TECHNICAL KNOWLEDGE

CREATED BY UCSB FINANCE CONNECTION

FOR THE FINANCE INDUSTRY

1 ACCOUNTING

- The 5 most important accounting concepts to understand
  - The 3 financial statements and what each one means
    - Income Statement
    - Balance Sheet
    - Cash Flow Statement
  - How the 3 financial statements link together and how to walk through questions where one or multiple items change
  - Different methods of accounting – cash based vs. accrual, and determining when revenue and expenses are recognized
    - Cash basis recognizes revenues when received and expenses when expensed
    - Accrual basis recognizes revenues with expenses when they occur, often referred to the "matching principle"
  - When to expense something and when to capitalize it
  - What individual items on statements mean

2 ENTERPRISE/EQUITY VALUE

- Enterprise Value represents the market value of the company assets that is attributable to all investors
- Equity Value represents the market value of the shareholders' equity portion
- When analyzing a company, you look at both because Equity Value is the number the public sees while Enterprise Value represents the company's "true value"

3 VALUATION

- 3 Major Valuation methodologies:
  - Public Comparables
    - Comparing companies based on similar metrics to determine their enterprise value
    - Most common valuation measures used in comparable company analysis are enterprise value to sales (EV/S), price to earnings (P/E), price to book (P/B), and price to sales (P/S)
  - Precedent Transactions
    - Uses past performance results of a company to help determine that company's valuation
    - Considers the companies' financial characteristics, size of transaction, and type of transaction
    - This method can be limited by the the public information provided or it might be hard to apply current market conditions to past transactions
  - Discounted Cash Flow Analysis

4 DISCOUNTED CASH FLOW (DCF)

- Walk-through of a DCF:
  - A DCF values a company based on the Present Value of its Cash Flows and the Present Value of its Terminal Value
  - First, project out company's financials using assumptions for revenue growth, expenses, and working capital
  - Then you get down to Free Cash Flow for each year, which you sum up and discount to a Net Present Value, based on your discount rate – usually WACC (weighted average cost of capital)
  - Next, determine the company's Terminal Value, using either the Multiples Method or the Gordon Growth Method, and then discount that back to its Net Present Value using WACC
  - Finally, add the two numbers together to determine company's Enterprise Value

5 MERGER MODEL

- Walk-through of a Merger Model:
  - A merger model is used to analyze the financial profiles of 2 companies, the purchase price, and how the purchase is made, and determines whether the buyer's earnings per share (EPS) increases or decreases
  - First, make assumptions about the acquisition – the price and whether it was cash, stock, or debt, or some combination
  - Next, determine the valuations and shares outstanding of the buyer and seller and project out an Income Statement for each
  - Then, combine the Income Statements, adding up line items like Revenue and Operating Expenses, and adjusting for Foregone Interest on Cash and Interest Paid on Debt in the Combined Pre-Tax Income line
  - Divide by the new share count to determine combined EPS
- Merger vs. Acquisition:
  - Merger – companies are close to same size
  - Acquisition – one is significantly larger (buyer)

6 LEVERAGED BUYOUT (LBO) MODEL

- Walk-through of a basic LBO Model:
  - Make assumptions about the Purchase Price, Debt/Equity ratio, Interest Rate on Debt, and other variables – might also assume something about the company's operations such as Revenue Growth or Margins
  - Create a Sources & Uses section – shows how you finance the transaction and what you use the capital for
  - Adjust the BS for the new Debt and Equity figures, and add in Goodwill & Other Intangibles on Assets side to make it balance
  - Project out the company's IS, BS, and CF, and determine how much debt is paid off each year, based on the available Cash Flow and required Interest Payments
  - Make assumptions about the exit after several years and calculate the return based on how much equity is returned to the firm

RESOURCES

1 RECOMMENDED READING/MATERIAL

All of the recommended study material can be accessed by Finance Connection members in the "Resources" section under the "Members" tab on our website at https://www.ucsbfinanceconnection.com.

- The Insider's Guide to Investment Banking
- Breaking into Wall Street
- Wall Street Oasis Guides
- Vault Guides
- Northwestern Lecture Series: The Investment Environment