

The Role of Corporate Finance in Maximizing Shareholder Value

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The purpose of corporate finance is to increase shareholder value through the pursuit of two separate but related activities:

- Financing the business at the lowest sustainable after-tax cost; and
- Allocating capital resources to investments that promise the highest risk-adjusted returns to investors.

Financing at the Lowest After-Tax Cost

Debt is a contractual obligation of the issuer to make interest and principal payments over a specified period. Consequently, the cash flows payable to debt holders are limited in amount and duration. In contrast, shareholders own the business, so the potential value and duration of their investment is open-ended.

Debt is a cheaper source of capital than shareholder equity because it has first call on the borrower's cash flow and, unlike dividends, interest payments are tax deductible. Debt's cost advantage over equity declines as the ratio of debt-to-equity increases, but never really disappears as long as the company remains viable. Despite the inherent cost advantage of debt, additional leverage becomes imprudent at some point along the debt/equity continuum and companies must consider selling more equity.

Debt holders are less tolerant of risk than equity investors because their profit potential is contractually limited (they cannot earn more than they are promised by the borrower). The existence of debt in a company's capital structure increases equity's return potential because it is a cheaper financing source. However, debt also increases equity's risk of loss because interest and principle payments are fixed costs that reduce the amount of cash flow available for reinvestment or distribution to equity investors.

Lenders respond to increasing leverage by demanding higher interest rates and seeking seniority over other creditors. Equity investors respond by bidding down the price of equity securities. Thus, the cost of both sources of capital rises as the ratio of debt-to-equity increases.

Access to debt capital is a function of a company's perceived ability to service debt out of available cash flow. Because future revenues are rarely known with certainty, analysis of a company's debt capacity tends to focus on the volatility of revenues over time and how this volatility affects cash available for debt service. The existence of fixed costs exaggerates the effect of revenue volatility on cash flow.

Companies in cyclical industries with high fixed operating costs, such as automobile manufacturing and mining, have less debt capacity per unit of cash flow than companies in industries with stable revenue streams (e.g., utilities) or low fixed operating cost (e.g., financial services companies). This lack of consistency among industries has led credit rating agencies, like Moody's, Standard & Poor and others to establish credit guidelines for companies engaged in different types of business.

Companies assigned one of several "investment grade" ratings are generally able to borrow long-term debt when they choose at premiums over yields on U.S. treasury securities ranging from 10 basis points (i.e., 0.10%) for the strongest "triple-A" rated borrowers, to 250 basis points for substantially weaker "triple-B" borrowers. Triple-B borrowers are limited to shorter debt maturities than triple-A borrowers (e.g., 10-12 years versus 30-40 years). However, to achieve these terms, triple-B borrowers may be forced to give lenders seniority over other lenders and/or give them direct security in selected assets.

"Non-investment grade" or "junk" borrowers pay much higher interest rates than investment grade borrowers because their risk of default is relatively high. Many investors will not lend to junk credits, even at higher interest rates, forcing these borrowers to rely on pools of capital that are smaller, shorter term and less reliable. Non-investment grade borrowers are also subjected to covenants that limit additional borrowing and restrict the use of discretionary cash flow, usually to the detriment of shareholders.

Even then, non-investment grade companies are often denied access to additional capital when they need it most. In these situations, companies are forced to conserve cash by cutting costs and liquidating assets. If these actions prove inadequate, vultures circle and the company becomes embroiled in a fight for its life. The result is rarely satisfactory to shareholders or debt holders.

Aversion to such situations motivates most companies to limit the use of debt to levels that assure continued capital access. This strategy results in a cost of capital above a company's theoretical minimum.

The pricing of equity securities is far more complex than setting the yield on debt securities because cash flows to shareholders are subject to wider variation and greater uncertainty (risk). These characteristics make it difficult for companies to ensure uninterrupted access to new equity at reasonable prices. However, prudently leveraged companies can expect to have consistently better access to equity capital than similar, but excessively leveraged, companies.

Allocating Capital Resources Among Competing Needs

Cash flow after debt service requirements is either distributed to shareholders in the form of dividends and share repurchases, or it is reinvested in the business to generate more cash flow in the future. When cash needs exceed available cash, companies seek to cover the shortfall by securing additional debt and equity capital. Investors provide additional capital only if they judge the risk-adjusted return to be attractive in comparison to competing opportunities.

This requires managers to evaluate the risk and return characteristics of internal opportunities against external opportunities available to investors. Closely held or privately owned companies may communicate directly with shareholders or involve them directly in the decision-making process. In the absence of direct investor involvement, managers are forced to assess the investment merits of internal opportunities against market-oriented measures of risk and return.

This market oriented approach is based on the theory that investors minimize risk by holding diversified portfolios of financial assets: if the price of a security falls because of poor management, act of God, or other reason unique to that company, other securities in the portfolio unaffected by those events will mitigate the effect of the price decline on the overall value of the portfolio. If the portfolio contains a sufficient number of different securities, the impact of risks unique to individual securities can be reduced substantially. However, risks common to all portfolio assets cannot be reduced through diversification. These risks include economic recession, which reduces earnings of most companies and higher interest rates, which depress the value of all assets.

Because unique risks can be managed through portfolio diversification, investors generally focus their attention on the amount of non-diversifiable or systematic risk in the assets they hold. Securities that increase the overall level of systematic risk are avoided, unless they are priced cheaply enough to produce extra returns (in terms of future income price appreciation) to compensate investors for the additional risk. The measure of systematic risk is known as beta or " β ", the second letter in the Greek alphabet.

A security with a beta of 1.2 is said to be 20% riskier than a security possessing a beta of 1.0. Investors bid down the price of the riskier security until expected future returns are high enough to compensate them for the additional risk.

Conclusions

The practical implications of the foregoing principles are enormous:

- For a given rate of return, businesses with less risk (as measured by beta or cash flow volatility) are more valuable to debt and equity investors than businesses with greater risk;
- Operating and financial leverage increase risk by contributing to fixed costs. Although both kinds of leverage are similar in their effect on the cost of debt and equity capital, financial leverage tends to be more discretionary. Debt policy therefore is a tool for managing overall risk.
- In the pursuit of shareholder value, investments should be evaluated in terms of risk and return. This analysis should extend to existing investments and new investments that do not require external financing.
- Risk measures are integral to developing useful guidelines that help business managers to determine (i) how new investments will affect shareholder value, (ii) the maximum acceptable purchase prices of acquisition candidates and (iii) the minimum acceptable selling prices of divestment candidates.

Corporate finance provides tools for (i) measuring the cost of financing alternatives, (ii) measuring the risk and return of new and existing investments, (iii) pricing acquisition and divestment candidates and (iv) developing integrated strategies that increase shareholder value. Managers have a responsibility to use these tools effectively.