MARGA Tutorial Note

Managerial Basics

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MANAGERIAL BASICS

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Managing a Company Economically - What does that Mean?

Economic business management is management based on figures or, more precisely, based on monetary data. And this is becoming more and more important! This is due to the globalised financial markets, which direct the capital that is globally available to those places with the highest return. Therefore, in order to always have sufficient investment capital, the sustainable generation of a sufficient return is the superior controlling goal of every company.

1. The Cycle of Money within a Company

But let's proceed step by step.First of all we must understand how a company works: to establish a company one needs (1.) **money** in order to (2.) invest in those **items** required for production: buildings and equipment, machinery, raw materials and consumables, etc. Furthermore, one needs cash to remunerate the staff and pay for other services purchased from third parties. These critical business assets serve for (3.) the aim to generate profits in the course of the current **business activities**.

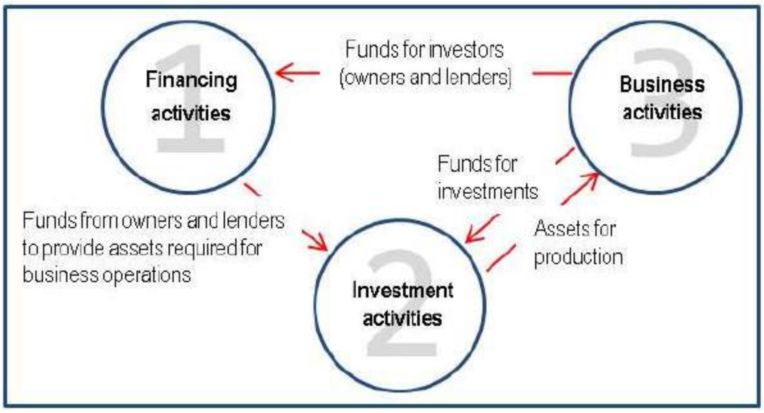
How are **profits** being generated? The business activities consist in the production of a product or service. If their sales price exceeds the production or provision costs, i.e. the company generates more money than has been put into it, the owner earns a surplus, the profit. The owner can either withdraw such profit for their private purposes (the dividend for the shareholders with companies limited by shares) or the money can remain within the company. In the second case it is directly available for further investments, which again provide the opportunity to generate further future profits. Thus, in terms of business management, entrepreneurial action can be described as a **cycle consisting of *(1.) financing activities, (2.) investment activities*** **and *(3.) operating business activities***. These activities will be described in detail below.

1.1. Financing activities

As part of the financing activities, firstly the owner provides private capital, and secondly loans are usually granted to the company by lenders, particularly banks. With companies limited by shares, the owners mostly include a large number of shareholders, and the investors also include other investors in the international debt capital markets apart from banks.

The characteristic of equity is that it is available to the company for an unlimited time since the owner has no claim to their capital contribution being returned. Thus, in extreme cases, they can loose their capital in full if the company suffers sustainable losses. In return, however, the owner is also entitled to the profits - this opportunity is the main reason why individuals and organisations provide their equity. Therefore, companies should ensure that the profits are high enough for the equity investors. We will return to this later on.

Debt capital is always only granted based on a repayment agreement. However, in return for this benefit, the lenders do not receive any profit-related payments (such as the owners) but usually an agreed fixed interest. Such interest is paid irrespective of the profit situation. The debt capital is divided into **liabilities** (e.g. the loan granted by a bank or the supplier the raw material supply of which has not yet been paid by the company) and so-called provisions. Provisions are financial obligations towards third parties the amount of which is not yet known - such as future warranty benefits to customers or pension liabilities of the company towards its employees. This means they are financial debts of the company towards third parties which, however, will not necessarily arise to the expected amount.



The total of the borrowed funds is shown on the **right side of the balance sheet**, the "**liabilities**". Thus, this side of the balance sheets provides information about what and how many funds are available to the company.

1.2. Investment activities

This (equity and debt) capital available to the company has one single purpose: to be invested in the **assets** already mentioned that are needed for making and selling the products and administering the company. Here a difference is made between assets that are being used and are thus available to the company in the long term ("non-current assets") and those that are being consumed, i.e. that remain in the company only for a short time ("current assets").

Non-current assets mainly include land and buildings, machinery, fixtures and fittings and the fleet of the company ("tangible assets"). Furthermore, the company also owns non-tangible assets: patents, rights and licences, but also the value of a subsidiary acquired in the past for which a higher price than the value of the assets and liabilities recognised in its balance sheet has been paid (so-called "goodwill"). If the company holds financial interests also in other companies, the value of such is also included in the non-current assets under "financial assets".

The **current assets** mainly comprise the inventory, the accounts receivable from those customers that have not yet paid for the goods they already received and the cash (cash on hand and cash at bank) of the company.

All of these assets are shown on the **left side of the balance sheet**, the "**assets**". Thus, it can be seen from the left side of the balance sheet how the capital (on the liabilities side) provided to the company has been invested. This comparison automatically means that the value of the assets included on the left side of the balance sheet exactly equals the debt capital and equity items on the right side of the balance sheet, i.e. one cannot invest more money than is available. This means that **altogether the balance sheet is balanced**.

Furthermore, it can be seen that the **value** of the entire company is the difference between the value of all assets less the debt capital (still to be paid back) - i.e. the **equity** to which the owners are entitled.

Assets	**Liabilities**
Non-current assets •Tangible assets • Non-tangible assets • Financial assets	Equity
Current assets • Inventories • Accounts receivable to customers • Cash on hand and cash at bank	Dept capital • Provisions • Liabilities

1.3. Operating business activities

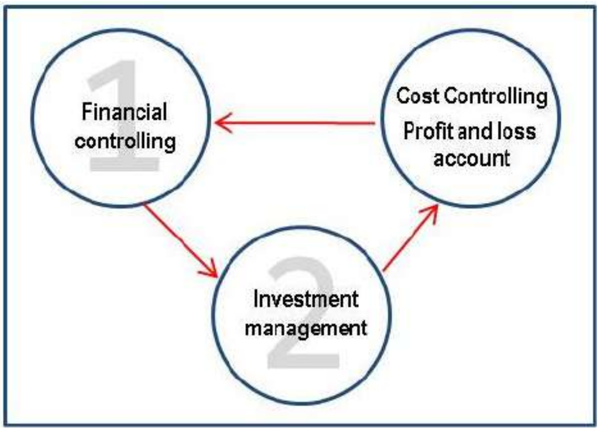
The assets on the assets side of the balance sheet reflect the company's potential for success. According to the management's assessment they ensure that the company will in future **generate more money through its operating business activities than the assets and their utilisation cost** - i.e. that it will be successful in financial terms. This success is measured by the **profit**, which a company must disclose for each financial year. Since the owners are entitled to the profit, it is added to the equity after the end of the year in which it was generated.

The fact that both sides of the balance sheet always have the same value also shows that, when the right side of the balance sheet increases through the equity, the value of the left side must also have grown. This effect is the logical reflection of the fact that the value of the sold products and services **(output)** exceeded the costs of their making or provision by using the assets **(input)**. Provided that all customers have paid and the money has not already been reinvested by the company, it is available in the form of **cash**. This leads to a new financing effect and the described **cycle starts anew**.

However, if the output is lower than the input, a loss arises that reduces the equity. **If the entire equity has been consumed sometime, the company must file for bankruptcy.** However, this does not normally occur.

2. Controlling

It is the aim of every company to have as much success (i.e. generate sufficient profits) that the existence of the company is not challenged. Therefore, business management means to continuously control the cycle consisting of financing, investing and success. Specific controlling instruments can be assigned to all three stages by means of which it can continuously be ensured that the business activities do not "stall", i.e. that the company does not generate any losses. These instruments include ***(1.) financial controlling, (2.) investment management*** **and** ***(3.) cost controlling*** **in conjunction with the** ***profit and loss account***.



2.1. Financial controlling

There are two critical issues in the financing field of the company: Is sufficient money available? Is the company satisfied with its capital sources?

The first question is the subject matter of entrepreneurial **liquidity management**. Since a company must be able to meet its financial liabilities at any time (otherwise it must file for **bankruptcy due to illiquidity**), this function is of great operating significance. Furthermore, securing the long-term capital requirements and optimising the capital structure (i.e. what is the ideal equity share and what are the conditions of loan agreements in terms of repayment terms and interest rates) form part of the **capital requirement planning**.

Financial controlling is a highly specialised discipline, due to which larger companies have specialist departments for this area. The operating areas of the company usually do not deal with these issues.

2.2. Investment management

What is more important for achieving the targets is the management of the investment activities: In order to prepare for future success, the company must invest in the right assets. This mainly includes building up **production capacities** (e.g. production machines), a **sales organisation** and the **corporate administration**. It is also possible to directly invest in the acquisition of a whole company that has already established these corporate functions.

The selection of the "right" assets is the **controlling discipline with the largest consequences**. Therefore, investment decisions must be prepared very carefully both qualitatively and in terms of their quantitative effects on the future success of the company.

The *qualitative* preparation is based on **strategic analyses** of future market developments, the evaluation of the strengths and weaknesses of the company and the question how the products and services to be sold should be designed with regard to quality and price. For this purpose, modern business management provides a host of analysis aids, e.g. in the form of portfolio presentations, which must be adjusted and selected very carefully depending on the specific situation. This is the responsibility of **strategic management** by the company's management.

In *quantitative* terms, investment projects are evaluated by means of the **investment appraisal**. As a basis, all future payments caused by the investment are planned and valuated with their present value. In extreme cases it can be necessary to plan for the next ten years or even more - a difficult undertaking. As a result, key data are obtained based on which the effect of the investment on future profits of the company can be assessed, e.g. the "net present value" or the "**internal rate of return**".

Due to the long-term planning period and in view of the prior strategic analyses, these key data serve for the ***strategic* controlling** of the company.

2.3. Cost controlling and profit and loss account

While the investment management deals with the question what capacities should be created, the instruments of cost controlling ensure that these capacities are **utilised in an optimum way** and **applied profitably**. A key characteristic of this is the creation of **transparency about the origination and the amount of the costs in the company**. This gives rise to many decisions that can positively affect efficiency.

For instance, the **product calculation** shows whether the price of a product covers its production, selling and administrative costs. **Contribution accounting** reflects how the cost structure changes with a changed production output, how one can respond to fluctuations in demand in a cost-optimum way and which production programme generates the highest profit. The **break-even analysis** determines the production output from which the sales proceeds exceed the costs and the company earns money. Cost accounting is the key controlling discipline for ***operating*** **(profit) control** at the company.

The key instrument for *measuring* success that shows whether the company has actually generated profits as planned is the **profit and loss account**. It shows whether the input (the costs for the use of the assets, for staff, etc.) exceeds the output (the value of the sold products and services paid by the customers). If this target has been achieved, profit has been generated and this profit increases the equity. In the opposite case, a loss has been incurred that has destroyed the capital of the owners.

Within the infinite controlling cycle, the profit and loss account thus is a kind of **intermediate operating result report**. It provides information about whether or not the company was "on the path of virtue" in the closed year.

3. The Path of Virtue: Value-Based Business Management

The key goal of any entrepreneurial activity is to **secure the long-term existence of the company**. And a company can only survive if it has sufficient profits in the long term in order to satisfy the equity owners' demand for return. This is the purpose - and the *only* purpose (!) - for which the profits are generated. However, before we deal with the interesting question how high the owners' demands for return are, we will briefly address the **systematics of value-based business management**.

Value-based controlling does not only look at whether the profits are high enough for the owners but **combines the investors and lenders as a whole**. After all, the lenders also expect a return (the interest on loan). As already described above, the entire capital available to the company is shown on the right side of the balance sheet: equity, provisions and liabilities. The total demands for return of these groups are the entire "**cost of capital**" of the company.

3.1. How much does the Capital Cost?

It depends on the demands of the investors and lenders how much the company must generate for them. First of all, there are the **owners**:

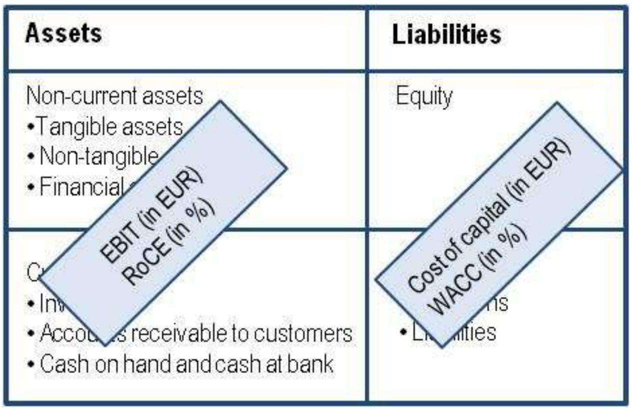
The crucial question is: What return does everyone of us expect of an investment in shares? Typically one expects more than a certain minimum return that could be expected if the money was invested in a safe government bond - approximately 4 to 5%. More since the investment in shares is subject to a more or less high **risk of default**. This "more" is called risk premium. Of course, the **risk premium** depends on the risk of each company and is thus individually determined for each company.

Therefore, the **owners' demands for return** are calculated based on a minimum return for a safe reference bond plus a company-specific risk premium.

The **lenders** as the second large group of investors expect a return to the amount of the **interest rate** agreed in the loan agreement. Since this has been contractually agreed, the risk of default is lower. Therefore, the interest claim is below that of the owners since it does not include the risk premium. Thus, liabilities are a cheaper capital source for companies than equity.
The third group of financing sources is the **provisions** already mentioned above. It depends on their purpose whether these must also yield interest. Pension provisions, for instance, must be increased annually. Costs are a stated for this in the profit and loss ac-

count that reduce the profit. Thus, the "**demand for return**" of the pension provisions equals the annual increase rate. By contrast, potential liabilities in relation with a legal dispute ("provision for court proceedings") will usually not change over the period of the legal proceedings. Therefore, **no cost of capital** results from them.

Thus, the entire **cost of capital** of the company is calculated as the average interest rate according to the demands for return of the owners and lender. This interest rate is called **WACC** ("weighted average cost of capital"). The amount of money of the cost of capital is this percentage rate multiplied by the total capital of the company.



In order to fulfil the claims of the owners and lenders of the company, the capital must have increased (the balance sheet must have lengthened) **by this amount in the relevant period**.

3.2. Who Generates the Cost of Capital?

This required capital increase must be generated by the company through its **assets** (listed on the left side of the balance sheet). More precisely, by those employees of the company who use these assets daily in order to make good products for and provide good services to their customers. With the aim to generate profits. However, it is not the profit that is compared to the cost of capital but the **profit *before deduction of interest expense and tax***, the so-called **EBIT** ("earnings before interest and taxes"). It is the profit before interest expense that is taken into account because the interest expense is already included in the cost of capital (it "belongs" to the right side of the balance sheet") - otherwise it would be taken into consideration twice. And it is the profit before tax since the performance of the operating management should not be adjusted by fiscal effects, which can practically not be influenced by the operating areas. Tax influences would also distort performance comparisons on an international basis.

Thus the EBIT is the **result of operations** of the company. It reflects how much the assets of the company have increased (i.e. the balance sheet has lengthened) during the period under review. On a percentage basis, the EBIT can also be expressed as the RoCE ("return on capital employed") by dividing the EBIT by the total assets (= the entire capital).

If this increase in assets exceeds the capital increase expected by the owners and lenders, the company has created value.

Or: If the EBIT exceeds the cost of capital (= RoCE is higher than WACC), the value of the equity has been increased.

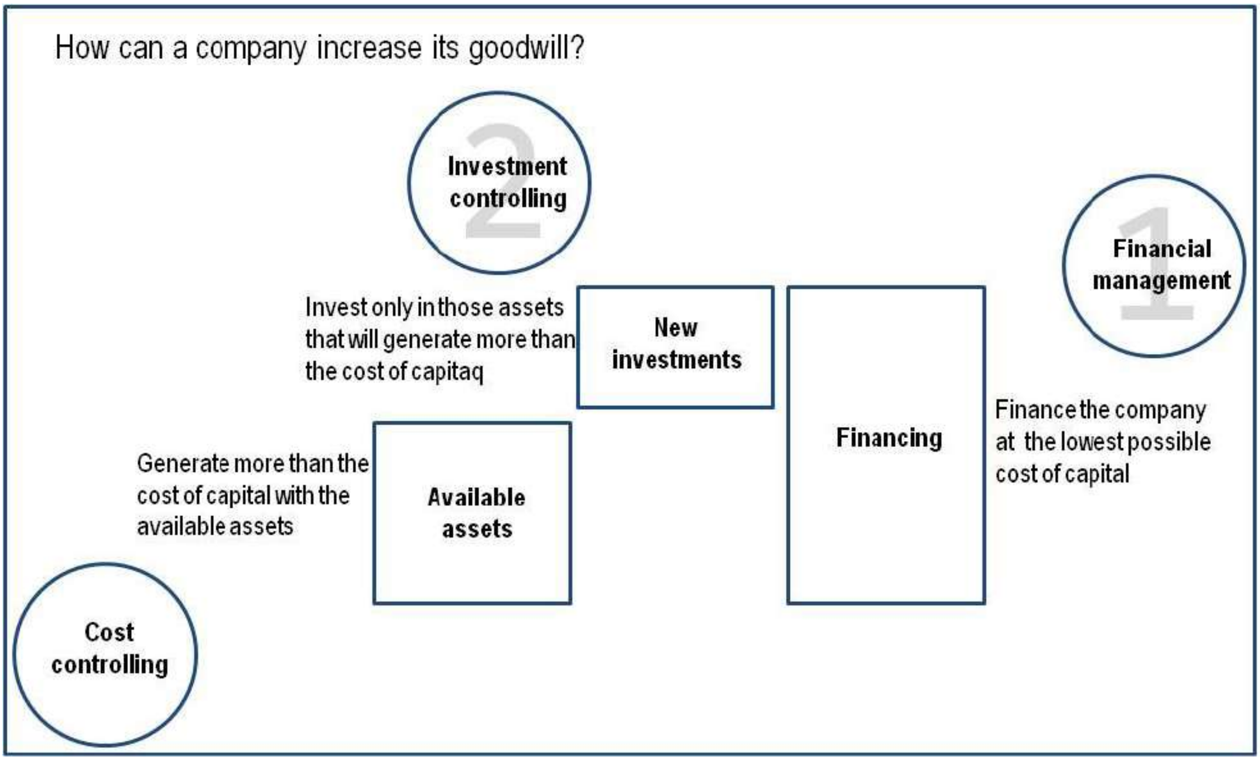
Value-based business management means to permanently pursue this aim.

4. Value-Based Controlling

Entrepreneurial controlling must ensure that the owners and lenders of the company are being satisfied in the long term. Thus, value-based controlling is indispensable in order to **sustainably secure the existence of the company**. As a consequence, the controlling derives all operating and strategic targets of the company from the "cost of capital hurdle".

The **controlling instruments** include those described above:
(1.) financial controlling,
(2.) investment management, and
(3.) cost controlling in conjunction with the profit and loss account.
The cost of capital hurdle in the form of the WACC is the key assessment criterion for "good" or "bad" business management. Therefore, this interest rate is taken into account with all instruments as follows:
(1.) Finance the company at the lowest possible cost of capital.
(2.) Invest only in those assets that will generate more than the cost of capital.
(3.) Always generate more than the cost of capital with the available assets.

Thus, economic business management means to control the company based on these three criteria: **value-based controlling!**



5. The Globalised Financial Markets

And why is this becoming more and more important? Why does the pressure for return constantly increase? Why have the demands for return of the owners and lenders become the focus of entrepreneurial interest during the past few years?

Because today we can invest our money almost everywhere and in real time via the internet. Day traders do not even need a bank anymore; they directly trade on the stock exchanges of the world. This also applies to life insurances, which are supposed to generate a comfortable pension for us and all other future pensioners in the industrial nations. Or the sovereign wealth funds, which must try to secure their country's wealth in the long term, e.g. through oil and gas production. And so on and so forth … And all of these investors finally only pursue a single aim: **return!**

Return, which the companies using this capital must generate. What has changed is the fact that - unlike 20 years ago - German companies do not only compete for capital with other German companies but globally. While in the relatively closed community of the past personal contacts and a sound management where sufficient promises for good profits, the permanent return can be the only measure of success in the anonymity of the global markets. We ourselves are the drivers of this pursuit of return since we also **select our money investments and pension products almost exclusively based on return aspects**.

6. Good Business Management

However, despite all figure orientation the following holds true: Sustainably high returns can only be generated by companies that also have happy customers. And customers can only be satisfied permanently if the company's employees feel that they are treated fairly. Therefore, **good personnel management** and **high customer-orientation** are indispensable conditions for **sustainable business success**, value enhancement and thus the long-term securing of the company's survival.

This is what figures cannot do. They are only the measure.