Financial Management

❑ Introduction to financial management

· *Objective of Financial Management → Maximisation of wealth for Shareholders*

- *Financial management of current Assets and Liabilities → Capital Management*
- *Management of Non-current Assets and Liabilities → Capital Budgeting*
- *Long term debt and equity instruments → Financing Decisions*

· *Agency Conflict → Conflict of interests between Principal(Owners) VS Agent(Managers)*

- *In large corporate environment, shareholders have very limited influence in actual management*
- *Managers have the fiduciary/ethical obligations to prioritise the Shareholder benefits(wealth) above the managers'*

· *Agency Cost → Do Managers really want to maximise shareholder wealth?*

- *Cost of conflict between the interests of Managers & Owners (Taking First Class rather than business class)*
- *Therefore, aligning the interests between management & shareholders is critical → But How?*
  1) *Board of Directors : Representing the Shareholder Interest*
  2) *Management Compensation : Providing Cash, Short Term and Long Term incentives*
  3) *Managerial Labour Market and Take-over Market Conditions : It's hard to find a job now*

· *Importance of Business Ethics → Society's ideas/perceptions on right&wrong*

- *Economic Concern(Profit), Legal Concern(Legal), Ethical Concern(Righteous)*
- *Ethicists claim that the legal boundary does not represent the corporate responsibility*

❑ Risk & Return : Present Value VS Future Value

· *Greater the Risk, Greater the Return → Compensation of investors bearing the risk*

· *Holding Period Returns : Total Return over holding period*

- *Consists 2 Components → 1) Capital Appreciation 2) Income*

1) *Capital Appreciation : Changes in the price of the Asset*
2) *Income : Cashflow from holding the asset(such as cash dividend)*

$$R_T = R_{CA} + R_I = \frac{\Delta P}{P_0} + \frac{CF_1}{P_0} = \frac{\Delta P + CF_1}{P_0}.$$

· *Expected Return : What do I expect to receive from the investment?*

- *Consists 2 determinants → 1) Probability (of receiving such return) 2) Return (estimated return amounts)*

$$E(R_{Asset}) = \sum_{i=1}^{n} (p_i \times R_i) = (p_1 \times R_1) + (p_2 \times R_2) + \ldots + (p_n \times R_n)$$

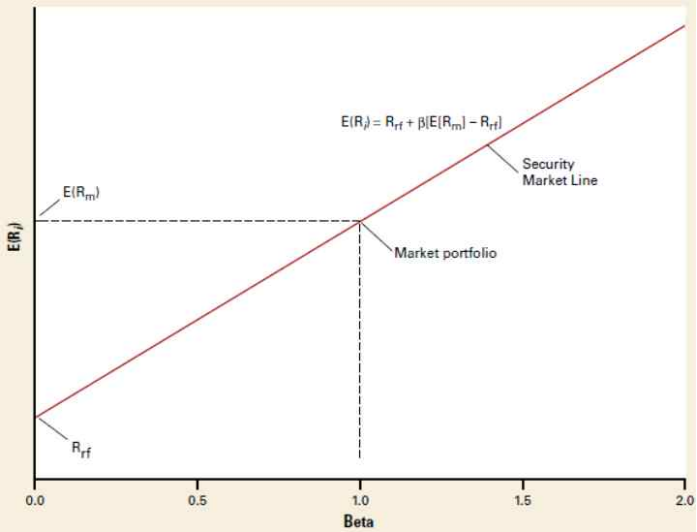
· *Measuring Systematic Risk : Using β(Beta)*

- *β(Beta) : Measures in the sensitivities of the returns on assets to the movement to the market*
- *When β = 1 (Asset Systematic Risk = Market Portfolio), β>1 (Asset Systematic Risk > Market Portfolio)*
- *Market Premium : Compensation for bearing market risk E(Rm) - Rf(Return of risk-free item)*

$$E(R_i) = R_f + \beta_i * (E(R_m) - R_f)$$ = Capital Asset Pricing Model(CAPM)

· *Capital Asset Pricing Model(CAPM) an Security Market Line(SML)*

- *Recognising 1) Risk Free Return 2) Level of Risk measured 3) Market Premium(Compensation for taking risk)*
- *Equivalent to the formula for security market line(SML), that CAPM also predicts various items*
- *Explaining relationship between expected returns and measures of risk(β)*



	Formula	Details
1	*Revenue* *– Operating Exp.*	· *Deducting expenses (excl. interest expense) that refers to the earnings of the business that ready to be measured / estimated*
2	*EBITDA* *– Dep'n & Ammortisation*	· *Substracting D&A as they are non-cash, but yet tax deductible expenses that decrease the amount of taxable income*
3	*EBIT* ** (1 – Tax Rate)*	· *Tax must be deducted from the earnings before estimating/evaluating any future economic benefits/impacts*
4	*NOPAT* *+ Dep'n & Ammortisation*	· *As the 'Shields' have done their job, add them backup in order to identify the initial estimates of forward cashflows*
5	*CF Opns* *– Capital Expenditures* *– Additions to Working Capital*	· *Cap. Exp : Investments required to purchase LT assets* · *Add WC : (Changes in Cash + A/R + Inventory) - Changes A/P*
6	*FCF* *± Salvage Value after tax*	· *Value recovered from terminating the project/assets* · *(Salvage Value – Book value) * Tax* · *Book value = Purchae price – Accumulated Depreciation*

※ *FCF impact is independent from accounting earnings, as accounting earnings reflect non-cash charges(D&A)*

❑ Financing of Working Capital

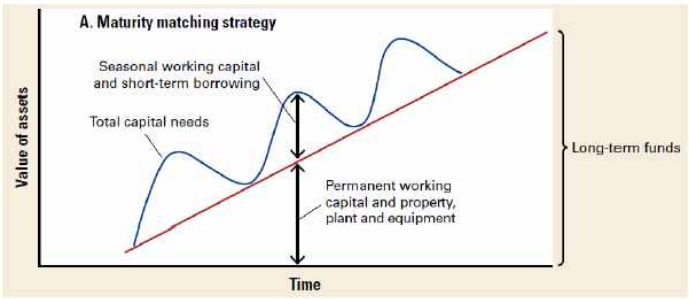
· *3 Methods of working capital Financing*

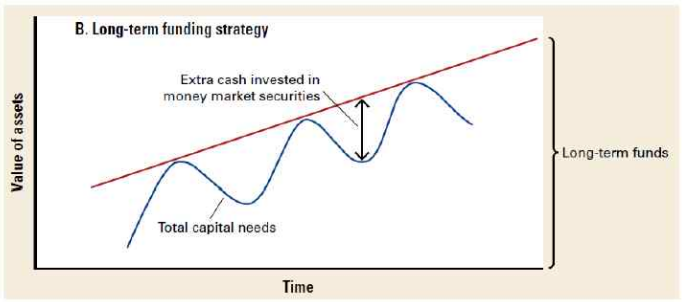
1) *Maturity Matching Strategy* : *'Long Term Assets with LT instruments, Short Term Assets with ST debts'*

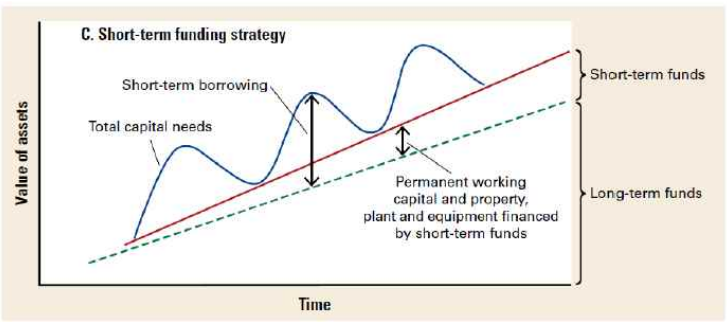
2) *Long Term Financing Strategy* : *'Conservative'* → *Covering both LT and ST Assets with LT instruments*

- *When non-season, excess working capital incurs → Adoption of projects*

3) *Short Term Financing Strategy* : *ALL ST Assets and part of LT Assets with ST debts*







※ *Matching of Maturities is commonly used in practice; avoid excess cost of refinancing*