

Contents

Preface.....	vii
Acknowledgements	ix
1. Introducing Finance	1
1.1 The Stuff of Finance	2
1.2 The Firm	4
1.2.1 What is a firm?	4
1.2.2 The objective of the firm	5
1.1.2.1 Profit maximisation or wealth maximisation?	6
1.3 Corporate Structure	7
1.3.1 Sole proprietorship	7
1.3.2 Partnership.....	8
1.3.3 Limited companies	9
1.4 The Finance Function	12
1.5 Principals and Agents	13
1.5.1 Maximising versus satisficing	15
1.5.2 Management goals.....	16
1.5.3 Shareholders' goals	17
1.5.4 Bondholders' goals.....	17
1.5.5 Other stakeholders' goals	18
1.5.6 In summary	19
1.6 Finance versus Accounting.....	20
2. The Financial Environment.....	23
2.1 Macroeconomics and Finance	23
2.2 The Financial System: Markets and Institutions	24
2.2.1 Types of financial market.....	26
2.2.2 Efficient markets	29
2.3 Investment and Finance	31
2.4 Accounting for Finance	32
2.4.1 The balance sheet	33

2.4.2	The income statement.....	34
2.4.3	The cash flow statement.....	35
2.5	Taxation and Inflation.....	37
2.5.1	Personal taxation.....	37
2.5.2	Capital gains tax.....	39
2.5.3	Corporation tax.....	39
2.5.5	Inflation.....	40
Appendix: Sources of Financial Information.....		43
	Traditional “print” media.....	43
	Online and broadcast media.....	44
	America Online, the Motley Fool and more.....	44
3.	Value: Finance Foundations.....	47
3.1	What Is Value?.....	47
3.2	The Time Value of Money I: Simple Interest.....	48
3.3	Simple Interest: Applications.....	50
3.3.1	Term loans.....	50
3.3.2	Discount claims.....	51
3.3.3	Yield-quoted instruments.....	52
3.4	The Time Value of Money II: Compound Interest.....	54
3.4.1	The mechanics of compound interest.....	54
3.4.2	Comparing simple and compound interest.....	56
3.4.3	Annuities.....	57
3.5	Net Present Value and Internal Rate of Return.....	59
3.5.1	Net Present Value.....	59
3.5.2	“Special” cashflow streams.....	62
3.5.3	The Internal Rate of Return (IRR).....	66
4.	Sources of Finance: Debt.....	71
4.1	What is debt?.....	71
4.2	Debt valuation.....	75
4.3	Not-quite-debt: hybrids.....	77
4.4	Interest rate determination.....	78
4.5	The Term Structure of Interest Rates.....	81
4.5.1	The Expectations Hypothesis.....	82
4.5.2	Liquidity Preference.....	84
4.5.3	Hedging pressure/Preferred habitat/Market segmentation.....	85
4.5.4	Clientele effect.....	87

4.5.5 Afterthoughts 87

Appendix: Notes on Debt Sources 89

 Short- and Medium-Term Debt..... 89

 Long-Term Debt 92

5. Sources of Finance: Equity 93

 5.1 What Is Equity? 93

 5.1.1 Types of share capital 93

 5.2 Ordinary Shares (or Stock) 94

 5.3 Preference Shares 95

 5.4 Other Points of Note 96

 5.5 Raising Equity Capital..... 97

 5.6 Equity Valuation..... 101

 5.6.1 Share price valuation I: The basic model 102

 5.6.2 Share price valuation II: The Gordon growth
 model 104

 5.7 Dividends..... 107

 5.8 Not-quite-equity: Options..... 109

6. Investment Appraisal: Capital Budgeting 115

 6.1 Investment Projects 116

 6.2 Cashflows 118

 6.3 Investment Appraisal: Basic (Non-DCF) Methods 120

 6.3.1 The payback period 121

 6.3.2 The finite horizon criterion..... 123

 6.3.3 Accounting Rate of Return..... 123

 6.3.4 Profitability index..... 124

 6.4 Investment Appraisal: Discounted CashFlow (DCF)
 techniques 124

 6.4.1 Net Present Value 124

 6.4.2 Internal Rate of Return (IRR)..... 128

 6.4.3 Capital rationing 132

 6.5 Comparison of NPV with IRR..... 133

 6.5.1 Number of solutions 133

 6.5.2 Scale and duration 136

 6.6 In Summary: Some General Guidelines for Capital
 Budgeting 138

 6.7 Real and nominal values..... 139

 6.8 Sensitivity and Scenario Analysis 142

6.8.1	Sensitivity analysis	142
6.8.2	Scenario analysis	143
6.9	Newer Approaches to Capital Budgeting	144
7.	Investment Appraisal: Risk	145
7.1	Risk and Return	146
7.1.1	Yield (or expected return)	146
7.1.2	Risk and uncertainty	149
7.1.2	Risk and probability	150
7.2	Portfolio theory: The Markowitz Approach	153
7.2.1	Portfolio returns	154
7.2.2	Portfolio risk	155
7.3	Market Risk	162
7.3.1	The beta coefficient (β)	163
7.4	The Capital Asset Pricing Model (CAPM)	166
7.4.1	Value additivity	171
7.5	Arbitrage Pricing Theory	172
8.	The Cost of Capital	175
8.1	Overview	175
8.2	Sources of Capital	175
8.3	The Cost of Debt	176
8.4	The Cost of Equity	177
8.5	Other Costs of Capital	179
8.5.1	The cost of retained earnings	179
8.5.2	The cost of preference shares	180
8.6	The Total Cost of Capital	181
9.	The Capital Structure Conundrum	185
9.1	Value maximisation	185
9.2	The “Traditional” View	186
9.3	Modigliani and Miller (1958)	188
9.3.1	Criticisms of Modigliani and Miller	191
9.3.2	MM Modifications	191
9.4	A Final Thought	194
10.	Extending the Focus: Some Applications	195
10.1	Valuation of the Firm	195
10.1.1	Free cash flows	196
10.1.2	EVA and MVA	196

- 10.2 Corporate Restructuring: Mergers and Acquisitions 197
 - 10.2.1 Leveraged buyouts (LBOs) 200
 - 10.2.2 Mergers and macroeconomics 200
 - 10.2.3 Merger evaluation..... 201
- 10.3 Pensions..... 203
 - 10.3.1 FRS 17 204
- 10.4 Finance in the International Arena 205
 - 10.4.1 Foreign exchange (forex or fx)..... 206
 - 10.4.2 International capital budgeting 215
- 10.5 The Limitations of Finance 217

- Bibliography..... 219

- Index 223