LATHAM & WATKINS LLP

WEB WOMEN ENRICHING BUSINESS

Berkeley UNIVERSITY OF CALIFORNIA Executive Education

FINANCIAL ANALYSIS FOR LEADERS PROGRAM

TOP TAKEAWAYS

Our Women Enriching Business (WEB) Committee partnered with the UC Berkeley Executive Education and Professor Panos Patatoukas to create an exclusive educational experience designed to provide foundational knowledge of financial information analysis for in-house lawyers. The program provided an introduction to corporate financial reporting, financial statement analysis, and corporate valuation, through practical, hands-on application.

The course was designed to put lawyers in a position to analyze financial information and challenge financial assumptions. Participants came away with a deep understanding of corporate value creation and increased confidence in their ability to engage with the financial professionals in their businesses. What follows are some of the course's top takeaways.

Financial Information Analysis (FIA) gives us a framework to think about value creation in a variety of settings, including public and private firms. It also enables us to:

- Measure drivers of value creation
- Understand past value creation
- Forecast future path of value creation
- Make comparisons over time and across firms
- Challenge price and be challenged by price

How to Read a Balance Sheet

Assets = liabilities + common equity

Assets represent probable future economic benefits. Examples include cash, intellectual property, real estate, and inventories.

Liabilities represent future economic sacrifices. Examples include accounts payable, taxes, and long- or short-term obligations.

Equity represents net assets attributable to common shareholders.

How to Read an Income Statement

Earnings = revenues – expenses

Earnings can also be thought of as the change in assets attributable to shareholders. They are a measure of new capital generated over the year, which can either be retained within the firm or distributed to shareholders.

Corporate Financial Reporting helps you forecast the future

The financial statements provide historical data on past and current business activities in three main areas: operating, investing, and financing activities. By using the data to understand the past, you can help forecast the future. Young companies have limited operating history and therefore less historical data, which makes it harder to forecast their future path to value creation.

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Fundamental value vs. market value

The fundamental value of a company is what can be justified by the facts (i.e., the amount of capital invested by shareholders), plus a set of assumptions about the future path of value creation in terms of sales growth and the profitability rate. If the market is efficient, the market value of a company should be equal to its fundamental value.

Value creation and earnings

Value creation is not just about generating positive earnings. Earnings need to be positive enough to compensate shareholders for their outside opportunities. Different groups of shareholders may have different outside opportunities depending on their invested capital and risk preferences.

Value creation and profitability

The key to corporate value creation is generating a profitability rate, also known as return on equity (ROE), that exceeds the cost of capital, i.e., shareholders' opportunity cost. ROE can be decomposed into different drivers, including margins, turns, and leverage.

Value creation and growth

Growth accelerates value creation when the firm is expected to generate a long-term ROE in excess of the cost of capital. However, growth accelerates value destruction if the firm does not have a path to profitability.

Long-term benchmarks for growth

The firm is part of its industry, the industry is part of the U.S. economy, and the U.S. economy is part of the global economy. Naturally, the benchmarks for the long-term growth potential of the firm depend on the dynamics of the industry and the macro economy.

Demystifying corporate value creation: The "three commandments" of FIA:

1. Generate return on equity capital that exceeds the cost of capital
2. Growth per se does not create value
3. Growth is a catalyst in the value reaction

Overall, our framework for FIA will help you gain a better understanding of the financial statements, identify opportunities for value creation, and tell the story behind the numbers in more effective ways.