GLEN ARNOLD

THE HANDBOOK OF CORPORATE FINANCE

A Business Companion to Financial Markets, Decisions and Techniques

FT Prentice Hall
FINANCIAL TIMES

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To Ben, Sam, Poppy and George

ABOUT THE AUTHOR

Glen Arnold, PhD. is a professor of finance (part time) at the University of Salford. He heads a research team focussed on stock market mispricing of shares and the exploitation of that mispricing. His university textbook *Corporate Financial Management* has quickly established its place as the leading UK-based textbook for undergraduates and post-graduates. He also wrote *The Financial Times Guide to Investing,* which provides a comprehensive introduction to investment and the financial markets. The book *Valuegrowth Investing*, describes the approaches of the great investors and synthesizes their insights into a disciplined form of investing.

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INTRODUCTION

Managers climbing the corporate ladder find the further they go the more they need to understand the concepts and jargon of finance, both for internal decision making and external interaction with investors, bankers and the City.

It is normally the case that managers have not received any formal training in finance. Furthermore, they are not in a position to take time out from the business to dedicate themselves to study. So what they need is a guide that will allow them to absorb and apply the essential tools of finance while they continue with their executive responsibilities. This book is that guide.

It is designed to be comprehensive, crystal-clear and directed at real world problem solving. It is rigorous without over-burdening the reader. It is not academic in the sense of laboriously expounding theory, but it nevertheless presents state-of-the-art techniques and frameworks, with a focus on managerial action.

The imperatives of day-to-day management mean that all middle and senior executives must have a firm grasp of the fundamental financial issues. These will touch every aspect of the business, ranging from deciding which capital expenditure projects are worthy of backing to managing business units for shareholder value.

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Discussion at boardroom level – which inevitably percolates down – is mostly couched in financial terms: what rate of return are we achieving? should we merge? how do we value a company? how do we control foreign exchange rate losses? etc. Because the language of business is largely financial, managers need to understand that language if they want to know what is going on, and to advance. They also need to read the financial pages of broadsheet newspapers to comprehend the wider environment in which the business operates. How can they expect to make senior level decisions without understanding the world around them? Newspapers such as the *Financial Times* assume knowledge of key financial concepts and jargon. This book will help with intelligent reading of these publications.

Some of the financial issues covered

- Value-based management is increasingly spoken of, but little understood. This book provides a thorough grounding.
- Mergers and the problem of merger failure (i.e. acquiring shareholders losing out) is discussed along with remedies.

- The proper use of derivatives as tools helping the business control risk, rather than increasing it, is explained in easy-to-follow and practically-oriented fashion.
- Modern investment appraisal techniques are contrasted with the traditional rules of thumb employed by many companies.
- There is an overview of modern financial markets and instruments with insight into the benefits brought by effective exploitation of the markets and perils of ignoring the demands of the finance providers.

The scope of corporate finance

To bring the book alive for readers, and to show the mutual reinforcement of practical management and finance theory, there are numerous examples of major UK companies employing the concepts and techniques discussed in each chapter. Much of the 'real-world' material is drawn from articles in the *Financial Times*. A typical case is shown in Exhibit I.1 which is used here to highlight the scope of the subject of corporate finance.

There are four key financial issues facing management:

In what projects are we going to invest our shareholders' money?

The directors of FlyBE believe that they have a fantastic investment opportunity in low-fare regional flying. Sound financial techniques are needed to make a judgment on whether it is worth committing the large sums required to build up its route network. Furthermore, financial tools will be essential in choosing between the alternative projects of (a) using Boeing aircraft, or (b) replacement of existing fleet with Airbus planes. Connected with the new strategy there will be dozens of smaller investment choices to be made, e.g. is it better to outsource particular operations or undertake the activity in-house? The first section of the book describes proven approaches adopted by all leading corporations in deciding where to concentrate the firm's financial resources. This class of decisions are sometimes referred to as capital expenditure or 'capex'.

How do we create and measure shareholder value creation?

Value creation by a corporation or by individual business units is about much more than deciding whether to invest in specific projects. FlyBE will need to consider a number of strategic implications of its actions, such as: what is the current and likely future return on capital in the industry it is choosing to enter? Will FlyBE have a competitive edge over its rivals in that industry? Value-based management brings together a number of disciplines, such as strategy and resource management,

Value creation by a corporation or by individual business units is about much more than deciding whether to invest in specific projects.

FlyBE negotiates to join the big league

Kevin Done **finds the short-haul airline, based at Southampton airport, is preparing to expand into the low-cost market**

FlyBE, formerly known as British European, has opened discussions with both Boeing and Airbus on an order for new short-haul aircraft as part of the renewal of its fleet and its ambitious transformation into a UK regional low fares airline.

The group is preparing for a stock market flotation or trade sale during the next three years.

It was built up by Jack Walker, the former steel stockholding millionaire and owner of Blackburn Rovers, and is still privately owned by one of the Walker family trusts.

FlyBE is seeking to build a route network in the provinces to compete with the leading no-frills airlines as it restructures and overcomes two years of heavy losses at the start of the decade.

The negotiations on new aircraft will pitch Boeing against Airbus in the latest of a series of fierce contests between the two aircraft makers in the fast-growing low-cost airline sector.

Jim French, FlyBE managing director, said the group was considering the 148-seat Boeing 737-700 against the 156-seat Airbus A319 to replace its ageing fleet of 15 112- and 98-seat BAe 146s. The group has already ordered 17 Bombardier 78-seat Q400 turbo-prop aircraft for its shorter routes this year. The move from the BAe 146s to Boeing or Airbus aircraft will represent a big jump in both capacity and ambition for FlyBE, and its success will be an important factor in influencing the timing of an initial public offering of the airline.

The Walker family trusts have had to inject £22.5m in fresh capital in the past two years to support the restructuring and provide for the airline's survival.

The airline's total passengers are forecast to rise from 3.9m this year to 4.5m in the year to March 2005, making FlyBE one of the largest independent regional airlines in Europe.

EXHIBIT I.1 Financial knowledge is crucial for FlyBE success

Source: *Financial Times* 10 December 2003

and draws on the measures developed in the finance field to help judge the extent of value creation from current operations or from new strategic and tactical moves (covered in Chapters 6 to 9). At the center of value-based management is recognition of the need to produce a return on capital devoted to an activity commensurate with the risk. Establishing the minimum required return is the 'cost of capital' issue – the logic behind this calculation is discussed in Chapter 10.

As FlyBE grows it may ponder the possibility of merger with other companies. This is a seductive and potentially treacherous path. To succeed, managerial thought and planning must extend beyond the narrow task of deal making. Chapters 11 and 12 consider the major issues here.

Being able to value business units, companies and shares is a very useful skill. It can help avoid over-paying for an established business. It can also give an insight into how stock market investors value the manager's company. FlyBE is preparing for a possible stock market flotation – managerial knowledge of how to

value its shares could be crucial. Chapter 13 covers the main valuation approaches used today. A further key value decision is how much of the annual profit to keep in the business to support investment and how much to pay out to shareholders. Is a 50:50 split about right? Or, how about keeping just 30 percent in the company and paying the other 70 percent in dividends? This is not an easy decision, but someone has to make it. Chapter 14 outlines the key considerations.

What type of finance should we raise?

The Walker family have pumped millions of pounds into FlyBE. Founder's capital is a very important source of finance for many firms. Others do not have such wealthy patrons to become established and grow. Fortunately for them the modern financial world presents a wide range of options from selling shares to issuing corporate bonds. The array of choices can be dizzying so the third part of the book provides some order, describing the characteristics of the main forms of finance and their relative advantages and drawbacks. Chapter 15 guides the reader through the benefits and dangers of using bank loans and overdrafts, hire purchase, leasing, trade credit and factoring. Then, we move to the forms of debt finance available to larger firms on the financial markets, from high-yield bonds to convertibles and eurobonds. Jargon is explained and the reader is guided to the selection of the most suitable mixture of finance given the company's circumstances. The final chapter in this section deals with the process of gaining a stock market quotation for a company's shares – a particularly apposite chapter for FlyBE managers. It also describes alternative ways of raising money by selling shares, for example, a rights issue, venture capital or business angel capital.

How do we manage risk?

FlyBE is faced with many operational risks. Perhaps it will fail to achieve the rise in passenger numbers it projects. Perhaps its new aircraft will be superseded by cheaper, quieter, faster aircraft bought by competitors a couple of years down the line. There are some risks that firms have to accept, including these operational risks. However, there are many others that can be reduced by taking a few simple steps. For example, the risk of a rise in interest rates wiping out profits can be reduced/eliminated in various ways, ranging from choosing a less risky capital structure (proportion of finance from debt and share capital) to the use of interest rate futures on financial markets. Options, forwards and futures can be used to avoid the danger of fuel price rises. The risk that comes from changes in foreign exchange rates can also be controlled through exotic sounding instruments such as swaps, forwards and options. The final section of the book considers the various financial risks managers have to confront and describes how they can be reduced by some simple tactical moves as well as the use of derivatives.

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