
Corporate Claims

The rest of the course focuses on “pure” corporate finance issues, rather than just capital budgeting and the cost of capital / financial markets.

With the notable exception of WACC and APV, there are few important formulas that help managers to quantify costs and benefits in this part of the course—instead, it is now the “softer” concepts that are so very important.

Basic Building Blocks

15-1,15-2

Debt

- Cash Flow Right: First Dib.
- Control Right: Force bankruptcy. (Plus Covenants.) (Plus some Fiduciary Responsibility.)
- Tax Status: *Interest* is good for firm.

Interest receipts are bad for non-tax exempt investors [capital providers].

- Liquidity: Often OTC.
- More: A zoo of features.

10-30% of capital in UK, 30-40% in CA, 20-30% in USA.

Common Equity

- Cash Flow Right: Later Dib. Gets all the upside.
- Control Right: Vote. (Fiduciary Responsibility.)
- Tax Status: *Dividends* are bad for firm.

Dividend receipts are better for non-tax exempt investors [capital providers].

- Liquidity: Often well traded.
- More: Usually uniform, often by law or exchange reg. (e.g., 1-share=1-vote]

Non-Financial Claims Do not fit in easily, but are important. Firm \neq Debt + Equity. Capital = Debt + Equity.

Payoff diagrams tell you nothing about control rights (or about the time dimension of cash flow rights).

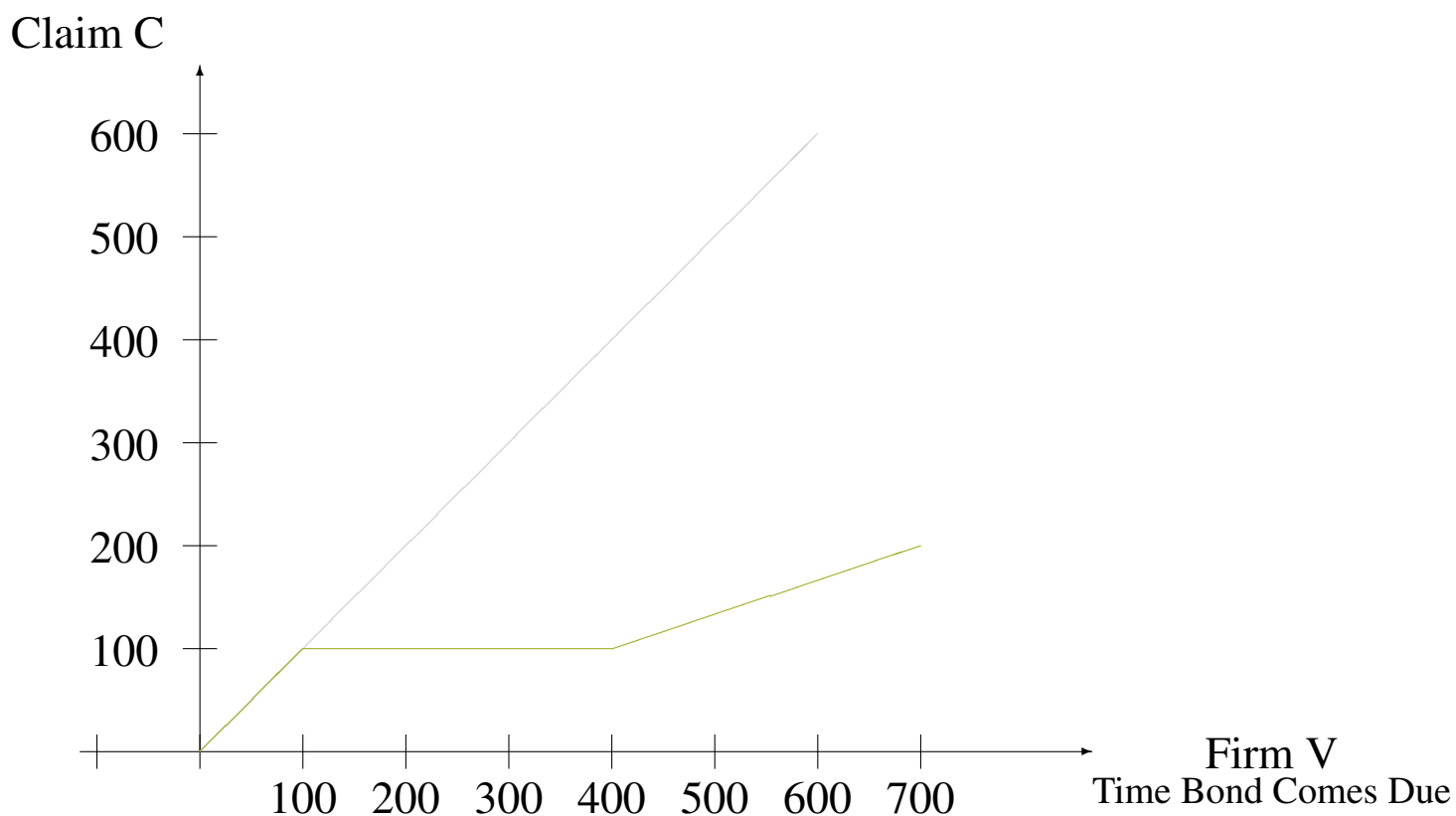
Pyramid Ownerships in other countries. Conflict is between special investors and other investors.

Payoff Diagrams/Tables

— Cash Flow Rights

15-1.D

- Security = Claim that is registered with SEC. But lose usage now.
- We already did the payoff tables. Payoff Diagrams.
- One example—a convertible bond, face value \$100, convertible into 25% of the value of the firm.



- Payoff diagrams “fail” on showing the time dimension (e.g., when there are multiple payoff dates); and they tell you nothing about the control rights.

Preferred, Warrants, Options, Convertibles, More Bond Features

15-3

Preferred Stock Now exceedingly rare in publicly traded firms.

- Cash Flow Right: Between Debt and Equity.
- Control Right: Only by contract.
- Tax Status: *Dividends* are bad for firm.

Mediocre for Non-Tax Exempt Capital Providers.

...except for corporate lenders. (“convertible preferred.”)

- Liquidity: Often Traded.

With better tax treatment of ordinary dividends, preferred equity is becoming less important. It may vanish from publicly traded corporations, and exist merely in private-equity context.

Warrants Fairly rare, except in small firms. Warrant = Call option where new shares are newly issued.

Puts Truly Rare. Firms issue securities that pay off when they tank.
Huh?

IBM

15-4

| Liabilities | 2001 | 2002 | 2003 |
|--------------------------------|-----------------|----------------|----------------|
| Long-Term Debt | \$15,963 | \$19,986 | \$16,986 |
| Short-Term Liabilities | \$35,119 | \$34,550 | \$37,900 |
| <i>inc. ST Fin Debt of</i> | <i>\$11,188</i> | <i>\$6,031</i> | <i>\$6,646</i> |
| Pension Liabilities | \$10,308 | \$13,215 | \$14,251 |
| Other Liabilities | \$5,465 | \$5,951 | \$7,456 |
| Minority Interest — none | | | |
| Negative Goodwill — none | | | |
| Total Liabilities | \$66,855 | \$73,702 | \$76,593 |
| Financial Debt | \$27,151 | \$26,017 | \$23,632 |

| Equity | 2001 | 2002 | 2003 |
|------------------------------|-----------|-----------|-----------|
| Total Issued Shares | | 1920.96 | 1937.39 |
| – Treasury Shares = | | – 198.59 | – 242.88 |
| Number of Shares | 1,723.19 | 1,722.38 | 1,694.51 |
| Book Price/Share | 13.61/s | 13.23/s | 16.44/s |
| Market Price/Share | 120.96/s | 77.50/s | 92.68/s |
| Stockholder's Equity (BV) | \$23,448 | \$22,782 | \$27,864 |
| Market Value of Equity .. | \$208,437 | \$133,484 | \$157,047 |

Measuring Leverage

Book has details:

LT Debt: Consists of many, many different bonds and notes. Different currencies, terms, etc.

Current Liabilities: ST Debt, Taxes, Accounts Payable, Compensation and Benefits, Deferred Income, Other Accrued. (All are about \$4 to \$8 billion each.)

Other Liabilities: Deferred Taxes, Deferred Income, Exec Compensation Accruals, Restructuring Actions, Postemployment, Disability Benefits, Environmental Accruals, etc. (All are between \$200 mill and \$2 bill.)

Equity: Not too informative in terms of categories.

Potential Categories:

- Claims mostly not under CFO control (e.g. pensions)
- Claims that can be changed (e.g., short-term notes).
- Claims changing constantly (e.g., equity).

Measuring Leverage

15-5

Measure should be: High Value = Levered. Low Value = Unlevered.

- We have no easy, good measures for *effective* leverage, taking into account operational leverage. Thus, we focus on financial and/or balance sheet leverage measures only.
- Financial-Debt/Capital, where FD is LT Debt plus debt in current liabilities. Between 0 and 1. (Well, weird exceptions are possible.)
- Financial-Debt/Equity, really the same, but not between 0 and 1.
- Total Liabilities/Assets—broader. converse is equity/assets.
- Total Liabilities/Equity—really the same.
- Avoid (occasionally used) Financial Debt/Assets.
The remainder are more non-financial liabilities than equity.
- Measure equity in book value (!) or market value.
Debt is almost always book value.
- For WACC calculations, use FD/Capital ratio. This is useful if the financial cost is the marginal cost of capital, and you want to get the cost of capital for a project that is the marginal project of the type of firm you already have.
Omits other sources of financing, and can misstate the financial “vulnerability” of firms.
- (15-5.D): The **Interest Coverage Ratio** is an altogether different measure. Its problem is that there are years in which cash flow and/or earnings are negative. Flow is often too ephemeral.

Homework Assignment

1. Reread Chapter 15.
2. Read Chapter 16.
3. Hand in all Chapter 15 end-of-chapter problems, due in 7 days.