Corporate Finance

Module Introduction and Overview

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1 Introduction to the Module

In this module you will study the main issues in modern corporate finance. The subject 'corporate finance' is a well-established discipline, which is concerned with corporations large enough to have issued shares that are 'quoted' on a stock market. We must, though, first clarify what we mean by the *main* issues, for the issues that are important to one person may be viewed as less important by others.

The financial manager of a large company, for example, faces a different set of financial problems compared to the owner of a small business. And a stock market dealer and financial theorist will also be interested in different issues in corporate finance, and these will not necessarily be the same issues that concern the financial manager. The first unit will examine the important issues from these differing perspectives, and conflicts between their specific interests will form the background to the theories considered throughout the module.

Methods used for making capital budgeting decisions will first be presented in Unit 2, which will focus on capital budgeting decisions 'under certainty'. You will learn there how to identify the cash flows associated with an investment project and how to use them to evaluate investments using the net present value (NPV) method. You will also learn to analyse other investment criteria and compare them with the NPV approach in this unit.

Unit 3 will then complement Unit 2 by providing an analysis of the equilibrium relationship between risk and return, which leads to the determination of the appropriate discount rates to be used when evaluating the NPV of risky investment projects – those where cash flows are uncertain. You will also study the Capital Asset Pricing Model (CAPM) in this unit.

Unit 4 deals with the efficiency of financial markets and its implications for long-term corporate financing decisions. The amount of financial resources that a company gets for every bond or equity issued in the primary market depends on the price at which these securities are sold when first issued, and that price is determined by the market. It is for this reason, as you will learn through studying this unit, that the efficiency of capital markets has implications for corporate financing decisions. The unit also introduces the theme of behavioural finance, which may be used to explain departures from market efficiency.

The effect of dividend policy on share values is explored in Unit 5. The principal model studied there is the dividend irrelevance proposition of Modigliani and Miller. You will also learn about the role of asymmetric information and the signalling hypothesis, and you will examine theories relating dividends to the conflict of interest between managers and shareholders. Ways in which variations in dividend policy are affected by the country's legal system are also considered in Unit 5.

In Unit 6, you will first study the debt-equity irrelevance theorem, which is the starting point of all analyses of corporations' choice of debt-equity ratio.

As you do so, you will examine the capital structure question, looking at the weighted average cost of capital, the cost of equity in a levered firm, corporate and personal taxes and bankruptcy costs. You will also be introduced to the reasoning behind the arbitrage pricing proof of Modigliani–Miller's first proposition, which is of great importance to corporate finance theory.

Unit 7 examines the capital structure question by relaxing some of the assumptions of the Modigliani–Miller irrelevance proposition. In studying this unit, you will learn to analyse the impact of information asymmetry on the financing decisions of firms. You will also learn to analyse the agency costs of equity and debt and their implications for a firm's capital structure.

In Unit 8 you will study takeovers in detail. In studying that unit, you will consider the rationale and pricing of mergers. You will explore the main empirical facts that dominate the debate on mergers, examine evidence on the sources of gain from mergers, and analyse agency cost theory and free cash flow. You will also undertake a critical analysis of changes in corporate governance and takeover waves.

2 The Module Authors

Bassam Fattouh graduated in Economics from the American University of Beirut in 1995. Following this, he obtained his Masters degree and PhD from the School of Oriental and African Studies, University of London, in 1999. He is a Reader in Finance and Management and academic director for the MSc in International Management for the Middle East and North Africa at the Department for Financial and Management Studies, SOAS. He is also currently Senior Research Fellow and Director of the Oil and Middle East Programme at the Oxford Institute for Energy Studies at the University of Oxford. He has published in leading economic journals, including the *Journal of Development Economics, Economics Letters, Economic Inquiry, Macroeconomic Dynamics* and *Empirical Economics*. His research interests are mainly in the areas of finance and growth, capital structure and applied non-linear econometric modelling, as well as oil pricing systems.

Luca Deidda completed his doctoral studies in 1999, while he was a lecturer in the Department of Economics at Queen Mary and Westfield College, University of London. He joined the Centre for Financial and Management Studies at SOAS in that same year, as lecturer in financial studies. His research focuses on financial and economic development, markets under asymmetric information and welfare effects of financial development. He is currently working at the Università di Sassari, Sardinia.

3 Study Materials

This study guide is your central learning resource as it structures your learning, unit by unit. Each of the eight units should be studied within a week. The module is designed in the expectation that studying the unit text and the associated core readings will require 15 to 20 hours each week, although this will vary according to your familiarity with the unit subject matter and your own study experience.

Key text

You will be have access to the following key text for this module:

Hillier D, S Ross, R Westerfield, J Jaffe and B Jordan (2016) *Corporate Finance*. 3rd European Edition. Maidenhead UK, McGraw-Hill Education.

This is a comprehensive and useful text, with challenging questions at the end of each chapter, which you should find helpful. There is also a companion website, available from:
http://highered.mheducation.com/sites/0077173635/student_view0/index.html

From this Student Edition website you can access case studies, appendices, some useful formulas and videos.

You will be directed in the study guide when to read from Hillier, Ross, Westerfield, Jaffe and Jordan.

Throughout the units in this module you will be directed to exercises in your key text. Where appropriate, answers will be available on the VLE.

Module readings

We also provide you with access to academic articles and other reports and material that are assigned as core readings in the study guide. You are expected to read them as an essential part of the module.

Excel worksheets

To reinforce your understanding of the worked examples of quantitative calculations in the text, we provide these in the form of Excel worksheets to be downloaded from the VLE. This will enable you to carry out further tasks we specify for you, to see for yourself how the calculations are affected. Please note that these are not 'self test' questions as such and therefore the workbooks do not carry 'solutions' to the exercises.

Virtual Learning Environment

Some of the academic articles and other reports and material that are assigned as core readings are available as part of the VLE Library resources and through the University of London Online Library. Some will require you to have an Athens username and password. You can obtain this from the University of London Online Library.

4 Module Overview

Unit 1 Perspectives on Corporate Finance

1.1 Introduction
1.2 Core Theories of Corporate Finance
1.3 Key Questions in Corporate Finance
1.4 The Objective of the Firm
1.5 Agency Problems
1.6 Conflict between Shareholders and Bondholders
1.7 Conclusion

Unit 2 Net Present Value and Capital Budgeting Decisions

2.1 Introduction to Capital Budgeting Decisions
2.2 Investment Principles and Net Present Value
2.3 Capital Budgeting Decisions
2.4 Analysing a Project – A Mini Case
2.5 Sensitivity and Scenario Analysis

Unit 3 Return, Risk, Portfolio and Asset Pricing Models

3.1 Introduction
3.2 Expected Return and Risk
3.3 How is the Equilibrium Return on Risky Assets Determined? The Capital Asset Pricing Model
3.4 A More General Model – Arbitrage Pricing Theory (APT)
3.5 Conclusion

Unit 4 Issues in Modern Finance: the CAPM, Efficient Market Hypothesis and Behaviour Finance

4.1 Introduction
4.2 The Use of CAPM for Calculating the Cost of Capital for Risky Projects
4.3 Efficient Capital Markets
4.4 Weak, Semi-strong and Strong Forms of Efficiency
4.5 Anomalies – Are they Meant to be Extinct?
4.6 Implications for Corporate Financing Decisions
4.7 Conclusion

Unit 5 Dividend Policy

5.1 Introduction
5.2 Empirical Evidence on Dividend Policy
5.3 The Irrelevance of Dividend Policy
5.4 Taxes Can Make Dividend Policy Matter
5.5 Asymmetric Information and Signalling
5.6 Dividend Policy and Agency Costs
5.7 Conclusion

Unit 6 Capital Structure I

6.1 Introduction – How Much Debt Should the Firm Issue?
6.2 The Debt-Equity Irrelevance Theorem

5 Learning Outcomes

When you have completed your study of this module you will be able to:

- describe modern principles of corporate finance and evaluate their validity
- rationalise corporate finance decisions in the light of agency problems and conflict of interest among corporations' stakeholders
- analyse firms' investment decisions
- discuss firms' choice of capital structure and its implications for the value of the firm
- examine and discuss the key issues related to dividend policy and their implications for the value of the firm
- critically assess the reasons behind mergers and acquisitions and their welfare implications.