

**CORPORATE FINANCE AND PRINCIPLES OF CAPITAL STRUCTURE IN PROJECTS**  
**VALUATION OF FINANCIAL ASSETS & SOURCES OF FUNDS**

**A. VALUATION OF FINANCIAL ASSETS**

- ✚ Securities are financial assets and include shares of stock and bonds.
- ✚ Valuation is the process of determining the true worth of a security or a business using the available financial data.
- ✚ It is the process that links risk and return to determine the worth of an asset.
- ✚ Valuation is carried out in the market by financial experts and the value attached to a security is known as the theoretical value or intrinsic value.
- ✚ The theoretical value forms the basis of determining whether a security is under or overvalued.

**Theories of valuation**

**1. Fundamental analysis theory**

- ✚ It states that every security has an implicit value which is equal to the present value of all cash flows expected from a company.
- ✚ The intrinsic value of a security is therefore equal to the total present value of all the expected future benefits to be realized from the security.
- ✚ The future benefits will be in form of dividends, interest income to disposal proceeds when a security is held for a definite period.
- ✚ According to this theory the value of a security will be influenced by other factors such as:
  - ✓ Capital structure including gearing level.
  - ✓ Dividend policy including amount and stability of dividend.
  - ✓ Price-Earnings ratio and Earning per share of a firm.
  - ✓ Political stability.
  - ✓ Economic conditions.
  - ✓ Past and expected future performance of the firm.

**2. Technical Analysis / Chartists theory**

- ✚ It states that historical price patterns are expected in future.
- ✚ It is based on the belief that history shall repeat itself i.e. past price patterns or trends will be repeated in the future.
- ✚ The past price patterns are plotted on a graph and the trend obtained is expected to recur in the future.
- ✚ The price patterns can be divided into the following:

## Characteristics of preference shares

### 1. Claims on income and assets

Preference shares have prior claims on income and assets to ordinary shares i.e. preference dividends must be paid before ordinary share dividends and in the event of liquidation preference shares have prior claim on asset distribution

### 2. Fixed dividends

Preference shares earn a fixed rate of dividends and preference dividends are not taxed deductible. Preference dividends are fixed income securities as they provide fixed income to investors

### 3. Cumulative dividends

Most preference shares have cumulative right to dividend requiring that all past unpaid dividends to be paid before any ordinary dividends are paid

### 4. Redemption

A company can issue preference shares which are either redeemable or irredeemable

Redeemable preference shares have maturity date at which the shares are bought back by the issue while irredeemable shares are not bought back

### 5. Participation feature

Some preference shares are participatory allowing holders to participate in extra ordinary profit earned by the company. This means that this type of preference shares earn dividends in excess of fixed dividends

### 6. Voting right

Preference shares do not have any voting right

### 7. Convertibility

Preference shares may be convertible or non convertible. Preference shares allow the holder to convert his preference shares into ordinary shares at a specified during a given period of time

## Advantages of preference shares

### 1. Dividend postponability

They provide some financial flexibility to the company. This is because they can post pone payment of dividends

### 2. Nonpayment of preference dividends does not force the company into insolvency

### 3. Fixed dividends

Preference dividends payments are restricted to the stated amount. Thus preference share holders don't participate in excess of profit like the ordinary share holders

### 4. Limited voting rights

Preference share holders do not have voting rights except in case of dividends in arrears. Thus the control of

ordinary shares is preserved

### **Disadvantages**

1. Non deductibility of dividends

Preference dividends are not tax deductible expenses hence making preference shares more expensive than debentures

2. Commitment to pay dividends

Although preference dividends can be omitted, they may have to be paid because of their cumulative nature

3. Nonpayment of preference dividends can adversely affect the image of the company

### **SHORT TERM SOURCES**

#### **1. Bank overdraft**

##### **Advantages**

- i. It is unsecured hence the firm does not need to sorry about assets to pledge as securities
- ii. Provides without conditions hence flexible source of capital
- iii. It does not involve floatation cost
- iv. Can be used for emergency financing
- v. Used without the consent of the shareholder
- vi. It cannot increase the gearing level and financial risk of the company

##### **Disadvantage**

- i. Interest rates on overdraft are higher than on long term loans
- ii. It can only be raised by financially sound companies which are well known to the lenders
- iii. It is open to misuse because the shareholders consent is not required to use this fund
- iv. It can only be raised in small amounts and cannot therefore be invested in long term projects

#### **2. Commercial paper (iou)**

- This is a short term debt instrument used by financially sound companies to enable them raise capital to finance their working capital needs
- It carries a fixed rate of return and its usually not secured
- It is issued at a discount
- The effective cost of this finance is the difference between the discounted sum and the face value of the debt instrument
- It can be issued through commercial banks or stock exchange
- Interest rate of the commercial papers is at premium above the treasury bill rate