

Lecture 10  
**Corporate Financing**  
Chapter 13



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**Topics Covered**

- ▶ Creating Value with Financing Decisions
- ▶ Common Stock
- ▶ Preferred Stock
- ▶ Corporate Debt
- ▶ Convertible Securities
- ▶ Patterns of Corporate Financing



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**Creating Value with Financing Decisions**

- ▶ Competition in financial markets is more intense than in most product markets.
- ▶ Firms should assume that securities they issue sell for their true values (prices that incorporate all information currently available to investors - Market Efficiency).
- ▶ Sale of securities at their market price can never be a positive-NPV transaction.
- ▶ “There are no free lunches on Wall Street ...”



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### Types of Securities

- ▶ **Equity**
  - Common stock
  - Preferred stock
- ▶ **Debt**
  - Commercial paper
  - Debentures
  - Guaranteed notes
  - Remarketable debt
  - Euro notes
  - Sterling notes
  - New Zealand dollar notes
  - Bank loans

4

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### Common Stock

**Treasury Stock**  
Stock that has been repurchased by the company and held in its treasury

**Issued Shares**  
Shares that have been issued by the company

**Outstanding Shares**  
Shares that have been issued by the company and are held by investors

5

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### Common Stock (Contd)

**Authorized Share Capital**  
Maximum number of shares that the company is permitted to issue without getting approval of current shareholders, as specified in the firm's articles of incorporation

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**Par Value**  
Value of security shown on certificate and company's accounts

**Retained Earnings**  
Earnings not paid out as dividends

6

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### Common Stock

**Additional paid-in capital (Capital surplus)**  
 Difference between issue price and par value of stock

**Book Value of Common Equity (Net Common Equity)**  
 Par value + Additional paid-in capital + Retained Earnings - Repurchased stock at cost - Adjustments

7

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### Common Stock (Contd)

**Book Value vs. Market Value**

- ▶ Book value is a backward looking measure. It tells us how much capital the firm has raised from shareholders in the past. It does not measure the value that shareholders place on those shares today.
- ▶ The market value of the firm is forward looking, it depends on the future dividends that shareholders expect to receive.

8

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### Common Stock (Contd)

**Example - H.J. Heinz Book Value vs. Market Value (4/2004)**

Total Shares outstanding = 352 million

Common Shares (\$.25 par)	108
Additional paid in capital	403
Retained earnings	4,857
Treasury shares at cost	-2,928
Other	-546
Net common equity (Book Value)	1,894

9

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### Common Stock (Contd)

**Example – H.J. Heinz Book Value vs. Market Value (4/2004)**

Total Shares outstanding = 352 million

April 2004 Market price =	\$38/sh
# of shares	x 352
Market Value	\$13.376 billion

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### Common Stock (Contd)

Corporate Equity Holdings

Category	Percentage
Households	40%
Mutual Funds	22%
Pension Funds	17%
Insurance Companies	7%
Rest of World	11%
Banks & Savings	2%
Other	1%

Figure 13-1: Holdings of corporate equities, 1<sup>st</sup> quarter 2005

11

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### Preferred Stock

- ▶ **Preferred Stock** – Stock that takes priority over common stock in regard to dividends.
- ▶ **Net Worth** – Book value of common shareholder’s equity plus preferred stock.
- ▶ Preferred stock rarely confers full voting privileges -> an advantage to firms that want to raise new money without sharing control of the firm with new shareholders.

12

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### Preferred Stock (Contd)

- ▶ Market price of preferred stock that pays a fixed dividend goes up and down as interest rates change.
- ▶ **Floating-Rate Preferred** – Preferred stock paying dividends that vary with short-term interest rates → its value is protected.

13

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### Corporate Debt

- ▶ **Default Risk** – is the term used to describe the likelihood that a firm will walk away from its obligation.
- ▶ **Bond Ratings** – are issued on debt instruments to help investors assess the default risk of a firm.

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### Corporate Debt (Contd)

- ▶ **Prime Rate** – Benchmark interest rate charged by banks to large customers with good to excellent credit.
- ▶ **Funded Debt** – Debt with more than 1 year remaining to maturity >< Unfunded debt (current liability).
- ▶ **Sinking Fund** – Fund established to retire debt before maturity.

15

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**Corporate Debt (Contd)**

- ▶ **Callable Bond** – Bond that may be repurchased by firm before maturity at specified call price >< “Straight” or noncallable bond.  
If interest rate falls, company wants to buy the bonds back and issues new bonds at new low interest rate. Price of callable bond increases as interest rate falls but will not rise above the call price.

16

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**Corporate Debt (Contd)**

- ▶ **Subordinated Debt** – Debt that may be repaid in bankruptcy only after senior debt is repaid.
- ▶ **Secured Debt** – Debt that has first claim on specified collateral in the event of default.
- ▶ **Investment Grade** – Bonds rated Baa or above by Moody’s, or BBB or above by S&P.
- ▶ **Speculative-grade (“Junk”) Bond** – Bonds with a rating below Baa or BBB.

17

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**Corporate Debt (Contd)**

- ▶ **Eurodollars** – Dollars held on deposit in a bank outside the United States.
- ▶ **Eurobond** – Bond that is marketed internationally, may be denominated in dollars, yen, or any other currency.
- ▶ **Private Placement** – Sale of securities to a limited number of investors without a public offering.

18

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**Corporate Debt (Contd)**

- ▶ **Protective Covenants** – Restriction on a firm to protect bondholders. *E.g. restrict amount of extra debt that firm can issue, do not allow firm to create new debt that is senior to them or to put aside assets for other lenders, limit the size of dividends that can be paid.*
- ▶ **Lease** – Long-term rental agreement, shown on company's balance sheet as a liability.

19

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**Corporate Debt (Contd)**

- ▶ **Indexed Bonds** – Borrowers link payments on their bonds to the price of a particular commodity.
- ▶ *E.g. Oil producer issued billions of dollars worth of bonds that provide an extra payoff if oil prices rise. Insurance company issued bonds with varying interest payments (payments on bonds are reduced if there is a hailstorm that damages at least 6,000 cars that have been insured by the company).*

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**Corporate Debt (Contd)**

- ▶ **Asset-Backed Bonds** – Borrower sets aside a group of assets and income from these assets is then used to service the debt.
- ▶ *E.g. House mortgages and credit card loans are packaged and resold as asset-backed bonds.*

21

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### Convertible Securities

- ▶ **Warrant** – Right to buy shares from a company at a stipulated price before a set date.
- ▶ **Convertible Bond** – Bond that the holder may exchange for a specified amount of another security.

Convertibles are a combined security, consisting of both a bond and a call option. Thus, a convertible bond sells at a higher price than a comparable bond that is not convertible.

22

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### Convertible Securities (Contd)

- ▶ **Convertible Preferred Stock** – Investor receives fixed dividend payments and has the option to exchange this preferred stock for common stock.

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### Patterns of Corporate Financing

- ▶ Firms may raise funds from external sources, or plow back profits (rather than distribute them to shareholders) so long as it goes to positive-NPV investments.
- ▶ Should a firm elect external financing, they may choose between debt or equity sources.

24

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### Patterns of Corporate Financing (Contd)

- ▶ **Internally generated funds** – Cash reinvested in the firm = depreciation + earnings not paid out as dividends.
- ▶ If firms rely on internal funds, they avoid costs of issuing new securities. The announcement of a new equity issue is usually bad news for investors, who worry that management may be trying to sell overpriced stock.

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### Patterns of Corporate Financing (Contd)

- ▶ **Financial Deficit** – Difference between the cash companies need and the amount generated internally.  
To make up the deficit, companies must either sell new equity or borrow.

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### Patterns of Corporate Financing (Contd)

- ▶ High debt ratios mean that more company are likely to fall into financial distress when a serious recession hits the economy.
- ▶ Low debt ratio is not always better, because debt has both risks and benefits.
- ▶ Financial managers need to find the optimal debt ratio.

27

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END OF LECTURE

THANKS FOR YOUR ATTENTION!



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