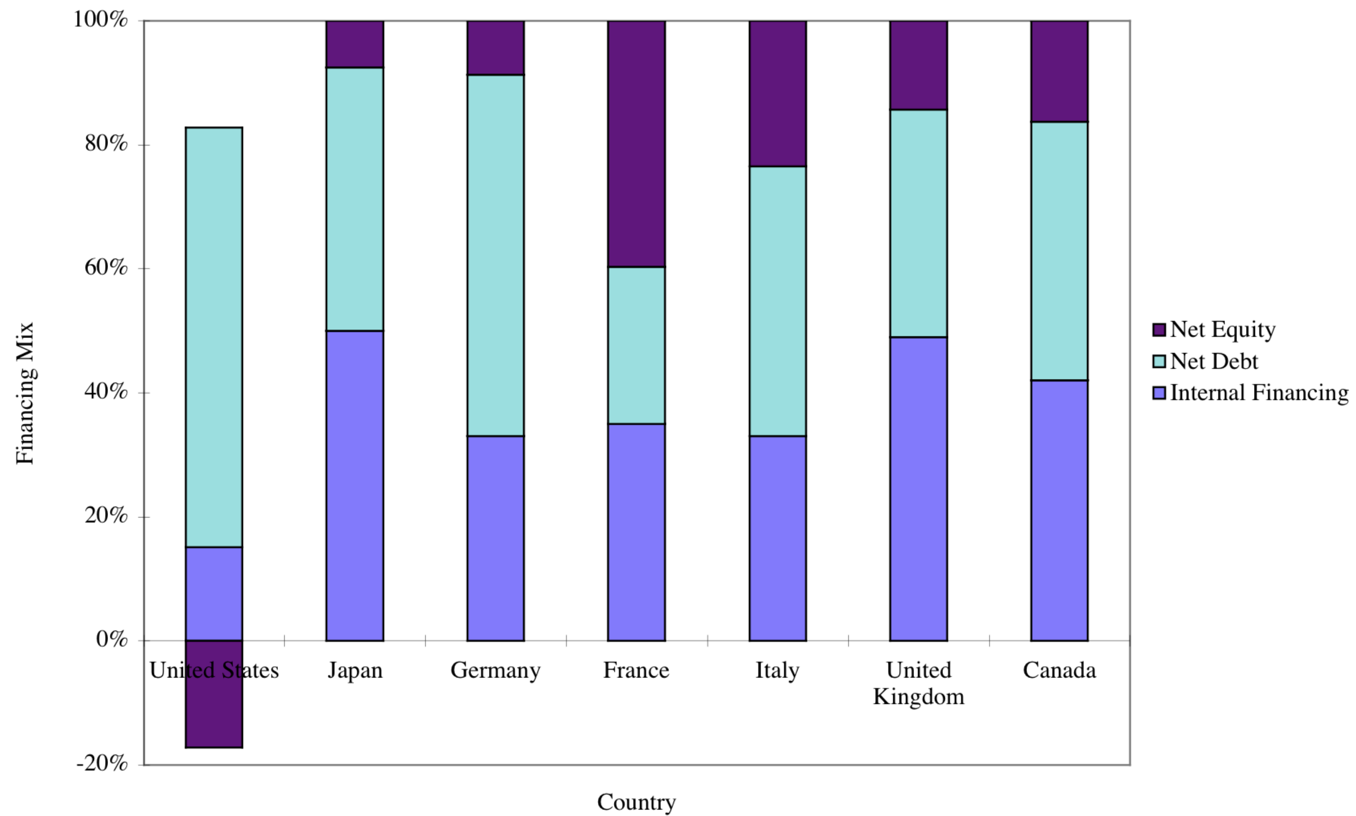


The Choices in Financing

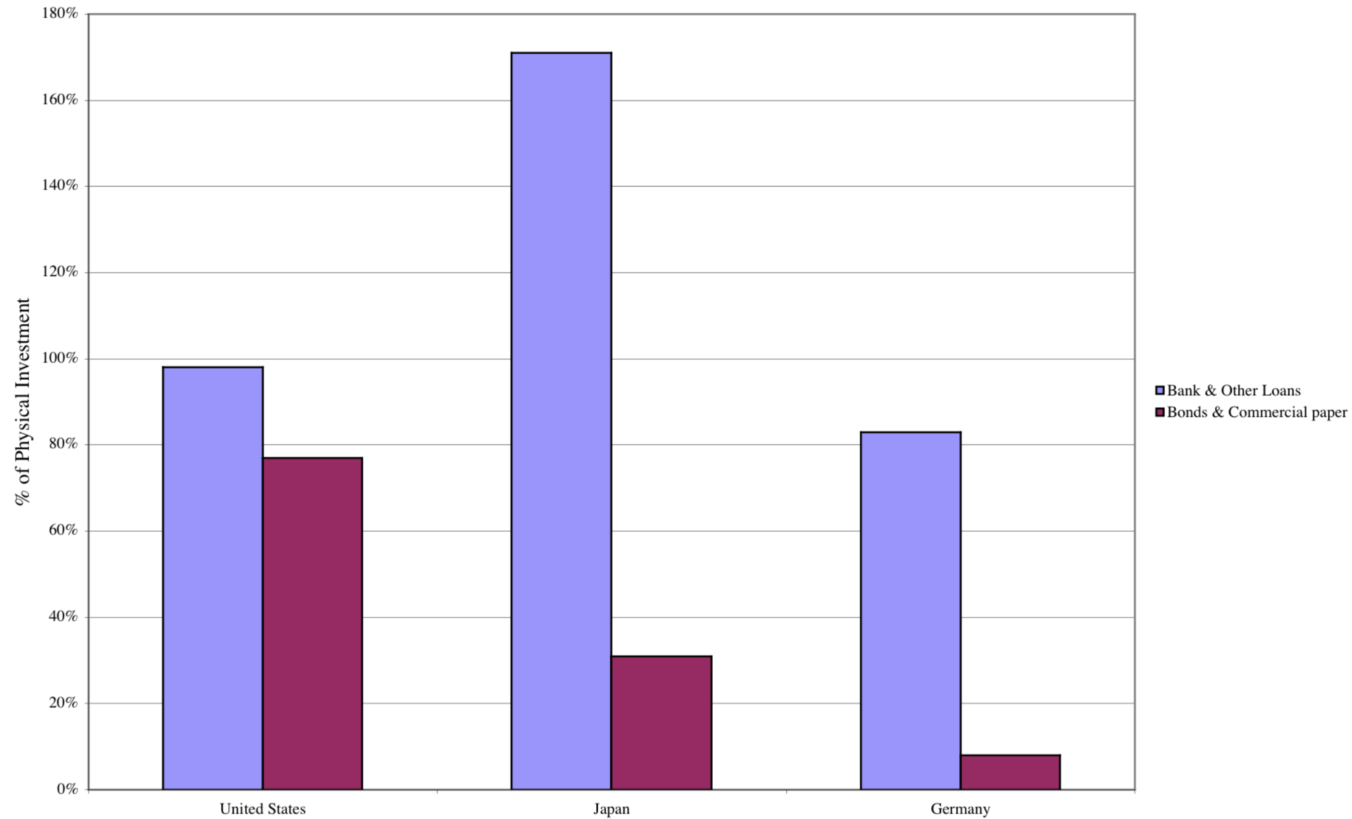
- There are only two ways in which a business can raise money.
  - The first is debt. The essence of debt is that you promise to make fixed payments in the future (interest payments and repaying principal). If you fail to make those payments, you lose control of your business.
  - The other is equity. With equity, you do get whatever cash flows are left over after you have made debt payments.



Global Patterns in Financing…

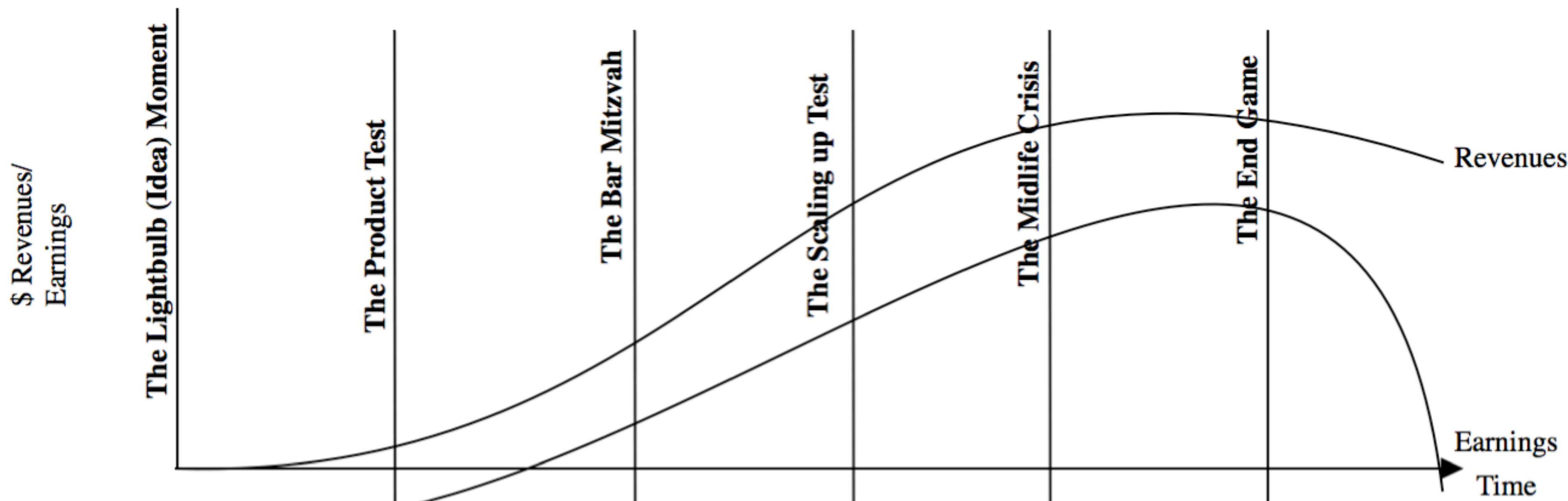


And a much greater dependence on bank loans outside the US…



Assessing the existing financing choices: Disney, Vale, Tata Motors, Baidu & Bookscape

	Disney	*Vale*	*Tata Motors*	*Baidu*
BV of Interest bearing Debt	$14,288	$48,469	535,914₹	¥17,844
MV of Interest bearing Debt	$13,028	$41,143	477,268₹	¥15,403
Lease Debt	$2,933	$1,248	0.00₹	¥3,051
Type of Debt				
Bank Debt	7.93%	59.97%	62.26%	100.00%
Bonds/Notes	92.07%	40.03%	37.74%	0.00%
Debt Maturity				
<1 year	13.04%	6.08%	0.78%	1.98%
1- 5 years	48.93%	23.12%	30.24%	68.62%
5-10 years	20.31%	29.44%	57.90%	29.41%
10-20 years	4.49%	3.00%	10.18%	0.00%
> 20 years	13.24%	38.37%	0.90%	0.00%
Currency for debt				
Debt in domestic currency	94.51%	34.52%	70.56%	17.90%
Debt in foreign currency	5.49%	65.48%	29.44%	82.10%
Fixed versus Floating rate debt				
Fixed rate debt	94.33%	100.00%	100.00%	94.63%
Floating rate debt	5.67%	0.00%	0.00%	5.37%



Growth stage	Stage 1 Start-up	Stage 2 Young Growth	Stage 3: High Growth	Stage 4 Mature Growth	Stage 5 Mature Stable	Stage 6 Decline
External funding needs	High, but constrained by other resources	High, relative to firm value.	Moderate, relative to firm value.	Declining, as a percent of firm value	Not needed	
Internal financing	Negative or low	Negative or low	Low, relative to funding needs	High, relative to funding needs	More than funding needs	
External Financing	Owner's Equity Bank Debt	Venture Capital Common Stock	Common stock Warrants Convertibles	Debt	Retire debt Repurchase stock	
Financing Transitions	Accessing private equity	Inital Public offering	Seasoned equity issue	Bond issues		

The Transitional Phases..

- The transitions that we see at firms – from fully owned private businesses to venture capital, from private to public and subsequent seasoned offerings are all motivated primarily by the need for capital.
- In each transition, though, there are costs incurred by the existing owners:
  - When venture capitalists enter the firm, they will demand their fair share and more of the ownership of the firm to provide equity.
  - When a firm decides to go public, it has to trade off the greater access to capital markets against the increased disclosure requirements (that emanate from being publicly lists), loss of control and the transactions costs of going public.
  - When making seasoned offerings, firms have to consider issuance costs while managing their relations with equity research analysts and rat

Measuring a firm's financing mix …

- The simplest measure of how much debt and equity a firm is using currently is to look at the proportion of debt in the total financing. This ratio is called the debt to capital ratio:

  Debt to Capital Ratio = Debt / (Debt + Equity)
- Debt includes all interest bearing liabilities, short term as well as long term. It should also include other commitments that meet the criteria for debt: contractually pre-set payments that have to be made, no matter what the firm's financial standing.
- Equity can be defined either in accounting terms (as book value of equity) or in market value terms (based upon the current price). The resulting debt ratios can be very different.