

Introduction to the world of Corporate Finance (Week 1-2)



Identify the goal of the firm

- Explain the various legal forms of business organisations
- Explain why it is important to ensure proper governance of financial management

Fundamentals of Financial Management

- The Role of Financial Management (FM)

FM is the management of all the process associated with the efficient acquisition and deployment of both short & long run resources.



“Goal of the firm”

“Maximise Shareholder’s wealth”

- FM stresses the efficient use of the finance in terms of:
- “Financial Planning & Financial Control”
Financial Planning (FP) – is the establishment of objectives and the formulation, evaluation and selection of policies, strategies, tactics and actions required to achieve them. It is long-term /strategic planning and short-term operation planning.

- Broadly speaking:

FM will need to plan to ensure that enough funding is available at the right time to meet the needs of the organisation.

Objectives of private sector companies

- Firms only exist to maximise the profits so that the stakeholders will be rewarded with reasonable dividends.



How are the wealth of shareholders and the value of a company measured

- If the financial objective of a company is to maximise the value of the company, and in particular the value of its ordinary shares, we need to be able to put values on a company and its shares. How do we do it?

Methods of valuing the business

- a) Balance sheet valuation, with assets valued on a going concern basis.
- b) Break- up basis
- c) Market values

Non-financial objectives (NFO)

- Examples:
 - a) The welfare of employees
 - b) The welfare of management
 - c) The welfare of society as a whole
 - d) The provision of a certain standard or level of service
 - e) The fulfilment of responsibilities towards customers & suppliers

Value for Money

- VFM means providing a service in a way which is economical, efficient and effective.



Question Time

- Which of the following areas of decision-making would be the responsibilities of a financial manager?
- Investment
- Financing
- Dividends
- Marketing



Financial Statement Analysis

(Week 3-4)

- The most important goal of FM is to be able to 'maximise the share price' in the long-run and not to maximise the net profit or the Earnings per share (EPS). Financial statements (FS) report both the firm's position at a point in time & on its operations over a period of time. However, the real purpose of preparing the FS is to enable the entity to be able to predict the future earnings & dividends.
- To help the Company to identify its strengths and its failures such that positive measures can be taken to put the house in order.

Ratio analysis (RA)

- RA is a technique that is employed to evaluate the performance of a business, by comparing the figures from the past.
- Types of ratios
 - Profitability ratios
 - Liquidity ratios
 - Efficiency ratios
 - Gearing ratios
 - Investment ratios



Financial ratios

Profitability ratio

- 1) Gross profit/ sales
- 2) Net profit /sales
- 3) Expenses/sales
- 4) Return on capital employed (ROCE)
- 5) Return on shareholders' equity

Liquidity ratios

- 6) Current ratio
- 7) Acid- test ratio

Efficiency ratios

- 7) Debtors to sales
- 8) Creditors to purchases

9) Stock –turnover ratio

10) Fixed asset turnover ratio

Gearing ratio



11) Debt / Capital employed

12) Debt / Shareholders' equity

Investment ratios

13) Price–Earning ratio

14) Earnings per share

15) Dividend cover

16) Interest cover



Limitations of ratio analysis

- 1) Many large firms operate different divisions industries, and for such companies it is difficult to develop a meaningful set of industry averages. Initiate some form of benchmarking.
- 2) Most firms want to be better than average, so merely attaining average performance is not necessarily good.
- 3) Seasonal factors can also distort financial statement analysis (RA).
- 4) Any form of inflation (creeping) can also distort the FS.
- 5) Firms can employ “window dressing” techniques to make their FS look attractive (over-statement of figures).
- 6) Different accounting practices can distort value – added comparisons.

Financing a business

Sources of finance

(Week 5 – 7)

- Here, we examine the various aspects of financing a business. We begin by considering the various sources of finance available to a business.
- Once we have considered the main sources of finance, we shall go on to examine various aspects of the capital markets (including the stock exchange) and the way in which share capital can be issued.

Objective

- Identify the main sources of finance available to a business.
- Explain the role of the stock exchange
- Identify the ways in which smaller business may seek to raise finance.
- Identify the ways in which the share capital can be issued.

Sources of finance

- When considering the various sources of finance for a business, it is useful to distinguish between external & internal sources of finance.
- Within each of these two categories, we can further distinguish between long-term and short-term sources. See appendix 12.1353

Long-term sources of external finance

The main categories of long-term external finance are:

- Ordinary shares;
- Preference shares;
- Loans;
- Leases (finance)



Ordinary Shares

- Ordinary shares (OS) form the backbone of the financial structure of a business.
- Ordinary share capital represents the business's risk capital. The OS do not get a fixed rate of dividend.
- The normal rule would be to pay a dividend to the OS only after the preference shareholders and lenders have been paid their dues (preference dividend and loan interest).

Preference shares (PS)

- PS offer investors a lower level of risk than OS. Provided there are sufficient profits available, preference shares will normally be given a fixed rate of dividend each year, and preference dividends will be paid before ordinary dividends are paid. In the event of receivership, PS may usually be given priority over claims of OS.

Loans & Debentures

- Many businesses rely on loans as well as share capital to finance their business operations.

Security for a loan may take the form of a fixed charge on particular assets of the business (freehold land and property are the best examples) or a floating charge on the whole of its assets.



Gearing & the LT financing decision

- It is important to appreciate the effect of gearing on the business.



- The level of gearing can also determine the returns to the OS.

Short-term sources of finance

They are:

Bank overdraft

Debt factoring

Invoice discounting

- Reducing stock levels
- Delaying payments to creditors.

Internal sources of financing

Retained profits

Tighter credit control



The Role of the stock exchange

- Here, we examine the role of the stock exchange (SE) in providing finance for the business. The SE acts as an important primary and secondary market in capital for businesses.
- As a primary market, its function is to enable businesses to raise finance for businesses.

Venture capitalists provide LT capital in the form of share and loan finance for different situations

Start-up capital

Growth capital



Buy-in

Share purchase capital

Recovery capital

Capital Investment Appraisal (capital budgeting) (Week 8-9)

This is one of the most important areas of FM, as investment decisions are made. The reason is that decisions involve investments in new machinery, new plant, property and similar long term assets and also in the share of businesses, irrespective of whether the investment is for an individual or a company.

Objectives of CIA

- Understand the nature and importance of capital budgeting
- Identify the main methods of CIA
- How to apply each of the different methods
- Discuss the relative merits and demerits of each method

The nature of investment decisions

Investment involves the making of an outlay of something of an economic value, usually cash, which is expected to yield useful economic benefits to the potential investor, at some point in time.

The ideal situation should be that the cost incurred should result in some benefits, which should make the economic decision worthwhile.

Investment decisions tend to be crucial to the business because:

- Large amounts of resources are often involved. In short, many investments today are in big amounts and as such we cannot afford to make a mistake. If a mistake is made, it can be catastrophic.

It is often difficult and / or expensive to 'save out' an investment, once it has been done, e.g., hotel.

Methods of investment appraisal

- Investment decisions are the key to the success of the entity and it is of utmost importance to ensure that proper screening of investment proposals are made. It is in this context that we use the appropriate methods to evaluate the viability of the projects to be undertaken.

- Research has shown that there are basically four methods used throughout the world when evaluating investment opportunities.

They are:



- 1) Accounting rate of return (ARR)
- 2) Payback period (PP)
- 3) Net Present Value (NPV)
- 4) Internal rate of return (IRR)

- It is possible to find that some businesses use variants of these four methods, and in some cases that the smaller ones use ‘gut feeling’ of the managers. However, most businesses use one of the four methods.

Accounting rate of return (ARR)

- The ARR takes the average of the accounting profits that the investment will generate and expressing it in percentage.

$$\text{ARR} = \frac{\text{Average of annual profit}}{\text{Average investment to earn that profit}} * 100$$

- The ARR and the Return on capital employed (ROCE) ratio take the same approach to performance measurement, in that they both relate accounting profits to the cost of investment to generate that profit. We can say that the ARR is an other way that assesses the potential performance of a particular investment.

- Payback Period (PP) method seems to go some way to overcoming the timing problem of ARR, or at least at first glance, it does. The PP is the length of time it takes for the initial investment to be recouped or recovered.
- The PP has some advantages:
 - It is easy and simple to calculate
 - It is easily understood by managers
 - It uses cash-flows rather than accounting profits

Disadvantages:

It ignores the 'time value of money'

It ignores the timing of the cash-flows.

Net Present value (NPV)

(The most superior of methods)

- The problems in the ARR & PP resulted in the movement towards the DCF method. The “Discounted Cash-Flow” (DCF) enabled the world of FM to reach a more reliable approach, broken into the NPV and the IRR method.

Why the NPV is superior to ARR & PP

The reasons are:

- The timing of the cash-flows
- The whole of the relevant cash-flows
- The objectives of the business.

The decision rule is:

Accept the project that gives the highest NPV and reject the project that has the lowest NPV or has negative NPV.

IRR

- This is the last of the four methods of CIA that are found in practice. It is, in fact, closely connected to the NPV method, in that, like NPV, it also involves discounting the future cash-flows. The IRR of a particular investment is the discount rate that gives a zero NPV.

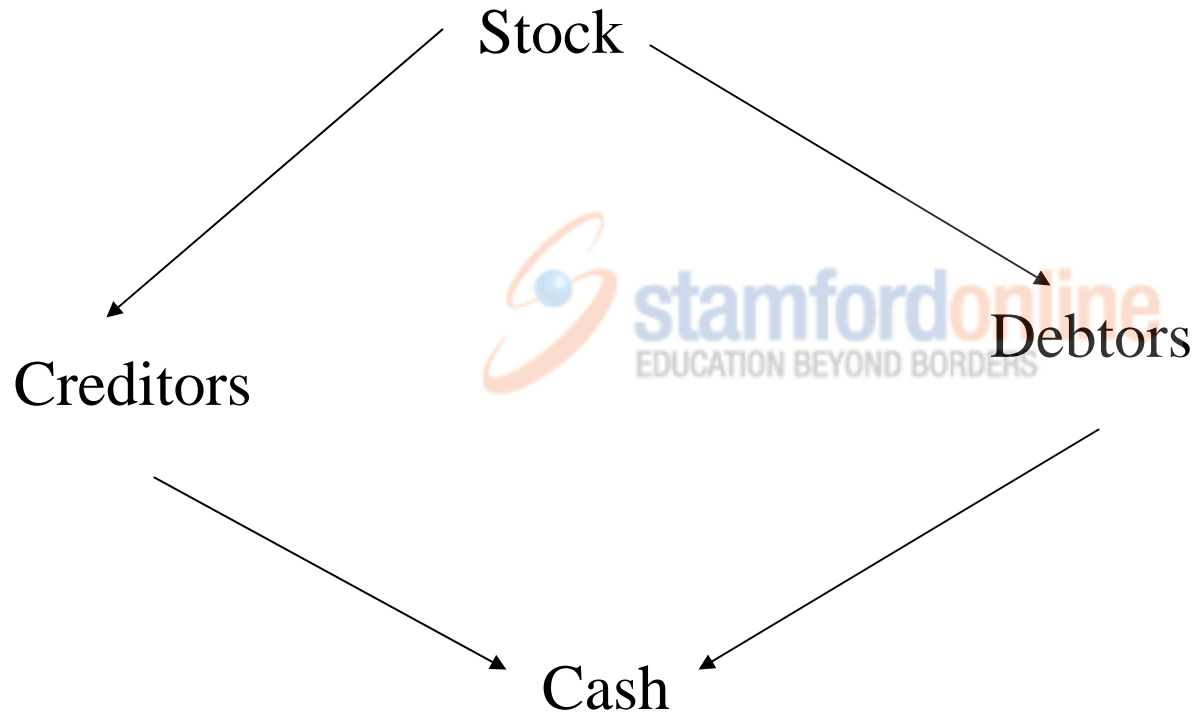
Working Capital Management (Week 10-13)

- The success or failure of a business does depend on the ability of the management to manage the working capital. This is, indeed, the heart of the business which will propel the business operations of all departments to achieve the required objective. Each element of the WC will be a vital link to the final destination.

The nature and purpose of Working Capital (WC)

- Working capital is usually defined as Current assets less current liabilities. Current assets (CA) consists of stock, debtors, bank & cash. Current liabilities consists of creditors, bank overdraft, dividends & corporation tax.

Working Capital cycle (WCC)



The components of the WC varies from industries to industries. For some business, the investment in WC can be very large e.g. a textile company as opposed to a service related industry.

WC represents a net investment in short-term assets. These assets are continually flowing into and out of the business, and are vital for the day to day operations.

The management of WC is an essential part of the business's short-term planning process. It is necessary for management to decide how much of each element should be maintained. The problem will be brought to light when hiccups take place when the components have been casually understood.

Management must be aware of the costs associated with these elements, particularly if stock is in short supply, for example. To this end, the potential benefits must be weighed against the likely costs in order to achieve the optimum investment.

Quiz 1

- What kind of changes in the environment might lead to a decision to alter the level of investment in WC.

- Answer:

Changes in I R

Changes in M d

Changes in S

Changes in the P



Management of Working Capital

- Stock

Management of stock includes some of the following:

- Being able to identify the E.O.Q.
- Set the minimum & maximum re-order levels
- Use budgets to plan
- Need to maintain reliable stock records
- use ratio analysis to evaluate the figures from one period to another
- Consider JIT and MRP solutions
- Ensure proper security controls systems are in place

Control of Debtors

- Use the 5 C's principle
Capital, capacity, character, condition & collateral.
Cost of allowing credit:
 - lost interest
 - lost of purchasing power
 - administration cost
 - cost of assessing customer creditworthiness
 - bad debts
 - cash discounts (if prompt payment)Cost of not giving credit
 - loss of customer goodwill

Management of cash

- The manner in which the “cash” is used will ensure the direction in which the organisation is moving.

Costs of holding insufficient cash:

- Costs of borrowing (if a need arises)
- inability to claim cash discounts
- loss of good opportunities
- loss of supplier goodwill



Steps to Effective cash management:

- receiving cash from debtor's faster than having to pay creditors.
- Optimum 'Cash operating cycle;
- transmit cash promptly
- bank in frequently
- establish a cash –management policy
- make use of bank-overdraft effectively

Effective use of trade creditors

- Trade credit arises from the fact that most businesses buy their goods and service requirements on credit. Trade creditors are an important source of finance for most business.



Steps:

- establish a policy when it comes to trade creditors
- exploit free credit as far as possible
- use accounting ratios