What is Advanced Corporate Finance?

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Note: Slides are on the web

What is finance?

- Deciding how to optimally manage a firm's assets and liabilities.
- Managing the costs and benefits associated with the timing of cash in- and outflows and how these can be influenced by the different financial instruments available to the firm (e.g., assets, liabilities and derivatives).

What is Corporate Finance?

- Managing the funds (in and outflows) related to a corporation's activities.
- It generally involves balancing firm profitability with the risk of financial distress over the short- and long-term, while attempting to maximize stakeholders' utility (usually the value of its equity).
  - It includes investing excess funds and raising funds (short-term or long-term) for new or ongoing uses.
  - It includes hedging financial risks.
- These decisions depend on the firm's objectives and constraints such as institutional or individual goals, time horizon, risk aversion and tax considerations.

What is Advanced Corporate Finance?

- Extension of previous courses to focus on the relationships between financial factors and firm decisions from the perspective of a financial manager.
- Financial factors / financial markets and instruments
  - Stocks
  - Bonds, Money market instruments
  - Derivatives
- Value of financial decisions
  - Determination of the fair value of corporate assets
    - How risky is the asset? When is it risky?
    - What cash flows will it produce? How valuable are they to me?
  - How does the market price compare to similar assets? What is its intrinsic value? Is it a worthwhile use of limited corporate funds?

Goal of the Course

Expand your financial "tool box"

- As global risks and opportunities have increased, financial markets have developed tools to help manage this risk and exploit these opportunities.
- This course focuses on identifying and evaluating the risks relevant to managers operating in today's global environment.
  - What types of risk do they face? Should these risks be managed? How can the risks be managed?
  - What types of opportunities? How can they be utilized?
  - What value do these bring to the firm?
- Developing a logical framework linking firms and financial markets to manage the risks and exploit the opportunities.

Course Overview

PART A
Introduction

ADVANCED CORP FIN

- Introduction to financial markets
- Identifying business and financial risks

PART B
Derivative Securities

RISK MANAGEMENT

- Designing hedging strategies
- Managing international assets

PART C
Financing Strategies

GLOBAL CAPITAL RAISING

- Introduction to global financial markets
- Global equity and debt financing strategies

PART D
Global Valuation and Investing

GLOBAL INVESTING

- Global capital budgeting
- International asset allocation

Administrative Issues

- Materials
  - Assigned readings: the case packet, and the class web page.
  - The materials are selected to complement the lectures, cases and class discussions.
- Office hours
  - "open door", but please email or call first
- Grades
  - Based on case brief (due next Tuesday), final exam and class contribution.
  - Final exam (April 29^{th}): 4 hour case with assigned questions

Class Contribution Grading

- Class-by-class record of contribution based on
  - My evaluation of each student's class-by-class contribution
  - Input from peer evaluation of contribution
- Aggregation:
  - At the end of the course, the quality and regularity of contributions over the course will be used to arrive at the final grade.

Case Analysis: Review

Steps to follow:

- Who is the decision maker?
- What is the decision?
- What are the criteria?
  - Maximizing shareholders' wealth? Corporate wealth? Management's wealth? NGO's?
  - Limiting risk? What type of risk(s)? How significant are each of these risks?
- Key alternatives to consider?
- Analysis and discussion of the alternatives.
- Decision and action plan.

What will we cover in this course?

- Identification and management of financial risk and its role in managing business or enterprise risk.
- Understanding the costs and benefits to raising funds for operations in foreign versus domestic markets.
- Evaluating the costs and benefits to purchasing and operating financial and non-financial assets in emerging and developed markets (i.e., M&As, JVs or greenfield).

Risk Management

Firms must manage two types of risk:

1. Business Risk
   - The risk associated with manufacturing and marketing the firm's products
2. Financial Risk
   - The risk associated with ensuring the firm has adequate cashflows to meet its commitments.

- How do these risks depend on our actions? Others' actions? Financial markets?
- Are they something we should try to hedge?
- What tools exist to perform the desired function?

Source of Financial Risks?

- Producing goods and services requires one to purchase inputs whose prices are influenced by global market conditions.
  – Commodity prices depend on global supply and demand (i.e., the price of oil)
- Financing your operations requires one to borrow or lend and these interest rates are influenced by global market conditions.
  – Interest rates depend on global demand for financial assets (i.e., the current US interest rates?)
- Selling your goods depends on market conditions in both your domestic market and international markets.
- **Can we / should we do anything about these risks?**

Where Do These Risks Originate?

- Global trade in goods, services and financial assets has resulted in increased risks and opportunities for firms. There are now greater sources of supply ***and*** demand.
  - Global trade has increased dramatically over the past 30 years.
  - Some reasons for this: technology, economic growth, decreasing trade barriers, improved transportation ...
- The most obvious sources of risk:
  - Importing requires buying Euros, or Yen with Canadian dollars.
  - Exporting our goods and services requires that people buy Canadian dollars and our prices remain competitive when converted to the other currency.
  - What about borrowing/lending?

Examples of Risks and Opportunities

- Financial Risk
  - Capital risk – debt or equity values
  - Currency risk – value of C$ for inputs and outputs
  - Liquidity risk – the ability to buy or sell financial securities
- Political Risks
  - Difficulty enforcing contracts or “rule of law”.
  - Changes in regulation or differences in regulation, expropriation.
- Market Imperfections
  - Legal restrictions on market access.
  - Market segmentation.
- Expanded Opportunity Set
  - Move production overseas. Economies of scale
  - Diversification of market risk.
  - Global investment opportunities and financing alternatives.

Why Face These Risks?

- Comparative advantage. Countries have different strengths and weaknesses.
- As barriers to trade have fallen, firms have started to take advantage of these differences to maximize their performance.

Revealed Comparative Advantages

	US	***Canada***	Germany	Italy	Japan
Food, drink & tobacco	0.31	***0.28***	-0.36	-0.29	-0.85
Raw materials	0.43	***0.51***	-0.55	-0.30	-0.88
Oil products	-0.64	***0.34***	-0.72	-0.74	-0.99
Chemicals	0.42	***-0.16***	0.20	-0.06	-0.58
Machinery	0.12	***-0.19***	0.34	0.22	0.80
Other manufacturing	-0.68	***-0.07***	0.01	0.01	0.40

Source: OECD

Identifying the Risks Faced by Firms?

- Key questions we will examine:
  - What are the risks? How serious are the risks?
  - How do these risks impact management, shareholders, and debt holders?
  - What should we (as managers) do about them?

- Some examples to consider:
  - Canadian Banks
  - Auto manufacturing in MI versus ON versus China
  - Canadian Tech Companies

Identifying the Risks Faced by Firms?

- Look at the Management Discussion and Analysis (MD&A) section for McDonalds Corporation (MCD – NYSE)

Managing Foreign Exchange Risk

To decide about hedging:

- What exactly is the risk?
  - Is it a financial or business risk? Is it a cash risk or an accounting risk?
- Are the risks significant? Are the opportunities large enough to offset these risks?
  - When are these risks largest?
  - What happens in a “worst case” scenario? “best case”?
  - What are the indirect costs and benefits?
- Are these risks we should be bearing? How effectively can we manage them?

Identifying Foreign Exchange Risk

Foreign exchange risk: How do *unexpected* exchange rate movements affect a company's financial performance?

The three main types of foreign exchange risk are:

- Transaction Risk
- Translation or Accounting Risk
- Economic or Operating Risk

- Transaction and Economic/Operating risks are "cash" risks, but Translation/Accounting is a "paper" risk.
  - We will discuss the different risk management strategies required to manage each of them, once they have been identified.

Beyond Hedging: Financing Strategies

- Global operations allow access to global financial markets.
- There are a wide variety of costs and benefits to using global financial markets to meet capital needs.
  - Decreased cost of capital, diversification of capital sources, hedging currency and interest rate risks, managing political risk
- Alternatives:
  - The standard choices you should always consider:
    - Internal versus External? Debt or Equity?
    - But also: International or Domestic? What currency? What maturity? Private or public?

Choosing Global Financing Strategies

Formally, we choose the corporate financing strategy that:

- Minimizes the expected after-tax cost of financing
- Maintains the risk within acceptable levels.

The risks and benefits to different financing strategies are more difficult to assess in an international setting.

- Currency and interest rate risks
- Institutional differences across countries
- Tax laws differ across countries
- Political risks, regulatory differences, investor preferences …

Cross-Border Investments

- Need to determine: is this an investment worth taking?
  - Standard valuation methodologies from previous courses …
- Are there differences in the risks and thus valuation between foreign and domestic projects?
  - Business risks? Political risks? Economic risks? Financial risks?
- How do we account for these in making our decision?
  - What is the required return for this type of investment? Comparables? Growth rates?

Managing (Global) Risks & Opportunities

In this course we will:

- Identify and characterize the financial (and business) risks and opportunities faced by a firm to determine how to best manage its cashflows.
- Determine the significance of the risks associated with the financial instruments available to improve the firm's competitive position and pursue its opportunities.
- Evaluate the different alternatives

→ Increase value to the firm's stakeholders!

Financial Markets?