

A Review On Valuation And Corporate Finance

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Abstract

Valuation is an important concept within the realms of corporate finance decisions. The concept of valuation is pervasive within all the three broad classifications of corporate finance decisions which include capital budgeting decisions, capital structure decisions, and working capital management decisions. The discussion under this theme has been divided into three sub-sections with one sub-section each being devoted for examination of the relationship between each of the three broad classifications of corporate finance decisions and valuation. For this study a systematic review of the literature specific to the broad area of valuation, as it related to corporate finance, directly and indirectly, was conducted involving the period from early April to mid-October 2019.

The researchers have theorized connections between various concepts related to capital structure, capital budgeting, and working capital management with the value of a firm. In the context of capital structure researchers have been trying to understand whether there is an optimal capital structure for an individual firm. Theories related to impact of debt, with or without imperfect conditions such as bankruptcy cost, agency cost, and tax shield, have been presented and criticized. The relation between firm valuation and capital budgeting decisions has been discussed, and various methods used for evaluating investment projects such as Net present value method, the internal rate of return, and Modified Internal Rate of Return, have been discussed. Lastly, researchers have found out that corporate finance manager regard working capital management to be vastly critical for their firms' value, and have presented various theories in this connection.

Key Words: Tax shield, Capital budgeting, Working capital, Capital structure, Firm valuation, Corporate finance.

1. Introduction

Valuation is an important concept within the realms of corporate finance decisions. Within the three broad classifications of corporate finance decisions such as capital budgeting decisions, capital structure decisions, and working capital management decisions, the process of determining the value – the value that accrues to the overall firm value – is essentially needed. Which also implies that the concept of valuation is unavoidably pervasive within the realm of corporate finance (Berk, DeMarzo, & Harford, 2014). This strong relationship between the corporate financial decisions and value of the firm provides for strong discipline to the behavior of top management as each and every decision taken by them has to add value to the firm's existing

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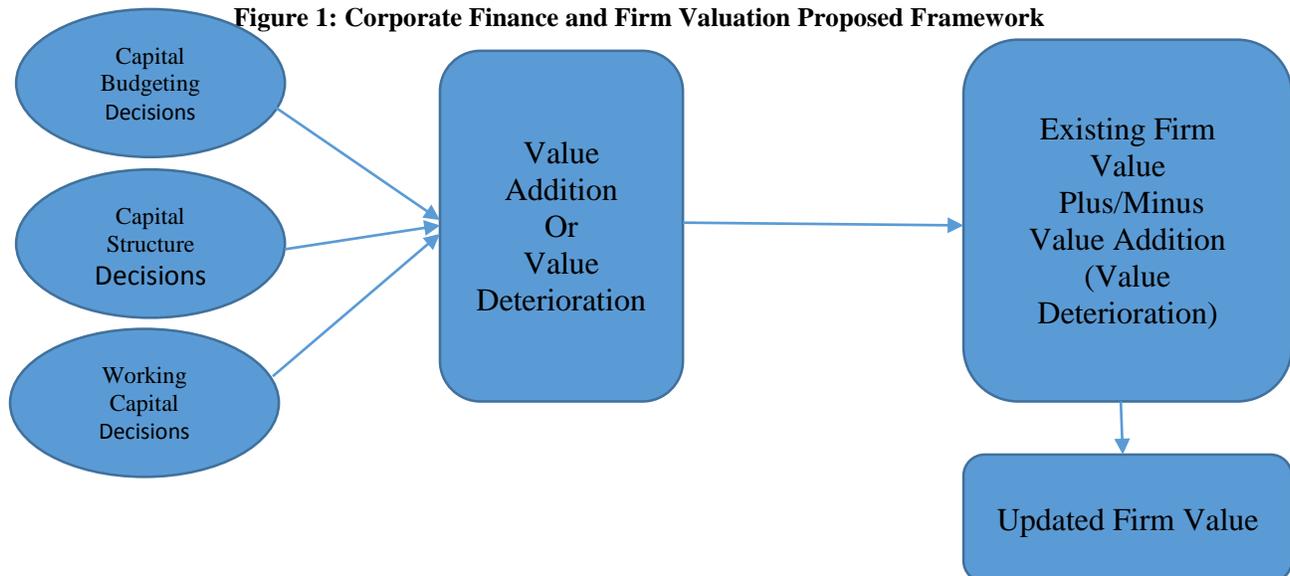
value; and that is how the decisions themselves could be well evaluated by the stakeholders (Brealey, Myers, & Allen, 2017).

As the prime purpose for corporate finance is the maximization of the firm value, the association between the tactical and strategic decisions - financial and investments - with the firm value is natural and has special significance (Brealey, Myers, & Allen, 2017). In other words, every corporate financial decision will not only involve determination of value but also considers as to how it will enhance the value of the firm in question (Li, Liao & Albitar, 2020). The existence of this relationship is reinforced by the management consulting firms which offer companies solutions as to how to increase value, and their suggestions have frequently led the firms to restructure themselves. A firm derives its value from the decisions that the top management makes: the investment decisions, the financing decisions, and decisions related to dividends. For the management appreciating these relationships clearly is necessary for ensuring value-enhancing tactical and strategic financial decisions in the areas of long-term investments, financial restructuring, and operating decisions (Damodaran, 2012). Of course, the other stakeholders are greatly benefited when they appreciate and consider this relationship in assessing and monitoring the performance of top management (Brealey, Myers, & Allen, 2017).

The first section of this study deals with the relationship between capital budgeting and firm valuation. The literature on capital structure decisions also discusses its impact on firm valuation. Within these sub-section theories specific to optimal capital structure – the capital structure at which the value of the firm is at highest level - have been discussed. The literature discusses relationship between working capital management and valuation of firm. In this section, theories specific to negative relationship between working capital and firm valuation, excessive investment in working capital, optimal allocation for working capital, and financial flexibility from working capital, have been discussed.

It is well understood in the literature that a rigorous, extensive, and organized literature review is a forceful mechanism to produce a meaningful overview of literature related to a specific area (Rousseau & Mccarthy, 2007) and (Köhn, 2018). The author of this paper could not find a holistic and systematic review of literature discussing the impact of all of the corporate financial decisions on firm valuation in a single study. The aim of the author is to fill this gap with a view to allow the researchers and practitioners an insight into the concepts and knowledge connected with the broad subject of corporate finance and firm valuation.

Figure 1: Corporate Finance and Firm Valuation Proposed Framework



This diagram shows that capital budgeting, capital structuring, and working capital decisions are the means of creating or deteriorating value for a firm. The value enhancement or deterioration so created finds its way to the existing firm value and that returns an updated value for the firm. This is an ongoing process that exists without a set pattern in terms of continuity of the process and the level of the value addition/deterioration from the three corporate finance decisions.

Of course, the stakeholders can evaluate or monitor the performance of the managers in terms of their ability to create overall value addition from these three decisions. Thus, as discussed above, valuation provides for a mechanism to discipline the behavior of top management.

2. Methodology

This section explains the approach employed for the review in terms of the type of literature, the period covered in the review undertaken, the sources of literature, and how the individual articles and books were selected. The section is composed of the following sub-sections such as *Motivation for this Review*, *Article Focus*, and *Articles Identification and Selection*.

To perform a review of the literature specific to the broad area of valuation as it relates to equity valuation, directly and indirectly, a systematic search was conducted involving the period from early April to mid-October 2019. English language journals and books were focused for this study which have the strongest impact created and recognized by the academic community in the area of corporate finance (De Matos 2018). A process involving four steps was used to identify relevant literature for the review. The first one involved a thorough search of several databases including google scholars, emerald, JSTOR, ELSEVIER, Springer, and ebray, for the words “corporate finance and valuation”, “corporate finance and firm valuation”, “capital structure and valuation”, “valuation of private firm”, “working capital and valuation”, and many other similar words. This step made available approximately 200 studies and books. The second step comprised of two screening-based activities which were: number one, examination of the title of the papers and the books for relevance; and number two, a quick browsing, focusing on the abstracts and the conclusions of the paper, and the table of contents for the books. The whole activity allowed reducing the list of books and studies to about 75 titles. The reviewing and scrutinizing of the selected list of literature was then reviewed and scrutinized in step two, with the objective of retaining only those directly relevant to the theme of valuation and Corporate Finance being the focus of this research paper; this step narrowed down the screened list to about 40 items. A quality cut-off was applied as a fourth step to ensure that only good research papers were included in the review (Bouncken & Gast, 2015). The h index based on google scholar was employed. All research papers carrying an h index lower than 15 were not considered unless they were cited by some other papers published in journals maintaining an h index of at least 20. Ultimately, the number that emerged out of the entire process is 25 papers.

3. Literature Review

3.1 Capital Structure and Firm Valuation

The capital structure is the blend of debt and equity that the firm uses to finance its operations, according to an analysis of corporate finance. Another meaning of capital structure is a particular combination of long-term money raised through financial markets (CFA Institute, 2019). One

crucial metric to depict the ratio of the firm's total obligations to its entire net value is financial leverage (Aggarwal & Padhan, 2017). On the other hand, the enterprise value of a company is the combined value of its debt and equity, often known as the value of the company's assets.

The concept of optimal structure is paramount in corporate finance; when a firm has optimal structure, its value is at the highest level. Therefore, managers strive to attain optimal capital structure (Brigham & Ehrhardt, 2011). The researchers have been debating seriously whether there is an optimal capital structure for an individual firm. Some, in the shape of (Modigliani & Miller, 1958) argued that the fraction of debt in the capital structure has no relevance to the value of value. They demonstrated that if any two firms have same risk and return characteristics and operate in a frictionless market with no bankruptcy costs, then their relative market values are not influenced by the changes in their capital structure.

This argument has led to the spawning of vast literature extending, criticizing and modifying the original argument. Other researchers have pointed to imperfect conditions that may cause the value of firm to change with the changes in the capital structure. Mari & Marra (2019) identified bankruptcy costs, (Jensen & Meckling, 2019) proposed agency costs, and (Fischer & Jensen, 2019) identified tax shield from debt. They therefore have been aggressively supporting for the existence of an optimal capital structure. Akcigit, Grigsby, Nicholas & Stantcheva, (2018) included the personal taxes to the analysis which were made previously, and he showed that optimal level of leverage occurs only at a macro-level, and not at the firm level. They stated that the tax saving from interest for the firm is offset at the investor level. Moreover, as reported by (Park, Park, & Maher, 2018) financial distress costs tend to heavily offset the tax benefits from increasing level of leverage.

Along with the growth of the literature, the research community has been increasingly interested in the factors that determine capital structure, company value, and the direction of their effects. Market capitalization is a tool used by several studies to estimate corporate worth (Chadha & Sharma, 2016; Chowdhury & Chowdhury, 2010; Dhankar & Boora, 1996). While this is going on, some studies want to utilize market leverage to determine how the firm's debt may be paid down depending on the firm's actual worth and investor perception (Danis, Retzl & Whited, 2014; Shah & Kausar, 2012; Charalambakis & Psychoyios, 2012). In addition to market leverage, Aggarwal & Padhan (2017) stress the significance of utilizing company quality and Z-score, which may be found in Altman (1968), to assess the dynamics that affect the business's capital structure.

Agency theory brought a new perspective to leverage by pointing out that high leverage may reduce the level of the agency costs and thereby enhance firm value by motivating managers to perform primarily for the interests of shareholders (Schäuble, 2018). This is because high leverage brings additional monitoring of managers by the debt holders and also increases the threat of liquidation – both these conditions put pressure on the managers to be more committed and diligent (Jensen & Meckling, 2019). The higher level of leverage has the potential to cause mitigation of conflicts of interest for shareholders and managers related to the use of funds, the level of risk to be assumed and the dividend policy (Brealey, Myers, & Allen, 2017). The theory of Pecking Order provides a different perspective regarding the capital structure puzzle (Frank, Goyal, & Shen, 2020). It refutes the existence of an optimal capital structure, and argues that the capital structure of the firm is primarily driven by asymmetry of information between the managers and the outsiders. Myers & Majluf (1984) developed the Pecking Order theory, which, initially, had been proposed by Donaldson (1961). This theory states that, funds generated internally are first employed, debt is then used once the internal funds are exhausted, and lastly new equity is used. Asymmetric information is the reason for the preference of debt over equity, as the issuance of

debt sends two signals a) that the board is confident about the desired investment, and b) the current stock price is undervalued.

According to Ross's (1977) Signaling Theory, a company's decision about its debt-to-equity ratio is determined by its desire to communicate with investors rather than by the concept of the ideal ratio. Profitable companies may try to overstate their future development prospects and deceive the market by unduly expanding debt above the ideal level in an effort to boost the stock price. In fact, despite the management's best efforts to mislead the public, they think that the additional cost of issuing loans will prohibit less profitable enterprises from taking advantage of higher leverage compared to those with superior performance. Additionally, Myers and Majluf (1984) suggest that managers tend to be reluctant to issue equity when it is thought to be undervalued; as a result, investors tend to view the issuance of stocks as a bad signal, assuming that managers only offer equity to the public if it is fairly priced or overpriced. In other words, the signaling hypothesis finds that there is a positive association between leverage and company performance.

Among the five theories, only MM and Signaling support the positive relationship between leverage and firm performance, while the other three theories – Agency, Trade-off and Pecking order – support the negative relationship. Based on the above discussion the propositions 1a and 1b of the study are as follows:

Proposition 1a: Based on the MM and signaling theory leverage and firm value are positively related.

Proposition 1b: Based on the agency, trade-off and pecking order theories leverage and firm value are negatively related.

3.2 Capital Budgeting and Firm Valuation

In terms of capital budgeting, again, the concept of valuation is very important. A firm manages investments in new projects based on whether or not the value of the projects would be higher than the required investments (Gompers, 2022). Effective capital budgeting system leads to higher revenue base, increased efficiency, and better quality of the product (Abor, 2016). The relation between firm valuation and capital budgeting decisions is very strong: with effective and dynamic capital budgeting existing within a firm – where only positive NPV projects are selected – the value of the company's stock – controlling for capital structure and working capital decisions – increases or remains stable (Norton III, 2003).

Every investment opportunity is evaluated by the top management in terms of its value-enhancing potential, and connection with the corporate strategy (Titus Jr & Anderson, 2018) and long-term objectives (Davis, Schoorman & Donaldson, 2018); therefore, needless to say, it is an ongoing process. Managers must evaluate a number of factors in making investment decisions including: number one, estimation of the change in firm's future cash flows resulting from the investment in a project; and number two, evaluation of the risk related to these estimated cash flows (Peterson & Fabozzi, 2002). These cash flows are discounted at a rate that represents investors' assessments of the risk related to the level and timings of these cash flows. The cash flow risks are sales risk and operating risk. Sales risk is the risk related to the level of sales; whereas operating risk, arises related to the structure of operating costs (Berk, DeMarzo, & Harford, 2014).

There are various methods used such as net present value methods, Internal Rate of Return, modified rate of return method, risk-adjusted present value method, and others. These methods

strongly focus on the concept of valuation (Brealey, Myers, & Allen, 2017). Net present value method is considered as the most theoretically sound technique with the requirement to use project-specific cost of capital (Aneja, 2019). But the method does not appeal to the practitioners as it does not produce a single and an easily understood output. The internal rate of return (IRR) technique does produce a single number of profitability in percentage terms, and therefore it is more appealing to the practitioners (Abor, 2016). But, of course, it is theoretically weak as the method assumes that project's cash flows are discounted – rather than by the project's cost of capital – by the projects own rate of return. To account for such a weakness, a variant in Modified Internal Rate of Return has been proposed and frequently used in practice. MIRR incorporates cost of capital by treating it as the relevant reinvestment rate for the cash flows to compound until the life of the projects (Brigham & Ehrhardt, 2011). Hence the study posits the following proposition.

Proposition 2: Capital budgeting is strongly related to firm valuation.

3.3 Working Capital Management and Firm Valuation

3.3.1 Importance of Working Capital Management

The literature considers working capital management (WCM) as critical for a firm's entire financial management domain. As such (WCM) significantly effects the performance and value of the firm; it is mainly a function of the inventory, accounts receivable and accounts payable levels. Additions in working capital requires additional funds (Aktas & Croci, 2015). Corporate finance manager regard working capital management to be vastly critical for their firms' value. This is reflected from the fact that a significant level of firms' assets generally remains parked within the category of net working capital (Kieschnick & Moussawi, 2013). For example, (García- Teruel & Martínez- Solano, 2007) as well as (Deloof, 2003) made the argument whereby as the firm becomes more profitable - with profitability measured through metrics such as return on investment and equity - their management of working capital turns out to be sounding effective and efficient than otherwise. Nevertheless, the contemporary literature is somewhat deficient in examining the impact of WCM on firm profitability and firm valuation, with the help of the same data. Moreover, only a few studies have addressed the association or impact of changes in WC on the firms' risk (Le, 2019).

3.3.2 Excessive Investment and Firm Valuation

(Aktas & Croci, 2015) found an inverse relationship between firm value and levels of WC in firms carrying excessive levels of WC. Providing trade credit also affect sales positively because it allows for price discrimination, and builds strong relationship with customers (Wilson & Summers, 2002). Conversely, working capital overinvestment may contribute to value deterioration for the shareholders. As is the case with other types of investment, working capital increases require additional funds, which actually results in costs such as financing and opportunity costs. Moreover, excessive investment in NWC might hamper the firms from the implementation of value-creating investment projects within the short run (Kieschnick & Moussawi, 2013).

3.3.3 Financial Flexibility and Working Capital Management

When firms have excess working capital, an approach to shift the excessive investment in working capital in favor of corporate investment should translate into enhanced firm performance (Bates, Kahle, & Stulz, 2009). The firm becomes more financially flexible with freeing up of investment in NWC in the short run, and also in the long run because of less requirements to finance operations. Moreover, firms with financial flexibility maintain a stronger capacity to undertake investment opportunities (Denis & Sibilkov, 2009).

3.3.4 Negative Relationship between Working Capital and Firm Value

Then there are studies suggesting a strong inverse relationship for firms' value and the levels of working capital carried by them (De Almeida & Eid Jr., 2014); (Kieschnick & Moussawi, 2013); (Filbeck, Krueger, & Preece, 2007); (García- Teruel & Martínez- Solano, 2007); (Deloof, 2003); (Wang, 2002). This relationship between the net working capital and corporate investment is not always negative or strong. This happens only in the case of unnecessary NWC investment; as with already low levels of NWC the freed-up cash flows would not be sufficient at all to support corporate investment (Filbeck, Krueger, & Preece, 2007).

3.3.5 Optimal Allocation for Working Capital

Reflecting on the trade-off from short-term investments, previous researches discuss - what has been referred as optimal allocation – the association found out for the levels of working capital and firm value. The researchers such as (Ben-Nasr, 2016), (Aktas & Croci, 2015) and (Baños-Caballero, García-Teruel, & Martínez-Solano, 2014) discuss the relationship as being inverted u-shaped whereby the value or performance of firms maintaining comparatively larger (smaller) levels of working capital changes inversely to the amount of investment in working capital. Moreover, such a relationship observes a speedy reversion in the direction of the so-called optimal working capital allocations as and when there is a deviation from the firms (Chauhan, 2019).

Based on the above the current study suggest the following proposition.

Proposition 3: Working capital management is strongly related to firm valuation.

4. Conclusion

As the prime objective of corporate finance is to maximize the firm value, the linkage between the financial decisions and corporate strategy with the firm value is to be appreciated for ensuring value-increasing decisions and for undertaking desirable financial restructuring. The researchers have theorized connections between various theories related to capital structure, capital budgeting, and working capital management with the value of a firm. In the context of capital structure researchers have been trying to understand whether there is an optimal capital structure for an individual firm. The argument of debt having no relevance to the value of firm has led to a vast literature - extending, criticizing and modifying the original argument. Other researchers have identified imperfect conditions such as bankruptcy cost, agency cost, and tax shield, and have,

therefore, been aggressively supporting the existence of an optimal capital structure. The relation between firm valuation and capital budgeting decisions is very strong: with effective and dynamic capital budgeting enhances the value of the company's stock. There are various methods used for evaluating investment projects. These methods strongly focus on the concept of valuation. Net present value method is considered as the most theoretically sound technique. The internal rate of return is appealing to the practitioners, but it is theoretically weak. To account for such a weakness, a variant in Modified Internal Rate of Return incorporates cost of capital by treating it as the relevant reinvestment rate.

Corporate finance manager regard working capital management to be vastly critical for their firms' value. There is an inverse and inverted u-shaped relationship between firm value and levels of WC in firms carrying excessive levels of WC. Working capital overinvestment may contribute to value deterioration for the shareholders because it results in additional costs such as financing and opportunity costs. This relationship with net working capital corporate investment is not always negative or strong. Although, excessive investment, generally, in NWC might hamper the firms from the implementation of value-creating investment projects within the short run; however, it makes the firm more financially flexible to undertake investment opportunities. Of course, this approach, however, may not be employed with already low levels of NWC.

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