

**CENTRE FOR FINANCIAL MANAGEMENT**

# **CFM QUARTERLY IN FINANCE**

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## A. ARTICLES /CASES

### 1. VARYING ASSUMPTIONS UNDERLYING COST OF CAPITAL CALCULATION

#### DR. PRASANNA CHANDRA

A recent (2012) survey conducted by the Association for Financial Professionals revealed that companies typically use discounted cash flow analysis for evaluating capital investments. In such analysis projected free cash flows are discounted by the weighted average cost of debt and equity. And to estimate the cost of equity, the capital asset pricing model (CAPM) is used predominantly.

But that is where the general argument ends. There seems to be wide variation about assumptions companies make in their financial models to quantify investment opportunities as the following table show:

What's your Forecast Horizon?	
Years	Respondents (%)
5	46%
10	34%
15	6%
Other	14%
What's Your Cost of Debt?	
Measure	Respondents (%)
Current rate on outstanding debt	37%
Forecast rate on new insurance	34%
Average historical rate	29%
What's the Risk-Free Rate?	
Rate on U.S Treasuries with Maturity of	Respondents (%)
90 days	16%
52 weeks	5%

5 years	12%
10 years	46%
20 years	4%
30 years	11%
Other	6%
What's the Equity –Market Risk Premium?	
Risk premium	Respondents (%)
Less than 3%	11%
3%-4%	23%
5%-6%	49%
7% or greater	17%
What's Your Beta Period?	
Period	Respondents (%)
One year	29%
Two years	13%
Three years	15%
Five years	41%
Other	2%
What's Your Debt-to-Equity Ratio?	
Measure	Respondents (%)
Current book debt to equity	30%
Targeted book debt to equity	28%
Current market debt to equity	23%
Current book debt to current market equity	19%

The wide variations seem to be a problem. As Michael.T. Jacobs and Anil Shivadasani put it: “These tremendous disparities in assumptions profoundly influence how capital is deployed in our economy .Despite record-low borrowing costs and record-high cash balances, capital expenditures by U.S. companies are projected to be flat or to decline slightly in 2012, indicating that most businesses are not adjusting their investment policies to reflect the decline in their cost of capital.” They further add, “with \$ 2 trillion at stake, the hour has come for an honest debate among business leaders and financial advisers about how best to determine investment time horizons, cost of capital, and project risk adjustment.”

## **2. POOR MAN’S GUIDE TO MARKET ASSESSMENT**

**Dr. Prasanna Chandra**

Here’s a simple exercise that might help you take the temperature of financial markets. I have listed a number of market characteristics. For each pair, check off the one you think is most descriptive of today. And if you find that most of your checkmarks are in the left-hand column, hold on to your wallet.

Economy:	Vibrant	Sluggish
Outlook:	Positive	Negative
Lenders:	Eager	Reticent
Capital Markets:	Loose	Tight
Capital:	Plentiful	Scarce
Terms:	Easy	Restrictive
Interest Rates:	Low	High
Spreads:	Narrow	Wide
Investors:	Optimistic	Pessimistic
	Sanguine	Distressed
	Eager to buy	Uninterested in buying
Asset owners:	Happy to hold	Rushing for the exits

Sellers:	Few	Many
Markets:	Crowded	Starved for attention
Funds:	Hard to gain entry	Open to anyone
	New ones daily	Only the best can raise money
	General partners	Limited partners have
	hold all the cards	bargaining power
Recent Performance:	Strong	Weak
Asset Prices:	High	Low
Prospective Returns:	Low	High
Risk:	High	Low
Popular qualities:	Aggressiveness	Caution and discipline
	Broad reach	Selectivity

### **3. FINANCIAL PLANNING AND FORECASTING AT GENERAL ELECTRIC**

#### **DR. PRASANNA CHANDRA**

General Electric (GE) is a large, complex, global enterprise. The main objective of forecasting at GE is to make sure that the management understands how various businesses are expected to perform so that it can allocate capital more efficiently.

To develop financial forecasts, GE has two main planning events each year. Starting in the spring, the company develops a strategic plan called “growth playbook,” which is a three to five-year plan for each of its businesses. Using its own variant of Michael Porter’s “five-factor” model, it asks its business teams to analyse and understand the environments they compete in. It’s a bottoms-up process that starts in April and about 45 profit and loss centres go through this process. The analysis ends up in producing a “base case,” which represents the most probable outcome. It also produces a distribution and range of outcomes, including worst-case and best-case scenarios. From this exercise a three- year financial model that encompasses a full balance sheet, an income statement, and a cash flow statement for the entire company emerges. In July, a

presentation is made to the board of directors in which separate financial statements on each of the 12 main business segments are reported. Based on this board presentation and the ensuing discussion, a list of seven to ten strategic priorities are identified for each business segment and for the company as a whole.

The planning process serves yet another important function. It helps in identifying risks and figuring out ways of managing them to acceptable levels. As Keith Sherman put it, "One purpose of our planning is to ensure that we have anticipated these downside risks and have either found a way to limit them, or have a plan to respond to them quickly if they materialize."

The second main planning event is the formulation of the budget. In the fall, the spring forecasts in the playbook are updated by the finance and operating teams using another six months of data. Along with updated forecasts, they provide detailed budgets for every operating business. The updated forecasts and budgets are presented in a summary form to the board. The budgets serve as the basis of the annual update with investors that take place each December. A lot of thought and effort goes into in these exercises.

The company also produces short-term as well as long-term outlooks. In the middle of every quarter, financial teams prepare financial statements (income statement, cash flow statement, and balance sheet) for the current quarter, the following quarter, and the entire year. In other words, the company has a system of preparing rolling forecasts.

There is a continual process of discussion and review. As Keith Sherman put it, "During the second and third months of each quarter, we have operating reviews of each of our businesses in which the CEO, the CFO, and their operating leaders spend a day reviewing their business operations without corporate leadership team. During the third month of each quarter, our planning and analysis leaders do a call every week to discuss the performance of their operations versus expectations. And at the end of each quarter, we have a major performance update with our investor relations team to prepare for our quarterly earnings release."

Thus, GE has strong financial controls and discipline which permeate the place. As Keith Sherman put it, "Every discussion between our CEO, Jeff Immelt, and the CEO of one of our operating businesses is intended to ensure that we have a thorough understanding of where we are in terms of performance and where we need to be. There's a huge amount of preparation and oversight that goes into our financial reporting –and this all takes place even though we no longer provide quarterly

guidance.:" He added, "Our goal is to deliver the performance we expect to achieve, subject to general market and industry conditions- we expect all our businesses to perform in the top quartile of their competitors. If we can meet our own expectations, we think we will provide the level of returns that we need to justify our use of investor capital. GE has some 3,000 finance professionals who are part of this financial analysis and planning process, getting real-time feedback for comparing performance against targets, and dealing with changes in the environment, and then trying to make adjustments.

To provide consistency in forecasting the corporate office provides exchange rates for translating projected overseas revenues into dollars as well as forecast commodity prices.

The primary goal of forecasting at GE is to improve the quality of discussion around the planning process. As Keith Sherman put it, "The goal of forecasting, from our organization's point of view, is not to get the most accurate point estimates. In fact, I'm not sure we've ever gotten on exactly right. What we really care about is the quality of thinking and the dialogue among our managers that takes place around the forecasting process. The assumptions behind our numbers are challenged at every step of the process. One of the positive things about the GE culture is that it is very open; can dour and debate are encouraged and very much in evidence. We look for the opposing point of view. We look for the risks to forecasts. And after we debate the question, we make a decision and we move forward."

## **B.SNIPPETS**

### **1. IBM's Acquisition Criteria**

IBM has completed more than 140 deals between 2000 and 2012. These acquisition have played a significant role in moving the company toward more profitable technologies and market opportunities in software and services. IBM's business development office evaluates each potential acquisition in terms of **enhancement of capability** (Does is build on or extend a capability of IBM?), **scalability** (Does it have scalable intellectual property?) and **leverage of reach** (Can it benefit from IBM's reach into 170 countries?).

IBM's business development office works with M&A service providers, biases with business units, measures and tracks the results of each deal, thus creating an M&A learning organization.

### **2. The Art of Giving : The Buffett Way**

Every society would have to find a way to rein in great fortunes for the benefit of the society at large and yet preserve the motivation for wealth creation. The growing divide between the super rich and the utterly poor has tarnished the image of capitalism as somewhat exploitative, particularly among the poor and the downtrodden and certain sections of intelligentsia. The year 2006 witnessed a seminal event in the history of capitalism when Warren Buffett donated the bulk of his considerable wealth to Bill and Melinda Gates Foundation in the largest philanthropic act in the history of mankind. Warren Buffett and Bill Gates have joined hands to promote the 'Pledging Wealth' movement. Many billionaires have joined them, including Azim Premji, Shiv Nadar, and Anil Agarwal from India. Hopefully, their actions will help in elevating capitalism to a more humane level. Apart from the moral and ethical aspects of giving, the super-rich would do well to get actively involved in philanthropic activities that mitigate the growing income/ wealth in the society and promote a more stable social order.

### **3. Rise of the Distorporation**

The master limited partnership (MLP) structure is essentially a "pass through" company which every year pays out more or less what it earns. As long as it distributes its earnings, it can largely avoid paying corporate tax. More and more businesses in the US are now tweaking their forms to qualify as pass-throughs. Such businesses account for more than two-thirds of new companies.

The "C" corporation, the familiar limited-liability joint-stock structure, is giving way to the distorporation. What does this shift imply? As the *Economist* put it: "In C corporations retained earnings can be used to fund investment and growth, assuring persistence. Without them, pass-through businesses have to be far more intertwined with investors. Staying alive means routinely inhaling capital, as well as exhaling."

While this shift prompts genuine concerns, it can be broadly virtuous because it enables capital to be channeled more productively. As the *Economist* put it, "That may, in the end, be the most compelling component of whatever defines the American system and enables it to be productive and innovative."

### **4. Indian Investors Tend to Lose in Stock Markets**

A study titled "Do retail investors in India make rational investment and portfolio decisions," done by the Indian School of Business, under the leadership of Sankar De, examined the daily trade data of million retail investors (considered as the largest sample used in an empirical study in behavioural finance) who collectively carried out 1.4 billion trades, with a total value of Rs. 37 lakh crore between January 2005 and June 2006. The study found that individual retail investors consistently chase a zero rate of return on their stock investments when they decide themselves. The study attributed



the dismal performance of retail investors to 'disposition effect' (selling the winners too quickly and holding on to the losers too long) and 'overconfidence' (taking credit for good decisions and attributing bad decisions to luck).

## **C.WIT AND WISDOM**

### **1. Humour**

- Dr Ernst of London, founder of the centenarian club, believed in thoroughly enjoying his life. His famous story is about the man who wanted to be a centenarian and was advised by his doctor to give up drinking, smoking, and women. "Will I live to be 100 then?" asked the patient, "No" said the doctor "but it will seem like it."
- When an American wife says, "Please get a handkerchief for me from upstairs," her husband obliges. In China, the husband will tell the child to get it. In Britain, the husband replies, "Have you broken your leg or something." In Russia the husband would get it and then say, "Comrade, I dropped my pencil while I was upstairs, will you get it for me."

### **2. Wise Saws**

- Hardening of the heart ages people more quickly than hardening of the arteries
- We judge ourselves by what we feel capable of doing, while others judge us by what we have already done.