Introduction to Corporate Finance
Learning objectives

By the end of this course, you will be able to:

- Discuss the main capital investment activities and valuation techniques
- Explain the process of mergers and acquisitions, and key considerations for the deal
- Compare debt financing with equity financing and explain the optimal capital structure
- Outline the capital raising process
- Explore various career paths in corporate finance
Introduction
The ultimate purpose of corporate finance is to maximize the value of a business through planning and implementing management resources while balancing risk and profitability.

**Corporate finance overview**

- **Capital Investments**
  - Decide what projects / businesses to invest in
  - Earn the highest possible risk-adjusted return

- **Capital Financing**
  - Determine how to fund capital investments
  - Optimize the firm's capital structure

- **Dividends & Return of Capital**
  - Decide how and when to return capital to investors
Players in corporate finance – primary market

Public accounting firms

Corporations

Investment Banks

“Sell side”

Bonds or shares

“Buy side”

Fund Manager

Institutions

Investors

Capital

Players in corporate finance – primary market

Public accounting firms

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Bonds or shares

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Investors

Capital
Players in corporate finance – secondary market

- **Wants to sell**: Fund Manager
- **Investment bank**: Sales, trading and research
- **Stock exchange / OTC**
- **Wants to buy**: Fund Manager
- **Investment bank**: Sales, trading and research
Types of participants

**Retail Investors**
- High net worth individuals

**Institutional Investors**
- Mutual funds
- Pension funds
- Private equity firms
- Venture capital firms
- Seed / angel investors

**Public Corporations**
- Traded on stock exchanges

**Private Corporations**
- Owned and traded by a few private investors
Types of transactions

- Initial public offering (IPO)
- Follow-on offering
- Private placement
- Mergers & acquisitions (M&A)
- Leverage buyout (LBO)
- Divestiture
What is a capital investment?

Any investment for which the economic benefit is greater than one year.

- Opening a new factory
- Entering a new market
- Acquiring another business
- Research and development of new products
Capital investments will **increase the assets** of a company.
Whether such investments are worthwhile depends on the approach that the company uses to evaluate them. A company may value the projects based on:

**Net Present Value (NPV):** The value of all future cash flows (positive and negative) over the entire life of an investment discounted to the present.

**Internal Rate of Return (IRR):** The expected compound annual rate of return that will be earned on a project or investment.
## Net Present Value (NPV)

<table>
<thead>
<tr>
<th>Future Cash Flows</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
<th>2022</th>
<th>2023</th>
<th>2024</th>
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</table>
Net Present Value (NPV)

Future Cash Flows | $100 | $100 | $100 | $100 | $100 | $100 | $100 | $100 | $100 | ... 

Forecast Period: 2019, 2020, 2021, 2022, 2023, 2024, 2025, 2026, ...
Net Present Value (NPV)

Future Cash Flows

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>2019</td>
<td>$100</td>
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<tr>
<td>2020</td>
<td>$100</td>
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<tr>
<td>2021</td>
<td>$100</td>
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<td>2022</td>
<td>$100</td>
</tr>
<tr>
<td>2023</td>
<td>$100</td>
</tr>
</tbody>
</table>
| 2024 onwards | $1,200

Forecast Period

- 2019
- 2020
- 2021
- 2022
- 2023
- 2024 onwards (terminal value)
Net Present Value (NPV)

Future Value

\[ \text{Future Value} = \sum_{n=0}^{t} \frac{FV}{(1+i)^n} \]

Present Value

\[ \text{Present Value} = \sum_{n=0}^{t} \frac{FV}{(1+i)^n} \]

Discount Rate
(Cost of Capital)

\[ i = 10\% \]

Forecast Period

2019 2020 2021 2022 2023 2024 - onwards (terminal value)

Net Present Value (NPV)

\[ \text{Net Present Value (NPV)} = $1,124 \]

Future Value

\[ \begin{align*}
FV_1 &= \frac{100}{1.10} = 91 \\
FV_2 &= \frac{100}{1.10^2} = 83 \\
FV_3 &= \frac{100}{1.10^3} = 75 \\
FV_4 &= \frac{100}{1.10^4} = 68 \\
FV_5 &= \frac{100}{1.10^5} = 62 \\
FV_6 &= \frac{1,200}{1.10^5} = 745
\end{align*} \]
Terminal Value: Value of free cash flow beyond the forecast period

Growing perpetuity formula

\[
\text{Terminal value} = \frac{\text{Free cash flow} \times (1 + \text{growth})}{\text{Cost of capital} - \text{growth}}
\]

Exit multiple formula

\[
\text{Terminal value} = \text{Financial Metric (i.e. Earnings, EBITDA, Revenue)} \times \text{Multiple}
\]
Terminal value

Perpetual growth

\[ \frac{\$100 \times (1 + 1.54\%)}{10.00\% - 1.54\%} = \$1,200 \]

Exit multiple

\[ 12 \times \$100 = \$1,200 \]
Unlocking the drivers of value

Free cash flow x (1 + growth)

Cost of capital - growth

= Terminal value

- Business strategy
- Revenue
- Cost structure
- Asset utilization

- Risk
- Current capital structure
- Macro factors

- Organic growth?
- What's sustainable?
Enterprise value vs. equity value

**Enterprise value** is the value of the entire business.

**Equity value** is the value shareholders would receive if the company is sold.

Enterprise value

\[ \text{Enterprise value} = \text{Equity Value} + \text{Debt} - \text{Cash} \]

\[ = \text{NPV of the business} \]

Market value of net debt

\[ \text{Market value of net debt} = \text{Share Price} \times \text{Outstanding Shares} \]

Equity value

\[ \text{Equity value} = \text{NPV of the business} - \text{Debt} + \text{Cash} \]
22% IRR is economically equivalent to earning a 22% compound annual growth rate.
Mergers and Acquisitions (M&A)

Mergers and acquisitions is the process of companies buying, selling, or combining businesses.

Benefits:

• Cost savings
• Revenue enhancements
• Increase market share
• Enhance financial resources

Potential drawbacks:

• Overpaying
• Large expenses associated with the investment
• Negative reaction to the merger or acquisition
Strategic versus financial buyers

**Strategic buyers**
- Operating businesses
- Horizontal or vertical expansions
- Involves identifying and delivering operating synergies

**Financial buyers**
- Private equity (financial sponsor)
- Professional investor (non-operator)
- Leverage for maximum equity returns
The vast majority of acquisitions are competitive or potentially competitive.

- Companies normally have to offer more than rival bidders
- To pay more than rival bidders, the buyer may:
  - Be able to “do more” with the acquisition
  - Accept a lower expected return
  - Have a different view or forecast for the future
Acquisition valuation process

Strategic Buyer Scenario:

1. Value the target as stand-alone

   Enterprise value

   • Sales growth
   • EBIT margin
   • Operating tax
   • Working capital requirements
   • Capital expenditures

2. Value synergies

   Hard (cost savings) and soft (revenue enhancements)

   • Sales (volume & price)
   • EBIT margin
     • Product mix
     • Overhead reductions
   • Operating tax
     • Tax efficiency
     • Tax losses
   • Working capital
     • Vendor relationships
   • Capital expenditures
     • Efficiencies
Best practice acquisition analysis

1. Stand-alone enterprise value
2. Hard synergies
3. Soft synergies
4. Transaction costs
5. Net synergies
6. Value created

Consideration (price paid)
Issues to consider when structuring a deal

Market Environment

Structuring Environment

- Contract law
- Antitrust rules
- Accounting rules
- Available financing
- Tax
- Corporate Law
- Market conditions
- Strategic plan
- Competing bidders
- Public vs private
- Capital structure
- Hostile vs friendly
- Strategic plan
- Capital structure
- Hostile vs friendly
- Public vs private
Corporate finance overview

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**Dividends & Return of Capital**
- Decide how and when to return capital to investors
Capital Financing
What is capital financing?

Any type of funding that is used to finance the purchase of an asset/project (an investment).

- **Equity**
- **Debt**
Capital financing will **increase the liabilities and/or equity** of a company.
Capital financing will increase the liabilities and/or equity of a company.

- **Capital investment** (spending money to purchase assets)
- **Assets**
- **Debt**
- **Equity**

**Capital financing** (where the money comes from)
Capital financing will increase the liabilities and/or equity of a company.
The business life cycle

- **LAUNCH**
- **GROWTH**
- **SHAKE-OUT**
- **MATURITY**

- **Sales**
- **Cash flow**
- **Profit**
- **Life cycle extension**

- Time

- $
The corporate funding life-cycle

- **LAUNCH**
- **GROWTH**
- **SHAKE-OUT**
- **MATURITY**

- Debt funding
- Business risk

Stage of the firm life cycle
**Capital Structure**: the amount of debt and/or equity employed by a firm to fund its operations and finance its assets. In order to optimize the structure, a firm will decide if it needs more debt or equity and can issue whichever it requires.
The equity versus debt decision relies on a large number of factors:

- **The current economic climate**
- **The business’ existing capital structure**
- **The business’ life cycle stage**

**Having too much debt** may increase the risk of default in repayment.

**Depending too heavily on equity** may dilute earnings and value for original investors.
Companies are usually looking for the **optimal combination of debt and equity** to minimize the cost of capital.
Weighted Average Cost of Capital (WACC) is the proportion of debt and equity a firm has, multiplied by their respective costs.

Cost of Equity:
The rate of return a shareholder requires for investing equity into a business

Cost of Debt:
The rate of return that a lender requires given the risk of the business

The optimal capital structure of a firm is often defined as the proportion of debt and equity that result in the lowest weighted average cost of capital (WACC) for the firm.
WACC formula

\[ \text{Cost of capital} = \frac{\text{Net debt} \times \text{Cost of debt}}{\text{Assets}} = \frac{\text{Market value of equity} \times \text{Cost of equity}}{\text{Market value of equity}} \]

Example

\[ \begin{align*}
\text{Net debt} & = 14\% \times 3.5\% = 0.5\% \\
\text{Market value of equity} & = 86\% \times 9.0\% = 7.7\% \\
\text{Cost of capital} & = 8.2\%
\end{align*} \]

*Rounded for ease of calculation.
Capital stack

How to optimally finance the capital investments through the business’ equity, debt, or a mix of both?

- Senior debt
- Subordinated debt
- Equity
Types of equity

- **Senior debt**: Higher liquidation position; no dividend but pays interest
- **Subordinated debt**: Higher liquidation and higher dividend priority (vs Common)
- **Equity**: Last liquidation position and last dividend position
Common shares

**Terms**
Typically the majority of a firm’s equity capital:
- Proportional share of residual value of the business
- Proportional payment of common dividends
- Voting rights (or not)

**Issues**
- Last level of priority (highest risk) for investors
Preferred shares

**Terms**
The ‘norm’ is for private equity to subscribe for preferred shares which are:
- Liquidity preference
- Have a fixed dividend
- Anti-dilution rights

**Issues**
Preferred shares are becoming less attractive as:
- More costly than Common shares
- Even if company has cash, payment may not be made if lack of distributable reserves.
Shareholder loans are a means for private equity houses to invest sufficient equity into a buyout situation, whilst still allowing management a significant equity stake.
Sources of equity

Private Markets
- Founders
- Venture Capital
- Private Equity

Public Markets
- Institutional
- Retail
Private equity firms manage funds or pools of capital that invest in companies that represent an opportunity for a high rate of return.

Private equity funds invest for limited time periods. Exit strategies include IPOs, selling to another private equity firm, etc.

Private equity funds are typically split into two categories:

1. **Venture capital funds typically invest** in early stage or expanding businesses that have limited access to other forms of financing.
   - Sequoia Capital
   - Y Combinator
   - Andreessen Horowitz

2. **Buyout or LBO funds typically invest** in more mature businesses, usually taking a controlling interest and leveraging the equity investment with a substantial amount of external debt. Buyout funds tend to be significantly larger than venture capital funds.
   - Blackstone
   - KKR
   - Carlyle Group
Typical exit routes for private equity

**Total Exit**
- Sale to Strategic
- Sale to Sponsor

**Partial Exit**
- Private Placement
- Corporate Restructuring

**Flotation/IPO**
Why use debt

**Corporation:** (1) to lower the cost of capital, and (2) avoid equity dilution

**Investor:** to increase their equity return

- **Debt/Total Capital (Leverage)**
- **Weighted Average Cost of Capital (WACC)**

- Senior debt: Three to five years, IRR = 28%
- Equity
Assessing debt capacity

**General measures**
- Level of EBITDA
- Volatility and hence stability of EBITDA
- Capital expenditures
- Cyclicality
- Risk
- Competition

**Balance sheet measures**
- Debt to equity
- Debt to capital
- Debt to assets
- Etc.

**Cash flow measures**
- Total debt / EBITDA
- Senior debt / EBITDA
- Net debt / EBITDA
- Cash interest cover
- EBITDA-Capex / interest
**Senior debt overview**

- **Revolver**: Revolving line of credit facility from a bank
- **Term loans**: have a fixed schedule where they repay or are amortized, and have a final principal repayment. Can be stacked.

**Senior Debt Capacity:**
- Provide 2x to 3x EBITDA
- Require 2x interest coverage
- Typically provided by: commercial banks, credit companies, insurance companies
Types of subordinated debt

Subordinated debt is used to fill the funding gap.

- Senior debt
- Subordinated debt
- Equity

Increasing subordination
Increasing return
Increasing dilution
How much subordinated debt?

Subordinated debt holders will only supply so much debt.

- Total debt / EBITDA ~ 5 to 6 times
- xEBITDA / Cash interest ~ 2 times
- Equity funding ~ 30% to 35%

The appropriate financial structure has to be constructed within these constraints.
# Credit ratings and high yield debt

**Investment grade**
- Low risk
- Low return
- Low fees

**High yield**
- High risk
- High return
- High fees

<table>
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<th>Moody’s</th>
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Mezzanine debt characteristics

Mezzanine debt:

• Non-traded
• Subordinated to senior debt
• Repaid as a bullet (not amortized)
• Combination of cash and accrued interest built into return
• Can have equity warrants attached
• Debt with warrants, convertible loan stock, convertible preferred shares
Mezzanine returns

- Cash pay interest
- Accrued interest
- Warrants 3% to 10% of post exit value

Total Mezzanine Return
(IRR 14% to 20%)
Mezzanine returns

- **Cash pay interest** (IRR 14% to 20%)
- **Accrued interest**
- **Warrants** 3% to 10% of post exit value
- **Total Mezzanine Return**

**Senior Debt**
- IRR <10%

**Subordinated Debt**
- Mezzanine investors
- IRR 14-20%

**Equity**
- IRR 20-30%
Debt repayment profiles

- **Equal amortizing**

- **Balloon repayment**

- **Bullet repayment**

- **Mezzanine finance – high yield debt**

- **Pay in kind debt**
Underwriting

The process where a bank raises capital for a corporation, or institution from investors in the form of equity or debt securities.

Underwriting involves conducting research, financial modeling, valuation, and marketing and a deal.
Types of underwriting commitment:

**Firm Commitment**

The underwriter agrees to buy the entire issue and assume full financial responsibility for any unsold shares.

**Best Efforts**

Underwriter commits to selling as much of the issue as possible at the agreed-on offering price, but can return any unsold shares to the issuer without financial responsibility.
Underwriting advisory services

**Planning**
- Identify investor themes
- Investment rationale
- Financial modeling & valuation
- Is IPO the best option?
- Size of float and lock-up issues
- Preliminary view on investor demand

**Issue Structure**
- Domestic or international
- Institutional investor focus
- Retail investor focus
- Offer for sale
- Intermediaries offer
- Introduction

**Timing and Demand**
- Hot or cold issue market
- Supported by positive news-flow
- Investor appetite
- Precedents and benchmark offerings
- Pricing

Corporate Finance Institute

®
Underwriting - the book building process

- Indicative price range
- Institutional investor commitment at firm price
- Book of demand built
- Price is set to ensure clearing
- Allocation
Underwriting - the road show

The roadshow is an opportunity for management to convince investors of the strength of the business cases.

Areas that are critical include:

- Management structure, governance and quality
- A thorough analysis of the industry/sector
- Strategy, both tactical and long-term
- Key risks
- Funding requirements and purpose: Cash in versus cash out
Pricing the issue

Key issues in pricing

- Price stability
- Buoyant after market
- Depth of investor base
Pricing the issue

After market price performance

Maximizing price
Under-pricing

There are two costs associated with a flotation:

• Direct cost / Fees
• Indirect cost / Under-pricing

There is a temptation for the advising bank to underprice the issue — why?

• Reduces the risk of equity overhang
• Ensures after market is buoyant
• BUT this fails to make the best possible returns for the current owners and could lead to profit-taking and hence volatility
The IPO pricing process

- Full value
- IPO discount
- IPO pricing
The IPO pricing process

- Full value
- IPO discount
- IPO pricing

Indicative maximum
10 to 15% pricing range
Indicative minimum
The IPO pricing process

- Full value
- IPO discount
- IPO pricing

Indicative maximum
Indicative minimum

10 to 15% pricing range
The IPO pricing process

You will be pricing the deal based on:
- Relative valuation
- Intrinsic valuation
Dividends and Return of Capital
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Corporate managers need to decide to:

**Distribute** the earnings to shareholders in the form of dividends or share buybacks, OR

**Retain** the excess earnings for future investments and operational requirements.
Internal Rate of Return (IRR)

IRR = 22% (based on cash flows)
WACC

\[ \text{WACC} = 28\% \]

\[ \text{% net debt} \times \text{Cost of debt} = \text{Contribution} \]

\[ \text{% equity} \times \text{Cost of equity} = \text{Contribution} \]
Decision

Internal Rate of Return = 22%

Cost of Capital = 28%

Return Capital (Dividend or Buyback)
# Retained earnings and excess cash

## Balance Sheet

<table>
<thead>
<tr>
<th>Assets</th>
<th>2023</th>
<th>2022</th>
<th>2021</th>
<th>2020</th>
<th>2019</th>
<th>2018</th>
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<tbody>
<tr>
<td>Cash</td>
<td>67,971</td>
<td>81,210</td>
<td>83,715</td>
<td>111,069</td>
<td>139,550</td>
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<tr>
<td>Accounts Receivable</td>
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<td>6,567</td>
<td>7,117</td>
<td>7,539</td>
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<tr>
<td>Inventory</td>
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<td>9,825</td>
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<tr>
<td>Property &amp; Equipment</td>
<td>45,500</td>
<td>42,350</td>
<td>40,145</td>
<td>38,602</td>
<td>37,521</td>
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<tr>
<td><strong>Total Assets</strong></td>
<td>126,376</td>
<td>139,065</td>
<td>140,252</td>
<td>167,319</td>
<td>195,951</td>
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<table>
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<tr>
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<th>2023</th>
<th>2022</th>
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<th>2020</th>
<th>2019</th>
<th>2018</th>
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<td>Accounts Payable</td>
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<td>Debt</td>
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<tr>
<td><strong>Total Liabilities</strong></td>
<td>53,902</td>
<td>54,800</td>
<td>34,912</td>
<td>35,265</td>
<td>35,671</td>
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<table>
<thead>
<tr>
<th>Shareholder’s Equity</th>
<th>2023</th>
<th>2022</th>
<th>2021</th>
<th>2020</th>
<th>2019</th>
<th>2018</th>
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<tr>
<td>Retained Earnings</td>
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<td>14,265</td>
<td>35,340</td>
<td>62,053</td>
<td>90,280</td>
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</tr>
<tr>
<td><strong>Shareholder’s Equity</strong></td>
<td>72,474</td>
<td>84,265</td>
<td>105,340</td>
<td>132,053</td>
<td>160,280</td>
<td></td>
</tr>
<tr>
<td><strong>Total Liabilities &amp; Shareholder’s Equity</strong></td>
<td>126,376</td>
<td>139,065</td>
<td>140,252</td>
<td>167,319</td>
<td>195,951</td>
<td></td>
</tr>
</tbody>
</table>
Retained earnings / excess cash decision flowchart

Retained earnings / Cash balance

- Rate of return on capital investment < WACC
  - Repurchase shares
  - Pay cash dividends

- Rate of return on capital investment > WACC
  - Reinvest in other projects
Dividend vs Share Buyback

**Dividend**
- Can be one-time or ongoing
- Contribute to the “yield” on a stock if ongoing regular dividends
- No impact on shares outstanding or EPS

**Buyback (Repurchase)**
- Reduces the number of shares outstanding
- Increases EPS
The ultimate purpose of corporate finance is to maximize the value of a business through planning and implementing management resources while balancing risk and profitability.

**Corporate finance overview**

- **Capital Investments**
  - Decide what projects / businesses to invest in
  - Earn the highest possible risk-adjusted return

- **Capital Financing**
  - Determine how to fund capital investments
  - Optimize the firm’s capital structure

- **Dividends & Return of Capital**
  - Decide how and when to return capital to investors
Corporate Finance Careers
Roles in corporate finance

**Banks (‘Sell side’)**
- Client facing / sales component
- Capital Markets hire from schools
- Retail hires at various points
- Long hours
- Competitive
- Quick career progression

**Public Accounting**
- Mix of client or inward focus
- Hire from schools or from other accounting firms
- Long / medium hours
- Competitive
- Clear career path

**Institutions (‘Buy side’)**
- More internally focused
- Hire from banks
- Hire grad school students
- Long hours
- Competitive
- Quick career progression

**Corporates**
- Internally focused
- Hire from banks, accounting firms, institutions and schools
- Hire across all entry points
- Hours vary
- Competitiveness varies by company
- Career progression varies