

Chapter 2

Corporate Finance

✓ "Finance" means

(i) **Science of money.**—Finance been called as the science of money management. Observation or understanding of the money management;

(ii) **Control of money.**—It studies the principles and the method of obtaining control of money;

(iii) **Decision relating money.**—The decision made by business firm for production, marketing, finance and personal depends upon the economic, therefore finance is one of the aspect of economic body. Circulatory system of the economic body; and

(iv) **Conversion of money.**—Finance is the process of conversion of accumulates funds to productive use.

✓ Definition of "finance"

Finance may be defined as the administrative area or set of administrative functions in an organization which relate with the arrangement of cash and credit so that the organization may have the means to carry out its objective as satisfactorily as possible.

Finance is defined as the management of money and includes activities such as investing, borrowing, lending, budgeting, saving, and forecasting. There are three main types of finance : (1) personal, (2) corporate; and (3) public/government.

Finance is a term for matters regarding the management, creation, and study of money and investments. Finance can be broadly divided into three categories, public finance, corporate finance, and personal finance. There are many other specific categories, such as behavioral finance, which seeks to identify the cognitive (e.g., emotional, social, and psychological) reasons behind financial decisions.

Finance is the study of money and how it is used. Specifically, it deals with the questions of how an individual, company or government acquires the money needed—called capital in the company context—and how they then spend or invest that money. Finance is defined as the management of money and includes activities such as investing, borrowing, lending, budgeting, saving, and forecasting. There are three main types of finance: (1) personal, (2) corporate, and (3) public/government.

✓ Finance, the process of raising funds or capital for any kind of expenditure. Consumers, business firms, and governments often do not have the

funds available to make expenditures, pay their debts, or complete other transactions and must borrow or sell equity to obtain the money they need to conduct their operations. Savers and investors, on the other hand, accumulate funds which could earn interest or dividends if put to productive use. These savings may accumulate in the form of savings deposits, savings and loan shares, or pension and insurance claims; when loaned out at interest or invested in equity shares, they provide a source of investment funds. Finance is the process of channeling these funds in the form of credit, loans, or invested capital to those economic entities that most need them or can put them to the most productive use. The institutions that channel funds from savers to users are called financial intermediaries. They include commercial banks, savings banks, savings and loan associations, and such non-bank institutions as credit unions, insurance companies, pension funds, investment companies, and finance companies.

✓ Three broad areas in finance have developed specialized institutions, procedures, standards, and goals : business finance, personal finance, and public finance. In developed nations, an elaborate structure of financial markets and institutions exist to serve the needs of these areas jointly and separately.

✓ Business finance is a form of applied economics that uses the quantitative data provided by accounting, the tools of statistics, and economic theory in an effort to optimize the goals of a corporation or other business entity. The basic financial decisions involved include an estimate of future asset requirements and the optimum combination of funds needed to obtain those assets. Business financing makes use of short-term credit in the form of trade credit, bank loans, and commercial paper. Long-term funds are obtained by the sale of securities (stocks and bonds) to a variety of financial institutions and individuals through the operations of national and international capital markets.

✓ Personal finance deals primarily with family budgets, the investment of personal savings, and the use of consumer credit. Individuals typically obtain mortgages from commercial banks and savings and loan associations to purchase their homes, while financing for the purchase of consumer durable goods (automobiles, appliances) can be obtained from banks and finance companies. Charge accounts and credit cards are other important means by which banks and businesses extend short-term credit to consumers. If individuals need to consolidate their debts or borrow cash in an emergency, small cash loans can be obtained at banks, credit unions, or finance companies.

The level and importance of public, or government, finance has increased sharply in Western countries since the Great Depression of the 1930s. As a result, taxation, public expenditures, and the nature of the public debt now typically exert a much greater effect on a nation's economy than previously. Governments finance their expenditures through a number of different methods, by far the most important of which is taxes. Government budgets seldom balance, however, and in order to finance their deficits governments must borrow, which in turn creates public debt. Most public debt consists of marketable securities issued by a government, which must make specified payments at designated times to the holders of its securities.

In the context of institutions, finance is often split into the following major

categories : investment management, corporate finance, personal finance and public finance.

At the same time, *finance* is about the overall "system", i.e., the financial markets that allow the flow of money, via investments and other financial instruments, between and within these areas; this "flow" is facilitated by the financial services sector. A major focus within finance is thus investment management—called money management for individuals, and asset management for institutions—and finance then includes the associated activities of securities trading and stock broking, investment banking, financial engineering, and risk management.

More abstractly, *finance* is concerned with the investment and deployment of assets and liabilities over "space and time", i.e., it is about performing valuation and asset allocation today, based on risk and uncertainty of future outcomes, incorporating the time value of money (determining the present value of these future values, "discounting", requires a risk-appropriate discount rate). As an academic field, finance theory is studied and developed within the disciplines of management, (financial) economics, accountancy and applied mathematics. Correspondingly, given its wide application, there are several related professional qualifications, than can lead to the field. As the debate to whether finance is an art or a science is still open, there have been recent efforts to organize a list of unsolved problems in finance.

What is Corporate Finance?

Corporate finance is the division of finance that deals with how corporations deal with funding sources, capital structuring, and investment decisions. Corporate finance is primarily concerned with maximizing shareholder value through long and short-term financial planning and the implementation of various strategies. Corporate finance activities range from capital investment decisions to investment banking.

Corporate finance is the acquisition and allocation of a corporation's funds, or resources, with the objective of maximizing shareholder wealth (i.e., stock value). In the financial management of a corporation, funds are generated from various sources (i.e., from equities and liabilities) and are allocated (invested) for desirable assets.

Corporate finance is the area of finance that deals with providing money for businesses and the sources that provide them. These sources provide capital to corporations to pay for structural improvements, expansion, and other value-added projects and enterprises. Capital is a good that can be used now. For this lesson, it will primarily refer to money. The purpose of corporate finance is to maximize shareholder value. There are many methods that a corporation can utilize to maximize shareholder value.

Corporate finance refers to activities and transactions related to raising capital for the creation, development and acquisition of a business. It is directly related to company decisions which have financial or monetary impacts. It can be considered as a liaison between the capital market and the organisation. The corporate finance definition also encompasses effective resource utilisation and expenditure minimisation. Factors that contribute to its decision include term

requirements of the company, urgency, risk appetite, etc. Corporate finance deals with the capital structure of a corporation, including its funding and the actions that management takes to increase the value of the company. Corporate finance also includes the tools and analysis utilized to prioritize and distribute financial resources.

Corporate finance plays a vital role in every business. Irrespective of the size or type of business operations, every company seeks to streamline its corporate financing arm for optimum wealth distribution and return generation.

Corporate finance meaning thus extends to an array of financing and investment decisions that encompass four primary aspects, viz. :

- Planning finances
- Raising funds
- Investing
- Monitoring

The first function of corporate finance, resource acquisition, refers to the generation of funds from both internal and external sources at the lowest possible cost to the corporation. Two main categories of resources are equity (i.e., owners' equity) and liability. Examples of equity are proceeds from the sale of stock, returns from investments, and retained earnings. Liabilities include bank loans or other debt, accounts payable, product warranties, and other types of commitments from which an entity derives value.

Resource allocation, the second function of corporate finance, is the investment of funds with the intent of increasing shareholder wealth over time. Two basic categories of investments are current assets and fixed assets. Current assets include cash, inventory, and accounts receivable. Examples of fixed assets are buildings, real estate, and machinery. In addition, the resource allocation function is concerned with intangible assets such as goodwill, patents, workers, and brand names.

It is the job of a corporation's financial manager or managers to conduct both of the aforementioned functions in a manner that maximizes shareholder wealth, or stock price. Financial managers must balance the interests of owners, or shareholders; creditors, including banks and bondholders; and other parties, such as employees, suppliers, and customers. For example, a corporation may choose to invest its resources in risky ventures in an effort to offer its shareholders the potential for large profits. However, risky investments may reduce the perceived security of the company's bonds, thus decreasing their value in the bond market and increasing the rate of interest that the firm must pay to borrow money in the future. Conversely, if the corporation invests too conservatively, it could fail to maximize the value of its equity. If the firm performs better than other companies, its stock price will rise, in theory, enabling it to raise additional funds at a lower cost among other benefits.

A business undertakes such decisions to achieve pre-set financial goals while ensuring maximisation of shareholder value.

Scope of Corporate Finance

- (i) Investment decisions that include analysis of different investment

types to arrive at the best available alternative.

(ii) Financing decisions that extend to raising capital through different sources to restructure business finance.

(iii) Dividend decisions which include analysis of stockholders' returns basis amount and time.

(iv) Management of working capital for efficient day-to-day running of the business.

(v) Corporate financial services extending to the advisory role during M&As.

(vi) Development of financial strategies for policy implementations, which also reflect the working of advanced corporate finance.

Types of Corporate Finance

Corporate financing includes raising funds via either :

- Equity funds
- Debt funds.

The types of corporate finance also emphasise the difference between ownership and management, the basis for the development of strategies and procedures under this concept.

(i) **Owner's funds.**—Equity or ownership finance is strictly limited to raising capital for the owners of a company.

(ii) **Debt funds.**—Also known as external finance, debt funds come in multiple options like debentures, corporate loans, private financing, etc. While debentures can be issued to the general public for refinancing, institutional lenders are the primary source of private finance. They also charge commercial rates of interest on the lent amount. For example, a business has to pay a pre-determined interest to the lender as per the corporate loan interest rate if it opts for corporate finance.

Availing corporate finance in India is made easier by lenders like Bajaj Finserv offering a range of loans to help finance a business's capital. It includes unsecured business loans, SME and MSME loans, plant and machinery loans, etc.

Additional examples of corporate finance

Some other corporate finance examples which can help in raising capital include :—

- Issuing company bonds;
- Avail loans and advances from NBFCs;
- Opting for ROVs (Real Options Valuation).

Complete the planning to monitoring stages of corporate finance to make suitable decisions regarding raising capital and investing. Accordingly, analyse and implement refinancing and restructuring strategies that help maximise the business's returns.

The ultimate purpose of corporate finance is to maximize the value of a business through planning and implementation of resources, while balancing risk and profitability.

Important Activities that Govern Corporate Finance

Investments and Capital Budgeting

Investing and capital budgeting includes planning where to place the company's long-term capital assets in order to generate the highest risk-adjusted returns. This mainly consists of deciding whether or not to pursue an investment opportunity, and is accomplished through extensive financial analysis.

By using financial accounting tools, a company identifies capital expenditures, estimates cash flows from proposed capital projects, compares planned investments with projected income, and decides which projects to include in the capital budget.

Financial modeling is used to estimate the economic impact of an investment opportunity and compare alternative projects. An analyst will often use the Internal Rate of Return (IRR) in conjunction with Net Present Value (NPV) to compare projects and pick the optimal one.

Capital Financing

This core activity includes decisions on how to optimally finance the capital investments (discussed above) through the business' equity, debt, or a mix of both. Long-term funding for major capital expenditures or investments may be obtained from selling company stocks or issuing debt securities in the market through investment banks.

Balancing the two sources of funding (equity and debt) should be closely managed because having too much debt may increase the risk of default in repayment, while depending too heavily on equity may dilute earnings and value for original investors.

Ultimately, it's the job of corporate finance professionals to optimize the company's capital structure by lowering its Weighted Average Cost of Capital (WACC) as much as possible.

Divisions and Return of Capital

This activity requires corporate managers to decide whether to retain a business's excess earnings for future investments and operational requirements or to distribute the earnings to shareholders in the form of dividends or share buybacks.

Retained earnings that are not distributed back to shareholders may be used to fund a business' expansion. This can often be the best source of funds, as it does not incur additional debts nor dilute the value of equity by issuing more shares.

At the end of the day, if corporate managers believe they can earn a rate of return on a capital investment that's greater than the company's cost of capital, they should pursue it. Otherwise, they should return excess capital to shareholders via dividends or share buy-backs.

A company's capital structure is crucial to maximizing the value of the business. Its structure can be a combination of long-term and short-term debt and/or common and preferred equity. The ratio between a firm's liability and

its equity is often the basis for determining how well balanced or risky the company's capital financing is.

A company that is heavily funded by debt is considered to have a more aggressive capital structure and, therefore, potentially holds more risk for stakeholders. However, taking this risk is often the primary reason for a company's growth and success.

Capital Budgeting

One method is capital budgeting, which involves long-term planning for use of capital on corporate financial projects that affect the overall capital structure of the corporation. Managers and executives must select criteria for the funding of projects that will provide the best possibility of maximizing value for shareholders. When executives determine that there is no additional room for value growth, they are expected to payout through dividend policies or stock repurchase programs using the surplus of capital. This adds perceived value to the corporation because of its ability to payout extra cash to investors.

Capital Sources

A corporation has two primary capital sources for investment purposes. These include :

- Self-generation of capital (primarily through revenue streams);
- External capital funding sources (primarily through debt and equity capital).

As managers and executives consider their options, they must determine the optimum mix of capital funding in order to maximize value for the corporation. For example, self-generation of capital takes time and resources and the end product (free cash on hand) can be minimal. This would decrease shareholder value over time. If they consider debt capital, the debt becomes a liability on the balance sheet and affects cash flow. Equity capital is less risky than debt capital, but it dilutes the value of share ownership.