

TIM 80C

5/11/17

Lecture 12

(1) Financing Overview, cont.

(2) Cash Flow Analysis
(Financial Strategy)

(3) Midterm

(1) Financing

Capital Structure of a company refers to how it is financed

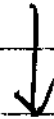
Companies are financed from two sources:

The company's owners
(shareholders)



cash contributed by shareholders is called equity capital

Financial institutions
(e.g., banks) or individuals that lend money to the company
(debt holders)



cash contributed by debt holders is called debt capital.

The capital structure of the company is the debt-to-equity ratio:

$$\frac{\text{debt capital}}{\text{equity capital}}$$

A high debt/equity ratio \Rightarrow

more earning potential, but
more risk

- called "being leveraged"

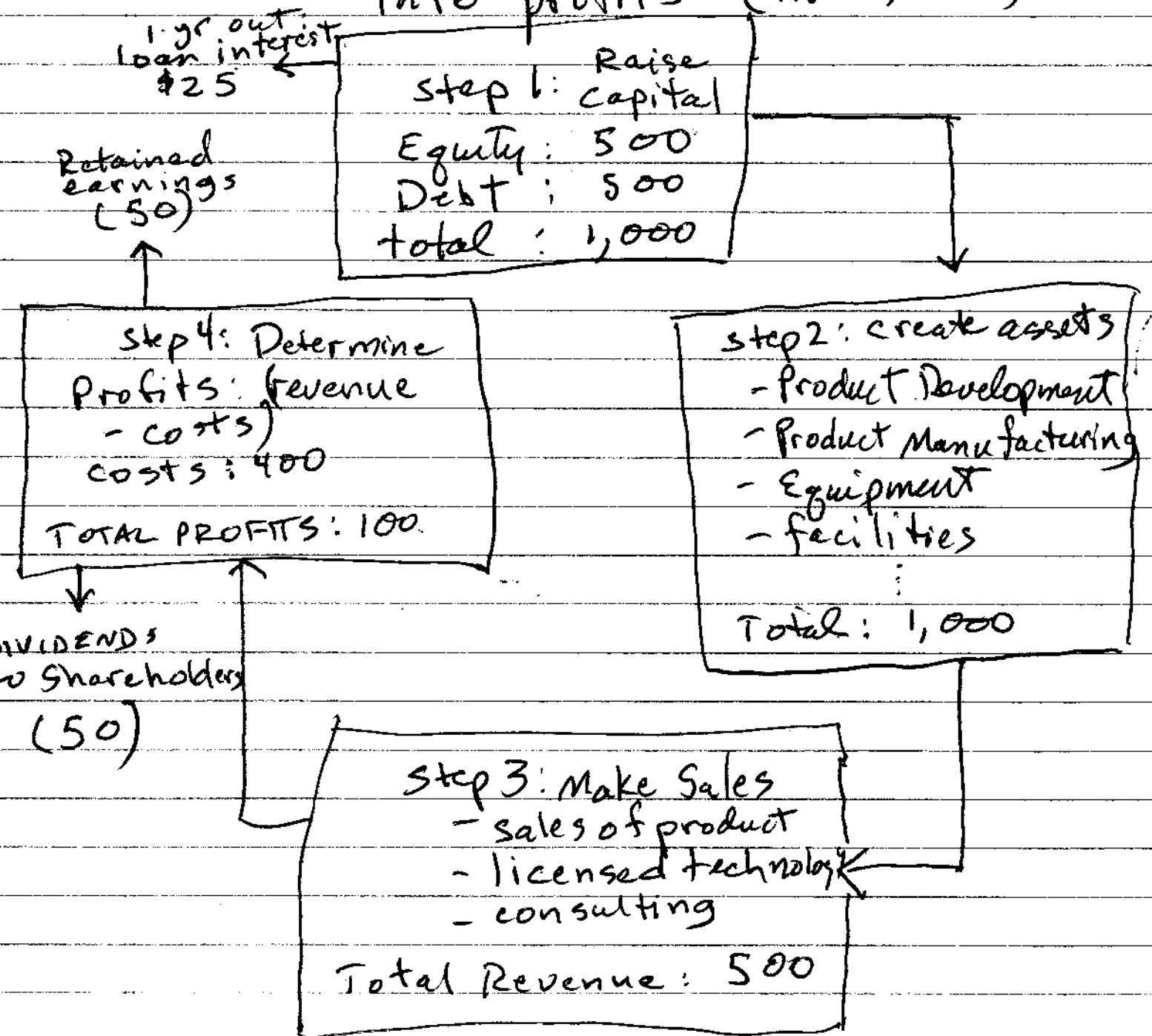
Typical "D/E ratios" ... it depends
on the market

e.g. hardware company > software
company

why?: inventory & machinery can
be sold to cover debt

A 1-year business cycle

Turning capital investment into profits (in \$1,000's)



Financial Metrics for Assessing a Company

(1) capital structure = $\frac{\text{debt}}{\text{equity}}$

EX: $\frac{\$500k}{\$500k} = 1$

(2) Return on Assets = $\frac{\text{Revenue}}{\text{Assets}}$
(ROA)

EX: $\frac{\$500k}{\$1,000k} = 0.5 \text{ or } 50\%$

(3) Profit Margin = $\frac{\text{Profit}}{\text{Revenues}}$

EX: $\frac{\$100k}{\$500k} = 20\%$
(very good)

(4) Retention Rate = $\frac{\text{Retained Earnings}}{\text{profit}}$

e.g.) $\frac{\$50k}{\$100k} = 50\%$

(5) Return on invested capital

ROIC

$$\frac{\text{Profit}}{\text{invested capital}}$$

E.g.: $\frac{\$100}{\$1,000} = 10\%$ (good)

(6) Return on Equity (ROE)

$$\frac{\text{Profit}}{\text{Equity Capital}}$$

Ex: $\frac{\$100}{\$500} = 20\%$

(7) Return on Debt

$$\frac{\text{Profit}}{\text{debt capital}}$$

E.g.: $\frac{\$100\text{K}}{\$500\text{K}} = 20\%$

(8) Equity cost: (%)

$$\frac{\text{dividends}}{\text{equity capital}}$$

e.g.: $\frac{\$50\text{K}}{\$500\text{K}}$

= 10%

(9) Debt cost: (%)

$$\frac{\text{interest payments}}{\text{debt capital}}$$

$\frac{\$25\text{K}}{\$500\text{K}}$

= 5%

(10) Weighted average cost of capital

$$\text{WACC: } \left(\left(\frac{\text{equity capital}}{\text{invested capital}} \right) \times \text{equity cost}(\%) \right) + \left(\left(\frac{\text{debt capital}}{\text{invested capital}} \right) \times \text{debt cost}(\%) \right)$$

$$= \left(\left(\frac{\$500\text{k}}{\$1,000\text{k}} \right) \times 10\% \right) + \left(\left(\frac{\$500\text{k}}{\$1,000\text{k}} \right) \times 5\% \right) = 7.5\%$$