

Part V

Capital Structure and Payout Policy

How To Finance Projects

Although you now know how you should value projects and how you should think about your costs of capital, you do not yet know how firms can best get new investors to part with their cash. We just assumed that if you had a positive-NPV project, then the cash to start it would be there. However, in the real world, you must somehow get funds first. For example, you could use earnings that you do not pay out. Or you could borrow money. Or you could sell off your accounts receivable. Or you could issue more equity to new shareholders. In this part, we discuss both the types of claims that firms can sell to potential investors and the selling process itself.

To explain the concepts, we shall again start off with a perfect market. This illustrates the first-order determinants and explains how you should think about the problems. Then we layer on more complexity again—how real-world market imperfections alter some of the conclusions that you would draw in the idealized perfect market.

What You Want to Learn in this Part

The goal of this part of the book is to explain how firms finance projects with debt and equity, and how their mix of funding sources influences the firm's cost of capital.

- Chapter 16 describes the principal phenomenon that this part of the book is focused on—corporate capital structure. It explains how you should think of securities that firms sell (issue), and how these securities are sold into the financial markets. It then shows how Intel's real-world capital structure evolved. This

helps you judge what the first-order aspects of capital structure are.

Typical questions: What kind of claims can firms issue to raise money? What are cash flow and control rights? What claims have what rights? How can payoff diagrams help you think of firms' capital structures?

- Chapter 17 begins the theoretical analysis of what capital structure firms should choose *in a perfect financial market*. It shows that the value of the firm is the value of its underlying assets and does not depend on whether the firm is financed with debt or equity.

Typical questions: Should firms maximize shareholder or firm value? What are the appropriate values, promised rates of return, and expected rates of return on different securities? What is the weighted average cost of capital, commonly called WACC?

- Chapter 18 moves on to an imperfect world, in which firms have to pay corporate income taxes. This market imperfection is important enough to deserve its own chapter. So how should firms make capital structure (and capital budgeting) decisions if they have to pay corporate income taxes? The chapter also explains why profitable firms with large corporate income tax obligations should prefer debt over equity.

Typical questions: What is the firm's cost of capital and value if it finances itself with 50% debt and 50% equity, instead of with 100% equity? What exactly are tax-adjusted WACC, APV, and flow-to-equity?

- Chapter 19 shows how firms should make capital structure and capital budgeting decisions if there are market imperfections other than corporate income taxes. The chapter explains that some market imperfections should push the firm toward having more equity, others toward having more debt. In addition, it describes what conflicted managers like.

Typical questions: Should different types of firms have different investor clienteles? Should a high-growth firm finance itself with more or less debt than a profitable value firm? What should investors be afraid of,

and how can managers comfort investors? How do these factors influence the firm's cost of capital?

- Chapter 20 describes equity payout strategies: dividends and share repurchases.

Typical questions: Are dividend payments better or worse than share repurchases? Does it matter? How do firms tend to pay out money they earn?

The companion contains some extra material that typically belong to this part but which few classes are likely to have the time to cover in the first course.