Three Issues in Global Corporate Financing

- Financing European and American Enterprises
  - The New European Capital Market
  - Capital markets in USA and Asia
  - Venture Capital and Corporate Venturing
- Shareholder Value and the "Cost of Capital"
  - Why shareholder value matters
  - Why the "cost of capital" matters
- Mergers, Acquisitions and Divestitures
  - How the market values acquisitions and divestitures
  - Where the money comes from
Managing Corporate Finance

- Bank Financing
- Capital Markets
- Risk Management Instruments

Corporate Finance Needs

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Banking and Capital Markets: Europe vs. USA

- Banks vs. Markets
- Relationships vs. Transactions
- On Balance Sheet vs. Off
- Domestic vs. Regional vs. Global
- Debt vs. Equity
- Bricks vs. Bytes

Banks vs. Markets

- Where are investors going?
- What do today’s shareholders expect?
- Where are corporations going?
- Where is your banker going?

Common theme: “The end of entitlement” (which implies the end of special responsibilities)
**Relationships vs. Transactions**

- Lower barriers to entry – more price competition
- Frequent re-calculation of benefits: “What will you do for me next?”
- Shareholder pressure weakens traditional relationships, obligations
- In business, the effect is toward alliances, contract manufacturing, out-sourcing
- Stability requires “new communities,” the more broadly-based the better

**Financial Innovation and the Shorter Product Life Cycle**

- More financial innovation
- But most innovations fail
- Fewer geographic barriers to entry
- Fewer information barriers to entry

![Excess returns graph](Time)
Innovation as Value Creation

- Innovations are costly to develop and produce, and easily copied, so
- For an innovation to succeed, it must create differentiated value for issuer, investor, or risk manager, by:
  - **Unbundling**: create simple, more primitive instruments to isolate risks, or
  - **Bundling**: create tailor-made instruments to reduce costs, minimize taxes, or circumvent restrictions or imperfections.

On Balance Sheet vs. Off

- “All my assets are for sale, all the time”
- Maximize ROE by increasing capital turnover – become originators instead of lenders

Market value of transactions in Europe
(1990-present) Euro bn

![Graph showing the trend of market value of transactions in Europe from 1990 to 2000, indicating a significant increase over the years. The graph is color-coded to highlight Asset-Backed Securities.]
**Domestic, Regional or Global?**

- Which are more mobile?
  - Goods markets
  - Labor
  - Services
  - Financial services

- Even domestic institutions must be able to compete in the world arena

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**Debt vs. Equity**

A $1 Investment in Different Types of Portfolios: 1926-1996

- Small Company Stocks
- Large Company Stocks
- Long-Term Government Bonds
- Treasury Bills

Year-End

- $4,495.99
- $1,370.95
- $33.73
- $13.54
- $8.85
Passive vs. Active Investors

- It’s an internet information age
- Domestic shareholders want global returns – asset managers must beat benchmarks
- Corporations or financial institutions which cling to underperforming assets will have lower ROE and share prices
- Which makes them vulnerable to restructuring or takeover – Europe’s new market for corporate control

Passive vs. Active Investors

- Investors expect results or sell their shares; “friendly holdings” become too costly, opportunity costs become explicit
- Venture capital, private equity funds attract investors by offering higher returns
- Market-based returns now expected by investors and lenders, and required of managers; local differences persist, but diminishing
Bricks vs. Bytes

- It’s a Nasdaq world, and it’s moving at “internet time”
- The old economy *needs* the new economy to meet shareholder expectations
  “To B2B, or not to be?”
- E-business or m-business?
- Equity, not debt, is financing the new economy

Whither European Financial Services?

- The Anglo-Saxon model of transparent financial markets is coming, at internet speed
- All assets must meet the test of the market – global shareholder return standards
- Otherwise…
**Example: Deutsche-Dresdner**

- What is Deutsche’s strategy?
- Does the Dresdner acquisition advance that strategy?
- What does it take to succeed in investment banking?

Deutsche-Dresdner case study

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**The Commercial Banking Model**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans</td>
<td>Deposits</td>
</tr>
<tr>
<td>Net interest revenues</td>
<td>Net interest costs</td>
</tr>
</tbody>
</table>

Goal: Add assets with positive net interest margin
The Investment Banking Model

- Sales
- Corporate Finance
- Customer-Driven Securities
- Capital Markets

Goal: Originate deals and sell them in the capital market as quickly as possible

The Asian Bet

- High growth disguised speculative financing structures
- Governments shielded companies and banks from capital market discipline
- Too much debt
- Too much foreign-currency debt
- Closely held ownership relying on reinvested earnings
**The Asian Bet**

- High growth disguised speculative financing structures
- Governments shielded companies and banks from capital market discipline
- Too much debt
- Too much labor
- Too much capacity
- Closely held ownership relying on reinvested earnings

**Corporate Finance**

- CORPORATE FINANCE DECISIONS
  - INVESTMENT
    - PORTFOLIO
    - CAPITAL
    - M&A
  - FINANCING
    - DEBT
    - EQUITY
  - RISK MGT
    - MEASUREMENT
    - TOOLS
**The CFO Questions**

- How fast can we grow? What criteria for spending money? Acquisitions? Divestitures?
- How should we finance our growth? What kind of equity?
- How much (cheap) debt should we have?
- What kind of debt should we have? Maturity? Fixed/floating? Currency? Asset-backed? Hybrids, such as convertibles?
- How should we manage our financial risks?
- What’s our plan for creating shareholder value?

**Corporate Financing Life-Cycle**

Leverage

Growth companies

Mature companies
### Firm Characteristics as Growth Changes

<table>
<thead>
<tr>
<th>Variable</th>
<th>High Growth Firms tend to</th>
<th>Stable Growth Firms tend to</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk</td>
<td>be above-average risk</td>
<td>be average risk</td>
</tr>
<tr>
<td>Dividend Payout</td>
<td>pay little or no dividends</td>
<td>pay high dividends</td>
</tr>
<tr>
<td>Net Cap Ex</td>
<td>have high net cap ex</td>
<td>have low net cap ex</td>
</tr>
<tr>
<td>Return on Capital Leverage</td>
<td>earn high ROC (excess return)</td>
<td>earn ROC closer to WACC</td>
</tr>
<tr>
<td></td>
<td>have little or no debt</td>
<td>higher leverage</td>
</tr>
</tbody>
</table>

### Three Issues in Global Corporate Financing

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The Goal of Financial Management

What are firm decision-makers hired to do?
“General Motors is not in the business of making automobiles. General Motors is in the business of making money.”

Alfred P. Sloan

Possible goals: Size, market share, profits

Three equivalent goals of financial management:
- Maximize shareholder wealth
- Maximize share price
- Maximize firm value

Value-based management drives our performance targets and incentives. We have set ambitious short and medium-term financial and operating targets and, to help meet these, have aligned the interests of management and employees with those of our shareholders and customers. Our incentive systems are linked to key aspects of shareholder value, such as margins and asset productivity. Our strategic focus is centred on profitable growth, better margins through innovation and higher productivity, improved asset management, and turnarounds in operations whose past performance has not been world class.
First Principles of Creating Shareholder Value

- Invest in projects that yield a return greater than the minimum acceptable hurdle rate.
  - The hurdle rate should be higher for riskier projects and reflect the financing mix used - owners' funds (equity) or borrowed money (debt).
  - Returns on projects should be measured based on cash flows generated and the timing of these cash flows; they should also consider both positive and negative side effects of these projects.
- Choose a financing mix that minimizes the hurdle rate and matches the assets being financed.
- If there are not enough investments that earn the hurdle rate, return the cash to stockholders.
  - The form of returns - dividends and stock buybacks - will depend upon the stockholders' characteristics.
- Minimize unnecessary financial risks.

Objective: Maximize the Value of the Firm

The Classical Objective Function

STOCKHOLDERS
- Maximize stockholder wealth
- Hire & fire managers
  - Board
  - Annual Meeting
- Lend Money

BONDHOLDERS
- Protect bondholder Interests

MANAGERS
- Reveal information honestly and on time
- Markets are efficient and assess effect on value
- Costs can be traced to firm
- Costs

FINANCIAL MARKETS

SOCIETY
- No Social Costs

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What Can Go Wrong?

**STOCKHOLDERS**
- Have little control over managers
- Managers put their interests over shareholders’

**BONDHOLDERS**
- Lend money
- Bondholders can get ripped off

**MANAGERS**
- Delay bad news or provide misleading information

**FINANCIAL MARKETS**
- Markets make mistakes and can overreact

**SOCIETY**
- Significant Social Costs
- Some costs cannot be traced to firm

A Contrast: Disney vs. Campbell Soup

<table>
<thead>
<tr>
<th>BEST PRACTICES</th>
<th>CAMPBELL SOUP</th>
<th>DISNEY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Majority of outside directors</td>
<td>Only one insider among 15 directors</td>
<td>7 of 17 members are insiders</td>
</tr>
<tr>
<td>Bans insiders on nominating committee</td>
<td>Yes</td>
<td>No: CEO is chairman of panel</td>
</tr>
<tr>
<td>Bans former execs from board</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Mandatory retirement age</td>
<td>70, with none over 64</td>
<td>None</td>
</tr>
<tr>
<td>Outside directors meet w/o CEO</td>
<td>Annually</td>
<td>Never</td>
</tr>
<tr>
<td>Appointment of “lead director”</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Governance committee</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Self-evaluation of effectiveness</td>
<td>Every two years</td>
<td>None</td>
</tr>
<tr>
<td>Director pensions</td>
<td>None</td>
<td>Yes</td>
</tr>
<tr>
<td>Share-ownership requirement</td>
<td>3,000 shares</td>
<td>None</td>
</tr>
</tbody>
</table>

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Overpaying on Takeovers

- The quickest and perhaps the most decisive way to impoverish stockholders is to overpay on a takeover.
- The stockholders in acquiring firms do not seem to share the enthusiasm of the managers in these firms. Stock prices of bidding firms decline on the takeover announcements a significant proportion of the time.
- Many mergers do not work, as evidenced by a number of measures.
  - The profitability of merged firms relative to their peer groups, does not increase significantly after mergers.
  - An even more damning indictment is that a large number of mergers are reversed within a few years, which is a clear admission that the acquisitions did not work.

What’s a Company Worth to Another Company?

- Required Returns
- Types of Models
  - Balance sheet models
  - Dividend discount & corporate cash flow models
  - Price/Earnings ratios
  - Option models
- Estimating Growth Rates
- Application: How These Change with M&A
Equity Valuation: From the Balance Sheet

Relative Valuation

- Do valuation ratios make sense?
  - Price/Earnings (P/E) ratios
    - and variants (EBIT multiples, EBITDA multiples, Cash Flow multiples)
  - Price/Book (P/BV) ratios
    - and variants (Tobin's Q)
  - Price/Sales ratios
- It depends on how they are used -- and what’s behind them!
Valuing a Firm with DCF: An Illustration

- Historical financial results
  - Adjust for nonrecurring aspects
- Gauge future growth
- Projected sales and operating profits
  - Adjust for noncash items

Projected free cash flows to the firm (FCFF)

Year 1 FCFF
Year 2 FCFF
Year 3 FCFF
Year 4 FCFF
... Terminal year FCFF

Discount to present using weighted average cost of capital (WACC)

Present value of free cash flows
+ cash, securities & excess assets
- Market value of debt
Value of shareholders equity

More Simply, Invest Only When

Return on Assets exceeds Cost of Financing
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Goals of Acquisitions

Rationale: Firm A should merge with Firm B if
[Value of AB > Value of A + Value of B + Cost of transaction]

- Synergy
- Gain market power
- Discipline
- Taxes
- Financing
**Fallacies of Acquisitions**

- Size (shareholders would rather have their money back, eg Credit Lyonnais)
- Downstream/upstream integration (internal transfer at nonmarket prices, eg Dow/Conoco, Aramco/Texaco)
- Diversification into unrelated industries (Kodak/Sterling Drug)

---

**Do Acquisitions Benefit Shareholders?**

**Successful Bids**

<table>
<thead>
<tr>
<th>Technique</th>
<th>Target</th>
<th>Bidders</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tender offer</td>
<td>30%</td>
<td>4%</td>
</tr>
<tr>
<td>Merger</td>
<td>20%</td>
<td>0</td>
</tr>
<tr>
<td>Proxy contest</td>
<td>8%</td>
<td>na</td>
</tr>
</tbody>
</table>

*Note: Abnormal price changes are price changes adjusted to eliminate the effects of marketwide price changes*
**Do Acquisitions Benefit Shareholders?**

**Unsuccessful Bids**

<table>
<thead>
<tr>
<th>Technique</th>
<th>Target</th>
<th>Bidders</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tender offer</td>
<td>-3%</td>
<td>-1%</td>
</tr>
<tr>
<td>Merger</td>
<td>-3%</td>
<td>-5%</td>
</tr>
<tr>
<td>Proxy contest</td>
<td>8%</td>
<td>na</td>
</tr>
</tbody>
</table>

**The Price: Who Gets What?**

<table>
<thead>
<tr>
<th></th>
<th>Daimler</th>
<th>Chrysler</th>
<th>Combined</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market value before deal leaked</td>
<td>$52.8</td>
<td>$29.4</td>
<td>$82.2</td>
</tr>
<tr>
<td>Value added by merger</td>
<td></td>
<td></td>
<td>$18.0</td>
</tr>
<tr>
<td>Merged Value</td>
<td></td>
<td></td>
<td>$100.2</td>
</tr>
<tr>
<td>Shareholders get</td>
<td>57.2%</td>
<td>42.8%</td>
<td>100%</td>
</tr>
<tr>
<td>Which is now worth</td>
<td>$57.3</td>
<td>$42.9</td>
<td>$100.2</td>
</tr>
<tr>
<td>Shareholders' shares of the gain</td>
<td>$4.5</td>
<td>$13.5</td>
<td>$18</td>
</tr>
<tr>
<td>Premium, as %</td>
<td>9%</td>
<td>46%</td>
<td></td>
</tr>
</tbody>
</table>
When Shareholders Gain From an Acquisition

- Gains from merger
- Synergies
- Control
- Top line
- Bottom line
- Financial restructuring
- Business Restructuring (M&A)

What is Corporate Restructuring?

- Any substantial change in a company’s financial structure, or ownership or control, or business portfolio.
- Designed to increase the value of the firm

- Restructuring
- Improve capitalization
- Improve debt composition
- Change ownership and control
It’s All About Value

How can corporate and financial restructuring create value?

- Fix the business
- Or fix the financing

Restructuring

| Fix the business mix – divestitures | Value assets to be sold |
| Fix the business – strategic partner or merger | Value the merged firm with synergies |
| Fix the financing – improve D/E structure | Revalue firm under different leverage assumptions – lowest WACC |
| Fix the kind of equity | What can be done to make the equity more valuable to investors? |
| Fix the kind of debt or hybrid financing | What mix of debt is best suited to this business? |
| Fix management or control | Value the changes new control would produce |
Getting the Financing Right
Step 1: The Proportion of Equity & Debt

- Achieve lowest weighted average cost of capital
- May also affect the business side

Step 2: The Kind of Equity & Debt

- Short term? Long term?
- Baht? Dollar? Yen?
- Bonds? Asset-backed?
- Convertibles? Hybrids?
- Debt/Equity Swaps?
- Private? Public?
- Strategic partner?
- Domestic? ADRs?
- Ownership & control?
**The CFO Questions at Bouygues**

- How fast can we grow? What criteria for spending money? Acquisitions? Divestitures?
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