

Certificate in Corporate Finance and Funding

Sample Course Content

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Study Unit 1: The Financial World

Section 1: The Financial World

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1. The Financial World

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Activity 1.1.2 - Corporate Governance

Most businesses start life as small enterprises with the owners also being the people in charge of day-to-day management. As a business grows it becomes necessary for the owners to rely on managers at various levels to direct resources and make decisions. It makes sense to devolve responsibilities because: (a) the one or two people at the centre simply cannot cope with an increasing volume of decisions, and; (b) these managers are likely to be professional and specialised and so can make better decisions. However, over time and with the growth of the firm, shareholders become separated from the control of it. Multinationals often have a large number of shareholders dispersed around the world, with little to coordinate their actions. Few shareholders vote at annual general meetings, or even sign *proxy* forms to assign voting rights to another person. Thus control of the firm often lies in the hands of the directors and senior executives. They have a high degree of discretion to push the *company* in their chosen direction because it is difficult to rally thousands or millions of shareholders to push for an alternative strategy or policy.


The separation or 'divorce' of ownership and control can lead to the problem that those acting as agents (managers) for the principals (shareholders) fail to do so in a way that maximises the wealth of shareholders. They may *put* their own interests first. There are various ways of pressing and encouraging managers to act in a more shareholder-orientated way, ranging from corporate governance codes of conduct through adjusting remuneration policies, to the takeover threat and removal of managers.


Resources


 [Core resources | 1.1.2 Corporate Governance](#) [+ show details](#)

Further Reading

Arnold, G. (2008) Corporate Financial Management, 4th Edition, Pearson Education. Chapter 1 pp.15-18

 [Further reading | European Corporate Governance Institute](#) [+ show details](#)

 [Core resources | Corporate governance in the new global economy - International Treasurer's Handbook 2009](#)

 [Further reading | Financial Services Authority - The Combined Code on Corporate Governance](#) [+ show details](#)

1.1.2 Corporate Governance

Study Unit: Study Unit 1 – The Financial World

Section: Section 1 – The Financial World

Date: 01 October 2008

Summary: An introduction to the problem of corporate governance in an environment where the providers of finance need to place trust in managers to act on their behalf. A discussion of the corporate governance approaches in some major economies.

Key words: Corporate governance, principal-agent problem, agency cost, regulation, board of directors, annual general meeting, AGM, managementism, managerialism, the combined code on corporate governance, keiretsu, Sarbanes-Oxley act, SOX.

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1 Introduction

Most businesses start life as small enterprises with the owners also being the people in charge of day-to-day management. As a business grows it becomes necessary for the owners to rely on managers at various levels to direct resources and make decisions. It makes sense to devolve responsibilities because: (a) the one or two people at the centre simply cannot cope with an increasing volume of decisions, and; (b) these managers are likely to be professional and specialised and so can make better decisions.

However, over time and with the growth of the firm, shareholders become separated from the control of it. Multinationals often have a large number of shareholders dispersed around the world, with little to coordinate their actions. Few shareholders vote at annual general meetings, or even sign proxy forms to assign voting rights to another person. Thus control of the firm often lies in the hands of the directors and senior executives. They have a high degree of discretion to push the company in their chosen direction because it is difficult to rally thousands or millions of shareholders to push for an alternative strategy or policy.

The separation or 'divorce' of ownership and control can lead to the problem that those acting as agents (managers) for the principals (shareholders) fail to do so in a way that maximises the wealth of shareholders. They may put their own interests first.

There are various ways of pressing and encouraging managers to act in a more shareholder-orientated way, ranging from corporate governance codes of conduct through adjusting remuneration policies to the takeover threat and removal of managers.

2 The principal-agent problem

The principal-agent problem is that the agents (in this case, managers) acting for the principals (in this case, shareholders) do so in such a way that is sub-optimal for the principals, and the principals incur costs in trying to avoid or correct errant behaviour. There may be a high degree of 'managementism' or 'managerialism' where

directors/managers run the firm in their own interests rather than the shareholders. For example, managerial concern for job security may lead to the minimisation (or limitation) of risk. Perhaps through takeovers they expand into numerous unrelated business areas to reduce the impact of volatility in the original product/market area (note: shareholders can diversify in a simpler and cheaper way by holding a portfolio of shares in a number of firms). They may reduce risk for themselves by financing with equity rather than borrowing, even though equity finance is more expensive and can lead to lower overall rates of return to shareholders.

They may raise their pay or perks and build their own fiefdoms. Managers may arrange for their rewards to be based on short-term performance measures and then select an investment capital expenditure project that ensures good short-term returns, even if another project would produce more long-term shareholder wealth.

Another agency cost is shirking by senior management. It is very difficult for outsiders to judge the degree of effort being made by executive directors and other top managers and so these people can reduce their effort without detection, set an example for juniors to follow and thus cost shareholders a great deal of money.

Not only do we need to allow for the consequence of the separation of ownership and control and for the non-shareholder wealth goals of managers but we also need to be aware of the asymmetry of information between agent and principal. Managers have access to an array of data and information on a daily basis that shareholders never see.

Thus shareholders, faced with a formidable set of circumstances compromising their interests, have realised that they need tools to encourage goal congruence – bringing the decisions managers make into greater alignment with the shareholder wealth maximisation objective. Shareholders will thus incur 'agency costs':

- Providing incentives to encourage shareholder-orientation. This could include share options and/or long-term incentive plans based on total shareholder return. Pay-outs must relate to the closeness of managerial decision outcomes to the interests of shareholders.
- Monitoring and controlling manager's behaviour. There will be contracts and implicit agreements, reviews of the link between remuneration and shareholder performance, auditing of financial statements.

- To the extent that incentives, monitoring and controlling do not work and managers continue to forge ahead with goals not in harmony with shareholder wealth there will still be an agency cost.

3 Corporate governance

Executives must be given a significant degree of discretion in the exercise of the powers given to them so that they can use their skills, experience and judgement on behalf of shareholders. However, there need to be ways of 'calling them to account' which strikes the right balance between executive freedom to act and accountability to shareholders.

Corporate governance is the system for managing and controlling a company. It is principally concerned with the relative powers, responsibilities and relationships between the following:

- Shareholders
- Board of directors
- Senior management

Through the interaction of these three groups a company develops its objective and places obligations and constraints on the executives. These relationships also provide the framework within which targets are set, performance monitored and rewards assigned.

3.1 The board of directors

The key body for good governance is the board of directors. This oversees the management of the company: it is meant to be an independent check on the executive team to ensure that they are working for the objective of the firm. The board hires and fires executive directors, advises senior executives and the chief executive, and decides on compensation for executive directors.

The board usually sets the policies and general strategy of the firm, but assigns the detail of achieving those to the executive directors. However, for major strategic moves, such as a merger with another firm, managers will need to get board (and sometimes shareholder) approval.

The board also has the responsibility of reporting accounting results to shareholders and may become involved in reviewing and approving significant investments, capital budgets and operating plans. In addition it is responsible for ensuring that all business activity complies with the law and is conducted in an ethical manner.

3.2 The annual meeting

Shareholders are entitled to expect the company to organise an annual general meeting (AGM) at which they can vote to change the board of directors if they are dissatisfied (proxy votes may be assigned if a shareholder cannot attend). The shareholders can thus, in theory, strongly influence the direction in which the company is travelling. However, there are some factors that considerably weaken this power:

- For many shareholders the cost of attending a meeting (or even sending in a proxy form) out-weighs the benefit, leading to many (most) votes being unused.
- Most shares quoted on public stock markets are now owned by institutional investors (e.g. pension funds, insurance funds). Many of the fund managers do not take their 'ownership' of stakes in a corporation seriously. When faced with the issue of what to do with a poor board of directors and senior management, rather than acting to remove them, they find it easier simply to sell the shares and move on.

4 Corporate governance in the UK

In the UK there are numerous institutional and legal pressures on companies to govern themselves in a shareholder focused way. These range from the Companies Act through stock exchange regulations to accounting body rules and the oversight of the Financial Services Authority (FSA). However, over the past fifteen years or so there has been a growing acceptance that these are not enough, especially in the light of a number of serious abuses of power. Thus the authorities (London Stock Exchange (LSE), Financial Reporting Council, FSA and various institutional investing bodies) have got together to develop a set of guidelines of best practice in corporate governance. A series of 'reports' written by the great and the good of the corporate world were eventually consolidated in the Combined Code of Corporate Governance.

The UK follows a 'comply or explain' approach. That is, it is expected that the guidelines will be followed but if a company has a good reason for not complying with a principle then this is accepted just so long as the reason for the deviation is fully and publicly explained. Companies listed on the LSE must state in their accounts how the principles have been applied and the reasons for deviations.

There is no regulator to intervene to say 'you must comply with this principle because the explanation for non-compliance is not adequate'. It is up to the shareholders to evaluate the company's statement. The shareholding financial institutions often accept that departure from the code is desirable in some circumstances, but they can become quite irate if they feel that executive director abuse is taking place (or arrangements are made that suggest greater potential for abuse) and then rally shareholders to vote against the directors at the AGM. For example, in 2008, many shareholders in Marks and Spencer were upset at the proposal for the CEO, Stuart Rose, to move to the position of executive chairman. This went against the code in two ways: first, there should not be one very powerful person sitting on a board of directors. A balance needs to be struck, with the chairman running the board and a separate chief executive officer with power over the running of the business operations. The chairman is supposed to be an independent non-executive. Mark Burgess, head of equities at Legal & General Investment Management said,

"As set out in the Combined Code, we believe strongly in the separation of the roles of chairman and chief executive, believing that this provides a much-needed balance in the boardroom and prevents potentially damaging concentration of power."(Financial Times 11.3.08 p.1)

Second, the CEO should not move to the position of chairman (non-executive or otherwise) because he/she, as the ex-CEO, would have undue influence on the new executive team (it could be quite intimidating for the new CEO) and would not be properly independent. Note: Not all non-executives are independent. To be independent the non-executive should not, for example, be an ex-employee, a customer, a supplier, a friend of the CEO or founding family, or in some other way 'connected' to the executive directors.

Some other principles of the Combined Code:

- One-half or more of the board should comprise of independent non-executive directors. This puts in place a counter-weight against the powerful executive block with its information advantage – at least in theory (in reality many boards are stuffed with ‘independents’ selected by the CEO for their docility). When the independents are truly independently minded and experienced they may bring a wider perspective when discussing major strategic moves, issues and dilemmas facing the firm. Executives can get a little too focussed on the detail, and often lack the experience and specialist knowledge of the non-executives. To ensure independence the non-executives are not supposed to be dependent on the fee they receive for their income. Their role is to constructively challenge and help develop proposals on strategy; to scrutinise managerial performance, and; to monitor the reporting of performance.
- Directors are to be appointed through a formal procedure using the nomination committee. Appointments are to be based on merit and information on terms and conditions are to be made public.
- Directors to retire by rotation at least every three years. They may be re-elected.
- Information on directors’ remuneration is to be publicly available. The remuneration committee, consisting of independent non-executives, decides remuneration.
- An audit committee should consist entirely of independent non-executive directors. This is responsible for validating financial figures – it appoints external auditors, for example. There should be at least three committee members (two for smaller companies), with at least one having significant financial knowledge and experience.
- Directors must communicate effectively with shareholders. For example, at the AGM the company’s performance must be explained and a discussion with shareholders encouraged.

Failure to comply or explain can result in shares being suspended from trading on the LSE.

Some of the Combined Code’s principles do not apply to companies outside of the largest (by market capitalisation) 350 listed on the LSE.

5 Corporate governance in the USA

The US also has a unitary board model (rather than the dual model in Germany and some other European countries). In the majority of cases the chairman and chief executive post are held by the same person. Even when the posts are held by different people the chairman is either a company insider or not independent.

There is a longer tradition of requiring the majority of the board to consist of independent directors than in the UK. However, there are more difficulties for shareholders in the selection of directors because the existing board nominates a slate of directors for election and therefore has effective control over circulation of the list of potential directors. Shareholders may nominate candidates, but if they wish to solicit votes from other shareholders they must do so separately at their own expense. This makes it difficult for shareholders to organise the election of directors not favoured by the CEO. There is much criticism of this system because management are then able to block the election of a director who might ask tough questions, Legislation and shareholder pressure is moving companies towards allowing shareholders to place proposals to be voted on at the AGM, as in the UK.

Most US corporations operate a 'plurality vote standard' whereby the candidate receiving the most votes becomes director. Thus, it is possible for the majority of shareholders to oppose a director-nominee, but for the director to still serve so long as he or she receives one vote in favour. The way around this is for the shareholders to put forward alternative candidates, but as discussed above, it is expensive to create a contest, so the list of nominees is usually the short one provided by the board. However, many companies have now acquiesced to shareholder pressure and accepted 'majority voting' (directors must be approved by more than 50% of the votes cast).

Brokers, banks and other financial institutions holding shares on behalf of shareholders are required to solicit voting instructions from the owners. However, shareholders frequently do not pass on their instructions and so brokers exercise the vote. They usually support the management slate of directors and other AGM resolutions. Currently between 20-25% of the vote is cast by brokers, usually in favour of the incumbent directors thus reinforcing their power.

Compensation committees, nomination committee (to identify and recommend individuals qualified to become board members) and audit committees must be composed entirely of independent directors.

The gaps in US corporate governance were highlighted by a number of scandals of executive abuse that came to light in the months after the turn of the century, e.g. Enron and WorldCom. In response the Sarbanes-Oxley Act (SOX) was introduced in 2002.

SOX sets out a range of rigid responsibilities for corporate managers, particularly with regard to accountability relating to the reporting of financial results. There are rules on auditor independence. The consequences for non-compliance are severe, with stiff penalties for corporate fraud and white-collar crime. The provisions include that the CEO and CFO must frequently acknowledge their responsibility for internal controls and state in financial reports how effective those controls are. Also, the audit committee members must be financially sophisticated. There is a feeling in corporate America that Sarbanes-Oxley went too far and needs to be refined. It is said to be a factor inhibiting firms from floating their shares on US markets.

6 Corporate governance in other countries

The UK, US and other 'Anglo-Saxon' models of corporate governance have grown in a system of relatively widely dispersed shareholdings, actively traded shares, easy access to financial markets, strong investor protection/regulation and (some) active shareowners keeping a check on executive behaviour. Generally, in the Anglo-Saxon systems there is just one class of ordinary share or common stock rather than a variety of different rights depending on the class of share held. Also each share usually carries one vote. Directors are required by law to act in the interests of the share owning members.

In many other countries financial institutions, particularly banks, are more important sources of finance and sources of power on company boards.

In Germany and some other Continental European countries corporate goals are defined more widely than shareholder wealth and corporate governance is conducted through other means. Banks often hold a large proportion of a company's shares.

Also the remaining shares are often concentrated in the hands of a family or two, and other industrial groups and insurance companies. There is also a greater emphasis on the social contribution of the firm. These factors influence the internal control mechanisms.

Most large firms in Germany for example have a bank representative on the board, and quite often this person takes on the role of chairman. Also German banks acquire the ability to cast proxy votes for shareholders who hold their shares at the bank for safekeeping and who choose not to turn up at the AGM or vote by post – so the banks typically end up with 80% or more of the voting power. The banks tend to support the directors (after all they were often involved in the board's past decisions anyway) making dissenting shareholder action somewhat futile. The long-term relationship between a company's main bank, the exchange of information and continual surveillance has been likened to the role played by venture capital firms in the Anglo-Saxon system of corporate governance.

Germany has the two-tier board system for larger firms. The Managerial board (Vorstand) is responsible for managing the enterprise. This is accountable to the Supervisory board (Aufsichtsrat). One-third to one-half of the Supervisory board is elected by employees in larger companies. Both the employee and non-employee groups have powers of veto over appointments. The Supervisory board, comprising non-executive directors, chooses the executive team, oversees strategy and monitors the management board in the interests of the company as a whole, not just shareholders or just employees. However, the quality of information flowing from the Managerial board to the Supervisory board varies tremendously and the Supervisory board meets a mere four times per year on average. Therefore the degree of control exercised has been questioned. The AGMs of shareholders hold both boards to account.

In Japan there are strong inter-relationships between firms, including cross-shareholdings and close industrial work relationships. A 'keiretsu' is a group of firms with interlocking business relationships and shareholdings, usually organised around a major bank. Thus, a manufacturer may purchase inputs from within the keiretsu and sell its output to members of the same group. The main bank will hold shares in each keiretsu company and they in turn hold shares in the bank and other keiretsu members thus reducing the shares available for outside investors. The bank will also arrange debt finance for group firms. Managers from the bank(s) and other keiretsu

firms take positions on the board. Power is thus divided between the bank, the keiretsu's largest members and the rest of the group. The mutual financial and managerial support is seen as a valuable protection against financial distress (it also prevents a lot of potential takeovers thus protecting incumbent managers).

The Japanese board may have 40 or 50 members, only a few of which are independent of the executives, and it is rare to witness active shareholders attacking the board of directors, sacking individuals or taking over companies. The CEO usually has control over nominations for board seats. Since 2003 Japanese companies have been allowed to appoint outside directors and create powerful board sub-committees but few have done so. Even today outside shareholders have little influence.

It is claimed, by critics of the Anglo-Saxon corporate governance systems, that the concentration of equity in the hands of blocks of investors in Japanese and European firms, especially banks, leads to more active engagement with the board given the greater incentive to monitor management by these key investors. In contrast, the Anglo-Saxon method is portrayed as relying on a more diffuse shareholder body and relying on institutional investors who, it turns out, are more prone to sell a shareholding rather than engage or to resort to the extreme options of accepting takeover bids or sacking directors. But the relative merits of the systems are hotly debated.

7 Complementary methods to achieve some goal congruence

In addition to corporate governance guidelines and legislation there are many actions taken to try to align the interests of managers with those of the shareholders:

7.1 Performance related pay

The remuneration (compensation) of managers can be linked to performance indicators such as operating profit, earnings per shares (eps), economic profit or return on capital employed. Many companies have long-term incentive plans (LTIPs) for senior executives, which at the end of three years or more, pay bonuses (often in the form of shares) based on longer term performance.

7.2 Executive share option schemes

Under these schemes directors (and other senior managers) are awarded the right to purchase a number of shares in the company at a fixed price between certain dates in the future. Thus, in 2009 a director may be granted the right to buy 100,000 company shares for €1.50 at anytime between 2012 and 2015. If the shares are currently trading at €1.30 the director is presented with a huge incentive to ensure the company performs well and the share price rises. If the shares surge to €3 in 2013 then the director could exercise the right to buy at €1.50 and immediately sell in the market at €3, netting a €150,000 bonus. If the director holds onto to the shares, all the better, as the alignment with shareholder interests will continue. Option schemes have been criticised on the grounds that share prices move in response to many other external factors, e.g. a rising stock market, that are not the responsibility of the managers. On the other hand, if the stock market falls managers can be demotivated if they have performed well for the company but this is not reflected in the share price and the options remain worthless.

7.3 Sale of shares, active shareholders and the hostile bid

Many investors take the attitude that if managers are not acting in their interests, then, rather than intervene to redirect the company, they will simply sell the shares. As a share declines the remaining shareholders become increasingly irritated with the board and become more open to suggestions for change. Some investors will take the lead as 'activist' investors calling for major strategic change, alterations of financial policy (e.g. more debt) or changes in senior personnel. They may press for their nominees to become directors. Sometimes an activist with a holding of less than 1% can rally enough votes from other investors to pose a serious challenge to the board. An even more powerful form of market discipline is the takeover threat, When one firm acquires another by appealing to shareholders to sell their shares for cash, shares in the acquirer or some other consideration, the directors are frequently removed or asked to take the firm in a new direction

7.4 Sackings

Shareholders, at an AGM, an extraordinary general meeting (EGM) or by pressurising the rest of the board to act, may remove directors from office. The background threat of the possibility of humiliation and possible halt to careers may encourage directors to avoid deviating too much from shareholder wealth.

7.5 Increasing the flow of information

It is vital that shareholders are informed about the progress of the company, and the threats and opportunities it faces, so that they can make informed choices about their level of satisfaction and whether to act to correct errant behaviour. The accounting profession, stock exchanges, institutional investors, press and financial regulators have all contributed to the greater release of timely, accurate and detailed information from companies. However, there is always a tension with companies cautious about disclosure that might assist competitors or distort the overall picture (or, at least there are companies using these arguments as excuses to limit the information flow).

CertCFF Sample Course Content

Study Unit 2: Valuation

Section 2: Practical Project Appraisal

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2. Practical Project Appraisal

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Activity 2.2.2 - The Investment Process

To originate, select and implement investment projects we need a lot more than mathematical tools. Net present value (NPV) and internal rate of return (IRR) are useful techniques but it must be recognised that the appraisal stage is but a small part of the process of creating successful – shareholder wealth enhancing – projects. This section explains the importance of the other stages, from the development of ideas through the sifting of proposals for *capital expenditure* down to the post-implementation assessment of outcome.

Resources

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Further Reading

Arnold, G. (2008) Corporate Financial Management, 4th edition, Pearson Education. Chapter 4, pp.135 – 144

2.2.2 The Investment Process

Study Unit: Study Unit 2 – Valuation

Section: Section 2 – Practical project appraisal

Date: 01 October 2008

Summary: Describes and explains the various stages in developing an investment project proposal, appraising the project, and following it up with a post-completion audit.

Key words: Capital appropriation request forms, corporate strategy, post-completion auditing, capital expenditure budgets.

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1 Introduction

Business is about making investments in the hope of high future returns. To originate, select and implement investment projects we need a lot more than mathematical tools. Net present value (NPV) and internal rate of return (IRR) are useful techniques but it must be recognised that the appraisal stage is but a small part of the process of creating successful – shareholder wealth enhancing – projects. This section explains the importance of the other stages, from the development of ideas, through the sifting of proposals for capital expenditure, down to the post-implementation assessment of outcome.

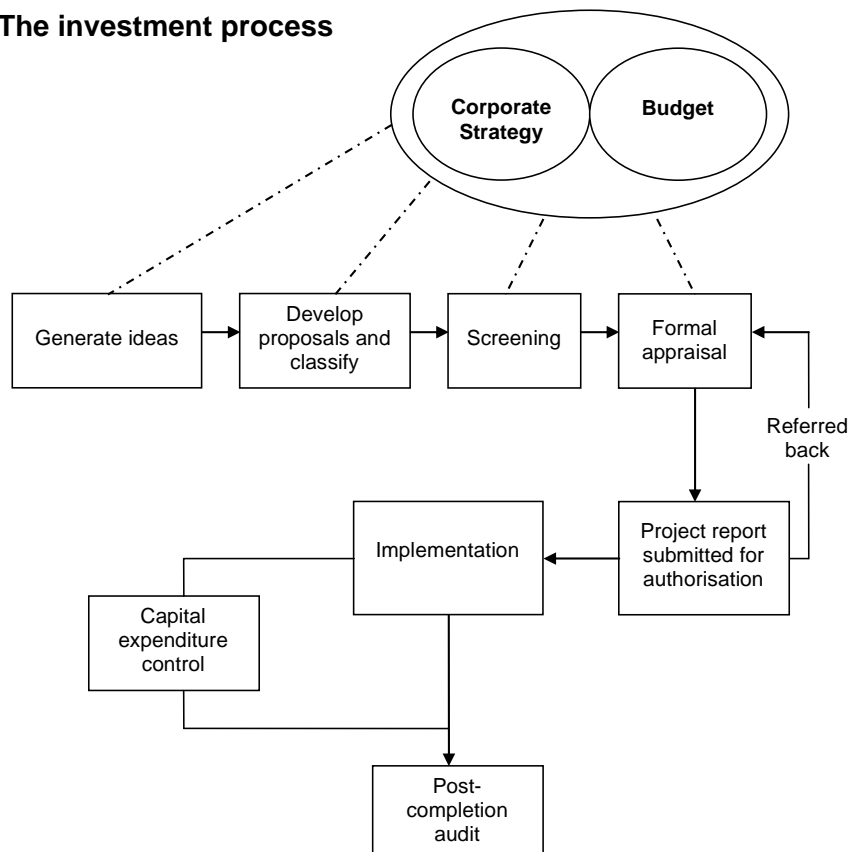
2 An overview of the investment process

There are four main elements in the capital investment process for a project:

1. Search and Generation
2. Appraisal, or evaluation
3. Authorisation
4. Implementation

These elements are illustrated in Exhibit 1.

Exhibit 1: The investment process



3 Idea generation

Of far greater import than the use of the correct evaluation technique (e.g. NPV rather than payback) is the creation of a culture and system that encourages people within the organisation to come forward with ideas for future projects or improvements to existing ones. An atmosphere that allows investment ideas to surface and to evolve can be a significant competitive advantage for a firm.

In some corporations it can be positively dangerous for the career prospects of employees for them to sponsor an idea for the use of investment money. They may set out full of enthusiasm and energy - searching for help from fellows in other disciplines and working out costs and likely future revenues - but they receive little senior manager support, encounter obstacles in their path and a culture of blame should events turn out less than perfect.

In a poorly functioning company people quickly realise that it is better to keep their heads down and avoid doing anything out of the ordinary.

In a well-run company by contrast, employees are brimming with ideas because they feel they will be backed and rewarded if they communicate them. Furthermore, they positively want to take on the difficult task of sponsoring a project through its various stages. Sponsorship might involve:

- presenting the idea to others who have specialist expertise helping to test the idea and shed light on the project's viability;
- considering how the investment fits with the strategic direction of the business;
- evaluating the project using the discounted cash flow techniques as well as more traditional techniques such as payback;
- applying for authorisation and funding – including responding to suggestions for change;
- taking a leading role in the project implementation; and
- helping to assess the project as it is being undertaken to see if it lives up to its promise, to learn from mistakes and to control a run-away cash outflow.

To avoid resentment, and even sabotage, sponsors and senior executives often go to great lengths to gain the understanding of key managers and other workers about the project and its contribution to the well-being of the firm.

The human factors of commitment and consensus are so important that sponsors often deliberately avoid quantification of a project's benefits and related costs early in the development of a project. The priority, initially, is to discuss the project with colleagues and senior managers in qualitative terms to gain their acceptance and commitment (e.g. wouldn't it be good to start pushing our products in vast French-speaking market given the poor quality of the potential competitors?). Then, once acceptance has taken hold, and the idea is seen as a fit with the firm's policy and strategy, the numbers are worked on to produce a report for authorisation. Thus the order of action is: first to gain general acceptance, and second, quantify.

Another reason for de-emphasizing the formal evaluatory techniques is that this may encourage a more entrepreneurial culture within the firm. It can be very demotivating for a dynamic manager with a great idea to be told that there are 30-page forms to be filled-in to gain authorisation to proceed or even to take the discussion to the next level. Managers are aware that in many cases the data that might go into a budget request is incomplete by its very nature and so it is virtually impossible to produce forecast cash flows that will bear any resemblance to what actually happens. Imagine if the managers designing the iPod or the iPhone were told to produce reams of detailed figures to support their application to spend money – would any projection, beyond a rough estimate, have any influence on the decision to proceed or not? Managers who prize fast-thinking and action will resent it if the finance department gets in the way and stifles entrepreneurialism rather than promotes it.

Much depends on the nature of the business environment and the type of project being discussed: many firms operate in very stable and predictable environments and so here formal quantitative techniques can be more reliable. Also, simple investment decisions, such as which truck to choose, can usually be made with data that is freely available. In these stable environments formal methods will triumph over more seat-of-the-pants approaches.

4 Develop proposals and classify

In a well-functioning system, idea generation should be conducted in a free-and-easy, unstructured manner. Naturally, however, there comes a point where some order is needed: ideas need to be examined in more critical detail as the data collected increases and estimates of future cash flows are refined. Many projects will be rejected at this early stage, as what seemed interesting when in embryonic form is seen to be clearly unviable. This early sifting will then allow evaluatory resources to be concentrated on the most promising prospects.

Multi-divisional companies often create systems that result in many projects being filtered out before being presented to head office (or the investment is for relatively small amounts and so the decision to invest is delegated to divisions).

As project sponsors consult with colleagues the project proposal is fine-tuned and it starts to gain the commitment of key individuals. They might add ideas or suggest alternative scenarios.

Some projects require major capital expenditures. These are treated differently in the evaluation process than more routine investments, such as the replacement of a €10,000 machine. It would be very expensive to apply sophisticated analysis to all projects. The managers contemplating the building of a €100m chemical plant could easily justify the hundreds of hours of the finance expert's time as well as the time required from the chemical engineers, logistics managers and so on to produce good-quality data. However, the managers deciding whether to purchase one type of company car or another can rarely justify an extensive search for data and widespread consultation.

A suggested classification of projects:

- **New products.** Companies such as Pfizer or BMW regularly undertake major new investments running into hundreds of millions. These investments are vital to allow the firm to evolve and compete. Here detailed (and costly) evaluations are usually necessary.
- **Expansion or improvement of existing products.** A company may decide to expand a business operation geographically or it might expand into related or complementary product lines, which requires major

expenditures. Alternatively, investment might be undertaken because it would improve the product quality and market position (e.g. washing power manufacturers switching to concentrated ecopacks).

- **Equipment replacement.** Most firms are faced with the dilemma of when to replace an old machine after it has been superseded by new technology or it is has increasing maintenance and other costs – even if it is only the decision on when to replace the office PCs. The amount of detail required to analyse these depends on the size of the investment – many can be undertaken with quite limited analysis either because the replacement decision is obvious, e.g, you are losing £400 a day due to a poor computer system that can be fixed with a £2,000 investment, or because the amount required is trifling. A change of equipment might be prompted by the rising/falling cost of a complementary product, e.g. when the price of oil rises many firms switch to cheaper modes of transport for distribution.
- **Cost reduction.** A well-run company will have a continuous programme of assessing and benchmarking the costs of various operations. Project appraisal techniques may be called on to assess the value created by changing methods and processes.
- **Statutory and welfare.** Many investments are imposed by law or to satisfy basic social norms, e.g. fire safety modifications and equipment. The objective here is to satisfy the requirement at lowest cost.

5 Screening, strategy and budget

Proposals needs to screened to filter out those that will not go forward to detailed project appraisal, so as not to over-burden managers with numerous evaluations. Those obviously lacking financial benefit are easily eliminated. Those showing promise on a preliminary analysis can be carried forward to the formal appraisal stage. However, many will not be taken further because they do not fit the strategic direction of the firm or because of some other limitation.

Throughout the search for ideas, the development of those ideas, the engendering of commitment to the project and the collection of data the managers would have held in their minds the strategic direction of the company and the human, financial and other constraints.

It is the role of the corporate centre to set the strategy of the company in terms of which product/markets to enter and how to compete in those markets. Divisional managers may not always see strategic opportunities as clearly as the centre – for example, the cross-selling opportunities available if two or three divisions work together in a market, or the value-enhancement from selling-off a division.

Occasionally projects are proposed that are contradictory to the strategic positioning of the company. Presumably the move down-market by Jaguar in producing the X-series cars looked good on paper (positive NPV project?) when examined in isolation, but the strategic damage done by cheapening the supposedly up-market image of the brand was considerable.

Deciding on the volume of projects to fund and the capital expenditure budget for the forthcoming year or two is usually a two-way iterative procedure. To some extent (especially in the long-run) the budget can expand or contract depending on the availability of positive NPV projects. However, there are frequently circumstances where the company is capital constrained and unable to finance all such projects.

6 Appraisal

Detailed cash flow forecasts will be needed for the appraisal of projects using NPV or IRR. Managers (especially project sponsors) may be provided with manuals to guide them in the use of the evaluatory techniques – especially to ensure that all relevant cash flows are included while sunk costs and other irrelevances are left out.

The manuals may also state the required rate of return for projects. This may not be a single number as many firms ask for projects to be classified into risk classes, say, low-, medium-, and high-risk, and there is a different discount rate for each class.

To draw up the numbers to go into the discounted cash flow analyses (or payback and accounting rate of return analyses) the sponsor may need help from the finance experts as well as the operating managers - from the marketing team estimating product demand and the production team assisting with cost estimates through to the logistics team with best guesses on distribution costs.

7 Report and authorisation

NPV, IRR, payback and ARR are often presented, together with a description of the project in qualitative terms and a risk analysis in 'capital appropriation request forms'. Whether these need to be sent to senior management for their consideration often depends on the breaching of fixed expenditure limits. Thus, for expenditure of less than, say, \$50,000 a decision will be made at divisional unit level. Anything above this will be referred to head office.

Senior executives (CEO, CFO, etc.) in committee will usually make decisions on major investments, but occasionally the board of directors will need to be consulted. By the time a project is firmed-up into a report it should have gained a significant amount of support within the organisation. A switched-on senior team would already be aware of the proposed investment thus few projects are refused by the investment committee once received in a capital appropriation request form, because if they thought the project was not viable they would have indicated this much earlier in the process.

Having said this, over the time it takes to prepare a proposal many of the factors influencing project returns (e.g. competitor action, raw material cost increases, government rules) may change and so it is possible that it will be turned down. Also many firms suffer from capital constraints meaning that they have to refuse (or delay) value-enhancing investments. On the other hand (for non-capital constrained firms) many marginally viable projects may still be accepted because to reject them would be demotivating to sponsoring managers and may send a bad message discouraging project idea propagation and project sponsorship.

8 Capital expenditure controls

While the investment phase of a project is underway managers need to track it to ensure that if there are delays, or costs different from the plan, they can take corrective action quickly.

Overspends of a few thousand or a few percentage points may be regarded as normal and may require little intervention. But when the numbers get much bigger the manager will be ready to act - this may even go so far as to cancel the project.

It is difficult to unravel the two main causes of project cost over-run so care is needed in judging the managers involved:

- Poor cost control
- Failure to accurately forecast future cash flows – often a perfectly understandable failure given the uncertainties inherent in the process

9 Post-completion audit

According to surveys of corporate practice most large firms post-audit most of their major investment projects. This means that they monitor and evaluate the progress on the project by comparing forecast cash flows with actual cash flows. This is conducted over many years for long-lived projects – perhaps monthly for the first year followed by annual reviews.

Reasons for post-completion audits:

- **To control the progress of the particular project under consideration.** If, over the years beyond the initial investment, the project is not performing as anticipated then steps can be taken to modify the project, or even to abandon it.
- **The knowledge gained from regular reviews of previous projects helps future capital investment decision-making.** Perhaps the process of project development, data collection and appraisal is flawed. These errors may be missed unless managers take time to reflect on past decisions and outcomes.
- **Psychological impact on managers.** Managers knowing that the projects they sponsor will be monitored for many years after implementation may put more effort into forecast accuracy (rather than empire building). These managers will also be encouraged to continue to take an interest in the project to ensure that everything goes to plan.

In judging the outcomes of investments senior managers need to tread carefully. If the audit process puts blame on individuals for failure to achieve cash flow targets managers may become averse to being project sponsors or only promote those with

low risk – many cash flows are subject to risk variables way beyond the control of the sponsor.

Another mistake might be to reward managers on the basis of the extent to which cash inflows exceed the projections – then the danger is that managers will deliberately lower estimated cash flows, resulting in many viable projects being eliminated from further consideration.

CertCFF Sample Course Content

Study Unit 4: Managing for Value

Section 3: Mergers and Acquisitions

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3. Mergers and Acquisitions


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Activity 4.3.5 - Mergers and Acquisitions Exercises

You have now completed the readings for Section 3 – Mergers and acquisitions. Now attempt these exercises to check that you have understood the course materials so far.

Resources

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4.3.5 Mergers and Acquisitions exercises

Study Unit: Study Unit 4 – Managing for Value

Section: Section 3 – Mergers and Acquisitions

Date: 01 October 2008

Summary: You have now completed all the readings for Section 3 – Mergers and Acquisitions. Attempt these short exercises to check that you have understood the course materials so far.

Key Words: Shareholder value, merger, acquisition, takeover, earnings per share, EPS, bootstrapping.

Question 1

Camelia plc is considering making a takeover bid for Desia plc. The current value of Camelia, as measured by the present value of its expected future cash flows and market price is £40m. Desia is currently valued by the stock market at £18m, which is the correct valuation as measured by its expected discounted cash flows as a separate business. The transaction costs of the merger would be £2m. If the two companies merged there would be synergistic savings of £1.5m per year for every future year. The appropriate discount rate for both companies is a WACC of 10% per annum.

- (a) What would be the effect on the shareholder value of Camelia's shareholders if a cash offer of £25m is accepted by Desia shareholders? What would be the effect on Desia's shareholders?
- (b) What would be the effect on the shareholder value of Camelia's shareholders if a cash offer of £37m is accepted by Desia's shareholders? What would be the effect on Desia's shareholders?
- (c) Describe the 'winner's curse' problem.
- (d) Camelia has 20m shares in issue. Desia has 6m shares in issue. If Camelia offers 4 newly created shares in itself for every one share in Desia, what value changes will be experienced by each group of shareholders assuming all the synergistic savings are realised? Express this in total terms and in per share terms.

Question 2

There are a number of disadvantages in using shares in the acquirer as payment for shares in the target. Which of the following is NOT a disadvantage?

- A. It may pull the company away from the optimum financial gearing ratio
- B. Near term earnings per share could decline.
- C. Managers who own a high proportion of the acquirer may be reluctant to allow an issue of shares that will dilute their control
- D. It will raise the financial gearing ratio of the company

Question 3

A vendor placing is best described as:

- A. The target's shareholders do not sell their shares, instead they are placed with registrars
- B. The shares in the acquirer are sold to financial institutions who then buy shares in the target company
- C. One or more financial institutions agree to buy the acquirer's shares received (nominally) by the vendors (target's shareholders) in return for cash. The target's shareholders receive cash for the shares in the acquirer.
- D. A stock broker sells shares in the target to the acquirer

Question 4

Describe the advantages of cash over shares as payment when making an offer to buy all the shares in another firm.

Question 5

Owens Inc is a fast growing food company. It has 30m shares in issue and generated earnings per share (EPS) of \$1 last year. The stock market expects Owens' EPS to rise relatively rapidly in future years and so its price earnings ratio (PER) is 22.

Lumbering Inc is a slow growing tree cutting service. It has 50m shares in issue and produced 30 cents earnings per share last year. These earnings are not expected to rise under the current management and strategy, and Lumbering's share price is \$3.

Owens is considering acquiring Lumbering by offering one share in itself in exchange for five shares in Lumbering.

- (a) Describe, explain and illustrate bootstrapping using the example of Owens and Lumbering.
- (b) If there are no economies of scale, managerial improvements or any other synergies realised from the combining of the two firms what should the price-earnings ratio be of the combined firm if Owens pays only the current market price for Lumbering in a nil-premium share offer (ie at current market value)?

Question 6

The academic empirical evidence on the 'winners' from merger activity shows that three of the following generally benefit. Which is the group that sometimes benefits but just as often does not?

- A. Shareholders of the acquiring firm.
- B. Shareholders in the target firm.
- C. Directors and managers of acquirer.
- D. Advisers such as investment banks.

Question 7

Which of the following best describes the absorption approach to post merger integration?

- A. The target's employees, culture, systems and operating procedures are consolidated with the acquirer's.
- B. The post-merger operating businesses operate largely independently – the degree of integration stretches as far as changes in financial control and reporting procedures, but little else is changed, with the possible exception of the transfer of some managerial skills.
- C. This approach tends to keep the unique cultures, organisation and operating styles separate. Each unit operates with a high degree of autonomy, but inter-action is encouraged to allow cross-fertilisation of ideas and transfer of skills.
- D. Costs from the various subsidiaries of the acquirer are absorbed by the target company

Question 8

When a merger is announced the managers of the bidding firm make public pronouncements about the benefits that will flow to shareholders in terms of enhancing competitive position or savings. However, what is not so openly talked about is that managers of acquirers often gain a great deal from the acquisition of other companies. Briefly describe and explain the following motives/reasons for merger:

- (a) Empire building
- (b) Economies of learning
- (c) Vertical integration synergies
- (d) Managerial over confidence

Answers

Question 1

- (a) First we need to work out the value of Desia to Camelia, in terms of the present value of the expected future cash flows:

Desia's value to Camelia = Desia's current value + present value of synergies – transaction costs

$$\text{Present value of synergies} = \frac{\text{Annual Savings}}{\text{WACC}} = \frac{\text{£1.5m}}{10\%} = \text{£15m.}$$

So Desia's value to Camelia = £18m + £15m - £2m = £31m

If Camelia bought Desia for £25m Camelia would boost its shareholders' wealth by £31m - £25m = £6m

And Desia's shareholders would have gained £25m - £18m = £7m

- (b) If Camelia bought Desia for £37m it would boost its shareholders' wealth by £31m - £37m = -£6m; ie it would **decrease** shareholders' wealth by £6m.

However Desia's shareholders would have gained £37m - £18m = £19m

- (c) The 'winners curse' problem arises when a bidder wins the takeover battle in terms of taking control of another firm, but does so at such a high price that all the value to be gained from the merger plus much additional value is lost to others, such as target shareholders and those that assist the transaction. In the heat of a takeover battle the price offered can go beyond the rational level.

In the case of Camelia and Desia the maximum rational price is £31m.

- (d) The current market value of Camelia is £40m. With 20m shares in issue each share is worth £2. Similarly Desia's share price is £18m/6m = £3 per share.

If four Camelia shares are offered for every Desia share then 4 x 6m = 24m Camelia shares will be issued.

The combined company will have a value of:

$$PV_{AB} = PV_A + PV_B + PV_{\text{gain}} - \text{transaction costs}$$

$$PV_{AB} = £40\text{m} + £18\text{m} + £15\text{m} - £2\text{m} = £71\text{m}$$

Post-merger there will be 20m (original) + 24m (new) = 44m Camelia shares in issue

And the value per share will be: $£71\text{m}/44\text{m} = £1.6136$ (rounded)

The value for Camelia's old shareholder's has moved from £2 per share held to £1.6136 per share held, a 19.32% value loss – the 'winner's curse'. The total loss is £7.727m, as the value of the original shares falls to $20\text{m} \times £1.6136 = £32.272\text{m}$.

Since Camelia issues 4 shares for each Desia share, the value for each of Desia's shareholders has moved from £3 per share to $£1.6136 \times 4 = £6.4544$ per (old Desia) share, a 115% increase. The total gain to Desia's shareholders is $24\text{m} \times £1.6136 - £18\text{m} = £20.726\text{m}$.

Note, however that the same additional value of £15m synergies - £2m transaction costs = £13m is split between the two groups of shareholders: $£20.726 - 7.727 = £12.999\text{m}$ (slight error due to rounding).

Additional comment

Clearly, Camelia's shareholders are being asked to give away too much of the combined company to achieve the merger. Desia owns 54.5% of the combined entity. When shares are offered as consideration, rather than easy-to-value cash, 'acquiring managers' can often lose sight of the amount of value they are giving away. Rather than thinking in terms of Camelia acquiring Desia they should be thinking 'more than one-half of Camelia sold to acquire assets worth less than that'.

Question 2

Answer D. It will raise the financial gearing ratio of the company

A. is a disadvantage as issuing equity may well change the capital structure of the acquirer. So is b. as the number of shares will increase, thus increasing the risk that EPS declines (or turns out lower than anticipated). C. is also a disadvantage.; which leaves D. –issuing

equity decreases gearing, which may well be an advantage as it makes the financial structure less risky to compensate for the risks inherent in making the acquisition.

Question 3

Answer C. One or more financial institutions agree to buy the acquirer's shares received (nominally) by the vendors (target's shareholders) in return for cash. The target's shareholders receive cash for the shares in the acquirer.

In a vendor placing the vendor (seller) of a business who receives shares in the acquiring firm as part of the deal immediately sells them on to an institutional investor at an agreed price (which need not be the market).

The vendor gets what he really wants (cash), the acquiring firm is able to pay for its acquisition the way it wants (shares) and the institutional investor gets shares in a firm that it likes at a price that will commonly be below the market price.

Question 4

Cash has the following advantages over shares as a payment method in mergers:

- Because it has a certain value (whereas share values can change daily) it may be more attractive to target shareholders and therefore the bid is more likely to succeed.
- Target shareholders can diversify away from holding shares in the combined entity more easily with cash than with shares because of lower transaction costs.
- The attractiveness of cash to the target shareholders may allow a quicker takeover or one that is more attractive than a rival bidder could muster, and this can shut out a rival from the process before they have time to react.
- The shareholders in the acquirer retain the same proportion of shares and therefore the same degree of power that they had before the bid.
- The acquirer may offer cash and borrow the funds required (or indeed issue shares) in order to change the capital structure (debt-equity ratio) of the firm to its optimum level.
- Regulations may require a cash bid rather than a share bid.

Question 5

(a) Bootstrapping occurs when a firm on a high PER takes over a firm on a low PER (with its own shares) and the stock market subsequently values the earnings of the combined entity at a high rate – usually in the expectation that the acquiring firm will raise the earnings growth rate of the acquired firm.

If the earnings growth rate in the target is indeed raised then all of this is rational and good from the acquirer's shareholders' viewpoint. However, sometimes the market assumes that this growth will be achieved, rather than checking that acquiring companies are actually working hard to improve the companies acquired. If such acquirers can keep the market believing that they will raise earnings growth in target companies, they can regularly take over low PER companies and boost their own EPS. Then if the market ascribes the same (or similar) PER to the firm after the merger as it had before, then the share price will rise.

However, if the earnings of the newly acquired subsidiaries continue on the same growth path they had before the merger (they may even decline due to neglect), eventually this will be noticed by the markets and the share price will fall. Nevertheless, this can be put off for a considerable period if the flow of purchases of low PER companies continues.

Bootstrapping illustration using Owens and Lumbering:

Owens has 30m shares in issue and generated earnings per share (EPS) of \$1 last year. So Owens has $30\text{m} \times \$1\text{m} = \30m earnings in the year. Owens' PER is 22, so its share price is $22 \times \$1 \text{ EPS} = \22 per share. And Owens' market capitalisation is $22 \times \$30\text{m}$ earnings = \$660m

Lumbering Inc has 50m shares in issue and produced 30 cents earnings per share last year. So Lumbering's earnings were $50\text{m} \times \$0.30 = \15m . Lumbering's share price is \$3, so its PER is $\$3 / \$0.30 = 10$.

So, if Owens offered one share in itself in exchange for five shares in Lumbering and the market believed that the earnings of Lumbering would start to grow at the same rate as the rest of Owen's earnings and therefore the PER for the combined firm is 22, then we would have the following:

	<u>Owens</u>	<u>Lumbering</u>	<u>Combined company</u>
Earnings	\$30m	\$15m	\$45m
Number of shares	30m	50m	40m
EPS	\$1	\$0.3	$\$45 / 40 = \1.125
PER	22	10	22 (as Owens)
Share price	\$22	\$3	$22 \times \$1.125 = \24.75
Market capitalisation	\$660m	\$150m	$40m \times \$24.75 = \$990m$

Owens shareholders would see their share price rise by 12.5%. Lumbering shareholders used to have a shareholding with a market capitalisation of \$150m. They now own shares with a market value of $\$24.75 \times 50m/5 = \$247.5m$. If the growth rate of Lumbering does pick up to the rate expected by the market all well and good. But Owens management might be tempted to boost Owens' EPS and share price by doing similar deals on a regular basis.

(b) If the share for share exchange is at Owens' market value, the shareholders of Lumbering will receive $\text{Lumbering Market Value} / \text{Owens' share price} = \$150m / \$22 = 6.818m$ shares in Owens.

The PER will be $\text{Total Market Capitalisation} / \text{Total Earnings} = \$810m / \$45m = 18$

If Lumbering's earnings continue on the same growth path after the merger then the figures would be:

	<u>Owens</u>	<u>Lumbering</u>	<u>Combined company</u>
Earnings	\$30m	\$15m	\$45m
Number of shares	30m	50m	$30m + 6.818m = 36.818m$
EPS	\$1	\$0.3	$\$45m / 36.818m = \1.2222
PER	22	10	$\$810m / \$45m = 18$
Share price	\$22	\$3	\$22 (given)
Market capitalisation	\$660m	\$150m	$\$660m + \$150m = \$810m$

Question 6

Answer A. Shareholders of the acquiring firm.

The shareholders in the acquirer have the most uncertain outcome. The bid premium generally gives shareholders in the target a much better price than they could have got by selling in the market. Management of the acquirer commonly do well out of mergers; they are highly unlikely to be paid any less than before, and at worst they can use the experience of the merger to enhance their reputation. Advisors generally do extremely well out of M&A as they are paid substantial fees and take only limited risks.

Question 7

Answer A. The target's employees, culture, systems and operating procedures are consolidated with the acquirer's.

A. is the correct answer. B. refers to the preservation approach, and C. is the symbiosis approach. D. is not a recognised approach to post merger integration.

Question 8

(a) Empire building is a suspected motivation in many mergers. The managers of the acquiring firms can experience many gains from being in charge of a larger organisation and so some are tempted to take the takeover route to growth as a quicker alternative to organic growth. The benefits include increased salary and perks, raised social status and increased job security. Being in charge of a larger number of employees can give an ego boost.

(b) Economies of learning can arise when, through repeating the production process workers and management can reduce the unit cost due to the organisational capacity for learning. For instance aircraft manufacturers benefit from the 'experience curve', which means the second aircraft is produced with more efficiency than the first, the third more than second, and so on. Mergers can enhance the potential for economies of learning by bring together people and systems that will complement each other: there can be a sharing of accumulated knowledge and experience.

(c) Vertical integration occurs when the two merging firms are at different points in the vertical production chain. Backward integration is when the acquiring firm purchases a company producing the up-stream output, e.g. a clothes manufacturer purchases a textile company. Forward integration occurs when the acquiring firm purchases a company

producing down-stream, e.g. a car producer buys car show rooms. Vertical integration synergies arise because:

- There can be high costs associated with transacting with suppliers, such as costs of contracting, of monitoring contract compliance, and of enforcing contract terms in the event of a breach.
- Vertical integration also offers the opportunity to reduce quality and delivery uncertainty.
- A supplier or customer might have undue pricing power and so it is worth acquiring them to avoid being 'held to ransom'.
- New competitive advantages vis-a-vis rivals could be created, such as the ability to control low cost inputs, or the ability to control distribution networks.

(d) Managerial over confidence is suspected as a contributing factor in a lot of merger activity, especially during or at the end of a period of economic and stock market boom. Based on past success, managers feel they are able to continue to apply the formula to a number of other companies and create large amounts of value. The over confidence theory of mergers does imply that managers are being selfish. They could be acting in what they perceive as a shareholder wealth enhancing way, and it is simply that subsequent performance reveals them to have been over-confident at the time of the merger.

CertCFF Sample Course Content

Study Unit 5: Sources of Finance

Section 2: Corporate Debt

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2. Corporate Debt


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Activity 5.2.4 - Private Placements


In essence Private Placements are non-public bonds. They are not listed on any exchange, are not normally traded, and are rarely publicised. Once the securities are issued, the placement typically remains with the buyer, or buyers, until *maturity*, although most have *documentation* facilitating change of ownership in certain circumstances.

Resources

 [Core resources | 5.2.4 Private Placements](#) [+ show details](#)

Further Reading

 [Further reading | The Treasurer - Debt finance on the quiet](#) [+ show details](#)

 [Further reading | The Treasurer - The appeal of private placements](#) [+ show details](#)

5.2.4 Private Placements

Study Unit: Study Unit 5 – Sources of Finance
Section: Section 2 – Corporate Debt
Date: 01 October 2008
Summary: An introduction to US Private Placements.
Key Words: Private placement, credit ratings, investors

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1 Introduction

The US private placement (PP) market saw \$39bn of issuance in 2007, with approximately 55% originating from non-US issuers. UK corporates accounted for 24% of this non-US issuance. Transactions sizes range from \$50m to \$1.2bn with most investor demand occurring in the 7 to 12 year maturity range. Investors are generally US insurance companies with a buy and hold mentality. Credit ratings are not required to access the market – investors will form their own view of the issuer’s implied rating. In volatile conditions the PP market has consistently remained open, with transactions being priced throughout the market turbulence in 2007/8. Issuers currently reliant on the bank market may wish to look to PP as a first step towards funding diversity, which is particularly important when there is a banking liquidity squeeze.

2 What is a private placement?

In legal terms, a Private Placement (“PP”) is an agreement between a willing seller and a willing buyer(s) to exchange an unlisted, negotiated, promissory note tailored to the requirements of both parties. Both the lender and the borrower are brought together by an intermediary agent, usually a relationship bank.

Private placement mandates represent prestigious fee income for relationship banks. Competition for a major role in a transaction is intense and treasurers will face a bank group that will aggressively use their ‘relationship’ to win a role in the transaction.

The term Private Placement can be confusing as it has no precise meaning. Moreover it is also used by the Securities & Exchange Commission (the “SEC”) to describe the array of exemptions from the requirement for registration when securities are only offered for sale to sophisticated buyers. For example Rule 144A (Refer to 2.3 – Debt Capital Markets) is a private placement exemption, but this is not how the term is used in this reading.

PPs are called ‘private’ because they are not listed on any exchange, are not normally traded, and are rarely publicised. Once the securities are issued, the placement typically remains with the buyer, or buyers, until maturity, although most have documentation facilitating change of ownership in certain circumstances.

PPs are an established source of long-term debt capital that many companies use to diversify their sources of finance, freeing up bank capacity for other purposes.

Issuance is generally in US Dollars although Euro and Sterling tranches can be placed. PPs have the following characteristics:

- Long-dated (5 -15 years+)
- A limited number of sophisticated, professional or institutional investors
- Flexibility through negotiated terms and conditions
- Can be arranged quickly
- Minimal public disclosure – less onerous than public and Rule 144A issues
- Low issuance cost
- Offering process ensures competitive pricing
- No public credit ratings required
- No US GAAP reporting requirement
 - Historically this was very important in the development of the PP market outside the US, although US GAAP reporting is also no longer required for issues under Rule 144A
- No SEC registration required
- No listing required
- Predictable pattern of investor demand
- International issuers are sought after
- Direct investor relationship
- Flexible issue size from around £20 million to £500 million equivalent

Private Placements offer an alternative to the high-profile public Euromarkets which can sometimes be volatile and offer an uncertain reception to many corporate borrowers. The Private Placement market is much more predictable and has remained open during recent turbulence in 2002 and 2007/8. This explains why many corporates have been prepared to look for alternative sources of capital and to redirect their attention towards the less well publicised, but perhaps more transparent and predictable, market of senior debt private placements.

3 Investors

Investors are almost exclusively insurance companies or pension funds, many of which (but not all) are based in the US. Unlike many of their counterparts elsewhere, US insurance companies manage their investments on a global asset allocation basis, with a heavy fixed interest weighting, and in recent years have increasingly been looking for geographical diversification by investing in UK and European companies.

Private placements generally provide higher-yielding investments with longer maturities and specific covenant and/or call protection that insurance companies find attractive. Other investors include private pension funds, state and local retirement funds, domestic bank trust departments and other institutions.

Over recent years, the investor universe has broadened significantly as institutional investors' geographical investment guidelines have globalised such that today, there is regular participation by a number of non-US investors who use the same regulatory framework, but provide direct local currency availability.

Some US insurers have opened offices in London in recent years to be even closer to the markets in which they want to invest. Lacklustre returns for equities, pension risk and accounting issues have rebalanced pension fund portfolios in the UK and Europe out of equities towards fixed interest, leading to some of the major European insurers becoming buyers of private placements.

4 Key features

4.1 Exemption from SEC registration

Most private placement financings are structured to be eligible for purchase by US institutional investors by using the safe haven exclusion provisions of the Securities and Exchange Act of 1933.

Section 4(2) of the 1933 Act, the private placement exemption, and the subsequent promulgation in 1982 of Regulation D, have defined the traditional private placement market by waiving SEC registration requirements for transactions by an issuer not involving any public offering. Therefore, such transactions are directed exclusively at sophisticated investors with significant credit analysis skills to evaluate and understand the particular credit characteristics of an issuer's business directly. Crucially such investors are able to do this without relying upon the view of any rating agency as is required by the Rule 144A.

4.2 Credit ratings

Although formal ratings are not required, investors will make their own credit assessment. Investors are looking for issuers with a rating equivalent to BB+/Ba1 and above. However, most issues will be made by investment grade issuers with a rating equivalent to BBB-/Baa3 and above.

4.3 Pricing

Issuers prepare a private placement memorandum setting out the terms of the offer and information about the issuer. This is used to attract potential investors and is often accompanied by a roadshow of one-to-one meetings. Although there is no formal book building as with a conventional bond issue, providing there is sufficient interest, competitive pricing should be achieved through informal price discussions.

Private placements are fixed rate borrowings. Borrowers will often enter into interest rate swaps to achieve floating funds or cross currency swaps where they do not have a need for dollars.

4.4 Structuring

The negotiated nature of the market allows issues to be structured in a variety of ways, often multi-tranche, multi-currency, using repayment structures differing from the vanilla bullet structures used in public bond markets. This is subject always to the proviso that

structural subordination remains an issue in all markets and senior note financings require *pari passu* treatment with other senior creditors.

A typical structure would be for the corporate to borrow unsecured with other options being either to guarantee support from asset holding subsidiaries or to limit subsidiary indebtedness.

Generally borrowers are able to replicate structure and covenant provisions based upon their existing bank documentation, albeit for a longer maturity.

Although private placements are transacted with maturities from 5 to 30 years, the deepest, and for UK borrowers the most competitive, area of the market is usually between 7 and 12 years, typically offering a longer maturity than most corporate borrowers can obtain in the bank market and sometimes even the public bond markets.

4.5 Early termination

The expectation of PP investors is that PPs will not be terminated early. However early termination is usually possible subject to a make-whole provision. This is structured in such a way as to make early termination an unattractive option.

A make-whole provision is a provision which gives the investor substantially his whole anticipated return, despite any early termination. Financially it is a call option that allows the borrower to pay off the PP early – ie the borrower has the right but not the obligation to buy the bond back from the holder. The borrower has to pay a lump sum to the holder based on the NPV of future coupon payments.

For example, an investor purchases a 3 year PP bond from Company A priced at 100bp over US Treasuries. The make-whole provision allows prepayment subject to a one-off payment calculated by discounting future unpaid coupons at the current Treasury rate + 25bp which results in a much higher price than at the fair market value of 100bp.