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Corporate Finance Insights

Decisions, Decisions

We've spent some time looking at a company's Market Value of Invested Capital ("MVIC") in the past few newsletters. It is surprising how often MVIC concepts come up in business, but we tend to talk about it in more general terms. MVIC is an important idea that represents the permanent capital of a company – both equity and debt. The groundwork for it was laid in the late 1950's and early 1960's by Franco Modigliani and Merton Miller with the following statement:

The value of a firm is independent of how it is financed.

It doesn't sound like much, but it has been one of the more influential ideas in corporate finance in the last 50 years. The leveraged buy-out ("LBO") boom of the 1980's, financial structure innovation in the 1990's and the growth of private equity firms up to the current date have all worked with this idea. The statement recognizes that financing comes in many forms and an owner has many choices about how to finance a company. So, while the value of the equity of a firm is affected by the level of debt, the overall value of the firm is independent of how the company is financed.

OK, now I am going to date myself. Back in the 1980's it wasn't uncommon to talk about a company's optimal capital structure. We used to spend time talking about ways that we could technically measure the point where a company balanced the tax savings from interest expense with the risks associated with too much debt (higher interest rates and greater chance of going bankrupt). But we don't talk about that much anymore. That's because the biggest part of the decision revolves around how much risk management wants to take-on, which is something that is seen differently by different people.

"I'm no expert, but I think it's some kind of cyber attack!"

Corporate Value Partners, Inc.

Corporate Value Partners is a corporate finance consulting firm. Services include:

- Preparing business valuations;
- Assisting with the acquisition or sale of a business, business unit or product line;
- Assisting with the placement of debt financing;
- Assisting creditors in corporate bankruptcies;
- Assisting attorneys with the financial aspects of lawsuits.

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Separate Decisions

An important part of the discussion is a general principle – keep the investment decision (or the decision about the value of something) separate from the financing decision (or the decision about how to finance the purchase). The risk is that we will incorrectly analyze a situation if we mix these two decisions. And we mix them all the time!

A common example is when we buy a car or house and focus on payments instead of the relative price of the car or house. "What's your monthly budget?" is a common question we are asked. If we focus on payments (which include how the purchase is financed) instead of relative value, we are much more likely to incorrectly analyze the situation and either over-value or under-value the asset we are purchasing.

More broadly, if we mix our investment and financing decisions we are setting ourselves up for much more volatility in the prices of assets we buy. We hear it often – interest rates are low so housing prices are going up. But what happens when interest rates go up? Or when credit availability is reduced? The market crash in 2008 highlighted this concept in stark terms. When market values and financing become tightly linked (as in the housing market) valuations can become more volatile.

I am not making a market timing call. I am not that smart. We do have to buy assets in a market and sometimes market prices are inflated, other times they are deflated. Each person has to make the call whether the market price is right for them or not. It is a risk/return trade-off. But it is important to remember that decisions about the value of an asset can be distorted when we build-in the effect that financing the purchase can have.

Corporate Value Partners has moved its office.

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