УЧЕБНО-МЕТОДИЧЕСКОЕ ПОСОБИЕ

SHAPING MODERN FINANCE

L. Kulik, L. Turinova

Экономический
факультет
МГУ
имени
М.В. Ломоносова

LOMONOSOV MOSCOW STATE UNIVERSITY
Faculty of Economics

L. Kulik, L. Turinova

Shaping Modern Finance

Moscow
2022

УДК 811.111
ББК 81.432.1
К90

Kulik L., Turinova L.

К90 **Shaping Modern Finance.** — М.: Экономический факультет МГУ имени М. В. Ломоносова, 2022. — 56 с.

ISBN 978-5-907690-02-8

Учебно-методическое пособие *Shaping Modern Finance,* предназначенное для магистров направления «Финансы и кредит», ставит своей целью совершенствование студентами-магистрами профессиональных навыков владения английским языком в финансовой сфере. В качестве текстового материала используются современные аутентичные англоязычные материалы экономического дискурса.

Пособие состоит из трех модулей, в рамках которых отрабатываются базовые soft & hard skills, наиболее востребованные в профессиональной деятельности будущих финансистов.

Модуль 1 – *Basic Tools of Analysis* – развивает подходы к работе с научным и публицистическим текстом и отрабатывает навыки ретроспективного, секторного, регионального и трендового анализа.

Модуль 2 – *Case-study Analysis: Company Valuation* – направлен, во-первых, на глубокую проработку терминологической и общенаучной лексики в рамках заданной темы и, во-вторых, на осмысление и эффективное использование кейс-метода.

Модуль 3 – *Research Report Presentation* – закладывает и отрабатывает алгоритм работы над собственным научным исследованием, что включает такие важные шаги как подбор и систематизация оригинальной литературы, выстраивание логики выступления на основе ментальной карты, написание аннотации Доклада и, наконец, собственно презентация на конференции и участие в дискуссии.

УДК 811.111
ББК 81.432.1

ISBN 978-5-907690-02-8

Contents

Module 1. Critical reading & Basic tools of analysis

Module 1 is designed to build fundamental skills in text analysis with a special emphasis on:

- Global reading (skimming)
- Focused reading (scanning)
- Annotating
- Interpreting & commenting
- Discussing & modeling
- Writing an abstract

Global Reading: Skimming

When you **skim** the text, you read it quickly to understand its message or main idea. Here are some strategies you can use to skim a text.

- Read the title, headings, and subheadings of the text.
- Read the 1st and last sentence of each paragraph.
- Look at captions, diagrams, and illustrations.
- Don't use a dictionary.
- Don't spend time on details.

Focused Reading: Scanning

Scanning is reading with the aim to find the answers to specific questions when you are pressed for time. Here are some strategies to scan the text for details.

- Find a key word in the question and search for the key word, or its synonym, in the text.
- Look for capitalized letters if you are looking for an answer to a *who* or *where* questions.
- Look for numbers if you have to answer a numerical question.
- Read the 1st and last sentence of each paragraph to find the paragraph which may contain the answer.

Text 1

A Before you Read: Survey the text

1 Skim the excerpts from *The Slumps that Shaped Modern Finance* to identify crises time periods and comment on the subheading of each passage.
2 Read the lead, the 1st and last sentence of each paragraph in Part 1 and identify the most frequent words.
3 Read the 1st sentence of each paragraph in Part 1 and try to infer the message of the entire text.
4 Scan the text for dates, figures, and proper names. Are they all familiar to you? Which associations do they invoke? Comment on them.

The slumps that shaped modern finance

Finance is not merely prone to crises; it is shaped by them.
Five historical crises show how aspects of today's financial system originated—and offer lessons for today's regulators

Part I

1. What is mankind's greatest invention? Ask people this question and they are likely to pick familiar technologies such as printing or electricity. They are unlikely to suggest an innovation that is just as significant: the financial contract. Widely disliked and often considered grubby, it has nonetheless played an indispensable role in human development for at least 7,000 years.

2. At its core, finance does just two simple things. *It can act as an* ***economic time machine****, helping savers transport today's surplus income into the future, or giving borrowers access to future earnings now. It can also act as a safety net, insuring against floods, fires or illness.* By providing these two kinds of service, <u>a well-tuned financial system</u> smooths away life's sharpest ups and downs, making an uncertain world more predictable. In addition, as investors seek out people and companies with the best ideas, finance acts as an engine of growth.

3. *Yet finance can also terrorize.* When bubbles burst and markets crash, plans paved years into the future can be destroyed. As the impact of the crisis of 2008 subsides, leaving its <u>legacy of unemployment and debt</u>, it is worth asking if the right things are being done to support what is good about finance, and to remove what is poisonous.

4. History is a good place to look for answers. Five devastating slumps—starting with America's first crash, in 1792, and ending with the world's biggest, in 1929—highlight two big trends in financial evolution. The first is that *institutions that enhance people's economic lives, such as central banks, deposit insurance and stock exchanges, are not the products of careful design in calm times but are cobbled together at the bottom of financial cliffs.* Often what starts out as a **post-crisis sticking plaster** becomes a permanent feature of the system. If history is any guide, decisions taken now will reverberate for decades.

5. This makes the second trend more troubling. The response to a crisis follows a familiar pattern. It starts with blame. New parts of the financial system are vilified: a new type of bank, investor or asset is identified as the culprit and is then banned or regulated out of existence. It ends by entrenching public backing for private markets: other parts of finance deemed essential are given more state support. It is an approach that seems sensible and reassuring.

6. But it is corrosive. Walter Bagehot, editor of this newspaper between 1860 and 1877, argued that financial panics occur when the "**blind capital**" of the public floods into unwise speculative investments. Yet well-intentioned reforms have made this problem worse. The sight of Britons stuffing Icelandic banks with sterling, safe in the knowledge that £35,000 of deposits were insured by the state, would have made Bagehot nervous. The fact that professional investors can lean on the state would have made him angry.

7. These five crises reveal where the titans of modern finance—the New York Stock Exchange, the Federal Reserve, Britain's giant banks—come from. But they also highlight the way in which successive reforms have tended to insulate investors from risk, and thus offer lessons to regulators in the current post-crisis era .

B ***While you read****: Annotate/ Analyze*

When you **annotate** a reading, you engage actively with a text by analyzing the author's ideas. Here are some recommendations for how and what to annotate:

- Underline or highlight main ideas, important details
- Circle key words, new vocabulary related to the topic
- References to other resource
- Write short notes and comments in the margin

(from *University Success*)

1 Highlight all the collocations with concepts 'finance' and 'crisis'. Which of them are topical for the current situation?

2 Make up a list of the underlined collocations and give their Russian equivalents. Contextualize them.

C *After you read:* *Reflect on your analysis/ Comment/ Debate*

1 Interpret the sentences in italics following the model: problem/ your opinion/ arguments for & against (for language input see: *Professional Discourse in Economics*, pp. 114-118).

2 Comment on the metaphors and idiomatic expressions used in Part 1: *economic time machine, post-crisis sticking plaster, blind capital.*

3 What metaphors are most frequently used in modern economic discourse?

4 In paragraph 5 the author describes a familiar pattern response to a crisis. Does it still hold true?

> **A metaphor** is a figure of speech in which a word or phrase is applied to an object or action to which it is not literally applicable.
>
> *(Oxford Reference)*

Part 2

A *Before you read:* *Survey the Text*

1 In small groups, work with a particular crisis period in Part 2.

2 Have a brief look at the first sentences in your passage and formulate its message.

3 Scan the text for dates, figures, and proper names. Are they all familiar to you?
4 Which associations do they invoke? Comment on them.

B *While you read:* *Annotate/ Analyse/ Retrospective Analysis*

> In a **retrospective study,** a sample is selected and the researcher looks back at the history of the members of this sample.
>
> *(ScienceDirect)*

1 Annotate the text and describe each crisis applying the model with 4 basic aspects:

- Historical context
- Specific features
- Pattern of the crisis
- Lessons learnt

1792: *The foundations of modern finance*

8. If one man deserves credit for both the brilliance and the horrors of modern finance it is Alexander Hamilton, the first Treasury secretary of the United

States. In financial terms the young country was a blank canvas: in 1790, just 14 years after the Declaration of Independence, it had five banks and few insurers. Hamilton wanted a state-of-the-art financial set-up, like that of Britain or Holland. *That meant a federal debt that would pull together individual states' IOUs. America's new bonds would be traded in open markets, allowing the government to borrow cheaply.* And America would also need a central bank, the First Bank of the United States (BUS), which would be publicly owned.

9. This new bank was an exciting investment opportunity. Of the $10m in BUS shares, $8m were made available to the public. The initial auction, in July 1791, went well and was oversubscribed within an hour. This was great news for Hamilton, because the two pillars of his system—the bank and the debt—had been designed to support each other.

10. Two things put Hamilton's plan at risk. The first was an old friend gone bad, William Duer. The scheming old Etonian was the first Englishman to be blamed for an American financial crisis. Duer and his accomplices knew that investors needed federal bonds to pay for their BUS shares, so they tried to corner the market. To fund this scheme Duer borrowed from wealthy friends and, by issuing personal IOUs, from the public. The other problem was the bank itself. On the day it opened it dwarfed the nation's other lenders. Already massive, it then ballooned, making almost $2.7m in new loans in its first two months. Markets for short sales and futures contracts sprang up.

11. The jitters began in March 1792. *The BUS began to run low on the hard currency that backed its paper notes. It cut the supply of credit almost as quickly as it had expanded it,* with loans down by 25% between the end of January and March. As credit tightened, Duer, who often took on new debts in order to repay old ones, started to feel the pinch. Rumors of Duer's troubles, combined with the tightening of credit by the BUS, sent America's markets into sharp descent. Prices of government debt, BUS shares and the stocks of the handful of other traded companies plunged by almost 25% in two weeks. By March 23rd Duer was in prison. But that did not stop the contagion, and firms started to fail.

12. Hamilton knew what was at stake. A student of financial history, he was aware that France's crash in 1720 had hobbled its financial system for years. And he knew Thomas Jefferson was waiting in the wings to dismantle all he had built. His response was America's first bank bail-out. Hamilton attacked on many fronts: *he used public money to buy federal bonds and pep up their prices, helping protect the bank and speculators who had bought at inflated prices. He funneled cash to troubled lenders.* And he ensured that banks with collateral could borrow as much as they wanted, at a penalty rate of 7% (then the usury ceiling).

13. Even as the medicine was taking effect, arguments about how to prevent future slumps had started. Everyone agreed that finance had become too frothy. Seeking to protect naive amateurs from risky investments, lawmakers sought outright bans, with rules passed in New York in April 1792 outlawing public futures trading. In response to this aggressive regulation a group of 24 traders met on Wall Street—under a Buttonwood tree, the story goes—to set up their own private trading club. That group was the precursor of the New York Stock Exchange.

14. Hamilton's bail-out worked brilliantly. With confidence restored, finance flowered. Within half a century New York was a financial superpower: the number of banks and markets shot up, as did GDP. But the rescue had done something else too. By bailing out the banking system, Hamilton had set a precedent. Subsequent crises caused the financial system to become steadily reliant on state support.

1825: *The first emerging-markets crisis*

15. Crises always start with a new hope. In the 1820s the excitement was over the newly independent Latin American countries that had broken free from Spain. Investors were especially keen in Britain, which was booming at the time, with exports a particular strength. Wales was a source of raw materials, cutting 3m tons of coal a year, and sending pig iron across the globe. Manchester was becoming the world's first industrial city, refining raw inputs into higher-value wares like chemicals and machinery. Industrial production grew by 34% between 1820 and 1825.

16. As a result, cash-rich Britons wanted somewhere to invest their funds. Government bonds were in plentiful supply given the recent Napoleonic wars, but with hostilities over (and risks lower) the exchequer was able to reduce its rates. The 5% return paid on government debt in 1822 had fallen to 3.3% by 1824. With inflation at around 1% between 1820 and 1825 gilts offered only a modest return in real terms. They were safe but boring.

17. Luckily investors had a host of exotic new options. By the 1820s London had displaced Amsterdam as Europe's main financial hub, quickly becoming the place where foreign governments sought funds. The rise of the new global bond market was incredibly rapid. In 1820 there was just one foreign bond on the London market; by 1826 there were 23. Debt issued by Russia, Prussia and Denmark paid well and was snapped up.

18. But the really exciting investments were those in the new world. The crumbling Spanish empire had left former colonies free to set up as independent nations.

Between 1822 and 1825 Colombia, Chile, Peru, Mexico and Guatemala successfully sold bonds worth £21m ($2.8 billion in today's prices) in London. And there were other ways to cash in: the shares of British mining firms planning to explore the new world were popular. The share price of one of them, Anglo Mexican, went from £33 to £158 in a month.

19. The big problem with all this was simple: distance. To get to South America and back in six months was good going, so deals were struck on the basis of information that was scratchy at best. Investors were not carrying out proper checks. Much of the information about new countries came from journalists paid to promote them. Investors were also making outlandish assumptions. Everyone knew that rivalry with Spain meant that Britain's government supported Latin American independence. But the money men took another step. Because Madrid's enemy was London's friend, they reasoned, the new countries would surely be able to lean on Britain for financial backing.

20. But there would be no British support for these new countries. In the summer of 1823, it became clear that Spain was on the verge of default. As anxiety spread, bond prices started to plummet. Britain's banks, exposed to the debt and to mining firms, were hit hard. Depositors began to scramble for cash: by December 1825 there were **bank runs.** The Bank of England jumped to provide funds both to crumbling lenders and directly to firms in a bail-out that Bagehot later regarded as the model for crisis-mode central banking. Despite this many banks were unable to meet depositors' demands. In 1826 more than 10% of the banks in England and Wales failed.

21. The most remarkable thing about the crisis of 1825 was the sharp divergence in views on what should be done about it. Some blamed investors' sloppiness: they had invested in unknown countries' debt, or in mining outfits set up to explore countries that contained no ores. A natural reaction to this emerging-markets crisis might have been to demand that investors conduct proper checks before putting money at risk.

22. But Britain's financial chiefs, including the Bank of England, blamed the banks instead. *Small private partnerships akin to modern private-equity houses, they were accused of stoking up the speculative bubble with lax lending.* Banking laws at the time specified that a maximum of six partners could supply the equity, which ensured that banks were numerous but small. Had they only been bigger, it was argued, they would have had sufficient heft to have survived the inevitable bust.

23. Mulling over what to do, the committees of Westminster and Threadneedle Street looked north to Scotland. Its banks were "joint stock" lenders that could have as many partners as they wanted, issuing equity to whoever would buy it. The Scottish lenders had fared much better in the crisis. Parliament passed a new banking act copying this set-up in 1826. England was already the global hub for bonds.

24. *The shift to joint-stock banking is a bittersweet moment in British financial history*. It had big upsides: the ancestors of the modern megabank had been born, and Britain became a world leader in banking as well as bonds. But the long chain of mergers it triggered explains why RBS ended up becoming the world's largest bank—and, in 2009, the largest one to fail. Today Britain's big four banks hold around 75% of the country's deposits, and the failure of any one of them would still pose a systemic risk to the economy.

1857: *Panics go global*

25. By the mid-19th century the world was getting used to financial crises. Britain seemed to operate on a one-crash-per-decade rule: the crisis of 1825-26 was followed by panics in 1837 and 1847. To those aware of the pattern, the crash of 1857 seemed like more of the same. But this time things were different. A shock in America's Midwest tore across the country and jumped from New York to Liverpool and Glasgow, and then London. From there it led to crashes in Paris, Hamburg, Copenhagen and Vienna. Financial collapses were not merely regular—now they were global, too.

26. On the surface, Britain was doing well in the 1850s. Exports to the rest of the world were booming, and resources increased with gold discoveries in Australia. But beneath the surface two big changes were taking place. Together they would create what this newspaper, writing in 1857, called "a crisis more severe and more extensive than any which had preceded it".

27. The first big change was that a web of new economic links had formed. In part, they were down to trade. By 1857 America was running a $25m current-account deficit, with Britain and its colonies as its major trading partners. *Americans bought more goods than they sold, with Britain buying American assets to provide the funds, just as China does today*. By the mid-1850s Britain held an estimated $80m in American stocks and bonds.

28. Railway companies were a popular investment. Shares of American railway firms such as the Illinois Central and the Philadelphia and Reading were so widely held by British investors that Britons sat on their boards. *That their earnings did not justify their valuations did not matter much: they were a bet on future growth.*

29. The second big change was a burst of financial innovation. As Britain's aggressive joint-stock banks gobbled up rivals, deposits grew by almost 400% between 1847 and 1857. And a new type of lender—the discount house—was mushrooming in London. These outfits started out as middlemen, matching investors with firms that needed cash. *But as finance flowered the discount houses morphed, taking in investors' cash with the promise that it could be withdrawn at will, and hunting for firms to lend to. In short, they were banks in all but name.*

30. Meanwhile in America, Edward Ludlow, the manager of Ohio Life, an insurance company, became caught up in railway fever. New lines were being built to link eastern cities with new frontier towns. One investment alone, in the Cleveland and Pittsburgh line, accounted for a quarter of the insurer's capital. In late spring 1857, railroad stocks began to drop. Ohio Life, highly leveraged and overexposed, fell faster, failing on August 24th. *When banks dumped their stock, prices fell further, magnifying losses*. By October 13th Wall Street was packed with depositors demanding their money. The banks refused to convert deposits into currency. America's financial system had failed.

31. The discount houses magnified the problem. They had become a vital source of credit for firms. But investors were suspicious of their balance-sheets. They were right to be: one reported £10,000 of capital supporting risky loans of £900,000, a leverage ratio that beats even modern excesses. As the discount houses failed, so did ordinary firms. In the last three months of 1857 there were 135 bankruptcies, wiping out investor capital of £42m. Britain's far-reaching economic and financial tentacles meant these caused panics across Europe.

32. As well as being global, the crash of 1857 marked another first: the recognition that financial safety nets can create excessive risk-taking. The discount houses had acted in a risky way, holding few liquid assets and small capital buffers in part because they knew they could always borrow from the Bank of England. Unhappy with this, the Bank changed its policies in 1858. *Discount houses could no longer borrow on a whim. They would have to self-insure, keeping their own cash reserves, rather than relying on the central bank as a backstop*. That step made the 1857 crisis an all-too-rare example of the state attempting to dial back its support. It also shows how unpopular cutting subsidies can be.

33. The Bank of England was seen to be "obsessed" by the way discount houses relied on it, and to have rushed into its reforms. *The Economist* thought its tougher lending policy unprincipled: we argued that decisions should be made on a case-by-case basis, rather than applying **blanket bans**. Others thought the central bank lacked credibility, as it would never allow a big discount house to fail. They were wrong. *In 1866 Overend & Gurney, by then a huge lender, needed emergency cash. The Bank of England refused to rescue it, wiping out its shareholders. Britain then enjoyed 50 years of financial calm,* *a fact that some historians reckon was due to the prudence of a banking sector stripped of moral hazard*.

1907: *Emergency money*

34. As the 20th century dawned America and Britain had very different approaches to banking. The Bank of England was all-powerful, a tough overseer of a banking system it had helped design. America was the polar opposite. Hamilton's BUS had closed in 1811 and its replacement, just around the corner in Philadelphia, was shut down in 1836. An atomised, decentralised system developed. Americans thought banks could look after themselves—until the crisis of 1907.

35. The absence of a lender of last resort had certainly not crimped the expansion of banking. The period after the civil war saw an explosion in the number of banks. By 1907 America had 22,000 banks—one for every 4,000 people. In most towns, there was a choice of local banks or state-owned lenders.

36. Despite all these options, savvy metropolitan investors tended to go elsewhere—to the trust companies. These outfits appeared in the early 1890's to act as "trustees", holding their customers' investments in bonds and stocks. By 1907 they were combining this safehouse role with riskier activities: underwriting and distributing shares and owning and managing property and railways. They also took in deposits. The trust companies had, in short, become banks.

37. And they were booming. *Compared with ordinary banks, they invested in spicier assets and were more lightly regulated*. Whereas banks had to hold 25% of their assets as cash (in case of sudden depositor demands) the trusts faced a 5% minimum. Able to pay higher rates of interest to depositors, they became a favourite place to park large sums. By 1907 they were almost as big as the national banks, having grown by nearly 250% in ten years.

38. America was buzzing too. Between 1896 and 1906 its average annual growth rate was almost 5%. This was extraordinary, given that America faced catastrophes such as the Baltimore fire of 1904 and San Francisco earthquake of 1906, which alone wiped out around 2% of GDP.

39. But two greedy scammers—Augustus Heinze and Charles Morse—wanted more. *The two bankers had borrowed and embezzled vast sums in an attemp to corner up the market in the shares of United Copper*. But the economy started to slow a little in 1907, depressing the prices of raw materials, including metals. *To prop up the market, they began to tap funds from the banks they ran. This whipped up trouble for a host of smaller lenders, sparking a chain of losses that eventually embroiled a trust company, the Knickerbocker Trust.*

A Manhattan favourite located on the corner of 34th Street and 5th Avenue, its deposits had soared from $10m in 1897 to over $60m in 1907, making it the third-largest trust in America.

40. Yet when news emerged that it was caught up in the Heinze-Morse financial contagion, depositors lined the street demanding cash. The Knickerbocker paid out $8m in less than a day. The Trust Company of America was the next to suffer a depositor run, followed by the Lincoln Trust. Some New Yorkers moved cash from one trust to another as they toppled. When it became clear that the financial system was unsafe, Americans began to hoard cash at home.

41. For a while it looked as though the crisis could **be nipped in the bud**. After all, the economic slowdown had been small, with GDP still growing by 1.9% in 1907. And although there were crooks like Heinze and Morse causing trouble, titans like John Pierpont Morgan **sat on the other side of the ledger**. As the panic spread and interest rates spiked to 125%, Morgan stepped in, organising pools of cash to help ease the strain. At one point he locked the entire New York banking community in his library until a $25m bail-out fund had been agreed.

42. But it was not enough. Depositors across the country began runs on their banks. Sensing imminent collapse, states declared emergency holidays. Those that remained open limited withdrawals. Despite the robust economy, the crash in New York led to a nationwide shortage of money. This hit business hard, with national output dropping a staggering 11% between 1907 and 1908.

43. With legal tender so scarce alternatives quickly sprang up. In close to half of America's large towns and cities, cash substitutes started to circulate. These included cheques and small-denomination IOUs written by banks. The total value of this private-sector emergency cash—all of it illegal—was around $500m, far bigger than the Morgan bail-out. It did the trick, and by 1909 the American economy was growing again.

44. The earliest proposals for reform followed naturally from the cash shortage. A plan for $500m of official emergency money was quickly put together. But the emergency-money plan had a much longer-lasting impact. The new currency laws included a clause to set up a committee—the National Monetary Commission—that would discuss the way America's money worked. The NMC sat for four years, examining evidence from around the world on how best to reshape the system. It concluded that a proper lender of last resort was needed. The result was the 1913 Federal Reserve Act, which established America's third central bank in December that year. Hamilton had belatedly got his way after all.

1929: *The big one*

45. Until the eve of the 1929 slump—the worst America has ever faced—things were rosy. Cars and construction thrived in the roaring 1920s, and solid jobs in both industries helped lift wages and consumption. Ford was making 9,000 of its Model T cars a day, and spending on new-build homes hit $5 billion in 1925. There were bumps along the way (1923 and 1926 saw slowdowns) but momentum was strong.

46. Banks looked good, too. By 1929 the combined balance-sheets of America's 25,000 lenders stood at $60 billion. The assets they held seemed prudent: just 60% were loans, with 15% held as cash. Even the 20% made up by investment securities seemed sensible: the lion's share of holdings were bonds, with ultra-safe government bonds making up more than half. With assets of such high quality the banks allowed the capital buffers that protected them from losses to dwindle. Markets were booming, with the shares of firms exploiting new technologies—radios, aluminium and aeroplanes—particularly popular. *For a time the puzzle—whether to raise rates to slow markets, or cut them to help the economy—paralysed the Fed. In the end the market-watchers won, and the central bank raised rates in 1928.*

47. It was a catastrophic error. The increase, from 3.5% to 5%, was too small to blunt the market rally: share prices soared until September 1929, with the Dow Jones index hitting a high of 381. But it hurt America's flagging industries. By late summer industrial production was falling at an annual rate of 45%.

48. Worse was to come. Bank failures came in waves. The first, in 1930, began with bank runs in agricultural states such as Arkansas, Illinois and Missouri. A total of 1,350 banks failed that year. Then a second wave hit Chicago, Cleveland and Philadelphia in April 1931. External pressure worsened the domestic worries. As Britain dumped the Gold Standard its exchange rate dropped, putting pressure on American exporters. There were banking panics in Austria and Germany. As public confidence evaporated, Americans again began to hoard currency.

49. This became clear in February 1933. A final panic, this time national, began to force more emergency bank holidays, with lenders in Nevada, Iowa, Louisiana and Michigan the first to shut their doors. Naturally the city bankers turned to their new backstop, the Federal Reserve. But the unthinkable happened. On March 4th the central bank did exactly what it had been set up to prevent. It refused to lend and shut its doors. In its mission to act as a source of funds in all emergencies, the Federal Reserve had failed. A week-long bank holiday was called across the nation.

50. It was the blackest week in the darkest period of American finance. Regulators examined banks' books, and more than 2,000 banks that closed that week never opened again. After this low, things started to improve. Nearly 11,000 banks had failed between 1929 and 1933, and the money supply dropped by over 30%. Unemployment, just 3.2% on the eve of the crisis, rose to more than 25%; it would not return to its previous lows until the early 1940s. It took more than 25 years for the Dow to reclaim its peak in 1929.

51. Reform was clearly needed. The first step was to de-risk the system. In the short term this was done through a massive injection of publicly supplied capital. The $1 billion boost—a third of the system's existing equity—went to more than 6,000 of the remaining 14,000 banks. *Future risks were to be neutralized by new legislation, the Glass-Steagall rules that separated stock market operations from more mundane lending and gave the Fed new powers to regulate banks whose customers used credit for investment.*

52. A new government body was set up to deal with bank runs once and for all: the Federal Deposit Insurance Commission (FDIC), established on January 1st 1934. By protecting $2,500 of deposits per customer it aimed to reduce the costs of bank failure. Limiting depositor losses would protect income, the money supply and buying power. And because depositors could trust the FDIC, they would not queue up at banks at the slightest financial wobble.

53. In a way, it worked brilliantly. Banks quickly started advertising the fact that they were FDIC insured, and customers came to see deposits as risk-free. For 70 years, bank runs became a thing of the past. Banks were able to reduce costly liquidity and equity buffers, which fell year on year. An inefficient system of self-insurance fell away, replaced by low-cost risk-sharing, with central banks and deposit insurance as the backstop.

54. Yet this was not at all what Hamilton had hoped for. He wanted a financial system that made government more stable, and banks and markets that supported public debt to allow infrastructure and military spending at low rates of interest. By 1934 the opposite system had been created: it was now the state's job to ensure that the financial system was stable, rather than vice versa. *By loading risk onto the taxpayer, the evolution of finance had created a distorting subsidy at the heart of capitalism.*

Concluding remarks

55. The recent fate of the largest banks in America and Britain shows the true cost of these subsidies. In 2008 Citigroup and RBS Group were enormous, with combined assets of nearly $6 trillion, greater than the combined GDP of the world's 150 smallest countries. Their capital buffers were tiny. When they ran out of capital, the bail-out ran to over $100 billion. The overall cost of the banking crisis is even greater—in the form of slower growth, higher debt and poorer employment prospects that may last decades in some countries.

56. *But the bailouts were not a mistake: letting banks of this size fail would have been even more costly. The problem is not what the state does, but that its hand is forced. Knowing that governments must bail out banks means parts of finance have become a one-way bet.* The IMF recently estimated that the world's largest banks benefited from implicit government subsidies worth a total of $630 billion in the year 2011-12. This makes debt cheap and promotes leverage. In America, meanwhile, there are proposals for the government to act as a backstop for the mortgage market, covering 90% of losses in a crisis. *Again, this pins risk on the public purse. It is the same old pattern.*

57. *To solve this problem means putting risk back into the private sector.* That will require tough choices. Removing the subsidies banks enjoy will make their debt more expensive, meaning equity holders will lose out on dividends and the cost of credit could rise. Cutting excessive deposit insurance means credulous investors who put their nest-eggs into dodgy banks could see big losses.

58. As regulators implement a new round of reforms in the wake of the latest crisis, they have an opportunity to reverse the trend towards ever-greater entrenchment of the state's role in finance. But *weaning the industry off government support will not be easy. As the stories of these crises show, hundreds of years of financial history have been pushing in the other direction.*

(Abridged from *The Economist*)

C *After you read:* *Reflect on your analysis/ Comment/ Debate*

1 Comment on the metaphors and idiomatic expressions (in bold type) used in *Part 2*: *blanket bans, be nipped in the bud, bank runs, to sit on the other side of the ledger.*

2 Interpret the sentences in italics following the model: problem/ your opinion/ arguments for & against/ current & future vision (for language input see: *Professional Discourse in Economics*, pp.114-118)

3 Select a Glossary specific for a particular crisis (15-20 units). Explain specific financial terms: e.g., *discount house, blind capital* etc.

4 Interpret the idea from Concluding remarks: It is the same old pattern. What is the common pattern of modern finance and what are its basic elements?

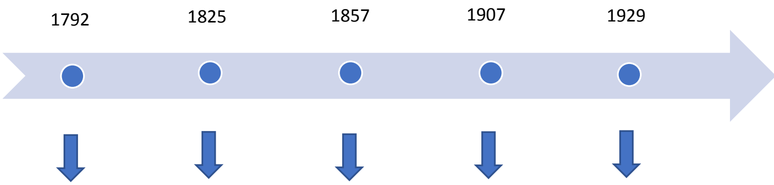
5 Give your assessment of Russia's financial system in terms of its reliance on state support.

D Team-working

PROJECT: *Slumps in finance in retrospect – XVIII-XX centuries*

1 Place the crisis you have analyzed on the timeline. Give the title to the crisis which will reflect its specificity.

2 Put the basic parameters (context, specific features, pattern, lessons learnt) on the timeline below.



------------------- ------------- --------------- ---------------- --------------

------------------- ------------- --------------- ---------------- --------------

Figure 1. Slumps in finance in retrospect — XVIII-XX centuries

3 Describe the crisis you have analyzed using the business cycle terms and collocations from your Glossary.

4 Make a group presentation on "Slumps in finance in retrospect".

- **a** Comment on the rise and development of financial institutions.
- **b** Formulate the lessons learnt from a particular crisis.
- **c** Explain if it is an ascent or descent of financial institutions.
- **d** Characterize the effect of a particular slump on modern financial system.

5 Summing up

- **a** Identify the common features of all crises.
- **b** Which crises affected modern finance most significantly?

6 Modelling

Each crisis ends up with a **response model**. What elements should be part of a common response model in modern finance?

7 Abstract writing

a Consult *Academic Focus for Postgraduates* for abstract-writing activity (see pp. 9-11).

b Using samples 1, 2 or 4 (from *Academic Focus*), write an abstract of the text *The slumps that shaped modern finance* (100-150 words).

Text 2

A *Before you Read*: *Survey the text*

1 Skim the text *Leviathan of last resort.* Comment on the title and subtitles. What can you infer from them?

2 Read the lead and the 1st paragraph. Identify the most frequent words.

3 Scan the text for proper names, dates, and figures. What do you know about them? What associations do they evoke?

> **le`viathan** *noun* **1** *Bible* – a sea monster, variously thought of as a reptile or a whale **2** anything huge or very powerful **3** a political treatise by Thomas Hobbs (1651) dealing with organization of the state
>
> *(Webster New World Dictionary)*

Leviathan of last resort

State subsidies and guarantees are once again corroding the financial sector and creating new dangers

1. Ever since Lehman Brothers went bankrupt in 2008 a common assumption has been that the crisis happened because the state <u>surrendered control of finance to the market</u>. The answer, it follows, must be more rules. The latest target is American housing, the source of the dodgy loans that brought down Lehman. Plans are afoot <u>to set up a permanent public backstop</u> to mortgage markets, with the government insuring 90% of losses in a crisis. Which might be comforting, except for two things. First, it is hard to see how entrenching state support will <u>prevent excessive risk-taking.</u> And second, whatever was wrong with the American housing market, it was not lack of government:

far from a free market, it was one of the most regulated industries in the world, funded by taxpayer subsidies and with lending decisions taken by the state.

2. Back in 1856 one of this newspaper's editors, Walter Bagehot, blamed crashes on what he called **'blind capital'**—periods when credulous cash, ignoring risk, flooded into unwise investments. Given not only the inevitability of such moments of panic but also finance's systemic role in the economy, a government had to devise some special rules to make finance safer. Bagehot invented one: the need for central banks to rescue banks during crises. *But Bagehot's rule **had a sting in the tail**: the bail-out charges should be punitive. That toughness rested on the view that governments should as far as they could treat financiers like any other industry, forcing bankers and investors to take as much of the risk as possible themselves.* The more the state protected the system, the more likely it was that people in it would take risks with impunity.

3. That danger was amply illustrated in 2007-08. *Having pocketed the gains from state-underwritten risk-taking during the boom years, bankers presented the bill to taxpayers when the bubble went pop.* Yet the lesson has not been learnt. Since 2008 there has been a mass of new rules, from America's unwieldy Dodd-Frank law to transaction taxes in Europe. *Some steps to boost banks' capital and liquidity do make finance more self-reliant: America's banks face a tough new leverage ratio.* But overall, the urge to regulate and protect leaves an industry that depends too heavily on state support.

Turning in his grave

4. The numbers would amaze Bagehot. In America a citizen can now deposit up to $250,000 in any bank blindly, because that sum is insured by a government scheme: what incentive is there to check that the bank is any good? Most countries still encourage firms and individuals to borrow by allowing them to deduct interest payments against tax. The mortgage-interest subsidy in America is worth over $100 billion.

5. Even Bagehot's own financial long-stop has been perverted into a subsidy. Since investors know governments will usually bail out big financial firms, they let them borrow at lower rates than other businesses. *America's mortgage giants, Fannie Mae and Freddie Mac, used a $120 billion funding subsidy **to line shareholders' pockets** for decades.* The overall subsidy for banks is worth up to $110 billion in Britain and Japan, and $300 billion in the euro area, according to the IMF. At a total of $630 billion in the rich world, the distortion is bigger than Sweden's GDP—and more than the net profits of the 1,000 biggest banks.

6. In many cases the rationale for the rules and the rescues has been to protect ordinary investors from the evils of finance. Yet the overall effect is **to add ever more layers of state padding** and distort risk-taking.

7. This fits a historical pattern. Regulation has responded to each crisis by protecting ever more of finance. Five disasters, from 1792 to 1929, explain the origins of the modern financial system. This includes hugely successful innovations, from joint-stock banks to the Federal Reserve and the New York Stock Exchange. But it has also meant a corrosive trend: a gradual increase in state involvement. Deposit insurance is a good example. Introduced in America in 1934, it protected the first $2,500 of deposits, a small multiple of average earnings then, reducing the risk of bank runs. Today America is an extreme case, but insurance of over $100,000 is common in the West. *This protects wealth, and income, and means investors ignore creditworthiness, worrying only about the interest-rate offer, sending deposits flocking to flimsy Icelandic banks and others with pitiful equity buffers.*

8. The overall effect is not just to enrich one industry, but to mute the beneficial effects of finance. Healthy financial markets speed up an economy, channeling credit to firms that need it. They can also make an economy fairer and more competitive, providing the funds for those without them to challenge incumbents. *Modern finance is a more slanted system in which savings are drawn towards subsidies and tax distortions. Debt-fueled housing goes wild while investment in machines and patents runs dry. All this dulls growth.*

Blame the grandparents

9. How can the **zombie-like shuffle** of the state into finance be stopped? Deposit insurance should be gradually trimmed until it protects no more than a year's pay, around $50,000 in America. That is plenty to keep the payments system intact. Bank bosses might start advertising their capital ratios, as happened before deposit insurance was introduced. Giving firms tax relief on financing costs is sensible but loading it all onto debt rather than equity is not. And still more can be done to punish investors, not taxpayers, for failure. *A start has been made with "living wills", which describe how to wind down a megabank, and loss-absorbing bonds, which act as buffers in a crisis. But Europe is far behind America here, and the issue of how to resolve huge, cross-border banks remains.*

10. The chances of politicians withdrawing from finance are sadly low. But they could at least follow Bagehot's advice and make the cost of their support explicit. The safety net for finance now stretches well beyond banks to undercapitalized clearing houses and money-market funds. *Governments* *should report these liabilities in national accounts, like other subsidies, and exact a proper price for them. Otherwise, they have merely set up the next crisis.*

(Abrdiged from The Economist)

B *While you read: Annotate/ Analyze/ Sector analysis*

> **Sector analysis** is the review of the current condition of a sector and an assessment of how the future prospect of the sector looks. Sector analysis thus gives an idea of how well a group of companies in a particular sector are going to perform as a whole. This assessment helps investors to make investment decisions and reap potential benefits. The idea behind this is the stock of companies will rise or fall in accordance with the performance of the sector.
>
> *(MBA Skool)*

1 Highlight all collocations with concepts 'finance' and 'investment'. Which of them reflect the current situation?

2 Write out the underlined collocations & give their Russian equivalents. Contextualize them.

3 Fill in the frames '*Market*', '*Risk*', '*Insurance*' and '*Tax*' with conceptual supports (from Text 2) which will specify the content of these concepts.

Market	Risk	Insurance	Tax

C *After you read: Reflect on your analysis/ Comment/Discuss*

1 Interpret the sentences in italics following the model: problem/ your opinion/ arguments for & against/ current & future vision.

2 Explain the meaning of metaphors and idiomatic expressions in a particular economic context: *zombie-like shuffle, to trim deposit insurance, corrode the financial sector, to add more layers of state padding, to turn in one's grave, to have a sting in the tail, to blame the grandparents, to line shareholders' pockets.*

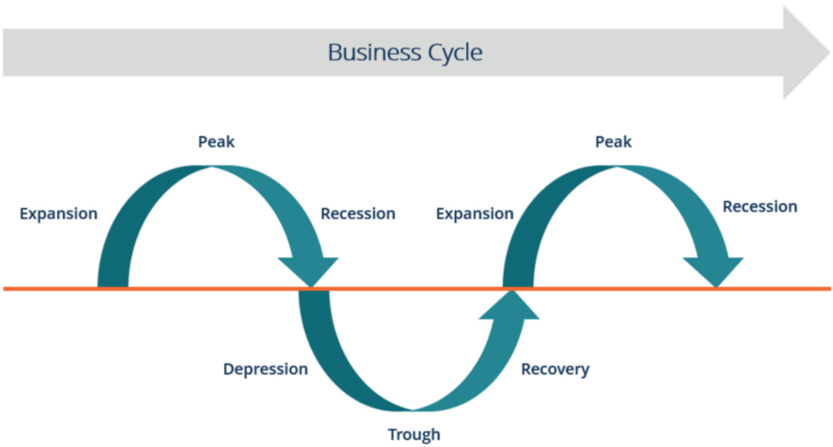
3 Comment on the metaphorical meaning of the title *Leviathan of last resort*? Does the author stand for regulation or deregulation in the banking sector?

4 Comment on the historical context of 1934. Why does the author call a gradual increase in state involvement in the banking sector a *corrosive trend*?

5 Find information on the economic school, its instruments and approaches, that helped rescue American economy from collapse.

6 Analyse the concept of 'business cycle' and its specific vocabulary. Describe the crisis you have analysed using the business cycle terms and collocations from your Glossary.

> A period during which economic activity increases and the economy is expanding is an **upturn** or **upswing**. If it lasts a long time, it is called a **boom**. The highest point of the business cycle is a peak, which is followed by a **downturn**, during which the amount of economic activity decreases. If the economy keeps contracting for more than six months, the downswing is called a **recession**. A serious, long-lasting recession is called a **depression** or a **slump.** The lowest point of the business cycle is a trough, which is followed by a **recovery**, when economic activity increases again, and a new cycle begins.
>
> *(Professional English in Use. Finance)*



4 Group the words in Box 1 into the following frames:

Expansion	**Contraction**	**Slump**
______________	______________	______________
______________	______________	______________
______________	______________	______________
______________	______________	______________
______________	______________	______________

Box 1

depression		upswing	recovery	boom
	downturn	crash	upturn	
crisis	peak	collapse	trough	recession

5 Explain the difference between Recession of 2008 and the Great Depression of 1929 in terms of crisis severity.

D Team-working

PROJECT: *Slumps in finance – XXI century*

1 In teams, analyze the text *Financial Crisis/ Summary* (Supplement I).

2 Put the basic parameters of 2008 & 2020 crises on the timeline (context, pattern, typical features, lessons learnt.

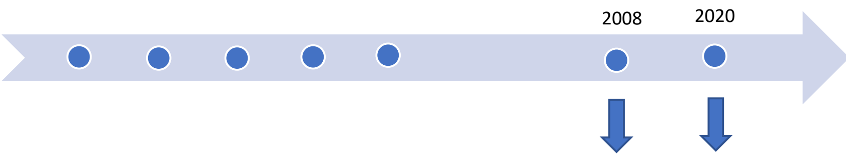


Figure 2. Slumps in finance – XXI century

3 Select a Glossary describing the 2008 crisis (15-20 units). Specify basic financial terms: *lender of last resort, bail out, equity buffers.*

4 In Text 2 find conceptual supports for regulation/ deregulation.

5 Group the collocations from your Glossary into the following frames.

Regulator & its functions

Slump of 2008

6 Make a group presentation on 2008 Great Recession with an emphasis on the following issues:

   a overall trend in regulation/ deregulation in the banking sector
   b types of crisis regulation which affected modern finance most significantly
   c punitive measures that should be taken to make financial sector more self-reliant
   d elements of a crisis response model in modern finance

7 Abstract writing

Write an abstract (max. 150 words) of the text *Leviathan of last resort* (Use Sample 4 from *Academic Focus for Postgraduates*).

Text 3

A Before you Read: Survey the text

1 Skim the text *World Development Report 2022*. Draw a mind map of the Text using subheadings as logical markers.

2 Scan the Introduction for dates and figures. What can you infer from them?

3 Scan the text and identify the four major policy areas.

World Development Report 2022: Finance For an Equitable Recovery

Introduction

1. In 2020, as communities around the world were struggling to contain the spread of COVID-19 (coronavirus) and manage the health and human costs of the pandemic, governments implemented a wide range of crisis response policies to mitigate the worst social and economic impacts of the pandemic. The mobility restrictions, lockdowns, and other public health measures necessary to address the pandemic rapidly produced the largest global economic crisis in more than a century. This was compounded by a drop in demand as the pandemic affected consumer behavior. Economic activity contracted in 2020 in about 90 percent of countries, exceeding the number of countries seeing such declines during two world wars, the Great Depression

of the 1930s, the emerging economy debt crises of the 1980s, and the 2007–09 global financial crisis. In 2020, the first year of the COVID-19 pandemic, the global economy shrank by approximately 3 percent, and global poverty increased for the first time in a generation.

2. The World Development Report examines the central role of finance in the recovery from what has been called a once-in-a-century crisis and charts pathways toward a robust and equitable recovery.

3. Addressing financial risks is important to ensure that governments and financial institutions can support the recovery, including through investments in public services, such as health care and education. *It is also critical that households and firms do not lose access to financial services that can strengthen resilience to economic shocks.*

4. **Resolving financial risks: A prerequisite for an equitable recovery.** The impact of the COVID-19 economic crisis has created unprecedented financial risks that will force governments, regulators, and financial institutions to pursue short-term stabilization policies and longer-term structural policies to steer their economies toward a sustained and equitable recovery. Traveling this path will require timely action in four policy areas:

   - Managing and reducing loan distress
   - Improving the legal insolvency framework
   - Ensuring continued access to finance
   - Managing increased levels of sovereign debt.

5. **Policy area 1: Managing and reducing loan distress.** *In many countries, the crisis response has included large-scale debt relief measures, such as debt moratoria and freezes on credit reporting.* Many of these policies have no historical precedent; it is therefore difficult to predict their longer-term impacts on the credit market. As governments wind down such support policies for borrowers, lenders should expect to see increases in nonperforming loans (NPLs) of varying magnitudes across countries and sectors.

6. **Improving transparency and supervision and reducing incentives for mismeasurement.** An important first step is to establish enforceable rules and incentives that support transparency about the true state of banking assets. Assessing asset quality during the pandemic is complex because of the great uncertainty about economic prospects and the extent and persistence of income losses. The wide-spread use of debt moratoria and other support measures for borrowers has made it even more difficult for banks to assess the true repayment capacity of both existing and prospective borrowers. Indeed, debt moratoria and other support measures have reduced the comparability of NPL metrics across time both in countries and among countries.

7. **Dealing with problem banks.** *When banks are unable to absorb the additional financial stress from the pandemic and develop a viable recovery plan, authorities must be able to deploy a robust set of early intervention measures to turn around ailing banks and resolve failing ones.* Measures for dealing with failing banks should include a legal regime that sets bank failures apart from the general insolvency framework and gives authorities more policy options and greater powers to allocate losses to shareholders and uninsured liability holders, thereby protecting depositors while shielding taxpayers against financial sector losses.

8. **Policy area 2: Improving the legal insolvency framework.** Many households and businesses are struggling with unsustainable debts as a result of the pandemic. *Insolvency proceedings can be an effective mechanism to help reduce excessive levels of private debt.* However, a sudden increase in loan defaults and bankruptcies resulting from the crisis poses a significant challenge for the capacity of insolvency frameworks to resolve bankruptcies in a timely manner, even in advanced economies with strong institutions.

9. **Policy area 3: Ensuring continued access to finance.** Many households and small businesses are at risk of losing access to formal finance because of multiple factors stemming from the pandemic. In these circumstances, lenders tend to issue less new credit, and the new credit they do issue goes to better-off borrowers. A review of quarterly central bank surveys on credit conditions in both advanced and emerging economies finds that the majority of economies for which surveys were available experienced several quarters of tightening credit standards after the onset of the crisis. In periods of tighter credit, the most vulnerable borrowers, including small businesses and low-income households that lack physical collateral or a sufficiently long credit history, tend to be the first cut off from credit.

10. **Policy area 4: Managing higher levels of sovereign debt.** The pandemic has led to a dramatic increase in sovereign debt. The average total debt burdens among low- and middle-income countries increased by roughly 9 percentage points of GDP during the first year of the pandemic, 2019–20, compared with an average increase of 1.9 percentage points over the previous decade.

11. **Resolving debt distress.** Once a government is in debt distress, the options to treat the problem are more limited and the urgency is greater. A primary tool at this stage is debt restructuring coupled with a medium-term fiscal and economic reform plan. Use of this tool requires prompt recognition of the extent of the problem, coordination with and among creditors, and an understanding by all parties that restructuring is the first step toward debt sustainability.

12. ***Conclusion.*** Addressing the interrelated economic risks produced by the crisis is a prerequisite for a sustained and equitable recovery. This will require prompt recognition of balance sheet problems, as well as active management of the economic and financial risks. In an ideal situation, governments would implement relevant policies to address each of the risks highlighted by the crisis: financial instability; overindebtedness among households and businesses; reduced access to credit; and rising sovereign debt. However, few if any governments have the resources and political leeway to tackle all these challenges at once. Countries will have to prioritize the most important policy actions needed. For many low-income countries, tackling unsustainable sovereign debt will be the priority. Middle-income countries whose financial sectors are more exposed to corporate and household debt may, in contrast, need to focus on policies supporting financial stability.

13. The COVID-19 pandemic is possibly the largest shock to the global economy in over a century. As fiscal, monetary, and financial stimulus programs are withdrawn, new policy challenges will emerge at both the domestic and global levels. Early diagnosis of the economic effects of the crisis and decisive policy action to remedy these fault lines are needed to sustain an equitable recovery. There is no room for policy complacency.

(World Development Report 2022)

B ***While you read***: *Annotate/ Analyze*

1 Highlight all collocations with concepts ‘risk’ and ‘recovery’. Which collocations are topical for the current situation?

2 Make up a list of the underlined collocations & give their Russian equivalents. Contextualize them.

3 Compare the structure of a journal article and economic report.

C ***After you read:*** *Reflect on your analysis/ Comment/ Debate*

1 Compile a Glossary of specific terms and collocations sufficient to discuss 2019 crisis (15-20 units).

2 Comment on the following financial terms: *nonperforming loans (NPLs), stabilization policies, debt relief measures, sovereign debt, bank governance, regulatory loopholes.*

3 Interpret the sentences in italics following the accepted model.

4 Provide your assessment of pandemic effects on global financial setup. Why is this crisis so disastrous?

5 Discuss the four basic policy priorities for 2022 in the financial sector for equitable recovery.

6 Write an abstract of the text *World Development Report 2022* (~150 words).

D Team-working

PROJECT: *Slumps that shaped modern finance: XXI century*

1 Drawing on information from Text 3, add 2019-2022 crisis on the timeline. Focus on: context, typical features, pattern, lessons learnt.

2 Describe the COVID-19 crisis you have analyzed using the business cycle terms and collocations from your Glossary.

3 Interpret the concepts of 'equitable recovery' and 'risk mitigation'.

4 Make a group presentation on 2019 crisis and its impact on the global economy with a special focus on:

- Key elements that should be part of a common crisis response model in modern finance.
- Financial risks policy model for a certain region or country.

E1 Trend analysis

> **A trend** is a general direction in which something is developing or changing overtime.
>
> *(Oxford Languages)*

1 Study the vocabulary describing various trends

Upward trend	**Downward trend**
Slight movement ↗ • To advance • To climb *Sharp movement* ↑ • To leap • To skyrocket • To shoot up • To soar • To surge	*Slight movement* ↘ • To slide • To ease • To slip *Sharp movement* ↓ • To crash • To sink • To dive • To drop • To slump • To plummet

Upward reverse trend ↘↗ • To rebound • To revive	**Downward reverse trend ↗↘** To top out
Static trend → • To remain stable/steady • To stabilize • To remain constant/ flat • To level off	To go up and down continuously • To fluctuate • To swing 

Degree of change:

Large change	Fast change	Regular change	Small change
Considerable(-ly) Dramatic(-ally) Sharp(-ly) Significant(-ly) Substantial(-ly)	Abrupt(-ly) Quick(-ly) Rapid(-ly) Sudden(-ly)	Gradual(-ly) Steady(-ily)	Moderate(-ly) Slight(-ly)

E2 Team-working

PROJECT: *Describing global trends*

1 Analyze one of most pronounced current financial trends in a particular region or country (advanced economy, emerging market, developing country).

2 Present the financial trend in the region or country with graphical support.

3 Provide a comparative analysis of the economies presented by different teams. Illustrate convergent or divergent trends in these economies. (For variants of analysis see *Supplement 3*).

Module 2. Case-study method

Module 2 is designed to demonstrate the possibilities of a case method in examining various aspects of a business.

A Before you read

Case studies are the preferred method when (a) "how" or "why" questions are being posed, (b) the investigator has little control over events, and (c) the focus is on a contemporary phenomenon within a real-life context.

(*Case Study Research*)

A case study is a research method that engages in the close, detailed examination of a single example or phenomenon.

(Oxford Reference)

1 Using additional sources, formulate the fundamental functions of a case study. Compare them to those given below:

A case study

- enables us to closely examine the data in a specific context
- provides a systemic way of observing the events
- allows for both quantitative and qualitative analyses of data
- helps to apply the received knowledge within a real-life context

2 Examine the algorithm of a case study analysis. Give your understanding of its logic.

- Description of the business
- Problems of the business
- Options for problem solving

- Dilemma
- Decision-making and its argumentation
- Action plan
- Findings & Conclusion

B While you read:

1 Study the case 'Company Valuation' (*Supplement 4*). Identify the stages of company analysis. Apply the algorithm given above.

2 Compile a Glossary for 'Company Valuation'.

3 Prepare a list of problematic issues for discussion.

C After you read: Reflect on your analysis/ Comment/ Debate

1 What is the purpose of the valuation using comparables?
2 What operational improvements does KKP plan to make? Assess these improvements in terms of acquisition attractiveness.
3 Explain the purpose of sensitivity analysis.

D Critical thinking

> In **case studies,** the richness of the phenomenon and the extensiveness of the real-life context require case study investigators to cope with a technically distinctive situation: There will be many more variables of interest than data points. In response, an essential tactic is to use multiple sources of evidence, with data needing to converge in a triangulating fashion. This challenge is but one of the ways that makes case study research "hard," although it has classically been considered a "soft" form of research
>
> (*Case Study Research)*

1 Comment on the quote. Give your reasoning.

2 Read the interview which is part of a case study "Company Valuation". Explain its function within the case.

Text 4

INTERVIEW with Joseph L. Rice, III

Joseph L. Rice, III is a founding partner and the former chairman of Clayton, Dubilier & Rice (CD&R). The firm is among the most respected private equity firms in the world. Its investments span a number of industry segments with enterprise values ranging from $1 Billion to $15 Billion.

QUESTION: *How has private equity business changed since you began in the industry?*

ANSWER: The term "private equity'' is very broad and today can cover virtually every kind of investing, short of investing in the stock or bond markets. The buyout business represents a significant component of the private equity market. Since I started in 1966, I've seen many changes as the asset class has matured. In the 1960s and 1970s, the buyout business had relatively little following. Limited capital availability kept transactions small, and we relied on unconventional funding sources. The total purchase price of my first transaction was approximately $3 million, financed through a secured bank line and from individuals contributing amounts ranging from $25,000 to $50,000. In contrast, in 2005, we bought Hertz from Ford for approximately $15 billion.

As the industry has evolved, the attractive returns generated from buyout investments has attracted broader interest from both institutions and high net worth individuals. Buyout firms apply a variety of value creation models, including financial engineering, multiple arbitrage, and industry sector bets, such as technology or healthcare. Today there is more focus on generating returns from improving business performance-which has always been CD&R's underlying investment approach. The character of the businesses that we buy has also changed. Traditionally, this was an asset-heavy business, with much of the financing coming from banks that lent against percentages of inventory and receivables and the liquidation value of hard assets. Now it's become more of cash flow business.

QUESTION: *What makes a company a good buyout candidate?*

ANSWER: We look to acquire good businesses at fair prices. Acquiring non-core, underperforming divisions of large companies and making them more effective has been a fertile investment area for CD&R. These divestiture buyouts tend to be complex and require experience and patience to execute. For example, we were in discussions with Ford management for three years prior to leading the Hertz division acquisition.

After running a series of projections based on information from management, we develop a capital structure designed to insure the viability of the acquisition candidate. We are relatively unconcerned with EPS but are very return conscious, focusing on cash and creating long-term shareholder value. We must also believe that we can generate a return on equity that meets our standards and justifies our investors' commitments to us.

We also acquire businesses confronting strategic issues where our operating expertise can bring value, such as Kinko's, a great brand franchise that we reorganized and expanded. We prefer service and distribution businesses to large manufacturers because of the wage differential between Asia and the United States and Europe. We also prefer businesses with a diversity of suppliers and customers and where there are multiple levers under our control to improve operating performance.

QUESTION*: Post acquisition, what is the role of the private equity firm?*

ANSWER: CD&R brings both a hands-on ownership style and capital. After closing a transaction, we assess current management's capability to do the job our investment case calls for. If necessary, we build and strengthen the management team. Then we work with them to determine the appropriate strategy to produce outstanding results. Finally, we aggressively pursue productivity, cost reduction, and growth initiatives to enhance operating and financial performance. At Kinko's, we restructured 129 separate S-corporations into one centralized corporation and installed a new management team. Our key strategic decision was transforming Kinko's from a loose confederation of consumer and small business-oriented copy shops into a highly networked company serving major corporations. In the end, that is what made the company an attractive acquisition for FedEx in 2004.

(from FINANSIERING BSC. MERC.)

3 Discuss and present the basic trend in M&A in pre-Recession period (before the 2008 crisis) and the current trend in 2022.

4 Roleplay an interview with the Chairman of a private investment fund in 2022. What, in your opinion, has changed since that time? Use the vocabulary of the interview.

E Team-working

PROJECT: *Case-study 'Company valuation'*

1 Choose any real or virtual company for the analysis of its performance.

2 Select and examine all available information on various aspects of the Company according to the above given algorithm of analysis (A2).

3 Identify research questions or other rationale for doing a case study.

4 Present the info on the Company covering the Steps of analysis given below (*see* B1) :

Step 1. Description of the business

Ideko Corporation	Financials:
• Publically traded • Sector: sports-fashion retail • Design and manufacturing of sports eyewear • HQ in Chicago	• Total Assets = $ 87 mln • Total Liabilities = $ 9 mln • Sales revenue = $75 mln • Net Profit after tax = $7 mln • Net Profit Margin = 9.3%

KKP Investments	Current intensions:
• Private equity firm • Buyout business: acquires firms at a fair price making them more effective • Return on investments (ROI)	• Buyout of Ideko • Implement operational and financial improvements • Generate returns from improving business performance of Ideko • Sell the business after improvements

Step 2. Problems of the business

- Estimation of Ideko corporation
- Building the financial model
- Post-acquisition strategy

Step 3. Options for problem solving

- Relinquished management control
- Underestimated borrowing capacity (low leverage)
- Underinvested product development, marketing, and sales
- Lax credit policy which entails difficulties in cash collection
- Inventories management inefficiency

Step 4. Dilemma

- Cancel the deal of Ideko acquisition
- Buyout and implement improvements

Step 5. Decision making

- Forecast profit and loss account, balance sheet and cash flow statement
- Value the Company using appropriate methods
- Verify the Company's liabilities & its financial performance

Step 6. Action plan

Devise the action plan for your Company with the focus on:

- obligatory procedures to settle the deal
- debt analysis
- working capital management policy
- operation performance improvements

Step 7 Findings/ Conclusion

- If an acquisition is not a good investment opportunity.........
- In case of success, assess the Company potential for future growth

5 Devise the scenario of Company development in the mid-term period. Present it to the public.

6 Choose the most effective approach to Company valuation. Analyse its strengths & limitations.

7 Assess other teams’ presentations.

Module 3. Writing a Research Report Subject: *"Rethinking Economic Paradigm"*

Module 3 is designed to introduce the algorithm of conducting an academic study and preparing a Research Report for a conference.

1 Individual research

- **a** Choose the subject for analysis. Write a thesis and its development. Prepare a 2-min brief with a mind map.
- **b** Select & look through 4-5 articles from quality journals on the subject you've chosen for the Report. Make up References.
- **c** Analyze and annotate selected literature.
- **d** Choose 2 articles most interesting for you. Provide an oral brief of them with a mind map (7-8 min.)
- **e** Make up a glossary of 60-70 units with 2-3 core concepts & Russian variant
- **f** Write abstracts on these two articles drawing on samples 4, 6-8 from Model 2 (see Academic Focus, pp. 26-27)
- **g** Select the Glossary from the articles which you will use in your Report.

2 Team-working. Preparing for the Conference

- **a** Think over the subject of your Report. Structure it according to the plan:
  Background – your topic within the overall financial context. Why is it necessary to examine this very topic? To what effect?
  Approaches – Aspects of the issue. Tools of analysis.
  Findings concerning the aspects of research.
- **b** Write an abstract of your Report drawing on sample 10/ Model 3 (see *Academic Focus*).
- **c** Make up the list of reports.
- **d** Group your reports into logical blocks. Identify and substantiate the basic aim of this block. Provide the overall economic context.
- **e** Make up teams, appoint the moderator of each team. In teams, present your individual research subject. Share your abstracts with the team.

- **f** Make up a mind map of your report, focusing on the thesis and the main aspects.
- **g** Prepare visual aids: 5 slides (including opening & closing ones).

1. In teams, provide a 7-minute presentation of the individual Report.
2. In teams, provide major findings and conclusion on the subject of your block.
3. **Q&A session**
4. Assess the content and presentation skills of your peers.

Supplement 1

Financial Crisis/ Summary

The credit crisis ran from June 2007 through to early 2009. The main causes of the crisis were macroeconomic and microeconomic.

Macroeconomic causes included the build-up of global financial imbalances and low real interest rates. The latter fuelled a credit boom, especially in mortgage lending.

Microeconomic causes were that consumers failed to understand the risks they were taking, managers of financial firms sought higher returns via increased leverage, compensation schemes were geared to encourage financial professionals to take on more risk, skewed incentives of credit rating agencies, and the substantial limitations in risk measurement, management and regulatory oversight.

The BIS identified five stages of the crisis: *Stage 1* (June 2007 up to mid-March 2008) — losses in US subprime market starting in the summer of 2007; *Stage 2* (mid-March to mid-September 2008) — events leading up to the Lehman Brothers bankruptcy; *Stage 3*(15 September to late October 2008) — global loss of confidence; *Stage 4* (late October 2008 to mid-March 2009) — investors focus on the global economic downturn; and *Stage 5* (from mid-March 2009) — signs of stabilization.

The rapid growth in securitization was a major cause of the crisis. This activity has had a major impact on the funding of residential property markets but also on the flexibility with which banks can manage their loan books. The collapse of subprime mortgage lending in the US and related securitized products is seen by many as the start of the credit crisis.

Securitization involves the process where banks find borrowers, originate loans but then sell the loans (repackaged as securities) on to investors. This is known as the originate-to-distribute model in contrast to the traditional originate and hold approach. Securitization relates to the pooling of credit-risky assets, traditionally residential mortgage loans (but nowadays other types of credits such as car loans, credit card receivables or any credit generating some form of predictable cash flow), and their subsequent sale to a special purpose vehicle (SPV), which then issues securities to finance the purchase of the assets. The securities issued By the SPV are usually fixed income instruments — known as MBS if backed by mortgages or ABS if backed by a variety of different types of loans — which are then sold to investors where the principal and interest depend on the cash flows produced by the pool of underlying financial assets.

The first major securitization activity in the US was by the savings and loans associations (S&Ls) that moved mortgage loans off their balance sheet and sold them on to investors. The government-sponsored enterprises (GSEs), such as Fannie Mae and Freddie Mae, were major operators in the US mortgage securitization business and they held an estimated at $5 trillion in mortgage-backed securities by mid-2008 (federal authorities had to step in and bail them out in September 2008).

Subprime refers to loans to higher risk borrowers — those that are not prime borrowers. Mortgage lending to subprime lenders grew rapidly not around $200bn in mid-2003 to more than $500bn by mid-2004, peaking at around $600bn in 2005-06. At this time, they accounted for about 20% of all new US residential mortgages. Around 80% of subprime mortgages were securitized. The attraction of subprime mortgage lending for banks was that they offered higher interest rates than prime mortgages — typically 2% more. The use of subprime loans in the underlying collateral allowed mortgage-backed securities (MBS) and collateralized debt obligation (CDO) packagers to enhance their profit margins while offering competitive returns on their securitizations.

Most securities issued By SPVs were rated by credit rating agencies — Standard & Poor's, Moody's, and Fitch — to make them more attractive to investors. While the credit quality of individual loans in the underlying pool of assets may Be low, the credit quality (and therefore the credit rating) of the overall portfolio held in the SPV can Be increased by pooling the portfolio of credit-risky assets so as to gain various diversification benefits.

In addition, the risks of the portfolio could further be improved by various credit enhancement techniques such as third-party guarantees (insurance from monoline insurers to protect the value of assets), overcollateralization (holding a larger pool of assets than securities issued) and by something known as excess spread (originators, namely banks, inject cash into the SPV that will bear certain early Losses). All the aforementioned practices, getting the asset-backed securities (ABS) or MBS rated and the various credit enhancement techniques, were put in place to increase the attractiveness of the securities issued to investors.

From early to mid-2007, a wave of defaults accumulated in the US subprime mortgage market and property prices began to fall. As the value of the collateral declined, investors realized that their investments were rapidly evaporating. Also, the complexity of the structures meant that it became well-nigh impossible to value the securities as it was also virtually Impossible to accurately value the underlying collateral. Securities that had been rated as low risk and investment grade by the rating agencies became speculative and even unsaleable. This prompted the meltdown in the subprime (and other) mortgage-backed securities markets. Banks stopped lending to each other as they did not know the exposure of each other to securitized assets held on and off their books. The interbank market dried up and central banks had to inject short-term funding into the markets by the end of 2007. The situation was made more complex by a new wave of securitization including CDOs and asset-backed commercial paper (ABCP). At the end of 2008, Bloomberg reported that bank losses stemming from the meltdown in the US subprime market amounted to $744.6bn — Wachovia had the biggest loss of $96.5bn, followed By Citigroup with $67.2bn; and Merrill Lynch with $55.9bn.

The credit crisis spread rapidly, having a particularly disastrous impact on the financial systems of the UK, Ireland and Iceland. No major European system was immune from its effects as banks failed or had to Be supported via capital and liquidity injections. Japanese banks appeared less affected by the crisis than most, although they have had a poorly performing domestic economy to worry about for over a decade. Governments and various international organizations have proposed major reforms to the financial system covering the cleansing of bank balance sheets, increased capital and liquidity requirements, increased oversight and regulation of securitization business, hedge funds and credit rating agencies.

Supplement 2

World Economic Outlook: Managing Divergent Recoveries

Executive Summary, International Monetary Fund (April 2021)

One year into the COVID-19 pandemic, the accumulating human toll continues to raise concerns, even as growing vaccine coverage lifts sentiment. High uncertainty surrounds the global economic outlook, primarily related to the path of the pandemic. The contraction of activity in 2020 was unprecedented in living memory in its speed and synchronized nature. But it could have been a lot worse. Although difficult to pin down precisely, IMF staff estimates suggest that the contraction could have been three times as large if not for extraordinary policy support. Much remains to be done to beat back the pandemic and avoid divergence in income per capita across economies and persistent increases in inequality within countries.

Improved outlook: After an estimated contraction of −3.3 percent in 2020, the global economy is projected to grow at 6 percent in 2021, moderating to 4.4 percent in 2022. The contraction for 2020 is 1.1 percentage points smaller than projected in the October 2020 *World Economic Outlook* (WEO), reflecting the higher-than-expected growth outturns in the second half of the year for most regions after lockdowns were eased and as economies adapted to new ways of working. The projections for 2021 and 2022 are 0.8 percentage point and 0.2 percentage point stronger than in the October 2020 WEO, reflecting additional fiscal support in a few large economies and the anticipated vaccine-powered recovery in the second half of the year. Global growth is expected to moderate to 3.3 percent over the medium term—reflecting projected damage to supply potential and forces that predate the pandemic, including aging-related slower labor force growth in advanced economies and some emerging market economies. Thanks to unprecedented policy response, the COVID-19 recession is likely to leave smaller scars than the 2008 global financial crisis. However, emerging market economies and low-income developing countries have been hit harder and are expected to suffer more significant medium-term losses.

Divergent impacts*:* Output losses have been particularly large for countries that rely on tourism and commodity exports and for those with limited policy space to respond. Many of these countries entered the crisis in a precarious fiscal situation and with less capacity to mount major health care policy responses or support livelihoods. The projected recovery follows a severe contraction that has had particularly adverse employment and earnings impacts on certain groups. Youth, women, workers with relatively lower educational attainment, and the informally employed have generally been hit hardest. Income inequality is likely to increase significantly because of the pandemic. Close to 95 million more people are estimated to have fallen below the threshold of extreme poverty in 2020 compared with pre-pandemic projections. Moreover, learning losses have been more severe in low-income and developing countries, which have found it harder to cope with school closures, and especially for girls and students from low-income households. Unequal setbacks to schooling could further amplify income inequality.

High uncertainty surrounds the global outlook: Future developments will depend on the path of the health crisis, including whether the new COVID-19 strains prove susceptible to vaccines, or they prolong the pandemic; the effectiveness of policy actions to limit persistent economic damage (scarring); the evolution of financial conditions and commodity prices; and the adjustment capacity of the economy. The ebb and flow of these drivers and their interaction with country-specific characteristics will determine the pace of the recovery and the extent of medium-term scarring across countries. In many aspects, this crisis is unique. In certain countries, policy support and lack of spending opportunities have led to large increases in savings that could be unleashed very quickly should uncertainty dissipate. At the same time, it is unclear how much of these savings will be spent, given the deterioration of many firms' and households' balance sheets (particularly among those with a high propensity to consume out of income) and the expiration of loan repayment moratoria. In sum, risks are assessed as balanced in the short term, but tilted to the upside later on.

Considering the large uncertainty surrounding the outlook, policymakers should prioritize policies that would be prudent, regardless of the state of the world that prevails—for instance, strengthening social protection with wider eligibility for unemployment insurance to cover the self-employed and informally employed; ensuring adequate resources for health care, early childhood development programs, education, and vocational training; and investing in green infrastructure to hasten the transition to lower carbon dependence. Moreover, they should be prepared to flexibly adjust policy support, for example, by shifting from lifelines to reallocation as the pandemic evolves, and linked to improvements in activity, while they safeguard social spending and avoid locking in inefficient spending outlays. It is important to anchor short-term support in credible medium-term frameworks (see the April 2021 *Fiscal Monitor*). Where elevated debt levels limit scope for action, effort should also be directed at creating space through increased revenue collection (fewer breaks, better coverage of registries, and switching to well-designed value-added taxes), greater tax progressivity, and by reducing wasteful subsidies.

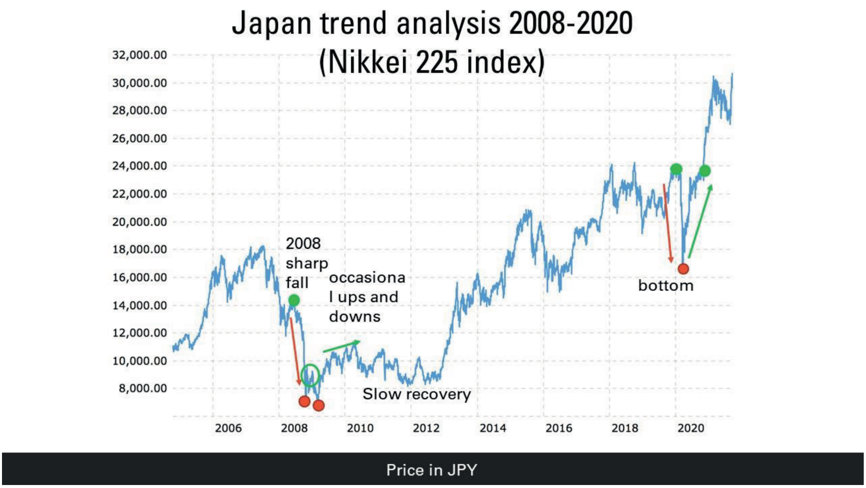
Policy priorities: The factors shaping the appropriate stance of policy vary by country, especially progress toward normalization. Hence, countries will need to tailor their policy responses to the stage of the pandemic, strength of the recovery, and structural characteristics of the economy. Once vaccination becomes widespread and spare capacity in health care systems is generally restored to pre-COVID-19 levels, restrictions can begin to be lifted. While the pandemic continues, policies should first focus on escaping the crisis, prioritizing health care spending, providing well-targeted fiscal support, and maintaining accommodative monetary policy while monitoring financial stability risks. Then, as the recovery progresses, policymakers will need to limit long-term economic scarring with an eye toward boosting productive capacity (for example, public investment) and increasing incentives for an efficient allocation of productive resources. It is a delicate balance, especially given the prevailing uncertainty. Therefore, when support is eventually scaled back, it should be done in ways that avoid sudden cliffs (for instance, gradually reducing the government's share of wages covered under furlough and short-time work programs while increasing hiring subsidies to enable reallocation as needed). All the while, long-term challenges—boosting productivity, improving policy frameworks, and addressing climate change—cannot be ignored. Differential recovery speeds across countries may give rise to divergent policy stances, particularly if advanced economies benefit sooner than others from wide vaccine coverage. Clear forward guidance and communication from advanced economy central banks is particularly crucial, and not just for calibrating the appropriate domestic monetary accommodation. It also vitally bears on external financial conditions in emerging markets and the impact that divergent policy stances have on capital flows.

Strong international cooperation is vital for achieving these objectives and ensuring that emerging market economies and low-income developing countries continue to narrow the gap between their living standards and those of high-income countries. On the health care front, this means ensuring adequate worldwide vaccine production and universal distribution at affordable prices—including through sufficient funding for the COVAX facility—so that all countries can quickly and decisively beat back the pandemic. The international community also needs to work together to ensure that financially constrained economies have adequate access to international liquidity so that they can continue needed health care, other social, and infrastructure spending required for development and convergence to higher levels of income per capita. Countries should also work closely to redouble climate change mitigation efforts. Moreover, strong cooperation is needed to resolve economic issues underlying trade and technology tensions (as well as gaps in the rules-based multilateral trading system). Building on recent advances in international tax policy, efforts should continue to focus on limiting cross-border profit shifting, tax avoidance, and tax evasion.

(from International Monetary Fund, Economic Outlook)

Supplement 3

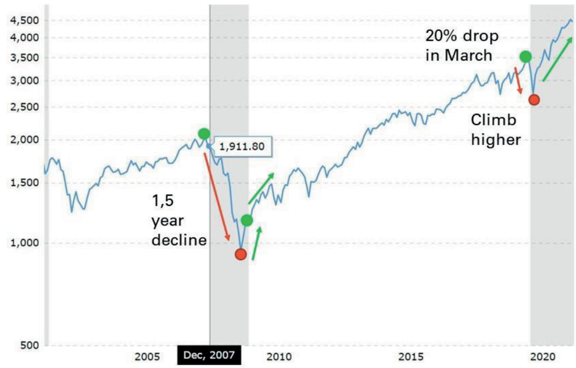
Regional analysis



Following a sharp fall at the end of 2008, Nikkei 225 relatively stabilized at the 8000-yen mark with occasional upturns and downturns. It faced a steady 2-week recovery by December 31, 2008. By mid-March, the Japanese index declined again and hit the bottom, followed by a period of stable growth while recovering from the crisis.

In the light of the 2020 COVID-19 crisis, the Japanese economy topped out in March and dropped unexpectedly because of the pandemic. However, the index rebounded in less than a year after the coronavirus outbreak, returning to its previous position. In early 2021, we see a strong positive trend, as the economy improved rapidly.

US trend analysis 2008-2020



S&P500 Index

US trend analysis 2008

After peaking in October, 2007, the S&P 500 Index weakened and was declining for almost 18 months. It started by dropping by approximately 5.7% by December 2007, and then again by 2.4% in January, 2008. We saw a slight rise in May 2008, but S&P 500 continued to go down and when it reached 1278.38 in June, 2008, US stocks officially entered a bear market. On Election Day (November 4, 2008), it fell by 21.33%, and again by 10.55% in January, 2009, the day of Barack Obama presidential inauguration. On March 9, 2009, S&P 500 bottomed out at 676.53, with a total decline of 56.8%. It took S&P 500 almost a year to recover.

US trend analysis 2020

After almost a decade of steady growth, with a couple of slight falls, S&P 500 reached 3419.05 by late January 2020, followed by a sharp drop by almost 20% in March due to the Covid-19 pandemic outbreak. But as the government took measures and eased the monetary policy, S&P 500 revived, peaking at an even higher point of 3685.83 by the end of August 2020. For the rest of the year the Index fluctuated, showing a gradual upward trend.

Supplement 4

Valuation and Financial Modeling

The goal of this case is to apply the financial tools to demonstrate how they are used in practice to build a valuation model of a firm. ln this case, we will value a hypothetical firm, Ideko Corporation. Ideko is a privately held designer and manufacturer of specialty sports eyewear based in Chicago. ln mid-2020, its owner and founder, June Wong, has decided to sell the business, after having relinquished management control about four years ago. As a partner in KKP Investments, you are investigating purchasing the company. If a deal can be reached, the acquisition will take place at the end of the current fiscal year. ln that event, KKP plans to implement operational and financial improvements at Ideko over the next five years, after which it intends to sell the business.

Ideko has total assets of $87 million and annual sales of $75 million. The firm is also quite profitable, with earnings this year of almost $7 million, for a net profit margin of 9.3%. You believe a deal could be struck to purchase Ideko's equity at the end of this fiscal year for an acquisition price of $150 million, which is almost double Ideko's current book value of equity. ls this *price reasonable*?

We begin this case by estimating Ideko's value using data for comparable firms. We then review KKP's operating strategies for running the business after the acquisition, to identify potential areas for improvements. We build a financial model to project cash flows that reflect these operating improvements. These cash flow forecasts enable us to value Ideko using the APV model and estimate the return on KKP's investment. Finally, we explore the sensitivity of the valuation estimates to our main assumptions.

Valuation Using Comparables

As a result of preliminary conversations with Ideko's founder, you have estimates of Ideko's income and balance sheet information for the current fiscal year shown in Table 19.1. Ideko currently has debt outstanding of $4.5 million, but it also has a substantial cash balance. To obtain your first estimate of Ideko's value, you decide to value Ideko By examining comparable firms.

A quick way to gauge the reasonableness of the proposed price for Ideko is to compare it to that of other publicly traded firms using the method of comparable firms. For example, at a price of $150 million, Ideko's price-earnings (P/E) ratio is 150,000/6939 = 21.6, roughly equal to the market average P/E ratio in mid-2020.

It is even more informative to compare Ideko to firms in a similar line of business. Although no firm is exactly comparable to Ideko in terms of its overall product line, three firms with which it has similarities are Oakley, Inc.; Luxottica Group; and Nike, Inc. The closest competitor is Oakley, which also designs and manufactures sports eyewear. Luxottica Group is an Italian eyewear maker, but much of its business is prescription eyewear; it also owns and operates a number of retail eyewear chains. Nike is a manufacturer of specialty sportswear products, but its primary focus is footwear. You also decide to compare Ideko to a portfolio of firms in the sporting goods industry.

A comparison of Ideko's proposed valuation to this peer set, as well as to the average firm in the sporting goods industry, appears in Table 1.2. The table not only lists P/E ratios, but also shows each firm's enterprise value (EV) as a multiple of sales and EBITDA (earnings before interest, taxes, depreciation, and amortization). Recall that enterprise value is the total value of equity plus net debt, where net debt is debt less cash and investments in marketable securities that are not required as part of normal operations. Ideko has $4.5 million in debt, and you estimate that it holds $6.5 million of cash in excess of its working capital needs. Thus, Ideko's enterprise value at the proposed acquisition price is 150 + 4.5 — 6.5 = $148 million.

At the proposed price, Ideko's P/E ratio is low relative to those of Oakley and Luxottica, although it is somewhat above the P/E ratios of Nike and the industry overall. The same can be said for Ideko's valuation as a multiple of sales. Thus, based on these two measures, Ideko looks "cheap" relative to Oakley and Luxottica, but is priced at a premium relative to Nike and the average sporting goods firm. The deal stands out, however, when you compare Ideko's enterprise value relative to EBITDA. The acquisition price of just over nine times EBITDA is below that of all of the comparable firms as well as the industry average. Ideko's low EBITDA multiple is a result of its high profit margins: At 16,250/75, OOO = 21.7%, its EBITDA margin exceeds that of all of the Comparables.

While Table 1.2 provides some reassurance that the acquisition price is reasonable compared to other firms in the industry, it by no means establishes that the acquisiti0n is a good investment opportunity. As with any such comparison, the multiples in Table 1.2 vary substantially. Furthermore, they ignore important differences such as the operating efficiency and growth prospects of the firms, and they do not reflect KKP's plans to improve Ideko's operations. To assess whether this investment is attractive requires a careful analysis both of the operational aspects of the firm and of the ultimate cash flows the deal is expected to generate and the return that should be required.

Table 1.1 Spreadsheet

Estimated 2020 Income Statement and Balance Sheet Data for Ideko Corporation

Year 2020	
Income Statement ($ 000)	
1. Sales	75,000
2. Cost of Goods Sold	
3. Raw Materials	(16, 000)
4. Direct Labor Costs	(18, 000)
5. Gross Profit	41,000
6. Sales and Marketing	(11,2 50)
7. Administrative	(13,5 00)
8. EBITDA	16,250
9. Depreciation	(5,500)
10. EBIT	10,750
11. Interest Expense (net)	(75)
12. Pretax Income	10,675
13. Income Tax	(3, 736)
14. Net Income	6,939

Year 2020	
Balance Sheet ($ 000)	
Assets	
1. Cash and Equivalents	12, 664
2. Accounts Receivable	18, 493
3. Inventories	6,165
4. Total Current Assets	37,322
5. Property, Plant, and Equipment	49,500
6. Goodwill	–
7. Total Assets	86,822
Liabilities and Stockholders' Equity	
8. Accounts Payable	4,654
9. Debt	4,500
10. Total Liabilities	9,154
11. Stockholders' Equity	77,668
12. Total Liabilities and Equity	86,822

Table 1.2

Ideko Financial Ratios Comparison, Mid-2020

RATIO	Ideko (Proposed)	OAKLEY, Inc.	Luxottica Group	NIKE, Inc.	SPORTING GOODS INDUSTRY
P/E	21.6x	24.8x	28.0x	18.2X	20.3X
EV/Sales	2.0X	2.0X	2.7X	1.5X	1.4X
EV/EBITDA	9.LX	11.6X	14.4X	9.3X	11.4X
EBITDA/Sales	21.7%	17.0%	18.5%	15.9%	12.1%

Problem

What range of acquisition prices for Ideko is implied by the range of multiples for P/E, EV/Sales, and EV/EBITDA in Table 1.2?

Solution

For each multiple, we can find the highest and lowest values across all three firms and the industry portfolio. Applying each multiple to the data for Ideko in Table 1.1 yields the following results:

	Range		Price (in $ million)	
Multiple	**Low**	**High**	**Low**	**High**
P/E	18.2X	28.0X	126.3	194.3
EV/Sales	1.4x	2.7X	107.0	204.5
EV/EBITDA	9.3X	14.4X	153.1	236.0

The Business Plan

While Comparables provide a useful starting point, whether this acquisition is a successful investment for KKP depends on Idec's post-acquisition performance. Thus, it is necessary to look in detail at Ideko's operations, investments, and capital structure, and to assess its potential for improvements and future growth.

Operational Improvements

On the operational side, you are quite optimistic regarding the company's prospects. The market is expected to grow by 5% per year, and Ideko produces a superior product. Ideko's market share has not grown in recent years because current management has devoted insufficient resources to product development, sales, and marketing. Conversely, Ideko has overspent on administrative costs. Indeed, Table 1.1 reveals that Ideko's current administrative expenses are 13,500/75,000 = 18% of sales, a rate that exceeds its expenditures on sales and marketing (15% of sales). This is in stark contrast to its rivals, which spend less on administrative overhead than they do on sales and marketing.

KKP plans to cut administrative costs immediately and redirect resources to new product development, sales, and marketing. By doing so, you believe Ideko can increase its market share from 10% to 15% over the next five years. The increased sales demand can be met in the short run using the existing production lines by increasing overtime and running some weekend shifts. However, once the growth in volume exceeds 50%, Ideko will definitely need to undertake a major expansion to increase its manufacturing capacity. For example, given the current market size of 10 million units and an expected growth rate of 5% per year, the spreadsheet calculates the expected market size in years 1 through 5. Also shown is the expected growth in Ideko's market share.

Table 1.3 Spreadsheet

Ideko Sales and Operating Cost Assumptions

			Year	2020	2021	2022	2023	2024	2025
	Sales Data	**Growth/Year**							
1.	Market Size	(000 units)	5.0%	10,000	10,500	11,025	11,576	12,155	12,763
2.	Market Share		1.0%	10.0%	11.0%	12.0%	13.0%	14.0%	15.0%
3.	Average Sales Price	($/unit)	2.0%	75.00	76.50	78.03	79.59	81.18	82.81
Cost of Goods Data									
4.	Raw Materials	($/unit)	1.0%	16.00	16.16	16.32	16.48	16.65	16.62
5.	Direct Labor Costs	($/unit)	4.0%	18.00	18.72	19.47	20.25	21.06	21.90
Operating Expense and Tax Data									
6.	Sales and marketing	(% sales)		15.0%	16.5%	18.0%	19.5%	20.0%	20.0%
7.	Administrative	(% sales)		18.0%	15.0%	15.0%	14.0%	13.0%	13.0%
8.	Tax Rate			35.0%	35.0%	35.0%	35.0%	35.0%	35.0%

Note that Ideko's average selling price is expected to increase because of a 2% inflation rate each year. Likewise, manufacturing costs are expected to rise. Raw materials are forecast to increase at a 1% rate and, although you expect some productivity gains, labor costs will rise at a 4% rate due to additional overtime. The Table also shows the reallocation of resources from administration to sales and marketing over the five-year period.

(from FINANSIERING BSC. MERC.)

Text Credits

P. 5 *The slumps that shaped modern finance*. The Economist, April 12th, 2014.

P. 6 *Norloff Charl, Moore Ruth*. University Success Writing Advanced, Student Book with MyEnglishLab. Pearson Education ESL, 2018, 432 pp.

p. 7 *Oxford Reference. Retrieved from:* https://www.oxfordreference.com/view/10.1093/oi/authority.20110803100153175#:~:text=A%20figure%20of%20speech%20in,it%20is%20not%20literally%20applicable

p. 7 *ScienceDirect. Retrieved from:* https://www.sciencedirect.com/topics/mathematics/retrospective-study

p. 17 *The slumps that shaped modern finance*. The Economist, April 12th, 2014.

p. 19 *Кулик Л. В., Кравченко Е. В., Клеймёнова Е. П.* Academic Focus for Postgraduates. Учебно-методическое пособие. М.: Экономический факультет МГУ имени М. В. Ломоносова; 2021, с. 25-26.

p. 19 *Webster New World Dictionary. Retrieved from:* https://www.merriam-webster.com/dictionary/leviathan

p. 22 Abridged from: *Leviathan of Last Resort*. The Economist, April 12th, 2014.

p. 22 *MBA Skool. Retrieved from:* https://www.mbaskool.com/business-concepts/marketing-and-strategy-terms/11374-sector-analysis.html

p. 23 *MacKenzie Ian*. Professional English in Use. Finance. Cambridge university Press, 2006, p.102.

p. 29 *World Development Report 2022* Finance for an Equitable Recovery. World Bank Group, 281 pp.

p. 30 *Oxford Languages. Retrieved from:* https://www.oxfordlearnersdictionaries.com/definition/english/trend_1

p. 32 *Yin Robert K.* Case study research: design and method. – 4th edition, SAGE Inc., 2009, p. 2.

p. 32 *Oxford Reference. Retrieved from:* https://www.oxfordreference.com/view/10.1093/oi/authority.20110803095553178

p. 33 *Yin Robert K.* Case study research: design and method. – 4th edition, SAGE Inc., 2009, p. 2.

p. 35 *Schultz Kenneth*. FINANSIERING BSC. MERC., (Copenhagen Business School, Department of Finance, Corporate Finance Case Study)

p. 43 *Valdez Stephen, Molyneux Philip*. An Introduction to Global Financial Markets, 8th edition. Springer. 2015, 552p. – 302p.

p. 47 *International Monetary Fund*. Economic Outlook: Tensions from the Two-Speed Recovery, April 2021, 192p. – xvi

p. 53 *Schultz Kenneth*. FINANSIERING BSC. MERC., (Copenhagen Business School, Department of Finance, Corporate Finance Case Study)

Кулик Л. В., Туринова Л. А.

SHAPING MODERN FINANCE

Научное электронное издание

ISBN 978-5-907690-02-8

9 785907 690028