

Introduction to
Corporate Finance

Sample pages

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Preliminary concepts

1

CHAPTER PREVIEW

This chapter aims to introduce the reader to the preliminary concepts that need to be understood prior to embarking on the study of corporate finance. The corporate financial objective—maximising the value of the company and thereby shareholder wealth—is discussed within the context of introducing financial assets and capital markets.

KEY CONCEPTS

1.1	The corporate objective and corporate financial decisions	2
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1.4	Maximising the wealth of corporate owners	5
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CONCEPT 1.1 The corporate objective and corporate financial decisions

This book deals with corporate finance, which is concerned with the process of corporate financial decision making. Corporate financial decisions are made by managers in the context of meeting the corporate objective, which may be stated as follows: ‘Maximise the value of the company.’

It can be demonstrated that this is the same as ‘Maximise shareholder wealth.’

At first glance, there may be some people who feel a little uneasy with this objective. To them, although they concede it appears to be a financially reasonable goal for companies, it seems to be, well, a bit socially inequitable. ‘Maximise shareholder wealth’ might conjure up visions of the 1980s-style excesses—an attitude of ‘greed is good’, ‘the rich get richer’ and the wolf of wall street. In reality, however, the corporate objective is nowhere near as insidious as this. Rather, it is a simple application of one of the basic principles of economics—make optimal use of scarce resources. The scarce resources that are used by the company are, primarily, capital and labour. To ensure optimal benefit to an economy, it is imperative that companies apply these resources in the most efficient manner possible. When this is done, the corporate objective is met—optimal use of resources ensures that the value of the company, and the wealth of shareholders, is maximised. This idea is further discussed in Concept 1.4.

Corporate managers face certain choices, requiring decisions to be made, on their way to meeting the corporate objective. The decisions are summarised below, and are explained in more detail later in the chapter.

1. The *investment decision* relates to the manner in which funds raised in capital markets are employed in productive activities. The objective of such investment is to generate future cash flows, thus providing a ‘return’ to investors. The investment decision is typically dealt with under the heading ‘capital budgeting’ or, alternatively, ‘project evaluation’ (Chapters 4 and 5).
2. The *financing decision* relates to the mix of funding obtained from capital markets, in terms of proportional holdings of equity and debt. This decision is typically addressed via an examination of ‘capital structure’ (Chapter 12).
3. The *dividend decision* relates to the form in which returns generated by the firm are passed on to equity holders. This decision is addressed in detail under ‘dividend policy’ (Chapter 11).

Look closely at these corporate financial decisions. It is clear that another description of the role of corporate finance is that it deals with the acquisition and use of cash by companies. In acquiring cash (the financing decision), the company has the primary objective of using it to acquire real assets (the investment decision). In turn, real assets are put to productive use to generate future cash flows. These future cash flows can then be used to provide a return to shareholders (the dividend decision).

CONCEPT CHECK

1. What is the objective of the firm from a financial management perspective?
2. What are the three key decisions facing corporate financial managers? Are these decisions interrelated or independent?

CONCEPT 1.2 Financial assets and capital markets

At this point, the concept of an ‘asset’ deserves further attention. In its broadest sense, the term ‘asset’ encompasses all kinds of property, both tangible and intangible (e.g. a legal right can be an asset). Real assets are those that can be put to productive use to generate returns. Machinery and equipment are good examples of real assets. However, in corporate finance we focus on financial assets.

A financial asset is a claim to a series of cash flows against some economic unit. This means that a ‘sentimental asset’, such as your grandmother’s picture of you—something that may be quite valuable to your grandmother—is not a financial asset, because it does not produce cash flows. Only something that produces cash flows, or that you can sell to produce a cash flow in the future, is a financial asset. A bank account is an example of a financial asset. Some people might not think of a bank account as an asset, but it is. It entitles the holder to cash flows—some interest in the future, plus the amount initially deposited into the account. It is also a claim against the bank. Hereafter, a reference to an ‘asset’ will be taken to mean a financial asset.

This book is primarily concerned with the valuation of assets—in particular, shares and bonds. Shares are a claim against a company. Two types of cash flows emanate from shares: dividends and sales proceeds. Dividends are generated while the shares are held. Then, when the shares are eventually sold, a further cash flow is generated—the share (sale) price. The difference between the sales proceeds and the amount paid for the share (the purchase price) is a capital gain or loss. This is discussed in more detail in Concept 1.6.

A bond is also a claim against an economic entity. In Australia, Hong Kong, India and Malaysia, for example, governments are important issuers of bonds. The cash flows that stem from bonds are interest payments and a lump sum repayment on maturity that some people think about as the principal.

A **capital market** is the medium for the issue and exchange of assets. In Australia, Hong Kong, India, Malaysia and the United Arab Emirates (UAE), HSBC is a multinational bank that forms part of their capital markets. The traditional role of this bank has been to hold deposits on behalf of customers, and to lend funds for purposes such as purchasing real estate, expanding a business, buying a car and so on. These days, however, banks are involved in a lot more

Capital market
The medium for the issue
and exchange of assets.

than just the borrowing and lending of money. For example, some of them operate stockbroking businesses. That is, they trade shares in domestic and overseas companies. Others are also money-market dealers, involved in trading bonds. These activities also form part of the capital market.

Another well-known element of capital markets are Stock Exchanges. These include the Australian Securities Exchange, Bursa Malaysia, National Stock Exchange, Stock Exchange of Hong Kong and Abu Dhabi Securities Exchange (ASX). These exchanges essentially constitute the 'meeting place' for buyers and sellers of shares. Until the early 1990's, the meeting place was a trading floor. However, buyers and sellers of shares no longer physically meet on trading floors. The market is now electronic, and transactions in shares are executed using a network of computers.

The government bond market is another important element of capital markets. Again, there is no physical trading floor where traders meet to buy and sell bonds. The bond market is an 'over-the-counter' market. For practical purposes, this means that transactions are typically arranged by telephone.¹ The bond market is also known as a 'dealer' market. Dealers are traders who are in the business of buying and selling bonds on their own account. An investor who wants to buy a bond would normally phone a bond broker, who in turn will usually phone a dealer to organise the transaction. Dealers typically post their quotes on electronic bulletin boards, operated by information vendors such as Reuters and Bloomberg.

At a conceptual level, the capital market is the place where individuals exchange current consumption for future consumption. For example, when you buy shares, you are forgoing current consumption and supplying the capital market with cash in the hope that in the future you will get your cash back plus a bit more (a return). It is likely that when you liquidate your shareholding in the future, you will be doing it to generate cash for consumption.

CONCEPT CHECK

3. What distinguishes 'financial' assets from other types of assets?
4. Is a bond a real asset or a financial asset?

CONCEPT 1.3 The flow of funds and the corporate capital market

Another way of conceptualising the nature of the capital market is to examine the flow of funds in the economy. Figure 1.1 illustrates that the flow of funds begins with investors. Investors make consumption and investment decisions. That is, they decide whether, and to what extent, they are willing to trade their present consumption for future consumption. If they decide to forgo present consumption, they may put their money in the bank or buy shares, thereby placing their cash into the capital market. Once cash is channelled into the capital market, it will flow to com-

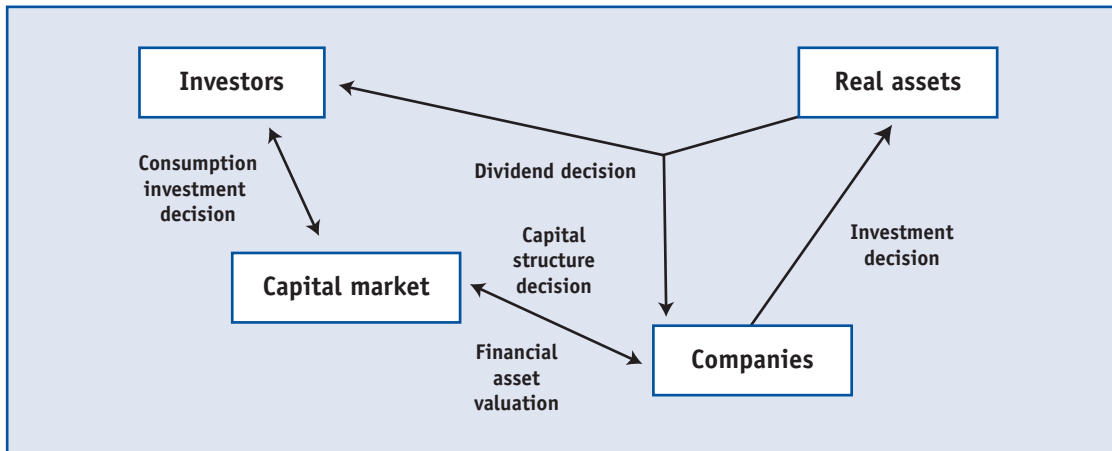


Figure 1.1 The flow of funds and the corporate capital market

panies. The financing decision is associated with this flow of funds from the capital market to companies. Associated with the financing decision is the capital structure decision, which refers to the segment of the capital market where funding is acquired by companies—the debt market or the equity market. Individual companies will normally acquire funding through the sale of financial assets. They can sell debt-type assets such as bonds, or equity-type assets such as shares. Either way, the amount of funding that a company can raise is dictated by the value of the assets sold in the capital market.

Once a company acquires funds, it will generally purchase real (productive) assets—the investment decision. In making investment decisions, companies will analyse the potential return on possible projects. This process is referred to as ‘capital budgeting’. The real assets acquired by the firm generate cash flows, which can then be used to do one of three things: they can be paid to shareholders, paid to bondholders or invested back into the assets of the company to fund internally further business opportunities. The third corporate financial decision, the dividend decision, becomes relevant here as the company decides on the level of dividends to be paid out (relative to retention of cash flows).

CONCEPT 1.4 Maximising the wealth of corporate owners

The key corporate objective requires that a company should make decisions that increase the wealth of its owners. Alternatively, this can be expressed as: the company makes decisions that increase the value of the firm. The two are synonymous, because the owners hold the value of a firm, and every time the directors of a company make a good decision, whereby its securities increase in value, the owners of these securities become wealthier.

Owner wealth is measured by the ‘market capitalisation’ of securities. For shares, market capitalisation is simply the total market value of all the shares of a company on issue. This is a direct measure of the total wealth of shareholders that is invested in the company. Calculating shareholder wealth is therefore relatively straightforward. Consider the following example: News Corporation, one of the largest media companies in the world, is run by the well-known (formerly Australian!) media baron Rupert Murdoch. Table 1.1 illustrates the two main securities issued by News Corporation that were trading on the ASX in 2021, including the price at which the securities were trading on Monday, 18 October 2021.

News Corporation is one of the largest companies listed on the ASX. It is also listed on the NASDAQ. News Corporation underwent a corporate restructure and became a United States company in November 2004, but was for many years one of the most successful international Australian companies. Table 1.1 illustrates that on 18 October 2021, News Corporation had 391.2 million Class A shares on issue, trading at \$32.21, and 199.6 million Class B shares trading at \$32.87.² The product of the number of shares on issue and the last sales price gives the market capitalisation of each security type. For example, the market capitalisation of Class A shares was \$12.6 billion, while the market capitalisation of Class B shares was \$6.6 billion. News Corporation was therefore worth \$19.2 billion in total. The assumption underlying this book is that, ultimately, Rupert Murdoch is trying to increase this value every time he makes a decision. There are a number of incentives and mechanisms in place that encourage the directors of a company to make decisions that maximise the wealth of owners.

Regulators such as the **Australian Securities and Investments Commission** (ASIC) in Australia are among these mechanisms. ASIC is similar to the Securities and Futures Commission in Hong Kong, Securities and Equities Commission in Hong Kong, Securities and Exchange Board of India and Dubai Financial Services Authority. Two important roles of securities commissions are to prevent corporate crime and to protect investors. Both of these roles are consistent with the maximisation of owners’ wealth. It is unlikely, however, that the existence of securities commissions will provide an airtight guarantee that directors of a company will pursue the interests of shareholders.

ASIC

The Australian Securities and Investments Commission enforces the company and financial services law. It regulates Australian companies, financial markets, financial services organisations and professionals who deal and advise in investments, superannuation, insurance, deposit taking and credit.

Table 1.1

Major News Corp. securities traded on the Australian Securities Exchange 18 October 2021 (\$ Australian)

SECURITY	ASX STOCK CODE	NO. ISSUED (M)	LAST SALE PRICE (\$)	MARKET CAPITALISATION (\$B)
Class A common stock	NWSLV	391.2	32.21	12.6
Class B common stock	NWS	199.6	32.87	6.6
Total				19.2

Source: Thompson Reuters.

Remuneration packages are another way in which the owners of a company can promote decision-making by a company that maximises owner wealth. That is, directors' salaries can be packaged such that every time the value of a company increases, the wealth of the directors also increases. A common and 'approximate' way of doing this is to pay bonuses to directors on the basis of the company's earnings performance. However, two possible problems are associated with this approach. First, it is well known that 'creative accounting' practices reduce the validity of earnings figures as indicators of corporate performance. Second, while earnings performance can influence the market capitalisation of companies, it is certainly not the sole (or even main) influence, which suggests that tying director remuneration to earnings is different from tying remuneration to the market capitalisation of a company.

Directors often hold shares in the companies that they run. This practice increases the likelihood that a director will attempt to maximise the wealth of shareholders, because the director's wealth will increase simultaneously! News Corporation is a good example of a company with such a mechanism in place. Through his family company, Rupert Murdoch owns up to 39 percent of News Corporation. It is highly likely that Rupert Murdoch is very interested in making decisions that result in a News Corporation share price increase, because every time the price of its shares increases by 1%, his own wealth increases by about \$192 million!

The market for corporate control (i.e. the takeover market) may also promote the maximisation of shareholder wealth. You may have heard of corporate raiders. They form part of the market for corporate control. One strategy of corporate raiders is to look for companies that are being managed badly. The idea is that if management is running a company inefficiently, the company's share price will be depressed. Corporate raiders aim to take over such companies by purchasing a majority shareholding, then use their acquired voting power partly or completely to replace the existing management. This is known as a 'hostile' takeover—'hostile' in terms of what happens to the existing management. In theory, the new (or upgraded) management team operates the business more efficiently (and therefore profitably), resulting in shareholder gains. The threat of job loss associated with hostile corporate raids therefore provides an incentive to management to pursue the objective of maximisation of share value—that is, shareholder wealth. This mechanism is sometimes referred to as the 'discipline of the capital market'.

Another mechanism that encourages management of a company to increase owner wealth is shareholder voting power. For example, a group of shareholders who are dissatisfied with the manner in which a company is run may decide to sack the management. Such a 'group' of shareholders typically does not refer to individual investors. While an ASX survey of shareholders in 2020 suggests that approximately 46% of Australian adults own shares, individuals rarely own a significant proportion of any one company. It is well known that the real controllers of companies are institutional investors such as Blackrock and Vanguard Asset Management—who

FINANCE EXTRA!

CEO pays shoot up in FY 2010-11: CBA, Coles, BHP heads leading

LUMPED together the pay checks collected by the top executives of BHP Billiton, Commonwealth Bank of Australia (CBA) and Coles for financial year 2010-2011 alone and you'll get more than \$43 million, which is more than enough for an average Australian to last a lifetime.

As reported by the Australian Council of Superannuation Investors earlier this month, the country's high-flying CEOs enjoyed salary spikes of more than 130 percent over the past 10 years, with an average chief executive from any of the blue chip firms said to have taken home a median pay of \$2.79 million in 2010 alone.

Such jaw-dropping executive remunerations were issued by leading companies amidst suggestions that many sectors of domestic economy were struggling, which were reflected by Australian workers average income of about \$66,000 each year while given only some 52 percent pay hike over the past decade.

As many companies flagged weak business environment, shareholders, the council report showed, only collected returns of 31 percent, leaving puzzling indicators on how the hefty payments could have been realised against a general backdrop of economic uncertainties, the council said.

From the annual company reports provided by the Australian Securities Exchange (ASX), CBA chief Ralph Norris secured the top position as the country's highest paid CEO as his company revealed that he had a pay slip totalling to \$16.2 million in the past financial year.

Coming close was Coles boss Ian McLeod, who amassed a total pay package of \$15.6 million last year, which according to Coles parent company, Wesfarmers, was mostly comprised of more than \$11 million in numerous form of bonuses.

McLeod, Wesfarmers said, was rewarded for his chief role in turning around the misfortunes of the grocery chain, which on August posted sales increase of more than \$32 billion and anchored on its 21 percent improvement on full-year earnings.

The Australian reported on Friday that judging by his declared year-round remuneration, McLeod earned much more in a single day what an average Australian had to toil for a year.

By comparison, McLeod bested the take home pay of BHP chief executive Marius Kloppers, who runs Australia's largest business operations and the world's biggest mining firm, and that of his own boss, Wesfarmers managing director Richard Goyder.

Kloppers, according to BHP's report this week, was paid a total of \$11.6 million in financial year 2010-2011 that covered his base salary, cash bonuses and incentives while Goyder's role as Wesfarmers chief only earned him \$6.9 million in the same period, which reflected a slide of 13 percent from his previous annual pay.

Source: International Business Times, September 23, 2011, <http://au.ibtimes.com/articles/218681/20110923/ceo-pays-shoot-up-in-fy-2010-11-cba-coles-bhp-lead-the-way.htm>.

manage money on behalf of others. These institutions typically hold large portions of companies' shares, and therefore control them. If institutions become dissatisfied with the way in which a company is run, they can combine their voting power and sack existing management.

Despite the fact that a number of mechanisms may be in place to promote the maximisation of owner wealth, there is always the presence of the principal–agent problem. Since the managers of a company (the agents) have control over the funds of shareholders (the principals), there is always a danger that they may not act in the best interests of shareholders. This is because they might prefer to take actions that enhance their own personal position, even if such actions are against shareholders' best interests. Accordingly, the mechanisms that are discussed here may not always be adequate to guarantee that the interests of owners of the firm will be pursued.

CONCEPT CHECK

5. How does market capitalisation relate to owners' wealth?
6. Are the interests of the managers of a company necessarily aligned with increasing shareholders' wealth?
7. What mechanisms are used to align the interests of managers with the interests of the shareholders?

CONCEPT 1.5 Asset valuation

One of the most important concepts in corporate finance is *value*—in particular, the value of assets. Consider a simple asset that guarantees the holder a cash flow of \$105 in one year's time, while at the same time the National Australia Bank (NAB) is offering a 5% p.a. rate of return on a basic passbook account. How much would you be willing to pay for this asset? Figure 1.2 uses a time line to illustrate this problem.

Would you be willing to pay \$105 for this asset? The answer to this question should be no! Why? Because if you put \$105 in the bank now, in one year's time you would end up with more money than \$105. In fact, you would end up with \$110.25 ($= \105×1.05). Hence, you would

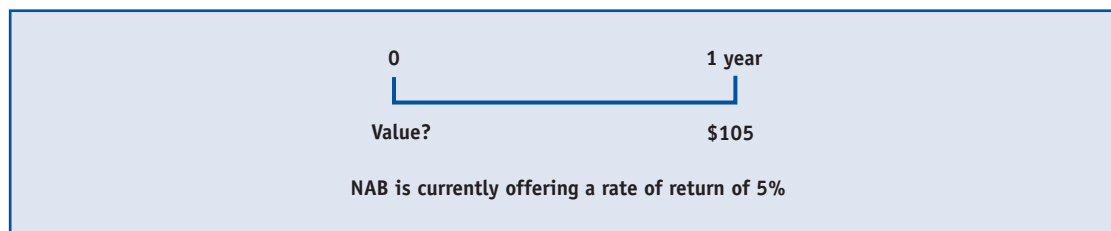


Figure 1.2 How much would you pay for this asset?

Time value of money

The simple concept that a dollar now is worth more than a dollar in the future, even after adjusting for inflation, because a dollar now can earn interest or other appreciation until the time the dollar in the future would be received.

Opportunity cost

The return an investment or resource could have provided in its best alternative use.

Intrinsic value

The amount that you are willing to pay for an asset, as opposed to its market price.

Present value

The current value of one or more future cash payments, discounted at some appropriate interest rate.

not pay \$105 for the asset because you would not be maximising your own personal wealth. (Note the use of wealth maximisation here at the individual, rather than corporate, level.) So, at \$105 this asset is overpriced. This example also demonstrates that \$105 in one year's time is not equal to \$105 today. The idea that \$1 in the future is not equivalent to \$1 today is related to the **time value of money**, which is derived from the fact that interest can be earned on an alternative investment opportunity (the bank account). The interest rate that you get from the bank is the opportunity cost of buying the asset or the **opportunity cost** of capital. It determines the future cash flow that the investor forgoes when purchasing the asset. Hence, the opportunity cost and time value of money are very important concepts in asset valuation.

Would you pay \$97 for this asset? The financially rational answer to this question is a resounding yes! The reason is that the alternative investment of \$97 in the bank with a 5% return would bring less than \$105 in one year's time (actually, \$101.85, i.e. $\$97 \times 1.05$). Hence, if you were able to purchase the asset for \$97, you would be maximising your own personal wealth.

What is the maximum amount that you would pay for the asset? Or alternatively, what value do you place on the asset? It is easy to show that \$100 is an appropriate price to pay for this asset. This is because if you pay \$100 for the asset, you equalise the rate of return you get from this asset and your opportunity cost. Another way of thinking about this is: if you pay \$100 for this asset, you have priced it in such a way that you generate a rate of return on the asset equal to your opportunity cost of capital. Alternatively, your terminal wealth (in one year) from purchasing the asset is the same as what you acquire from investing your money in the alternative opportunity (bank account): \$105. This price that you are willing to pay for the asset is sometimes called its **intrinsic value**. The intrinsic value of an asset is determined by: (1) the future cash flow expected from the asset, and (2) the opportunity cost of capital. These two inputs are the only two pieces of information required to value an asset properly.

In valuing the simple asset described above, you were implicitly determining the amount you would have to invest in the bank account, at the bank's prevailing deposit rate, in order to generate a future cash flow (terminal wealth from bank account) equivalent to the asset's promised future cash flow (terminal wealth from asset). Put another way, you were finding the value of PV that makes the following expression true:

$$\$105 = PV(1 + 0.05)$$

or more generally:

$$FV = PV(1 + r) \quad (1.1)$$

where PV is the amount that needs to be invested in the bank account at the deposit rate of interest r to generate a future cash flow of FV . PV is also known as the **present value** of the future

Practitioner's POV

Stockbrokers and fund managers often evaluate the share price performance of shares by comparing the rate of return on the shares with the rate of return on the market index. If the return on the shares exceeds the return on the market index (on a risk-adjusted basis), the shares have outperformed the market. If the return on the shares is less than the return on the market, the shareholding has underperformed. The most common indices used by practitioners in Australia to evaluate the performance of shares are the S&P/ASX 200 Index, in Malaysia, it's the FTSE Bursa Malaysia KLCI, in Hong Kong, it's the Hang Seng Index and in the UAE, it's the ADX General Index.



CONCEPT 1.7 The 'markets' section of the financial press

The performance of different shares on any day can be ascertained by examining the markets section of a major paper including the *Australian Financial Review* in Australia, the *South China Morning Post* in Hong Kong and the *Asian Wall Street Journal* for markets in South East Asia. Most of the markets sections are fairly similar. Figure 1.3 is an extract of the markets section on 19 March 2021.

The markets section of the *South China Morning Post* lists all shares that are traded on the Hong Kong Stock Exchange (HKSE), together with a host of market and other information for each share. Take, for example, the AIA Group, made famous as sponsors of the Tottenham Hotspur Football Club in England. The row containing 'AIA Group' provides market information for shares of AIA traded on Tuesday, 18 March 2021 (the day prior to the publication date of the newspaper). The HKSE code column indicates that the stock code under which AIA Group shares trade on the HKSE is '1299'. The most critical information is contained in the 'Close' column, indicating the last traded price of each share. For example, the last trade in AIA Group on 18 March 2021 was at \$97.60—obviously in Hong Kong dollars. The previous closing price of the share can be ascertained by examining the chg column, which reports the change in the price of the shares since the close on the previous trading day. For AIA Group the change in the price was +0.10 cents on the day illustrated, suggesting that it traded for \$97.50 at the close of trading on 17 March 2021 (which was the previous *trading* day).

The 52-week high and low columns report the highest and lowest price, respectively, at which each share traded during the previous 12 months. This information can give the reader an indication of the price volatility of each share. For example, the price of AIG ranged from \$109.3 to \$60.05 during the year, indicating that it was quite volatile in the past 52 weeks.

CODE	SHARE	CLOSE	CHG	% CHG	V'000	52-WEEK		PE	YIELD
						HIGH	LOW		
1530	3SBio Inc	7.570	0.080	1.07	8,364	14.50	6.66	18.1	-
797	7Road Holdings Ltd	2.630	-0.010	-0.38	10	2.93	2.50	-	-
2018	AAC Tech	43.050	0.200	0.47	3,700	63.95	35.65	21.4	0.2
2686	AAG Energy	1.200	-0.050	-3.94	2,516	1.40	0.97	5.3	9.5
3383	Agile Group Holdings Ltd	11.020	-	-	4,344	11.98	7.60	5.2	8.2
1288	Agricultural Bank Of China	3.210	0.010	0.31	68,219	3.30	2.38	5.0	6.2
1299	AIA Group	97.600	0.100	0.10	17,716	109.30	60.05	22.7	1.3
753	Air China	7.210	-0.150	-2.04	9,617	7.38	4.49	14.1	0.7
1789	AK Medical Holdings Ltd	11.580	0.580	5.27	4,116	27.65	9.80	41.3	0.7
9926	Akeso, Inc	47.400	0.200	0.42	2,468	62.20	22.10	-	-
9988	Alibaba Group Holding Ltd	222.600	1.200	0.54	18,719	309.40	167.60	-	-
241	Alibaba Health	24.200	0.200	0.83	26,850	30.15	10.80	-	-
1060	Alibaba Pictures Group Ltd	1.040	-	-	22,490	1.47	0.89	-	-
3319	A-Living Services	29.350	0.150	0.51	2,686	48.55	26.75	28.6	1.7
373	Allied Group	3.140	-	-	296	3.85	1.75	4.4	4.0
9966	Alphamab Oncology	12.980	0.660	5.36	1,333	24.15	11.18	-	-
347	Angang Steel Ord Shs A	4.220	-0.140	-3.21	24,343	4.47	1.77	20.3	1.5
2020	ANTA Sports Products Ltd	121.800	0.700	0.58	6,283	154.30	42.00	56.1	0.5
6996	Antengene Corporation Ltd	17.720	1.040	6.24	780	22.50	14.48	-	-
860	Apollo FMG	0.510	0.010	2.00	11,746	0.91	0.35	-	-
9990	Archosaur Games Inc	16.960	-0.100	-0.59	800	28.40	14.20	-	-
6855	Ascentage Pharma Group	33.750	-0.250	-0.74	1,073	54.70	19.80	-	-
743	Asia Cement (China)	7.910	-0.080	-1.00	1,797	10.34	6.50	3.6	6.9
1675	Asialfo Technologies Ltd	11.700	0.320	2.81	1,548	14.20	7.23	19.0	2.2
522	ASM Pacific	99.350	0.450	0.46	1,412	133.80	66.50	65.2	1.4
1717	Ausuntria Dairy Corp Ltd	11.920	-0.340	-2.77	11,675	17.78	10.04	19.5	1.9
2518	Autohome Inc	185.200	3.500	1.93	1,568	187.00	178.20	-	-
2357	AviChina Industry	5.040	0.160	3.28	16,358	8.13	2.63	20.9	0.7
1958	BAIC Motor Corp Ltd	2.780	0.040	1.46	11,014	4.17	2.51	5.1	6.2
2100	BAIOO Family Interactive Ltd	2.040	-0.030	-1.45	6,990	3.25	0.76	33.1	1.2
874	Baiyunshan Pharmaceutical	20.450	0.050	0.25	472	24.70	17.66	9.6	3.2
3988	Bank of China	2.930	0.040	1.38	272,877	3.19	2.33	4.4	7.1
1963	Bank of ChongQing	5.230	-0.030	-0.57	1,429	5.30	3.50	3.8	4.9
3328	Bank of Communications	4.620	0.010	0.22	13,949	5.09	3.66	4.2	7.5

Figure 1.3 The market section of The South China Morning Post, 19 March 2021

Source: South China Morning Post

Another important piece of market information is the volume column, which indicates the number of shares that were traded during the day. This gives the reader an impression of how actively traded (or 'liquid') the share is. For example, AIA traded more than 17.7 million shares during the day depicted, which based on a price of \$97.60 means that 1.7 billion Hong Kong dollars worth of shares in AIA changed hands and therefore AIA can be considered highly liquid. In comparison, Air China, also listed on the HKSE, traded approximately 9.6 million shares worth 69.1 million Hong Kong dollars and is therefore less liquid than AIA.

The internet adds a fast and easy companion to the information sources provided in newspapers and financial magazines. Yahoo! Finance provides a very valuable source of information on the current prices of various listed securities and the various share price indices. Yahoo! Finance also provides a price history of traded shares, as well as a history of dividend payments.

Practitioner's POV

Information is the lifeblood of financial markets. Stockbrokers and fund managers obtain information relating to stock market activity from information vendors. The most common vendors are Bloomberg, IRESS and Reuters. These companies typically provide computer screens attached to an electronic feed that continually update share prices, quotes, volumes, etc. during the day as trading occurs in the marketplace. If you were thinking of subscribing, a Bloomberg terminal costs around \$1500 a month, or \$18 000 a year!



CONCEPT CHECK

14. Financial information sources contain various measures of the activities in the market, market highs and lows, daily closing price and buy and sell quotes. Which measure is the best indicator of the market value of a firm's shares?
15. If you wished to compare the performance of a share with some general measure of performance, what would you use?

CONCEPT 1.8 Foreign exchange rates: A side note

Finance is universal, and the concepts that will be covered in this textbook are similarly universal. However, there are considerable differences in the language, business culture and rules and regulations that operate in different markets. Another key difference that is particularly pertinent to this book and the many real-life examples that will be drawn upon is the currencies.

Many of the examples in this textbook are drawn from global markets including USA, Australia, Hong Kong, Malaysia and the UAE. As you work your way through this book, you will come across the currencies of each of these countries. They are set out in Table 1.2 below.

Table 1.2 Examples of currencies used in Global Markets

Country	Currency	Symbol
USA	USA Dollar	USD or \$
Australia	Australian Dollar	AUD or \$
Hong Kong	Hong Kong Dollar	HKD or \$
India	Indian Rupees	INR
Malaysia	Malaysian Ringgit	MYR or RM
UAE	UAE Dirham	AED

Student Learning Centre

CONCEPT CHECKLIST

In this chapter the following concepts were discussed:

- ▶ The main objective underlying corporate financial decisions
- ▶ The nature of financial assets
- ▶ The flow of funds through the capital market and its relationship to corporate finance
- ▶ Why directors maximise the wealth of corporate owners
- ▶ How to value an asset paying a single cash flow
- ▶ How to calculate the rate of return from holding assets
- ▶ How to read some of the information contained in the financial press such as *The Australian Financial Review*

SELF-TEST QUESTIONS

1. The cash flows generated from the real assets of the firm can be used for what three purposes?
2. What is the maximum amount a rational investor would be willing to pay for an asset that guarantees the holder a cash flow of \$560 in one year's time, while at the same time the rate of return on similar assets is 12%?

Self-test answers

1. (a) Paid to shareholders as dividends.
(b) Paid to debt holders.
(c) Invested back into the assets of the company to internally fund further business opportunities.
2. Using Equation 1.2:

$$PV = \frac{FV}{1+r}$$

$$PV = \frac{560}{1.12}$$

The maximum a rational investor would pay is \$500.

DISCUSSION QUESTIONS

1. What is an opportunity cost? Why is it such an important concept in finance?
2. The text refers to three types of financial decision—the investment decision, the financing decision and the dividend decision. Describe each in detail, and explain how these decisions relate to the corporate objective. Categorise each of the following decisions in terms of whether it is an investment, financing or dividend decision, and explain why it is in that category.

- (a) Javelin Pharmaceutical Ltd purchases all of the shares in O'Hara Ltd.
 - (b) Tabcorp Holdings Ltd buys new poker machines for its business.
 - (c) Brushwood Ltd hopes to raise \$53 million in an equity issue of ordinary shares and will use the funds to repay its long-term debt.
 - (d) Devastation Games Ltd purchases the copyright for a new video game.
 - (e) News Corporation declares a dividend of 20 cents per share.
 - (f) Brushwood Ltd pays \$5 million to repurchase 1% of the shares held by its current shareholders.
 - (g) Creek Ltd announces the raising of \$50 million in bonds in the USA.
 - (h) Charles Grogin sells shares to finance his new online wine cellar.
3. On what basis is the corporate objective of 'maximising shareholder wealth' justified? How does this corporate objective affect corporate financial decision making?
 4. 'Maximising the value of the firm to its shareholders is consistent with the firm exercising considerable social responsibility.' Discuss.
 5. What is the difference between a real asset and a financial asset? Give an example of each.
 6. What is a capital market? Give examples of Australian capital markets, and state the main participants in these markets.
 7. How do capital markets allow consumers to meet their present and future consumption needs?
 8. You wish to buy a new laptop. However, your cash is insufficient for this purchase. How can capital markets assist you in this case?
 9. How does maximising the price of a firm's share equate to maximising shareholder wealth?
 10. What is a bond? What are the cash flows that are received by bondholders?
 11. You were told by the management of XYZ Limited that the company's goals are to maximise the company's assets. Is this inconsistent with maximising shareholder wealth?
 12. Discuss some of the institutional mechanisms that exist in Australia for ensuring that financial managers act in the best interests of the company owners.
 13. It has been said that the objective of a firm is to look after the interests of the owners of the firm—the ordinary shareholders. However, firms are run by managers (directors) who are often not owners (shareholders). Surely, then, managers would be more interested in looking after their own interests rather than those of some faceless crowd. True or false? Explain. Are the interests of the two groups necessarily incompatible?
 14. Managers of companies face an impossible task because they cannot really increase the wealth of each and every shareholder. Because there are thousands of shareholders, it is impossible to find projects that allow the manager to meet the investment and consumption needs of every shareholder. As a consequence, managers should follow the rule that they should invest in projects that provide them with the best satisfaction and not consider the needs of investors. Do you agree? What investment rules should managers follow and why?
 15. What is meant by 'the market for corporate control'? How does this market contribute to the efficiency of capital markets overall?
 16. A security exists that promises to pay \$300 in one year's time. If the market rate of interest is 20% p.a. and the security is for sale for \$200, what would you do and why? Ultimately, what would you expect to happen?
 17. How does investing in projects that have a rate of return equal to or greater than the market rate of interest maximise shareholders' wealth?

PRACTICAL QUESTIONS

BASIC

1. Your current part-time job pays \$500 per week. Another similar job requiring similar effort pays \$550 per week. You are thinking of quitting your current job to take up the higher paying job. What is the opportunity cost of doing so?

BASIC

2. Refer to Table 1.1 in the chapter. Assume that on 2 May 2023, prices of News Corp.'s major securities were:

Security	ASX stock code	Last sale price (\$)
Class B common stock	NWS	25.58
Class A common stock	NWSLV	26.00

What is News Corp.'s market capitalisation as at 2 May 2023?

BASIC

3. If you placed \$5000 in a bank for one year, how much would you have accumulated in one year if the rate of return was 6.75%?

BASIC

4. What is the rate of return on an asset that will pay \$104 000 in one year if it is priced at \$97 000 today?

BASIC

5. What is the rate of return on an asset priced at \$4695 today that will pay \$5000 in one year?

BASIC

6. You bought an ounce of gold last year for \$1300 and sell it today for \$1400. What is your rate of return?

BASIC

7. How much would you receive in one year if you invested in an asset priced at \$8000 today, with a rate of return of 5.25%?

BASIC

8. How much would you have to invest today to accumulate \$20 000 in one year if the current rate of return is 9.8%?

INTERMEDIATE

9. If you were able to obtain a rate of return of 6.5% by placing funds in a bank for one year, how much would you be willing to pay for an alternative asset that promises to return \$18 000 in one year?

INTERMEDIATE

10. (a) Would you pay \$100 000 today for an asset that will pay \$105 000 in one year if the rate of return is currently 6% p.a.? Explain your answer.

(b) Would you pay \$98 000 today for an asset that will pay \$105 000 in one year if the rate of return is currently 6% p.a.? Explain your answer.

INTERMEDIATE

11. (a) What is the rate of return on the All Ordinaries Index if its opening value is 4030.3 points and its closing value is 4096.6 points?

(b) What is the rate of return on the All Ordinaries Index if its opening value is 4041.5 points and its closing value is 4033.3 points?

INTERMEDIATE

12. If you purchased National Australia Bank shares in the morning at \$28.78 and sold them at the end of the day at \$28.93, what rate of return would you have realised?

INTERMEDIATE

13. A company is expected to produce one (and only one) cash flow of \$44 million in one year. If the appropriate interest rate is 10% p.a., what is the value of the company? If there are one million shares on issue, what should its share price be?

INTERMEDIATE

14. A firm has identified the following six potential projects. Each project requires an investment of \$100 and will return (without risk) the following amounts:

Project A \$124

Project B \$106