Role of the capital and efficient market finance essay

Finance

The purpose of this report will help understand how a large company demonstrates key areas of financial management in practice. This will include the role and importance of capital market and EMH firstly. Secondly, the different sources of finance available to large companies and the relative merits and risks. Last, the importance of cost of capital to large companies and its implications on the capital structure.

Introduction

Financial management is about planning income and expenditure, and making decisions that will enable you to survive financially. Functions of financial management are to study and implement: Investment decision, financing decision and dividend decision. Because proper choices of sources of finance will make good financing decision. A good financing decision will lead to competitive investment opportunities. This report will align the decision to the overall company strategies.

2. 0 Role of the capital market and efficient market

2. 1 The role and importance of capital market

The capital market is part of the financial markets, which includes all related to the supply and demand for long-term capital institutions and transactions. Long-term capital, including the company's fractional ownership such as stocks, long-term bonds, long-term corporate bonds, more than a year of large negotiable certificates of deposit, real estate mortgages and financial derivatives, also including collective investment funds and other long-term form of loans, but does not include the commodity futures. The capital market is a market form, rather than a physical location, it refers to all those

who traded on this market, institutions and their relationships.(Source: Sullivan, arthur; Steven M. Sheffrin (2003). Economics: Principles in action. Upper Saddle River,: Pearson Prentice Hall. pp. 283. ISBN 0-13-063085-3.)These long-term financing mechanisms available in the capital markets can be characterized further by identifying how they transfer funds from the lender to the borrower. A distinction can be made between two groups of funds-transfer mechanisms. The fist group involves devices such as term loans and financial leases, where the borrower obtains the finance through a financial intermediary such as a bank. For example, if a business needs to obtain funds to invest in new equipment, it can approach its bank and borrow the required funds via a term loan or lease. This financing arrangement is therefore solely between the bank and customers and is often called the intermediated finance. The second group comprises long-term debt securities (such as debentures, notes and bonds), equity instruments (such as ordinary shares and preference shares) and ‘ hybrid securities’ (such as convertible notes). These securities are sold or issued directly by the firm to investors, either via a public offering through the share market or by a private placement. As seen earlier, this direct sale or issues of securities is classified as a primary-market transaction. Once these securities have been issued, they can then be resold through the share market, thus being classified as a secondary-market transaction.

2. 2 The role and importance of efficient market

The efficient market hypothesis actually deals with the speed with which information is impounded into security prices. Under the efficient market hypothesis, information is reflected in security prices with such speed that

there are no opportunities for investors to profit from publicly available information. In effect, an efficient market is one characterized by a large number of profit-driven individuals who act independently of one another. In addition, new information regarding securities arrives in the market in a random manner. Given this setting, investors adjust to this new information immediately and buy and sell the security until they feel that the market price correctly reflects the new information. Whether or not the price adjustment turns out to be correct is not important, but it is important that the price adjustment not be biased that is, that investors cannot predict whether or not it is an over or under-adjustment. To sum up, an efficient market is one in which the values of all assets and securities at any instant in time fully reflect all available information. (Source: Burton G. Malkiel (1987). " Efficient market hypothesis," The New Palgrave: A Dictionary of Economics, v. 2, pp. 120–23.)If the securities market is working efficiently, the market value and the intrinsic value of a security will be equal. This is because whenever a security’s intrinsic value differs from its current market price; investors aiming to make a profit will either buy or sell the security. The result of these supply and demand forces will be to drive the security’s market price back into equilibrium with the intrinsic value. Another outcome of an efficient market is that the market values of all securities at any instant in time will fully reflect all available information. This will occur because investors, who are assumed to act rationally, will use the information to determine the intrinsic value of the security. Their actions to buy or sell the security will result in the market value (price) of the security changing to be the same as the intrinsic value. Because this occurs, it is extremely difficult

for an investor to make extra profits by consistently predicting asset market prices that are different from intrinsic values. The implication of market efficiency has been the source of much disagreement between academics and professional investors. For example, many finance academics have contended that, because markets are efficient, investors could select their investments by throwing darts at a list of securities and make as much profit as professional money managers who believe they can consistently identify undervalued and overvalued securities. The market professionals, on the other hand, retort that the academic view of market efficiency and investors acting rationally is too divorced from the reality that some professional investors can analyse the information available about securities and consistently pick undervalued and overvalued securities and thereby make superior profits.

3. 0 Different sources of finance available

A business requires funds to purchase fixed assets like land and building, plant and machinery, furniture etc. These assets may be regarded as the foundation of a business. The capital required for these assets is called fixed capital. A part of the working capital is also of a permanent nature. Funds required for this part of the working capital and for fixed capital is called long term finance. The main sources of long term finance are as follows:

3. 1 Internal sources

Retained earning

The surplus cash is called retained earnings in corporate finance. Retained earnings are seen as a ready source of cash; the decision on the amount to

pay shareholders (and hence on the amount of retained earnings) is an internal decision and so does not require a company to present a case for funding to a third party; retained earnings have no issue costs; there is no dilution of control as would occur with issuing new equity shares; there are no restrictions on business operations as might arise with a new issue of debt. Retained earnings must not be confused with the accounting term ' retained profit', which is found in both profit and loss accounts and balance sheets. Retained profit in the profit and loss account may not be cash, and retained profit in the balance sheet does not represent funds that can be invested. Only cash can be invested. A company with substantial retained profits in its balance sheet, no cash in the bank and a large overdraft will clearly be unable to finance investment from retained earnings.

Ordinary shares

The ordinary share like both bonds and preference shares, an ordinary share's value is equal to the present value of all future cash flows expected to be received by the shareholder. In contrast to bonds, companies that have issued ordinary share do not promise to pay investors a regular interest income or a maturity payment. Nor does the company promise to pay a predetermined constant dividend as with preference shares. Instead, for ordinary shares the dividend paid by the company is determined by two components. The first components is that the company can pay dividend only from accounting profits, and the second components is that the amount of dividend paid on ordinary share is based purely on how much profits the company's board of directors decide to pay. As a consequence, the future dividend stream for an ordinary share is uncertain. However, it is possible to

identify some pattern to the future amount of ordinary dividends if they are expected to increase with an anticipated growth in corporate earning

. Preference shares

Like a bondholder, the owner of a preference share should receive a constant amount in each period. However, because preference share are form equity, this constant amount comes in the form of dividend payment rather than as interest. This distinction is especially important for taxation purposes, as dividends and interest income are treated differently. Sometimes companies create preference shares that are redeemable. That is, the constant dividend amount is paid only for a period of time until the shares are redeemed by the company. As redeemable preference shares have a finite life, their valuation is analogous to the valuation of bonds. Usually, preference shares are irredeemable. This makes them ordinary shares because the constant dividend amount is theoretically paid forever (unless the company is liquidated.) we can therefore model the constant dividend stream as a perpetuity, which makes finding the value Vp relatively easy.(Source: Kieso, Donald E., Weygandt, Jerry J., and Warfield Terry D. (2007) Intermediate Accounting, 12ed John Wiley & Sons. ISBN 0-471-74955-9 p. 738)

3. 2 External sources

Bank loan

Traditionally, commercial banks in India do not grant long term loans. They grant loans only for short period not extending one year. But recently they have started giving loans for a long period. Commercial banks give term

loans i. e. for more than one year. The period of repayment of short term loan is extended at intervals and in some cases loan is given directly for a long period. Commercial banks provide long term finance to small scale units in the priority sector. (Source: Getting Started in Small Business". Canadian Bankers Association..)

Merits of long term borrowings from Commercial Banks:

The merits of long-term borrowing from banks are as follows: 1. It is a flexible source of finance as loans can be repaid when the need is met. 2. Finance is available for a definite period, hence it is not a permanent burden. 3. Banks keep the financial operations of their clients secret. 4. Less time and cost is involved as compared to issue of shares, debentures etc. 5. Banks do not interfere in the internal affairs of the borrowing concern, hence the management retains the control of the company. 6. Loans can be paid-back in easy instalments. 7. In case of small-scale industries and industries in villages and backward areas, the interest charged is low.

Demerits:

Following are the demerits of borrowing from commercial banks: 1. Banks require personal guarantee or pledge of assets and business cannot raise further loans on these assets. 2. In case the short term loans are extended again and again, there is always uncertainty about this continuity. 3. Too many formalities are to be fulfilled for getting term loans from banks. These formalities make the borrowings from bankstime consuming and inconvenient. (Source: de Albuquerque, Martim (1855). Notes and Queries.)

Debenture

Merits of debentures:

Following are some of the advantages of debentures:

1) Raising funds without allowing control over the company:

Debenture holders have no right either to vote or take part in the management of the company.

2) Reliable source of long term finance:

Since debentures are ordinarily issued for a fixed period, the company can make the best use of the money. It helps long term planning.

3) Tax Benefits:

Interest paid on debentures is treated as an expense and is charged to the profits of the company. The company thus saves income tax.

4) Investors' Safety:

Debentures are mostly secured. On winding up of the company, they are repayable before any payment is made to the shareholders. Interest on debentures is payable irrespective of profit or loss. (Source: Glossary: D on FINRA website, United States)

Demerits:

Following are the demerits of debentures: 1. as the interest on debentures have to be paid every year whether there are profits or not, it becomes burdensome in case the company incurs losses. 2. Usually the debentures are secured. The company creates a charge on its assets in favour of debentureholders. So a company which does not own enough fixed assets

cannot borrow money by issuing debentures. Moreover, the assets of the company once mortgaged cannot be used for further borrowing. 3. Debenture-finance enables a company to trade on equity. But too much of such finance leaves little for shareholders, as most of the profits may be required to pay interest on debentures. This brings frustration in the minds of shareholders and the value of shares may fall in the securities markets. 4. Burdensome in times of depression: During depression the profits of the company decline. It may be difficult to pay interest on debentures. As interest goes on accumulating, it may lead to the closure of the company. Until now you have learnt about issue of shares and debentures as two main sources of raising long term finance. You have also learnt about the merits and demerits of the two. Now let us make a comparative study of shares and debentures for raising long term capital.

4. 0 The importance of cost of capital to large companies and its implications on the capital structure

4. 1 Cost of capital

The cost of capital is a technical term that may be defined in several ways, such asthe minimum required ROI for proposals using capital funds; the cut off rate for capital expenditures; the target ROI that must be surpassed if capital-use is to be justified; orthe financial standard. Each type of capital has its associated cost, and this may be influence by several factors, over some of which management has control, including: company policy on distribution of profits, and on the retention of profits; the capital structure itselfthe level of the stock market at the time of a new issue; the size of the issue; andthe market standing of the company.(Source: Brealy &al. "

Principles of Corporate Finance", Chapter 10)A company can be viewed as a collection of projects. As a result, the use of an overall cost of capital as the acceptance criterion (hundred rates) for investment decisions is appropriate only under certain circumstances. These circumstances are that the current projects of the firm are of similar risk and that investment proposals under consideration are of the same character. If investment proposals very widely with respect to risk, the required rate of return for the company as a whole is not appropriate as the sole acceptance criterion. The advantage of using the firm's overall required rate of return is, of course, its simplicity. Once it is computed, projects can be evaluated using a single rate that does not change unless underlying business and financial market conditions change. Using a single hurdle rate avoids the problem of computing individual required rates of return for each investment proposal. It is important to note, however, that if the firm's overall required rate of return is used as an acceptance criterion, projects should generally correspond to the foregoing conditions. Otherwise, one should determine an individual acceptance criterion for each project. So the company can not make wrong decisions, then they will have less invest opportunity.

4. 2 Capital structure

A mix of a company's long-term debt, specific short-term debt, common equity and preferred equity. The capital structure is how a firm finances its overall operations and growth by using different sources of funds. Debt comes in the form of bond issues or long-term notes payable, while equity is classified as common stock, preferred stock or retained earnings. Short-term debt such as working capital requirements is also considered to be part of

the capital structure. (Source : Baker, Malcolm P.; Wurgler, Jeffrey (2002). " Market Timing and Capital Structure". Journal of Finance 57 (1): 1–32.)Financial management has two basic roles to play: to participate in the process of putting funds to work within the business, and so control their profitability in those uses: andto identify the need for the need for funds and select the sources to be used. In relation to (2) above, the extent of the capital fund available, to firm might appear to be relatively simple to determine. However, this is not so. A firm's fund is composed of debt, as well as share capital. The proper balance of share capital and debt capital will tend to be determined by: the company's growth rate; the stability of sales; the competitive structure of the industry; the company's asset structure; lenders' attitudes towards the company and its industry; the control position of the owners and management andattitudes towards risk. A timid company will tend to have little debt capital, and a large fund of liquid resources. In contrast, an aggressive growth company will tend to employ large amounts of debt, and make extensive use of overdraft facilities in its effort to grow in terms of turnover, assess and above all, profits. The higher a company's earning and the more rapid is growth, the greater is the financial incentive to finance by debt rather than shares. When debt is used, it is necessary that liquid funds be available to service that debt. The optimal capital structure is that which minimizes the cost of capital by a particular combination of debt and equity, and also maximizes the market value of company for given level of capital input. Insofar as the movements and application of a company's capital fund are within the company's power, they will comprise: the raising of additional equity capital; the raising of other types of share capital; the

raising of loans or their payment; the retention or distribution of profits; andthe allocation of funds to projects. The existence of several different types of capital permits an infinite variety of combinations. For example, if a relatively large investment is tied to a particular from of financing, a significant change in the capital structure may result□ the purchase of land financed by a mortgage, a merger financed by a new issue of shares, and the acquisition of equipment by a non-recoverable long lease are all transactions that will change a firm’s capital structure. Any significant change in the capital structure may only be of temporary nature. However, if this structure is permanently changed, it ought to be as a result of a separate decision that such a change is desirable. There are times when a company will wish to consider a permanent change on its capital structure, because of a belief that a change in the relative costs of different forms of capital, or a change in the risks faced, would make a different capital structure more desirable. Any decision involving a permanent change should be considered on its merits, independently of any specific decision to acquire assets.

4. 3 POT to advice the board.

Pecking Order theory tries to capture the costs of asymmetric information. It states that companies prioritize their sources of financing (from internal financing to equity) according to the law of least effort, or of least resistance, preferring to raise equity as a financing means " of last resort". Hence: internal debt is used first; when that is depleted, then debt is issued; and when it is no longer sensible to issue any more debt, equity is issued. This theory maintains that businesses adhere to a hierarchy of financing sources

and prefer internal financing when available, and debt is preferred over equity if external financing is required. Thus, the form of debt a firm chooses can act as a signal of its need for external finance. (Source: Testing Trade-Off and Pecking Order Predictions about Dividends and Debt, Review of Financial Studies, 2002)It means that if the K0 is too high. The capital of market can be not competitive. It is difficult to look for projects exceeding the cost of capital. With a high K0, the risk of capital of market is high. It will affect share price. When the capital of market is not competitive, it will be more difficult to access the capital market.

Conclusion

Financial management is largely about making decisions-decisions such as what assets or products to invest in, how to manage cash, and to raise funds for growth. Though this report, it shows that: the market capital and EMH is very important. In the finance management, there are many sources to choice, base on long-term funds; it can be divided internal source and external source. Each source has own merits and risks. The importance of cost of capital to large companies and its implications on the capital structure. All in all, it can be said that, the decisions facing financial managers are often affected by forces outside the firm, in the business environment. Having a business organization that considers financial management is business which can easily make decision.