

Financial Management

4/10/23

- Management → Decision Making
 - Household, trust, school business
 - Government - All have mgmt

- Business ~~not~~ ^{of} ?

- * Definition of business varies based on one perspective
- * HR personnel → Business is an assembly of men and machines that produces profit
- * Consumer Relations people → Business is basically the process of satisfying the customer
- * Engineer → (some technical definition)
- * Finance Guy

Business is the process of generating income using your assets

Asset : Right, entitlement, possession

Asset is a stored value

Asset is something that can be exchanged for some benefit

Business start ~~at 20~~ to ~~at 20~~ Assets
Procure ~~at 20~~ ~~4500~~ £ |

Suppose u want to open a hydro plant
you need turbine

you already don't own a turbine
so you buy a turbine

Nobody will give u a turbine free free

Steps

- (1) Get some money
- (2) Invest it in buying the turbine
- (3) Get the asset (turbine)

- If there are no options, no decision ~~can be~~ needs to be taken
- If there are options, a decision has to be taken (~~it~~ is mandatory to transform and take a formal decision whenever ~~there are~~ there is availability of multiple options)

Own Capital is the first source of finance

Sources of finance are of 2 types

- ① short term source
- ② long term source

which provide
money for
long period

Example : Own capital,
shareholder's capital,
retained earnings

Those items which
supply you ~~long~~
the funding only
for a short definite
period

Example : Bank loan,
creditors

We will study Corporate financial mgmt

Business = Risk -

Own capital is called equity share capital
Partnership business :- Partner's capital

Committed Payment : The payment that you ~~has need~~ to give to someone have to pay mandatorily to someone as a legal obligation. Example : Worker's wages, loan repayment, tax

① Equity Share Capital : Same as own capital

① Shareholder Capital : Considered as a part of equity share capital

② Borrowed Capital / Debt Capital

→ Terms of Repayment

- Pay after fixed time
- Pay in ~~total~~ fixed installments
- Pay as soon as able

~~Non-Convertible~~

IRREDEEMABLE

↓
Own capital cannot be refunded before the liquidation of the business

Liquidity : Ability to use the concerned asset to pay your immediate committed payments

Debentures / Bonds → Companies can issue bonds to independent people / entities to obtain loans from such people or entities.

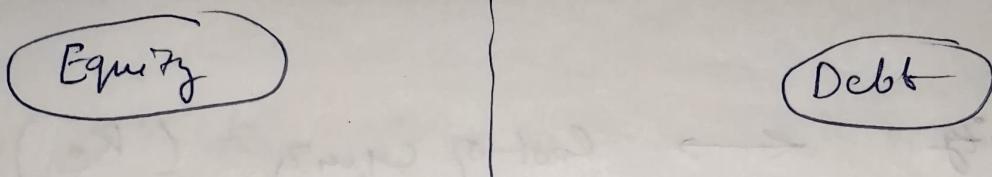
~~Debentures and bonds~~ Any money invested in these debentures or bonds can be claimed back using legal process

Hypothecation / Mortgage



③ Retained earnings : Reinvested capital

④ Preference share capital :



first pay the debtors, then pay the shareholders

Risk bearing is the acid test of ownership
Equity share holders are the ultimate owners of a company

$$\frac{\text{Debt}}{\text{Equity}} = \text{Capital structure}$$

Financing decision \Rightarrow Decision made in order to obtain the money needed to start a business.

100% equity OR 60% equity 40% debt OR

50% equity, 40% debt, 10% retained OR

Something else. Which option to choose??

This decision making is called ^{Financially} decision

Cost of Capital (K)

Expectation of the providers of fund

Equity \longleftrightarrow Cost of equity (K_e)

Debt \longleftrightarrow Cost of Debt (K_d)

Retained earning \longleftrightarrow " of retained earning (k_s)

Preferred \longleftrightarrow " " Pref. (K_p)

Suppose a business has

60% funding from equity $K_e = \text{£4 lakh}$

40% from debt $K_d = \text{£2 lakh}$

$$K_o = \frac{K_e \times \frac{60}{100} + K_d \times \frac{40}{100}}{\frac{60}{100} + \frac{40}{100}}$$

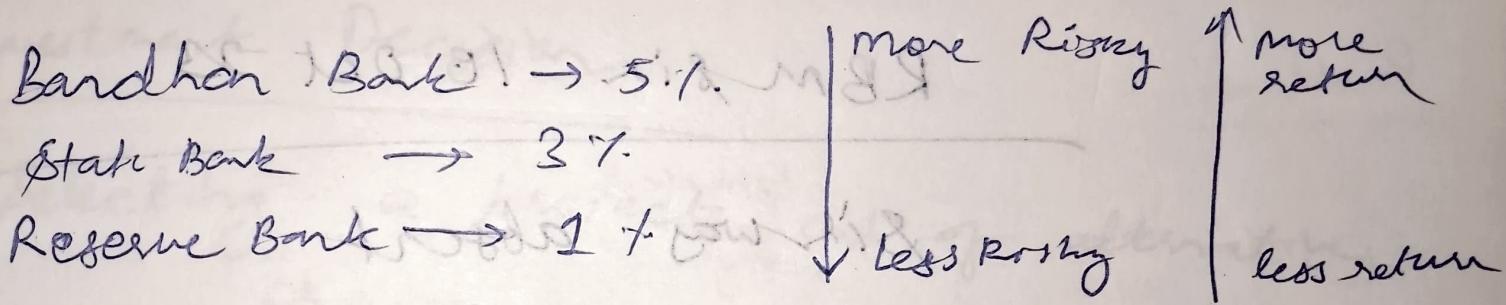
(Weighted average)

Risk perception for investor

No risk \rightarrow No gain

Small risk \rightarrow Small gain

Big risk \rightarrow Large gain



$$K_d < K_e$$

Ayan Pandey → Financing decisions

Asset → Gives Benefit ^{now} ← ^{in future}
 Asset → Gives Benefit ^{in future} [long term ^{store of value}]

Liability → Bank loan

You get benefit now
 But you need to pay back the original
 benefit + interest ^{give} in the future

- ① Own capital / Partnership capital / Equity share capital
- ② ~~fact~~ Debt Capital
- ③ Re-investment of past profits (Retained earnings)
- ④ Preference Capital

[Midway between equity and debt]

Preference 1 → Debtor

Preference 2 → Equity share holder

Decision to be made : 60% debt 40% equity

OR

50% debt and 50% equity

OR

Something else?

| <u>Type of finance</u> | <u>Cost of capital</u> |
|--------------------------|--|
| ① Own capital / Equity / | Cost of Equity Share Capital (K_e) |
| ② Debt | K_d |
| ③ Retained earning | K_e |
| ④ Preference | K_p |

For a mixture of ①, ②, ③, ④

Cost of capital = weighted average

* Cost of capital = Expectation of the providers of the capital.

* If risk is more, expectation is more

* Risk is maximum for the last person in the queue

The Order : Debt → Equity

Why do we don't have 100% debt financing

Equity share holders are the real risk holders

Very good

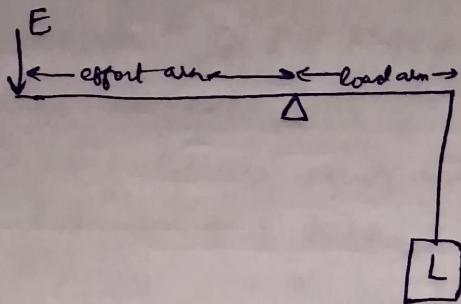
get cash from

lenders

Leverage

concept of leverage -

"The fixed point magnifies the effort"



Operating leverage

$$\text{Degree of operating leverage} = \frac{\text{Change in EBIT}}{\text{Change in EPS}}$$

Degree

Numericals will come from these formula

$$\text{Degree of Operating leverage} = \frac{\text{Change in Earnings before taxes and interest}}{\text{Profit change in sales}}$$

$$= \frac{\text{EBIT at present change } f \text{ in sales}}{\text{Change in sales}}$$

$$\text{Degree of financial leverage} = \frac{\text{Change in EBIT}}{\text{Change in EPS}}$$

$$\text{Degree of combined leverage} = \frac{\text{Change in EPS}}{\text{Change in Sales}}$$

EBIT \rightarrow independent variable

EPS \rightarrow dependent

interest bearing securities

$$\text{Combined leverage} = \frac{\text{Operating leverage} \times \text{Financial leverage}}{\text{Not controllable}}$$

\uparrow \uparrow

Can be controlled
by
using appropriate
ratio of $\frac{\text{debt}}{\text{equity}}$

If we have high operating leverage then we
low percentage of debt and high percentage of
equity

Income \longrightarrow EPS story

RBM sir - 18 Oct - 23

Sikway assert

RBM sir 1/nov/2023

financing decision

4 sources → ~~कितना कितना कितना कितना~~ कितना कितना कितना + Decide कितना

↓
collect funds

↓
Build capital

↓
Invest in the business

↓
Calculate profit

If Profit, Continue with same policy

If loss; Change policies

Investment Decision

Selecting a project ~~lasted 10 days~~ out of alternative choices

Suppose we have 10 lakh rupees capital

We can → Operate a ~~shop~~ shop

→ do Project 1

→ do Project 2

→ do

Basket of goods and services that a can command by using 1 unit of currency ~~and~~

= Purchasing Power of that currency

1 rupee today \neq 1 rupee tomorrow

The value of money

Discounting

+ Opposite of

compounding

Compounding

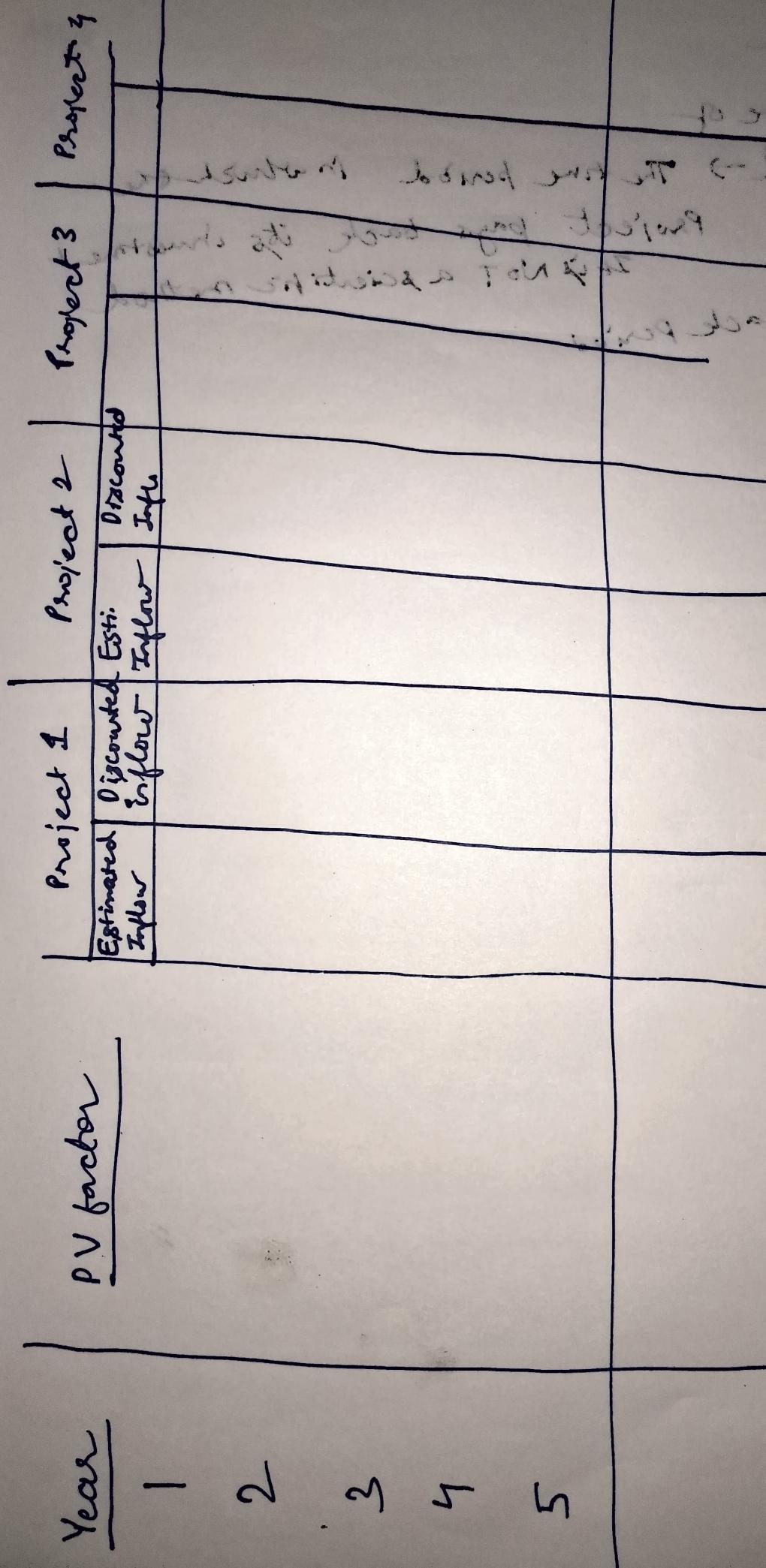
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Problem

Outlay, Life, Inflow, Discounting Rate
will be given

Present value factor = $\frac{1}{(1+i)^n}$

Present value factor = $\frac{1}{(1+i)^n}$



NPV method

IRR → Rate of

Payback Period → The time period in which the
Project pays back its investment
It's NOT a scientific method

Discounted Payback Period