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Third Edition

Corporate Finance

Economic Foundations and Financial Modeling

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CORPORATE FINANCE

Economic Foundations and Financial Modeling

Third Edition

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FOREWORD

I am honored to introduce this second edition of *Corporate Finance: A Practical Approach*, which promises to be an important and comprehensive discourse on corporate financial management. The significant additions in this edition and revisions to the first edition build on the topic areas introduced in 2008. Furthermore, they bring much-needed practical dimensions to the complex and dynamic aspects of corporate finance.

Certainly, the global financial landscape has changed dramatically since the release of the first edition of this work. The economic drama and financial carnage injected into the marketplace starting in late 2007 have penetrated the very core of financial thought and practice and have challenged long-standing economic beliefs and relationships. The effects on corporate governance, capital structure, and budgeting caused by this extreme market volatility and economic upheaval have moved corporate treasurers and chief financial officers to the front lines in their companies' continuing pursuits of profitability and financial security. Only those institutions that can quickly adapt their financial management and corporate structure to this "new normal" will survive well into the future. The chapters in this edition have been revised to take into consideration some of the profound changes that have affected this new global financial setting. Yet, it is refreshing to note that no matter what economic environment exists in the future, sound, traditional financial management practices will always be essential to the long-term success of any entity.

The authors of these chapters are leading industry practitioners and recognized academic thought leaders. Their unique perspectives and thorough understanding of their respective topic areas are invaluable in providing readers with a factual exposition of the subject matter. In addition, their commonsense approach of highlighting important learning outcomes and incorporating practical problem-solving tools gives readers techniques they can apply in real-world financial settings.

Like the original text, this edition is assembled from readings used in the CFA Program curriculum. The CFA Program is a comprehensive, self-directed, distance learning program administered by CFA Institute. Since the early 1960s, the attainment of the CFA designation has been viewed as a significant achievement in the realm of finance and investment management. Those who enter the CFA Program sit for three consecutive and rigorous examinations that cover a broad range of important financial topics, including accounting, quantitative methods, equity and fixed-income analysis, portfolio management, and ethics. Most who enter this program already possess a strong record of achievement in the financial industry, as well as advanced business degrees, but welcome the additional focus and comprehensive curriculum of this designation program. I am fortunate to have earned the CFA charter and am proud to serve on the Board of Governors of CFA Institute.

WHY THIS TEXT IS IMPORTANT

Competing in the global financial arena has been a far more daunting challenge during this decade than in earlier periods. The scarcity of credit and risk capital following the global financial challenges of the past few years, along with the evolution of emerging economies as formidable players on the world financial stage, demands that businesses operate at utmost efficiency. Optimal financial management and peak operating effectiveness are prerequisites not only for success but also for survival. And in order to successfully commit risk capital, companies must incorporate disciplined, systematic capital-budgeting techniques so as to allocate capital to only those projects with optimal returns. Furthermore, companies must be able to understand the life spans of projects, effectively anticipate cash flow needs, and accurately forecast lean periods in their liquidity to avoid potentially devastating shocks to their financial and market health. Also critical in this new financial environment is the ability to properly analyze the effects of inflation, disinflation, foreign currency shocks, and regulatory risk on existing projects, as well as the ability to recognize capital-budgeting biases and errors. This book offers comprehensive insights into avoiding these common pitfalls.

In particular, the chapter on capital budgeting is instrumental in instilling in the reader the discipline to anticipate extraneous influences on capital planning. Another critical section of the book concerns forecasting and evaluating the weighted average cost of capital that an entity faces. Recent as well as long-term financial history has taught everyone the importance of properly analyzing this crucial financial component. The degree of assumed leverage, tax benefits and implications of using debt over other forms of capitalization, the cost of debt versus common and preferred equity, and the impact of changes in debt ratings—all are essential areas of knowledge for company leaders. The ability to use the cost of capital as an effective discipline in organizational budgeting is yet another key component of continued financial stability.

In addition to the tools and techniques for measuring the cost of capital, the appropriate use of financial leverage is an important topic in this text. Clearly, increased leverage heightens the level of earnings volatility and, ultimately, the cost of equity and the overall risk attached to any company. Properly understanding the prudent use of financial leverage as an earnings-enhancement vehicle is essential. Furthermore, examining the degree of operating leverage and the impact of cost structure on production is a vital component of measuring and evaluating the operating efficiency of any organization. And last but not least, an incredibly large part of ultimately determining the financial competitiveness of a company is successfully anticipating and accounting for the effect of taxes.

A key element of attracting investors and maintaining adequate sources of capital is fully understanding how an entity manages its own equity in the context of dividends and share repurchases. In addition, I cannot overstate the advantages of having a technical grasp of the effects on financial statements of altering dividend policy or engaging in share buybacks or secondary offerings, nor can I overemphasize the commensurate impacts on a company’s effective cost of capital and overall financial flexibility. In this environment of heightened investor focus on liquidity and financial health, effective working capital management is a necessity. The text walks the reader through the important steps in successfully monitoring an optimal cash balance, contains a primer on short-term investment instruments, and delves into accounts receivable and inventory management. It also examines the benefits of short-term borrowing versus cash disbursements and other accounts payable strategies.

Finally, the critical steps in a merger and acquisition strategy are defined and analyzed. This segment of the text highlights the effects of the successful use of these approaches on firm competitiveness, scale, and market power and addresses the potential pitfalls of integration and cost management. Finally, this section examines the impact of taxes and regulatory challenges on a potentially successful business combination tactic, as well as discussing when an acquisition posture makes sense.

WHAT HAS CHANGED SINCE THE FIRST EDITION

This second edition provides the reader with comprehensive updates on all topics, especially where new techniques or technologies have emerged, and gears the learning outcomes, descriptions, and end-of-chapter exercises to the new economic realities of this decade. The sections on dividend policy, share repurchases, and capital structure have also been revised and reconstructed. These chapters contain significantly new content as well as updated exercises.

No book can provide a practitioner or student with a no-fail recipe for comprehensive success in financial management, and most entities have discovered that challenges and impacts generally appear from unexpected sources and directions. The authors have tried to create a substantial taxonomy of corporate financial topics with real-world, commonsense applications as well as rigorous problems and exercises that allow readers to test their comprehension of the subjects covered.

This book will become an important resource for a wide array of individuals. Some may ask whether the intricacies of capital budgeting, corporate liquidity, and dividend policy are of interest to a cross section of practitioners, but as many have discovered over the past five years, ignoring the key building blocks of an optimal corporate financial structure and a lean, competitive, and well-capitalized organization can be perilous. Today's corporate landscape, with all its volatility and high barriers to entry, requires that most members of a corporate entity be well schooled in the fundamentals of financial management. Organizations today must deal with formidable foreign competition, an older workforce, and significant capital investments in order to achieve critical scale. A sound understanding of the capital management techniques needed to maintain competitiveness and innovation is a necessity. Students will use this book either as a resource to gain a broad understanding of corporate financial practice or as a useful reference tool for quickly comprehending specific areas of the financial domain.

The long-term performance of all organizations is based on sound decision making by their constituents, whose decisions have wide-ranging implications for the future soundness of their companies. I hope this book will prove to be a valuable resource for present and future members of these organizations.

Matthew Scanlan, CFA
President and CEO
Renaissance Institutional Management LLC
CFA Institute Board of Governors

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We would like to thank the many individuals who played important roles in producing this book.

The standards and orientation of the second edition are a continuation of those set for the first edition. Robert R. Johnson, CFA, former senior managing director of CFA Institute, supported the creation of custom curriculum readings in this area and their revision. Dennis W. McLeavey, CFA, initiated the project during his term as head of Curriculum Development. Christopher B. Wiese, CFA, oversaw final organization, writing, and editing of the first edition for the CFA curriculum.

First edition manuscript reviewers were Jean-Francois Bureau, CFA, Sean D. Carr, Rosita P. Chang, CFA, Jacques R. Gagné, CFA, Gene C. Lai, Asjeet S. Lamba, CFA, Piman Limpaphayom, CFA, and Zhiyi Song, CFA. Chapter authors Pamela P. Drake, CFA, and John D. Stowe, CFA, provided notable assistance at critical junctures. We thank all of the above for their excellent and detailed work.

For this second edition, Gregory Noronha, CFA, was added to the author lineup. Second edition manuscript reviewers were Evan Ashcraft, CFA, David K. Chan, CFA, Lee Dunham, CFA, Philip Fanara, CFA, Usman Hayat, CFA, William Jacobson, CFA, Frank Laatsch, CFA, Murli Rajan, CFA, Knut Reinertz, CFA, Sanjiv Sabherwal, Sandeep Singh, CFA, Frank Smudde, CFA, and Peter Stimes, CFA.