

 CENGAGE

SIXTH EDITION

Gabriel Hawawini Claude Viallet

FINANCE FOR EXECUTIVES

MANAGING FOR VALUE CREATION



83,68	1,17	1,42
36,18	0,75	2,11
87,78	2,11	2,46
39,31	0,49	1,26
91,55	0,20	0,23
87,78	2,11	2,46
39,31	0,49	1,26
83,68	1,17	1,42

SOME NOTATIONS

ADF	Annuity discount factor	MVA	Market value added
APR	Annual percentage rate	MVR	Market value at risk
APV	Adjusted present value	NOPAT	Net operating profit after tax
β_U	Levered beta (also called equity or market beta)	NOPLAT	Net operating profit less adjusted tax
β_L	Unlevered beta (also called asset beta)	NPV	Net present value
C	Call price	P	Price of a bond, a stock, or a put option
CAPM	Capital asset pricing model	PBR	Price-to-book ratio
CAPEX	Capital expenditures	PI	Profitability index
CF	Cash flow	PER	Price earnings ratio
CFE	Cash flow to equity holders	PPP	Purchasing power parity
CML	Capital market line	PV	Present value
CP	Coupon payment (of a bond)	ρ_{ij}	Correlation coefficient between asset i and asset j returns
Cov(R_i, R_j)	Covariance between asset i and asset j returns	R_F	Risk-free rate
D	Debt value	R_M	Return on the market portfolio
DCF	Discounted cash flow	ROCE	Return on capital employed
Δ	Option's delta or hedge ratio	ROE	Return on equity
DDM	Dividend discount model	ROIC	Return on invested capital
DF	Discount factor	SGR	Self-sustainable growth rate
DPS	Dividend per share	σ_i	Standard deviation of asset i returns (volatility)
E	Equity value	σ_i^2	Variance of asset i returns (variability)
EAT	Earnings after tax	σ_{ij}	Covariance between asset i and asset j returns
EBIT	Earnings before interest and tax	SML	Security market line
EBITDA	Earnings before interest, tax, depreciation and amortization	T	Time in years
EIL	Efficient investment line	T_C	Corporate tax rate
EPS	Earnings per share	TV	Terminal value
$E(R_i)$	Expected return of asset i	V_E	Value of the firm's equity (same as E)
EV	Enterprise value	V_L	Value of the firm with debt (levered value)
EVA®	Economic value added	V_U	Value of the firm without debt (unlevered value)
F	Face value of a bond	Var (R_i)	Variance of asset i returns (same as σ_i^2)
FCF	Free cash flow	WCR	Working capital requirement
IPO	Initial public offering	WACC	Weighted average cost of capital
ITS	Interest tax shield	X	Exercise or strike price of an option
k_D	Cost of debt	y	Yield to maturity (of a bond)
k_E	Cost of equity		
LBO	Leverage buyout		

SOME USEFUL FORMULAS

1. **Discount factor (Chapter 2, equation 2.3)**

Value of \$1 to be received at time T, discounted to the present at the rate k

$$DF_{T,k} = \frac{\$1}{(1+k)^T} = \left(\frac{\$1}{1+k} \right)^T = \$1 \times (1+k)^{-T}$$

2. **Present value (Chapter 2)**

Value today of a T-year cash-flow stream discounted at rate k

$$PV = [CF_1 \times DF_{1,k}] + \dots [CF_t \times DF_{t,k}] + \dots + [CF_T \times DF_{T,k}]$$

3. **Present value of a perpetuity (Chapter 2, equation 2.6)**

The present value of an infinite stream of identical cash flows discounted at rate k

$$PV = \frac{CF}{k}$$

4. **Present value of a constant growing perpetuity (Chapter 2, equation 2.9)**

Present value, at rate k, of a perpetuity growing at the constant rate g where the cash flow at the end of the first year is CF₁

$$PV = \frac{CF_1}{k-g} \text{ with } k > g$$

5. **Present value of an annuity (Chapter 2, equation 2.11)**

Present value of a T-year annuity at a rate k with a cash flow CF

$$PV = CF \times ADF_{T,k} \text{ with}$$

$$ADF_{T,k} = \frac{1}{k} \left[1 - \frac{1}{(1+k)^T} \right]$$

6. **Sharpe ratio of asset i (Chapter 3, equation 3.8)**

$$\text{Sharpe ratio of asset } i = \frac{E(R_i) - R_F}{\sigma_i}$$

7. **Beta coefficient of stock i (Chapter 3, equation 3.11)**

$$\beta_i = \frac{\text{Cov}(R_i, R_M)}{\text{Var}(R_M)} = \frac{\rho_{iM} \sigma_i \sigma_M}{\sigma_M^2} = \rho_{iM} \left(\frac{\sigma_i}{\sigma_M} \right)$$

8. **Capital asset pricing model (Chapter 3, equation 3.13a, Chapter 10, equation 10.11a and Chapter 12, equation 12.10)**

$$E(R_i) = R_F + [E(R_M) - R_F] \beta_i$$

9. **Invested capital (Chapter 4, equation 4.5)**

$$\text{Invested capital} = \text{Cash} + \text{Working capital requirement} + \text{Net fixed assets}$$

10. **Capital employed (Chapter 4, equation 4.6)**

$$\text{Capital employed} = \text{Short-term debt} + \text{Long-term debt} + \text{Owners' equity}$$

SOME USEFUL FORMULAS

11. Working capital requirement (Chapter 4, equation 4.7)

$$\begin{aligned} \text{WCR} &= [\text{Accounts receivable} + \text{Inventories} + \text{Prepaid expenses}] \\ &\quad - [\text{Accounts payable} + \text{Net accruals}] \end{aligned}$$

12. Earnings before interest, tax, depreciation, and amortization (Chapter 4, equation 4.10)

$$\text{EBITDA} = \text{EBIT} + \text{Depreciation expense} + \text{Amortization expense}$$

13. Free cash flow (Chapter 4, equation 4.15)

$$\begin{aligned} \text{FCF} &= \text{EBIT}(1 - T_c) + \text{Depreciation expense} \\ &\quad - \Delta\text{WCR} - \text{Capital expenditures (net of disposals)} \end{aligned}$$

14. Return on equity (Chapter 6, equation 6.1)

$$\text{ROE} = \frac{\text{Earnings after tax}}{\text{Owners' equity}}$$

15. Return on invested capital before tax (Chapter 6, equation 6.4)

$$\text{ROIC}_{\text{BT}} = \frac{\text{EBIT}}{\text{Invested capital}} = \frac{\text{EBIT}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Invested capital}}$$

16. The structure of a firm's return on equity (Chapter 6, equation 6.9)

$$\text{ROE} = \frac{\text{EBIT}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Invested capital}} \times \frac{\text{EBT}}{\text{EBIT}} \times \frac{\text{Invested capital}}{\text{Owners' equity}} \times \frac{\text{EAT}}{\text{EBT}}$$

17. Self-sustainable growth rate (Chapter 6, equation 6.12)

$$\text{SGR} = \text{Profit retention rate} \times \text{Return on equity}$$

18. Net present value (Chapter 7)

$$\begin{aligned} \text{NPV}(k, T) &= -\text{CF}_0 + \frac{\text{CF}_1}{(1+k)^1} + \frac{\text{CF}_2}{(1+k)^2} + \dots + \frac{\text{CF}_t}{(1+k)^t} + \dots + \frac{\text{CF}_T}{(1+k)^T} \\ &= -\text{CF}_0 + \sum_{t=1}^T \frac{\text{CF}_t}{(1+k)^t} \end{aligned}$$

19. Bond price (Chapter 10, equation 10.2)

$$P = \frac{\text{CP}_1}{(1+y)} + \frac{\text{CP}_2}{(1+y)^2} + \dots + \frac{\text{CP}_T + F}{(1+y)^T}$$

20. Share price (Chapter 10, equation 10.9)

$$P = \frac{\text{DPS}_1}{(1+k_E)} + \frac{\text{DPS}_2}{(1+k_E)^2} + \dots + \frac{\text{DPS}_t}{(1+k_E)^t} + \dots$$

21. Constant dividend growth model (Chapter 10, equation 10.10)

$$P = \frac{\text{DPS}_1}{k_E - g}$$

22. Enterprise value and Equity value (Chapter 10, equation 10.13)

Enterprise Value (EV) = Equity Value + Debt – Cash and other financial assets

$$\text{Equity Value (V}_E\text{)} = \text{Enterprise Value (EV)} + \text{Cash} - \text{Debt}$$

23. Equity (levered) beta (Chapter 12, equation 12.6)

$$\beta_{\text{equity}} = \beta_{\text{asset}} \left[1 + \frac{\text{Debt}}{\text{Equity}} \right]$$

24. Weighted average cost of capital (Chapter 12, equation 12.12)

$$\text{WACC} = k_D(1 - T_C) \frac{D}{E + D} + k_E \frac{E}{E + D}$$

25. Interest tax shield (Chapter 13, equation 13.3)

$$\text{ITS} = T_C \times k_D \times D$$

26. Market value of a levered firm (Chapter 13, equation 13.4)

$$V_L = V_U + \text{PV}_{\text{ITS}}$$

27. Market value at risk (Chapter 15, equation 15.1)

$$\begin{aligned} \text{MVR} &= [\text{Reduction in the firm's value if the risk will occur}] \\ &\times [\text{Probability that the risk will occur}] \end{aligned}$$

28. Put-call parity relationship (Chapter 16, equation 16.5)

$$P_0 = C_0 + Xe^{-R_f T} - S_0$$

29. Black-Scholes option pricing formula (Chapter 16, equation 16.6 and 16.7)

$$\begin{aligned} C_0(\text{call option}) &= S_0 N(d_1) - Xe^{-R_f T} N(d_2) \\ P_0(\text{put option}) &= Xe^{-R_f T} [1 - N(d_2)] - S_0 [1 - N(d_1)] \end{aligned}$$

30. Market value added (Chapter 18, equation 18.1)

Market value added (MVA) = Market value of capital – Capital employed

31. Return on invested capital (Chapter 18)

$$\text{ROIC} = \frac{\text{NOPAT}}{\text{Invested capital}} = \frac{\text{EBIT}(1 - T_C)}{\text{Invested capital}}$$

32. Economic value added (Chapter 18, equation 18.6)

$$\text{EVA} = [\text{Return spread}] \times \text{Invested capital} = [\text{ROIC} - \text{WACC}] \times \text{Invested capital}$$

FINANCE FOR EXECUTIVES

Managing for Value Creation



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INSEAD

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To our spouses, children and grandchildren, with love and gratitude.

GH and CV, 2018

*This edition of Finance for Executives is dedicated to the memory of
Claude Viallet, my friend, colleague and co-author.*

Gabriel Hawawini, 2019

BRIEF CONTENTS

PART I	FINANCIAL CONCEPTS AND TECHNIQUES	1
CHAPTER 1	Financial Management and Value Creation: An Overview	1
CHAPTER 2	The Time Value of Money	31
CHAPTER 3	Risk and Return	53
PART II	ASSESSING BUSINESS PERFORMANCE	99
CHAPTER 4	Interpreting Financial Statements	99
CHAPTER 5	Analyzing Operational Efficiency and Liquidity	153
CHAPTER 6	Analyzing Profitability, Risk, and Growth	189
PART III	MAKING INVESTMENT DECISIONS	227
CHAPTER 7	Using the Net Present Value Rule to Make Value-Creating Investment Decisions	227
CHAPTER 8	Alternatives to the Net Present Value Rule	261
CHAPTER 9	Identifying and Estimating a Project's Cash Flows	287
PART IV	MAKING FINANCING DECISIONS	315
CHAPTER 10	Valuing Bonds and Stocks	315
CHAPTER 11	Raising Capital and Paying Out Cash	359
CHAPTER 12	Estimating the Cost of Capital	411
CHAPTER 13	Designing a Capital Structure	445
PART V	MAKING BUSINESS DECISIONS	487
CHAPTER 14	Valuing and Acquiring a Business	487
CHAPTER 15	Managing Corporate Risk	531
CHAPTER 16	Understanding Forward, Futures, and Options and Their Contribution to Corporate Finance	555
CHAPTER 17	Making International Business Decisions	609
CHAPTER 18	Managing for Value Creation	653
	Answers to Self-Test Questions	691
	Glossary	741
	Credits	763
	Index	765

CONTENTS

PART I	FINANCIAL CONCEPTS AND TECHNIQUES	1
CHAPTER 1	Financial Management and Value Creation: An Overview	1
	The Key Question: Will Your Decision Create Value?	2
	<i>The Importance of Managing for Value Creation</i>	3
	<i>The Saturn Story</i>	4
	The Fundamental Finance Principle	5
	<i>Measuring Value Creation with Net Present Value</i>	5
	<i>Only Cash Matters</i>	6
	<i>Discount Rates</i>	6
	<i>A Proposal's Cost of Capital</i>	7
	Applying the Fundamental Finance Principle	8
	<i>The Capital Budgeting Decision</i>	8
	<i>The Payout Policy</i>	10
	<i>The Capital Structure Decision</i>	11
	<i>The Business Acquisition Decision</i>	11
	<i>The Foreign Investment Decision</i>	12
	The Role of Financial Markets	12
	<i>The Equity Market</i>	13
	<i>The Vioxx Recall</i>	14
	<i>External Versus Internal Financing</i>	15
	The Business Cycle	15
	HLC's Financial Statements	17
	<i>The Balance Sheet</i>	17
	<i>A Variant of the Standard Balance Sheet: The Managerial Balance Sheet</i>	19
	<i>The Income Statement</i>	20
	How Profitable Is the Firm?	21
	<i>The Profitability of Equity Capital</i>	21
	<i>The Profitability of Invested Capital</i>	22
	How Much Cash Has the Firm Generated?	22
	<i>Sources and Uses of Cash</i>	23
	<i>The Statement of Cash Flows</i>	23
	How Risky Is the Firm?	23
	Has the Firm Created Value?	25
	The Role of the Chief Financial Officer	26

	Key Points	26
	Further Reading	27
	Self-Test Questions	27
CHAPTER 2	The Time Value of Money	31
	Present Values and Future Values	32
	<i>Compounding</i>	33
	<i>Discounting</i>	34
	<i>Using a Financial Calculator to Solve Time Value of Money Problems</i>	35
	<i>Using a Spreadsheet to Solve Time Value of Money Problems</i>	36
	Interest Rate Quotation and Calculation	36
	<i>The Annual Percentage Rate Versus the Effective Annual Rate</i>	37
	<i>Nominal Versus Real Rates</i>	38
	The Present Value of a Stream of Future Cash Flows	38
	<i>The Net Present Value (NPV) Rule</i>	39
	<i>The Internal Rate of Return (IRR) Rule</i>	39
	The Present Value of a Perpetual Cash-Flow Stream	40
	The Present Value of a Growing Perpetuity	41
	The Present Value of a Standard Annuity	42
	The Present Value of a Growing Annuity	44
	The Future Value of an Annuity	46
	Key Points	47
APPENDIX 2.1	Proof of Formula 2.9 and Formula 2.6	49
	Further Reading	49
	Self-Test Questions	49
	Review Questions	50
CHAPTER 3	Risk and Return	53
	Measures of Return	54
	<i>Realized Returns</i>	54
	<i>Expected Return</i>	55
	<i>Annualized Returns</i>	55
	Measures of Risk	55
	<i>Measuring Risk with the Variance of Returns</i>	55
	<i>Measuring Risk with the Standard Deviation of Returns</i>	56
	<i>Variance versus Standard Deviation</i>	56
	<i>Annualized Measures of Risk</i>	56
	Return Distributions	57

Mean-Variance Analysis	57
<i>Attitudes Toward Risk</i>	60
<i>Evidence from Financial Markets</i>	61
Combining Two Stocks into a Portfolio	61
<i>Portfolio Expected Return</i>	63
<i>Portfolio Risk and Correlations</i>	63
<i>Diversification Can Reduce Risk and Raise Return</i>	65
<i>The Opportunity Set of a Two-Stock Portfolio</i>	65
<i>The Optimal Portfolio of a Risk-Averse Investor</i>	68
<i>Changes in the Correlation Coefficient</i>	68
Combining More Than Two Stocks into a Portfolio	68
<i>Portfolio Expected Return</i>	69
<i>Portfolio Risk and Diversification</i>	69
<i>Portfolio Diversification in Practice</i>	72
<i>Firm-Specific Risk versus Market Risk</i>	73
<i>The Opportunity Set with More Than Two Stocks</i>	74
Optimal Portfolios when there is a Riskless Asset	75
<i>The Efficient Investment Line</i>	75
<i>The Sharpe Ratio</i>	76
<i>Making Optimal Investment Choices</i>	77
The Market Portfolio and the Capital Market Line	79
<i>The Expected Return of the Market Portfolio</i>	79
<i>Proxies for the Market Portfolio</i>	80
<i>The Sharpe Ratio and the Efficiency of the Market Portfolio</i>	80
<i>The Capital Market Line</i>	80
<i>Modern Investment Management: Allocation Beats Selection</i>	82
A Closer Look at Systematic Risk	83
<i>Beta and the Market Model</i>	84
<i>Calculating Beta</i>	84
<i>The Properties of Beta</i>	85
<i>Estimated Stock Betas</i>	85
<i>Portfolio Beta</i>	86
The Capital Asset Pricing Model	87
<i>The Expected Return of an Individual Stock</i>	87
<i>Using the CAPM to Estimate a Company's Cost of Equity Capital</i>	88
<i>Using the CAPM to Evaluate Investment Performance</i>	89
<i>Using the CAPM to Test the Informational Efficiency of Stock Markets</i>	90
Key Points	91
Further Reading	92
APPENDIX 3.1 How to Get the SML Equation	93
Self-Test Questions	94
Review Questions	95

PART II **ASSESSING BUSINESS PERFORMANCE** 99**CHAPTER 4 Interpreting Financial Statements** 99

Financial Accounting Statements 99

The Balance Sheet 100

Current or Short-Term Assets 101*Noncurrent or Fixed Assets* 105*Current or Short-Term Liabilities* 107*Noncurrent Liabilities* 108*Owners' Equity* 110

The Managerial Balance Sheet 110

Working Capital Requirement 111

The Income Statement 114

Net Sales or Turnover 116*Gross Profit* 116*Operating Profit* 117*Earnings Before Interest and Tax (EBIT)* 117*Earnings Before Tax (EBT)* 118*Earnings After Tax (EAT)* 118Earnings Before Interest, Tax, Depreciation, and Amortization
(EBITDA) 118

Reconciling Balance Sheets and Income Statements 119

The Structure of the Owners' Equity Account 120

The Statement of Cash Flows 121

Preparing a Statement of Cash Flows 122*Net Cash Flow from Operating Activities* 123*Net Cash Flow from Investing Activities* 125*Net Cash Flow from Financing Activities* 126*The Statement of Cash Flows* 127*Problems with the Statement of Cash Flows* 127

Free Cash Flow 128

Key Points 129

**APPENDIX 4.1 Obtaining the Net Cash Flow from Operating Activities Using
Balance Sheet and Income Statement Accounts** 132

Measuring Cash Inflow from Sales 132

Measuring Cash Outflow from Operating Activities 132

Cash Outflow from Purchases 132*Cash Outflow from SG&A and Tax Expenses* 133*Cash Outflow from Net Interest Expense* 134

Net Cash Flow from Operating Activities 134

APPENDIX 4.2 Specimen Financial Statements	136
The GlaxoSmithKline (GSK) Financial Statements	136
GSK's Balance Sheets and Managerial Balance Sheets	136
<i>GSK's Balance Sheets</i>	136
<i>GSK's Managerial Balance Sheets</i>	139
GSK's Income Statements	140
GSK's Statements of Cash Flows	142
Further Reading	144
Self-Test Questions	145
Review Questions	148
CHAPTER 5 Analyzing Operational Efficiency and Liquidity	153
The Structure of the Managerial Balance Sheet	154
<i>The Three Components of a Firm's Invested Capital</i>	154
<i>The Two Components of a Firm's Capital Employed</i>	158
<i>The Structure of OS Distributors' Managerial Balance Sheet</i>	158
The Matching Strategy	158
A Measure of Liquidity Based on the Funding Structure of Working Capital Requirement	160
Improving Liquidity through Better Management of the Operating Cycle	163
<i>The Effect of the Firm's Economic Sector on Its Working Capital Requirement</i>	163
<i>The Effect of Managerial Efficiency on Working Capital Requirement</i>	165
<i>The Effect of Sales Growth on Working Capital Requirement</i>	167
Traditional Measures of Liquidity	168
<i>Net Working Capital</i>	168
<i>The Current Ratio</i>	170
<i>The Acid Test or Quick Ratio</i>	171
Key Points	171
APPENDIX 5.1 Financing Strategies	173
APPENDIX 5.2 The GlaxoSmithKline Liquidity and Operational Efficiency	176
GSK's Liquidity Position	176
GSK's Management of the Operating Cycle	177
Further Reading	179
Self-Test Questions	180
Review Questions	182

CHAPTER 6 Analyzing Profitability, Risk, and Growth 189

Measures of Profitability 190

Return on Equity 190

Measuring Return on Equity 190

The Effect of Operating Decisions on ROE 191

The Effect of Financing Decisions on Return on Equity 197

The Incidence of Taxation on Return on Equity 199

Putting It All Together: The Structure of a Firm's Profitability 200

The Structure of ROE Across Industries 202

Other Measures of Profitability 203

Earnings Per Share (EPS) 203

The Price-to-Earnings Ratio (P/E) 203

The Market-to-Book Ratio 204

Financial Leverage and Risk 204

How Does Financial Leverage Work? 205

Two Related Caveats: Risk and the Ability to Create Value 206

Self-Sustainable Growth 207

Key Points 211

APPENDIX 6.1 GlaxoSmithKline's Profitability 213

GSK's Profitability Structure 213

Return on Equity 213

The Effect of Operating Margin on GSK's Operating Profitability 213

The Effect of Invested Capital Turnover on GSK's Operating Profitability 217

The Effect of GSK's Financial Policy on Its Return on Equity 218

The Effect of Taxation on GSK's Return on Equity 219

Further Reading 219

Self-Test Questions 219

Review Questions 222

PART III MAKING INVESTMENT DECISIONS 227

CHAPTER 7 Using the Net Present Value Rule to Make Value-Creating Investment Decisions 227

The Capital Investment Process 228

Would You Buy This Parcel of Land? 230

The Alternative Investment 230

The Opportunity Cost of Capital 231

The Net Present Value Rule 232

A One-Period Investment 232

A Two-Period Investment without an Intermediate Cash Flow 234

<i>A Two-Period Investment with an Intermediate Cash Flow</i>	235
<i>Multiple-Period Investments</i>	236
Applying the Net Present Value Rule to a Capital Investment Decision	237
Why the NPV Rule is a Good Investment Rule	238
<i>NPV Is a Measure of Value Creation</i>	239
<i>NPV Adjusts for the Timing of the Project's Cash Flows</i>	240
<i>NPV Adjusts for the Risk of the Project's Cash Flows</i>	240
<i>NPV Is Additive</i>	244
Special Cases of Capital Budgeting	246
<i>Comparing Projects of Unequal Size</i>	246
<i>Comparing Projects with Unequal Life Spans</i>	248
Limitations of the Net Present Value Criterion	251
<i>Managerial or Real Options Embedded in Investment Projects</i>	251
<i>Dealing with Managerial Options</i>	253
Key Points	254
Further Reading	256
Self-Test Questions	256
Review Questions	257
CHAPTER 8 Alternatives to the Net Present Value Rule	261
The Payback Period	261
<i>The Payback Period Rule</i>	262
<i>Why Do Managers Use the Payback Period Rule?</i>	265
The Discounted Payback Period	267
<i>The Discounted Payback Period Rule</i>	268
<i>The Discounted Payback Period Rule versus the Ordinary Payback Period Rule</i>	269
The Internal Rate of Return	270
<i>The IRR Rule</i>	271
<i>The IRR Rule May Be Unreliable</i>	273
<i>Why Do Managers Usually Prefer the IRR Rule to the NPV Rule?</i>	276
The Profitability Index	277
<i>The Profitability Index Rule</i>	277
<i>Use of the Profitability Index Rule</i>	278
The Average Accounting Return	279
<i>The Average Accounting Return Rule</i>	280
Key Points	280
Further Reading	282
Self-Test Questions	282
Review Questions	283

CHAPTER 9 Identifying and Estimating a Project's Cash Flows 287

The Actual Cash-Flow Principle 287

The With/Without Principle 288

The Designer Desk Lamp Project 290

Identifying a Project's Relevant Cash Flows 292

Sunk Costs 292

Opportunity Costs 293

Costs Implied by Potential Sales Erosion 293

Allocated Costs 294

Depreciation Expense 294

Tax Expense 294

Financing Costs 295

Inflation 296

Estimating a Project's Relevant Cash Flows 297

Measuring the Cash Flows Generated By a Project 298

Estimating the Project's Initial Cash Outflow 299

Estimating the Project's Intermediate Cash Flows 303

Estimating the Project's Terminal Cash Flow 304

Should SMC Launch the New Product? 305

Sensitivity of the Project's NPV to Changes in the Lamp Price 306

Sensitivity of NPV to Sales Erosion 306

Key Points 307

Further Reading 308

Self-Test Questions 308

Review Questions 310

PART IV MAKING FINANCING DECISIONS 315

CHAPTER 10 Valuing Bonds and Stocks 315

What Are Bonds and Common Stocks? 316

Bond Features and Terminology 316

Common Stock Features and Terminology 317

The Discounted Cash Flow (DCF) Model 318

Valuing Bonds 320

Finding the Price of a Bond when its Yield Is Known 320

How Changes in Yield Affect Bond Prices 321

Bond Price versus Face Value 322

Finding the Yield of a Bond When Its Price Is Known 322

The Market Yield of a Bond Is the Cost of Debt to the Firm 323

Price Quotation and Yield Conventions 323

The Case of Zero-Coupon Bonds 324

The Case of Perpetual Bonds 326

A Closer Look at Bond Yields and Risk 327

Risk Is the Major Determinant of a Bond's Yield 327

Credit Risk, Credit Ratings, and Credit Spreads 327

<i>The Term Structure of Interest Rates</i>	329
<i>Finding the Price and the Yield of a Bond If the Spot Rates are Known</i>	333
<i>Interest-Rate Risk</i>	334
<i>Duration as a Measure of Interest-Rate Risk</i>	335
Valuing Common Stocks	336
<i>Valuation Based on the Dividend-Discount Model (DDM)</i>	336
<i>Valuation Based on Discounted Free Cash Flows</i>	339
<i>Valuing PEC with the Discounted Free Cash Flow Model</i>	341
<i>Valuation Based on Discounted Cash Flows to Equity Holders</i>	343
<i>Comparing the Three Discounted Cash Flow Models</i>	345
<i>Valuation Based on Comparable Firms</i>	345
<i>Direct Valuation of a Firm's Equity Based on the Price-to-Earnings Ratio</i>	346
<i>Direct Valuation of a Firm's Equity Based on the Price-to-Book Ratio</i>	347
<i>Indirect Valuation of a Firm's Equity Based on the EV-to-EBITDA Ratio</i>	347
Key Points	348
APPENDIX 10.1 The Properties of Duration	350
Further Reading	353
Self-Test Questions	354
Review Questions	355
CHAPTER 11 Raising Capital and Paying Out Cash	359
Estimating the Amount of Required External Funds	360
The Financial System: Its Structure and Functions	364
<i>Direct Financing</i>	364
<i>Indirect or Intermediated Financing</i>	364
<i>Securities Markets</i>	367
How Firms Issue Securities	371
<i>Private Placement</i>	371
<i>Public Offerings</i>	371
Raising Debt Capital	375
<i>Borrowing through Bank Loans</i>	376
<i>Borrowing through Lease Agreements</i>	376
<i>Borrowing by Issuing Short-Term Securities</i>	379
<i>Borrowing by Issuing Corporate Bonds</i>	379
Raising Equity Capital	383
<i>Preferred Stocks</i>	383
<i>Tracking Stock</i>	385
<i>Equity Warrants</i>	385
<i>Contingent Value Rights</i>	385
Distributing Cash to Shareholders	386
<i>Observed Payout Policies</i>	386

How and Why Firms Pay Dividends and Buy Back their Shares	390
<i>How Firms Pay Dividends</i>	391
<i>How Firms Repurchase their Shares</i>	391
<i>Differences Between Dividend Payments and Share Repurchases</i>	392
Does a Firm Payout Policy Affect Its Share Price and the Wealth of Its Shareholders?	394
<i>Paying an Immediate Special Dividend of \$250 Million</i>	396
<i>Buying Back \$250 Million of Shares in the Open Market</i>	397
<i>Issuing \$100 Million of New Equity to Pay an Immediate Dividend of \$350 Million</i>	398
<i>Investing \$250 Million in a Project</i>	399
<i>Payout Policy Is Irrelevant in a Perfect Market Environment as Long as the Firm's Investing and Financing Policies do not Change</i>	399
<i>Payout Policy with Market Imperfections</i>	400
Key Points	402
Further Reading	405
Self-Test Questions	406
Review Questions	407

CHAPTER 12 Estimating the Cost of Capital 411

Identifying Proxy or Pure-Play Firms	412
Estimating the Cost of Debt	413
Estimating the Cost of Equity	415
<i>Estimating the Cost of Equity Using the Dividend-Discount Model</i>	415
<i>Estimating the Cost of Equity Using the Capital Asset Pricing Model</i>	417
Estimating the Cost of Capital of a Firm	426
<i>What Is a Firm's Cost of Capital?</i>	426
<i>The Firm's Target Capital Structure</i>	427
<i>The Firm's Costs of Debt and Equity</i>	429
<i>Summary of the Firm's WACC Calculations</i>	430
Estimating the Cost of Capital of a Project	430
<i>The Project's Risk Is Similar to the Risk of the Firm</i>	430
<i>The Project's Risk Is Different from the Risk of the Firm</i>	431
<i>Three Mistakes to Avoid When Estimating a Project's Cost of Capital</i>	434
Key Points	438
Further Reading	439
Self-Test Questions	439
Review Questions	440

CHAPTER 13 Designing a Capital Structure 445

The Capital Structure Decision in a World without Corporate Income Tax and Financial Distress Costs	446
<i>Effects of Borrowing on the Firm's Profitability (No Corporate Income Tax and No Financial Distress Costs)</i>	446

Understanding the Trade-Off Between Profitability and Risk 449
Effect of Borrowing on the Value of the Firm's Assets and Its Share Price (No Corporate Income Tax and No Financial Distress Costs) 450
Effect of Borrowing on the Firm's Cost of Capital (No Corporate Income Tax and No Financial Distress Costs) 453

The Capital Structure Decision in a World with Corporate Income Tax but without Financial Distress Costs 455

Effect of Borrowing on the Value of a Firm's Assets (with Corporate Income Tax and No Financial Distress Costs) 456
Effect of Borrowing on the Firm's Market Value of Equity (with Corporate Income Tax and No Financial Distress Costs) 460
Effect of Borrowing on the Firm's Share Price (with Corporate Income Tax and No Financial Distress Costs) 460
Effect of Borrowing on the Cost of Capital (with Corporate Income Tax and No Financial Distress Costs) 461

The Capital Structure Decision when Financial Distress is Costly 464

Formulating a Capital Structure Policy 467

A Closer Look at the Trade-Off Model of Capital Structure 467
Factors Other Than Taxes That May Favor Borrowing 470
Factors Other Than Financial Distress Costs That May Discourage Borrowing 473
Is There a Preference for Retained Earnings? 475
Putting It All Together 476

Key Points 479

APPENDIX 13.1 Capital Structure and Systematic Risk (Beta) 481

How to Extract Unlevered Betas from Levered Betas 481

Case 1: The Debt-to-Equity Ratio (D/E) is Constant Over Time 482

Case 2: The Amount of Debt (D) is Constant Over Time 482

Which Formula Should Be Used to Get Unlevered Betas? 483

Further Reading 484

Self-Test Questions 484

Review Questions 485

PART V MAKING BUSINESS DECISIONS 487

CHAPTER 14 Valuing and Acquiring a Business 487

Alternative Valuation Methods 488

Valuing a Firm's Equity Using Comparable Firms 489

Direct Estimation of a Firm's Equity Value Based on the Equity Value of Comparable Firms 492

Indirect Estimation of a Firm's Equity Value Based on the Enterprise Value of Comparable Firms 494

Valuing a Firm's Business Assets and Equity Using the Discounted Cash Flow (DCF) Method	496
Estimation of OS Distributors' Enterprise and Equity Values	497
<i>Step 1: Determination of the Length of the Forecasting Period</i>	498
<i>Step 2: Estimation of the Free Cash Flow from Business Assets</i>	498
<i>Step 3: Estimation of the Weighted Average Cost of Capital</i>	502
<i>Step 4: Estimation of the Terminal Value of Business Assets at the End of Year 5</i>	503
<i>Step 5: Estimation of the DCF Value of Business Assets (Enterprise Value)</i>	504
<i>Step 6: Estimation of the DCF Value of Equity</i>	504
<i>Comparison of DCF Valuation and Valuation by Comparables</i>	505
Estimating the Acquisition Value of OS Distributors	505
<i>Identifying the Potential Sources of Value Creation in an Acquisition</i>	505
<i>Why Conglomerate Mergers Are Unlikely to Create Lasting Value Through Acquisitions</i>	508
<i>The Acquisition Value of OS Distributors' Equity</i>	510
Estimating the Leveraged Buyout Value of OS Distributors	514
<i>Estimating the Leveraged Buyout Value of Business Assets Using the Adjusted Present Value Method (the APV Method)</i>	516
<i>Will OS Distributors Be Able to Service Its Debt?</i>	520
Key Points	523
Further Reading	525
Self-Test Questions	525
Review Questions	526

CHAPTER 15 Managing Corporate Risk 531

What Is Risk?	532
Why Should Firms Manage Risk?	533
<i>Risk Management Can Reduce Corporate Income Tax Payments</i>	534
<i>Risk Management Can Lower the Cost of Protection Against Risk</i>	534
<i>Risk Management Can Lower Financial Distress Costs</i>	534
<i>Risk Management Can Provide Clearer Information to Investors About the Firm's Core Activities</i>	534
<i>Risk Management Can Lower Agency Costs</i>	534
Corporate Risk Management	535
<i>Risk Netting</i>	535
<i>Cost Savings</i>	535
<i>Risk Policy</i>	536
<i>Risk Learning</i>	536
The Risk Management Process	536
<i>Step 1: Risk Identification</i>	537
<i>Step 2: Risk Measurement</i>	545
<i>Step 3: Risk Prioritization</i>	546
<i>Step 4: Risk Policy</i>	547
<i>Step 5: Risk Monitoring</i>	551

Key Points	551
Further Reading	552
Self-Test Questions	552
Review Questions	553

CHAPTER 16 Understanding Forward, Futures, and Options and Their Contribution to Corporate Finance 555

Forward Contracts	556
<i>Price Risk</i>	556
<i>Counterparty Risk</i>	556
<i>Liquidity Risk</i>	557
Futures Contracts and Markets	557
<i>How Futures Markets Mitigate Counterparty Risk</i>	557
<i>How Futures Markets Mitigate Liquidity Risk</i>	558
<i>Available Futures Markets and Contracts</i>	559
<i>Hedging Risk with Futures Contracts</i>	559
The Pricing of Forward and Futures Contracts	562
<i>The Relationship Between the Spot Price and the Forward Price</i>	562
<i>The Relationship Between the Expected Spot Price and the Forward Price</i>	565
Option Contracts	566
<i>Option Contracts Defined</i>	567
<i>Over-The-Counter (OTC) Options Versus Traded Options</i>	567
<i>European versus American Options</i>	567
<i>Option Buyers and Option Writers</i>	568
<i>Call Options</i>	568
<i>Put Options</i>	571
<i>The Put-Call Parity Relationship</i>	574
Getting Option Prices with the Black and Scholes Formula	577
<i>The Price of a European Call on a Non-Dividend-Paying Stock</i>	577
<i>The Price of a European Put on a Non-Dividend-Paying Stock</i>	577
<i>Using a Spreadsheet to Calculate the Price of European Options</i>	577
<i>The Price of European Options on Dividend-Paying Stocks</i>	579
<i>The Price of American Options</i>	579
<i>Response of Option Prices to Changes in Input Values</i>	581
<i>Implied Volatility</i>	582
<i>How Good Is the Black-Scholes Model?</i>	583
<i>Delta: A Measure of the Sensitivity of Option Prices to Changes in the Underlying Stock Price</i>	583
<i>An Investment in an Option Is Always Riskier Than the Same Investment in the Underlying Stock</i>	584
Option-Based Investment Strategies	585
<i>Speculating on a Rise in Stock Price with Naked Calls</i>	585
<i>Hedging Against a Drop in Stock Price with Protective Puts</i>	585
<i>Insuring Equity Portfolios</i>	587
<i>Writing Covered Calls to Generate Income</i>	587

<i>Collars: Covered Calls with Protective Puts</i>	587
<i>Hedging Stock Price Volatility with Long Straddles</i>	587
<i>Arbitraging Option Prices with Money Spreads or Time Spreads</i>	588
Securities with Option Features	588
<i>Equity as a Call Option on the Firm's Assets</i>	588
<i>Corporate Bonds As Risk-Free Bonds and Short Puts on the Firm's Assets</i>	591
<i>Collateralized Loans</i>	591
<i>Right Issues, Warrants and Contingent Value Rights</i>	591
<i>Callable and Convertible Bonds</i>	592
Real Options and Strategic Investment Decisions	592
<i>Expanding Abroad</i>	593
<i>Calculating the Project's NPV with the Option Value</i>	595
<i>Discussion</i>	596
<i>Different Types of Real Options Embedded in Projects</i>	597
Key Points	597

APPENDIX 16.1 The Binomial Option Pricing Model 601

Creating a Riskless Covered Call Position	601
Finding the Call Price Based on the Riskless Covered Call Position	602
Further Reading	602
Self-Test Questions	602
Review Questions	605

CHAPTER 17 Making International Business Decisions 609

The Firm's Risk Exposure from Foreign Operations	610
<i>Accounting, or Translation, Exposure</i>	610
<i>Economic Exposure</i>	610
Managing Currency Risk	612
<i>The Foreign-Exchange Market</i>	613
<i>Hedging Contractual Exposure to Currency Risk</i>	614
<i>Hedging Long-Term Contractual Exposure to Currency Risk with Swaps</i>	620
Factors Affecting Changes in Exchange Rates	622
<i>How Differences in Inflation Rates Affect Exchange Rates: The Purchasing Power Parity Relation</i>	623
<i>The Relationship between Two Countries' Inflation Rates and Interest Rates: The International Fisher Effect</i>	624
<i>How Differences in Interest Rates Affect Exchange Rates: The Interest-Rate Parity Relation</i>	625
<i>The Relation between Forward Rates and Future Spot Rates</i>	626
<i>Putting It All Together</i>	627
Analyzing an International Investment Project	628
<i>The Net Present Value Rule: A Brief Review</i>	628
<i>Surf and Zap Cross-Border Alternative Investment Projects</i>	629

Managing Country Risk	635
<i>Invest in Projects with Unique Features</i>	635
<i>Use Local Sourcing</i>	635
<i>Choose a Low-Risk Financial Strategy</i>	636
<i>Design a Remittance Strategy</i>	636
<i>Consider Buying Insurance Against Country Risk</i>	636
Key Points	637

APPENDIX 17.1 Translating Financial Statements with the Monetary/ Nonmonetary Method and the All Current Method 639

The Monetary/Nonmonetary Method	639
The All Current Method	640
Which Method Is Better?	642

APPENDIX 17.2 The Parity Relations 643

The Law of One Price	643
The Purchasing Power Parity Relation	644
The International Fisher Effect	644
The Interest-Rate Parity Relation	645
<i>Strategy 1: Investment in US Dollars</i>	645
<i>Strategy 2: Investment in Euros</i>	646
Further Reading	647
Self-Test Questions	647
Review Questions	648

CHAPTER 18 Managing for Value Creation 653

Measuring Value Creation	654
<i>Estimating Market Value Added</i>	654
<i>Interpreting Market Value Added</i>	657
<i>A Look at the Evidence</i>	658
Identifying the Drivers of Value Creation	660
<i>Linking Value Creation to Operating Profitability, the Cost of Capital, and Growth Opportunities</i>	661
<i>Only Value-Creating Growth Matters</i>	663
<i>Linking Value Creation to Its Fundamental Determinants</i>	664
Linking Operating Performance and Remuneration to Value Creation	665
<i>Mr. Thomas Hires a General Manager</i>	666
<i>Has the General Manager Achieved His Objectives?</i>	667
<i>Economic Profits Versus Accounting Profits</i>	669
<i>Designing Compensation Plans That Induce Managers to Behave Like Owners</i>	670

Linking the Capital Budgeting Process to Value Creation	671
<i>The Present Value of an Investment's Future EVA Is Equal to Its MVA</i>	672
<i>Maximizing MVA Is the Same as Maximizing NPV</i>	672
Putting It All Together: The Financial Strategy Matrix	675
<i>The Business Is a Value Creator but Is Short of Cash</i>	676
<i>The Business Is a Value Creator with a Cash Surplus</i>	676
<i>The Business Is a Value Destroyer with a Cash Surplus</i>	677
<i>The Business Is a Value Destroyer That Is Short of Cash</i>	677
Key Points	677

APPENDIX 18.1 Adjusting Book Values to Estimate the Amount of Invested Equity Capital and Operating Profit 679

Adjusting the Book Value of Equity Capital	679
Adjusting Earnings Before Interest and Tax	680

APPENDIX 18.2 Estimating Market Value Added (MVA) when Future Cash Flows are Expected to Grow at a Constant Rate in Perpetuity 682

Further Reading	683
Self-Test Questions	683
Review Questions	685
Answers to Self-Test Questions	691
Glossary	741
Credits	763
Index	765



PREFACE

Finance is an essential and exciting area of management that many executives want to learn or explore in more depth. Most finance textbooks, however, are either too advanced or too simplistic for many nonfinancial managers. Our challenge was to write an introductory text that is specifically addressed to executives, and that is both practical and rigorous.

The target audience includes executives directly and indirectly involved with financial matters and financial management, which is just about every executive. Over the past few years, several thousand managers around the world have used most of the material in this book. The text works well in executive-development programs – including executive masters of business administration (EMBA) programs – and corporate finance courses for an undergraduate or MBA audience either as a core text, where a more practical and applied emphasis is desired, or as a companion to a theoretical text to translate theory into practice.

Finance for Executives has a number of important features:

- **The book is based on the principle that managers should manage their firm's resources with the objective of increasing their firm's value.**

Managers must make decisions that are expected to raise their firm's market value. This fundamental principle underlies our approach to management. This book is designed to improve managers' ability to make decisions that create value, including decisions to restructure existing operations, launch new products, buy new assets, acquire other companies, and finance the firm's investments.

- **The book fills the gap between introductory accounting and finance manuals for nonfinancial managers and advanced texts in corporate finance.**

Finance for Executives is based on modern finance principles. It emphasizes rigorous analysis but avoids formulas that have no direct application to decision making. Whenever a formula is used in the text, the logic behind it is explained and numerical examples are provided. Mathematical derivations of the formulas are given in the appendices that follow the chapter in which they first appear. Recognizing that executives often approach financial problems from a financial accounting perspective, we begin with a solid review of the financial accounting system. We then show how this framework can be extended and used to make sound financial decisions that enhance the firm's value.

- **The chapters are self-contained.**

Each chapter can be read without prior reading of the others. When knowledge of a previous chapter would enhance comprehension of a specific section, we direct the

reader to that previously-developed material. Further advice on this score is provided in the section titled “How to Read This Book.”

- **The book can be read in its entirety or used as a reference.**

The book can be used as a quick reference whenever readers need to brush up on a specific topic or close a gap in their financial management knowledge. A comprehensive glossary and the index at the end of the book help the reader determine which chapters deal with the desired issue or topic. Most financial terms are explained when first introduced in the text; they appear in boldface type and are defined in the glossary.

- **Data from the same companies are used throughout the book to illustrate diagnostic techniques and valuation methods.**

We focus on the same set of firms to illustrate most of the topics covered in this book. This approach provides a common thread that reinforces understanding.

- **Spreadsheet solutions and formulas are included in the text.**

Recognizing that spreadsheets have become part of most executives’ tool kit, the text shows the spreadsheet solutions to all the examples, cases, and self-test questions, when applicable. Formulas used in the spreadsheets are shown at the bottom of the tables for an immediate understanding of the solutions and for reproduction of the spreadsheets for personal use.

- **Each chapter is followed by self-test and review questions.**

The self-test questions that appear at the end of each chapter allow the readers to assess their knowledge of the subject. Most of the questions require the use of a financial calculator or a spreadsheet. Detailed, step-by-step solutions to the self-test questions can be found at the end of the book.

The review questions, which follow the self-test questions at the end of each chapter, provide the readers with the opportunity to challenge their knowledge of the subject and give the instructors relevant material to test the student’s grasp of the concepts and techniques presented in the chapter. Solutions to review questions are available online only to instructors.

MAJOR CHANGES IN THE SIXTH EDITION

As was the case with the previous editions of *Finance for Executives*, we have incorporated in the sixth edition recommendations received from our colleagues at INSEAD and other schools and from a large number of students and executives who have attended courses and seminars in which the book was assigned. Here are the major changes from the last edition:

- We have written an entirely new chapter (Chapter 16) entitled Understanding Forward, Futures, and Options and Their Contribution to Corporate Finance.
- We have moved the presentation on currency risk from Chapter 15 (Managing Corporate Risk) to Chapter 17 (Making International Business Decisions).
- We use a new set of international companies from the pharmaceutical industry, GlaxoSmithKline and Sanofi, to illustrate how to perform a financial analysis using the concepts and techniques presented in Chapters 4 through 6.

- We have updated all chapters with the latest available financial information.
- We have introduced spreadsheets throughout the chapters to illustrate the valuation of bonds, stocks, and companies.
- We have prepared a new set of professionally designed PowerPoint slides to accompany the book.

WHAT IS IN THIS BOOK?

Although the book consists of self-contained chapters, those chapters follow a logical sequence built around the idea of value creation. The overall structure of the book is summarized in a diagram on the following page that illustrates the value-based business model. Managers must raise cash (the right side) to finance investments (the left side) that are expected to increase the firm's value and the wealth of its owners.

Part I, Financial Concepts and Techniques, begins with a chapter that surveys the principles and tools executives need to know to manage for value creation. Chapter 2 presents the concept of time value of money and reviews the mechanics of calculating present values for different streams of cash flows. Chapter 3 explains the relationship between the risk of a financial asset and its expected return, and examines the implications for financial investment management and the valuation of financial assets.

Part II, Assessing Business Performance, reviews the techniques that executives should use to assess a firm's financial health, evaluate and plan its future development, and make decisions that enhance its chances of survival and success. The chapters in this part examine in detail a number of financial diagnostics and managerial tools that were introduced in Chapter 1. Chapter 4 explains and illustrates how balance sheets, income statements, and statements of cash flows are constructed and interpreted. As an application, the appendix includes the financial statements of GlaxoSmithKline, an international pharmaceutical company. Chapter 5 shows how to evaluate a firm's operational efficiency and its liquidity position. Chapter 6 identifies the factors that drive a firm's profitability, analyzes the extent of its exposure to business and financial risks, and evaluates its capacity to finance its activities and achieve sustainable growth. The financial analysis tools presented in these chapters are applied to GlaxoSmithKline, whose financial statements are presented in Chapter 4. The analyses appear in the appendices to Chapters 5 and 6, including a comparative analysis of GlaxoSmithKline and one of its major competitors, Sanofi.

Part III, Making Investment Decisions, demonstrates how managers should make investment decisions that maximize the firm's value. Chapter 7 examines the net present value (NPV) rule in detail and shows how to apply this rule to make value-creating investment decisions. Chapter 8 reviews a number of alternative approaches to the NPV rule, including the internal rate of return (IRR) and the payback period rules, and compares them with the NPV rule. Chapter 9 shows how to identify and estimate the cash flows generated by an investment proposal and assess the proposal's capacity to create value.

Part IV, Making Financing Decisions, explains how managers should make financing decisions that maximize value. Chapter 10 shows how to value bonds and common stocks. Chapter 11 explains how firms raise fresh capital from financial markets policy and share buybacks. Chapter 12 shows how to estimate the cost of capital for a particu-

WHAT IS IN THIS BOOK?

PART I: FINANCIAL CONCEPTS AND TECHNIQUES

Chapter 1:

What does managing for value creation mean?

Chapter 2:

How to convert a stream of future cash flows into their present value.

Chapter 3:

What is the relationship between the risk of a financial asset and its expected return, and what are the implications for financial and investment management and the valuation of financial assets?

PART II: ASSESSING BUSINESS PERFORMANCE

Chapters 4 to 6:

How to interpret financial information to assess performance (Chapter 4), and how do financial structure and operational efficiency affect a firm's liquidity (Chapter 5), profitability, risk, and capacity to grow (Chapter 6)?

PART IV: MAKING FINANCING DECISIONS

Chapter 10:

How to value the securities that firms issue to raise funds?

Chapter 11:

How do firms raise the funds needed to finance their investments and return cash to shareholders?

Chapter 12:

What is the cost of the funds the firm raises?

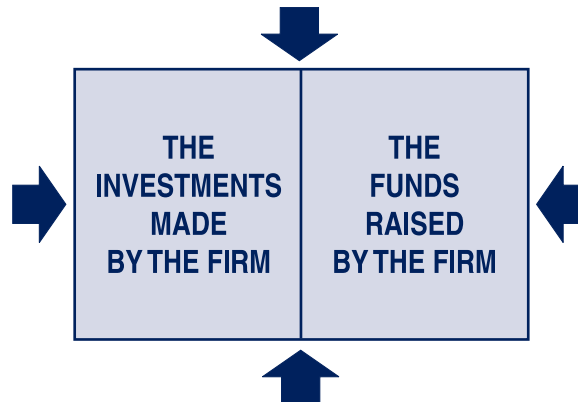
Chapter 13:

What is the best mix of owners' funds and borrowed funds?

PART III: MAKING INVESTMENT DECISIONS

Chapters 7 to 9:

How should firms evaluate investment proposals and select value-creating projects?



PART V: MAKING BUSINESS DECISIONS

Chapter 14:

How is a firm valued?

Chapter 15:

How risky is the firm?

Chapter 16:

How to use forward, futures and option contracts to control risk.

Chapter 17:

How do international activities affect the firm's value?

Chapter 18:

Is the firm using its resources efficiently to create value?

lar project as well as an entire firm. Chapter 13 explains how a firm should make value-creating financing decisions by designing a capital structure (the mix of owners' funds and borrowed funds) that maximizes its market value and minimizes its cost of capital.

Part V, Making Business Decisions, concludes with five chapters on making value-creating business decisions. Chapter 14 reviews various models and techniques used to value firms in the context of an acquisition. Chapter 15 provides a comprehensive framework to identify, measure, and manage the risks a firm faces. Chapter 16 shows how forward, futures, and option contracts can be used to control risk. Chapter 17 looks at financial management and value creation in an international environment where currency and country risks must be taken into account. Chapter 18 summarizes the analytical framework underlying the process of value creation and examines some of the related empirical evidence.

HOW TO USE THIS BOOK

Depending on your background and your needs, you may want to use this book in different ways. Below are a few guidelines. Also, refer to the exhibit on the next page for suggested sequences of chapters to cover depending on the type of program taken.

- If you are unfamiliar with financial management and financial accounting, you may want to begin by reading Chapter 1. It provides an overview of these subjects and will help you understand the fundamental objective of modern corporate finance and the logical relationships among the various issues and topics that make up that field. Although reading the first chapter will facilitate the understanding of those that follow it, it is not necessary to read it to comprehend the rest of the book – the chapters are self-contained.
- If you are not familiar with the basic concept of discounting and the calculation of present values, you should read Chapter 2. The chapter also shows you how to perform present value calculations with a financial calculator and spreadsheets. If you skip Chapter 2, you will find a review of these concepts in Chapter 7.
- If you wish to familiarize yourself with the concept of portfolio diversification and financial investment management you should read Chapter 3, but you do not need to read that chapter to understand any of the other chapters in the book.
- If you are not familiar with financial statements, it would be helpful, but not essential, to read Chapter 4 before you continue with the chapters in Part II. The chapter explains how to read a balance sheet, an income statement, and a statement of cash flows, and how to restructure these statements to interpret the information they provide.
- If you are unfamiliar with the functioning of financial markets, you should read the first five sections of Chapter 11 before you continue with the rest of Part IV. These sections provide an overview of the structure, organization, and role of financial markets.
- Last, if you have a basic knowledge of accounting and finance, you can go directly to the chapter dealing with the issue you wish to explore. Because the chapters are self-contained, you will not have to review the preceding chapters to fully understand your chosen chapter.

RECOMMENDED CHAPTERS ACCORDING TO TYPE OF PROGRAM

Chapter/Topic	Executive Education		MBA Program	
	1 st course	2 nd course	1 st course	2 nd course
1. Overview	✓		✓	
2. The time value of money	✓		✓	
3. Risk, return, and portfolio analysis			✓	
4. Financial statements analysis	✓		✓	
5. Operational efficiency and liquidity management	✓		✓	
6. Profitability and risk management	✓		✓	
7. Capital budgeting: NPV	✓		✓	
8. Capital budgeting: IRR & other methods	✓		✓	
9. Capital budgeting: Cash flow analysis	✓		✓	
10. Bond valuation		✓	✓	
10. Common stock valuation		✓	✓	
11. Financial markets and raising capital		✓	✓	
11. Dividend policy and share buybacks		✓		✓
12. Estimation of the cost of capital		✓		✓
13. Designing a capital structure		✓		✓
14. Valuing and acquiring a business		✓		✓
15. Corporate risk management		✓		✓
16. Forward, futures, and option contracts		✓		✓
17. International capital budgeting		✓		✓
18. Managing for value creation		✓		✓

ABOUT THE AUTHORS



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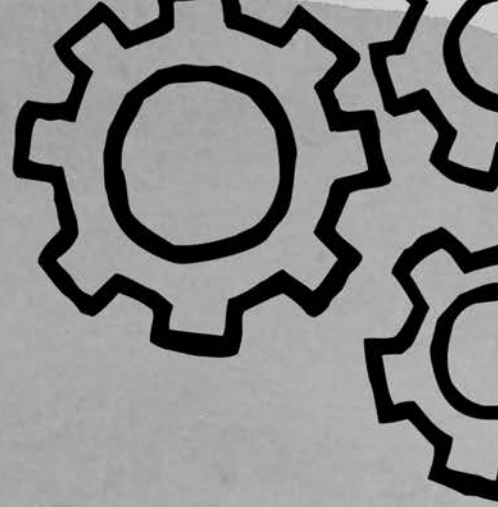
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*Gabriel Hawawini
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BE UNSTOPPABLE



FINANCIAL MANAGEMENT AND VALUE CREATION: AN OVERVIEW

CHAPTER

1

An executive cannot be an effective manager without a clear understanding of the principles and practices of modern finance. The good news is that these principles and practices can be communicated simply, without sacrificing thoroughness or rigor. Indeed, you will discover that most of the concepts and methods underlying modern corporate finance are based on business common sense. But translating business common sense into an effective management system can be a real challenge. It requires, in addition to a solid understanding of fundamental principles, the determination and the discipline to manage a business according to the precepts of modern finance. Consider, for example, one of financial management's most useful guiding principles:

Managers should manage their firm's resources with the objective of increasing the firm's value.

This may seem to be an obvious statement. But you probably know a number of companies that are not managed to their full potential value. You may even know well-intentioned managers who are value destroyers. Their misguided actions, or lack of actions, actually reduce the value of their firms.

How do you manage for value creation? This book should help you find the answer. Our main objective is to present and explain the methods and tools that will help you determine whether the firm's current investments are creating value and, if they are not, what remedial actions should be taken to improve operations. We also show you how to determine whether a business proposal – such as the decision to buy a piece of equipment, launch a new product, acquire another firm, or restructure existing operations – has the potential to raise the firm's value. Finally, we show you that managing with the goal of raising the firm's value provides the basis for an integrated financial management system that helps you not only evaluate actual business performance and make sound business decisions, but also design effective management compensation packages – compensation packages that align the interests of the firm's managers with those of the firm's owners.

This introductory chapter reviews some of the most challenging issues and questions raised by modern corporate finance and gives a general but comprehensive

overview. Although the topics surveyed here are examined later in detail, many of the important terms and concepts are introduced and defined in this introduction with a clear indication of the relevant chapters you need to consult to get a complete presentation of each topic. After reading this chapter, you should have a broad and clear understanding of the following:

- The meaning of managing a business for value creation
- How to measure the value that may be created by a business proposal, such as an investment project, a change in the firm's financial structure, a business acquisition, or the decision to invest in a foreign country
- The significance of the firm's cost of capital and how it is measured
- Why some firms pay out cash dividends to their shareholders and buy back their own shares in the open market
- The function of financial markets as a source of corporate funds and the role they play in the value-creation process
- A firm's business cycle and how it determines the firm's capacity to grow
- The basic structure and the logic behind a firm's balance sheet, income statement, and cash-flow statement
- What is risk and how to define it, and how it affects the firm's cost of capital
- How to measure a firm's profitability
- How to determine if a firm is creating value

THE KEY QUESTION: WILL YOUR DECISION CREATE VALUE?

Suppose you have identified a need in the marketplace for a new product. You believe the product can be manufactured cheaply and rapidly. You are even confident it can be sold for a tidy profit. Should you go ahead? Before you make this decision, you should check the project's *long-term financial viability*. How will your firm finance the project? Where will the money come from? Will the project be sufficiently profitable to cover the cost of the funds required to finance it? More to the point, will the firm be more valuable with the project than without it? You should answer these questions before making a final decision.

The proposed venture will be financed by the firm's owners, its **shareholders** (you may be one of them), and by those who lend money to the firm, the **debt holders** (a bank, for example). Cash contributed by shareholders is called **equity capital**; cash contributed by lenders is **debt capital**. As with any other resource, capital is not free. It has a cost. Let's assume that the firm's annual **cost of capital** is 12 percent of the total amount of **capital employed**, the sum of equity and debt capital. The firm's owners will find the venture attractive only if its *operating profitability exceeds* 12 percent, that is, only if its profitability *before financing* the venture is higher than the cost of capital of 12 percent. Why? Because a project whose operating profitability *exceeds* its cost of capital should generate *more* cash than is required to pay for the cost of capital. It is that excess cash that makes the firm more valuable. (We will explain this in more detail throughout the book.) In other words, before deciding to go ahead with a business proposal, you should ask yourself the Key Question:

Will the proposal create value?

If, in light of existing information and proper analysis, you can confidently answer "yes", then go ahead with the project. Otherwise, you should abandon it.

The Key Question applies not only to a business proposal but also to current operations. If some existing **assets** are destroying rather than creating value, you should take immediate corrective actions. If these actions fail to improve performance, you should seriously consider selling those assets.

THE IMPORTANCE OF MANAGING FOR VALUE CREATION

We realize, of course, that the Key Question is much easier asked than answered. The next section describes how to apply the **fundamental finance principle** to help you answer the Key Question. Before introducing that principle, we want to explain why management's paramount objective should be the creation of value for the firm's owners. This objective makes business common sense if you think about a firm whose recent management decisions *reduced* the firm's value. What would happen in this case? The firm may be unable to attract the equity capital it needs to fund its activities. And without equity capital, no firm can survive.

You may rightly ask whether we are forgetting the contributions of employees, customers and suppliers. No firm can succeed without them. Great companies have not only satisfied owners, but also loyal customers, motivated employees, and reliable suppliers. The point, of course, is not to neglect customers, squeeze suppliers, or ignore the interest of employees for the benefit of owners: more value for shareholders does not mean less value for employees, customers, or suppliers. On the contrary, firms managed with a focus on creating value for their owners are among those that have built durable and valuable relationships with their customers, employees, and suppliers. They know that dealing successfully with employees, customers, and suppliers is an important element in achieving their ultimate objective of creating value for their owners.

Indeed, evidence supports the fact that firms that take care of their customers and employees also deliver value to their owners. Consider the results of an annual survey that asked executives, outside directors, and financial analysts to rate the ten largest companies in their industry according to the following criteria: (1) quality of management; (2) quality of products or services; (3) ability to attract, develop, and keep talented people; (4) company's value as a long-term investment; (5) use of corporate assets; (6) financial soundness; (7) capacity to innovate; and (8) community and environmental responsibilities.¹ The companies with the *highest* scores across all industries significantly outperformed the Standard & Poor's market index (an average of 500 companies) during the ten-year period that preceded the ranking. What was the stock market performance of the companies with the *lowest* scores? They were value destroyers. They delivered a *negative* return to their shareholders during the ten-year period that preceded the ranking. An analysis based on only the three criteria that relate to the way companies treat their customers (the second criterion), their employees (the third criterion), and their community (the last criterion) showed similar results.²

These results clearly indicate that the *ability of firms to create value for their shareholders is related to the way they treat their customers, employees, and community*. But you should not conclude that the guaranteed recipe for value creation consists of delighting customers, establishing durable relations with suppliers, and motivating employees. Some firms that deal successfully with their customers, employees, and suppliers are unable to translate this goodwill into a higher firm value.

¹ See fortune.com/worlds-most-admired-companies.

² See Edmans (2011) and (2012). For international evidence, see Edmans, Li, and Zhang (2014).

What should the firm's managers do in this case? They must revise the firm's current business strategy because their shareholders will eventually question the relevance of a strategy that does not allow the firm to produce a satisfactory return on the equity capital they have invested in it. Dissatisfied shareholders, particularly those holding a significant portion of the firm's equity capital, may try to force the firm's management to change course or may try to oust the existing management team. Or, they may simply withdraw their support by selling their holdings to others who might force changes.

Whether shareholders will be successful in getting management to change its strategy, or even be replaced, depends on a number of factors, including the institutional and legal frameworks that govern the relationship between management and shareholders, and the structure and organization of the country's equity markets in which the firm's shares are listed and traded. We simply suggest that *no firm can afford to have delighted customers, motivated employees, and devoted suppliers for too long if it does not also have satisfied shareholders.*

When asked in whose interest corporations are run, Mr. Jack Welch, the former chief executive officer of General Electric, replied, "A proper balance between shareholders, employees, and communities is what we all try to achieve. But it is a tough balancing act because, in the end, if you don't satisfy shareholders, you don't have the flexibility to do the things you have to do to take care of employees or communities. In our society, whether we like it or not, we have to satisfy shareholders."³

THE SATURN STORY

In the early 1980s, General Motors (GM), then the world's largest vehicle manufacturer, faced strong competition from foreign producers of small, efficient, reliable, and inexpensive cars. In response to this challenge, in 1985, GM set up a separate company to build an entirely new car, the Saturn. The car was designed, produced, and sold according to the best practices available at the time. Workers were highly motivated, car dealers could not keep up with demand, and customers were extremely satisfied with their cars. According to these criteria, Saturn was an undeniable success story.

The first car rolled off the assembly line in 1990. The project, however, never delivered the rise in the value of GM's shares that management had hoped would occur.⁴ Why?

According to knowledgeable consultants, the \$6 billion spent developing, manufacturing, and marketing the Saturn line of models was already so high that for GM to earn an acceptable return for its shareholders it would have had "to operate existing facilities at full capacity forever, earn more than double standard profit margins, and keep 40 percent of the dealers' sticker price as net cash flow."⁵

In 2009 GM stopped producing its line of Saturn cars, and in 2010 it discontinued the Saturn brand after acknowledging that it had lost about \$20 billion on the project.⁶

³ *Fortune*, May 29, 1995, p. 75.

⁴ *Fortune*, December 13, 2004, "GM's Saturn Problem," pp. 119–127.

⁵ McTaggart, Kontes, and Mankins (1994), p. 16.

⁶ See the *New York Times*, October 1, 2009, "GM to Close Saturn After Deal Fails," and "Saturn Corporation" in Wikipedia.org.

Our question is: how long should a firm fund a project that delights its customers, pleases its distributors, and satisfies its employees, but fails to deliver value to its shareholders? Obviously, not very long if it wishes to survive. So what can we conclude about the ultimate purpose of a business enterprise? Is it exclusively about shareholder wealth creation, or is it about a “**stakeholders’ approach**” that tries to balance the interests of all the parties associated with the firm (its customers, employees, suppliers, and owners)? We believe that this is a false debate. The focus should be on making decisions that raise the value of the firm, *and in doing so, the firm ultimately creates value for its stakeholders and society as a whole.*⁷

THE FUNDAMENTAL FINANCE PRINCIPLE

Recall the Key Question you should ask before making a business decision: will the decision create value? The Key Question can be answered with the help of the fundamental finance principle:

A business proposal – such as a new investment, the acquisition of another company, or a restructuring plan – will create value only if the present value of the future stream of net cash benefits the proposal is expected to generate exceeds the initial cash outlay required to carry out the proposal.

The **present value** of the future stream of expected net cash benefits is the amount of dollars that makes the firm’s owners *indifferent* to whether they receive that sum today or get the expected future cash-flow stream. For example, if the firm’s owners are indifferent to whether they receive a **cash dividend** of \$100,000 today or get an expected cash dividend of \$110,000 next year, then \$100,000 is the present value of \$110,000 expected next year. (See Chapter 2 for a review of how present values are calculated.)

MEASURING VALUE CREATION WITH NET PRESENT VALUE

The difference between a proposal’s present value and the initial cash outlay required to implement the proposal is the proposal’s **net present value** or **NPV**:

Net present value = –Initial cash outlay + Present value of future net cash benefits

For example, if a firm’s owners are indifferent between \$100,000 today and \$110,000 in one year, then a project that requires \$105,000 today to buy a machine that is expected to generate a net cash flow of \$110,000 next year, has a *negative* NPV of \$5,000 because next year’s cash flow is worth \$100,000 today, which is \$5,000 less than the initial cash outlay:

$$\text{NPV} = -\$105,000 + \$100,000 = -\$5,000$$

If the project is undertaken, it would reduce the value of the firm by \$5,000.

We can use the NPV concept to restate the fundamental finance principle more succinctly:

A business proposal creates value if its NPV is positive and destroys value if its NPV is negative.

⁷ For a discussion on whether creating value for owners also creates value for all the firm’s stakeholders, see John Martin, William Petty, and James Wallace (2009).

The proposal's NPV goes to the investors who *own* the project – in other words, to the shareholders of the firm that undertakes the project. This means that the shareholders should be able to sell their equity stake in the company that announced the project for *more* than they could sell it for if the project were not undertaken, and the difference should be equal to the project's NPV.

The firm's ability to identify the project, and the market expectation that the firm will carry out the project successfully, create an immediate increase in the firm's value and in the wealth of its owners. More precisely, if the shares of the firm are listed and traded on a stock exchange, the market value of the firm (the share price multiplied by the number of shares outstanding) should rise by an amount equal to the project's NPV on the day the project is announced, assuming the announcement is *unanticipated*, and the market agrees with the firm's analysis of the project's profitability. We return to this point later in the chapter when we examine the role played by financial markets in the process of value creation.

ONLY CASH MATTERS

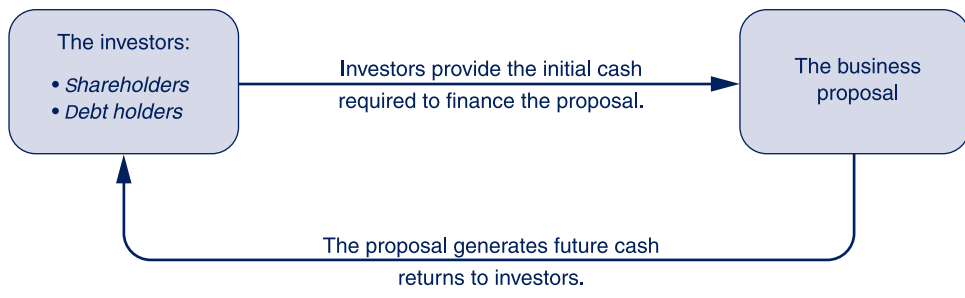
The fundamental finance principle requires that the initial investment needed to undertake a proposal, as well as the stream of net future benefits it is expected to generate, be measured in cash. As Exhibit 1.1 shows, the investors who are financing the proposal – the firm's shareholders and debt holders – have invested *cash* in the firm and thus are interested only in *cash* returns. Note that the cash benefits of a project must not be confused with the increase in the firm's net profit expected from the project because profits are accounting measures of benefits, not of cash returns.

Chapter 4 identifies the differences between a firm's cash flows, its revenues, its expenses, and its net profit, and Chapter 9 shows how to estimate the cash flows that are relevant to an investment decision.

DISCOUNT RATES

Consider an investment proposal that requires shareholders to invest \$100,000 today in order to generate an expected \$110,000 of cash at the end of the year. Suppose that the present value of the \$110,000 is \$100,000. Recall that the present value is the value that makes the firm's owners indifferent to whether they receive \$100,000

EXHIBIT 1.1 ONLY CASH MATTERS TO INVESTORS.



today or receive the expected \$110,000 in one year. This is the same as saying that the firm's owners expect to receive a return of 10 percent from the project because \$100,000 invested at 10 percent will yield \$110,000 in one year. The 10 percent is called the **discount rate**: it is the rate at which the future cash flow must be *discounted* to find its present value. In other words, \$100,000 is the *discounted value* at 10 percent of \$110,000 to be received in one year.

If we want to estimate the NPV of a proposal, we must first discount its future cash-flow stream to find its present value and then deduct from that present value the initial cash outlay required to carry out the proposal. Chapter 2 examines the **discounting** mechanism in detail and explains how to calculate present values and how to estimate a project's NPV when the project has an expected cash-flow stream that is longer than one year.

In our example, we know the discount rate (10 percent) because we already know the expected future cash flow (\$110,000) and its present value (\$100,000). However, this is not usually the case. In general, a proposal's future cash flow must be estimated, and the discount rate must be determined. But what discount rate should be used? *A proposal's appropriate discount rate is the cost of financing the proposal.*

In the example, the return expected from the project must be at least 10 percent to induce shareholders to invest in the project. In other words, because 10 percent is the rate of return required by shareholders to fund the project, it is also the project's **cost of equity** capital. It represents the cost of using shareholders' cash to finance the investment proposal.

A PROPOSAL'S COST OF CAPITAL

In the previous example, the project was funded only with equity capital. Firms, however, typically finance their investment proposals with a combination of equity capital and debt capital, and both shareholders and debt holders require a return from their contribution to the financing of the proposal. When a project is funded with both equity and debt capital, the cost of capital is no longer equal to just the cost of equity. It is the weighted average of the project's cost of equity and its **after-tax cost of debt**,⁸ where the weights are the proportions of equity and debt financing in the total capital used to fund the project.

To illustrate, suppose a project will be financed 50 percent with equity and 50 percent with debt. Also, assume the project has an estimated after-tax cost of debt of 4 percent and a cost of equity of 12 percent. Then, the project's **weighted average cost of capital** or **WACC** is equal to 8 percent:

$$\begin{aligned}\text{Project cost of capital (WACC)} &= (4\% \times 50\%) + (12\% \times 50\%) \\ &= 2\% + 6\% \\ &= 8\%\end{aligned}$$

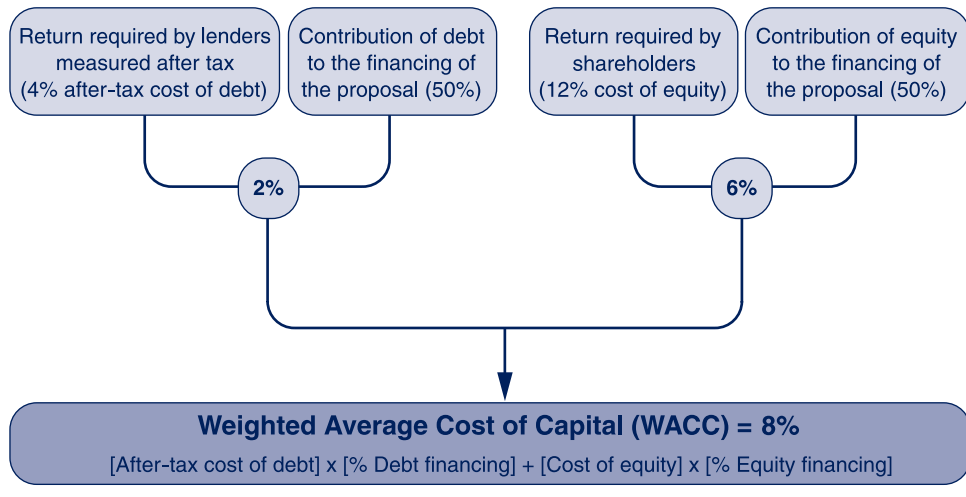
In other words, the contribution of debt financing to the project's cost of capital is 2 percent (50 percent of 4 percent) and that of equity financing is 6 percent (50 percent of 12 percent) as shown in Exhibit 1.2.

If the proportions of equity and debt financing are modified, the WACC will be affected, not only because the financing proportions have changed but also because the **cost of debt** and the cost of equity change when the financing proportions are

⁸ We explain in Chapter 12 why the cost of debt must be taken after tax.

EXHIBIT 1.2

THE COST OF FINANCING A BUSINESS PROPOSAL IS ITS WEIGHTED AVERAGE COST OF CAPITAL.



altered. Chapter 12 shows how to estimate a project's cost of debt as well as its cost of equity and WACC. Chapter 13 demonstrates how the WACC is affected when the financing proportions change.

APPLYING THE FUNDAMENTAL FINANCE PRINCIPLE

The fundamental finance principle has widespread applications in major areas of corporate decision-making. In this book, we address the capital budgeting decision (whether an investment project should be accepted or rejected), the payout policy (when and how much cash the firm should distribute to its shareholders through cash dividends and/or by buying back its own shares in the open market), the capital structure decision (how much of the firm's assets should be financed with equity and how much with debt), the business acquisition decision (how much should be paid to acquire another company), and the foreign investment decision (how to account for multiple-currency cash flows and for the different risks of operating in a foreign country). The capital budgeting decision is covered in Chapters 7 through 9, the payout policy in Chapter 11, the capital structure decision in Chapter 13, the acquisition decision in Chapter 14, and the management of cross-border operations in Chapter 17. This section provides an overview of these corporate decisions.

THE CAPITAL BUDGETING DECISION

The **capital budgeting decision**, also called the **capital expenditure decision**, is primarily concerned with the acquisition of fixed assets, such as plant and equipment. This is a major corporate decision because it typically affects the firm's business performance for a long period of time. The decision criteria used in capital budgeting,

such as the **NPV rule** and the **internal rate of return (IRR) rule**, are direct applications of the fundamental finance principle.

THE NET PRESENT VALUE RULE

The NPV rule is a direct application of the fundamental finance principle because it says that a project should be undertaken only if it does not destroy value. A project does not destroy value when its NPV is positive or zero. It destroys value when its NPV is negative.

A project with a positive NPV creates value because the present value of its expected future cash benefits is *greater* than the initial cash outlay required to launch the project. A project with a negative NPV destroys value because the present value of its expected future cash benefits is *less* than the initial cash outlay required to launch the project. A project with a zero NPV neither creates nor destroys value: it breaks even and should be undertaken because it covers all its costs. In general, the NPV rule can be stated as follows:

A project should be undertaken if its NPV is positive or zero and should be rejected if its NPV is negative.

The properties of the NPV rule are examined in detail in Chapter 7.

THE INTERNAL RATE OF RETURN RULE

One of the most commonly used alternatives to the NPV rule, especially in the analysis of capital expenditures, is the IRR rule. A project's IRR is a measure of its *operating* profitability, meaning that it *excludes* the cost of *financing* the project. Thus, to find out if a project creates value, you must compare the project's IRR to the cost of financing the project. Recall that the cost of financing a project is its WACC.

Suppose that a firm has a project whose IRR is 15 percent. The project can be financed at an estimated WACC of 10 percent. Should the firm invest in this project? The answer is yes because its operating profitability, measured by its IRR (which excludes the cost of funding the project), *exceeds* the cost of financing the project, measured by its estimated WACC. If a project's IRR is *lower* than its WACC, the project cannot be financed profitably and should be rejected. If the IRR is equal to the WACC, the project breaks even and should be undertaken because it covers all its costs. In general, the IRR rule can be stated as follows:

A project should be undertaken if its IRR is higher than, or equal to, its cost of capital, and should be rejected if its IRR is lower than its cost of capital.

Chapter 8 examines the properties of the IRR rule as well as other capital budgeting rules and compares them with the NPV criterion.

SOURCES OF VALUE CREATION IN A BUSINESS PROPOSAL

We have seen that firms with positive NPV proposals are expected to generate excess cash profits – that is, cash profits above the level required to remunerate the firm's shareholders. However, there is nothing more powerful than excess cash profits to attract a horde of eager competitors into a new market. Clearly, the challenge for firms with *recurrent* positive NPV businesses is to keep competitors at bay and