

## Week 2 Lecture

Welcome to Week 2 of the course. Last week, we learned about business ethics, budgeting, forecasting, and variance analysis. We also created a proforma financial statement and a personal budget. This week, we will expand our learning opportunity into the primary topic of working capital management.

Let's first consider some key fundamentals related to working capital management. Capital refers to investor-supplied long-term and short-term loans from individuals and institutions. The capital "structure" is the mixture of debt, common stock, preferred stock, and retained earnings used to finance a firm's operations. Mostly all firms need money sources to grow and this capital is often obtained in the form of debt or equity.

There are two primary advantages to debt financing: first, interest paid is tax deductible, whereas dividends are not, thus the debt's relative cost to equity is lower. Second, the return on debt is fixed, so stockholders do not have a share of the firm's profits. This is especially advantageous if the company becomes highly successful. However, obtaining debt increases the firm's risk, which raises the cost of debt and equity. In addition, there is a risk component in that if the company's operating income is not enough to cover interest charges, then the firm may go bankrupt. In general, companies with stable earnings and operating cash flows can benefit from debt financing.

One of the most important working capital related concepts to understand is called weighed average cost of capital, or WACC. A company's assets are financed by either debt or equity, and the weighted average cost of capital, or WACC, is the average cost of funding sources, each of which is weighted by its respected use in a given situation. The WACC valuation includes all capital sources, common stock, preferred stock, bonds, and any other long-term debt. The weighted average provides knowledge on how much interest the company is paying for every dollar it finances and the overall required return on the firm as a whole. This is particularly important when analyzing the economic feasibility of expansions and mergers. The WACC is impacted by the firm's financing and investment decisions, as well other factors beyond the firm's control like general economic conditions.

View this short video on WACC:

<https://www.youtube.com/watch?v=wzheZkH2Cms>

Comparing a company's return on invested capital, or ROIC, with its weighted average cost of capital, WACC, can reveal if the invested capital is used effectively. Total capital

includes long-term debt and common and preferred shares. Fluctuations in ROIC are caused by many factors, such as economic booms, recessions, new product introductions by an organization and its competitors, and so on. Business risk varies from industry to industry, from those in the same industry, and with changes over time.

As you will learn this week, financial managers should try to achieve an optimal capital structure that maximizes the firm's stock price. This typically requires a debt/capital ratio that is lower than the one that maximizes expected earnings per share or EPS.

However, capital structure that maximizes the stock price also minimizes the WACC, it is easier to predict how a capital structure changes will affect the WACC than the stock price. Therefore, the estimated relationship between capital structure and the WACC guides capital structure decisions.

Seasoned financial managers can determine the impact of capital structure on the cost of debt using forecasting models. For example, increasing the debt ratio increases the risks that bondholders face and thus the cost of debt. Likewise, more debt can raise stockholder risk, which raises the cost of equity.

Effective working capital management involved balancing optimal levels for cash, marketable securities, accounts receivable, and inventory, and then financing this working capital at the lowest cost. Managing this capital successfully can reduce financing costs and generate significant cash for an organization.

As a reminder, there are some great supplemental articles and videos this week. Be sure to review them to gain further insight. Enjoy the upcoming week!