

Some pending matters about corporate finance

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Expansión, 23 December 2006

No other area in social studies than researching on corporate finance has probably have so much impact in real life. Corporate finance deals with the studying of a company's liability balance. This finance area analyses specifically which is the most optimum combination among different funding sources for minimizing a company's capital cost, which are those financial tools and, finally, which factors are going to decide their cost.

I would like to suggest here a list of problems still unsolved by researching on corporate finance which researchers are currently trying to answer. These are examples of how bankers, institutional investors and politicians have turned to researching in their search for solutions. These are examples of the social value of researching on corporate finance.

A suitable definition for risk

In 1964, the economists William Sharpe and John Lintner designed the Capital Asset Pricing Model (CAPM), an assessment model for assets which in its simplest version predicts that an asset expected return must always be the interest rate without risk plus a bonus which depends on that asset systematic risk. Systematic risk means the inherent risk of a financial asset that cannot be removed through diversification. In other words, the "market risk amount" carried by any financial tool. The systematic risk measure of an asset is called beta, a sacred term in financial jargon. For decades, we have taught the CAPM at business schools and financial analysts have applied it when they have to make investment decisions. However, recent results have questioned this model usefulness. Firstly, it has been proved that non systematic risk (an asset risk that can be removed through diversification) is rewarded by markets.

The use of the CAPM by investors is more and more uncommon. However, academics have not achieved yet a scientific comparable option.

An accurate assessment of liabilities is not possible without an asset assessment model. This prevents from measuring, for instance, the capital cost of multinational companies which, as Spanish banks, are funded or invest in emerging markets. It is not possible either assessing investments because its risk cannot be measured accurately. Nestlé, the Swiss company, carries a beta of 0,55 which means its expected return is less than market return (its premium risk is technically half as much as market premium risk). However, its average return has been an annual 25% during the last 24 months.

Optimum capital structure at irrational markets

The use of psychology concepts on finance has helped to explain some investors behaviours which were previously considered as anomalous (or of limited rationality, according to technical terminology).

According to financial theory, the investor was always a rational agent, someone able to process all the information available and to make optimum decisions. However, as we know, all investors and top managers are too confident and they end by overestimating the accuracy of their own valuations. CEOs of companies whose shares are quoted at 50 euros sometimes acknowledge they are undervalued and so they value them at 60 euros instead.

It has also been noticed that markets players are often too optimistic. A top managers survey carried out in February 2006 showed that 36 per cent of Deutsche Bank top managers considered their firm had a risk level smaller than other companies in the same industry, while only 16 per cent believed the risk level was greater. It is not statistically possible everybody is right, which reflects average managers are excessively optimistic. This psychological bias makes 19 per cent of the Americans think they are among 1 per cent of rich people or 60 per cent of drivers consider themselves better than the average. If investors and top managers are not rational, we could then understand why most companies involved in mergers pay too much for the firms they acquire. Or why the vast majority of stock exchange individual investors lose money.

Irrationality also explains a concept known as silly money by which investment funds with an excellent year receive more money influx next year. Afterwards, the fund return falls sharply (and vice versa). The term silly money suggests that fund investors use to choose the wrong fund. Thus, in such a market, investors do not value financial tools good enough and top managers make the wrong funding decisions. On this scenario, corporate finance has not yet concluded which is the debt and capital combination for maximazing a company's value.

Paying dividends or buying back shares?

When a company generates profits, how they should be distributed among shareholders? There are two options: a company can pay dividends and aslo buy back some of its shares. In the first case, all shareholders receive a reward proportional to their shareholding. If a shareholder do not want his dividend he must sell his shares, whereas in a shares buy back only those shareholders who sell (in an open market or through a public offering) can turn their investments into cash. Dividens may be a less democratic way of rewarding shareholders because they have no choice. Since in some cases buy backs carry tax advantages, shares buy backs increased during the 90's. Now it seems dividens are on the rise because investors want their investments to be materialized immediately and do not want their money turn into something unproductive in the hands of managers.

Where is the dilemma with regard to dividens and buy backs? Assuming that both are a way of rewarding shareholders, they should be welcome in markets. However, this is not always the case. When Vodafone announced in May 2005 it was going to buy back shares for 4.500 million pounds, its share price fell 2,7 per cent in

one day. Why? Because after making big acquisitions (Mannesmann), shareholders realized Vodafone did not know what to do with so much cash and they punished the firm. Thus it is not always easy to decide the most favourable dividend policy for firms.

Besides, the rise of buy backs does not take into account that they favour those investors who leave a company (because they sell their shares), not those who keep their long term investment in a firm.