

SECOND EDITION

Corporate Finance Principles & Practice

Denzil Watson and Antony Head

Sheffield Hallam University

From Fraining to go and write

Chris edition is quarty charter a calculate and can be Nation Series and the Markersa

manti Aca by Phresos Education (Conjunction Field and An Dona 1 (1969), "ratia





puis

Copyright © 2001 by Pearson Education Ltd. This edition is published by arrangement with Pearson Education Ltd.

The right of Hugh Denzil Watson and Antony Head to be identified as authors of this work has been asserted by them in accordance with the Copyright, Designs and Patents Act 1988.

All rights reserved. No part of this publication may be reproduced, stored in a database or retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of the publisher.

ISBN 81-7808-734-0

First Indian Reprint, 2002

This edition is manufactured in India and is authorized for sale only in India, Bangladesh, Pakistan, Nepal, Sri Lanka and the Maldives.

Published by Pearson Education (Singapore) Pte. Ltd., Indian Branch, 482 F.I.E. Patparganj, Delhi 110 092, India

Exclusively distributed in India by Taxmann Publications (P) Ltd., 59/32, New Rohtak Road, New Delhi 110 005

Printed in India by Baba Barkha Nath Printers.

Price: Rs 375

Contents

Pre	eface	xi
2	4.3 Republic States States (Sept. 2.4)	
1	The finance function	1
	LEARNING OBJECTIVES · INTRODUCTION	
	1.1 The role of the financial manager	2
	1.2 Corporate objectives	5
	1.3 How is shareholders' wealth maximised?	7
	1.4 Agency theory	9
	Vignette 1.1 Shareholders place corporate responsibility high on	
	agenda	14
	1.5 Corporate governance	15
	Vignette 1.2 Most companies 'flout code on corporate governance'	17
	1.6 Conclusion	18
	KEY POINTS · QUESTIONS · QUESTIONS FOR REVIEW ·	
	QUESTIONS FOR DISCUSSION · REFERENCES · RECOMMENDED READING	
2	Capital markets, market efficiency and ratio analysis	23
	LEARNING OBJECTIVES · INTRODUCTION	
	2.1 Sources of business finance	24
	2.2 The capital markets	27
	2.3 Ratio analysis	33
	2.4 Conclusion	45
	KEY POINTS · QUESTIONS · QUESTIONS FOR REVIEW ·	
	QUESTIONS FOR DISCUSSION · REFERENCES · RECOMMENDED READING	
3	An overview of investment appraisal methods	52
		52
	LEARNING OBJECTIVES · INTRODUCTION	53
	3.1 The payback period3.2 The accounting rate of return method	55
	Example Calculation of the accounting rate of return	56
	3.3 The net present value method	58
	Example Calculation of the net present value	59
	3.4 The internal rate of return method	62
	Example Calculation of internal rates of return	63
	3.5 A comparison of the NPV and IRR methods	67
	3.6 The profitability index and capital rationing	72
	3.7 The discounted payback method	75

entransis in the solution of the nurse of

V

5°.4		3.8 Conclusion	76
		KEY POINTS • QUESTIONS • QUESTIONS FOR REVIEW QUESTIONS FOR DISCUSSION • REFERENCES • RECOMMENDED READING	
	4	Investment appraisal: applications and risk	83
		LEARNING OBJECTIVES · INTRODUCTION	
		4.1 Relevant project cash flows	84
		4.2 Taxation and capital investment decisions	85
		Example NPV calculation involving taxation	88
		4.3 Inflation and capital investment decisions	89
		Example NPV calculation involving inflation	91
		4.4 Investment appraisal and risk	92
		Example Application of sensitivity analysis	94
		4.5 Empirical investigations of investment appraisal	100
		4.6 Conclusion	105
		KEY POINTS · QUESTIONS · QUESTIONS FOR REVIEW ·	
		QUESTIONS FOR DISCUSSION · REFERENCES · RECOMMENDED READING	
	5	Sources of long-term finance: equity finance	112
		LEARNING OBJECTIVES · INTRODUCTION	
		5.1 Equity finance	113
		5.2 The new issues market	114
		Example Tender issue	116
		5.3 Rights issues	120
		Vignette 5.1 Opinions split on Pearson discounted rights issue	125
		5.4 Scrip issues, stock splits, scrip dividends and share repurchases	126
		5.5 Preference shares	127
		5.6 Conclusion	129
		KEY POINTS · QUESTIONS · QUESTIONS FOR REVIEW ·	-
		QUESTIONS FOR DISCUSSION · REFERENCES · RECOMMENDED READING	
	6	Sources of long-term finance: debt finance, hybrid finance	- 1
		and leasing	136
		LEARNING OBJECTIVES · INTRODUCTION	
		6.1 Loan stock and debentures	137
		6.2 Bank and institutional debt	139
		6.3 International debt finance	140
		6.4 Hybrid finance	141
		6.5 The valuation of fixed interest debt securities	144
		6.6 The valuation of convertible loan stock	145
		Example Valuation of a convertible loan stock	147
		6.7 Leasing	148
		Example Evaluation of leasing vs buying	152

~	n	M	т	C.	81	т	c
С	υ	n.		c.	n.	٠	Э

3

	6.8 Conclusion	155
	KEY POINTS · QUESTIONS · QUESTIONS FOR REVIEW ·	
	QUESTIONS FOR DISCUSSION • REFERENCES • RECOMMENDED READING	
7	Dividend policy	162
	LEARNING OBJECTIVES · INTRODUCTION	
	7.1 Dividends: operational and practical issues	163
	7.2 Dividend irrelevance	166
	7.3 Dividend relevance	168
	Vignette 7.1 M&S buoyed by relief	169
	7.4 Dividend relevance or irrelevance?	172
	7.5 Dividend payout strategies	172
	7.6 Alternatives to cash dividends	175
	Vignette 7.2 Cadbury defends the bid price	176
	Vignette 7.3 Corporate cashpoints	177
	7.7 Empirical evidence on dividends	178
	7.8 Conclusion	180
	KEY POINTS · QUESTIONS · QUESTIONS FOR REVIEW ·	
	QUESTIONS FOR DISCUSSION · REFERENCES · RECOMMENDED READING	
8	The cost of capital and capital structure	187
	LEARNING OBJECTIVES · INTRODUCTION	
	8.1 Calculating the cost of individual sources of finance	188
	8.2 Calculating the weighted average cost of capital	191
	Example Calculation of the WACC	192
	8.3 Average vs marginal cost of capital	193
	8.4 The practical application of the WACC	195
	8.5 Gearing: its measurement and implications	197
	8.6 The concept of an optimal capital structure	199
	8.7 The traditional approach to capital structure	201
	8.8 Miller and Modigliani (I) – net income approach	202
	8.9 Miller and Modigliani (II) and market imperfections	205
	8.10 Miller and personal taxation	208
	8.11 Pecking order theory	209
	8.12 Does an optimal capital structure exist? A conclusion	210
	KEY POINTS · QUESTIONS · QUESTIONS FOR REVIEW ·	
	QUESTIONS FOR DISCUSSION · REFERENCES · RECOMMENDED READING	
9	Portfolio theory and the capital asset pricing model	218
	LEARNING OBJECTIVES · INTRODUCTION	
	9.1 The measurement of risk	219
	9.2 The concept of diversification	222
	9.3 Investor attitudes to risk	226
	9.4 Markowitz's portfolio theory	227
	9.5 An introduction to the capital asset pricing model	229
	7.5 An introduction to the capital asset pricing model	
		vii

	9.6 Using the CAPM to value shares	230
	Vignette 9.1 Equity risk	236
	9.7 The CAPM and investment appraisal	238
	Example The CAPM in the investment appraisal process	241
	9.8 Empirical tests of the CAPM	243
	9.9 Conclusion	246
	KEY POINTS · QUESTIONS · QUESTIONS FOR REVIEW ·	
	QUESTIONS FOR DISCUSSION · REFERENCES · RECOMMENDED READING	
10	Working capital management	253
	LEARNING OBJECTIVES · INTRODUCTION	
	10.1 The objectives of working capital management	254
	10.2 Working capital policies	254
	10.3 Working capital and the cash conversion cycle	258
	Example Calculation of required working capital	258
	10.4 Overtrading	260
	10.5 The management of stock	261
	Example Use of the EOQ model	263
	10.6 The management of cash	265
	10.7 The management of debtors	269
	Example Evaluation of a change in debtor policy	271
	Example Cost-benefit analysis of factoring	272
	10.8 Conclusion	273
	KEY POINTS · QUESTIONS · QUESTIONS FOR REVIEW ·	
	QUESTIONS FOR DISCUSSION · REFERENCES · RECOMMENDED READING	
11	Mergers and take-overs	279
	LEARNING OBJECTIVES · INTRODUCTION	
	11.1 Terminology associated with mergers and take-overs	280
	11.2 Justifications for acquisitions	281
	Example Boot-strapping	285
	11.3 Trends in take-over activity	287
	11.4 Valuation of the target company	289
	Example Take-over (Simpson and Stant)	289
	11.5 The financing of acquisitions	296
	11.6 Strategic and tactical issues	300
	11.7 Empirical research on acquisitions	306
	11.8 Conclusion	309
	KEY POINTS · QUESTIONS · QUESTIONS FOR REVIEW · 1009	
	QUESTIONS FOR DISCUSSION · REFERENCES · RECOMMENDED READING	
12	Risk management	316
_	LEARNING OBJECTIVES · INTRODUCTION	
	12.1 Interest and exchange rate risk	317
	12.2 Internal risk management	321
	12.2 internal risk management	541

viii

227

12	.3 External risk management	323
	Example Forward rate agreement	324
12	.4 Futures contracts	325
	Example Using interest rate futures	326
	Example Using US currency futures	326
12	.5 Options	327
	Example Using interest rate options	330
	Example Using exchange rate options	330
12	.6 Swaps	333
	Example Plain vanilla interest rate swap	334
	Example Fixed to floating currency swap	336
12	.7 Issues in risk management	338
12	.8 Conclusion	342
KE	Y POINTS · QUESTIONS FOR REVIEW ·	
QU	ESTIONS FOR DISCUSSION · REFERENCES · RECOMMENDED READING	
13 In	ternational investment decisions	349
LEA	ARNING OBJECTIVES · INTRODUCTION	
13	.1 The reasons for foreign investment	350
13	.2 Different forms of international trade	352
	Vignette 13.1 New access to top trading partner	353
13	.3 The evaluation of foreign investment decisions	356
	Vignette 13.2 Positive experience in difficult markets	357
	Example Foreign direct investment evaluation	361
13	4 The cost of capital for foreign direct investment	363
13	.5 Political risk	366
13	.6 Conclusion	368
KE	Y POINTS · QUESTIONS · QUESTIONS FOR REVIEW ·	
QU	ESTIONS FOR DISCUSSION · REFERENCES · RECOMMENDED READING	
Append	ix: Answers to end-of-chapter questions	374
Glossar	ý	425
	value tables	432
Index		434

ix

CONTENTS