

# Chapter 1

## WHAT IS CORPORATE FINANCE?

*To whet your appetite . . .*

The primary role of the financial manager is to ensure that his company has a sufficient supply of capital.

The financial manager is at the crossroads of the real **economy**, with its industries and services, and the world of **finance**, with its various financial markets and structures.

There are two ways of looking at the financial manager's role:

- a buyer of capital who seeks to minimise its cost, i.e. the traditional view;
- a seller of financial securities who tries to maximise their value. This is the view we will develop throughout this book. It corresponds, to a greater or lesser extent, to the situation that exists in a capital market economy, as opposed to a credit-based economy.

At the risk of oversimplifying, we will use the following terminology in this book:

- the **financial manager** or **chief financial officer** (CFO) is responsible for financing the firm and acts as an intermediary between the financial system's institutions and markets, on the one hand, and the company, on the other;
- the **business manager** invests in plant and equipment, undertakes research, hires staff and sells the firm's products, whether the firm is a manufacturer, a retailer or a service provider;
- the **financial investor** invests in financial securities. More generally, the financial investor provides the firm with financial resources, and may be either an equity investor or a lender.

### Section 1.1

THE FINANCIAL MANAGER IS FIRST AND FOREMOST A SALESMAN . . .

**1/** THE FINANCIAL MANAGER'S JOB IS NOT ONLY TO "BUY" FINANCIAL RESOURCES . . .

The financial manager is traditionally perceived as a buyer of capital. He negotiates with a variety of investors – bankers, shareholders, bond investors – to obtain funds at the lowest possible cost.

Transactions that take place on the **capital markets** are made up of the following elements:

- a commodity: money;
- a price: the interest rate in the case of debt; dividends and capital gains in the case of equities.

In the traditional view, the financial manager is responsible for the company's financial procurement. His job is to minimise the price of the **commodity** to be purchased, i.e. the **cost of the funds** he raises.

We have no intention of contesting this view of the world. It is obvious and is confirmed every day, in particular in the following types of negotiations:

- between corporate treasurers and bankers, regarding interest rates and value dates applied to bank balances (see Chapter 49);
- between chief financial officers and financial market intermediaries, where negotiation focuses on the commissions paid to arrangers of financial transactions (see Chapter 25).

## 2/ . . . BUT ALSO TO SELL FINANCIAL SECURITIES

That said, let's now take a look at the financial manager's job from a different angle:

- he is not a buyer but a **seller**;
- his aim is not to reduce the cost of the raw material he buys but to **maximise a selling price**;
- he practises his art not on the capital markets, but on the market for financial instruments, be they loans, bonds, shares, etc.

We are not changing the world here; we are merely looking at the same market from another point of view:

- the **supply** of financial securities corresponds to the demand for capital;
- the **demand** for financial securities corresponds to the supply of capital;
- the **price**, the point at which the supply and demand for financial securities are in equilibrium, is therefore the **value of security**. In contrast, the equilibrium price in the traditional view is considered to be the interest rate, or the cost of funds.

We can summarise these two ways of looking at the same capital market in the following table:

Analysis/Approach	Financial approach: financial manager as salesman	Traditional approach: financial manager as purchaser
Market	Securities	Capital
Supply	Issuers	Investors
Demand	Investors	Issuers
Price	Value of security	Interest rate

Depending on your point of view, i.e. traditional or financial, supply and demand are reversed, as follows:

- when the **cost of money** – the interest rate, for example – **rises**, demand for funds is greater than supply. In other words, the supply of financial securities is greater than the demand for financial securities, and **the value of the securities falls**;
- conversely, when **the cost of money falls**, the supply of funds is greater than demand. In other words, the demand for financial instruments is greater than their supply and **the value of the securities rises**.

The cost of capital and the value of the securities vary in opposite directions. We can summarise with the following theorem, fundamental to this entire book:

Minimising financing cost is synonymous with maximising the value of the underlying securities.

For two practical reasons, one minor and one major, we prefer to present the financial manager as a seller of financial securities.

The minor reason is that viewing the financial manager as a salesman trying to sell his products at the highest price casts his role in a different light. As the merchant does not want to sell low-quality products but products that respond to the needs of his customers, so the financial manager must understand his capital suppliers and satisfy their needs without putting the company or its other capital suppliers at a disadvantage. **He must sell high-quality products at high prices.** But he can also repackage his product to better meet investor expectations. Indeed, financial markets are subject to fashion: in one period convertible bonds (see Chapter 2) can be easily placed; in another period it will be syndicated loans (see Chapter 21) that investors will welcome.

The more important reason is that when a financial manager applies the traditional approach of minimising the cost of the company's financing too strictly, erroneous decisions may easily follow. The traditional approach can make the financial manager **short-sighted**, tempting him to take decisions that emphasise the short term to the detriment of the long term.

For instance, choosing between a capital increase, a bank loan and a bond issue with lowest cost as the only criterion reflects flawed reasoning. Why? Because suppliers of capital, i.e. the buyers of the corresponding instruments, do not all face the same level of risk.

The investor's risk must be taken into account in evaluating the cost of a source of financing.

The cost of two sources of financing can be compared only when the suppliers of the funds incur the same level of risk.

All too often we have seen managers or treasurers assume excessive risk when choosing a source of financing because they have based their decision on a single criterion: the respective cost of the different sources of funds. For example:

- increasing short-term debt on the pretext that short-term interest rates are lower than long-term rates can be a serious mistake;
- granting a mortgage in return for a slight decrease in the interest rate on a loan can be very harmful for the future;
- increasing debt systematically on the sole pretext that debt costs less than equity capital jeopardises the company's prospects for long-term survival.

We will develop this theme further throughout the third part of this book, but we would like to warn you now of the pitfalls of faulty financial reasoning. **The most dangerous thing a financial manager can say is, “It doesn’t cost anything.” This sentence should be banished and replaced with the following question: “What is the impact of this action on value?”**

## Section 1.2

. . . OF FINANCIAL SECURITIES . . .

Let’s now take a look at the overall concept of a financial security, the product created by the financial manager.

### 1/ ISSUANCE OR CREATION OF SECURITIES

There is a great variety of financial instruments, each of which has the following characteristics:

- it is a contract . . .
- . . . executed over time, and . . .
- its value derives solely from the series of cash flows it represents.

Indeed, from a mathematical and more theoretical viewpoint, a financial instrument is defined as a **schedule of future cash flows**.

Holding a financial security is the same as holding the right to receive the cash flows, as defined in the terms and conditions of the issue that gave rise to the financial instrument. Conversely, for the issuer, creating a financial instrument is the same as committing to paying out a series of cash flows. In return for this right to receive cash flows or for taking on this commitment, the company will issue a security at a certain price, enabling it to raise the funds needed to run its business.

#### A financial security is a contract . . .

You’ve undoubtedly heard people say that the financial manager’s stock-in-trade is “paper”. Computerisation has now turned financial instruments from paper documents into intangible book entries, reducing them to the information they contain, i.e. the contract. The essence of finance is, and will always be, **negotiation** between an issuer seeking new funds and the investors interested in buying the instruments that represent the underlying obligations. And negotiation means markets, be they credit markets, bond markets, stock markets, etc.

#### . . . executed over time . . .

Time, or the term of the financial security, introduces the notion of time remuneration and **risk**. A debt instrument that promises cash flows over time, for example, entails risk, even if the borrower is very creditworthy. This seems strange to many people who consider that “a deal is a deal” or “a man’s word is his bond”. Yet, experience has shown that a wide variety of risks can affect the payment of those cash flows, including political risk, strikes, natural disasters and other events.

. . . and materialised by cash flows.

Further on in this book you will see that financial logic is used to analyse and choose among a firm's investment options. The financial manager transforms flows of goods and services, deriving from the company's industrial and other business assets, into cash flows. You will soon understand that the world of finance is one of **managing rights on the one hand and commitments on the other, both expressed in terms of cash flows.**

In a market for financial instruments, it is not the actual flows that are sold, but the rights associated with them. The investor, i.e. the buyer of the security, acquires the rights granted by the instrument. The issuing company assumes contractual obligations deriving from the instrument, regardless of who the owner of the instrument is.

For example, commodity futures markets make it possible to perform purely financial transactions. You can buy sugar "forward", via financial instruments called futures contracts, knowing full well that you will never take delivery of the sugar into your warehouse. Instead, you will close out the position prior to maturity. The financial manager thus trades on a market for real goods (sugar), using contracts that can be unwound prior to or at maturity.

A property investor acts similarly. After acquiring real property, the value of which fluctuates, he can lease it or resell it. Viewed this way, real property is as fungible as any other property and is akin to a financial asset.

Clearly, these assets exhibit different degrees of "financiality". To take the argument one step further, you turn a painting into a financial instrument when you put it in your safe in the hope of realising a gain when you sell it.

The distinction between a real asset and a financial asset is therefore subtle but fundamental. It lies either in the nature of the contract or in the investor's motivation, as in the example of the painting.

Lastly, the purchase of a financial security differs from the purchase of a durable good in that the financial security is undifferentiated. A large number of investors can buy the same financial security. In contrast, acquiring a specific office building or building an industrial plant is a very specific, unique investment.

**In conclusion, every financial instrument represents a series of cash flows to be received according to a set timetable. Mathematically, it can be expressed as a series of future cash flows  $F_1, F_2, F_3, F_4, \dots, F_n$  over  $n$  periods.**

## 2/ TYPES OF FINANCIAL SECURITIES

### (a) Debt instruments (Chapters 20 and 21)

The simplest financial instrument is undoubtedly the contract that ties a lender (investor) to a borrower (company). It represents a very strong commitment, not only to repay, but to repay with interest. Loans become financial securities when they are made negotiable on a secondary market (see page 7) and "listed". Bonds and commercial paper fall into this category.

A bond is a negotiable debt security representing a fraction of a borrowing contracted by a company, a financial institution or a sovereign state (gilts in the UK, Bunds in Germany, etc.).

Commercial paper is a negotiable debt security representing a fraction of a short-term borrowing (generally between one day and two years) contracted by a company. If the company is a bank, the security will be called a **certificate of deposit**. Short-term sovereign debt instruments go by different names depending on the country; in Spain, for example, they are called *Bonos del Estado*, while they are called *Treasury Bills* in the US.

Strictly speaking, investors in these securities do not assume any industrial risk. **Their return is set contractually** and may be fixed or floating (i.e. variable). If it is floating, it will be indexed on an interest rate and not on the results of the company.

In Chapter 21 we will see that the lender nevertheless assumes certain risks, namely the failure of the borrower to honour the debt contract.

### (b) Equity securities (Chapter 22)

**Equity** represents the capital injected into a company by an investor who bears the full risk of the company's industrial undertakings in return for a share of the profits.

If the company is organised under a limited liability structure, then the equity is divided into **shares**. The risk borne by the shareholders is limited to the amount they contribute to the firm. Unless otherwise noted, we will be dealing in this book with finance as it relates to the various forms of "limited companies".

Shareholders' equity is a source of financing for the enterprise, but the related financial security, the share, guarantees the investor neither a fixed level of income nor repayment. The shareholder can realise his investment only by selling it to someone else. The investor obtains certain corporate rights, however: a claim on the company's earnings and – via his voting rights – management oversight.

### (c) Other securities (Chapter 24)

As you will discover in Chapter 24, financial engineering specialists have invented hybrid securities that combine the characteristics of the two categories discussed above. Some securities have the look and feel of equity from the point of view of the company, but the corresponding cash flows are fixed, at least partially. Others instruments have yields that are dependent on the performance of the company, but are considered loans, not equity capital. Financial imagination knows no bounds. Keep in mind that these instruments are like the cherry on the top. As such, we won't tempt you with them until Chapter 24!

There is a specific type of financial instrument, however, **the option**, whose associated cash flows are actually less "important" to the investor than the rights the option conveys. This instrument grants the right, but not the obligation, to do something.

In sum, financial instruments carry a wide spectrum of characteristics, which, from the investor's point of view, ranges from rights to commitments.

## Section 1.3

. . . VALUED CONTINUOUSLY BY THE FINANCIAL MARKETS

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Our view of finance can take shape only in the context of well-developed financial markets. But before examining the technical characteristics of markets (Section II of this book), let's spend a moment on definitions.

## 1/ FROM THE PRIMARY MARKET TO THE SECONDARY MARKET

Once launched by its issuer, a financial security lives a life of its own. It is sold from one investor to another, and it serves as support for other transactions. The instrument itself evolves, but the terms of the contract under which it was issued do not.

The life of a financial security is intimately connected with the fact that it can be bought or sold at any moment. For example, shares issued or created when a company is founded can later be floated on a stock exchange, just as long-term bonds may be used by speculators for short-term strategies.

**The new issues market (i.e. creation of securities) is called the primary market.** Subsequent transactions involving these securities take place on the **secondary market**. Both markets, like any market, are defined by two basic elements: the product (the security) and the price (its value).

From the point of view of the company, the distinction between the primary and secondary markets is fundamental. **The primary market is the market for “new” financial products**, from equity issues to bond issues and everything in between. It is the market for newly minted financial securities where the company can raise fresh money.

**Conversely, the secondary market is the market for “used” financial products.** Securities bought and sold on this market have already been created and are now simply changing hands, without any new securities being created and consequently without any new money for the company.

The primary market enables companies, financial institutions, governments and local authorities to obtain financial resources by issuing securities. These securities are then listed and traded on secondary markets. The job of the secondary market is to ensure that securities are properly priced and traded. This is the essence of **liquidity**: facilitating the purchase or sale of a security.

The distinction between primary and secondary markets is conceptual only. The two markets are not separated from each other. A given financial investor can buy either existing shares or new shares issued during a capital increase, for example.

If there is often more emphasis placed on the primary market, it is because the function of the financial markets is, first and foremost, to ensure equilibrium between financing needs and the sources of finance. Secondary markets, where securities can change hands, constitute a kind of financial “innovation”.

## 2/ THE FUNCTION OF THE SECONDARY MARKET

Financial investors do not intend to remain invested in a particular asset indefinitely. Even before they buy a security, they begin thinking about how they will **exit**. As a result, they are constantly evaluating whether they should buy or sell such and such an asset.

Monetising is relatively easy when the security is a short-term one. All the investor has to do is wait until maturity. The need for an exit strategy grows with the maturity of the investment and is greatest for equity investments, whose maturity is unlimited. The only way a shareholder can exit his investment is to sell his shares to someone else.

As an example, the successful business person who floats his company on the stock exchange, thereby selling part of his shares to new shareholders, diversifies his own portfolio, which before flotation was essentially concentrated in one investment.

The secondary market makes the investor's investments liquid.

**Liquidity** refers to the ability to convert an instrument into cash quickly and without loss of value. It affords the opportunity to trade a financial instrument at a "listed" price and in large quantities without disrupting the market. An investment is liquid when an investor can buy or sell it in large quantities without causing a change in its market price.

The secondary market is therefore a **zero-sum game** between investors, because what one investor buys, another investor sells. In principle, the secondary market operates completely independently from the issuer of the securities.

A company that issues a bond today knows that a certain amount of funds will remain available in each future year. This knowledge is based on the bond's amortisation schedule. During that time, however, the investors holding the bonds will have changed.

Secondary market transactions do not show up in macroeconomic statistics on capital formation, earning them the scorn of some observers who claim that the secondary market does nothing to further economic development, but only bails out the initial investors.

We believe this thinking is misguided and reflects great ignorance about the function of secondary markets in the economy. Remember that a financial investor is constantly comparing the primary and secondary markets. He cares little whether he is buying a "new" or a "used" security, so long as they have the same characteristics.

The secondary market plays the fundamental role of valuing securities.

In fact, the quality of a primary market for a security depends greatly on the quality of its secondary market. Think about it: who would want to buy a financial security on the primary market, knowing that it will be difficult to sell it on the secondary market?

The secondary market determines the price at which the company can issue its securities on the primary market, because investors are constantly deciding between existing investments and proposed new investments.

We have seen that it would be a mistake to think that a financial manager takes no interest in the secondary market for the securities issued by his company. On the contrary, it is on the secondary market that his company's financial "raw material" is priced every day. When the raw material is equities, there is another reason the company cannot afford to turn its back on the secondary market: this is where investors trade the voting rights in the company's affairs and, by extension, control of the company.

### 3/ DERIVATIVE MARKETS: FUTURES AND OPTIONS

Derivative markets are where securities that derive their value from another asset (share, bond, commodity or even climate index) are traded. There are two main types of derivative products: options (which we will develop in Chapter 23 as they have become a key matter in financial theory and practice) and futures (Chapter 50).

Derivatives are instruments for taking positions on other instruments, or "contracts on contracts". They let you take significant short or long positions on other assets with a limited outlay of funds.

Derivative instruments are tailored especially to the management of financial risk. By using derivatives, the financial manager chooses a price – expressed as an interest rate,



an exchange rate or the price of a raw material – that is independent of the company's financing or investment term. Derivatives are also highly liquid. The financial manager can change his mind at any time at a minimal cost.

Options and futures allow one to take important risks with a reduced initial outlay due to their leverage effect (this is called speculation), or on the contrary to transfer risks to a third party (hedging).

## Section 1.4

### MOST IMPORTANTLY, HE IS A NEGOTIATOR . . .

Let's return to our financial manager who has just created a financial security. Because the security is traded on a secondary market, he doesn't know who holds the security. Nor does he know who has sold it, especially as, via the futures market, investors can sell the security without ever having bought it.

But what exactly is our financial manager selling? Or, put another way: how can the value of the financial security be determined?

From a practical standpoint, the financial manager "sells" management's reputation for integrity, its expertise, the quality of the company's assets, its overall financial health, its ability to generate a certain level of profitability over a given period and its commitment to more or less restrictive legal terms. Note that the quality of assets will be particularly important in the case of a loan tied to and often secured by specific assets, while overall financial health will dominate when financing is not tied to specific assets.

Theoretically, the financial manager sells expected future cash flows that can derive only from the company's business operations.

A company cannot distribute more cash flow to its providers of funds than its business generates. A money-losing company pays its creditors only at the expense of its shareholders. When a company with sub-par profitability pays a dividend, it jeopardises its financial health.

The financial manager's role is to transform the company's commercial and industrial business assets and commitments into financial assets and commitments.

In so doing, he spreads the expected cash flows among many different investor groups: banks, financial investors, family shareholders, individual investors, etc.

Financial investors then turn these flows into negotiable instruments traded on an open market, which values the instruments in relation to other opportunities available on the market.

Underlying the securities is the market's evaluation of the company. A company considered to be poorly managed will see investors vote with their feet. Yields on the company's securities will rise to prohibitive levels and prices on them will fall. Financial difficulties, if not already present, will soon follow. The financial manager must therefore keep the market convinced at all times of the quality of his company, because that is what backs up the securities it issues!

The different financial partners hold a portion of the value of the company. This diversity gives rise to yet another job for the financial manager: **he must adroitly steer the company through the distribution of the overall value of the company.**

Like any dealmaker, he has something to sell, but he must also:

- assess his company's overall financial situation;
- understand the motivations of the various participants;
- analyse the relative powers of the parties involved.

## Section 1.5

. . . WHO NEVER FORGETS TO DO AN OCCASIONAL REALITY CHECK!

The financial investors who buy the company's securities do so not out of altruism, but because they hope to realise a certain rate of return on their investment, in the form of interest, dividends or capital gains. In other words, in return for entrusting the company with their money via their purchase of the company's securities, they require a minimum return on their investment.

The financial manager must therefore analyse proposed investment projects and explain to his colleagues that some should not be undertaken because they are not profitable enough compared to the return investors are looking for. In short, he sometimes has to be a "party-pooper". He is indirectly the spokesman of the financial investment community.

Consequently, the financial manager must make sure that over the medium term the company makes investments with returns at least equal to the rate of return expected by the company's providers of capital. If so, all is well. If not, if the company is consistently falling short of this goal, then it will destroy value, turning what was worth 100 into 90, or 80. This is corporate purgatory. On the other hand, if the profitability of its investments consistently exceeds investor demands, transforming 100 into 120 or more, then the company deserves the kudos it will get. But it should also remain humble. With technological progress and deregulation advancing apace, repeat performances are becoming more and more challenging.

If the profitability over several years of the company's operating assets is not at least equal to the return looked for by investors, then the financial manager should discuss how to improve the situation with operational people. Sometimes he will become a strategist and suggest to the top management of his company that it should review its perimeter. Underperforming units where the company has been struggling to get a return commensurate with their risks should be sold to free up resources allowing it to expand, organically or through acquisitions, the most promising or efficient divisions.

## Section 1.6

. . . HE IS ALSO NOW A RISK MANAGER

Fluctuations in interest rates, currencies and the prices of raw materials are so great that financial risks are as important as industrial risks. Consider a Swiss company that buys copper in the world market, then processes it and sells it in Switzerland and abroad.

Its performance depends not only on the price of copper but also on the exchange rate of the US dollar vs. the Swiss franc, because it uses the dollar to make purchases abroad and receives payment in dollars for international sales. Lastly, interest rate fluctuations have an impact on the company's financial flows. A multi-headed dragon!

The company must manage its specific interest rate and exchange rate risks because doing nothing can also have serious consequences. As the bumper sticker says, "If you think education is expensive, try ignorance!"

Take an example of an economy with no derivative markets. A corporate treasurer anticipating a decline in long-term interest rates and whose company has long-term debt has no choice but to borrow short term, invest the proceeds long term, wait for interest

rates to decline, pay off the short-term loans and borrow again. You will have no trouble understanding that this strategy has its limits. The balance sheet becomes inflated, intermediation costs rise, and so on. Derivative markets enable the treasurer to manage this long-term interest rate risk without touching his company's balance sheet.

Generally, the CFO is responsible for the identification, the assessment and the management of risks for the firm. This includes not only currency and interest rate risks but also liquidity and counterparty risk. Recent years have shown that a CFO with strong know-how in such matters is highly appreciated.

We are far from the CFOs of the sixties who were mainly top-of-the-class accountants! Nowadays they are required not only to perfectly master accounting and finance, but also to be gifted in marketing and negotiation, not to mention tax and legal issues, risk management, and to be able managers of their teams. The best of them also have a strategic way of thinking, and their intimate knowledge of the company and its human resources allows them to be serious candidates for the top job. As an illustration, the current CEOs of Siemens, WPP, Pepsico and Michelin are all former CFOs of their companies.

How's that appetite?

We're going to leave you with these appetisers in the hope that you are now hungry for more. But beware of taking the principles briefly presented here and skipping directly to Section III of the book. If you are looking for high finance and get-rich-quick schemes, this book is definitely not for you. The menu we propose is as follows:

- First, an understanding of the firm, i.e. the source of all the cash flows that are the subject of our analysis (**Section I: Financial analysis**).
- Then an appreciation of markets, because it is they who are constantly valuing the firm (**Section II: Investors and markets**).
- Then an understanding of how value is created and how it is measured (**Section III: Value**).
- Followed by the major financial decisions of the firm, viewed in the light of both market theory and organisational theory (**Section IV: Corporate financial policies**).
- Finally, if you persevere through the foregoing, you will get to taste the dessert, as **Section V: Financial management** presents several practical, current topics in financial engineering and management.

*The summary of this chapter can be downloaded from [www.vernimmen.com](http://www.vernimmen.com).*

The financial manager has three main roles:

- To ensure the company has enough funds to finance its expansion and meet its obligations. To do this, the company issues securities (equity and debt) and the financial manager sells them to financial investors at the highest possible price. In today's capital market economy, the role of the financial manager is less a buyer of funds, with an objective to minimise cost, and more a seller of financial securities. By emphasising the financial security, we focus on its value, which combines the notions of return and risk. We thereby de-emphasise the importance of minimising the cost of financial resources, because this approach ignores the risk factor. Casting the financial manager in the role of salesman also underlines the marketing aspect of his job, which is far from theoretical. He has customers (investors) that he must convince to buy the securities his company issues. The better he understands their needs, the more successful he will be.

## SUMMARY

- To ensure that over the long run the company uses the resources investors put at its disposal to generate a rate of return at least equal to the rate of return the investors require. If it does, the company creates value. If it does not, it destroys value. If it continues to destroy value, investors will turn their backs on the company and the value of its securities will decline. Ultimately, the company will have to change its senior managers, or face bankruptcy.
- To identify and manage the financial risks the company is facing.

In his first role, the financial manager transforms the company's real assets into financial assets. He must maximise the value of these financial assets while selling them to the various categories of investors.

His second role is a thankless one. He must be a "party-pooper", a "Mr No" who examines every proposed investment project under the microscope of expected returns and advises on whether to reject those that fall below the cost of funds available to the company. But it is also the job of a strategist who may go as far as to challenge the current perimeter of the company's activities.

In his last role, the financial manager guarantees that the operational performance of the company is not spoiled by financial events.

## QUESTIONS

- 1/Should the unexpected announcement of a rise in interest rates automatically result in a drop in the stock market index?
- 2/Would your answer be the same if the announcement had been anticipated by the market? So what is the most important factor when valuing securities?
- 3/Other than the word "market", what is the key word in corporate finance?
- 4/How is it possible to sell something without actually having bought anything?
- 5/You are offered a loan at 3.5% over 10 years without guarantee, and a loan at 3% over 10 years with guarantee. You need the loan. How should you go about deciding which loan to take out?
- 6/Is a financial security a financial asset or a financial liability? Why?
- 7/Can you define a financial security?
- 8/Provide an example of something that was assumed to be a financial asset, but which proved on analysis to be a financial liability.
- 9/How important is it to think in terms of an offer of and a demand for securities, and not in terms of an offer of and a demand for capital, for:
  - shares;
  - bonds;
  - medium-term syndicated loans;
  - bilateral bank loans.

Why?
- 10/What other financial term should immediately spring to mind when you hear the word "returns"?

- 11/In your view, are more securities issued on the primary market or exchanged on the secondary market?
- 12/What other financial term should immediately spring to mind when you hear the word “risk”?
- 13/Which instrument carries the greater risk – a share or a bond? Why?
- 14/Explain how the poor performance of the secondary market can impact the primary market.
- 15/What are the two biggest flaws of a bad financial manager?
- 16/What are the two main types of securities issued by a firm?
- 17/Why do you believe management has to do some roadshows before issuing new shares or bonds?
- 18/Why would you finance a firm’s investments with a very short-term loan? What would the drawback be?

*More questions are waiting for you at [www.verimmen.com](http://www.verimmen.com).*

### Questions

- 1/As an automatic reaction, yes, as value moves in the opposite direction to interest rates.
- 2/The answer in this case would be no. The most important factor in valuing securities is anticipation.
- 3/Value.
- 4/On the futures market.
- 5/Is it worth providing a guarantee for a gain of 0.5%?
- 6/A financial asset if the present value of future flows is positive (which it is for the investor), and a liability if not (which is the case for the issuer).
- 7/A financial security is a tradable contract represented by a series of cash flows to be received according to a set timetable.
- 8/The inheritance of an estate, the debts of which exceed the value of the assets.
- 9/In order – 1 = very important; 2 = of moderate importance; 3 = unimportant: 1,2,2,3, because they are more or less easily traded.
- 10/Risk.
- 11/No, far fewer securities are issued on the primary market than exchanged on the secondary market. In 2016, worldwide, listed companies issued \$440bn worth of new shares, whereas the value of shares exchanged was \$115 300bn (source: World Federation of Exchanges).
- 12>Returns, the two are inextricably linked.
- 13/Shares, as returns are not guaranteed for the investor, and creditors are paid out before shareholders.
- 14/If the value of shares continues to decline long term, market pessimism descends, and investors become reluctant to subscribe shares on the primary market, as they are convinced that the value of such shares will fall once issued.
- 15/Shortsightedness and poor marketing skills.
- 16/Shares and debts (loans and bonds).
- 17/This is called marketing: they are trying to sell at best one product, which is a financial instrument in order to lower their cost of funding.
- 18/To benefit from lower interest rates (as we will see in Chapter 19, short-term interest rates are generally lower than long-term interest rates). But in that case the firm will run a strong liquidity risk as it will constantly be subject to the availability of loans on the market. The firm would probably be better off taking a long-term financing.

### ANSWERS

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