

Chapter 12

FINANCING

Tell me how you're financed and I'll tell you who you are

When you evaluate how a company is financed, you must perform both dynamic and static analyses.

When it is founded, a company makes two types of investments. Firstly, it invests to acquire land, buildings, equipment, etc. Secondly, it makes operating investments, specifically start-up costs and building up working capital.

To finance these investments, the company must raise either equity or debt financing. The investments, which initially generate negative cash flows, must generate positive cash flows over time. After subtracting returns to the providers of the company's financing (interest and dividends), as well as taxes, these cash flows must enable the company to repay its borrowings.

If the circle is a virtuous one, i.e. if the cash flows generated are enough to meet interest and dividend payments and repay debt, the company will gradually be able to grow and, as it repays its debt, it will be able to borrow more (the origin of the illusion that companies never repay their loans).

Conversely, the circle becomes a vicious one if the company's resources are constantly tied up in new investments or if cash flow from operating activities is chronically low. The company systematically needs to borrow to finance capital expenditure, and it may never be able to pay off its debt, not to mention pay dividends.

This is the dynamic approach.

- In parallel with the dynamic approach, you must look at the current state of the company's finances with two questions in mind:
 - Given the proportion of the company's assets financed by bank and other financial debt and the free cash flow generated by the company, can the company repay its debt?
 - Given the term structure of the company's debt, is the company running a high risk of illiquidity?

This is the static approach.

Section 12.1

A DYNAMIC ANALYSIS OF THE COMPANY'S FINANCING

To perform this analysis you will rely on the cash flow statement.

1/ THE FUNDAMENTAL CONCEPT OF CASH FLOW FROM OPERATING ACTIVITIES

The cash flow statement (see Chapter 5) is designed to separate operating activities from investing and financing activities. Accordingly, it shows cash flows from operating and investing activities and investments on the one hand and from financing activities on the other. This breakdown will be very useful to you when valuing the company and examining investment decisions.

The concept of cash flow from operating activities, as shown by the cash flow statement, is of the utmost importance. It depends on three fundamental parameters:

- the rate of growth in the company's business;
- the amount and nature of operating margins;
- the amount and nature of working capital.

An analysis of the cash flow statement is therefore the logical extension of the analysis of the company's margins and the changes in working capital.

Several problems can be dealt with using the concept of cash flow.

By dissociating industrial and financial policy, the cash flow statement emphasises the cash flow from operating activities. Cash flow from operating activities constitutes a fundamental aspect of the company's profitability, especially in an economy where the value of assets on the balance sheet is low. There is no way round the following basic truth: to be profitable, a company must sooner or later generate cash in excess of what it spends. In other words, it must generate a net positive cash flow from operating activities.

Analysing the cash flow statement means analysing the profitability of the company from the point of view of its operating dynamics, rather than the value of its assets.

We once analysed a fast-growing company with a high working capital. Its cash flow from operating activities was insufficient, but its inventories increased in value every year. We found that the company was turning a handsome net income, but its return on capital employed was poor, as most of its profit was made on capital gains on the value of its inventories. Because of this, the company was very vulnerable to any recession in its sector.

In this case, we analysed the cash flow statement and were able to show that the company's trade activity was not profitable and that the capital gains just barely covered its operating losses. It also became apparent that the company's growth process led to huge borrowings, making the company even more vulnerable in the event of a recession.

2/ HOW IS THE COMPANY FINANCED?

As an analyst, you must understand how the company finances its growth over the period in question. New equity capital? New debt? Reinvesting cash flow from operating activities? Asset disposals can contribute additional financial resources. The cash flow

statement will enable you to understand the origin of the company's financial resources over the period.

Did the company issue new equity capital during the period and, if so, for what purpose? To pay down debt or to finance a large investment programme?

As we will see in Chapter 38, the company's dividend policy is also an important aspect of its financial policy. It is a valuable piece of information when evaluating the company's strategy during periods of growth or recession:

- Is the company's dividend policy consistent with its growth strategy?
- Is the company's cash flow reinvestment policy in line with its capital expenditure programme?

You must compare the amount of dividends with the investments and cash flows from operating activities of the period. For a family-owned company, we would also advise increasing dividends by repayment of shareholders loans, and any other unusual operating costs or payments that could be substitutes for dividend payments. You could also look at the company's pay-out ratio.

Analysing the net increase or decrease in the company's debt burden is a question of financial structure.

- If the company is paying down debt, is it doing so in order to improve its financial structure? Has it run out of growth opportunities? Is it to pay back loans that were contracted when interest rates were high?
- If the company is increasing its debt burden, is it taking advantage of unutilised debt capacity? Or is it financing a huge investment project or reducing its shareholders' equity and upsetting its financial equilibrium in the process?

In conclusion, it is imperative that you analyse the cash flow statement to understand the dynamics of the company's cash flows.

In Section III, we will examine the more complex reasoning processes that go into determining investment and financing strategies. For the moment, keep in mind that analysis of the financial statements alone can only result in elementary, common-sense rules.

As you will see later, we stand firmly **against** the following "principles":

- The amount of capital expenditure must be limited to the cash flow from operating activities. **No!** After reading Section III you will understand that the company should continue to invest in new projects until their marginal profitability is equal to the required rate of return. If it invests less, it is underinvesting; if it invests more, it is overinvesting, even if it has the cash to do so.
- The company can achieve equilibrium by having the "cash cow" divisions finance the "glamour" divisions. **No!** With the development of financial markets, every division whose profitability is commensurate with its risk must be able to finance itself. A "cash cow" division should pay the cash flow it generates over to its providers of capital.

Studying the equilibrium between the company's various cash flows in order to set rules is tantamount to considering the company as a world unto itself. This approach is diametrically opposed to financial theory. It goes without saying, however, that you must determine the investment cycle that the company's financing cycle can support. In particular, debt repayment ability remains paramount. We have already warned you about that in Chapter 2!

Section 12.2

A STATIC ANALYSIS OF THE COMPANY'S FINANCING

Focusing on a multi-year period, we have examined how the company's margins, working capital and capital expenditure programmes determine its various cash flows. We can now turn our attention to the company's absolute level of debt at a given point in time and to its capacity to meet its commitments while avoiding liquidity crises.

1/CAN THE COMPANY REPAY ITS DEBTS?

The best way to answer this simple, fundamental question is to take the company's business plan and project future cash flow statements. These statements will show you whether the company generates enough cash flow from operating activities such that after financing its capital expenditure, it has enough left over to meet its debt repayment obligations without asking shareholders to reach into their pockets. If the company must indeed solicit additional equity capital, you must evaluate the market's appetite for such a capital increase. This will depend on who the current shareholders are. A company with a core shareholder will have an easier time than one whose shares are widely held. It will also depend on the value of equity capital (if it is near zero, maybe only a **vulture fund**¹ will be interested).

Naturally, this assumes that you have access to the company's business plan, or that you can construct your own from scenarios of business growth, margins, changes in working capital and likely levels of capital expenditure. We will take a closer look at this approach in Chapter 32.

Analysts and lending banks have in the meantime adopted a "quick-and-dirty" way to appreciate the company's ability to repay its debt: the ratio of net debt to EBITDA. This is in fact the most often used financial covenant in debt contracts!

This highly empirical measure is nonetheless considered useful, because EBITDA is very close to cash flow from operating activities, give or take changes in working capital interests and income tax. A value of 4 is considered a critical level, below which the company should generally be able to meet its repayment obligations.

If we were to oversimplify, we would say that a value of 3 signifies that the debt could be repaid in three years provided the company halted all capital expenditure and didn't pay corporate income tax during that period. Of course, no one would ask the company to pay off all its debt in the span of three years, but the idea is that it could if it had to.

Conversely, bank and other financial borrowings equal to more than 4 times EBITDA is considered a heavy debt load, and gives rise to serious doubts about the company's ability to meet its repayment commitments as scheduled. As we will see in Chapter 44, LBOs can display this type of ratio. When the value of the ratio exceeds 5 or 6, the debt becomes "high-yield", the politically correct euphemism for "junk bonds".

Bankers are more willing to lend money to sectors with stable and highly predictable cash flows (food retail, utilities, real estate), even on the basis of high net debt to EBITDA ratio, than to others where cash flows are more volatile (media, capital goods, electronics).

The following table shows trends in the net debt/EBITDA ratio posted by various different sectors in Europe over 1998–2007.

¹ An investment fund that buys the debt of companies in difficulty or subscribes to equity issues with the aim of taking control of the company at a very low price.

NET DEBT/EBITDA RATIO FOR LEADING LISTED EUROPEAN COMPANIES

Sector	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Oil & Gas	79%	125%	104%	100%	110%	89%	70%	47%	56%	76%
Chemical	91%	114%	101%	152%	138%	128%	108%	108%	126%	106%
Basic Resources	140%	134%	134%	188%	162%	158%	129%	110%	98%	112%
Construction and Materials	71%	66%	104%	112%	83%	65%	91%	101%	118%	116%
Industrials Goods and Services	59%	80%	108%	110%	124%	104%	100%	96%	89%	87%
Automobiles & Parts	125%	159%	162%	210%	168%	156%	135%	133%	103%	154%
Food & Beverage	131%	139%	206%	185%	170%	164%	162%	181%	189%	181%
Personal & Household Goods	80%	85%	116%	116%	97%	98%	76%	86%	98%	100%
Health Care	77%	93%	109%	127%	108%	96%	77%	114%	94%	108%
Retail	41%	73%	89%	89%	89%	69%	56%	105%	73%	117%
Media	6%	19%	19%	67%	78%	55%	20%	48%	44%	125%
Travel & Leisure	173%	143%	210%	224%	151%	160%	148%	112%	146%	122%
Telecommunications	120%	137%	102%	139%	93%	88%	85%	104%	102%	64%
Utilities	158%	155%	175%	148%	171%	226%	218%	216%	175%	185%
Technology	-28%	-28%	-4%	8%	-17%	-57%	-72%	-71%	-63%	-27%

Source: Infinancials

Travel/leisure and utilities are the most highly leveraged sectors. One explanation is their capital intensity, which is strong. Another is the willingness of lenders to lend money to these sectors as they own real estate assets with a value independent from the business (a film theatre can be redeveloped into a commercial area) or with high long-term visibility on cash flows (concession contracts).

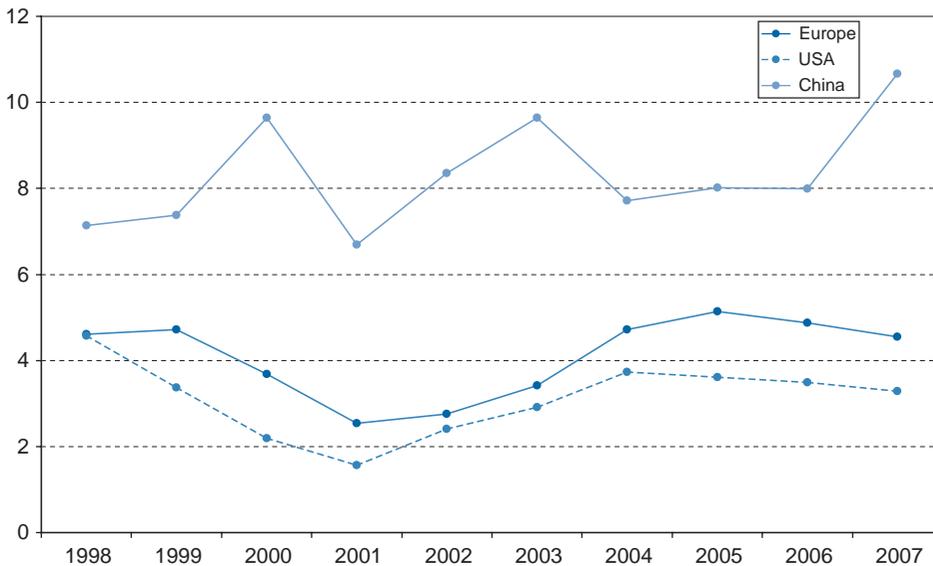
Similarly, analysts look at the debt service ratio (or debt service coverage), i.e. the ratio of EBIT to net interest expense. A ratio of 3:1 is considered as the critical level. Below this level, there are serious doubts as to the company's ability to meet its obligations as scheduled, as for the transport sector post 9/11. Above it, the company's lenders can sleep more easily at night!

The following table shows trends in the net debt service coverage ratio in different regions of the world over the past 10 years.

Until around 15 years ago, the company's ability to repay its loans was evaluated on the basis of its debt-to-equity ratio, or gearing, with a 1:1 ratio considered the critical point.

Certain companies can support bank and other financial debt in excess of shareholders' equity, specifically companies that generate high operating cash flow. KPN, the Dutch telecom operator, which generates robust cash flows from its fixed-line telephony business, is an example. Conversely, other companies would be unable to support debt

DEBT SERVICE COVERAGE RATIO FOR LEADING LISTED COMPANIES



Source: Infinancials

equivalent to more than 30% of their equity, because their margins are very thin. For example, the operating profit of Thomas Cook, the travel company, is at best only 2% of its sales revenue.

We advise against using the debt-to-equity ratio as a measure of the company's repayment capacity: shareholders' equity capital serves to repay loans only in the event of bankruptcy, not in the ordinary course of the business.

2/ IS THE COMPANY RUNNING A RISK OF ILLIQUIDITY?

To understand the notion of liquidity, look at the company in the following manner: at a given point in time, the balance sheet shows the company's assets and commitments. This is what the company has done in the past. Without planning for liquidation, we nevertheless attempt to classify the assets and commitments based on how quickly they are transformed into cash. When will a particular commitment result in a cash disbursement? When will a particular asset translate into a cash receipt?

A company is illiquid when it can no longer meet its scheduled commitments.

To meet its commitments, either the company has assets it can monetise or it must contract new loans. Of course, new loans only postpone the day of reckoning until the new repayment date. By that time, the company will have to find new resources.

Illiquidity comes about when the maturity of the assets is greater than that of the liabilities. Suppose you took out a loan, to be repaid in six months, to buy a machine with a useful life of five years. The useful life of the machine is out of step with the scheduled

repayment of the loan and the interest expenses on it. Consequently, there is a risk of illiquidity, particularly if there is no market to resell the machine at a decent price and if the activity is not profitable. Similarly, at the current asset level, if you borrow 3-month funds to finance inventories that turn over in more than three months, you are running the same risk.

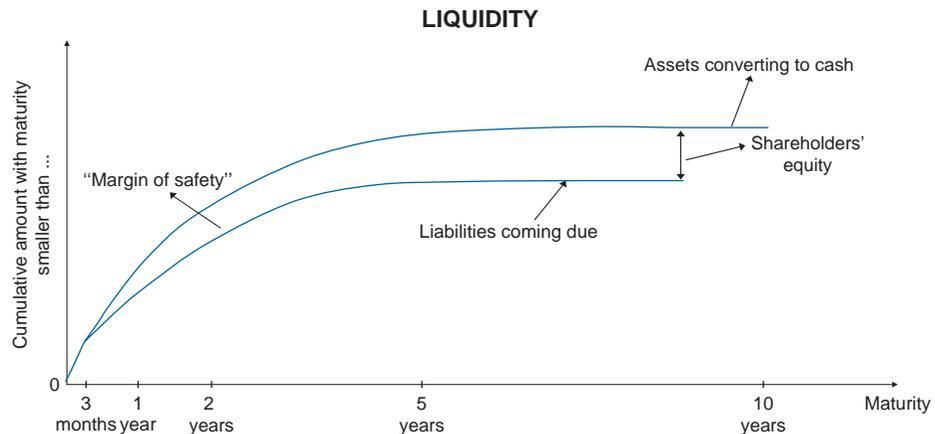
The risk of illiquidity is the risk that assets will become liquid at a slower pace than the rate at which the liabilities will have to be paid, because the maturity of assets is longer. In a sense, liquidity measures the speed at which assets turn over compared with liabilities.

An illiquid company is not necessarily required to declare bankruptcy, but it must find new resources to bridge the gap. In so doing, it forfeits some of its independence, because it will be obliged to devote a portion of its new resources to past uses. In times of recession, it may have trouble doing so, and indeed be forced into bankruptcy.

Analysing liquidity means analysing the risk the company will have to “borrow from Peter to pay Paul”. For each maturity, you must compare the company’s cash needs with the resources it will have at its disposal.

We say that **a balance sheet is liquid when, for each maturity, there are more assets being converted into cash (inventories sold, receivables paid, etc.) than there are liabilities coming due.**

This graph shows, for each maturity, the cumulative amount of assets and liabilities coming due on or before that date.



If, for a given maturity, cumulative assets are less than cumulative liabilities, the company will be unable to meet its obligations unless it finds a new source of funds. The company shown in this graph is not in this situation.

What we are measuring is the **company’s maturity mismatch**, similar to that of a financial institution that borrows short-term funds to finance long-term assets.

(a) Liquidity ratios

To measure liquidity, then, we must compare the maturity of the company’s assets to that of its liabilities. This rule gives rise to the following ratios, commonly used in loan covenants. They enable banks to monitor the risk of their borrowers.

- **Current ratio:**

$$\frac{\text{Current assets (less than one year)}}{\text{Current liabilities (due in less than one year)}}$$

This ratio measures whether the assets to be converted into cash in less than one year exceed the debts to be paid in less than one year.

- The **quick ratio** is another measure of the company's liquidity. It is the same as the current ratio, except that inventories are excluded from the calculation. Using the quick ratio is a way of recognising that a portion of inventories corresponds to the minimum the company requires for its ongoing activity. As such, they are tantamount to fixed assets. It also recognises that the company may not be able to liquidate the inventories it has on hand quickly enough in the event of an urgent cash need. Certain inventory items have value only to the extent they are used in the production process.

The quick ratio (also called **acid test ratio**) is calculated as follows:

$$\frac{\text{Current assets (less than one year) excluding inventories}}{\text{Current liabilities (due in less than one year)}}$$

- Finally, the **cash ratio** completes the set:

$$\frac{\text{Cash and cash equivalents}}{\text{Current liabilities (due in less than one year)}}$$

The cash ratio is generally very low. Its fluctuations often do not lend themselves to easy interpretation.

(b) More on the current ratio

Traditional financial analysis relies on the following rule:

A company must maintain a buffer between sources and uses of funds maturing in less than one year to cover risks inherent in its business (loss of inventory value, deadbeat customers, decline in sales, business interruption costs that suddenly reduce shareholders' equity capital), because liabilities are not subject to such losses in value.

By maintaining a current ratio above one (more current assets than current liabilities), the company protects its creditors from uncertainties in the "gradual liquidation" of its current assets, namely in the sale of its inventories and the collection of its receivables. These uncertainties could otherwise prevent the company from honouring its obligations, such as paying its suppliers, servicing bank loans or paying taxes.

If we look at the long-term portion of the balance sheet, a current ratio above one means that sources of funds due in more than one year, deemed stable,² are greater than fixed assets, i.e. uses of funds "maturing" in more than one year. If the current ratio is below 1, then fixed assets are being financed partially by short-term borrowings or by a negative working capital. This situation can be dangerous. These sources of funds are liabilities that will very shortly become due, whereas fixed assets "liquidate" only gradually in the long term.

The current ratio was the cornerstone of any financial analysis years ago. This was clearly excessive. The current ratio reflects the choice between short-term and long-term financing. In our view, this was a problem typical of the credit-based economy, as it

² Also called "permanent financing". They include shareholder's equity, which is never due, and debts maturing after one year.

existed in the 1970s in Continental Europe. Today, the choice is more between shareholders' equity capital and banking or financial debt, whatever its maturity. This said, **we still think it is unhealthy to finance a permanent working capital with very short-term resources. The company that does so will be defenceless in the event of a liquidity crisis, which could push it into bankruptcy.**

(c) Financing working capital

To the extent that working capital represents a permanent need, logic dictates that permanent financing should finance it. Since it remains constant for a constant business volume, we are even tempted to say that it should be financed by shareholders' equity. Indeed, companies with a high working capital are often largely funded by shareholders' equity. This is the case, for example, with big champagne companies, which often turn to the capital markets for equity funding.

Nevertheless, most companies would be in an unfavourable cash position if they had to finance their working capital strictly with long-term debt or shareholders' equity. Instead, they use the mechanism of revolving credits, which we will discuss in Chapter 26. For that matter, the fact that the components of working capital are self-renewing encourages companies to use revolving credit facilities in which customer receivables and inventories often collateralise the borrowings.

By their nature, revolving credit facilities are always in effect, and their risk is often tied directly to underlying transactions or collateralised by them (bills discounting, factoring, securitisation, etc.).

Full and permanent use of short-term revolving credit facilities can often be dangerous, because it:

- exhausts borrowing capacity;
- inflates interest expense unnecessarily;
- increases the volume of relatively inflexible commitments, which will restrict the company's ability to stabilise or restructure its activity.

Working capital is not only a question of financing. It can carry an operational risk as well. Financing through short-term borrowing solves the immediate cash management problem, but makes the company very vulnerable to any changes in its trade and financial environment. Such financing has provoked some spectacular bankruptcies or quasi bankruptcies (i.e. Vivendi). Short-term borrowing does not exempt the company from strategic analysis of how its operating needs will change over time. This is a prerequisite to any financing strategy.

Companies that export a high proportion of their sales or that participate in construction and public works projects are risky inasmuch as they often have insufficient shareholders' equity compared with their total working capital. The difference is often financed by revolving credits, until one day, when the going gets rough . . .

In sum, you must pay attention to the true nature of working capital, and understand that a short-term loan that finances a permanent working capital cannot be repaid by the operating cycle except by squeezing that cycle down or, in other words, by beginning to liquidate the company.

(d) Companies with negative working capital

Companies with a negative working capital raise a fundamental question for the financial analyst. Should they be allowed to reduce their shareholders' equity on the strength of their robust, positive cash position?

Can a company with a negative working capital maintain a financial structure with relatively little shareholders' equity? This would seem to be an anomaly in financial theory. On the practical level, we can make two observations.

Firstly, under normal operating conditions, the company's overall financing structure is more important and more telling than the absolute value of its negative working capital.

Let's look at companies *A* and *B*, whose balance sheets are as follows:

Company <i>A</i>			
Fixed assets	900	Shareholders' equity	800
Working capital	1,000	Net debt	1,100
Company <i>B</i>			
Fixed assets	125	Shareholders' equity	100
Cash & cash equiv.	105	Neg. working capital	130

Most of company *A*'s assets, in particular its working capital, are financed by debt. As a result, the company is much more vulnerable than company *B*, whose working capital is well into negative territory and whose fixed assets are mostly financed by shareholders' equity.

Secondly, a company with a negative working capital reacts much more quickly in times of crisis, such as recession. Inertia, which hinders positive working capital companies, is not as great.

Nevertheless, a negative working capital company runs two risks:

- The payment terms granted by its suppliers may suddenly change. This is a function of the balance of power between the company and its supplier, and unless there is an outside event, such as a change in the legislative environment, such risk is minimal. On the contrary, when a company with a negative working capital grows, its position *vis-à-vis* its suppliers tends to improve.
- A contraction in the company's business volume can put a serious dent in its financial structure.

Section 12.3**CASE STUDY: INDESIT³**

³ The financial statements for Indesit are on pages 55, 56 and 174

Cash flow from operating activity remains healthy from 2005 to 2007 (remaining over €200 million each year, even in 2005 when the activity slowed down slightly). Cash flows from operating activity are therefore sufficient to cover capital expenditure.

In 2005 the free cash flows after financial expense are almost just enough to cover dividend payment and the net debt of the group therefore remains constant. In 2006 and 2007, Indesit generates large enough free cash flows to distribute dividends and to reduce its net debt level significantly.

The combination of a reduction net debt and an increasing EBITDA leads to a sharp decrease in net debt level measured by the ratio net debt/EBITDA (from $2.6 \times$ in 2004 to $1.0 \times$ in 2007). The net debt can now be considered as low (a term that we could not have used in 2004).

Analysing the balance sheet, the liquidity of the group in 2007 could be questioned as short-term debt (€276 million) is higher than the available cash and cash equivalent (€187 million). Digging a little further we find that c. €100 million of short term debt are against receivables. In addition, in 2006 the group secured for five years a syndicated loan of €350 million which is undrawn. We can therefore conclude that Indesit has no liquidity issue.

SUMMARY

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Analysing how a company is financed can be performed either by looking at several fiscal years, or on the basis of the latest available balance sheet.

In the dynamic approach, your main analytical tool will be the cash flow statement. Cash flow from operating activities is the key metric.

Cash flow from operating activities depends on the growth rate of the business and on the size and nature of working capital. Cash flow from operating activities must cover capital expenditure, loan repayment and dividends. Otherwise, the company will have to borrow more to pay for its past use of funds.

The company uses shareholders' equity and bank or financial debts to finance its investments. These investments must gradually generate enough positive cash flow to repay debt and provide a return to shareholders.

In the static approach, analysis tries to answer the following two questions:

- Can the company repay its debts as scheduled? To answer this question, you must build projected cash flow statements, based on assumed rates of growth in sales, margins, working capital and capital expenditure. To perform a simplified analysis, you can calculate the net debt/EBITDA ratio. If the company is to have an acceptable capacity to meet its repayment commitments as scheduled, the ratio should not be in excess of 4. Similarly, the EBIT/debt service ratio should be at least equal to 3.
- Is the company running the risk of being illiquid? To answer this question, you must compare the dates at which the company's liabilities will come due and the dates at which its assets will be liquidated. Assets should mature before liabilities. If they do, the company will remain liquid.

QUESTIONS

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quiz

- 1/Why is it imperative to analyse the cash flow statement?
- 2/Should capital expenditure level depend on cash flow from operating activities?
- 3/Your marketing manager suggests that you launch a marketing drive, giving some customers discounts and advantageous payment terms. State your views.

- 4/Is financial expense included in cash flow from operating activities?
- 5/Is a company with negative working capital illiquid?
- 6/In your view, should short-term debt be separated out from medium- to long-term debt on the cash flow statement? Why?
- 7/Short-term interest rates are currently very low and you are offered a 3-month loan. State your views.
- 8/The debt-to-equity ratio of Allied Domecq plc (spirits group) was 2.1 mid 2004. State your views.

- 1/ Below are the key figures for company Ivankovic over the last five years.

	2004	2005	2006	2007	2008
Fixed assets	100	110	120	130	140
Working capital	200	225	250	280	315
EBITDA	38	40	44	48	52
Depreciation and amortisation	10	10	11	12	13
Financial expense	14	15	17	19	22
Income tax expense	7	7.5	8	8	8.5
Dividends	5	5	5	6	6

Draw up the cash flow statement for years 2005–2008.
State your views.

- 2/ Analyse and compare the summary cash flow statements of companies A, B and C.

	A	B	C
Cash flow from operating activities	−100	50	−50
Capital expenditure	−150	−30	250
Capital increase	250	0	0
Dividends paid	0	−15	0
Decrease in net debt	0	5	200

- 3/ What is your view of Ringkvist AB?

Ringkvist AB	2005	2006	2007
Cash flow from operating activities	400	700	1 600
Capital expenditure	1000	1300	1400
Asset disposals	0	0	0
Capital increase	300	300	0
Dividends paid	0	100	200
Decrease in net debt	−300	−400	0

EXERCISES

4/ What is your view of Moser srl?

Moser srl	2005	2006	2007
Cash flow from operating activities	400	300	-200
Capital expenditure	1000	1100	300
Asset disposals	0	0	300
Capital increase	300	0	600
Dividends	0	0	0
Decrease in net debt	-300	-800	400

5/ What is your view of the liquidity of this company?

7-year fixed assets	200	Shareholders' equity	100
3-year fixed assets	200	5-year debts	200
3-month inventories	300	1-year debts	300
2-month receivables	100	1-month debts	400
1-day liquidities	200		
Total	1000	Total	1000

ANSWERS

Questions

- 1/ In order to emphasise the dynamic of returns on investments.
- 2/ No, because financing can always be found for an investment that will bring returns, but sooner or later these returns must generate cash flows.
- 3/ This will have a double impact on cash flow from operating activities (drop in margins and increase in working capital).
- 4/ Yes, see Chapter 5.
- 5/ Normally no, as negative working capital provides the company with cash, solving any liquidity problem it may have. Nevertheless, if the company has invested this cash in fixed assets and the business is contracting, change in working capital will become a cash drain and the company may face a liquidity crisis.
- 6/ No, net decrease in debt provides more information (see Chapter 5).
- 7/ How would you pay off a loan in three months? You run the risk of not being able to raise new funds when your cheap loan matures.
- 8/ This level of debt can only be evaluated in relation to Allied Domecq's capacity to generate substantial cash flow. Most of the time spirits companies generate high cash flows.

Exercises

1/ Cash flow statement

	2005	2006	2007	2008
Cash flow	17.5	19	21	21.5
Change in working capital	25	25	30	35
Cash flow from operating activities	-7.5	-6	-9	-13.5
Capital expenditures	20	21	22	23
Dividends paid	5	5	5	6
Decrease in net debt	-32.5	-32	-36	-42.5

The company Ivankovic is in a high-growth and high capital expenditure phase. Ivankovic is unable to control working capital, hence a large cash deficit. This deficit is covered by debt, leading to a sharp rise in financial expense. The financial situation of Ivankovic is worsening and, if there is a slump in the economy, Ivankovic might face bankruptcy.

2/ Company A is probably a newly-formed company – its cash flow from operating activities is still negative. It will have to make huge capital expenditures. Given the high level of risk, it finances its needs using equity exclusively.

Company B has reached maturity, its operating activities generate more cash than is needed to cover its capital expenditure. The company will be able to reduce its debt.

Company C is clearly in trouble. Its operations generate a large cash deficit, and the company is no longer investing but is shedding assets in order to reduce debt.

3/ Ringkvist AB is in a virtuous circle of growth. The company is investing, the investments are generating in-flows, cash from operating activities thus increases every year, and the company does not need to borrow much. In period 3, Ringkvist AB generates enough cash through operating activities to finance its capital expenditures, pay dividends, and stabilise its debt level.

4/ Moser srl is in a vicious circle. Cash flow from operating activities declines from year to year. Moser srl thus has to borrow heavily in year 2 to finance its capital expenditure. In year 3, the company experiences serious cash shortfalls, since cash generated by operating activities is negative. The company is forced to call on its shareholders to bail it out. It also launches a programme to refocus on its core business, which leads to asset disposals. Net capital expenditures are thus nil. Moser srl must reduce its debt.

5/ There is no guarantee of liquidity in one month (shortfall of $400 - 200 = 200$), nor in one year (shortfall of $700 - 600 = 100$), nor in five years (shortfall of $900 - 800 = 100$). The company will have to restructure its debt quickly in order to postpone payment of instalments due.

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