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Confronting Contemporary Business Challenges through Management Innovation

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Yaakov Weber,
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FOREWORD

The Annual Conference of the EuroMed Academy of Business aims to provide a unique international forum to facilitate the exchange of cutting-edge information through multidisciplinary presentations on examining and building new theory and business models for success through management innovation.

It is acknowledged that the conference has established itself as one of the major conferences of its kind in the EuroMed region, in terms of size, quality of content, and standing of attendees. Many of the papers presented contribute significantly to the business knowledge base.

The conference attracts hundreds of leading scholars from leading universities and principal executives and politicians from all over the world with the participation or intervention of Presidents, Prime Ministers, Ministers, Company CEOs, Presidents of Chambers, and other leading figures.

This year the conference attracted over 250 people from over 65 countries. Academics, practitioners, researchers and Doctoral students throughout the world submitted original papers for conference presentation and for publication in this Book. All papers and abstracts were double blind reviewed. The result of these efforts produced empirical, conceptual and methodological papers and abstracts involving all functional areas of business.

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Special thanks go to the Conference Chair Professor Vitor Ambrosio, the Conference Organising Committee and the Faculty of Estoril Higher Institute for Tourism and Hotel Studies, in Portugal, for accomplishing an excellent job.

It is acknowledged that a successful conference could not be possible without the special co-operation and care of the Track Chairs and Reviewers for reviewing the many papers that were submitted to this conference. Special thanks to the Session Chairs and Paper Discussants for taking the extra time to make this conference a real success.

The last but not the least important acknowledgment goes to all those who submitted and presented their work at the conference. Their valuable research has highly contributed to the continuous success of the conference.

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VARIANCES ANALYSIS OF THE FREE CASH FLOWS TO FIRM AND ITS IMPACT ON THE FINANCIAL STRUCTURE. SPARE PARTS MANUFACTURERS IN THE ITALIAN AUTOMOTIVE INDEPENDENT AFTER MARKET IN THE 2008-2011 PERIOD.

Guelfi, Silvano

Department of Management and Production Engineering - DIGEP, Politecnico di Torino, Italy, silvano.guelfi@polito.it

ABSTRACT

All along, the financial balance is basic for the continuity of a company and especially when money is the critical resource. The competitive strategy needs a coherent structure and the financial receipts and payments related to the core business drive the financial structure, i.e. the relationships between equity and financial debts. In this direction, management awareness is a true source of competitive advantage and for this reason it's necessary a coherent method of analysis and a comprehensive system of measures. The present essay investigates through the variances analysis the relationship between the free cash flows to firm and the change in the financial structure and it supports the idea of an equilibrated financial structure is first of all a question of core business competitiveness, namely the distinctive quality of its products, customers, suppliers, technologies, core competences, processes, etc., and then a financial evaluation. At the end it's summarized the variances analysis of the free cash flows to firm, and the related impact on the financial structure, with reference to the Spare Parts Manufacturers, 291 limited companies, operating in the Italian Independent Automotive Aftermarket in the 2008-2011 period.

Keywords: free cash flows to firm, variances analysis, financial structure, ebitda, net working capital

1. INTRODUCTION

The primary goal of every living organism is to continue to exist in the best state of health. For the company there are the same rules and the goal of a healthy continuity is essentially nourished of balance and, in particular, of economic and financial balance. The economic

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balance is achieved if, when and as the return on invested capital (Phillips, 1997) of the firm is higher than the cost of capital (Modigliani and Miller, 1958) (also defined as the return that would have generated the same capital risk in similar conditions): in this scenario, the company creates economic value. The financial balance has multiple views that, for the object of this paper, are substantially related to two: the attitude of the company, on one side, to generate cash from its operating activities and, secondly, to finance consistently its own competitive strategies using the financial resources of the shareholders rather than debt capital, the so-called financial structure (Myers *et al*., 1984).

With particular attention to financial equilibrium, the objective of this work is to investigate, under a purely financial point of view and then without analyzing the economic impact, the relationships that exist between operating cash flow and the choices, often constrained and binding, of financial structure.

In this framework of analysis, the basic thesis of the following pages is that the relations between the two expressions of financial equilibrium are, on one side, deep and mutually interconnected and, on the other side, essential to guide the competitive strategies in the sign of a lasting health.

These conditions of financial equilibrium, once shared the main methodological implications, are then analyzed in practice versus a real economic sector, so that you can better appreciate the significance, scope of interpretation and application issues.

2. LOGIC AND METRIC OF THE ANALYSIS

The logic and the metric chosen for the analysis at issue are consistent with the objective of the company management to acquire promptly the wider awareness of the management priorities and to orientate properly their managerial decisions and actions. Consistently with this logical line are available “ad hoc” models of financial analysis more consistent with the above “managerial objectives” and in particular:

a. as concerns the dynamic of cash flows, i.e. the receipts and the disbursements of the company, the logical driver is in the rational management that triggers them and in the different management area to which they belong: in this direction, there are operating cash flows related to the core business (the so-called free cash flows to firm) (Damodaran, 2001), cash flows related to the fiscal relationship with the treasury, cash flows related to extraordinary non-recurring events and cash flows related to shareholders’ equity and third-parties lenders debt;

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b. as regards the variances analysis the focus is on the individual factors that contribute to the determination of the free cash flows to firm (Fig. 1) and consequently cause changes in the financial structure. Through the variances analysis, as Anthony *et al.* (2004) claim, "Management wants to know not only *what* the amounts of the differences between actual and planned results were but also, and more important, *why* these variances occurred".

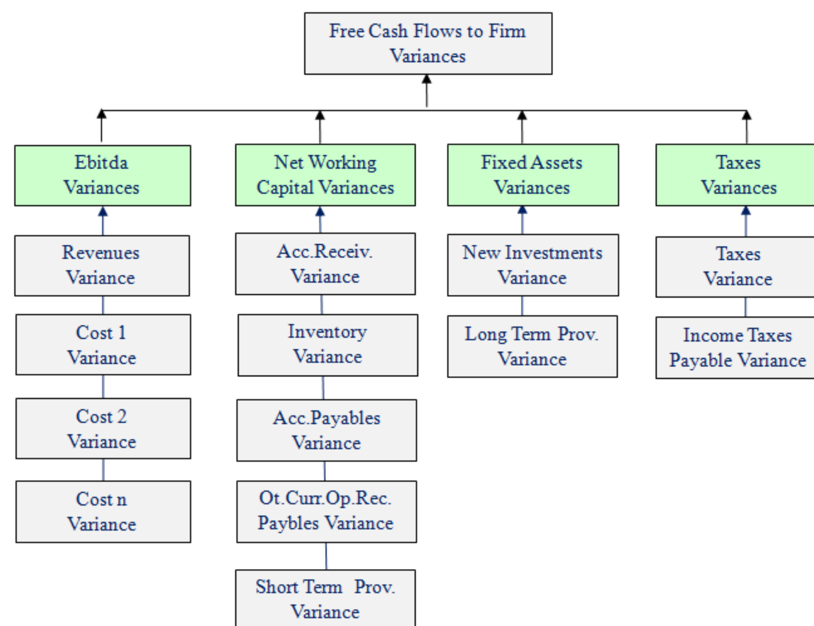

Fig. 1 – An overview of the Free Cash Flows to Firm variances analysis

c. as concerns the financial structure, the logical assumption is the distinction of the funding sources between pure "full risk" lenders, the shareholders, and pure "partial risk" lenders, the third-parties lenders debt: in other words the financial structure under investigation is exclusively composed of shareholders' equity and net financial position lenders, the so called pure providers of capital.

2.1. Free cash flows to firm. Two basic ingredients

Before we get into the analysis of the dynamic relationships between free cash flows to firm (FCFF) variances and financial structure it's useful a synthetic overview of their nature. In this direction, FCFF:

a. are a magnitude-flow, that is they belong to the family of the financial variables that can find measurement only with reference to a specific period of time (for example, an administrative exercise);

b. arise from the union of the economic components of a given period and from the changes in balance sheet items (always related to the same period);

c. show the ability of the company to generate or absorb financial resources from its own core business;

d. determine the financial requirements to satisfy by resorting to the use of the financial leverage or new financial resources contributed by the shareholders.

Two basic ingredients

The determination of the free cash flows to firm requires two basic ingredients:

1. revenues and related costs summarized in the so-called Income Statement (or Profit and Loss Statement or Earnings Statement): the following Tab. 1 shows (among the many) a classic synthetic Added Value-Ebitda Income Statement based view:

Income Statement	Time Period n	% vs Net Revenues	Time Period n-1	% vs Net Revenues	Managerial Meaning
a) Net revenues (or sales)	1.000	100,00%	950	100%	Product between volumes sold and related selling prices
b) External operating costs	-400	40,00%	-390	-41,05%	Product between volumes purchased from external suppliers (raw materials, services, consulting, etc.) and related purchasing prices
c=a+b) Added value	600	60,00%	560	58,95%	Value added by internal operating costs (labor costs and depreciation) compared to the external operating costs
d) Labor cost	-250	25,00%	-260	-27,37%	Amount of the costs related to wages and salaries
e=c+d) Earnings before interests, depreciation and amortization (Ebitda)	350	35,00%	300	31,58%	Margin generated by the core business before interests, depreciation and amortization
f) Depreciation and amortization	-40	4,00%	-30	3,16%	Periodic decrease in an asset's value caused by obsolescence
g) Provisions for risks and future costs	-10	1,00%	-10	1,05%	Periodic provisions to support future risks and costs
h=∑e:g) Earnings before interests and taxes (Ebit)	300	30,00%	260	27,37%	Margin generated by the core business
i) Interests	-50	5,00%	-50	5,26%	Financial expenses (or incomes) generated by financial debts (assets)
a) Extraordinary revenues/costs	0	0,00%	0	0,00%	Extraordinary expenses (or incomes)
k=∑h:j) Earnings before taxes (Ebt)	250	25,00%	210	22,11%	Margin before taxes
l) Taxes	-100	10,00%	-84	8,84%	Fiscal costs due to the Tax Authorities
m=k+l) Net income (NI)	150	15,00%	126	13,26%	Margin after taxes

Tab. 1 - Income Statement focused on Valued Added and Ebitda

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2. investments and related funds of capital summarized in the so-called Balance Sheet (or Statement of Financial Position): the following Tab. 2 shows (among the many) a classic synthetic Balance Sheet view based on Net Operating Capital Invested (Brealey *et al.*, 2011), just net operating assets, financed by shareholders' equity and third-parties lenders debt, just pure capital providers:

Balance Sheet	Time Period and % to Net Operating Capital Invested				Managerial Meaning
	Time Period n	% to NOCI	Time Period n-1	% to NOCI	
a=∑b:d) Current operating assets	390	97,50%	350	102,94%	Financial resources invested in the core business for a period < 12 months
b) Accounts receivable	300	27,50%	270	79,41%	
c) Inventories	80	20,00%	60	17,65%	
d) Other current operating receivables	10	2,50%	20	5,88%	
e=∑f:i) Current Operating Liabilities	180	45,00%	180	52,94%	Financial resources provided by operating resources suppliers for a period < 12 months
f) Accounts payable	110	27,50%	130	38,24%	
g) Income taxes payable	50	12,50%	40	11,76%	
h) Other current operating payables	20	5,00%	10	2,94%	
i) Short term accumulated provisions for risks	0	0,00%	0	0,00%	
j=a-e) Net Working Capital	210	52,50%	170	50,00%	Net financial resources invested in the core business for a period < 12 months
k) Tangible and intangible long term asset, net	240	60,00%	220	64,71%	
l) Long term accumulated provisions for risks and costs	50	12,50%	50	14,71%	
m=k-l) Net Fixed Assets	190	47,50%	170	50,00%	Net financial resources invested in the core business for a period > 12 months
n=j+m) Net Operating Capital Invested (or total net operating assets)	400	100,00%	340	100,00%	Total net financial resources invested in the core business
o=∑p:s) Shareholders' Equity	290	72,50%	220	64,71%	Financial resources provided by shareholders' equity
p) Common stock	50	12,50%	50	14,71%	
q) Additional paid-in capital	30	7,50%	30	8,82%	
r) Retained earnings	60	15,00%	14	4,12%	
s) Net income	150	37,50%	126	37,06%	
t=∑u:z) Third-Parties Lenders Debt (or Net Financial Position)	110	27,50%	120	35,29%	Net financial resources provided by third-parties lenders debt
u) Short term financial debts	50	12,50%	60	17,65%	

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v) Cash and cash equivalent	-10	.2,50%	-10	-2,94%	
w) Long term financial debts	80	20,00%	80	23,53%	
z) Investment securities	-10	-2,50%	-10	-2,94%	
x=o+t) Net Operating Capital Acquired (or net financial position and shareholders' equity)	400	100,00%	340	100,00%	Net financial resources provided by shareholders' equity and third-parties lenders debt

Tab. 2 – Balance Sheet focused on Net Operating Capital Invested and Shareholders' equity and third-parties lenders debt

An appropriate mix of economic and balance sheet components generates automatically (through the indirect method) the so-called Cash Flows Statement: the following Tab. 3 shows (among the many) an "ad hoc" Cash Flows view based on the distinction between operating and financial cash flows and the related impact on the Financial Structure (shareholders' equity and net financial position):

Cash Flows Statement	Time Period and % to Revenues				Managerial Meaning
	Time Period n	% to Revenues	Time Period n-1	% to Revenues	
a) Ebitda	350	35,00%	300	31,58%	Margin generated by the core business before interests, taxes, depreciation and amortization
b=∑c:i) Δ Net Working Capital	-50	-5,00%	-10	-1,05%	Cash provided/required by decreasing/increasing of Net Working Capital
c) Δ Accounts Receivable	-30	-3,00%	-20	-2,11%	Cash provided/required by decreasing/increasing of accounts receivable
d) Δ Inventories	-20	-2,00%	-10	-1,05%	Cash provided/required by decreasing/increasing of inventories
e) Δ Accounts Payable	-20	-2,00%	10	1,05%	Cash provided/required by increasing/decreasing of accounts payable
f) Δ Other current operating receivables	+10	1,00%	+5	0,53%	Cash provided/required by decreasing/increasing of other current operating receivables
g) Δ Other current operating payables	+10	1,00%	+5	0,53%	Cash provided/required by increasing/decreasing of other current operating payables
h) Δ Short term accumulated provisions (risks and costs)	0	0,00%	0	0,00%	Cash required by core business short term risk and costs
i) Provisions for short term risks and costs	0	0,00%	0	0,00%	
h=a+b) Current Cash Flow	300	30,00%	290	30,53%	Cash provided/required by core business before investments and taxes
i) Δ Tangible and intangible long term asset, net	-20	-2,00%	-10	-1,05%	Cash required by long term investment in the core business
j) Depreciation and	-40	-4,00%	-30	-3,16%	

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amortization					
k) Δ Long term accumulated provisions (risks and future costs)	0	0,00%	0	0,00%	Cash required by core business long term risk and costs
l) Provisions for long term risks and costs	-10	-1,00%	-10	-1,05%	
m=∑i:l) Δ Gross Fixed Assets	-70	-7,00%	-50	-5,26%	Cash provided/required by decreasing/increasing of Gross Fixed Assets
n=h+m) Gross Cash Flows to Firm	230	23,00%	240	25,56%	Cash provided/required by core business before taxes
o) Operating Taxes	-120	-12,00%	-84	-8,84%	Cash required by fiscal impact
p) Δ Income taxes payable	+10	1,00%	+5	0,53%	
q=∑n:p) Free Cash Flows to Firm	120	12,00%	161	16,95%	Company's attitude to provide/require financial resources (after taxes) from its own core business
r) Extraordinary revenues/cost (tax shield net)	0	0,00%	0	0,00%	Cash in/cash out due to extraordinary revenues/cost (net tax impact)
s=q-r) Free Cash Flows to (Pure) Lenders	120	12,00%	161	16,95%	Free cash flow available to pure lenders
t) Financial revenues/costs (tax shield net)	-30	-3,0%	-30	-3,16%	Cash in/cash out due to financial revenues/cost (net tax impact)
u) Dividends to shareholders	-80	-8,0%	-80	-8,42%	Shareholders' pay out
v) Δ Shareholders' equity	0	0,00%	0	0,00%	Variance of financial resources invested by Shareholders' equity
w) Δ Net financial position	-10	-1,00%	-51	-5,37%	Variance of net financial resources invested by third-parties lenders debt

Tab. 3 - Cash Flows Statement focused on FCFF and free cash flows to pure lenders

2.2. Financial structure and financial leverage

As concerns the financial structure, the latter is the mix of the financial resources provided by pure capital suppliers: shareholders' equity (common stock, additional paid-in capital, retained earnings, net income) and third-parties lenders debt (short and long term financial debts net of cash and cash equivalents and investment securities).

The relationship between net financial position and shareholders' equity is the so-called financial leverage (Blazenko, 1996) (see the following Tab. 4). The latter is a very important ratio for managerial trade-off evaluations in terms of financial risk (Markowitz, 1952), funding opportunities, cost funding, company reputation, etc. and for these reasons it's rich of pervasive managerial implications.

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Financial Structure	Time Period and % to Net Operating Capital Invested				Managerial Meaning
	Time Period n	% to Net Operating Capital Invested	Time Period n-1	% to Net Operating Capital Invested	
a=Shareholders' Equity	290	72,50%	220	64,71%	Financial resources provided by shareholders' equity
b= Third-Parties Lenders Debt (or Net Financial Position)	110	27,50%	120	35,29%	Financial resources provided by third-parties lenders debt
c=b/a) Financial Leverage	0,38		0,55		Company's attitude to finance core business with equity to financial debts

Tab. 4 - Financial structure and financial leverage

2.3. The variances analysis of the free cash flows to firm

A variance is the difference between two values (Anthony, 2004). Typically, the first value represents what actually happened, that is, the performance actually achieved. The other value is a performance benchmark, such as a planned result (what the firm wanted to happen) or a historical result (what happened in the past) or the best competitor performance. A variance analysis involve the breakdown of the global variance into the individual factors that caused the variance. Obviously the algebraic sum of the single variances is equal to the global variance, but it's very important to realize that there isn't only one way to do variance analysis and managers perform different variances analysis because, as Anthony *and al.* claim, "the techniques used to analyze variances depend on management's judgment as to how useful the results are likely to be".

The variances analysis methodology involves five basic steps:

1. identify the individual factors that cause the global variance;
2. define the most useful sequence of the individual factors identified: generally, from a cash flow point of view, revenues are the starting point for the variances analysis;
3. always from a cash flow point of view, it's useful to normalize each absolute value to the revenues;
4. accordingly with the previous most useful sequence, the next step, so-called flexible phase of the values, is to replace each past value with its actual value and calculate the resulting amounts;
5. calculate the variance between the two above said amounts. In particular, there are two different algebraic evaluations about variance:

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1. an *unfavorable variance* is the one that makes, all other conditions being equal, actual revenues/margins (costs) value lower (higher) than in the past (or planned target): for example, if the actual external operating costs are higher than in the past, the variance is said to be unfavorable;
2. a *favorable variance* makes actual revenues/margins (costs) value higher (lower) than in the past (or planned target): for example, if actual revenues are higher than in the past, the variance is said to be favorable. As Anthony *and al.* claim, "The words favorable and unfavorable do not necessarily connote value judgments about managerial performance … but indicate only the algebraic impact of a variance …".

As concerns FCFF variances analysis, the individual factors that caused the global variance between two periods (for example two years) and a related useful sequence are shown by the following Tab. 5. In particular, these eleven individual factors are connected to four different variances:

1. *ebitda (earnings before interest taxes depreciation and amortization) variance* generated by three individual factors - revenues, external operating costs and labor costs – coming from income statement;
2. *net working capital variance* generated by five individual factors coming from balance sheet - change in accounts receivable, change in inventories, change in accounts payable, change in other current operating receivables and payables, change in short term accumulated provisions and provisions for risks and costs - and by one individual factor coming from a mix between Balance Sheet and Income Statement, change in short term accumulated provisions and provisions for risks and costs;
3. *fixed assets variance* generated by two individual factors - change in tangible and intangible long term (net) assets and depreciation and amortization, change in long term accumulated provisions and provisions for risks and costs – coming from a mix between Income Statement and Balance Sheet;
4. *taxes variance* generated by one individual factor, taxes and change in payable income taxes, coming from a mix between Income Statement and Balance Sheet.

Individual factors of the global variance and a related useful sequence		
From	Through	To

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Income Statement	1. revenues 2. external operating costs 3. labor costs	Ebitda variance
Balance Sheet	4. Δ accounts receivable 5. Δ inventories 6. Δ accounts payable 7. Δ other current operating receivables and payables 8. Δ short term accumulated provisions and provisions for risks and costs	Net Working Capital variance
A mix between Income Statement and Balance Sheet	9. Δ tangible and intangible long term (net) asset and depreciation and amortization 10. Δ long term accumulated provisions and provisions for risks and costs	Fixed Assets variance
	11. taxes and Δ payable income taxes	Taxes variance

Tab. 5 - Individual factors of the global variance and a related useful sequence. From Income Statement and Balance Sheet to four basic variances: Ebitda, Net Working Capital, Fixed Assets and Taxes

Using the symbol Δ (delta) to represent the difference between an actual amount and a past one, the commonly used rules to find the single variances (V) are as follows:

a. as concerns the individual factors related to the Ebitda V there are three specific variances (all the following variances can be further broken down; for example, the revenues variance can be splitted into three components: volumes (or quantity) variance, product mix variance and price variance (Anthony, 2004); the costs variance too can be decomposed into four components: volumes (or quantity) variance, mix variance, efficiency variance, price variance; the collection times variance can be disaggregated into three components related to the revenues: volumes (or quantity) variance, customer mix variance and price variance; etc.):

1. the *intensity revenues V* measures the effect on the FCFF related to a different amount of revenues:

   revenues V= Δrevenues x (1 - past % cash absorption)= 50 x (100,00% - 83,05%)= 8,47

   In synthesis, the increasing revenues generates, all other conditions being equal, a favorable variance equal to 8,47 (2,18% to actual revenues or 5,26% to past FCFF);

2. the *external operating costs efficiency V* measures the change in the FCFF caused by a different rate of external operating cost efficiency:

   external operating costs V= actual revenues x Δ% cash absorption by external operating costs= 1.000 x (41,05% - 40,00%)= 10,52

   In synthesis, the better external operating costs efficiency produces, all other conditions being equal, a favorable variance equal to 10,52 (1,05% to actual revenues or 6,54% to past FCFF);

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3. the *efficiency labor costs V* measures the effect on the FCFF due to a different level of efficiency labor costs:

   labor costs V= actual revenues x Δ% cash absorption by labor costs= 1.000 x (27,37% - 25,00%)= 23,68

   In synthesis, the improved labor cost efficiency generates, all other conditions being equal, a favorable variance of 23,68 (2,37% to actual revenues or 14,71% to past FCFF).

The sum of the above 1), 2) and 3) variances generates the so-called Ebitda variance:

Ebitda V= revenues V + external operating costs V + labor costs V= 8,47 + 10,52 + 23,68= 42,68.

In synthesis, the higher Ebitda produces, all other conditions being equal, a favorable variance of 42,68 (4,27% to actual revenues and 26,51% to past FCFF).

b. as concerns the individual factors related to the Net Working Capital V there are five different variances:

1. the *collection times V* measures the effect on the FCFF related to a different days sales outstanding:

   collection times V= actual revenues x Δ% cash absorption by accounts receivable= 1.000 x (- 3,00% - (- 2,11%))= - 8,95

   In synthesis, the worsening of collection times from customers generates, all other conditions being equal, an unfavorable variance of -8,95 (-0,89% to actual revenues or 5,56% to past FCFF);

2. the *inventory V* measures the effect on the FCFF related to a different days inventory outstanding:

   inventory V= actual revenues x Δ% cash absorption by inventory= 1.000 x (- 2,00% - (- 1,05%))= - 9,47

   In synthesis, the worsening of the inventory rotation produces, all other conditions being equal, an unfavorable variance of -9,47 (-0,95% to actual revenues or 5,88% to past FCFF);

3. the *payment times V* measures the effect on the FCFF due to a different payment time of suppliers:

   payment times V= actual revenues x Δ% cash absorption by accounts payable= 1.000 x (- 2,00% - 1,05%)= - 30,53

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In synthesis, the worsening of time payment to suppliers generates, all other conditions being equal, an unfavorable variance of 30,53 (3,05% to actual revenues or 18,96% to past FCFF);

4. the *other current operating receivables and payables V* measures the effect on the FCFF due to a different incidence of the other current operating receivables and payables:

   other current operating receivables and payables V= actual revenues x Δ% cash absorption by other operating receivables and payables= 1.000 x (2,00% - 1,05%)= 9,47

   In synthesis, the improving of the current operating receivables and payables incidence generates, all other conditions being equal, a favorable variance of 9,47 (0,95% to actual revenues or 5,88% to past FCFF);

5. the *short term provisions risks V* measures the effect on the FCFF related to a different level of use of short term provisions for risks:

   short term provisions for risks V= actual revenues x Δ% cash absorption by use of short term provision for risks= 1.000 x (0,00% - 0,00%)= 0,00

The sum of the above 1), 2) 3), 4) and 5) variances generates the so-called Net Working Capital variance:

Net Working Capital V= collection times V + inventory V + payment times V + other current operating receivables and payables V + short term provisions risks V=

-8,95 – 9,47 – 30,53 + 9,47 + 0,00= - 39,47.

In synthesis, the greater amount of Net Working Capital produces, all other conditions being equal, an unfavorable variance of -39,47 (3,95% to actual revenues and 24,52% to past FCFF).

c. as concerns the individual factors related to the Fixed Assets V there are two different variances:

1. the *new investments* (originated by the algebraic sum of change in the net fixed assets and depreciation and amortization) *V* measures the effect on the FCFF related to a different rate of new tangible and intangible investments:

   new investment V= actual revenues x Δ% cash absorption by new investments= 1.000 x (- 6,00% - (- 4,21%))= - 17,89

   In synthesis, the increasing new investments generate, all other conditions being equal, an unfavorable variance of -17,89 (-1,79% to actual revenues or 11,11% to past FCFF);

2. the *long term provisions risks V* measures the effect on the FCFF related to a different level of use of provisions for risks:

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long term provisions risks V= actual revenues x Δ% cash absorption by use of provision for risks= 1.000 x (- 1,00% - (- 1,1%))= 0,53

In synthesis, the higher use of provisions for risk generates, all other conditions being equal, an unfavorable variance of 0,53 (0,05% vs actual revenues or 0,33% vs past FCFF);

The sum of the above 1) and 2) variances generates the so-called Fixed Assets variance:

Fixed Assets V= new investments V + long term provisions risks V= -17,89 + 0,53= - 17,36.

In synthesis, the greater amount of Fixed Assets Capital produces, all other conditions being equal, an unfavorable variance of -17,36 (1,74% to actual revenues and 10,78% to past FCFF).

d. as concerns the individual factors related to the Taxes there are two variances:

1. the *taxes pressure V* measures the effect on the FCFF related to a different tax rate pressure:

   taxes pressure V= actual revenues x Δ% cash absorption by taxes pressure= 1.000 x (-12,00% - (- 8,84%))= - 31,58

   In synthesis, a higher tax rate pressure generates, all other conditions being equal, an unfavorable variance of -31,58 (-1,90% to actual revenues or -19,61% to past FCFF);

2. the *payable income taxes V* measures the effect on the FCFF related to a different payable income taxes level:

   payable income taxes V= actual revenues x Δ% cash absorption by payable income taxes= 1.000 x (1,00% - 0,53%)= + 4,74

   In synthesis, the higher level of payable income taxes pressure generates, all other conditions being equal, a favorable variance of +4,74 (+0,47% to actual revenues or 2,94% to past FCFF);

The sum of the above 1) and 2) variances generates the so-called Taxes variance:

Taxes V= taxes pressure V + payable income taxes V= -31,58 + 4,74= -26,54.

In synthesis, the increasing negative fiscal cash flows produces, all other conditions being equal, an unfavorable variance of -26,54 (2,65% to actual revenues and 16,67% to past FCFF).

The following FCFF Bridge, Fig. 2, summarizes the contribution of each individual variance to the FCFF global variance. In particular, it's very important to identify if the

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change in FCFF is due to an Income Statement factor or to a Balance Sheet factor, and in particular to a contribution of ebitda, net working capital, fixed assets and taxes.

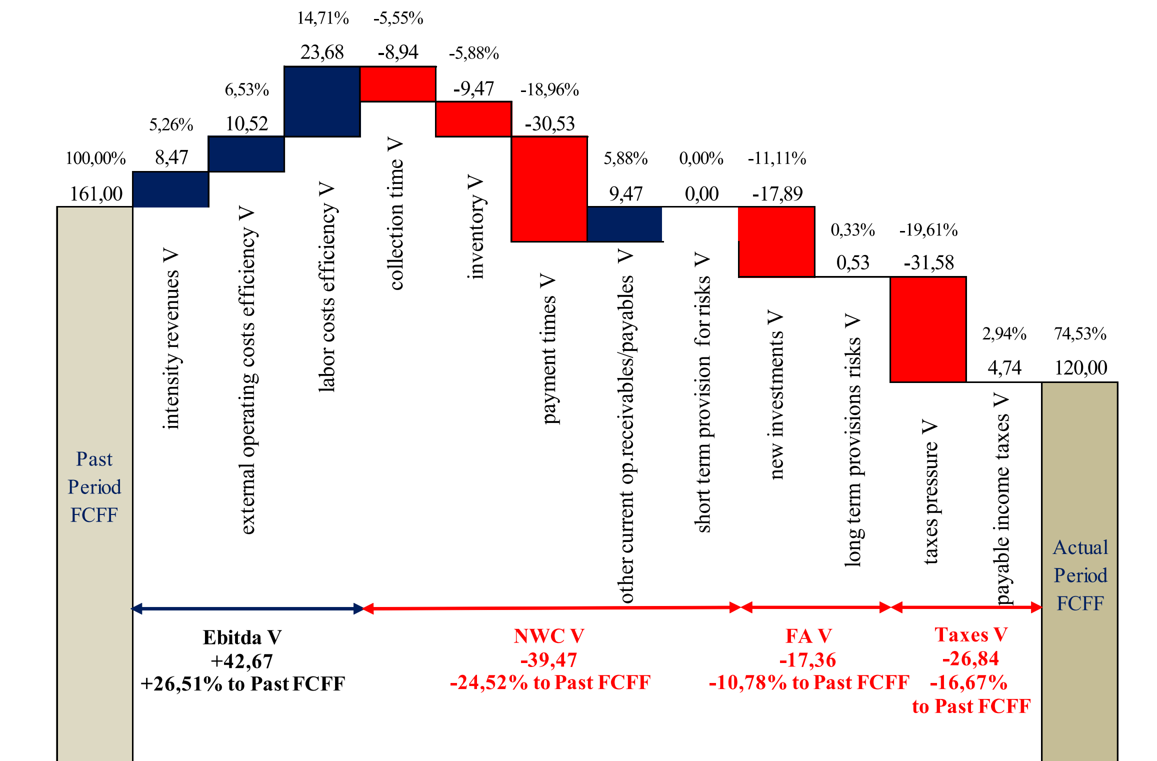

Fig. 2 – Free Cash Flows to Firm bridge

Under a managerial point of view it is essential, on one side, to measure which managerial processes – selling, purchasing, innovation, etc. - are increasing (or decreasing) FCFF and, on the other side, to identify the best way to preserve good performance, that is the positive FCFF variances (in the example the ebitda components), and to correct bad performance, that is the negative FCFF variances (in the example the net working capital and taxes components). By the variances quantification, the management conquests the precious opportunity to focus the right energies on the most relevant critical points and to concentrate on the existing, and frequently hidden, relationships between the different variances.

3. From the variances analysis of the free cash flows to firm to a different financial structure. Synthetic relationships of equilibrium

Between FCFF and financial structure there is a strong relationship in terms of financial equilibrium and healthy continuity of the firm. In this direction, positive FCFF variances are, financial and extraordinary costs paid, the most authentic way to lead the company towards a double purpose: the financial structure target and the competitive position target. In particular, the positive FCFF variances, all other conditions being equal, allow:

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a. the strengthening of the degree of financial independence and therefore a greater bargaining power towards stakeholders;
b. a continuous pay out of dividends with a consequent shareholders' satisfaction;
c. an improvement of the financial debts quality: extension of financial debt maturities, lower funding costs, greater possibilities to reduce the amount of financial debts;
d. a better competitive reputation.

In the above example the reduction of FCFF, from 161,00 to 120,00, causes, all extraordinary and financial and dividends conditions being equal, an identical impact, -41,00 on the process of reducing the Net Financial Position, from 51 of the past year to 10 for the current year (Tab. 6). In particular, this is the difference between positive ebitda variance (+42,67) and negative net working capital (-39,47), fixed assets (-17,36) and taxes (-26,84) variances.

Financial Values	Time Period and % to Net Revenues				Managerial Meaning
	Time Period n	% to Net Revenues	Time Period n-1	% to Net Revenues	
a. Free Cash Flows to Firm	120	12,00%	161	16,95%	Company's attitude to provide/require financial resources (after taxes) from its own core business
b.Free Cash Flows to (Pure) Lenders	120	1,00%	161	16,95%	Cash flows available for pure lenders
c. Financial revenues/costs (tax shield net) and Dividends to shareholders	-110	-11,00%	-110	-11,58%	Cash out by financial revenues/costs and dividends
d=b-c)Net Financial Position reducing through change in FCFF	10	1,00%	51	5,37%	
e.Net Financial Position	110	11,00%	120	12,63%	Financial resources provided by third-parties lenders debt

Tab. 6 – The change in Free Cash Flows to Firm drive (extraordinary, financial and dividends cash out conditions being equal) changes on the financial structure

4. Spare Parts Manufacturers in the Italian Automotive Independent After Market. The variances of the free cash flows to firm and the financial structure in the 2008-2011 period

This last section highlights, in brief and in accordance with the purpose of the present work, the results obtained from the Competitive Risk and Entreprise Value Research Center of the Polytechnic of Turin (Italy), whose mission is to develop models and metrics for measuring economic performance. First of all, some information about the analysis scope:

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a. the results of the analysis are focused on the free cash flows to firm variances analysis and their impact on the financial structure;
b. the statistical sample is composed by 291 limited companies operating in Italy as Spare Parts Manufacturers for the Italian Automotive Independent After Market. The above 291 companies are composed by 36 large companies (turnover greater than € 100 million), 43 medium-sized enterprises (turnover between 30 and 100 million euro) and 212 small business (turnover lower than € 30 million). All data, extracted from the financial statements officially registered at the Italian Chambers of Commerce, are public;
c. the 2008-2011 is the analyzed period and for each period the FCFF variances analysis shows the contribute of each individual factor as ebitda, net working capital, fixed assets and taxes and the related relationship with the financial structure.

The set of all the 291 companies shows, in brief (Tab. 7), the following financial highlights:

a. a slight increase in revenues (2011-2008 cagr of +0,47%);
b. a meaningful decrease in ebitda (2011-2008 cagr of -2,08%);
c. a small increase in taxes with a 2011-2008 cagr of +0,36%;
d. an increasing of net capital invested (cagr of +0,98%) in both its components, net working capital (cagr of +1,33%) and net fixed assets (cagr of +0,55%);
e. a consistent improving in the financial structure: shareholders' equity, cagr of + 1,95%, and third-parties lenders debt, cagr of -19,38%.

Financial Highlights	2011	2010	2009	2008	Cagr 2011/2008
Net revenues	14.367.975	13.794.764	11.865.651	14.168.271	0,47%
Ebitda	1.057.623	1.097.205	894.752	1.126.306	-2,08%
Taxes	229.053	211.284	152.926	226.569	0,36%
Net Working Capital	2.391.162	2.280.608	2.125.237	2.298.281	1,33%
Net Fixed Assets	1.910.717	1.939.896	1.867.210	1.879.459	0,55%
Net Capital Invested	4.301.879	4.220.503	3.992.447	4.177.740	0,98%
Shareholder's Equity	4.179.437	4.367.495	4.124.765	3.944.051	1,95%
Third-Parties Lenders Debt	122.442	-146.992	-132.318	233.689	-19,38%

Tab. 7 – The main financial highlights for the Spare Parts Manufacturers in the Italian Automotive Independent After Market

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As concerns the individual factors of the FCFF variances analyses, the Tab. 8 highlights some interesting observations:

a. except for 2010, ebitda has always negatively contributed to the improvement of the FCFF: in other words, the lower Ebitda produces for three years on four, all other conditions being equal, an unfavorable variance: -0,53% to 2011 revenues, -0,36% to 2009 revenues and -1,41% to 2008 revenues. The critical point is especially related to the external operating costs (always negative except the 2009) which are absorbing the positive contribution of revenues to FCFF: it's an uneconomic exchange between revenues and external operating cost. On the contrary, labor cost generates a favorable variance in 2011 and in 2010, but is not enough to change the sign of ebitda variance;
b. as regards to the net working capital the contribution to FCFF is always, except for 2010, positive and first of all thanks to lower collection times, for the second consecutive year, and to a favorable variance of the other current operating receivables and accounts payable;
c. the positive fixed assets variance is mainly due to an investment slowdown and this trend could have a negative impact on future results; without this investment cutting, 0,95% to revenues in 2011, the FCFF variance would have been negative in 2011, -0,10% to revenues;
d. higher taxes produce an increasing unfavorable variance: -0,47 to revenues in 2011 and -0,22 to revenues in 2010.

Free Cash Flows to Firm: Individual Factors V (to Revenues)	2011	2010	2009	2008	Δ2011-2008
a=b+c+d+e)Free Cash Flows to Firm V	0,85%	-2,13%	3,11%	0,80%	0,05%
b)Ebitda V	-0,53%	0,92%	-0,36%	-1,41%	0,88%
b1)Revenues V	0,06%	0,51%	0,05%	0,00%	0,06%
b2)External operating costs V	-0,77%	-0,53%	1,12%	-0,86%	0,09%
b3)Labor costs V	0,17%	0,94%	-1,52%	-0,56%	0,73%
c)Net Working Capital V	0,63%	-2,46%	0,02%	3,48%	-2,85%
c1)Collection times V	0,70%	0,51%	-4,22%	4,27%	-3,58%
c2)Inventory V	-0,79%	-2,07%	2,21%	0,71%	-1,50%
c3)Payment times V	-0,58%	2,02%	1,62%	-4,06%	3,47%
c4)Other current op. rec. acc. paybles V	1,31%	-2,93%	0,40%	2,55%	-1,25%

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d)Fixed Assets V	1,23%	-0,37%	1,83%	-1,63%	2,86%
d1)New investments	0,95%	-0,06%	2,56%	-2,31%	3,25%
d2)Long term provisions risks V	0,28%	-0,31%	-0,74%	0,68%	-0,40%
e)Taxes V	-0,47%	-0,22%	1,62%	0,37%	-0,84%
e1)Taxes pressure V	-0,20%	-0,10%	0,68%	0,48%	-0,67%
e2)Income taxes payable V	-0,27%	-0,13%	0,94%	-0,11%	-0,17%

Tab. 8 – The main individual factors of the FCFF variances analysis for the Spare Parts Manufacturers

in the Italian Automotive Independent After Market

As concern the relationship between the FCFF variance and the impact on the financial structure, Tab. 9 shows how the positive 2011 FCFF V, +0,85% to revenues, is higher than extraordinary revenues/costs (tax shield net) V, -0,69% to revenues, but not enough to hold up shareholders' equity V needs, -3,80% to revenues, and all this in despite of a positive financial revenues/costs (tax shield net) V to revenues, +0,35. It means a financial deficit V to revenues equal to -3,28% satisfied through, on the one hand, the 2011 FCFF, +1,40% to revenues, and, on the other side, an increasing of the Net Financial Position V, + 1,89% to revenues.

Free Cash Flows to Firm: Individual Factors V vs Revenues	2011	2010	2009	2008
a)FCFF V to revenues	0,85%	-2,13%	3,11%	0,80%
b)Extraordinary revenues/costs (tax shield net) V to revenues	-0,69%	0,74%	0,46%	-0,58%
c=a-b)Free Cash Flows to Pure Lenders V to revenues	0,17%	-1,39%	3,57%	0,22%
d)Financial revenues/costs (tax shield net) V to revenues	0,35%	-0,28%	0,39%	0,31%
e)Net Shareholders' equity V to revenues	-3,80%	-1,35%	-0,55%	-0,87%
f=c+d+e)Financial Surplus (-Deficit) V to revenues	-3,28%	-3,02%	3,40%	-0,33%
g)Third-Parties lenders debt (or net financial position) V to revenues	1,89%	-0,11%	-3,08%	1,13%
h)FCFF actual period to revenues	1,40%	3,13%	-0,32%	-0,80%
i=g+h)Third-Parties lenders debt V vs revenues + FCFF actual period to revenues	3,28%	3,02%	-3,40%	0,33%

Tab. 9 – The main individual factors of the FCFF variances analysis for the Spare Parts Manufacturers

in the Italian Automotive Independent After Market and the impact on the financial structure

In synthesis, in 2011 Spare Parts Manufacturers generate a favorable but insufficient FCFF V: at the same time, they, on the one hand, increase third-parties lenders debt and, secondly,

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decrease shareholders' equity realizing by this way an important change in the Financial Structure in the direction of worsening the level of financial independence.

3. CONCLUDING REMARKS

As shown in the present essay there are strong relationships between free cash flow to firm and financial structure: a rigorous management of FCFF is the best way to manage seriously the financial structure (and sometimes vice versa). The variances analysis is a simple, flexible and precious method able to quantify the impact of the management process, from competitive strategies to managerial actions, on the financial structure equilibrium. Through ebitda, net working capital, fixed assets and taxes variances it's possible to investigate each link between the economic and balance sheet side and the financial one, too often the dark side of the firm crisis/weakness and almost always the true over boosting for a continuous competitiveness. Each variance in the individual factors of the FCFF is, all extraordinary and financial cash in cash out being the same, a variance in the financial structure and consequently it is a variance compared to those who finances the company and its possibilities to belong to the future.

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