

This project, which has a positive NPV, does three things for the owners:

1. recovers the initial cash outlay of £1,000
2. meets the finance charge, the required return on capital ($15\% \times £1,000$) £150
3. and, in addition, it generates a surplus of £150

Making a total of £1,300.

The surplus after meeting the interest charge and recovering the initial capital outlay, when discounted, is simply the NPV of the project:

$$\frac{£150}{(1.15)} = £130$$

Hence, the NPV of the project equals the increase in shareholder wealth or value. A value-maximising company will attempt to develop and exploit as many positive NPV projects as it can, in order to maximise the wealth of its shareholders. In our example, the value of the project is £1,130 and the value created is £130. Since a firm is a collection of projects, the value of a company is simply the value of all its projects or the sum of all future discounted cash flows. This is sometimes called its **capitalisation**.

Value Determinants

Figure 1.2 expresses the determinants of company value, and thus the focus of this course. Essentially, these centre on, firstly, the investment policy of the company, which determines the cash flows from which dividends may be paid, and, secondly, the discount rate at which these cash flows are discounted. The **discount rate**, or **required return**, depends on the inherent **risk** of the company's chosen activity *and* also the **financial policy** it adopts. For example, does the company use a mixture of equity and debt? This is often considered risky because of the legal obligation to meet interest charges whatever happens. And if it does use debt, what mixture of long-term debt and short-term debt does it use? Short-term debt is often considered riskier than long-term debt as it can be withdrawn at short notice. Although there are advantages in all debt financing, the additional financial risk imposed does sometimes compel companies to offer a higher return as compensation.

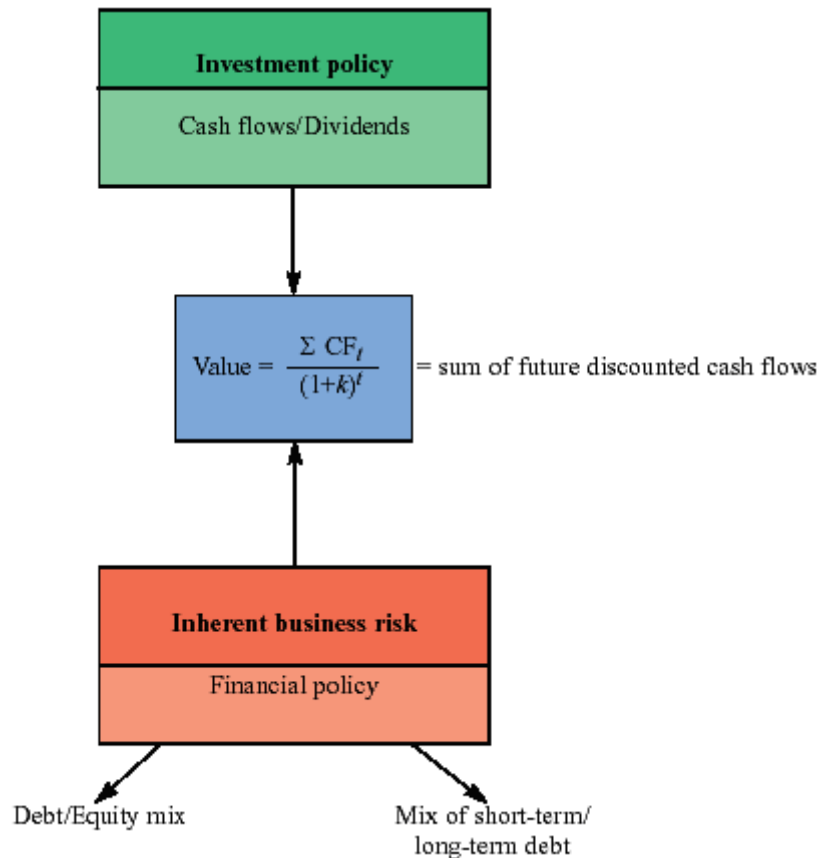


Figure 1.2: Value determinants

➤ Risk-Return Trade-Off

Our previous comments about risk and return lead to the consideration of the **risk–return trade-off**. Any developed capital market will establish a clear relationship between the rate of return required (or yield) on different types of security and their risks. The yield on **short-term government stock**, which is often considered risk-free, establishes the benchmark. Any other securities have to offer an extra yield or risk premium, as compensation for the risk they carry. The riskiest securities of all are ordinary shares because there is no obligation for the company to pay a dividend and, in the event of insolvency, the ordinary shareholder, being the last to receive anything, will probably receive nothing. Conversely, the risk to the company is low since failure to pay a return – the dividend – will not result in legal action, as would be the case with corporate bonds. It is useful to remember the two-sided nature of the risk of securities.

Identification of the risk–return frontier is important for the financial manager as it defines the rate of return which investors require on different types of security and therefore dictates the cost of capital, the denominator in the valuation expression. Normally, investors are risk-averse – they dislike risk but can be enticed to accept it, given suitable encouragement by a higher than expected return.

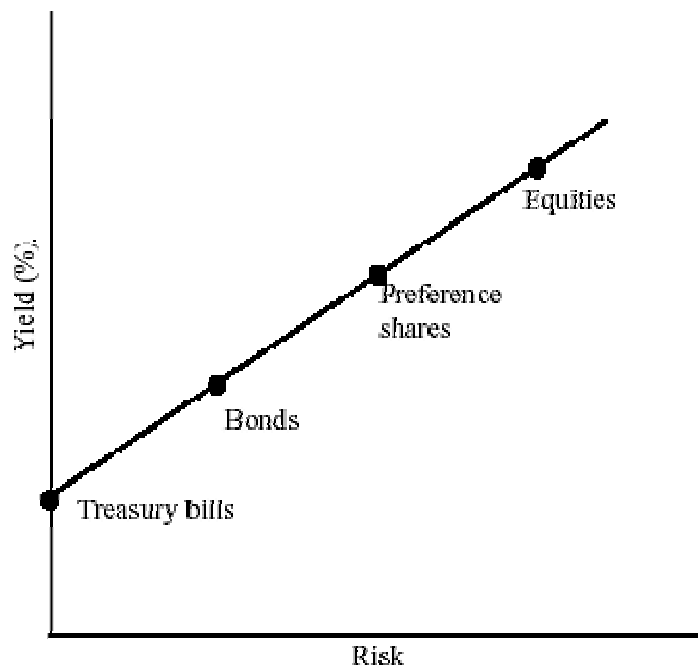


Figure 1.3: The risk–return trade-off

☞ The Accountant Versus The Strategist

Modern financial management centres on the concept of value and how it can be created for the owners of the firm. In this respect, the focus has moved away from that of traditional accounting. For the traditional accountant, a company was a set of assets to be valued on ‘prudent’ accounting principles of (usually) historic cost less depreciation. The modern financial manager is far more aware of the importance of marketing and strategic management, and aware that the development and pursuit of strategies creates value for the owners. As a result, modern financial management involves identifying the factors which create value – the **value drivers** – and managing these appropriately.

Key value drivers

The concept of a value driver stems from the work of Michael Porter who defined two generic forms of corporate strategy – exploiting a **cost advantage** (applicable to ‘commodity’ products) and exploiting **product advantages** (often applicable to products sold to the final consumer). The relative importance of the various cost drivers is likely to vary according to the type of strategy followed. However, for most businesses, the following list would be relevant:

- period over which competitive advantage is expected to persist
- market share
- sales growth
- operating profit margin
- fixed investment programme
- working capital requirements
- cost of finance
- rate of tax and tax outflows.

Some of these factors may work in two directions. Taxation is essentially a drag on value, but the company’s tax bill can be minimised by exploiting certain tax breaks, for example, using debt finance and thus setting interest against profit for tax purposes, and investing in capital equipment thus generating tax-allowable depreciation allowances. The resulting tax savings from exploiting these tax reliefs are called the **tax shield**.

The key value drivers are displayed in Figure 1.4, which shows the three foci of strategy, and how they create value through the various value drivers.

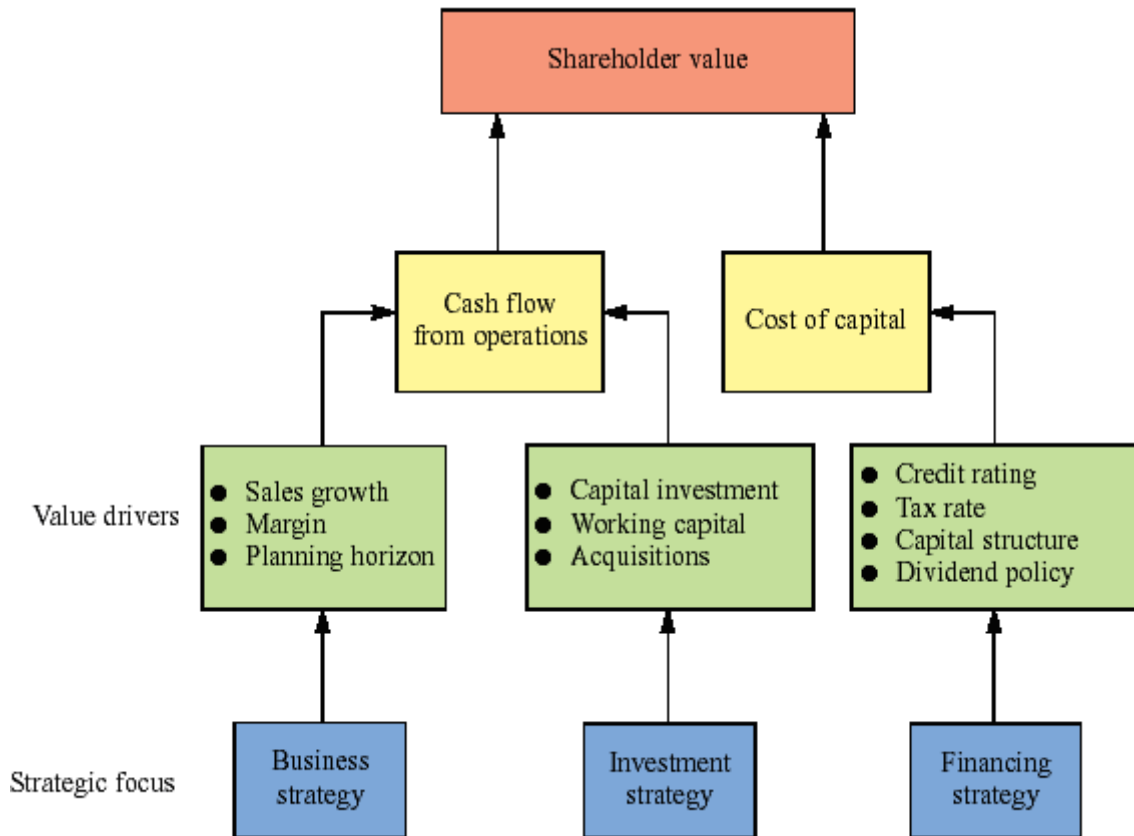


Figure 1.4: Shareholder value analysis framework

The concept of shareholder value permeates this course and it is therefore important that you absorb this philosophy (whether or not you agree with it!). We will show you how to formally calculate shareholder value in Unit 2.

Q ACTIVITY 1.1: QUESTION

This list of value drivers looks a little vague without application to an actual company. To illustrate them better, identify the key value drivers for a particular company. Choose a company in a sector producing a well-known product, for example, soft drinks, denim jeans, an airline, a motor car manufacturer.

Delivering Value

Value creation is one issue – deciding how to deliver to shareholders is another. Shareholders receive value in two forms, payment of dividends and appreciation in share price. Taking the two elements together, we have a concept known as **Total Shareholder Return (TSR)**. Most companies, if they are successful, will deliver a mixture of returns. As you will see in Unit 6, the precise balance between the two components can be an important decision variable.