Finance for Executives

A Practical Guide for Managers

Nuno Fernandes
Nuno Fernandes is Professor of Finance and Director of Strategic Finance at IMD, a top-ranked business school. IMD is ranked No. 1 in open enrollment programs worldwide (2012 and 2013) and No. 1 in executive education outside the United States (2008–2013) by the Financial Times. At IMD, Professor Fernandes directs the Strategic Finance program, as well as many partnership programs for leading international companies.


Professor Fernandes advises companies and financial institutions in Asia, Europe, Latin America, and the Middle East in formulating winning financial strategies, global portfolio investments, international valuations, M&As, risk management, and emerging market investments.

Professor Fernandes is Portuguese and holds a PhD from IESE Business School (Spain). Prior to joining IMD, he was Director of the Master in Finance (CFA Program Partner) at Católica Lisbon School of Business & Economics (Portugal) and a Visiting Scholar at Columbia Business School (New York). His work has earned him some distinguished awards, including the AEFIN prize and a grant from the FDIC (the US regulator for financial institutions). In 2008 he received the Lamfalussy Fellowship from the European Central Bank. This fellowship is conferred on the top researchers in finance worldwide.
What Is This Book About?

Finance is an exciting and key area for executives to master. Over the course of my career, I have developed a significant number of educational programs for executives that cover many fields in finance and their links with business. But I always faced a challenge. One question was frequently asked after these sessions: “This was great, and I’d like to know more about it. Can you recommend a book for me to read that covers these topics?” Most finance textbooks are too complex and long, and the practical relevance for executives is obscured by more theoretical and technical topics. Some other books are too basic and limited in scope, covering only a very limited set of topics, such as accounting ratios. When faced with this question, eventually I would recommend a couple of chapters from one book, some readings from another, or the kind of 1000-page handbook that people love to carry on the plane back home. After several years, I realized that too many people were asking for the same thing, but “that thing” did not exist in the market. That is why I decided to write this book.

I have noticed when working with general managers that many of them fear finance, the culprits often being jargon, complicated math, and non-standard concepts that do not make intuitive sense. In this book, I try to avoid all these pitfalls by using sound academic research and theories (many of them Nobel Prize winning), and focusing only on the important “nuggets” that are relevant for practitioners, without delving into all the complicated technical details underlying the conclusions. In addition, the book presents several practical applications of key finance tools, how they link with strategy, and how to implement them with Microsoft Excel.

This book has been designed to meet the needs of executives, both finance as well as non-finance managers. Any executive who wants to probe further and grasp the fundamentals of strategic finance issues will benefit from this book.

OBJECTIVES

Finance should be fun, and practical as well. With this book at hand as a reference, executives will have access to a set of tools that will help them develop their intuition for solving key financial problems, analyze alternatives in decision making, and formulate strategies.
Finance is simple. It is about connecting money with ideas. There are several investors with money available, and there are several ideas looking for financing. Finance is just the engine that connects these two forces: money and ideas. And, of course, the overall goal is successful companies that create value for both the suppliers of money and the suppliers of ideas!

These core personal premises regarding finance led me to build in the following features into my book to maximize its utility:

- Simplicity — The core concepts in finance are simple, and they should also become intuitively transparent after using this book.
- Conciseness — The chapters are short and self-contained to appeal to busy executives who are keen on value-added activities.
- Practical focus — The core concepts are explained, but the reader will also learn to identify the problems and pitfalls of different real-world choices.
- Application of theory to practice — It is important for top executives to become familiar with important academic research that impacts their companies. This book is grounded in world-class research, and only presents the salient highlights of academic research on each topic. It is therefore not a literature review of all that has been written on each topic.
- Real-world focus — The book features examples from actual companies and empirical data on many companies and industries around the world.

From my experience, working with real-world problems and real-world data is more fruitful than theoretical discussions on formulas. Because practice with real-world data is crucial to learning finance, each chapter of this book presents empirical examples of the concepts, uses real-world data to illustrate the key ideas, and allows global executives to “think finance” and have fun with finance!

**TARGET AUDIENCE**

Most executives need to understand and drive the strategy of their company on the basis of sound financial principles, but with the overarching goal of value creation. This book targets them.

*Finance for Executives* is a book for business executives, from all backgrounds, seeking

- To focus on the links between finance and the strategy of their company, be it a private or publicly traded company
- To discover how to create value for their company and boost its financial performance
- To understand the key ingredients of long-term value creation
What Is This Book About?

• To create a cost-of-capital culture within a company
• To refresh and broaden their understanding of the latest financial concepts and tools
• To learn not just about accounting numbers, but also about sound financial decision making in areas such as financing and payout policies, mergers and acquisitions (M&As), project valuation, or risk management and derivatives
• To ultimately make better decisions

This book can also be used in executive training programs in finance, as well as in MBA, master’s, and executive MBA programs. Indeed, the book is based on many years of executive education and consulting with world-class corporations from all continents of the world. I have been teaching corporate valuation, capital structure and other financial policies, M&As, and risk management for different audiences. I have learned a lot from my regular interactions with practitioners, including CEOs, CFOs, and other senior executives who are interested in the broad world of strategic finance. I have therefore been able to identify what key topics are relevant to different companies, private or public, and what difficulties exist (often language related) in addressing them in practice. Each chapter in this book has benefited from this rich experience.

EXCEL TEMPLATES

In most of the chapters, concrete examples are explained step by step. Further, an Excel spreadsheet containing all the models used in the different chapters is available for download from the book’s website:

www.FinanceforExecutives.net

Practitioners will find the file easy to use and to customize to their own requirements. It is useful in a variety of situations: value creation and its decomposition into managerial drivers or key performance indicators (KPIs), cost of capital estimation, project evaluation, mergers and acquisitions, company valuation, options valuation, etc.

ACKNOWLEDGMENTS

The ideas in this book have been developed and reinforced by many people. I have greatly benefited from my regular interactions with hundreds of executives from all backgrounds, including CEOs and CFOs of many companies around the world, teaching sessions, developing company-specific programs, consulting, and even informal conversations. I am grateful to them for sharing their wisdom with me and inspiring many of the ideas in the book.
I owe a big thank you to the following academic reviewers and colleagues for their constructive advice and insightful reviews of this book through its many drafts: Yiorgos Allayannis (Darden), Bo Becker (Stockholm School of Economics), Geert Bekaert (Columbia Business School), Arnoud Boot (University of Amsterdam), Guilherme Brito (Católica Lisbon), José Manuel Campa (IESE), Andrey Golubov (Cass Business School), José Guedes (Católica Lisbon), Campbell Harvey (Duke University), Pedro Matos (Darden), Igor Osobov (University of Connecticut), and Daniel Rogers (Portland State University).

I am also extremely grateful to my colleagues at IMD, professors Arturo Bris, Salvatore Cantale, Kamran Kashani, Stuart Read, and Leif Sjoblom, for their comments on this book. At IMD, I must specifically thank people who have generously read, edited, and provided comments on drafts of this book, namely, Susan Broomfield, Marianne Foerster, Beverley Lennox, Lindsay McTeague, Michelle Perrinjaquet, and Susan Stehli. I am also indebted to Raphaël Thiébaud, my assistant at IMD, for his diligent help and support along this journey. Among many other things, he expertly oversaw the production of all the exhibits in this book, an amazing task given the multitude of databases and formats employed. He has been instrumental in getting this book from its early stages to its final form. I also appreciate the support received from a very good and capable friend, Kyryl Lakishyk, who managed the entire cover design process.

I could not have created this work without my students, who read and used virtually the entire book in their finance classes at IMD, in MBA, and executive education courses. Over the years, they endured reading earlier drafts of the book, corrected mistakes, commented on the content, and provided additional thoughts and insights that helped shape *Finance for Executives* into the book that you now hold in your hands.

Many business professionals were kind enough to read various chapters and share their observations with me. Among this group, a special word of thanks goes to Marc Chauvet, Viktor Dobrikov, Natalia Filchakova, Jacques Guillemot, Luís Henzler, Hammad Hussain, Tracey Keys, Paulo Marcos, Pedro Marques, Alexandre Mesquita, Urs Rohner, Severin Schwan, Isaak Tsalicoglou, Stephan Wullschleger, and Yingjie Yang.

This book could not have been written without the love and support of my family. My wife, Isabel, gave unsparingly of her time and effort to support my writing. She has read and commented on different drafts of this book, and has always been a sounding board and source of ideas for my work. Finally, my two children helped me with their patience and uncomplainingly sacrificed time with their dad on account of his work on this book. Francisco had to put up with his dad typing away for long hours instead of helping him assemble and disassemble his Legos, and Luísa had to count her teddy bears and PLAYMOBIL toys on her own.
HOW TO USE THIS BOOK

This is a book to be used, not a book to be read from beginning to end.

Each chapter is highly readable and practical, yet rigorous. The self-contained chapters include fundamental concepts, analytical tools, and demonstrations of applications of those tools. Executives can then tailor their reading to the specific circumstances applicable to their company.

This book contains empirical evidence, based on real company cases, of the value of financial techniques/tools. In essence, each short chapter is written in a way that allows executives to put the concepts immediately into practice.

Outline

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This book starts with a chapter on the main financial ratios and key accounting terms. **Chapter 1** reviews the key accounting statements, focusing on the main points executives should look at when analyzing financial statements.

**Chapter 2** covers questions such as the following: What is the cost of capital, and how does it change over time? How does the cost of equity vary across different companies? How do I compute my company’s weighted average cost of capital? What is the relation between risk and cost of capital?

**Chapter 3** focuses on what value creation is and how it should link to the company strategy. Indeed, value creation is the responsibility of every executive, yet not all executives have access to the latest strategies and tools of value creation. This chapter outlines a best-practice foundation in value creation for different companies and organizations.

**Chapter 4** focuses on questions such as the following: Which of two apparently profitable investment projects should my company choose? How can I ensure that my company allocates capital to projects that add value? What criteria should we use to decide between different capital expenditures? How do I decide between different cost reduction projects? How do I evaluate brands? What should we pay attention to when we evaluate projects outside the company’s core business?

**Chapter 5** addresses practical issues associated with the financing policy: Why do some companies have sustainably very high amounts of debt? How much debt should we have in our company? How does the optimal financing mix vary across industries? What is the impact of debt on operations (customers, suppliers, employees, etc.)?

**Chapter 6** covers capital-raising activities in debt markets, addressing questions such as the following: Should we issue fixed-rate debt or floating-rate debt? My company has traditionally used only bank loans. Are corporate bonds an alternative? How do rating agencies look at different companies? What is the risk of investing in bonds? What are credit default swaps (CDSs)? Should we have long-term or short-term debt?

**Chapter 7** addresses questions such as: Should my company go public? How do equity-raising processes work? What are the stages in an initial public offering? What are the costs and fees of public equity issues? What happens when a company issues rights? Why do companies have stock splits? Is there value in being listed in different exchanges around the world?

**Chapter 8** answers questions such as the following: My company has been trading on the stock exchange for 8 years, and is profitable. Is it time to start paying dividends? What is the best way of returning money to shareholders? When should a company repurchase shares? Why don’t we keep all the cash in the company? How do I design an optimal strategy to remunerate shareholders?
Chapter 9 describes the main methods used to value companies, addressing questions such as the following: Our company is considering spinning off a division that is no longer core to our business. What is its fair value? How many years should we use when valuing companies? What are the different methods used to value companies? How do different multiples work?

Chapter 10 covers mergers and acquisitions (M&As), their objectives, and the techniques used in the valuation of a target company. We address questions such as the following: When do mergers create value? What are the appropriate methodologies to value potential acquisition candidates? How can we ensure that our acquisitions create value? How do I choose between different payment methods? What happens after the M&A deal is concluded?

Chapters 11 to 13 cover key concepts related to derivatives markets. Effective usage of derivatives can create significant value and allows for effective risk management strategies. The functioning of the markets is described, and several pitfalls of using derivatives are illustrated. The chapters address questions such as the following: Why and when should we use derivatives for risk management? What are the differences between futures and forwards? How are stock options valued? How do derivatives markets work, and how can companies use them effectively? How are futures, swaps, and options priced in the market?

Overall, this book moves beyond spreadsheets and accounting, and takes a broader perspective on finance. The main objective of the book is for executives in any part of the organization to understand and internalize the links between company strategy and finance. The unifying thread running across the different chapters is the emphasis on the managerial implications of financial analysis.