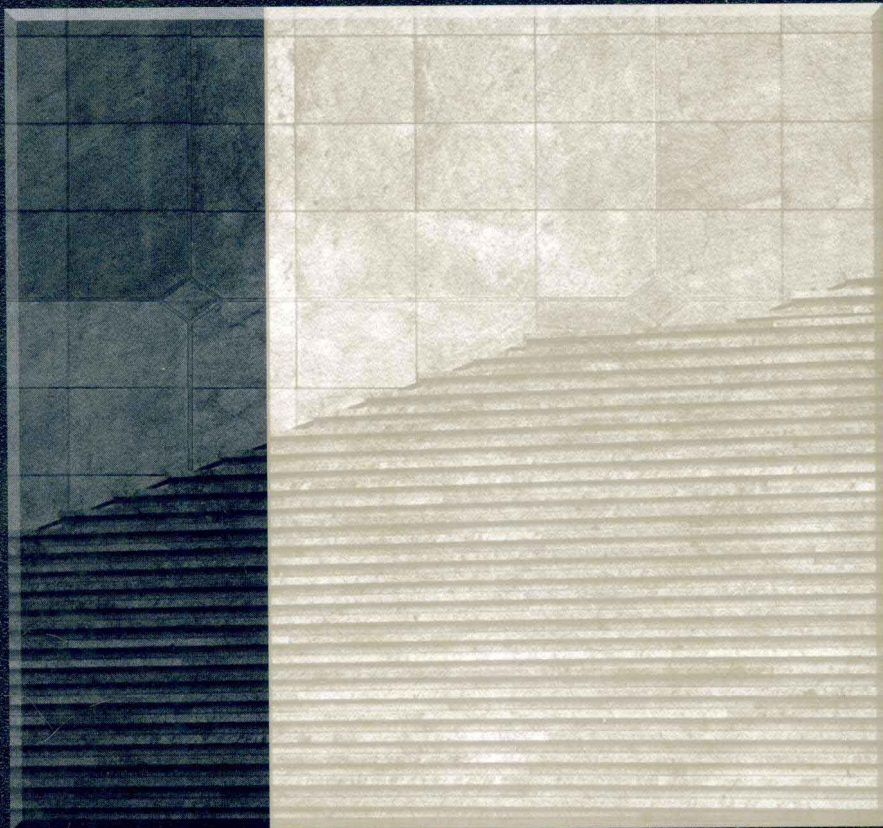


Second Edition

FINANCE FOR EXECUTIVES

Managing for Value Creation



Hawawini ■ Viallet

Second Edition

FINANCE FOR EXECUTIVES

Managing for Value Creation

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To our spouses and children, with love and gratitude.

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PREFACE

Finance is an essential and exciting area of management that many executives want to discover or explore in more depth. Most finance textbooks, however, are either too advanced or too simplistic for many non-financial managers. Our challenge was to write an introductory text that is specifically addressed to executives, and that is both practical and rigorous.

The target audience is executives directly and indirectly involved with financial matters and financial management—that is, just about every executive. The text will also work well in executive-development programs—including executive MBA programs—and in finance courses at the college level. Over the past few years, most of the material in this book has been used by several thousands of managers around the world. Business students, both undergraduates and graduates, have found it either a good substitute for, or a helpful complement to, their main textbook.

Finance for Executives has a number of important features:

- **It is based on the principle that firms should be managed to increase the wealth of their shareholders.**

Managers must make decisions that are expected to increase the wealth of shareholders. This fundamental principle underlies our approach to management. This book was designed to improve your ability to make decisions that create shareholder value, including decisions to restructure existing operations, launch a new product, buy a new asset, acquire another company, and finance the firm's investments.

- **It fills the gap between introductory accounting and finance manuals for non-financial managers and advanced texts in corporate finance.**

Finance for Executives is based on modern finance principles. It emphasizes rigorous analysis but avoids complicated formulas that have no direct application to decision making. Whenever a formula is used in the text, we explain the intuition behind it and provide detailed applications. The mathematical derivations of the formulas are given in the appendices that follow the chapter where they first appear. Recognizing that executives often approach financial problems from a financial accounting perspective, we begin with a solid review of the financial accounting system. We then show how this framework can be extended and used to make sound financial decisions that enhance the firm's value.

- **Most chapters are self-contained.**

Most chapters can be read without prior reading of the others. Where knowledge of a previous chapter would enhance comprehension of a specific section, we direct the reader back to that previously developed material. Further advice on this score is provided below in the section entitled “How to Read this Book.”

- **It can be read in its entirety or used as a reference.**

The book can be used as a quick reference whenever there is a need to brush up on a specific topic or close a gap in your financial management knowledge. A comprehensive glossary and the index at the end of the book will help you determine which chapters deal with the desired issue or topic. Most financial terms are explained when first introduced in the text; they appear in boldface type and are defined in the glossary.

- **Data from the same companies are used throughout the book to illustrate diagnostic techniques and valuation methods.**

We focus on the same set of firms to illustrate most of the topics covered in this book. This approach provides a common thread that reinforces understanding.

- **Each chapter is followed by review problems.**

The review problems that appear at the end of each chapter allow you to test your knowledge of the subject. Most of the questions require use of a financial calculator. Detailed, step-by-step solutions can be found at the end of the book.

THE STRUCTURE OF THE TEXT

Although the book consists of self-contained chapters, those chapters do follow a logical sequence built around the idea of value creation. The overall structure of the book is summarized in the following diagram, which shows the value-based business model. Managers must raise cash (the right side) in order to finance investments (the left side) that are expected to increase the firm’s value and augment the wealth of the shareholders.

Part I begins with a chapter that surveys the principles and tools executives need to know in order to manage for value creation. Chapter 2 then explains and illustrates how balance sheets and income statements are constructed and interpreted. As an application, the appendix includes the financial statements of Polo Ralph Lauren.

Part II reviews the techniques executives use to assess a firm’s financial health, evaluate and plan its future development, and make decisions that enhance its chances of survival and success. The chapters in this part examine in detail a number of financial diagnostics and managerial tools that were introduced in Chapter 1. Chapter 3 shows how to evaluate a firm’s liquidity position and operational efficiency. Chapter 4 shows how to assess the firm’s ability to generate and control its cash flow. Chapter 5 identifies the factors that drive a firm’s profitability, analyzes the extent of its exposure to business and financial risks, and evaluates its capacity to finance its activities and achieve sustainable growth. The

WHAT'S IN THIS BOOK?

PART I: INTRODUCTION

Chapter 1:

What does managing for value creation mean?

Chapter 2:

How are balance sheets and income statements constructed?

PART II: FINANCIAL DIAGNOSIS AND MANAGEMENT

Chapters 3 to 5:

How do financial structure and operational efficiency affect a firm's liquidity (Chapter 3), its ability to generate cash (Chapter 4) and its profitability, risk, and capacity to grow (Chapter 5)?

PART IV: FINANCING DECISIONS

Chapter 9:

How do firms raise the funds needed to finance their investments?

Chapter 10:

What is the cost of these funds?

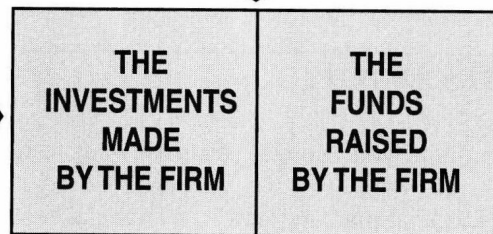
Chapter 11:

What is the best mix of shareholders' funds and borrowed funds?

PART III: INVESTMENT DECISIONS

Chapters 6 to 8:

How should firms evaluate investment proposals and select value-creating projects?



PART V: BUSINESS DECISIONS

Chapter 12:

How is a business valued?

Chapter 13:

How do international activities affect business decisions?

Chapter 14:

Is the firm using its resources to create shareholder value?

financial analysis tools presented in these chapters are applied to Polo Ralph Lauren, whose statements were shown in the Chapter 2 appendix. The analyses appear in appendices to Chapters 2 through 5.

Part III demonstrates how managers should make investment decisions that maximize the firm's value. Chapter 6 examines the net present value (NPV) rule in detail and shows how to apply this rule to make value-creating investment decisions. Chapter 7 reviews a number of alternative approaches to the NPV rule, including the internal rate of return (IRR) and the payback period rules, and compares them to the NPV rule. Chapter 8 shows how to identify and estimate the cash flows generated by an investment proposal and assess the proposal's capacity to create value.

Part IV explains how managers should make financing decisions that maximize value. Chapter 9 looks at the function of financial markets as a source of cash and examines the role markets play in the process of value creation. Chapter 10 shows how to estimate the cost of capital for a project and for the entire firm. Chapter 11 explains how a firm can make value-creating financing decisions by designing a capital structure (the mix of owners' funds and borrowed funds) that maximizes its market value and minimizes its cost of capital.

Part V concludes with three chapters on making value-creating business decisions. Chapter 12 reviews various models and techniques used to value firms, particularly in the context of an acquisition. Chapter 13 looks at financial management and value creation in an international environment where currency and country risks must be taken into account. Chapter 14 summarizes the analytical framework underlying the process of value creation and examines some of the related empirical evidence.

HOW TO READ THIS BOOK

Depending on your background and your needs, you may want to use this book in different ways. Here are a few guidelines.

If you are unfamiliar with financial management and financial accounting, you may want to begin by reading Chapter 1. It provides an overview of these subjects and will help you understand the fundamental objective of modern corporate finance and the logical relationships among the various issues and topics that make up that field. Although reading the first chapter will facilitate the understanding of those that follow it, it is not necessary to read it in order to comprehend the rest of the book—the chapters are self-contained.

- If you are not familiar with financial statements, it would be helpful, but not essential, to read Chapter 2 before you go through Part II. Chapter 2 explains balance sheets and income statements.
- If you are not familiar with the techniques of discounted cash flows, you should read Chapter 6 before going through Part III. Chapter 6 reviews the foundations of discounted cash flow techniques.
- If you are unfamiliar with the functioning of financial markets, you should read Chapter 9 before going through Part IV. Chapter 9 provides an overview of the structure, organization, and role of financial markets.

-
- Lastly, if you have a basic knowledge of accounting and finance, you can go directly to the chapter dealing with the issue you wish to explore. Since the chapters are self-sustained, you will not have to review the preceding chapters to fully understand your chosen chapter.

MAJOR CHANGES IN THE SECOND EDITION

Since the first edition of *Finance For Executives* was published, we have received numerous comments from colleagues at INSEAD as well as other schools and from executives who have attended courses where the book was assigned. These comments were overwhelmingly positive. They also came with recommendations for improvement. We have listened to them and have introduced some changes in the second edition. Here are the most important ones we have made.

- We added appendices to Chapter 2 through 5 to show how the financial analysis tools developed in those chapters can be applied in the real world. Polo Ralph Lauren Corporation, a well known designer and distributor of lifestyle products, is the firm we use to illustrate our approach to identify the drivers of a firm's liquidity, cash flows, and profitability.
- To improve the readability of the text, nearly all the exhibits that were presented in landscape format in the first edition appear now in portrait format.
- We updated the text with the most recent data and references relevant to the topics addressed in the book.
- A problem set with solutions, lecture outlines, and presentation slides are available to instructors who adopt the book.

ABOUT THE AUTHORS



Gabriel Hawawini is the Dean of INSEAD (European Institute of Business Administration) and the Henry Grunfeld Chaired Professor of Investment Banking. He taught finance at INSEAD, New York University, Columbia University, and the Wharton School of the University of Pennsylvania where he won the Helen Kardon Moss Anvil Award for Excellence in Teaching.

Professor Hawawini is the author of ten books and over 60 research papers. Besides serving as Vice President of the French Finance Association, he has organized, directed, and taught in management development programs at INSEAD and around the world.



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Professor Viallet has been President of the European Finance Association and has published widely in leading academic and professional journals. He has also organized, directed, and taught in management development programs in Europe, the United States, Asia, and Latin America.

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Finally, we would like to express our gratitude to Margaret Hardouin and her colleagues at INSEAD for their secretarial support and to the staff at South-Western for their great help in all the phases of development and production

Gabriel Hawawini
Claude Viallet
Fontainebleau
May 2000

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