Financial Management for Managers

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Lecture 02

Fundamentals of Financial Management Part II

Welcome all. So, we have started learning about the Financial Management and the basic concepts of financial management or the fundamentals of financial management. So, in the previous class, in the first class I just tried to build up the foundation of this particular concept, this particular area and we discuss some basics of financial management or some fundamental requirements of the financial management. So, now I will take you forward in the process and in the end of the previous class we were talking about the investment analysis.

So, I told you in the previous class also that investment analysis, a proper investment analysis is very very important. If your investment analysis is not important even these days what happens, that when we start say even for the existing firms also if they want to start a new product, they want to launch a new product, new product or new service self is considered as a full fleshed project.

For the existing firms I am talking about, even if it is a multinational company want to start a new product or any new service, it is a new project for them, they create a full fleshed sub division for that and they supported completely like a new organization, new firm, new business. And every analysis is done for the success of that product or that service and as I told you in the previous class that analysis begin with the market and demand analysis.

Because there is a back bone of the success or failure of any product, if you can manufacture any product, you can manufacture any products for example I was reading sometimes back some say something some written some in some magazine, that general motor’s you have heard about, its say American car manufacturing company they had said that any person in the world can think having any kind of the car, any kind of the car.

You think of the features in the car you want to have it and tell us that I want a car, price is not the limitation I am ready to pay any price for that but these these features should be there in my car. You think about that, give the design of your car to us within 15 days we will hand you over the keys of the car.

What does it mean to say? Means in today's global competitive scenario manufacturing of any product or rendering of any service is not a challenge. The challenge is accepting the product by the people, by your customers in the market. And if the product is accepted in the market, your business is successful. With the product is rejected in the market, your business is a failure.

I tell you the story of one very very important product, that product was fruit beer, anchor group you have heard about, anchor group is basically at their time now today it is a taken over group by the Panasonic but earlier it was a anchor. They used to manufacture the electrical products switches, wire and all that.

They thought of that after liberalization of Indian economy they thought of diversification and they thought because now in the electrical segment when the multinationals will some to India or may be the when the sector is open for any global competition and when the multinational companies will some to India certainly the electrical products a segment may become very very competitive for them. It may be possible that they may not be able to compete with the multinationals or the transnational companies into the area of the business in which the anchor is already.

Anchor was a leader in the market when it was a closed economy, but anchor had to face the challenges when the economy is open for the global competition and they were preparing for success being successful in the market. So, they thought of that for example if any challenge comes up in the electrical product segment then we must start or start thinking of diversification and we must start to diversifying other areas.

And when they consulted the people in the market, the experts in the market that if you want to diversify from the electrical products segment to some other areas, what are the important other areas they can diversify to? They got the answer form many experts and many research and analysis agenesis that see this is a very large country in terms of population. We are 1.2 billion people, at that time it was today we are grown up to 1.3 or 5 billion people but at that time I am talking about the late 90's.

So, we are this country, large country of 1.2 billion people has minimum to eat something. So, if you want to diversify today, you diversify towards the consumer products, anything which you manufacture if it is related to the consumer area or the human consumption area then certainly the chances of success are more as compared to if you move to any industrial product or any other product where the chances of the success may be not as good as there in the consumer segment or the consumer area or in the consumer market.

They concede one product which is called as fruit beer. Fruit beer is a very common product which is non alcoholic everybody knows it. Everybody can drink it, even the say kids, even the women, anybody can take it and it is a very common product in the other countries in US, in Europe, even in some advance countries in Asia.

Fruit beer is a very common product. They got some advice after some analysis in the market that yes if they manufacture in a start, means say introduce this product in the market, in the countries market in India's market they will become the pioneer in this area number one and the product will be very very successful.

They read all market and demand analysis, everything. The response was very good and finally they started giving shape to the concept, to the idea and they created a plant near Gurgaon for manufacturing the fruit beer they invested 350 crores at that time, in the late 90's I am talking about. And they started manufacturing the product.

When they manufactured the product they started distributing it initially free of cost. Because every company at the time of the launch of the new product they manufacture and they start distributing it to the people free of cost sometimes so that people know about what the product is, what are the properties of the product, what is the taste of the product, how they feel it, so that now after sometimes they start buying about it.

They started distributing it and finally people rejected the product, product failed, 350 crores of investment made in the market, product failed, people rejected the product. Now, you can miss raise a question here that after so much of the detailed analysis about that particular product, about that particular concept, about that product which is very successful in the other countries market, why that product was not successful in India?

Company lost, anchor lost 350 crores of the scarce resources and finally that miss proved to be a flop show, so they lost that money that money went down in the drain. That was a company the anchor which was in the market for so many years, they could sustain that big loss and that big shock, the financial shock in the market, they could sustain but later on also means their all operations could not be sustain and finally that company had to acquired by some other company in the market.

Now, the anchor is acquired with the Panasonic and it known anchor by the Panasonic now, they could not sustain independently, that have to sell of their business in the market but you see why I am discussing this story that when you are talking about the investment analysis, their financial management comes into the picture and that starts, that analysis starts with the market and demand analysis.

If the market is good, if the demand for the product is good, if it is verified in the market then only your business can sustain. Now, why their fruit beer failed in the market? Because later on when they got the feedback from the market, they came to know that in India people use beer as the product for intoxication not for any other purpose.

Fruit beer cannot be used in India as the say you can call it as a supplement or the substitute for tea, coffee, juice or any cold drink or even for the plain water. No it is not possible because price was almost kept as of the same product which is in normal beer in the market which has the say alcoholic content in the beer.

The price of the fruit beer was fixed by the anchor almost the same as there is the price of the normal alcoholic beer in the market. In India the purpose of taking the beer is different, people take the beer for the intoxication not for the relaxation purpose, so the product finally failed. At the time of survey market and demand analysis, when they did the survey in the market, people said yes the product is going to acceptable to them but later on when the product was manufactured and distributed to the people in the people in the market, people rejected it.

So, detailed analysis is required to be done. For the beginners I would like to caution here that if you want to start means as a startup or at the small level you do a proper market and demand analysis. If for example you do not have the funds for that then you do what your say so many people who became very established entrepreneurs and who have converted their soul (())(10:10) firms into the now the national companies or international companies, you learn from their experiences.

For example you talk about nirma, nirma is the name in the market now which is into the manufacturing, which is into the services sectors both. Nirma was started long back in 1982 by Karsanbhai, a person who started the business by simply converting the caustic soda into the washing powder and you look at, at that time though he was very sure about the success of his product but still he did not take much risk.

He did not means immediately converted that into a big manufacturing organization, started manufacturing the product, invested huge amount of resources and started distributing the product at a larger scale, No, he did not do like this, his strategy of moving into the market was, he started manufacturing the product and started distributing it to his near and dears.

First his distributed to the locality, people in the locality where he himself was residing, then he started giving it to his relative and people, friends and other near and dears. And when the response was very good form the market then he scaled up his operations. And today you see that means it is a nirma, the product which became the first important a competitive product for a company like HUL, Hindustan Unilever Limited and at that time their bought two product were coming in the market, one was the surf and second was the sunlight.

And sunlight was comparable to the, means surf was for the premium segment people and sunlight was for the low segment people and at that time people were not even able to afford to buy even sunlight. So, when this new product came in the market, number one he added very good attributes, good qualities in the product which fulfilled the basic requirement of washing the clothes by the people and second thing he kept in the mind was the price of the product. In 1982 he started selling 1 kg of the washing powder for 10 rupees a Kg.

And that was the success of because the product was fulfilling the basic need of the people, it was very much within the reach of the people and the response became tremendous, response became alarming and then finally you see that the growth, the spectacular growth of the nirma, today that company which started as a soul proprietorship organization that this company has its presence in many areas now both in manufacturing and services sector.

So, I am emphasizing upon that better financial management will depend upon or beginning of the better financial management depends upon the best investment analysis. You do the proper analysis how much investment I am required to make here or my company is required to make here, how much time will be required which is known as the adjustation period and what will be the overall investment requirements.

My proper financial usage requirement and then how would I manage the finances. So, that they magnify the grow up at the desired pace and ultimately the objective of the value maximization of my firm is latent, this is the first requirement in the financial decision areas, detailed financial analysis investment analysis.

Second is the working capital management, normally what happens when we start thinking of say going into the business we only think of say giving a shape to the organization that we will require this much amount of land, plant, building, machinery, furniture or some other say assets like vehicles.

We sometimes forget about the finance which is called as working capital management, if you have the plant, if you have the building, if you have the machines, they need raw material to convert the raw material into the finished product. They need human resources to work on those machines they need human resources to manufacture the products, to take your product from another place of production to place of consumption.

So, you need to pay them, you need raw material, you need human resources, you need the other inputs like poser, water other inputs lubricants fuels and for that we need the working capital. So, you need two type of the sources of the funds in any business one is the long term funds for creating the fixed assets, second is the short term funds for creating the short term assets or for fulfilling your working capital requirement.

Short term financial requirement for buying of raw material, you can buy some of the material on credit but even getting the credit from the market requires a some presence in the market, reputation in the market, creditability in the market. Form the first day on wards nobody will start giving you the raw material on credit.

Human resources can wait for paying for their salaries for 30 days, it is a virtual credit available from the market, but after 30 days you have to pay to them, power supply companies can wait for 30 days or 60 days but they have to be paid at the end of this period. Water supply companies can wait for some time but they have to be paid at the end of that period. So, that all requires the working capital. We make the proper estimates and some times for the long term funds investments requirements, but we sometime make either we underestimate the working capital requirements or simply we forget to make the proper estimates for the working capital.

So, proper mix of the funds of for the long terms requirements and for the short terms requirements has to be there, so that you can create a balanced organization and all sort of the requirements of any firm can be easily met. So, working capital is the important part. Working capital means that for running the day to day operations of the business, the amount or the funds required is called as the working capital.

So, you need the long term investment for the land, plant, building, machinery, furniture, vehicles. You need the funds for materials, employees, electricity, water, oils, lubricants fuels and that is called as working capitals. So, you have to create a proper mix of these two sources and these two are independent areas of learning. Investment analysis a full fleshed area of learning and decision making. Working capital management is also a full fleshed area of learning and decision making, you need to be very careful about both these areas.

Next thing is the sourcing and the cost of funds. From where the funds will come, what are the sources? You wanted to be entrepreneurs, you wanted to after doing your MBA, you wanted to have a started up, form where the funds will come, your investment analysis has given you answer to the question that yes my product is very good, my idea is very good, my concept is good, I am going to be very successful in the market and I need 1 million rupees just in the beginning to invest into my business.

In your pocket there must be only 100 thousand, you maximum can arrange 100 thousand from your own saving, from your parents and from other sources only 100 thousand. One tenth of the requirement, remaining nine tenth of the requirement will come from where? You have to now think about that, and here the financial mix requires to carefully decide about the cost of the funds, because if you go to the banks, they will not give you money because you are a new into the business, if you go to the say shareholders, you cannot come out with an IPO or equity capital or nothing like that.

You have only options available either you discuss your idea with some of your friends or likeminded people and ask them that see this is my product, this is my idea, this is my concept or this service I want to generate if you join hands with me, we can join together three four people and we can start our own business and then we can grow with this organization rather than starting working for some other organization.

So, this is a one option available, but for example you are the four friends and you get 400 thousand rupees, still we require 600 thousand rupees more, more than half a million, investment is more required now. From where the funds will come? You have only one option, to go to the venture capitalist, and if you go to the venture capitalist you discuss your idea with him, your project proposal with him, your investment analysis with him, they may agree, that the project is good, the idea is good, concept is good.

They may it is very it is quiet unlikely that they become your partner in the progress through private equity. Sometimes they give you the venture capital and when they give you the venture capital it is a sort of loan to the firm and the rate of interest is very high 40 45 percent. Later on when it starts working well they may convert that into a private equity or the rate of interest may come down.

But initially to save the business from the very high cost of financing, you have to be very careful about that what is the total requirement of my investment, what is the total investment requirement, from where the funds will come, and what is the cost of those funds? I can tell you that even sometimes a better operating structure, but a very poor financial structure can create the problem for the organization.

Your operating structure is very good but your financial structure is so heavy, the cost of funds is so high that whatever the profits you are generating, whatever the revenue you are generating by selling their products or service in the market, larger part of that you are using in servicing that dept. So, even sometimes a well functioning organization or a businesses which are expected to start earning the profits at the much earlier stage they become the loss making businesses.

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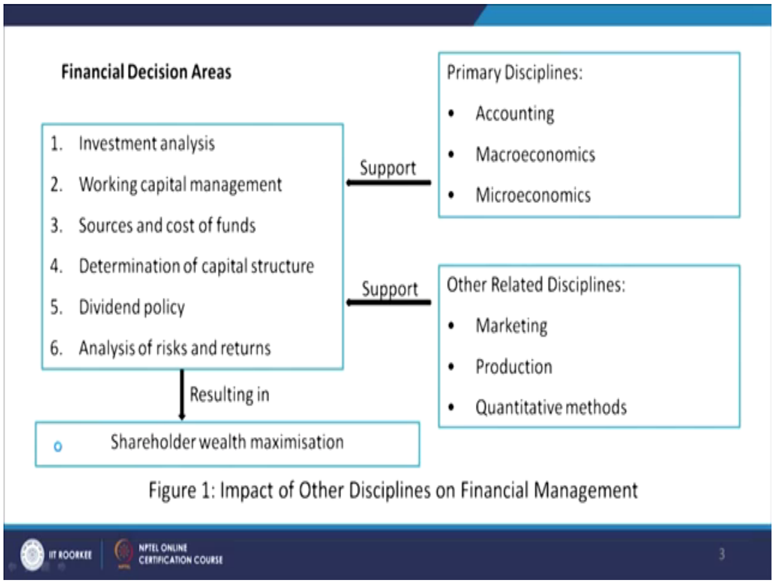

So, be careful this is very very important third area of decision, sources and cost of funds. Then is the determination of capital structure, another important question, we will discuss all this concepts in detail one by one but today I am just building the foundation and just I am say clarifying the fundamentals so that what we are going to discuss in this course in the time to come you should be very clear about that.

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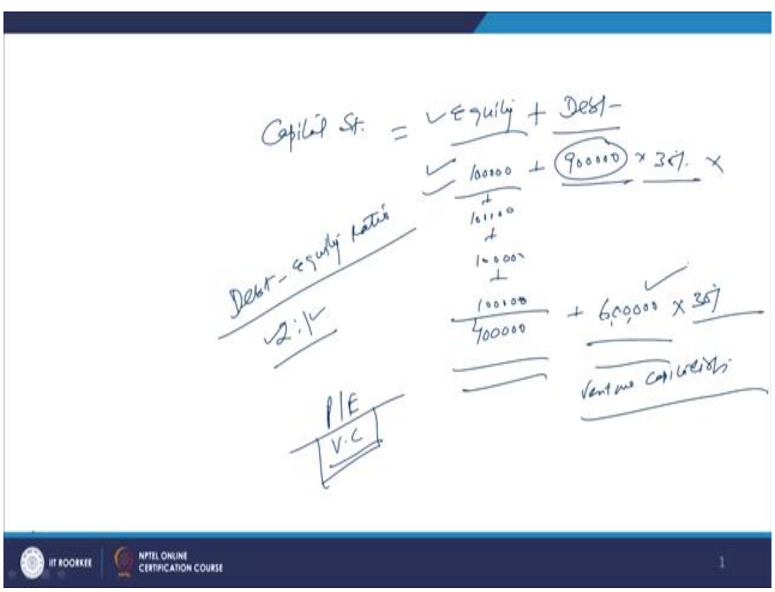

So, determination of the capital structure, you have funds, you have different options of the funds available and when you talk about the capital structure, the capital structure talks in terms of that the capital structure of a form is, when you talk about the capital structure you can see here that, capital structure means, having the mix of the funds from different sources and what are the different sources? Here are the different sources which are called as equity plus debt, this is equity and debt, this is called as the two sources and now in the capital structure you have to decide the mix of these equity and debt.

So, equity means because it is a new firm, new organization even for the existing firms also in the beginning equity is not allowed to be raised from the market by selling the stocks in the market or may be coming out with any IP or anything. Initially the firm has to prove its potential and be successful with the business in the initial years later on then they can supplement the existing financial resources with the new financial resources and the equity issues may come in the market with the help of the initial public offers.

So, if the equity from the public cannot be arranged, cannot be generated then you have two options, that whatever the equity as entrepreneurs, the people who are the initial beginners or the initial investors in the market they have to invest from your pocket. For example I was talking to you if the one person tries to become entrepreneur he has 100 thousand in his pocket, requirement is plus that will be 9 lacks 9000 thousand and if you take this debt because the business is new and 900 thousand you are arranging and the rate of interest is for example even if it 30 percent per annum, the cost of funds is going to be very high.

So, what you can do here is, you can try to find out that from say this source, equity is considered as that it is not the say risky source of funds because equity, the person who gives the equity or invest into the equity of any firm, they are not means say supposed to be paid the return every time every year. It all depends upon when there is sufficient returns available they can be paid by the dividend if there is no profitability in the business or required amount of the profit in the business no dividend has to be returned back to them.

So, say this is going to be very very risky proposition that 1 lack and 9 lack is the borrowing from the market. Whatever you earn with the help of this 10 lack rupees, larger part of that will be spent on servicing this jet so this option is not workable. So, what can you do is, you can try to minimize this amount. 9 lacks has to be minimize if you because your investment requirement is all 1 million 10 lakh rupees. So, you want to minimize this, it means if you want to minimize this, you have to maximize this, so you can bring people like minded people in the market for example you say that four people join hands and they invest 1 lack rupees each.

So, it means total amount becomes, how much? This amount becomes 400 thousand, so if this becomes 400 thousand so it means our borrowing requirement has come down to 600 thousands, at least not 900 thousand. We have now brought it down to 600 thousands. So, 600 thousand and into 30 percent of that is still lesser as compared to you are paying the interest for 9 lack rupees you are borrowing.

So, it means your debt equity ratio, it means capital structure is that capital structure creates a something that once you decide any capital structure you are going to have something which is called as debt equity ratio. Debt equity ratio, debt equity ratio means standard debt equity ratio is 2 is to 1 for the existing firms, existing organizations. 2 is to 1 means if you invest 1 rupee from your pocket you have the right to borrow 2 rupees from the market.

So, this ratio becomes 2 is to 1. Either business is doing well then the lender can lend you any amount of money then this ratio can be even 9 is to 1. This ratio can be 8 is to 1, it can be 8 is to 1, it can be 10 is to 1, that depends upon the borrower and the lender but normally the standard ratio for any solvent and optimally vanished business is considered as the optimum ratio is the ratio the dept equity ratio has to be 2 is to 1.

So, it means as per this ratio if the business has not proven its potential in the market it is a new business, so it means if you invest 1 lack rupees from your pocket, you are allowed to borrow 2 lack rupee from the market but 2 lack rupees means at a normal rate of interest, normal market rate of interest. For example we talk about borrowing from the banks or other financial institutions but since here borrowing requirement is very high here that is 4 lack 4 people have in their pocket.

Total investment requirement is 10 lacks, so 6 lacks you have to borrow from the market and normally because debt equity ratio allows only maximum is how much that you can borrow 8 lack rupees sorry 4 lacks rupees from the market but that only happens for the, or may be 2 is to 1 ratio so you can have 8 lack rupees borrowing from the market but that will happen only for the businesses which have proven their potential in the markets.

Since yours is a new business nobody will be ready to give you this say 8 lacks rupees of the investment or 6 lack rupees of investment at the normal ratio of interest, so for this you have to look for some avenues of investment which charge higher rate of interest and they are called as venture capital.

They are called as venture capitalist and you have to go to the venture capitalist, there are the two sources. One is called as private equity and second is called as venture capital, venture capital is basically the one which comes into being into the business in the beginning of any big business provided when we go to the venture capitalist they ask us to explain the concept of the business, the product which we are going to manufacture, the service which we are going to render out of its business and how it is going to be a successful concept, is a successful idea and what are going to be the financials of the business.

You have to explain them everything that from today to next 10 years, what is going to happen with this product in the market, how the financials will behave and from the day 1 till the last day of the 10 year where you will start working from, where you will arrive at, so if they like the idea, the venture capitalist like the idea that yes idea is very good and if we make sufficient investment in this particular concept in this particular idea then certainly means this idea can become a very good business tomorrow.

So, they may agree, they may say that yes you have 4 lack rupees in your pocket we will give you four lack rupees but over rate of interest is 30 percent, so you have to agree you have no other choice so in this case what will happen? Your financial structure become very heavy will become poor but I am again emphasizing upon if you are operating structure is going to be very strong, if your product or service which you are going to manufacture or render is going to be very strong then certainly you can take this risk and go ahead.

Because part of the risk is already you have transport to the venture capitalist and venture capital funds their people are so smart they can easily find out whether this product or ideas is going to be successful in the market or not. They do not take the decision of investment until and unless they are sure about that whatever you are talking about is going to be the real thing tomorrow in the market. So, initially till the time we are not into the profit or we do not reach at the breakable situation, you accept this and then finally once we have started earning the profits then there is arrangements that this funds will remain or will continue supporting for this much number or years.

After that it depends upon that it if they want to continue, then this venture capital can be converted into private equity or if they want to withdraw, they can withdraw and since now the business has started earning the profits so any other source will be able to jump into the business, even you go to the banks any other financial institutions tell them we are a business manufacturing this product, this is our balance sheet for the past 3 to 4 years, we have crossed the breakable point now or we have reached the breakable point, we have crossed the loss making area, we are at the breakable point and now are we have started making the profits.

Anybody will venture into, so the venture capitalist will move out and you will replace that very very expensive financial resource of 30, 35 or 40 percent, whether they be normally 15 to 18 percent or 18 to 20 percent and then the financial structure of the firm can also be improved because operating structure was good so it is helping now to improve the financial structure also.

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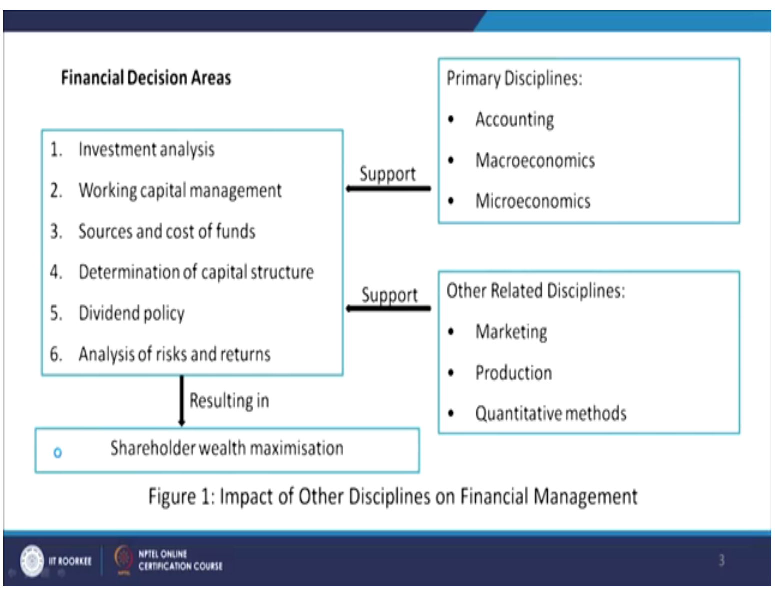

So, in this case what we have to do is, you have to decide about the determination of the capital structure. Capital structure is basically is the mix of the debt and equity, equity is the owned funds by the owners of the business, and debt is the borrowed capital form the market. So, as per as the owned funds are concerned there is no problem at all.

Because maximum risks to owned funds is that if the business does not work well, your maximum risk that whatever the investment you have made in the business that will go down in the drain, you will lose that, all 4 people, all 4 friends they invested 1 lack rupees each and business has not responded we.

So, after 2 3 years they tried their luck but they thought that this business is not working we have to close it down so you lost 1 lack rupees each. Fine but the question is that if the component of dept is very high and that dept is (())(30:45) against the assets of the firm and if the assets of the firm are not sufficient sometimes then sometimes it can create a problem that the personal assets which are given as a guarantee by the owners of the business, they can also be attached and the financial institutions can do anything for recovering their dept.

So, apart from the business becoming insolvent even sometime the owners of the business also becomes insolvent. So, you have to become very very careful while deciding the capital structure of the firm. If the capital structure is fine, balanced capital structure in the initial years of the business more funds should come from your own pocket. Borrowed composition of the borrowed funds you should be as low as possible.

So, if you invest least amount of the borrower funds then certainly you can expect the better performance otherwise you can say that the chance of risk is very high. So, I would caution you that to be a better financial manager component or the magnitude or extend of the borrowed capital in the business should be as low as possible until unless it starts making the profits.

You can start borrowing from the market later on when we have the proven potential and we are sure of profitability of the business. Until and unless that is means assured we should depend as less as possible on the borrowed capital so very carefully we have to take the fourth decision in the business about deciding its capital structure. Other important decision areas like dividend policies and analysis of the risk and returns and other supportive areas. I will discuss in detail with you but that two in the next class. I will stop here, thank you very much.