Informative essay on long term financing

It offers powerful and intuitively pleasing predictions about how to measure risk and the relation between expected return and risk. The risk in this model comprise of systematic risk means risk undiversifiable risk or market risk. This Model basically takes into account asset's sensitivity to non-diversifiable risk RE: (Capital asset pricing model From Wikipedia, the free encyclopedia).

Earlier pricing models do not reflect changes in financial markets but with the emergence of Financial Pricing Models in form of Capital Pricing Models and Discounted Cash Flow models, changes in financial market, risk and return on individual investment can be easily ascertained RE: (http://www. business. uiuc. edu/~s-darcy/present/ratemake. ppt#256, 1, Ratemaking: A Financial Economics Approach).

CAPM is based on certain assumptions such as investors should be rational, fixed quantity of assets, perfect efficient capital markets, production plans are fixed, no inflation, no change in level of interest rate, similar expectation. However having numerous advantage of this model it is also affected by certain limitations and based on certain assumptions which does not perfectly exists.

As it fails to appear adequate variation in stock returns, it assumes that there are no taxes or transaction cost which is not suitable in prevailing market situation. It assumes all assets of fixed quality which can never be possible, every market is not perfectly efficient, it varies on the basis of several factors. Inflation makes direct effect on the interest rate so can it be possible to remain unaffected with such change.

In comparison to previous Model, Discounted Cash Flow Model (DCF) helps to determine that what one person is willing to pay today in order to obtain the expected cash flow in future years. In short, it can be said that Discounted cash Flow Model is the method of conversion of futures earning in today’smoney. DCFM helps in calculation of cash needed to be invested to receive expected cash flow in future years. The DCFM reflects following Reference:-

1. The time Value of money means investor must be compensated for the delay of their cash flow.

Risk Premium states that investor can demand high amount in form compensation. The key inputs in Discounted Cash Flow Model are discount rate, cash flows and growth to get future cash flows. This model helps in determining the company’s current value according to its estimated future cash flows. DCFM is an important tool in making judgment about company performance. However DCFM are powerful, but they have certain limitations as they are limited to mechanical valuation, small changes in inputs may result in large changes in the value of a company. DCFM are not suitable for short term investment as it focus on long term investing RE: (http://pages. stern. nyu. edu/~adamodar/pdfiles/dcfinput. pdf).

So, from the study of both the model it can be concluding that both are suitable at their own place subject to consideration of certain assumption and limitation.

The company’s evaluates various debts policy and dividend policy to arrive at final decision so that maximum benefit can be provided to company, shareholder, creditors or other persons. To valuate debts and equities various theories are discussed in connection with the sum of debt or equity needed in the organization. Cost of capital play a very important role in selection of the amount of debt and equity such as cost of debt, cost of preference shares, cost of debentures, cost of common shares etc.

Then to identify factors which affect capital structure such as political risk, cash flows, discount rate and terminal value. Calculation of net present value, interest rate of return and adjusted net present value is done to ascertain the suitability of capital budget. So first, cash flow forecasting is to be done by adopting various principles. Then categorization of cash require is made in form of shorter cash, medium term and long term. Then the capital structure is decided by considering various aspects such as cost of equity capital.

Then after having profits the company decide whether whole or part of profit is distributed. The factors should be considered while taking the decision policy decision. Then procedure for payment of dividend is sketched and then impact of divided is noted on the position of shareholders RE: (http://www. cma-srilanka. org/pub/professionalII. pdf).

Hence it is clear from the evaluation of debt/equity mix and dividend policy that how much they are necessary to strengthen company’s position. Therefore it is advisable that there must be judicious mixture of debt and equity that must add value by reducing taxes and strengthening management as too much debt result in heavy loss of business and perhaps a costly organization.

REFERENCE

Referred to sites:-

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2. http://www. biu. ac. il/soc/sb/stfhome/lauterbah/794/part6/fama_capm. pdf

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3. http://www. valuebasedmanagement. net/methods_dcf. html

DCF method Discounted Cash Flow

4. http://www. cma-srilanka. org/pub/professionalII. pdf

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