3/Key Elements of a Corporate Finance Strategy

3-1 Capital Budgeting and Investment Decisions

Companies decide which projects to invest in through a process called capital budgeting. It involves evaluating each potential investment's expected return against the risk involved and comparing it to other projects' returns. Good capital budgeting practices enable companies to make sound investment decisions and allocate resources to the highest-ROI projects.

They accomplish this using various financial analysis tools:

- **Net present value (NPV)** is the most widely used. It calculates the total value of a potential investment by discounting the expected cash flows to their present value and subtracting the initial investment cost. A positive NPV indicates that the project is expected to generate value exceeding its cost.
- **Internal rate of return (IRR)** is the discount rate that makes the NPV of all cash flows from a particular project equal to zero. In simpler terms, it represents the expected annualized rate of return on the project. Projects with an IRR exceeding the company's required rate of return are typically considered viable.
- **Payback period** measures how long it takes for the investment to "pay back" its initial cost from its cash inflows. While it is useful for assessing the liquidity and risk associated with the project, it doesn't account for the time value of money or cash flows beyond the payback period.
- **Profitability Index (PI)**, also known as the benefit-cost ratio, is calculated by dividing the present value of future cash flows by the initial investment. A PI greater than 1 suggests that the project generates more value than its cost.

Many businesses also perform a sensitivity analysis. This involves changing key assumptions or variables to see how they affect the project's outcomes (like NPV or IRR). It helps in understanding how sensitive the project is to changes in inputs and identifying the risk factors.

3-2 Financing Decisions

Most businesses need outside capital to fund their operations, especially when they're starting out or expanding. The primary sources of capital include equity (shares) and debt (loans).

- **Equity financing** is the process of raising capital by selling shares in a company to investors. It comes at the cost of diluting ownership and profits. Examples include common stock (to public investors), preferred stock (to VCs or angel investors), and retained earnings (to reinvest in the business). It does not require repayment.
- **Debt financing** involves borrowing money from banks or other lenders. It comes in the form of loans, bonds, or lines of credit and requires repayment within a set period with interest. Debt financing allows companies to raise capital without diluting ownership or profits.
- **Hybrid instruments** like mezzanine financing and convertible bonds combine elements of both equity and debt financing.

The optimal capital structure (that is, the mix of equity and debt financing) is unique to each company. While equity offers more flexibility, debt is sometimes a less expensive source of capital because interest rates are generally lower than the cost of issuing new shares. But taking on too much debt increases the company's financial risk if it has difficulties repaying the loans.

Finance teams can take a few different approaches to optimization:

- **Weighted average cost of capital (WACC)**, where each category of capital is proportionately weighted
- The **trade-off theory**, which balances the tax benefits of additional debt against the costs of potential financial distress from extra debt loads
- The **pecking order theory**, which applies the principle of least resistance, preferring to raise equity as a last resort

Managing Risk

A company's financial risk is its exposure to potential financial loss. It is a function of how much debt it carries, its industry and market trends, economic conditions, and operational risks like fraud or non-compliance.

- **Credit risk** arises from the company's borrowers, suppliers, or clients defaulting on their payments. It can be mitigated by setting limits on how much credit to extend, monitoring customer financials and payment histories, diversifying the client base, and requiring collateral.
- **Market risk** is a company's exposure to changes in interest rates, exchange rates (for international businesses), commodity prices, equity prices, and other variables. Hedging is a common strategy to reduce market risk.
- **Operational risk** stems from inadequate internal controls, systems failures, fraud, or legal non-compliance. Mitigation measures include setting up control mechanisms and processes, implementing cybersecurity protocols, and conducting appropriate audits.

Financial strategies will always incorporate a risk assessment and consider the company's risk appetite before making decisions about where to diversify, invest, and make policy changes.

Short-Term Financial Management