Financing Decisions

BMA Ch 14

• Financing Math and NPV
• Financing and Investment Decisions Compared
• Financial Market Efficiency
• Six Lessons of Market Efficiency
Ex: Guaranteed (Subsidized) Student Loan

The government facilitates your borrowing $100,000 at below market rates to finance your masters degree.

Term: 10 years
Rate: 3%, with annual interest payments
Repayment: on maturity (no amortization)

What is the value of the subsidized loan, if alternative (market rate) financing costs 10%?

\[ \text{NPV} = \text{amount borrowed} - \text{PV of interest pmts} - \text{PV of loan repayment} \]
Financing and Investment Decisions Compared

• Optimization of right side of B.S.
  – Financing decisions easier because of efficient capital markets
  – Efficient capital markets imply zero NPV transactions
  – Financing decisions can be reversed easily

• Searching for capital market inefficiencies
  – Information asymmetry
  – Transactions costs
  – Taxes
  – Other subsidies
Financial Market Efficiency
Random Walk Theory

• The movements of stock prices from day to day DO NOT reflect any pattern
• Statistically speaking, the movement of stock prices is random (*skewed positive over the long term*).
Financial Market Efficiency
Random Walk Theory

S&P Composite
(correlation = -.07)

Source: Undetermined
Financial Market Efficiency

• Weak Form Efficiency
  – Market prices reflect all historical information

• Semi-Strong Form Efficiency
  – Market prices reflect all publicly available information

• Strong Form Efficiency
  – Market prices reflect all information, both public and private
Lessons of Market Efficiency

-produce

Markets have no memory
Trust market prices
Read the entrails
There are no financial illusions
The do it yourself alternative
Seen one stock, seen them all
Corporate Financing Overview

- Patterns of Corporate Financing
  - Equity
  - Debt
- Financial Markets
- Financial Institutions
Patterns of Corporate Financing

• Internal sources
  – Profits from operations, net of dividends
  – Retained Earnings = Profits – Dividends

• External sources
  – Equity – stock sales
  – Debt – other people’s money
Patterns of Corporate Financing

Year

Internal Funds
New Equity
New Debt
# Consolidated Balance Sheet

**Merck & Co., Inc. and Subsidiaries**  
**December 31**  
**IS in millions**

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Source: Undetermined
Financial Markets

Diagram:
- Money
  - Primary Markets
  - Secondary Markets
  - OTC Markets
Financial Institutions

Company

Intermediaries

Banks
Insurance Cos.
Brokerage Firms

Obligations
Funds
Financial Institutions

Intermediaries

Obligations

Funds

Investors

Depositors

Policyholders

Investors
Debt

• Patterns of Corporate Financing
• Characteristics of Debt
  – Maturity
  – Repayment Provisions
  – Seniority
  – Flexibility
  – Security
  – Fixed v. Floating Rates
  – Cost
  – Risk to Lender
• Selecting a Debt Instrument
• Debt Market Processes
• Other Debt Terminology
• Debt Ownership Distribution
# Patterns of Corporate Financing

## Consolidated Balance Sheet

**Merck & Co., Inc. and Subsidiaries**

**December 31**

**IS in millions**

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Characteristics of Debt Maturity

• Short term (T<1 yr)
  – Non-interest bearing
  – Interest bearing
    • Bank Loan
    • Bank credit agreement
    • Commercial paper
  – To finance current assets
• Intermediate term (1 yr<T<10 yrs)
  – Often available in pools
  – Variable rates
  – To finance equipment
Characteristics of Debt
Maturity

• Long term (T>10 yrs)
  – Conventional mortgage
  – Public bonds
  – Private placement
  – For permanent financing
    • Building
    • Other long term assets
Characteristics of Debt Repayment Provisions

- Level payment amortization on single note
- Balloon payment
  - Interest-only loans
  - Other funky opportunities
- Bond Series
  - See Revenue Bond description (later)
Characteristics of Debt
Seniority

• Place in cash flow queue
  – Senior debt
  – Subordinated debt

• Pecking order for cash - expanded
  – Employees
  – Utilities
  – Government
  – Critical vendors
  – Senior debt
  – Subordinated debt
  – Other vendors
  – Preferred stockholders
  – Common stockholders
Characteristics of Debt

Flexibility of Contract

• Call option – repay early (option to buy)
• Asset maintenance
• Additional parity indebtedness
• Restrictions on leasing
• Required reserves - debt service reserve fund
• Operating requirements
  – Debt service coverage ratio
  – Other financial ratios
Characteristics of Debt

Other

• Security - what pledged to lenders
  – mortgage
  – unsecured

• Fixed v. floating rates

• Cost - effective interest rate
  – IRR
Characteristics of Debt
Risks to Lenders

• “Default Risk” is the term used to describe the likelihood that a firm will walk away from its obligation, either voluntarily or involuntarily.

• “Bond Ratings” are issued on debt instruments to help investors assess the default risk of a firm.
  – Investment Grade
    • Moody’s: Baa or above
    • S&P: BBB or above
  – Speculative Grade (Junk)
    • Lower than Baa or BBB
Characteristics of Debt
Risks to Lenders

• Interest rate risk
  – Prevailing rates can rise
    • Firm-specific causes
    • General market causes
      – Inflation
      – Federal Reserve Board action
    • Bond prices fall

• Compensation for risk
  – Higher interest rate (risk premium)
  – Security pledge
  – Covenants and other restrictions on management
Selecting a Debt Instrument

Criteria

• True borrowing cost
  – Effective interest rate

• Payback period (term) compared to period financing needed

• Flexibility of contract terms
Debt Market Processes

• See NFP Revenue Bond description
Other Debt Terminology

• Prime Rate - Benchmark interest rate charged by banks to best credit risks
• Funded Debt - Debt with more than 1 year remaining to maturity
• Sinking Fund - Fund established to retire debt before maturity
• Private Placement - Sale of securities to a limited number of investors without a public offering
• Convertible Bond - Bond that the holder may exchange for a specified amount of another security

- Pension Funds: 26.6%
- Insurance Companies: 10.3%
- Households: 14.3%
- Rest of World: 18.9%
- Mutual Funds, etc.: 11.7%
- Banks: 9.0%
- Other: 9.1%

Percent of Holdings
Equity

- Patterns of Corporate Financing
- Equity on Balance Sheet
- Common Stock
- Preferred Stock
- Equity Ownership Distribution
- Ownership Sequence
- Other Equity Terminology
# Patterns of Corporate Financing

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Equity on the Balance Sheet

- Common stock at par
- Additional paid-in capital
- Retained earnings
- Preferred stock
- Book Value v. Market Value
## Equity on the Balance Sheet
**Merck, December 31, 2004**

### Book Value

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<th>Description</th>
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<td>Par $.01</td>
<td>$ 29.8 M</td>
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### Market Value

- (2.976 – 0.768) = 2.208 B shares
- Price per share $46
- Total Market Value $101,568 M
Common Stock

• Share in ownership of firm
  – Vote in affairs of firm
  – Receive dividends – last claim on cash flows

• Value
  – Book Value
    • capital the firm has raised from shareholders in the past over history of firm
  – Market Value
    • depends on the future dividends (and share price appreciation) that shareholders expect to receive
Preferred Stock

• Fixed dividends
• Priority in dividend payment over common stock
• No voting rights
• Quasi-debt
• Net Worth - Book value of common shareholder’s equity plus preferred stock
Equity Ownership Distribution
Holdings of Corp Equities (2004)

- Households: 36.8%
- Pension Funds: 21.1%
- Mutual Funds, etc.: 21.0%
- Insurance Companies: 7.4%
- Other: 3.2%
- Rest of World: 10.4%

Percent of Holdings
Ownership Sequence

- Founders
- Venture Capitalists
- Public
# Ownership Sequence
## From Founders to VCs

### First Stage Market Value Balance Sheet ($mil)

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<th>Liabilities and Equity</th>
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<td>Cash from new equity</td>
<td>New equity from venture capital</td>
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<td>Other assets</td>
<td>Your original equity</td>
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<td>Value</td>
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Ownership Sequence
Additional VC Financing

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<th>Second Stage Market Value</th>
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<td>4.0</td>
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<td>Fixed assets</td>
<td>1.0</td>
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<td>9.0</td>
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<td><strong>Value</strong></td>
<td>14.0</td>
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Ownership Sequence
Initial Public Offering

• Initial Public Offering (IPO) - First offering of stock to the general public
• Underwriter - Firm that buys an issue of securities from a company and resells it to the public
• Spread - Difference between public offer price and price paid by underwriter
• Public offer price depends on
  – Firm’s future earning potential
  – Number of shares
  – Percentage of firm going into hands of public
• Prospectus - Formal summary that provides information on an issue of securities
• Successful IPO
  – Market value of shares is established
  – Founders get rich
  – Firm is underway
Ownership Sequence
U.S. Venture Capital Investments

$ Million

0  20  40  60  80  100  120


Ownership amounts for each year:
- 1993: $3.7 Million
- 1994: $4.2 Million
- 1995: $7.6 Million
- 1996: $11.5 Million
- 1997: $14.8 Million
- 1998: $21.2 Million
- 1999: $54.4 Million
- 2000: $106.2 Million
- 2001: $40.7 Million
- 2002: $21.2 Million
- 2003: $18.4 Million
Other Equity Terminology

• Seasoned Offering - Sale of securities by a firm that is already publicly traded
• General Cash Offer - Sale of securities open to all investors by an already public company
• Rights Issue - Issue of securities offered only to current stockholders
• Private Placement - Sale of securities to a limited number of investors without a public offering
Not-for-Profit Equity

• See Cherry Community Hospital
Dividend Policy

• Choice of Payout Policy
• Types of Payout
• How Dividends are Determined in Practice
• Payout Controversy
  – Irrelevant
  – Decrease value
  – Increase value
• Taxes and Dividend Policy
Choice of Payout Policy

• Payout is capital structure decision
• Criterion for payout decision should be effect on value of firm
• Does a dividend payment increase or decrease the value of the firm to its owners?
Types of Payout

• Cash Dividend – Firm pays cash to shareholders
  • Regular cash dividend
  • Special cash dividend

Market value of equity (share price) declines proportionally
Types of Payout

• Stock Dividend or Split – Firm issues additional shares to shareholders
  No effect on market value of equity
  Share price declines proportionally
Types of Payout

• Stock Repurchase – Firm buys back stock from shareholders (treasury shares)
  1. Buy shares on the market
  2. Tender offer to shareholders
  3. Dutch auction
  4. Private negotiation

Market value of outstanding equity declines
Can increase share price
How Dividends are Determined in Practice

Linlner’s “Stylized Facts”

1. Firms have longer term target dividend payout ratios.
2. Managers focus more on dividend changes than on absolute levels.
3. Dividend changes follow shifts in long-run, sustainable levels of earnings rather than short-run changes in earnings.
4. Managers are reluctant to make dividend changes that might have to be reversed.
5. Firms repurchase stock when they have accumulated a large amount of unwanted cash or wish to change their capital structure by replacing equity with debt.
Payout Controversy: Dividend Policy is Irrelevant

• Perfect capital markets
  – No transactions costs
  – No taxes
  – Good information
  – No other imperfections

• Since investors do not need dividends to convert shares to cash, they will not pay higher prices for firms with higher dividend payouts.

• Dividend policy will have no impact on the value of the firm.
Payout Controversy: Dividends Increase Value

Transactions Costs and Clientele Effect

• There are natural clients for high-payout stocks.
• They want cash flow, and they want to avoid the transactions cost associated with selling shares to get cash.
• These clients increase the price of the stock through their demand for a dividend paying stock.
Information and Dividends as Signals

• Dividend increases send good news about cash flows and earnings. Dividend cuts send bad news.

• Because a high dividend payout policy will be costly to firms that do not have the cash flow to support it, dividend increases signal a company’s good fortune and its manager’s confidence in future cash flows.
Payout Controversy: Dividends Decrease Value

**Tax Consequences**

- Companies can convert dividends into capital gains by reducing dividend payout.
- If dividends are taxed more heavily than capital gains, taxpaying investors should welcome such a move and value the firm more favorably.
- In such a tax environment, the total cash flow retained by the firm and/or held by shareholders will be higher than if dividends are paid.
Taxes and Dividend Policy

• If capital gains are taxed at a lower rate than dividend income, companies should pay the lowest dividend possible.
• Dividend policy should adjust to changes in the tax code.
Taxes and Dividend Policy

In U.S., shareholders are taxed twice (figures in dollars)

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<td>After Tax income (paid as div)</td>
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<td>Income tax paid by investors at 15.0%</td>
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<td>Cash to Shareholder</td>
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Counterpoint: Are corporations not separate entities from their owners?

Source: Undetermined
Capital Structure

- Capital Structure Criteria
- Financial Leverage
- The Magic of Financial Leverage
- M+M Propositions
- Selecting a Capital Structure
- Benefit of Debt
- Cost of Debt – Financial Distress
- Optimal Capital Structure
Capital Structure Criteria

• Structure that minimizes overall cost of financing
  – WACC
  – Structure that maximizes value of firm
  – Relevant Question: What is effect of change in financing mix on firm value? Is there an optimal capital structure?
Financial Leverage

• Definition:
  – Use of relatively cheap debt to increase expected ROE

• Measurement:
  – Debt Financing Ratio
    • D/(D+E)
  – Long-Term Debt to Capitalization
    • LTD/(LTD+E)

Note: Market (not book) values of debt and equity correctly determine capital structure
The Magic of Leverage

Macbeth Spot Removers: 
A Tale of Two Capital Structures

<table>
<thead>
<tr>
<th>Capital Structure</th>
<th>All Equity</th>
<th>Half Debt (r_D=0.1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares</td>
<td>1000</td>
<td>500</td>
</tr>
<tr>
<td>Price per share</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Equity value</td>
<td>10000</td>
<td>5000</td>
</tr>
<tr>
<td>Debt value</td>
<td>0</td>
<td>5000</td>
</tr>
<tr>
<td>Asset value</td>
<td>10000</td>
<td>10000</td>
</tr>
</tbody>
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<table>
<thead>
<tr>
<th>Operating Result</th>
<th>likely</th>
<th>likely</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income before interest</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>Interest expense</td>
<td>0.50</td>
<td>5.0</td>
</tr>
<tr>
<td>Net income</td>
<td>1000</td>
<td>500</td>
</tr>
<tr>
<td>Earnings per share</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td>Return on equity</td>
<td>0.10</td>
<td>0.10</td>
</tr>
</tbody>
</table>

Effects of Financial Leverage:
1. Increases ROE for likely business result
2. Increases variability in ROE (financial risk)
3. Effect on firm value depends on whether r_D and r_E rise with leverage

Source: Undetermined
M+M Propositions

- Proposition 1 - In perfect capital markets
  - No taxes
  - No transactions costs
  - Free information
  - No other imperfections

  Firm value is determined by left side of B.S. (asset structure), not by D/(D+E)

- Proposition 2 - Required rate of return on equity increases in proportion to D/(D+E)

- Implications
  1. In PCM, there is no optimal capital structure
  2. To find optimal capital structure, find imperfections
Expected return on assets: $r_A = \frac{\text{expected operating income}}{\text{market value of all securities}}$

Math Proof:

$$r_A = \left( r_D \times \frac{D}{D+E} \right) + \left( r_E \times \frac{E}{D+E} \right)$$

$$r_E = r_A + (r_A - r_D) \times \frac{D}{E}$$
M+M Propositions

Macbeth Spot Removers:
A Tale of Two Capital Structures

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<td>500</td>
</tr>
<tr>
<td>Net income</td>
<td>500</td>
<td>1000</td>
</tr>
<tr>
<td>Earnings per share</td>
<td>0.5</td>
<td>1</td>
</tr>
<tr>
<td>Return on equity</td>
<td>0.05</td>
<td>0.1</td>
</tr>
</tbody>
</table>

Results: $r_E$ increases with leverage
WACC is independent of leverage
Firm value is unaffected by financial structure

Source: Undetermined
Selecting a Capital Structure
Naïve View of Leverage and WACC

Financing cost can be minimized (and firm value can be maximized) through full use of debt.
Selecting a Capital Structure
M+M View of Leverage and WACC

Financing cost (and firm value) are unaffected by use of debt.
Selecting a Capital Structure

Traditional View of Leverage and WACC

Financing cost can be reduced (and firm value can be increased) through judicious use of debt.
Selecting a Capital Structure

• More debt - debt subsidies
  – Income tax deductibility of interest expense
  – Access to tax-exempt debt

• Less debt
  – More likely financial distress – higher business risk
  – More severe financial distress – fewer assets that can be monetized
Benefit of Debt
Income Tax Deductibility of Interest Expense

• Lowers WACC because of lower net cost of debt (net interest rate on debt) to the borrower

\[ WACC = r_D \times (1 - mtr) \times \left( \frac{D}{A} \right) + \left( r_E \times \frac{E}{A} \right) \]

• Lower financing cost increases firm value

Source: Undetermined
Benefit of Debt

Income Tax Deductibility of Interest Expense

• Creates Interest Tax Shield - Tax savings resulting from deductibility of interest payments

\[ \text{Tax Shield} = r_D \times mtr \times D \]

• Increases value of firm by

\[ \text{PV(TS)} = \frac{(r_D \times mtr \times D)}{r_D} \]

• Firm Value = Value of All Equity Firm + PV Tax Shield

• Implication: Firms with higher tax rates (and other debt subsidies) should use more debt
Cost of Debt
Financial Distress

• Definition
  – Bankruptcy
  – “Skating on thin Ice” - insufficient cash to meet short term obligations
    • Payroll
    • Debt service

• Causes
  – Business risk – in product (or factor) market where cash flows uncertain
  – Financial risk – high debt financing ratio (D/A)
Cost of Debt
Financial Distress

• Costs
  – Distorted business decisions
  – Covenants imposed by lenders
    • Control over additional indebtedness
    • Maintenance of cash reserves
    • Maintenance of asset value
    • Control over business decisions
  – Higher interest rates

• Implications:
  – Firms with higher business risk should use less debt
  – Firms with lesser ability to monetize assets should use less debt
Optimal Capital Structure

- Optimal amount of debt
- Maximum value of firm
- Costs of financial distress
- Value of levered firm
- PV of interest tax shields
- Value of unlevered firm

Market Value of The Firm vs. Debt
Optimal Capital Structure

Structure of Bond Yield Rates

Bond Yield

\( r \)

D

A
Optimal Capital Structure
Health Care Organizations

- HMOs and financing firms
  - No assets
  - No CBR
  - Many taxable
  - High business risk

- Hospitals and nursing homes
  - Some assets
  - Some CBR
  - Some taxable
  - Low business risk
Optimal Capital Structure
Hospitals

Long Term Debt to Capitalization

Year

LTDCAP


0 0.1 0.2 0.3 0.4 0.5 0.6 0.7 0.8 0.9
Why did they do that?

• Reduced subsidies for debt
  – Increasing net interest rates as Capital Cost-Based Reimbursement is eliminated

• Higher business risk
  – Lenders require higher interest rates
How did they do that?

• Investor-owneds have the advantage
  • Sell stock
  • Make higher profits

• NFPs suffer from lesser access to equity
  • Demise of health care philanthropy
  • Pressure on profits
IO Firms Adjust Leverage

Capital Structure and Risk

Firm Type

- Insurance Firms
- HMOs
- Hospitals
- SNFs
- HHCs

Beta
Debt/Cap
IOs make more money

Hospital Profits

Year

IO Op Mar
NFP Op Mar
IO Tot Mar
NFP Tot Mar
NFPs protect themselves (with cash, of course)

Days Cash on Hand

Year


Days

0 10 20 30 40 50 60 70 80

Day

IO
NFP
Credit Rating Criteria
(Moody’s Investors Service, etc.)

- Strategy is paramount (tie to financial plan)
- Management (and governance): development of new skills and understanding over time (learning organization)
- Medical staff: strategies to link medical staff and patients to hospitals
- Services and service area:
  - Attractiveness of services array to purchasers
  - Low-cost alternatives
Credit Rating Criteria (cont.)

• Competition:
  – For physicians
  – Market share of clinical services (pick winners)
  – For covered lives
• Financial performance
  – Cash was king
    • Focus on balance sheet
    • Still important
  – Cash flow is now king
    • Focus on operations (income statement)
    • Revenue pressure from payers
The Keys to Good Credit Ratings
(from interviews with CFOs)

● Management of the balance sheet.
● Management of the income statement. This is seen as increasingly difficult by several systems, because of market pressures.
● Management of relations with the credit community.

“We have a AA balance sheet, and a B income statement. So, we have a A- credit rating.”
Optimal Capital Structure

**Trade-off Theory** - Capital structure is based on a trade-off between benefits (tax savings) and costs (distress) of debt.

**Pecking Order Theory** - Firms have ordered preference for financing
1. internal sources (profits)
2. debt
3. external equity
Lease Financing

- Lease Financing Defined
- Reasons to Consider Leasing
- Financial v. Operating Leases
- Accounting Treatment of Leases
- Lease Contract
- Valuing Financial Leases
- Leasing and Adjusted Present Value
Lease Financing Defined

- Means by which firm can acquire use of an asset for period of time without purchasing asset outright
- Rental agreement extending for year or more and involving series of fixed payments
- One of three basic financing methods
  - Purchase with equity
  - Borrow and purchase
  - Lease – viewed by financial markets as form of debt
Reasons to Consider Leasing (valid)

• May be lower interest rate
• May be income tax advantage (or other subsidy)
• Way to avoid risk of technological change
• Way to avoid transactions costs associated with buying and selling
• Way to avoid restrictions (covenants) of debt financing
• Maintenance costs may be included
Reasons to Consider Leasing (specious)

• Way to improve balance sheet
  – off-balance-sheet-financing is limited by accounting rules and unlikely to fool many
• Way to conserve capital
  – borrowing does, too
• Way to avoid expenditure controls
  – Internal
  – External
Financial v. Operating Leases

Financial: Noncancelable contractual commitment on part of lessee to make series of payments to lessor for use of asset, and one of the following applies:

• Lease transfers title to lessee before lease expires
• Lease has option to purchase at bargain
• Lease period exceeds 75 percent of asset life
• PV of lease payments exceeds 90 percent of value

If these conditions met, most of economic value of asset transferred to lessee

Operating: Cancelable at option of lessee or none of the above conditions holds. Most of economic value retained by lessor
Accounting Treatment of Leases

• Financial (Capital) Leases
  – Leased asset reported as fixed asset
  – PV of future lease payments reported as liability - “Obligations Under Capital Leases”

• Operating Leases
  – Footnote disclosure
Lease Contract

• Basic lease period (not cancelable)
• Timing and amounts of payments during blp
• Option to renew lease or purchase asset at end of blp
• Provision for payment of cost of maintenance, repairs, taxes, insurance, utilities, etc.
  – Net - lessee pays
  – Full Service or Rental - lessor pays
Valuing Financial Leases

What: Compare financing provided by lease to financing provided by equivalent loan

Why: Leasing is commitment for fixed payments similar to debt

How: Discount lease cash flows at net after-tax (and other subsidies) interest rate firm would pay on equivalent loan

$$\text{NPV} = \text{Initial Financing Provided} + \frac{(\text{LCF}_t)}{(1-r_D)^t}$$

where LCF =

- lease pmt
+ tax shield of lease pmt
- depn tax shield lost
Valuing Financial Leases

Example

Asset cost = $200,000
T = 10 years
No salvage value
Lease payment = $27,000 (pd at beginning of yr)
Debt int rate = .10
mtr = .3 (effect is at end of year)
No difference in operating costs
Leasing and Adjusted Present Value

Some Rules:

1. Keep financing and investment analyses separate

2. When financing and investment decisions interact, the analysis needs to reflect the effect on value of both the investment and financing aspects of the decision

$$\text{APV} = \text{basic (investment) NPV} + \text{NPV of financing caused by project}$$
Leasing and Adjusted Present Value

- Positive NPV of lease means if you acquire asset lease financing is advantageous (less costly than debt financing)
- It does not, however, mean you should acquire asset
- In general, asset acquisition depends on (investment) NPV of project
- But favorable lease terms can sometimes rescue negative NPV project by creating a positive APV
Leasing and Adjusted Present Value Example

• Assume the NPV of acquiring the asset in the previous example, employing your firm’s overall cost of capital of .09 (after tax) was determined to be -$3000.
• You therefore should tentatively make the decision not to purchase it.
• If, however, the seller offers to lease the asset to you at the terms in the example, which imply a lower cost of financing (again after tax) than your typical interest rate
• Then, the whole activity takes on a positive APV:

\[
\text{APV} = \text{NPV of project} + \text{NPV of lease} = -$3000 + $11,838 = $8838
\]
Financial Analysis and Planning

- Purpose of the Financial Plan
- Contents of the Financial Plan
- Steps in Financial Plan Development
  - Assess Financial Position
  - Define Debt Policy
  - Determine Asset Requirements
  - Evaluate Financing Options
  - Integrate into Management Control Structure
Purpose of the Financial Plan

• Assuring that the strategic plan of the organization is achieved
• Analyzing interactions of financing and investment choices open to firm
• Projecting future consequences of present decisions
• Deciding which alternatives to undertake to as part of the financial plan
• Measuring subsequent performance against goals
Contents of the Financial Plan

1. Pro Forma Financial Statements
   A. Balance Sheet
   B. Income Statement
   C. Cash Statement

2. Capital Expenditure and Business Strategy

3. Planned Financing
Steps in Financial Plan Development

1. Assess Financial Position
2. Define Debt Policy
3. Determine Asset Requirements
4. Evaluate Financing Options
5. Integrate into Management Control Structure
1. Assess Present Financial Position

• Financial Ratio Analysis
  – Capital Structure
  – Profitability
  – Efficiency or Productivity
  – Liquidity
  – Market Value

• Long Run Viability Analysis (Dupont Analysis)
  – Focus on ROE
  – Disaggregated into important components
Dupont Analysis

\[ \text{ROE} = \frac{\text{assets}}{\text{equity}} \times \frac{\text{sales}}{\text{assets}} \times \frac{\text{EBIT} - \text{taxes}}{\text{sales}} \times \frac{\text{EBIT} - \text{taxes} - \text{interest}}{\text{EBIT} - \text{taxes}} \]

- **leverage ratio**
- **asset turnover**
- **profit margin**
- **debt burden**

\[ \text{ROA} \]
Return on Equity

- ROE = Net Income/Equity = (EBIT-int-tax)/equity
- Profitability ratio
- ROE = rate of growth in equity
- ROE is key to financial (and therefore operational and strategic) success
- If the firm can grow equity, then
  - It qualifies to borrow (can raise debt funds) on good terms
  - It can purchase necessary assets
  - It can provide the services consistent with its mission and strategic plan
Leverage Ratio

• LR = Assets/Equity
• Capital structure ratio
• Shows benefit of using financial leverage in multiplying an operating result
• Inverse of EFR (= Equity/Assets)
  – EFR = percent of assets financed by equity
  – EFR is complement of DFR (= Debt/Assets)
  – EFR and DFR are important determinants of firm’s access to debt
Asset Turnover

• TAT = Sales (or Revenue)/Assets
• Efficiency or productivity ratio
• Indicates the productivity of assets in generating revenue
  – Dollars of revenue produced per dollar of assets employed
• Age of Assets
  – Accumulated Depreciation/Depreciation Expense
  – Older assets can increase TAT
Profit Margin

• PM = Net Income/Sales
  – (EBIT-tax)/Sales
    • Profit to all investors
  – (EBIT-interest-tax)/Sales
    • Profit to equity investors

• Profitability ratio

• Percent of revenues converted to profit
Debt Burden

- DB = (EBIT-taxes-interest)/(EBIT-taxes)
- Capital structure ratio
- Shows extent to which profits reduced by debt (interest expense)
- Times Interest Earned
  - EBITDA/Interest Expense
  - Indicates cash flow available to cover interest payment
Return on Assets

• ROA = (EBIT-taxes)/Assets
• Profitability measure
• Return on investment to all investors
  – Equity investors
  – Debt investors
Market Value Ratios

• Stock Price = EPS (or DIV)/(r-g)

• Market to Book = Stock Price/Book Equity per Share
  – Extent to which book value understates market value
  – Extent to which firm value has increased since stock sales to owners

• Price Earnings Ratio = Stock Price/Earnings per Share
  – Conceptual inverse of market capitalization rate ($r_E$)
Other Ratios

• **Current Ratio** = Current Assets/Current Liabilities
  - CA = assets converted to cash within a year
  - CL = debts to be paid off within a year
  - CR = dollars in CA per dollar of CL
  - Liquidity ratio
  - Indicates short term solvency

• **Payout Ratio** = Dividends/Earnings
  - Percent of net income paid out as dividends
  - Plowback Ratio = 1 - Payout Ratio
  - Equity Growth from Plowback
    = (Earnings - Dividends)/Earnings
Dupont Analysis

Executive Paper

Dupont Analysis

<table>
<thead>
<tr>
<th>Metric</th>
<th>Value</th>
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</thead>
<tbody>
<tr>
<td>Return on equity (ROE)</td>
<td>0.14</td>
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<tr>
<td>Leverage ratio</td>
<td>2.69</td>
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<tr>
<td>Asset turnover</td>
<td>1.55</td>
</tr>
<tr>
<td>Profit margin</td>
<td>0.05</td>
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<tr>
<td>Debt burden</td>
<td>0.64</td>
</tr>
<tr>
<td>ROE calculated</td>
<td>0.14</td>
</tr>
</tbody>
</table>
2. Define Debt Policy

Equity Financing Ratio = .4

Current Ratio = 2.0
3. Determine Asset Requirements

Fixed Asset Additions: $1,300,000,000

Less Depreciation and Write-offs: (250,000,000)

Additional Working Capital Needed: 200,000,000

Net Add’l Capital Requirements: $1,250,000,000
4. Evaluate Financing Options

- Additional Equity (15% per year)
  - Retained earnings $540M
  - Stock sales?

- Additional Debt
  - Long term $620M
  - Short term $90M

- Feasibility of Financial Plan
  - Depends on equity growth rate
  - Revision options
    - Slower asset growth
    - Higher debt financing
5. Integrate into Management Control Structure

- ROE (req’d) from LRFP informs the $r_E$ in the WACC
- Proposed projects evaluated at WACC (with appropriate risk adjustment)
- If NPV positive, project generates enough cash to
  - Cover operating costs
  - Cover debt service
  - Grow equity at rate sufficient to make the Financial Plan work
Statement of Cash Flows (Review) (AICPA)

• Purposes
  – Rationalize accruals measures to cash
  – To show where cash came from and where it went to
  – To show how to get from one balance sheet to the next

• Cash receipts and cash disbursements are classified into three categories:
  – Operating activities
  – Financing activities
  – Investing activities

• The term cash includes cash equivalents (demand and time deposits)
Equation for Statement of Cash Flows

Basic accounting equation:
Assets = Liabilities + Net Assets

CE + OA = L + NA

where CE = cash and cash equivalents, and
where OA = all other assets

CE = L + NA - OA
Equation for Statement of Cash Flows

• Cash Inflows result from an increase in the value of the right-hand side of the equation
  – Increases in Liabilities
  – Increases in Net Assets
  – Decreases in Other Assets

• Cash Outflows result from decreases in value of right-hand side
  – Decreases in Liabilities
  – Decreases in Net Assets
  – Increases in Other Assets
Classification of Cash Flows

• Cash receipts and cash disbursements are classified into three types of economic activity on the statement of cash flows:
  – Operating Activities
  – Investing Activities
  – Financing Activities
Operating Activities

Cash Flow from transactions directly or indirectly related to the provision of patient care and other operating activities

- Change in Net Assets
  - Operating Statement - revenue and expense transactions that enter into the determination of the hospital’s net income
  - Other changes in Net Assets

- Adjustments
  - Non-cash expenses
  - Entries reflecting Investing and Financing Activities

- Balance Sheet Differences
  - Current and Other Assets
  - Current and Other Liabilities
Investing Activities

Cash Flow from transactions related to the purchase and sale of financial securities (that are not cash equivalents) and plant assets

- Investments (financial assets)
  - Purchases
  - Sales

- Plant and Capital Equipment (real assets)
  - Acquisitions
  - Sales
Financing Activities

Cash Flow from transactions related to the acquisition and repayment of funding obtained through intermediate-term and long-term borrowings

- Acquisition of financing
  - New Bonds Payable
  - New Mortgages Payable
  - New Lease Financing Obligations

- Repayment of financing
  - Repayment of loans
  - Principal payments
  - Lease obligation reductions

(interest payments on these debts are treated as cash outflows related to operating activities)
Form and Content of the Statement of Cash Flows

Sample Hospital Financials (again)

- Statement of Operations
- Balance Sheet
- Statement of Changes in Net Assets
- **Statement of Cash Flows**
- Notes
Form and Content of the Statement of Cash Flows

Note from BS that the cash balance falls over the year by $1119. Where did this cash go?

• Increase from operating activities of $9,978
• Decrease from investing activities of $8,497
• Decrease from financing activities of $2,600
Cash From Operating Activities
Key Sources

• Net Income
• Depreciation Expense (main non-cash expense)
• Other non-cash gains and losses
• Other changes in net assets
• Decreases in current and other assets
• Increases in current and other liabilities
Information on Cash Statement

• Where is cash coming from and going to?
• Was there enough cash from operations to support capital expenditures?
• How are we choosing to finance our capital expenditures?
  – Debt
  – Operating cash flows
Working Capital Management

- Working Capital Definitions
- Credit Management
- Accounts Receivable Management
- Cash Management
Working Capital Definitions

• Net Working Capital
  – Current assets minus current liabilities
  – Often called working capital.

• Cash Conversion Cycle - Period between firm’s payment for materials and collection on its sales.

• Carrying Costs - Costs of maintaining current assets, including opportunity cost of capital.

• Shortage Costs - Costs incurred from shortages in current assets.
Credit Management

**Credit Policy** - Standards set to determine the amount and nature of credit to extend to customers.

**Benefits of Credit Extension**
- Increased sales
- Interest on loan

**Costs of Credit Extension**
- Financing costs
- Costs of credit department
- Costs of collections department
- Bad debts expense
Accounts Receivable Management

• Tracking AR
  – Days AR
  – Aging of Receivables
  – Writing off AR (bad debts recognition)

• Factoring AR

• Selling AR
Cash Management

• Optimal Cash Balances
  – Carrying Cost
  – Transactions Cost

• Static cash balance models

• Variable cash balance models
Cash Budget

Purpose: To project the stock of cash on hand in each time period

Method: Convert accruals measures of revenues and expenses to cash inflows and outflows

Rule: Focus on large items

Steps:
- Convert revenues to cash inflows - AR cycle
- Convert expenses to cash outflows
- Payroll
- Other scheduled cash payments
Revenues to Cash Inflows

- Aging of accounts receivable
- Timing of payment receipt
- Cash receipts analysis
Expenses to Cash Outflows

- Cash basis payroll expense
- Operating cash disbursements