

Finance in Business Decisions

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The Role of Finance in a Corporation

The *Chief Financial Officer* (CFO) is usually the most important person below the CEO.

Why?

Finance function — two important roles:

- ▶ Providing capital,
 - ▶ Day to day operations
 - ▶ Capital investments.
- ▶ Deciding on the merits of the firms' investments.
 - ▶ → Estimation of the *value* implications of the investment.

This course: Finance's role in practical business decision: Yes/No decisions.

Finance's unique role

Quantification – lets decision maker ask:

Does a proposed investment *add to firm value*?

or (in finance terms), is it a *positive net present value project*?

Finance's unique role

Basis for decision on a project/investment opportunity:

- ▶ Quantification: *cash flow implications* of the project
 - ▶ → a *forecast* of future cash flow (often highly uncertain).
- ▶ Quantification: *risk* of the project
 - ▶ → a risk-adjusted cost of capital
- ▶ → *Evaluation*: Is this a positive NPV project?

Finance's unique role

Digging in:

Possibilities for implementing decisions:

- ▶ Evaluate the project on its own (standalone).
- ▶ Calculate how the project affects total firm value.
 - ▶ Calculate the value of the firm without the proposed change.
 - ▶ Calculate the value of the firm after the proposed change.
 - ▶ Is the second value higher?

Building Blocks

Doing finance analysis:

Build upon blocks from a bachelor education in business.

- ▶ From Accounting:
Inflows and outflows, basis for *cash flow forecasts*
- ▶ From Economics:
Understanding of demand and supply. (Forecasting sales)
- ▶ From Marketing:
Manipulating demand (forecasting sales)
- ▶ From Strategy:
Consequences of major strategic decisions (e.g. market expansion). Cash flow consequences?

Building Blocks

From Finance:

- ▶ The mechanics of *discounting* – tools for estimating present values
- ▶ The mechanics of *risk adjustment* – A more risky investment demand a higher return. Tool: The Capital Asset Pricing Model – Risk is measured by *beta*
- ▶ Pricing stocks (equities) – Estimating the required return for the firm's equity financing.
- ▶ Pricing bonds (debt) – Estimating the cost of the firms borrowing.
- ▶ *Project evaluation* methods
 - ▶ Net present value
 - ▶ Internal rate of return
 - ▶ Payback

Company valuation

At the corporate level, decisions made through the lens of a *corporate valuation*

- ▶ Framework
 - ▶ Detailed forecasts for a short horizon
 - ▶ Long horizon simplified growth assumption
 - ▶ Corporate cost of capital

Company valuation

How to generate cash flow forecasts?

- ▶ Understand your project, project sales, costs, etc.
- ▶ From accounts forecast to cash flow forecast

How to estimate a given company/investment project's costs of capital?

- ▶ Using equity market data to estimate a company's equity risk.
- ▶ What is the cost of a company's borrowing?

From those inputs: Discounting the expected cash flows at the cost of capital:

Output: Decision Support

What is the *value* of a project?

- ▶ Total value, or
- ▶ Added value

Continuous Decision Support

Valuations as decision support A company's valuation: Decision input to the company itself.

A company need to maintain a “living” spreadsheet: What is our current value?

A proposed new investment: How does it change the current spreadsheet? What is the added value?