General Financial Terms

1. What is the Difference between Vertical Analysis and Horizontal Analysis?

Vertical analysis reports each amount on a financial statement as a percentage of another item. For example, the vertical analysis of the balance sheet means every amount on the balance sheet is restated to be a percentage of total assets. If inventory is Rs.100,000 and total assets are Rs.400,000 then inventory is presented as 25 (Rs.100,000 divided by Rs.400,000). If cash is Rs.8,000 then it will be presented as 2 (Rs.8,000 divided by Rs.400,000). The total of the assets will now add up to 100. If the accounts payable are Rs.88,000 they will be presented as 22 (Rs.88,000 divided by Rs.400,000). If owner's equity is Rs.240,000 it will be presented as 60 (Rs.240,000 divided by Rs.400,000). The restated amounts from the vertical analysis of the balance sheet will be presented as a common-size balance sheet. A common-size balance sheet allows you to compare your company's balance sheet to another company's balance sheet or to the average for its industry.

Vertical analysis of an income statement results in every income statement amount being presented as a percentage of sales. If sales were Rs.1,000,000 they would be restated to be 100 (Rs.1,000,000 divided by Rs.1,000,000). If the cost of goods sold is Rs.780,000 it will be presented as 78 (Rs.780,000 divided by sales of Rs.1,000,000). If interest expense is Rs.50,000 it will be presented as 5 (Rs.50,000 divided by Rs.1,000,000). The restated amounts are known as a common-size income statement. A common-size income statement allows you to compare your company's income statement to another company's or to the industry average.

Horizontal analysis looks at amounts on the financial statements over the past years. For example, the amount of cash reported on the balance sheet at December 31 of 2012, 2011, 2010, 2009, and 2008 will be expressed as a percentage of the December 31, 2008 amount. Instead of rupee amounts you might see 134, 125, 110, 103, and 100. This shows that the amount of cash at the end of 2012 is 134% of the amount it was at the end of 2008. The same analysis will be done for each item on the balance sheet and for each item on the income statement. This allows you to see how each item has changed in relationship to the changes in other items. Horizontal analysis is also referred to as trend analysis.

Vertical analysis, horizontal analysis and financial ratios are part of financial statement analysis.

2. How do you calculate the Payback Period?

The payback period is calculated by counting the number of years it will take to recover the cash invested in a project.

Let's assume that a company invests Rs.400,000 in more efficient equipment. The cash savings from the new equipment is expected to be Rs.100,000 per year for 10 years. The payback period is 4 years (Rs.400,000 divided by Rs.100,000 per year).

A second project requires an investment of Rs.200,000 and it generates cash as follows: Rs.20,000 in Year 1; Rs.60,000 in Year 2; Rs.80,000 in Year 3; Rs.100,000 in Year 4; Rs.70,000 in Year 5. The payback period is 3.4 years (Rs.20,000 + Rs.60,000 + Rs.80,000 = Rs.160,000 in the first three years + Rs.40,000 of the Rs.100,000 occurring in Year 4).

Note that the payback calculation uses cash flows, not net income. Also, the payback calculation does not address a project's total profitability. Rather, the payback period simply computes how fast a company will recover its cash investment.

3. What is a Current Asset?

A current asset is cash and any other company asset that will be turning to cash within one year from the date shown in the heading of the company's balance sheet. (If a company has an operating cycle that is longer than one year, an asset that will turn to cash within the length of its operating cycle is considered to be a current asset.)

4. What is Financial Leverage?

Financial leverage refers to the use of debt to acquire additional assets. Financial leverage is also known as trading on equity. Below are two examples to illustrate the use of financial leverage, or simply leverage.

5. What is a Current Liability?

A current liability is an obligation that is 1) due within one year of the date of a company's balance sheet and 2) will require the use of a current asset or will create another current liability. If a company's operating cycle is longer than one year, current liabilities are those obligation's due within the operating cycle. Current liabilities are usually presented in the following order:

- the principal portion of notes payable that will become due within one year
- accounts payable
- the remaining current liabilities such as payroll taxes payable, income taxes payable, interest payable and other accrued expenses

6. What is Trend Analysis?

In the analysis of financial information, trend analysis is the presentation of amounts as a percentage of a base year.

If I want to see the trend of a company's revenues, net income, and number of clients during the years 2006 through 2012, trend analysis will present 2006 as the base year and the 2006 amounts will be restated to be 100. The amounts for the years 2007 through 2012 will be presented as the percentages of the 2006 amounts. In other words, each year's amounts will be divided by the 2006 amounts and the resulting percentage will be presented. For example, revenues for the years 2006 through 2012 might have been Rs.31,691,000; Rs. 40,930,000; Rs. 50,704,00; Rs. 63,891,000; Rs. 79,341,000; Rs. 101,154,000; Rs. 120,200,000. These revenue amounts will be restated to be 100, 129, 160, 202, 250, 319, and 379.

Let's assume that the net income amounts divided by the 2006 amount ended up as 100, 147, 206, 253, 343, 467, and 423. The number of clients when divided by the base year amount are 100, 122, 149, 184, 229, 277, and 317.

From this trend analysis we can see that revenues in 2012 were 379% of the 2006 revenues, net income in 2012 was 467% of the 2006 net income, and the number of clients in 2012 was 317% of the number in 2006. Using the restated amounts from trend analysis makes it much easier to see how effective and efficient the company has been during the recent years.

Trend analysis can also include the monitoring of a company's financial ratios over a period of many years.

7. What is the Operating Cycle?

The operating cycle is also known as the cash conversion cycle. In the context of a manufacturer the operating cycle has been described as the amount of time that it

takes for a manufacturer's cash to be converted into products plus the time it takes for those products to be sold and turned back into cash.

8. What are the Reasons for High Inventory Days?

The days sales in inventory is high when the inventory turnover is low.

Since inventory turnover is associated with sales and average inventory, changes in either sales or inventory can cause a high amount of inventory days. For example, if a company has maintained its inventory quantities, but economic factors cause a significant drop in its sales, the company's inventory days will increase dramatically. If a retailer increases its inventory in order to generate additional sales, but sales do not increase, there will also be an increase in the number of inventory days.

9. What is Liquidity?

Liquidity refers to a company's ability to pay its bills from cash or from assets that can be turned into cash very quickly. The quick ratio, also known as the acid-test ratio, is an indicator of a company's liquidity.

10. What is Leverage?

In accounting and finance, leverage refers to the use of a significant amount of debt and/or credit to purchase an asset, operate a company, acquire another company, etc. Generally the cost of borrowed money is much less than the cost of obtaining additional stockholders' equity. As a result, it is usually wise for a corporation to use some debt and leverage. Perhaps this is one of the reasons that leverage is also known as trading on equity.

Financial ratios such as debt to equity and debt to total assets are indicators of a corporation's use of leverage. In these ratios debt is the total amount of all liabilities (current and noncurrent). This means that a corporation's debt includes bonds payable, loans from banks, loans from others, accounts payable, and all other amounts owed.

11. What are the flaws with public company comparable?

There may be various flaws with public company comparable. But the following three stands out –

The stock market doesn't have a fixed way of reacting. It reacts impulsively on the events or happenings in the market. So, it is very difficult to predict the reaction of the stock market on a given day. Thus, the factors you use may not help you at all.

100% comparison of one company with another is never possible. There will always be room for error.

Smallest companies have tiniest stocks. And these stocks may not always reflect the actual value of the company.

12. How would you value a private company?

Valuing a private company is slightly different than valuing a public company. Of course, you will use the comparables, precedent transactions, DCF, but here are few differences–

First of all, you need to think about the liquidity of the private company. Naturally, private companies wouldn't be as liquid as public companies. Thus, while valuing the private company, the discounting rate would increase.

It wouldn't be possible to use future share price analysis; because there would be none.

DCF becomes very difficult as there is no beta in the case of a private company.

In the case of a private company, the enterprise value would be taken into account.

13. What is your investment strategy?

In finance, an investment strategy is a set of rules, behaviors or procedures, designed to guide an investor's selection of an investment portfolio. Individuals have different profit objectives, and their individual skills make different tactics and strategies appropriate. Some choices involve a tradeoff between risk and return. Most investors fall somewhere in between, accepting some risk for the expectation of higher returns.

14. Where do you think the SENSEX will be in three months and six months - and why?

Predicting equity markets and stock movements are not easy, equity analysts use many methods and indicators to predict market movements.

These indicators are both fundamental (price-to-earning, or P/E, ratio, price-to-book value, or P/B, ratio, interest rates) and technical (put-call ratio, volumes traded).

Fundamental Indicators

Dividend Yield: If the dividend yield is low, the share price is relatively higher than the dividend paid and hence the stock may be overvalued. This indicates a possible decline in the future.

A high dividend yield, on the other hand, means subdued interest in the stock and that the company is trying to woo investors by paying higher dividends. It means the stock price is undervalued.

This can be extended to a stock index too. One can calculate the aggregate dividend yield of an index, compare it with past dividend yields and see if the current yield is low or high. A low dividend yield indicates an overpriced market and vice versa.

Insider Moves: Though the name smells of something unlawful, not all insider trades are illegal. According to Indian laws, an insider is a top official, director or shareholder who owns a specified per cent of shares and has access to unpublished price-sensitive information about the company. An 'insider' can buy or sell shares provided they inform the stock exchanges on which the stock is listed if the transaction goes beyond a certain threshold. Studies suggest that while an insider may have many reasons to sell, the only reason for buying can be that he is bullish on the prospects of the company.

Interest rates: Changes in interest rates impact companies. Conventional wisdom says one must buy shares when short-term rates (treasury bills) are low and sell when they are high.

Trading volume: Trading volume indicates the number of shares or contracts traded in the market. It tells if a particular price trend is supported by market players. If the price of a share is increasing with higher than normal volume, it indicates investors support the rally and that the stock would continue to move upwards. However, a falling price trend with big volume signals a likely downward trend.

Put-Call Ratio: A put option is an agreement between two parties to exchange an asset at a pre-determined rate on or before a specific date. The buyer of the put option has the right but no obligation to sell the asset (stock, commodity) at a specified price on or before a fixed date, while the seller has the obligation to buy at the pre-specified price if the buyer wishes to exercise the option.

If the put-call ratio is increasing, it means the number of traded put options is increasing, signaling that either investors fear the market will fall or are hedging their portfolios foreseeing a decline.

15. Under what circumstances do corporations buyback stock?

Stock buybacks refer to the repurchasing of shares of stock by the company that issued them. A buyback occurs when the issuing company pays shareholders the market value per share and re-absorbs that portion of its ownership that was previously distributed among public and private investors. With stock buybacks, aka share buybacks, the company can purchase the stock on the open market or from its shareholders directly. In recent decades, share buybacks have overtaken dividends as a preferred way to return cash to shareholders. Though smaller companies may choose to exercise buybacks, blue-chip companies are much more likely to do so because of the cost involved.

Since companies raise equity capital through the sale of common and preferred shares, it may seem counter-intuitive that a business might choose to give that money back. However, there are numerous reasons why it may be beneficial to a company to repurchase its shares, including ownership consolidation, undervaluation, and boosting its key financial ratios.

16. What are the advantages and disadvantages of a company issuing stock to finance its operations rather than use debt?

Businesses often need external money to maintain their operations and invest in future growth. There are two types of capital that can be raised: debt and equity.

Debt Capital

Debt financing is capital acquired through the borrowing of funds to be repaid at a later date. Common types of debt are loans and credit. The benefit of debt financing is that it allows a business to leverage a small amount of money into a much larger sum, enabling more rapid growth than might otherwise be possible.

In addition, payments on debt are generally tax-deductible. The downside of debt financing is that lenders require the payment of interest, meaning the total amount repaid exceeds the initial sum. Also, payments on debt must be made regardless of business revenue. For smaller or newer businesses, this can be especially dangerous.

Equity Capital

Equity financing refers to funds generated by the sale of stock. The main benefit of equity financing is that funds need not be repaid. However, equity financing is not the "no-strings-attached" solution it may seem.

Shareholders purchase stock with the understanding that they then own a small stake in the business. The business is then beholden to shareholders and must generate consistent profits in order to maintain a healthy stock valuation and pay dividends. Since equity financing is a greater risk to the investor than debt financing is to the lender, the cost of equity is often higher than the cost of debt.

17. How to choose between Debt and Equity

The amount of money that is required to obtain capital from different sources, called cost of capital, is crucial in determining a company's optimal capital structure. Cost of capital is expressed either as a percentage or as a dollar amount, depending on the context.

The cost of debt capital is represented by the interest rate required by the lender. A Rs.100,000 loan with an interest rate of six percent has a cost of capital of six percent, and a total cost of capital of Rs. 6,000. However, because payments on debt are tax-deductible, many cost of debt calculations take into account the corporate tax rate.

Assuming the tax rate is 30 percent, the above loan would have an after-tax cost of capital of 4.2%.

18. When is debt financing more attractive than equity financing?

Companies are never totally certain what their earnings will amount to in the future (although they can make reasonable estimates). The more uncertain their future earnings, the more risk is presented. As a result, companies in very stable industries with consistent cash flows generally make heavier use of debt than companies in risky industries or companies who are very small and just beginning operations. New businesses with high uncertainty may have a difficult time obtaining debt financing and often finance their operations largely through equity.

19. What is a "swap" and how does it work?

Swaps are financial agreements to exchange cash flows. Swaps can be based on interest rates, stock indices, foreign currency exchange rates and even commodities prices.

Let's walk through an example of a plain vanilla swap, which is simply an interest rate swap in which one party pays a fixed interest rate and the other pays a floating interest rate.

The party paying the floating rate "leg" of the swap believes that interest rates will go down. If they do, the party's interest payments will go down as well.

The party paying the fixed rate "leg" of the swap doesn't want to take the chance that rates will increase, so they lock in their interest payments with a fixed rate.

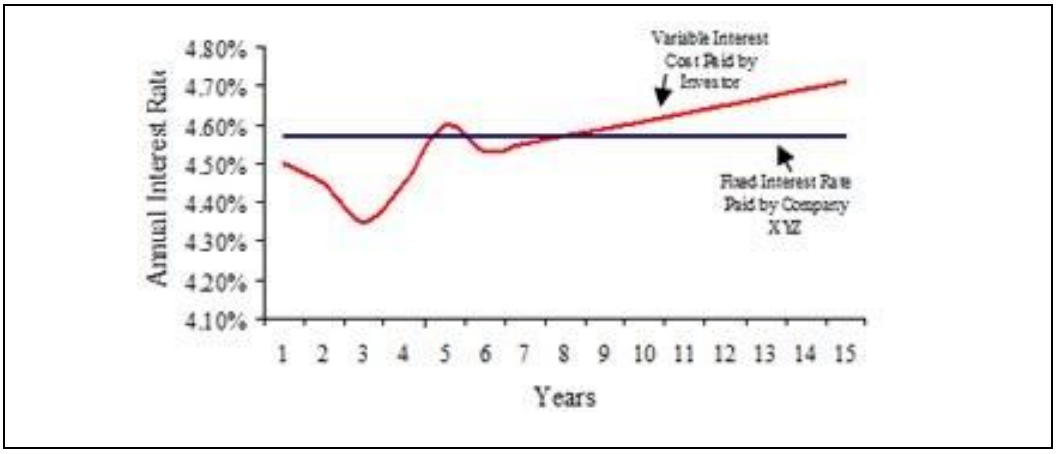
Company XYZ issues $10 million in 15-year corporate bonds with a variable interest rate of LIBOR+ 150 basis points. LIBOR is currently 3%, so Company XYZ pays bondholders 4.5%.

After selling the bonds, an analyst at Company XYZ decides there's reason to believe LIBOR will increase in the near term. Company XYZ doesn't want to be exposed to an increase in LIBOR, so it enters into a swap agreement with Investor ABC.

Company XYZ agrees to pay Investor ABC 4.58% on $10,000,000 each year for 15 years. Investor ABC agrees to pay Company XYZ LIBOR + 1.5% on $10,000,000 per year for 15 years. Note that the floating rate payments that XYZ receives from ABC will always match the payments they need to make to their bondholders.

Investor ABC thinks that interest rates are going to go down. He is willing to accept fixed rates from Company XYZ

To do this, Company XYZ structures a swap of the future interest payments with an investor willing to buy the stream of interest payments at this variable rate and pay a fixed amount for each period. At the time of the swap, the amount to be paid over the life of the debt is the same.



The investor is betting that the variable interest rate will go down, lowering his or her interest cost, but the interest payments from Company XYZ will be the same, allowing a gain (i.e. arbitrage) on the difference.

20. How would you go about valuing this department for a spin-off?

A spinoff is the creation of an independent company through the sale or distribution of new shares of an existing business or division of a parent company. A spinoff is a type of divestiture. The spun-off companies are expected to be worth more as independent entities than as parts of a larger business. A spinoff is also known as a spin out or starbust.

Understanding Spinoff

When a corporation spins off a business unit that has its own management structure, it sets it up as an independent company under a renamed business entity. The company that initiates the spinoff is referred to as the parent company. A spinoff retains its assets, employees, and intellectual property from the parent company, which gives it support in a number of ways, such as investing equity in the newly formed firm and providing legal, technology or financial services.

A spinoff may occur for various reasons. A company may conduct a spinoff so it can focus its resources and better manage the division that has more long-term potential. Businesses wishing to streamline their operations often sell less productive or unrelated subsidiary businesses as spinoffs. For example, a company might spin off one of its mature business units that are experiencing little or no growth so it can focus on a product or service with higher growth prospects.

Alternatively, if a portion of the business is headed in a different direction and has different strategic priorities from the parent company, it may be spun off so it can unlock value as an independent operation.

A company may also separate a business unit into its own entity if it has been looking for a buyer to acquire it for a while but couldn't find one. For example, the offers to purchase the unit may be unattractive, and the parent company might realize that it can provide more value to its shareholders by spinning off that unit.

A corporation creates a spinoff by distributing 100 percent of its ownership interest in that business unit as a stock dividend to existing shareholders. It can also offer its existing shareholders a discount to exchange their shares in the parent company for shares of the spinoff. For example, an investor could exchange $100 of the parent's stock for $110 of the spinoff's stock. Spinoffs tend to increase returns for shareholders because the newly independent companies can better focus on their specific products or services.

Special Considerations

The downside of spinoffs is that their share prices can be more volatile and can tend to underperform in weak markets and outperform in strong markets. They can also experience high selling activity; shareholders of the parent may not want the shares of the spinoff they received because it may not fit their investment criteria. The share price may dip in the short term because of this selling activity, even if the spinoff's long-term prospects are positive.

Spinoffs are a common occurrence; there are typically dozens each year in the United States. You may be familiar with Expedia's spinoff of TripAdvisor in 2011; United Online's spinoff of FTD companies in 2013; Sears Holding Corporation's spinoff of Sears Canada in 2012; or eBay's spinoff of PayPal, to name just a few examples.