

# **3 FUNDAMENTAL TOPICS FOR CONTEMPORARY CORPORATE FINANCE**

*White paper*

Alberto Dell'Acqua

Director, Master in Corporate Finance  
Associate Professor of Practice  
SDA Bocconi School of Management

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### 3 FUNDAMENTAL TOPICS FOR CONTEMPORARY CORPORATE FINANCE

In my capacity as Director at the SDA Bocconi School of Management of the 1-year full time Master in Corporate Finance, which is considered a point of reference for the generation and exchange of new theoretical and practical knowledge in the corporate finance field, I feel the duty of reflection and elaboration on the topics that characterize today the discipline of reference. Corporate finance has undergone important changes in the last twenty years, which have shown the features of a constantly evolving subject to the detriment of those who, like many and myself, thought about it as a corpus of knowledge with irremovable cornerstones. The theoretical cornerstones have in fact remained intact but the constant and often radical changes that have taken place above all in the corporate perspective have also shaped the most consolidated and traditional approaches to corporate valuation and financing. In this *white paper* I intend to offer a summary of these main changes and the thematic ideas that have been derived to update the discipline from a contemporary perspective. I summarize the reflections and related considerations in three points which I believe identify the salient features of today's corporate finance.

**1. Market prices are the determining vector in the identification of the fair value.** In the traditional prospect, the "intrinsic value" of a company (or a portion of it), a concept that we can assimilate to the Anglo-Saxon term of *fair value*, must be kept well distinct from the "value in the market perspective", incorporated into the prices deriving from market transactions (share trading prices, IPOs, M&As). The central role of the capital markets, the strong increase in transactions on the capital of companies and the greater traceability of the same with ample data availability have made market prices the central element of the evaluation process. The focus on market prices strongly highlighted that the concept of "intrinsic value" originating from methodologies based on fundamentals (such as the Discounted Cash Flow valuation method, the income method, the EVA method) is an indicator of theoretical and virtual value, based on assumptions and perspectives influenced by elements of subjectivity. While the market price gives a more factual and real indication of the company value, albeit recognizing its greater variability. The strong changes that have taken place at the level of the economic sectors with innovative business models and competitive logic different from the canonical paradigms have weakened the link between some economic determinants and the value of companies. Therefore, even if for some it may seem a heresy, it is no longer clear that a company is worth according to its current cash flows, which could signal high profitability and liquidity but also a lack of propensity for medium-long term strategic investments. While the projected cash flows, being virtual, may never be realized in the size and the measure envisaged, and therefore can be reasonably considered unreliable for the quantification of today's value. In this perspective, it is rather fundamental to select and apply the market prices that can be found in the quotes of similar companies and comparable transactions, working carefully in the circumscription of peer comparables, in identifying the elements that imply premiums or discounts in market prices.<sup>1</sup> The greater data combined with the tools and the modern big data analysis techniques allow to dissect and filter the determinants of prices with more precision and to arrive, through a more sophisticated segmentation of the database, to a guided fair value indication from the complex of market transaction prices.

**2. Evaluation of innovative companies and start-ups with the application of multiples able to capture the basics of value.** There is no doubt that in the last twenty years there has been a strong push towards innovation, the creation of new businesses and the intensive exploitation of research and development findings. This trend has created new evaluation needs by posing to corporate finance professionals complex challenges for the identification of the value of companies that root their competitive advantage increasingly on intangible elements with respect to tangible and real activities. In many cases the responses were provided by appropriately re-adapting consolidated methodologies to the changed corporate characteristics, reshaping the DCF (as in the *3-stage model versions* or *DCF with exit multiple* or the *Risk-adjusted NPV*) or the multiples method (as in the case of the *venture capital method*). Some alternative methodologies, advanced by sophisticated

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<sup>1</sup> Such as majority acquisition vs. minority acquisitions, private placements vs. public transactions, the nature of an industrial vs. the one of a financial buyer.

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theoretical contributions and apparently coherent with the new physiognomies and business dynamics, such as the *Decision Tree Analysis* and *Real Options*, have proven to be largely inapplicable or limited to some areas (such as the Biotech and Pharma). The difficulties and the application limits of the traditional methodologies, although readapted, have brought out extemporaneous and "ad hoc" methods of evaluation, built on operational metrics, capable of at least solving many impasses by satisfying the much requested and universal requirement of simplicity. The result of this new "valuation case" has produced two different solutions that can be placed at opposite ends: traditional "readapted" methods, which maintain fidelity to the demand for a certain evaluation rigor and an articulated structure of the determinants of value, and "ad hoc" methodologies, which satisfy the requirement of speed and simplicity of application, albeit at the expense of the underlying economic construct. But *virtus in medium est*, the "truth lies in the middle", and the synthesis of equilibrium can be traced in the use as reference methodologies of two multiples that in many cases solve the arcane, combining simplicity and speed with the necessity of a link with some metrics that make up the value. The multiples in question are the EV/Sales and the EV/Total Assets. The EV/Sales reconnects the value to the development of a company turnover as the first measure of the validation of the product and service offered by the start up to the market. The underlying logic is that, sooner or later, the success of any company must pass through the market and the turnover is therefore the "litmus test" of this success. The multiple in question can also be used to evaluate companies in the preliminary stages of life, linking it to forecasted revenues then opportunely discounted for risk (in the typical logic of the *venture capital method*). The EV/Total Assets is a bit out of fashion but can solve many problems, especially in the case of the valuation of companies that invest heavily in intangible and innovative assets as the main sources of value (think of companies that develop a portfolio of patents or that develop prototypes or invest in new scientific findings). With this metric and using databases that collect it on comparable transactions it is possible to correctly evaluate developing companies, combining the simplicity of a metric that is easily understood and shared with the underlying logical-methodological motivations.

**3. The determination of the optimal financial structure is feasible, but its composition requires greater financial sophistication.** Many years ago, but not too many, a dozen or so, in the classrooms at the business school I used to illustrate the theory of the optimal financial structure elaborated by Modigliani-Miller but then conclude that its practical application was difficult and that it was practically impossible to calculate the optimal financial structure of a company. Therefore some participants in the Master courses showed me grimaces of disappointment, as if to say "why do you explain that if we are not able to apply it in practice?". For this reason, for a few years I have almost given up on dedicating sessions to the analysis of the optimal financial structure and I limited myself to briefly mentioning it as the theoretical foundation behind the definition of the cost of capital for a company. In recent years, however, the greater amount of data and the ease of access to them (in particular the estimates of *risk-free rate* and *market risk premium*) have allowed us to have all the inputs to calculate in a timely manner the optimal financial structure of a company. This practicality of calculation, although always clashing with a measure in constant change (the debt ratio of a company actually changes in every second), allows at least to measure the optimal point of the financial structure from a static point of view. In other words, we can then at least say what is the current debt on equity ratio that can minimize the cost of company capital today.<sup>2</sup> Solved this problem of application, which allows me to return to the classrooms of the business school with more bravado being able to provide participants with a practical feedback on the optimal financial structure, avoiding disappointment, other practical problems have then emerged for those involved in the management of the optimal capital structure. In fact, the great financial innovation of the last twenty years combined with a considerable development of the capital markets, has produced a great variety of financial instruments available for companies that go beyond the simple dichotomy between a debt instrument, periodically remunerated with interest and reimbursed according to a defined plan, and an equity instrument, that instead must be remunerated, but without obligation, with dividends and capital gains. Financial innovation has allowed us to generate a plurality of instruments that have assumed mixed characteristics, often referred to as "hybrids", and for which it is very difficult to attribute the quality of debt or equity. Consider, for example, convertible bonds, cum warrant bonds, equity instruments, leveraged loans and hybrid bonds used in complex financial transactions. This wide array of solutions allows us to design new and more sophisticated financial structures, in continuous evolution and with a continuous interchangeability between

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<sup>2</sup> A practical demonstration can be found in my book *Corporate Debt Management*, published by Egea, 2018.

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debt and equity, which obviously make it more difficult to say what the best financial structure in practice is. The classical theory has in fact always brought back the problem of the determination of the optimal financial structure to the cost of capital and to the search of its minimization. Once this problem has been solved, another problem has been immediately presented because the key variable that determines the optimal debt choices is no longer just the cost of capital, but today it is also the concept of financial flexibility. Therefore, cost of capital and financial flexibility now guide the choices of the optimal debt structure. The problem is complicated but it is also more interesting. Therefore, the answer to the quest for the optimal financial structure will remain half-completed. It will not suffice to provide only the formula for calculating the optimal debt, but we will have to accompany this with the description of the range of financial solutions that can be used today and that allow us to design multiple optimal financial structures.

Alongside these three themes, of more technical and professional relevance, another one is added which, in my opinion, has assumed an absolute pre-eminence in contemporary corporate finance. In fact, financial practice must be nourished, today more than ever, by a great contribution of ethical and moral values. Ethics is not, and should not be, just a further label to be set to dress up a different and more salable image, or even worse to cover misdeeds and reprehensible behavior. Corporate finance has in itself, in its DNA, a strong ethical matrix that consists in the commitment to make the necessary financial resources flow to the productive, creative and innovative areas that represent the nerve of the economic and social system and that can generate work and welfare. The valuation of a company or its financing, if aimed at the noble objective of supporting companies, the management, the entrepreneur or the startupper, in their efforts to develop economic activities, has a great social importance. Therefore, those who practice corporate finance today, although faced with greater technicalities, sophisticated and complex tools, logics that require greater knowledge and experience, must keep faith to their own roots of value, which is the very essence of this profession. The serious corporate finance practitioner should avoid falling into easy temptations that in the past have created serious damage not only to the financial system itself but also to the economy, the society and to people's life.