MN50324 Corporate Finance

Revision Lecture

Course Structure

- Investment Appraisal => Real Options
- Capital Structure
- Payout policy: dividends/share repurchases
- Venture Capital
- Behavioural Corporate Finance

Skills Required:-

- Conceptual (essays): lecture notes/ articles/text book

- Analytical (numerical/game theoretical)

Conceptual

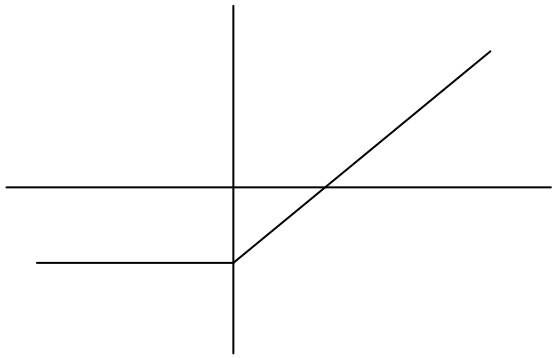
- Essay structure:
- Good relevant introduction setting the scene for the forthcoming essay
- Main body of essay:-
- => theories covered in the course: including intuition for the models, diagrams, key equations (??)
- => any practical/empirical examples
- => conclusion.

Essay

- Quality, not quantity
- Focussed/relevant
- Including ALL the ingredients on the previous slide.
- Half a page of A4 not usually sufficient
- Essays full of opinions not sufficient.
- Typically good essay: 4+ sides of A4 (depending on writing size!)

Real Options

- Standard NPV is now-or-never decision
- Real Option approach: recognises flexibility
- => “Now-or-later”
- Option to delay, option to abandon, option to expand.
- Option Diagrams



Real options (continued)

- Talk about pricing of options
- RO value-added = static NPV + option value
- Effect of risk?
- Option to expand: R and D
- Effects of competition: (Smit and Ankum, Smit and Trigeorgis)
- Use of game theory to analyss (show normal form game/ game tree)
- Trade-off between delaying to add value, and protecting competitive advantage (equation)
- Behavioural: refusal to abandon? (Statman and Caldwell)

Capital Structure

- Introduction (relevant to the question!)
- Theories:
- Modigliani-Miller (equations? Diagrams.)
- => perfect market assumptions.
- Tax
- Agency problems: Jensen and Meckling
- Jensen FCF, other papers: disciplining role of debt
- => trade-off model

Capital Structure (continued)

- Asymmetric Information
- Ross: signalling with debt (good signal): mgrl (justified) confidence, and debt bankruptcy threat.
- Myers-Majluf: equity and signalling (bad signal): mgr has inside information on future ‘news’ of firm.
- => Pecking order theory (RE/Debt/equity)

Capital Structure (continued)

- Practical methods:
- Survey work (Graham and Harvey): trade-off versus pecking order.
- Life-cycle model
- Benchmarking (irrational/herding?)
- Trade-off versus pecking order (China: reverse pecking order?)
- Case? Eg BT (Fairchild 2003): Debt ↑ credit rating ↓
- Behavioural: OC => more (value-reducing?) debt. Eg BT?

Dividend Policy

- Introduction (relevant)
- Miller Modigliani dividend irrelevance:
- Cap gains plus dividends
- Source and application of funds argument
- Home-made dividends
- Perfect mkt assumptions
- Lintner's (1956) survey: dividend smoothing…
- Gordon Growth model: real trade-off between paying dividends and investing for growth.
- Agency problems: Jensen's free cash flow (1986), Easterbrook (1984)

Dividend Policy (continued)

- Signalling/asymmetric info
- Miller and Rock: high divs signal high cashflow/good firm => can afford high dividend
- But: Div cuts not always bad news: lots of good opportunities available (Wooldridge and Ghosh paper => ITT and Gould)

Dividend Policy (continued)

- Free cashflow versus siganlling hypothesis
- Fuller and Thakor: both hypotheses: high divs good (only -ve NPV project available)
- Fairchild: positive NPV project available.
- Conflicting hypotheses.
- Behavioural aspect: investors conditioned to think high divs are good.
- Cut divs => communication/reputation important
- 6 roundtable discussions of CF.

Game theory

- Solving a game by backward induction:
- Example:
- VC equity-negotiation/effort game.
- Take equity stakes as given:
- Solve for optimal effort given those equity stakes
- Move back to solve for VC's optimal equity offer.
- What about if the VC can then force renegotiation after the players have exerted effort? We will talk about this next week!!!