

Corporate Finance (Corporate Investment Appraisal)

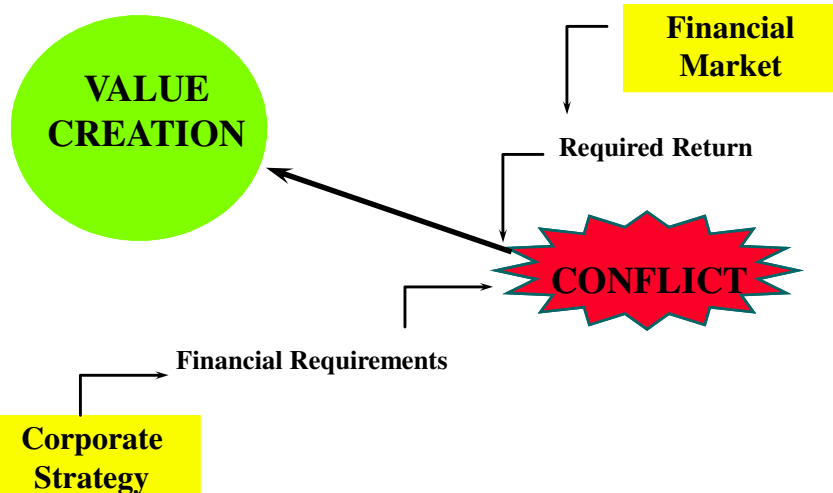
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Course Outline

- Introduction
- Assessing Business Performance
 - Case study assigned for evaluation: UNILEVER, PLC
- Estimating the Cost of Capital
 - Case Study: TELUS
 - Case study assigned for evaluation: APPOLO TYRES
- Capital Budgeting
 - Case Study: New Heritage Doll
- Designing a Capital Structure
 - Case Study: RM Furniture Kraft (A) and (B)
- Dividend policy and share repurchasing
 - Case Study: Strong Motors

1. INTRODUCTION

The Role of Finance in Corporations



The fundamental principle of finance

Net Present Value (NPV) is the difference between the present value of cash inflows and the present value of cash outflows:

$$NPV = -I_0 + \sum_{i=1}^n \frac{CF_i}{(1+k)^i}$$

Where

CF_i = net cash (inflow-outflow) during the period i

I_0 = total initial investment expenses

k = discount rate, and

i = number of time periods

NPV is used in most strategic decisions (e.g. capital budgeting to analyze the profitability of an investment or project, new issues, Debt tender offer) as well as operational decisions (discounts to customer for collecting in advance).

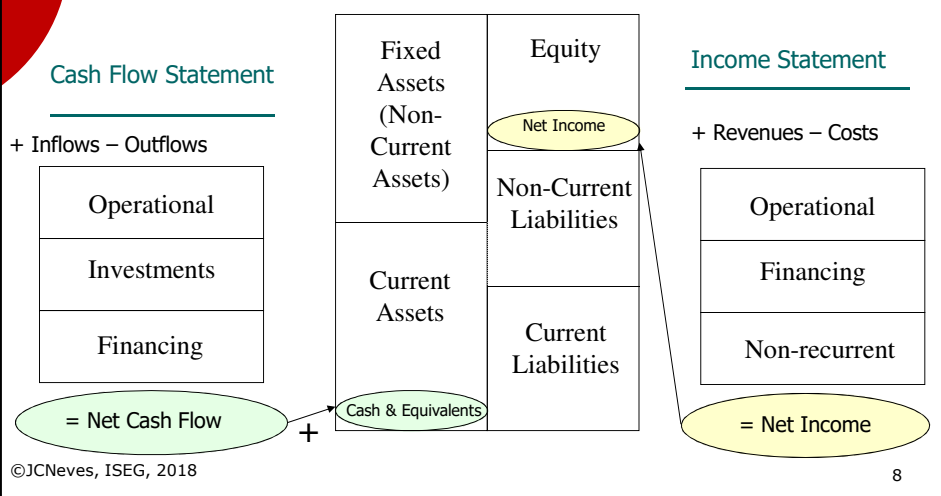
2. ASSESSING PERFORMANCE

2. Assessing Performance Outline

1. The managerial balance sheet
 2. Traditional measures of liquidity
 3. Liquidity based on the funding structure of working capital
 4. Improving liquidity through better management of the operating cycle
 5. Financing strategies
 6. Assessing profitability
 7. Assessing operating and financial risk
 8. Analyze of shareholder's value creation
- Case study assigned for evaluation: UNILEVER, PLC

Relations between Financial Statements

Balance Sheet or Financial Position Statement



The Accounting Balance Sheet Structure

ASSETS	Noncurrent (or Fixed) Assets	Shareholders Equity	LIABILITIES	LONG-TERM FINANCING
		Noncurrent (or long-term) Liabilities		
	Current (or short-term) Assets	Current (or short-term) Liabilities		

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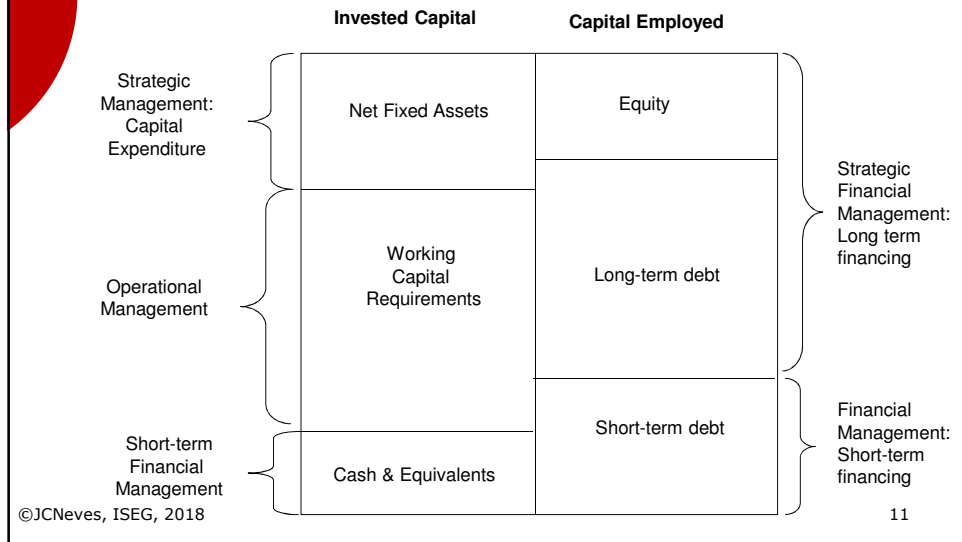
The Managerial Balance Sheet Structure

Management Cycle	Uses of Funds	Sources of Funds	Management Cycle
Strategic Management: Capital Expenditure	Fixed Assets	Equity	Strategic Financial Management: Long term financing
		Long-Term Debt	
Operational Management	Operating Assets = Inventories + Trade receivables + Tax receivables + Prepaid expenses + Other operational assets	Operating Liabilities	Operational Management
		=	
		Trade payables	
		+ Tax payables + Accrued expenses + Other operational liabilities	
Short-term Financial Management	Cash & Equivalents	Short-term Debt	Financial Management: Short-term financing

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The Managerial Balance Sheet Reorganized



The coherence with capital budgeting and company valuation

Capital Budgeting Coherence:

$$\text{Capital Expenditure} = \text{Fixed Assets Investment} + \Delta \text{Working Capital Requirements} + \text{Minimum Cash}$$

Company Valuation Coherence:

$$\text{Enterprise Value} = \text{Market Value of Equity} + \text{Market Value of Debt} - \text{Cash \& Equivalents}$$

The use of ratios when assessing performance

- Raises questions about the time-line performance of the company
- Better understanding of the effect of strategic decisions
- Evaluation of the performance in comparison to competitors
- *No absolute interpretation. Requires a benchmarking:*
 - Capital return vs. cost of capital
 - Actual ratios vs. Historical ratios
 - Actual ratios vs. Objectives or Budget based ratios
 - Company ratios vs. competitor or sample of competitors ratios
 - Company ratios vs. Industry or Sector ratios

Balance Sheet Structure Analysis: Financial Strength

Financial Structure Analysis Based on the Accounting BS

- $Debt\ ratio = \frac{Liabilities}{Equity+Liabilities}$
- $Debt\ structure = \frac{Short-term\ liabilities}{Liabilities}$
- $Assets\ Structure = \frac{Net\ fixed\ assets}{Total\ assets}$

Capital Structure Analysis Based on the Managerial BS

- $Debt\ ratio = \frac{Debt}{Equity+Debt}$
- $Debt\ structure = \frac{Short-term\ debt}{Debt}$

Other measures of financial strength

In order to have a better understanding of the company's capabilities to repay debt you may use ratios that include income items or cash based items, particularly recurring items:

- Typical ratios used in the market to analyze debt repayment capability:

$$\text{Net debt to EBITDA} = \frac{\text{Debt} - \text{Cash \& equivalents}}{\text{EBITDA}}$$
$$\text{Coverage of short term debt} = \frac{\text{EBITDA}}{\text{short term debt}}$$

I prefer to use the following ratios to have a better view on the capabilities of debt reimbursement:

- *Estimated repayment (number of years)* = $\frac{\text{Debt} - \text{Cash \& equivalents}}{\text{Recurring Cash Earnings}}$
- *Coverage of short debt* = $\frac{\text{Recurring Cash Earnings}}{\text{short term debt}}$

Additional ratios of financial strength analysis

- The coverage of interest expenses uses the following ratios:

$$\text{Times interest earnings} = \frac{\text{Operating income}}{\text{Financial expenses}}$$

- Or if you prefer a cash basis ratio:

$$\text{Interest coverage} = \frac{\text{EBITDA}}{\text{Financial expenses}}$$

Traditional Measures of Liquidity: Based on Accounting Balance Sheet

- $Current\ ratio = \frac{Current\ assets}{Current\ liabilities}$
- $Acid\ test\ or\ quick\ ratio = \frac{Cash\ \&\ equivalents + Accounts\ receivables + Short\ term\ investments}{Current\ liabilities}$
- $Cash\ ratio = \frac{Cash\ \&\ Equivalents}{Current\ liabilities}$
- A less conventional ratio:
 - $Cash\ in\ days\ of\ sales = \frac{Cash\ \&\ equivalents}{Sales\ revenue} \times 365$

The cash & equivalents are seen here as a buffer of security for potential delays of collection period from customers.

Liquidity based on the funding structure of working capital

$$NLB = WC - WCR \geq 0$$

$$\frac{NLB}{S} = \frac{WC}{S} - \frac{WCR}{S}$$

WC - Working Capital

WCR - Working Capital Requirements

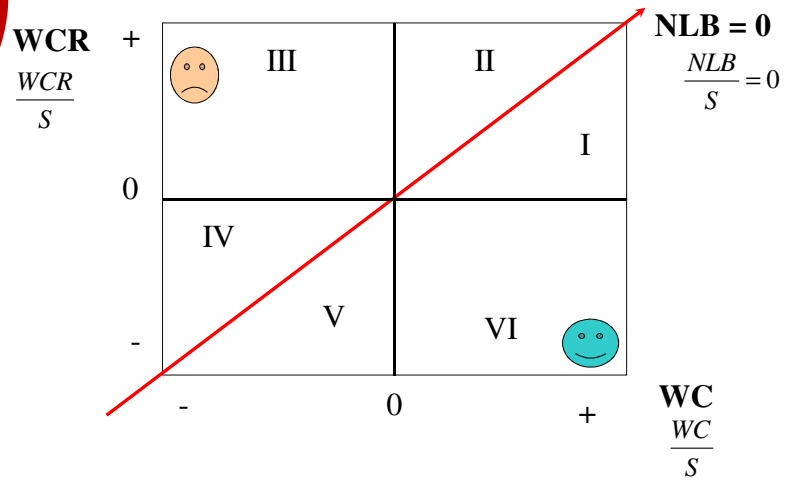
NLB - Net Liquid Balance

$WC = Long\ term\ financing - Net\ fixed\ assets$
Long-term financing is equity plus long-term liabilities.

Working capital requirements (WCR) is the amount of working capital required by operations:

$$WCR = Operating\ Assets - Operating\ Liabilities$$

Liquidity matrix



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Financial Policy

Strategic Finance:

- Capital Budgeting Policy
- Capital Structure Policy
- Dividends Policy

Working Capital

-

Operational management:

- Net Trade Cycle

Working Capital Requirements

=

Cash Management

Net Liquid Balance

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Levels of decision

	WC	-	WCR	=	NLB
Board of Directors	Policy Maker & Decision		Policy Maker		Overall Policy Is Critical
Operational Managers	Advisor and Execution		Decision and Execution		Execution is critical
Financial Director	Advisor and Execution		Advisory and Control		Decision and Execution

Analysis of Financial Strength and Liquidity

- What is the liquidity of the company?
- Is the financial Structure adequate?
- Is the financing policy consistent with the strategy, growth, risk and dividends policy?
- Any areas that need change of policy?