Forwards or Backwards

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Business and company finance

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Follow a fictional British manufacturer through retained profits, debt and equity, earnings and cash, dividends, P/E valuation, IPOs and corporate bonds. Dated UK lending data explains how interest rates reach investment and profits. All company figures are labelled illustrations.

Educational documentary. Not financial or investment advice.

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1. One business, three ways to find money



A factory can be busy and still run out of money. Orders arrive, workers need paying, and a new machine could make production cheaper. But the customer may pay after the wage bill falls due. Business finance begins with that awkward gap between a useful idea and the money needed to make it work.

Our example is a fictional British manufacturer called Northbridge Works. Its factory makes metal components. Its accounts and every company figure in this video are illustrations, not reports about a real investment. We will follow the same business from its workshop to its shareholders and lenders.

Money can come from profits kept inside the business, from lenders, or from new owners. Those sources can fund staff, machinery and a reserve for difficult months. Each brings a different claim on what the business produces.

A machine does not care who supplied its purchase money. The people who supplied it certainly do. Some expect repayment on a schedule. Others accept uncertain returns in exchange for owning part of the business.

Retained profits means earnings kept rather than paid to owners. Debt means borrowed money that carries repayment obligations. Equity means ownership, sold through shares in the company.

Keeping profits can be slower than borrowing. Borrowing creates bills even when sales disappoint. Selling ownership shares spreads the risk but gives existing owners a smaller fraction of the whole. There is no universally best choice.

Funding is the money coming in. Value creation is what the business does with it. A larger factory creates value only if the benefits justify the money committed and the risk taken.

That distinction connects all the headlines we are about to meet. Earnings describe what remains after expenses. Dividends distribute part of the result. Valuation asks what those prospects are worth. Shares and bonds give investors different positions in the same story.

2. Why ownership became tradable



To understand shares, briefly leave the factory for a harbour. In sixteen oh two, the Dutch East India Company became an early landmark in exchange history. Its abbreviated name is VOC. Euronext identifies that company and that date with the origins of the Amsterdam exchange.

Amsterdam is in the Netherlands, across the North Sea from London. This locator map shows the places, not a historic shipping route. The harbour behind it is an illustration of the period, not a photograph or an exact reconstruction of a surviving scene.

The useful financial idea is pooling capital. A venture can be too large, too slow or too risky for a single owner. Shares let several owners contribute money and hold separate pieces of the same undertaking.

The timeline starts with the VOC landmark in sixteen oh two. It ends at our modern factory in twenty twenty-six. It links an early example of tradable ownership to a present-day question, without claiming that all company finance began there.

Tradability matters because an investor can seek a buyer for their stake without asking the whole undertaking to close. The company can continue operating while ownership changes hands. A market price also emerges from what buyers offer and sellers accept.

A new share sale can put money into the company. A later sale between investors normally puts money into the seller's pocket. Both involve shares, but the destination of the payment is different.

Return to Northbridge's metal components and machinery. When a pension fund buys its shares from an existing holder, that transaction does not automatically buy the factory a new machine. It changes who owns the claim on the business. Keep that distinction in mind when we reach a public offering.

3. Funding growth and creating value



Northbridge wants to replace a machine and hire staff. The project might improve output, reduce waste and win repeat orders. It could also arrive late, cost more than expected or sit idle. Financing cannot turn a poor project into a good one.

Reinvestment keeps money inside the factory. A loan puts money in now and sends repayments back to the lender later. New equity puts money in from new owners who share the uncertain outcome.

Using retained profits avoids a new lender, but it still has a cost. Owners could have received that money and used it elsewhere. Keeping it requires an explanation of why the factory is a worthwhile place for it.

Imagine existing owners hold a million shares. The company issues another quarter of a million equal shares. Existing holders now own eighty per cent of the total, while new holders own twenty per cent. This is our simplified dilution example.

Dilution means a smaller ownership fraction. It does not necessarily mean a smaller valuable stake. If the extra money funds a successful expansion, a smaller fraction of a more valuable company can be worth more. If it funds persistent losses, the result can be worse.

The project needs returns that justify its financing cost and risk. Expected sales must survive realistic costs, delays and weaker demand. The test concerns the extra investment, not merely whether the company gets bigger.

Debt can protect the existing ownership fraction while increasing financial pressure. Equity can reduce repayment pressure while sharing future gains. In practice, companies often combine sources. The balance changes as their cash generation, opportunities and risks change. Our next task is to see what the factory actually earns.

4. Revenue is not earnings



On an accounting desk sits Northbridge's annual income statement. This is the report that follows sales through expenses to profit. Revenue means sales recorded for the period. It is the starting line, not the amount available to shareholders.

Our illustrative annual revenue is ten million pounds. Operating costs take eight million pounds. That leaves two million pounds before interest and tax, including the machinery's annual depreciation expense within operating costs.

That intermediate profit is called EBIT. The letters stand for earnings before interest and taxes. It helps separate the performance of production and selling from financing costs and tax, though accounting definitions need checking when comparing companies.

Interest takes half a million pounds from that operating result. Tax takes three hundred thousand pounds. Net profit, after those expenses, is one point two million pounds. Here, earnings means that bottom-line profit.

A rising sales total can coexist with falling earnings. Materials might cost more. Customers might demand discounts. The company might need more staff to deliver the same orders. Profit growth therefore needs an explanation of what changed in both revenue and costs.

Growing earnings means the bottom line is rising. Stable earnings means it is broadly holding up. Falling earnings means it is shrinking. Those descriptions need comparable periods and an explanation of unusual gains or losses.

An asset sale could temporarily lift profit without improving the factory's regular business. A weak year could include a charge that will not recur. Neither should be ignored, and neither tells the whole story alone. Looking across several reports helps distinguish a durable improvement from a convenient headline. Now ask whether those earnings actually arrived as cash.

5. Profit is not cash



Northbridge delivers components and sends an invoice. The customer owes money but has not paid yet. On the desk, the sales ledger and the bank statement tell different stories. Profit measures a period's income and expenses under accounting rules; cash measures money actually moving.

A credit sale can enter revenue before the customer's payment arrives. An invoice then becomes cash only when the customer pays. A profitable order can therefore leave a temporary hole in the factory's bank balance.

The company still needs to cover wages while it waits. More orders can deepen that gap if every extra order needs materials purchased before customers pay. Growth can consume money before it produces money.

Buying a machine takes cash when payment is made. Depreciation means spreading the machine's accounting cost over its useful life. The annual expense and the purchase payment belong to different schedules.

That does not make depreciation imaginary. Machines wear out and eventually need replacing. Adding a non-cash charge back when examining cash generation does not remove the future cost of maintaining the factory.

Operating cash flow is cash generated or used by everyday business activity. Investment cash flow records spending such as machinery purchases. Financing cash flow records money raised from owners or lenders and money returned to them.

Together, those categories explain how the bank balance changes. For Northbridge, the practical question is what remains after necessary investment and debt payments. Strong reported profit with slow collections can be fragile. Strong cash from selling a machine can also be temporary. The next headline, the dividend, depends on this distinction.

6. Can the dividend last?



A dividend is a payment to shareholders. For ordinary shares, it is a decision rather than a guaranteed interest bill. Our factory could distribute money, retain it for machinery, or build a buffer. Paying owners today competes with uses of the same cash tomorrow.

Northbridge's illustrative annual dividend totals six hundred thousand pounds. Another six hundred thousand pounds of the year's profit is retained. The split is half for shareholders and half kept in the business, before considering the separate cash-flow question.

The dividend payout ratio means dividends divided by earnings. In this example it is fifty per cent. That tells us the share of profit distributed, but it does not prove that cash after investment comfortably covers the payment.

Each share receives sixty pence for the year. At a share price of twenty-four pounds, the dividend yield is two point five per cent. Yield means the annual dividend divided by the share price.

Yield is a comparison with the price someone pays for the share. It is not an extra payment from the factory. It also cannot promise the dividend will continue.

If the share price falls to twelve pounds, the same dividend produces a five per cent yield. The payment has not grown. The percentage rises because the price has fallen, perhaps because investors fear a future cut.

Suppose the factory needs a replacement machine while customers pay late. Management may cut the dividend to preserve cash. A high headline yield can vanish precisely when the business is under pressure. To understand sustainability, follow cash after investment and debt needs, rather than treating a percentage as a guarantee.

7. What price for those profits?



The factory makes components, but its shares have a price too. Valuation means assessing that price against the business's prospects and risks. A familiar starting point is the price-to-earnings ratio, shortened to P/E. It compares the share price with earnings per share.

Northbridge earns one point two million pounds in our example. With a million equal ordinary shares throughout the year, basic earnings per share is one pound twenty. There are no preferred shares or changing share counts in this simplified calculation.

Earnings per share is often shortened to EPS. It is an allocation of reported profit, not a promise that this amount will be paid as a dividend. Real accounts may also show diluted EPS, which allows for instruments that could create additional shares.

The illustrative share price is twenty-four pounds. Divide that by earnings per share of one pound twenty. The price-to-earnings ratio is twenty, meaning the price is twenty times that year's earnings per share.

That is a ratio, not a repayment timetable. Earnings can rise, fall or disappear. A high ratio might reflect expected growth, resilience or excessive optimism. A low ratio might reflect a neglected opportunity, shrinking earnings or substantial risk. Neither supplies its own verdict.

Trailing earnings means a past reporting period. Forecast earnings means an estimate of a future period. Compare similar businesses using consistent periods, while checking their growth, debt and exposure to setbacks.

A manufacturer with dependable repeat orders differs from one depending on a temporary boom. When earnings are zero or negative, ordinary P/E becomes unhelpful. Other evidence is needed. Even positive earnings can be unusually high at the top of a cycle. The price only makes sense alongside the quality and durability of the profit underneath it.

8. What happens in an IPO?



Now imagine Northbridge offers shares to the public for the first time. An initial public offering is called an IPO. It is commonly accompanied by an exchange listing, which supports subsequent trading. The workshop and its machinery remain the same business even as its ownership arrangements change.

New shares sold in an IPO send proceeds to the company, after offering costs. Existing holders' shares send proceeds to those sellers. An offering can contain both, so the headline total is not necessarily all new money for the factory.

The prospectus is the offering document explaining the business, risks and terms. Its use-of-proceeds section matters because a machine purchase, debt repayment and a founder's sale do different things. None can be inferred from the excitement of a listing alone.

Newly issued shares can dilute existing ownership. Selling an existing share transfers that share without creating another. The terms also identify restrictions on when certain holders may sell, often called lockups.

A lockup delays specified sales for a stated period. It is not a permanent promise that insiders will keep their stakes. Details depend on the offering, so our diagram uses stages rather than inventing a universal number of days.

An offer price belongs to the initial sale. Later market prices belong to subsequent trades. Demand, available supply and new information can move those prices sharply while investors assess the

business.

A rising first-day price does not prove the factory has suddenly earned more. A falling price does not by itself explain what went wrong. The public company still faces questions about orders, margins and cash. Listing makes ownership tradable; it does not turn an uncertain business into a safe one. Investors can also fund companies by lending rather than buying ownership.

9. When investors lend



A corporate bond is a loan to a company, packaged as a security investors can hold or trade. The investor is a creditor, which means someone owed money. Northbridge receives funding now and promises payments under the bond's terms. This differs from owning a share of its uncertain future profits.

Our illustrative bond starts with a thousand-pound principal, the amount borrowed. Its annual coupon rate is six per cent. That gives a sixty-pound interest payment each year, assuming the promise is honoured.

A coupon is the bond's interest payment. For this plain example it is fixed. Other bonds have different terms. A rate printed on the certificate does not necessarily equal the return available at a later market price.

The timeline runs for five years. It shows annual coupons and the principal returning at maturity, the repayment date. The final payment combines that year's interest with the original thousand pounds, if Northbridge pays as promised.

Default means failing to make a promised payment. A creditor's legal claim can still produce a loss when the company lacks enough assets. Priority determines who has an earlier claim, with secured and unsecured debts differing under their terms and applicable law.

Creditors stand ahead of ordinary shareholders in claims when a business fails. That priority does not guarantee full recovery. Owners take the remaining outcome after the obligations ahead of them are

dealt with.

Bond prices also change. If newly available bonds offer better returns for comparable risk, an older fixed payment can become less attractive. Its market price can fall even while the company keeps paying the coupon.

Our fictional corporate yield is six per cent, compared with a four per cent gilt yield. A gilt is a British government bond. The difference is two percentage points, also called two hundred basis points, using comparable currency and maturity.

That difference is the credit spread. It reflects more than expected default losses: trading conditions, demand and sentiment matter too. A narrow spread is not a guarantee of safety. A corporate yield can rise with its government benchmark even if the spread stays unchanged. That leads us back to the factory's borrowing costs.

10. Higher rates change the calculation



Higher interest rates reach a factory through several doors. New loans may cost more. Existing variable-rate borrowing can reprice. Fixed-rate debt can postpone the impact until refinancing, which means replacing an old borrowing arrangement with a new one. The timing matters as much as the headline direction.

The Bank of England's September record reports July twenty twenty-six lending data. New bank loans to private non-financial companies averaged five point six two per cent. The increase was twenty basis points, and this is a corporate lending average rather than Bank Rate.

An average is not the rate Northbridge would necessarily receive. Its size, collateral and financial condition affect the offer. Different types of borrowing also have different prices.

New lending to small and medium-sized enterprises averaged six point six one per cent. The previous reading was six point three six per cent. These figures describe that lending category, not every small company's debt contract.

The September committee judged household and corporate vulnerabilities broadly unchanged since July. It also acknowledged pressure from energy prices and borrowing costs. That combination describes aggregate resilience alongside strain on some borrowers, rather than a prediction that every business will fail.

Higher borrowing costs can reduce the projects a factory can justify. More interest can also reduce profit left after financing. Investors may then change what they will pay for the remaining future cash,

while growth expectations can offset or intensify the effect.

Valuing future money means comparing it with what money can earn elsewhere and allowing for risk. Higher required returns reduce its present value when expected cash is unchanged. Share prices still depend on changing expectations, so this mechanism is not a forecast of a particular market move.

Interest coverage means operating profit before interest and tax divided by the interest bill. Our two-million-pound operating profit covers a half-million-pound interest bill four times. If interest becomes eight hundred thousand pounds, coverage falls to two point five times.

That stress case holds operating profit constant. A fall in orders could make coverage weaker still. Coverage is an earnings test, not a cash balance or a test of principal repayment. Fixed-rate borrowing can delay the squeeze, but an approaching maturity brings the refinancing question back.

11. The five questions to take away



Return to Northbridge's factory, machine and accounts. We have followed funding into production, through profit and cash, and back to owners and creditors. The useful result is a connected set of questions. A dividend, a valuation ratio or a bond yield becomes more meaningful when we know what supports it.

Start with revenue growth: are customers buying more on terms that make sense? Then ask whether profits are sustainable and arrive as cash. A busy workshop can still struggle if its invoices are unpaid or its costs outrun its prices.

For our illustrative business, the income statement explains the profit after expenses. The cash-flow statement explains the bank balance's movement. Neither replaces the other. A durable improvement should be visible in the business explanation as well as the headline numbers.

Next ask how much debt exists and when repayment falls due. Then ask whether earnings comfortably cover interest under weaker conditions. A distant fixed-rate maturity and an imminent refinancing can create different pressures despite similar debt totals.

This is where lenders and shareholders share an interest in the company's survival, while holding different claims. A bondholder cares about promised payments being met. A shareholder also cares about what remains and whether investment can grow that remainder. Both need to understand the cash demands coming first.

Finally ask what price is being paid relative to risk. A share price needs context about growth and earnings quality. A bond yield needs context about default, repayment terms and the comparable government benchmark.

Our fictional factory has no buy or sell verdict. Its purpose is to connect the vocabulary to the movement of money. Retained profits, borrowing and new shares are ways to fund activity. Earnings, dividends and valuations describe different aspects of the result. An IPO changes access to ownership; a bond creates a repayment promise. The central test remains whether the business turns the money entrusted to it into benefits that justify the cost and risk.

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