STRATEGY AND FINANCE – CORPORATE LIFE CYCLE

2017

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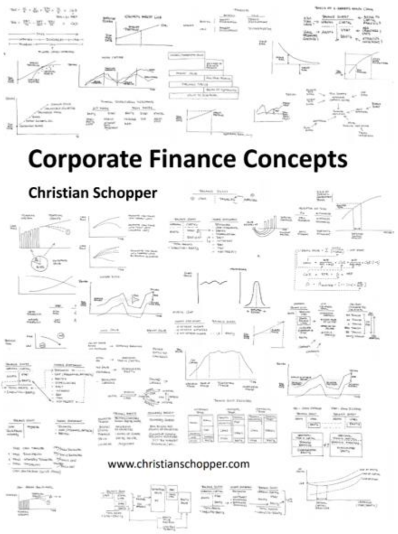

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Intro

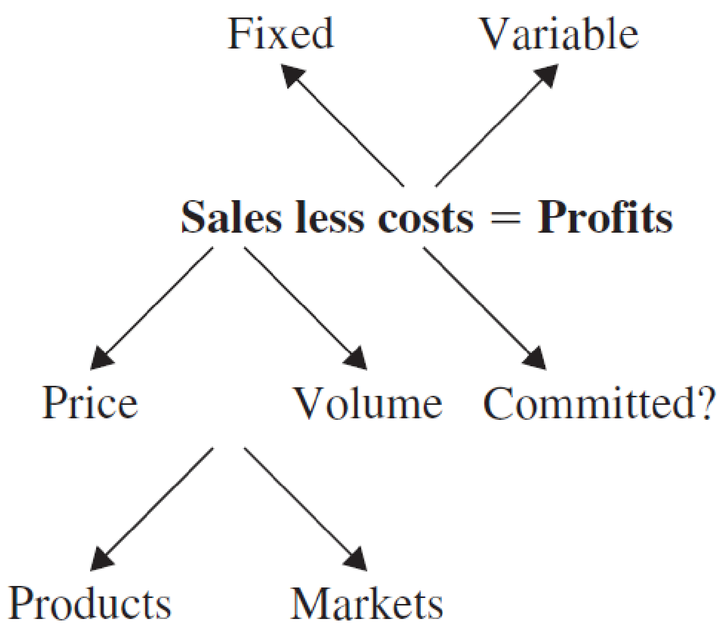
- **Business risk** is the inherent risk associated with the underlying nature of the particular business and the specific competitive strategy that is being implemented
  - It relates to everything except the risk from the financing structure

- **Financing risk** is about debt/equity mix
  - Debt and equity have different risk profiles for investor and company, and their use has to be balanced to meet the company ' s particular circumstances
  - It is inappropriate for a company with high business risk to adopt a financial strategy that involves high financial risk

- A **life cycle model** is introduced, which considers the risks companies face at the launch, growth, maturity, and decline stages

- Latter forms the basis for a profile of the suitable financial strategy for each type of company, showing how its financing and its dividend policy should change as it develops

Assessing Business Risk



- Business risk describes the inherent risk associated with both the **underlying nature of the particular business** and the **specific competitive strategy** which is being implemented

- Thus a very new, focused, single product, high-technology company would have a very high intrinsic business risk

- Business risk thus deals with the **volatility of the operating cash flows**

Analysing Business Risk

Demand volatility

- market factors
- changes in tastes
- short product lives
- competitors' actions

Input cost volatility

- number and strength of suppliers
- efficiency
- relative level of fixed costs
- reliance on commodity markets
- level of committed costs in terms of volume and price

Growth drivers

- ability to develop new products
- ability to find new sites on which to expand
- ability of existing management to take the company to the next stage of development

Selling price volatility

- market factors
- price wars
- economic conditions
- prices of substitutes and complements
- over-supply (or shortages)

Expense volatility

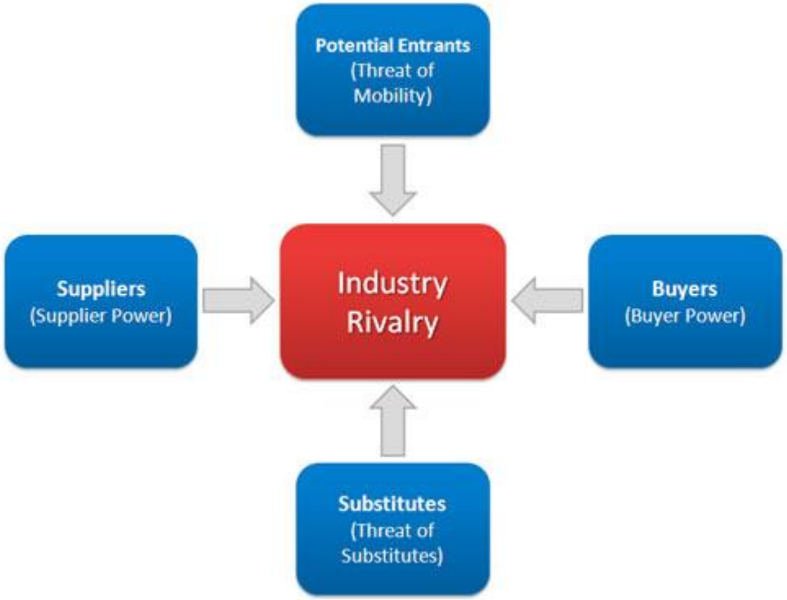
- reliance on key suppliers
- relative level of fixed costs
- how significant is the level of expenses relative to the size of the business?
- level of committed costs (e.g. leases)

Other issues to consider

- industry analysis – relative strengths of rivals, suppliers, and customers; likelihood of new industry entrants; availability of substitutes
- analysis of political, environmental, social, technological, legal, and economic developments that may affect future business
- working capital needs
- exposure to currency risks

Strategic Analysis

Porter´s Five Forces



- Indicate the **attractiveness of an industry to a particular player**, and suggest where they might wish to compete:
  - The relative bargaining power of buyers,
  - The relative bargaining power of suppliers,
  - The threat of new entrants,
  - The threat of substitute products,
  - The degree of rivalry amongst existing firms in the industry

- By rating the threat posed by each of the five areas, a quick picture of industry attractiveness can be obtained as well

Strategic Analysis (cont´d)

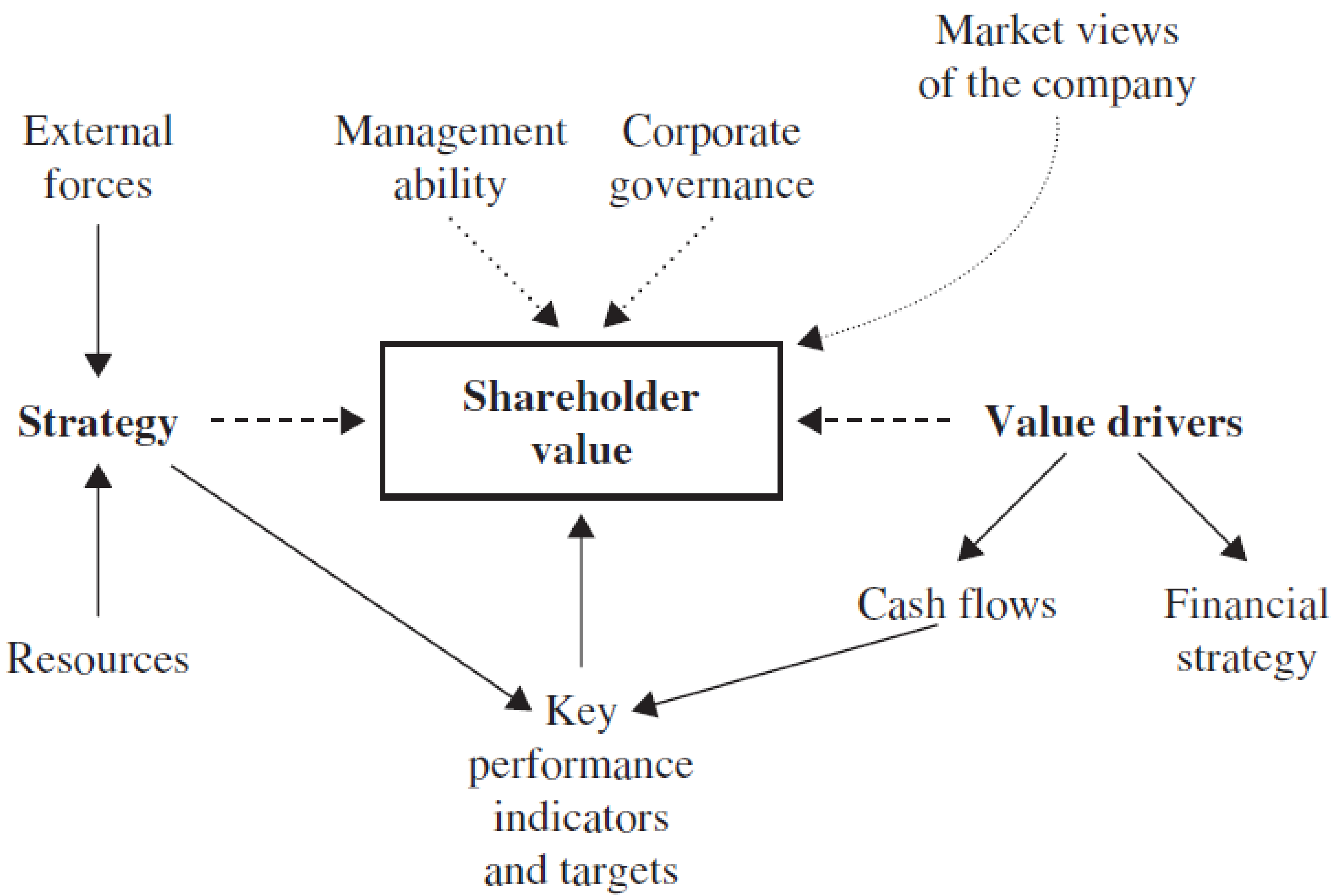
Pestle Analysis

- It is essential to understand how **changes in certain parameters** will **affect** industry **attractiveness** and ongoing strategy
  - Political
  - Economic
  - Social
  - Technological
  - Legal and
  - Environmental issues

Resource-Based Theory

- Focuses on the **competitive advantage** in the company's own **unique set of assets**
- Respective assets should have the following characteristics :
  - Valuable
  - Rare
  - Imperfectly imitable and
  - Non-substitutable

Linking Corporate and Financial Strategies



Creating Shareholder Value

Value drivers as per Alfred Rappaport

1. Increase sales growth
2. Increase operating profit margin
3. Reduce cash tax rate
4. Reduce incremental investment in capital expenditure
5. Reduce investment in working capital
6. Increase time period of competitive advantage
7. Reduce cost of capital

- In **different businesses, different drivers** will be more important
  - **Hotel**
    - Amid high fixed cost base, most important driver is sales (i.e. occupancy rate)
    - Increasing the sale of room nights by 10% is likely to have far more of an impact on value than increasing margins by 10%
  - **Bank lending to corporate customers**
    - Profits arise from slim margin between the rate at which the bank borrows and that at which it lends
    - More value will be created by improving interest margins and by reducing operating costs than can be derived from increasing volume

Constituents of Financial Strategy

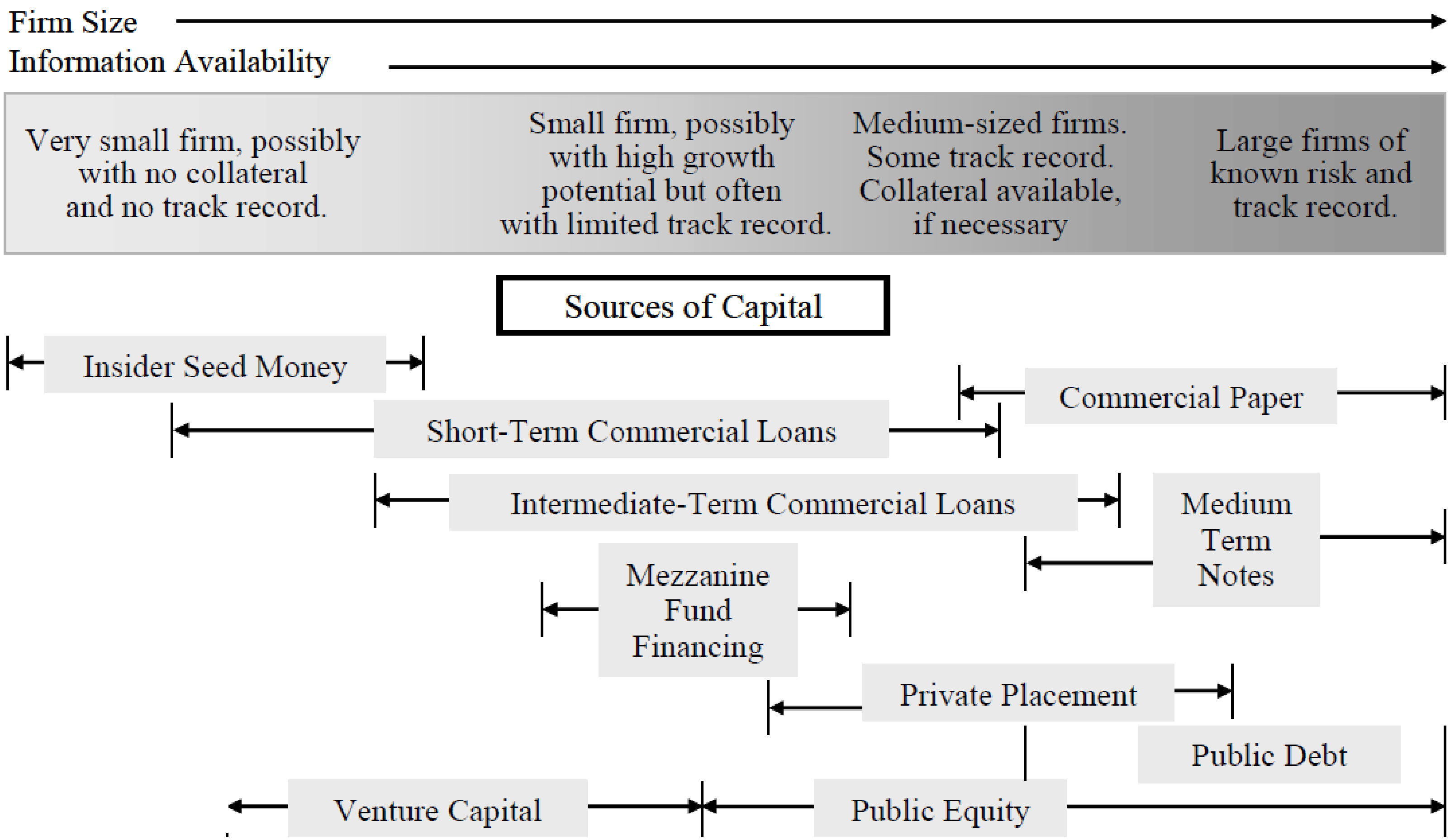
- Financial strategy is in essence driven by the **flows of funds** through a company as a basis to generate profits (dividends, retained earnings)

- Those **profits** will **depend on** its **operating efficiency**
  – But the ultimate level available to shareholders will depend on the interest burden - which itself depends on the level of debt it takes on

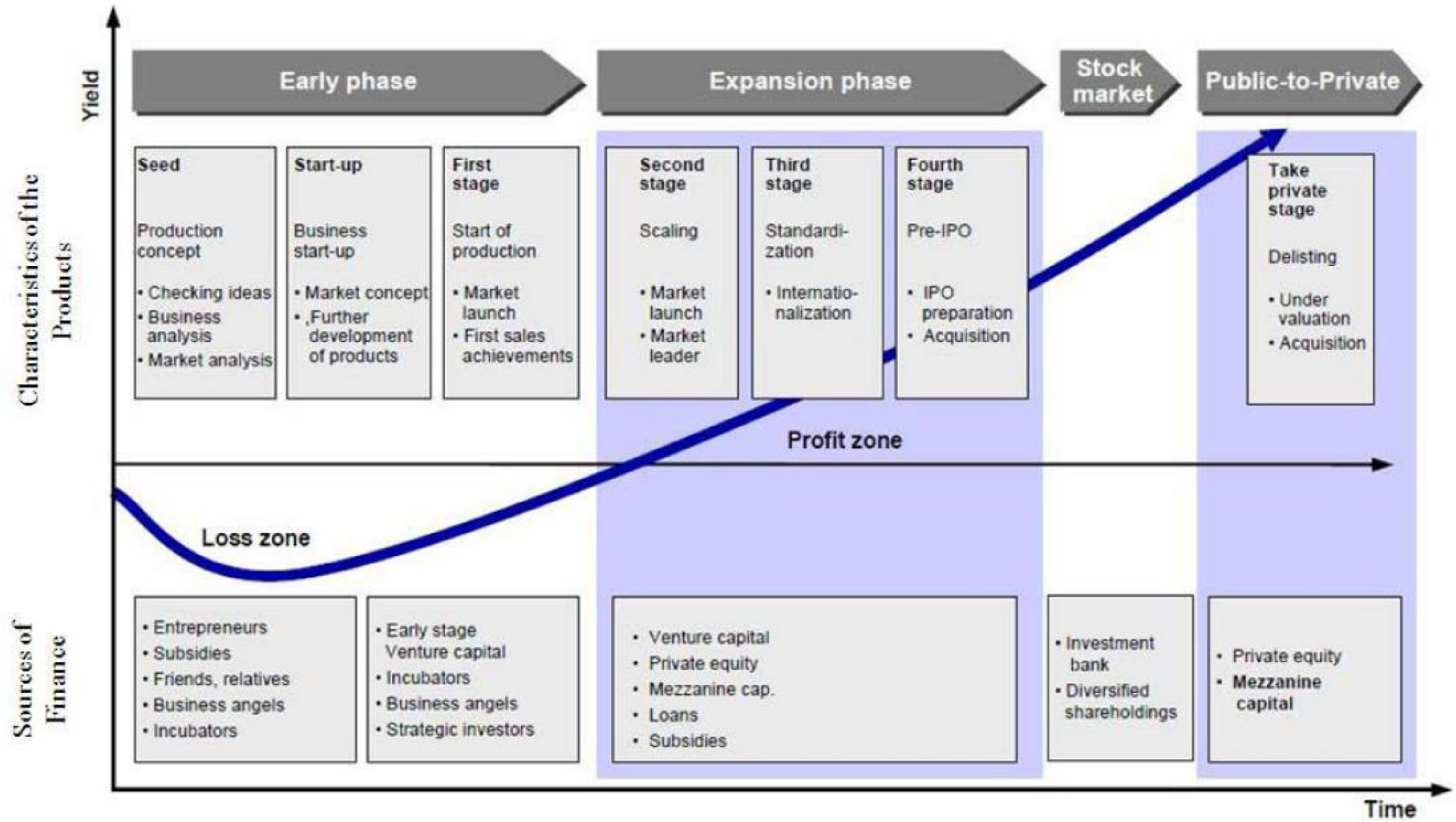
- Thus three **decisions** are to be made:
  1. How large do we want (or need) the **asset base** to be?
  2. How much of the company`s finance should be as **debt**?
  3. How much of the profit should be paid out in **dividend** (and how much should be retained)?

- The three decisions above describe a relatively closed system. There is however another decision to be made:
  – 4. Should we issue new **equity**?

Sources of Capital



Sources of Capital (cont´d)



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Financial Risk

	Debt	Equity
Features for user (the company)	• Interest must be paid • Repayments must be made • The lender may have the right to repossess assets A HIGH-RISK INSTRUMENT	• Can choose whether to pay dividends • No repayment obligation A LOW-RISK INSTRUMENT
Features for provider (the investor)	• Interest is contractual • Repayment is contractual • The lender may obtain security A LOW-RISK INSTRUMENT	• Dividends are at the discretion of the company • No requirement to repay the capital A HIGH-RISK INSTRUMENT

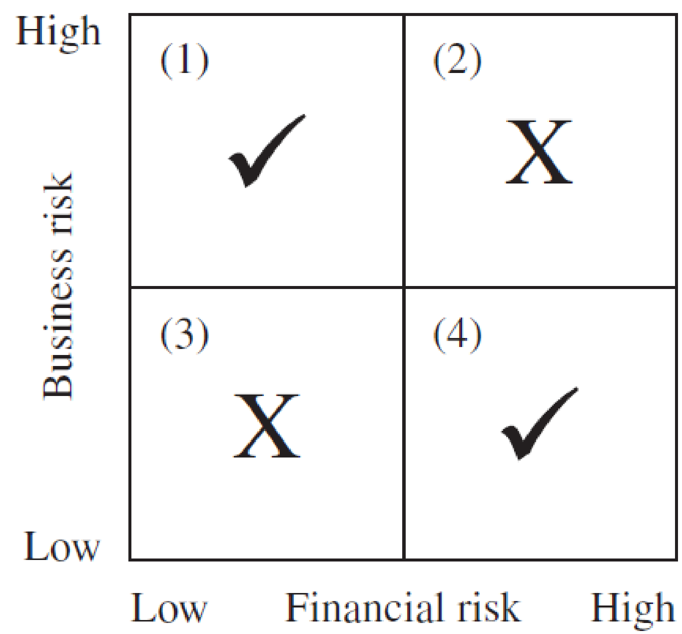
Balancing Business and Financial Risks

Financial risk should complement the business risk profile

- E.g.: High business risk firms to use low-risk financing (equity, VC), and keep cost bases utmost variable and discretionary

- E.g.: Combination of low business risk strategy and even lower financial risk (i) is unsatisfactory for shareholders, and (ii) can lead to hostile takeover bids amid undervaluation by the capital markets

- Hence, there should be an **inverse correlation** between the business risk of a company and its financial risk profile



Excursion: Privately-Held Companies

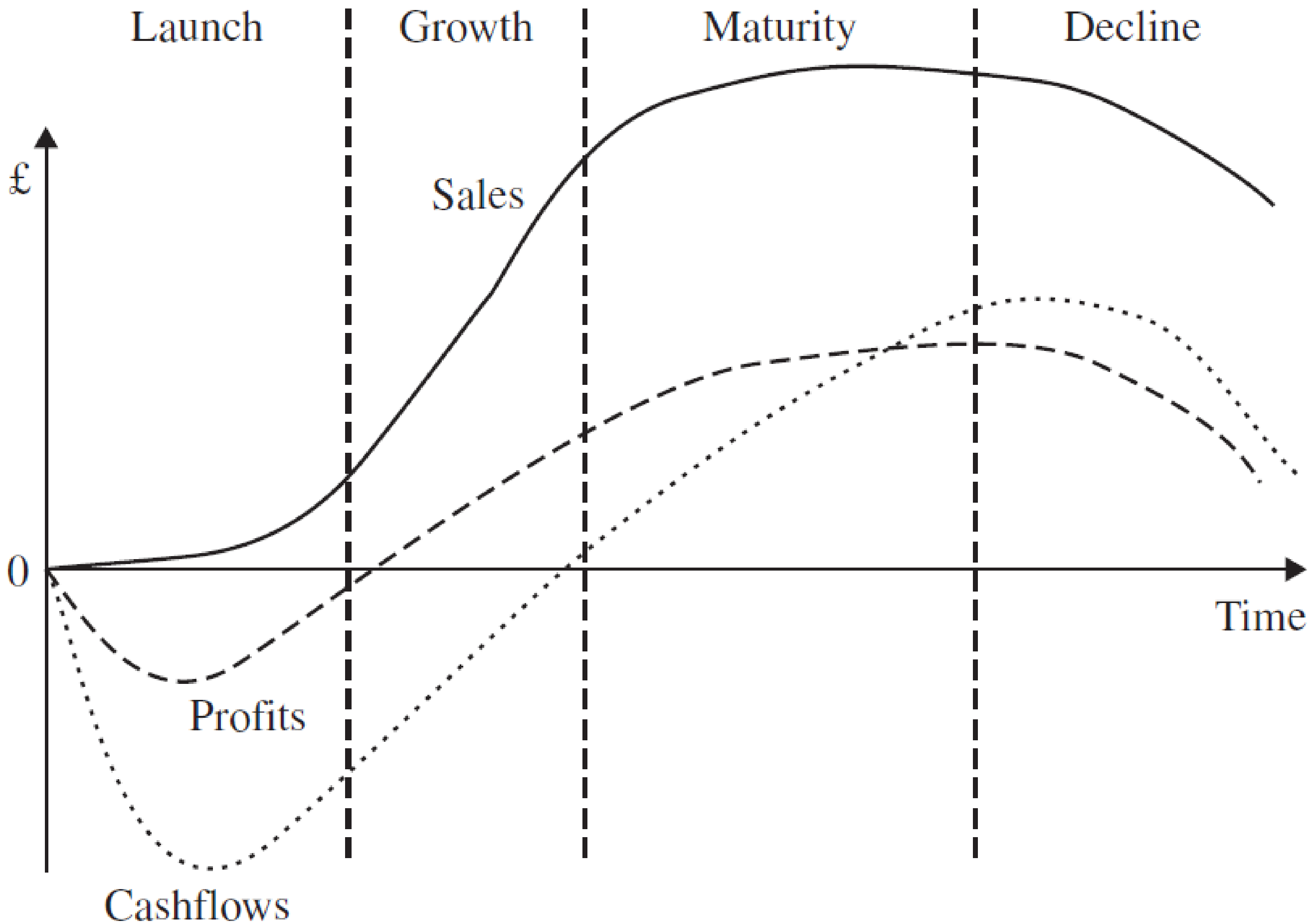
- **Directors** of private companies are **often** the **owners**, or there is likely a strong link
  - Accordingly, the directors can ask the shareholders directly what they want from the company

- In many private companies the **chief objectives** may be **financial security** for the (family) shareholders - and not shareholder value

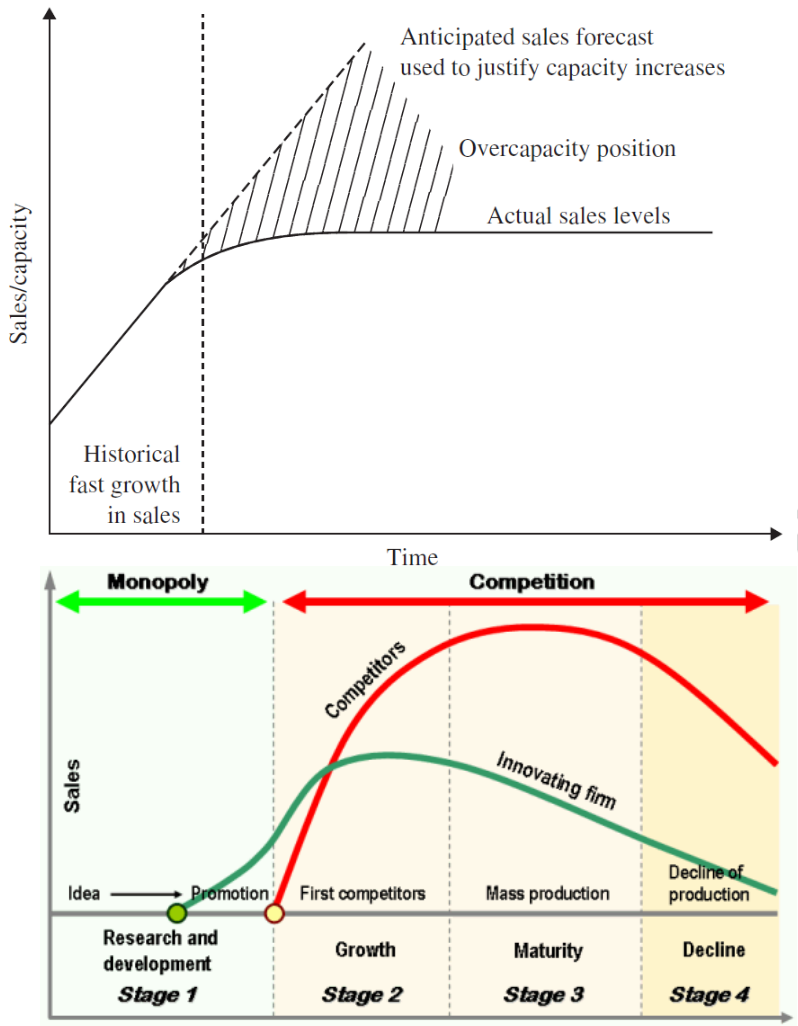
- Accordingly, shareholders in private companies may be **reluctant to take on any debt**

- Also, private companies are **not exposed** to potential threats of **hostile takeovers**
  - Therefore, there is no need to follow the prescribed strategy of gearing up a low-risk business

Understanding the Life Cycle



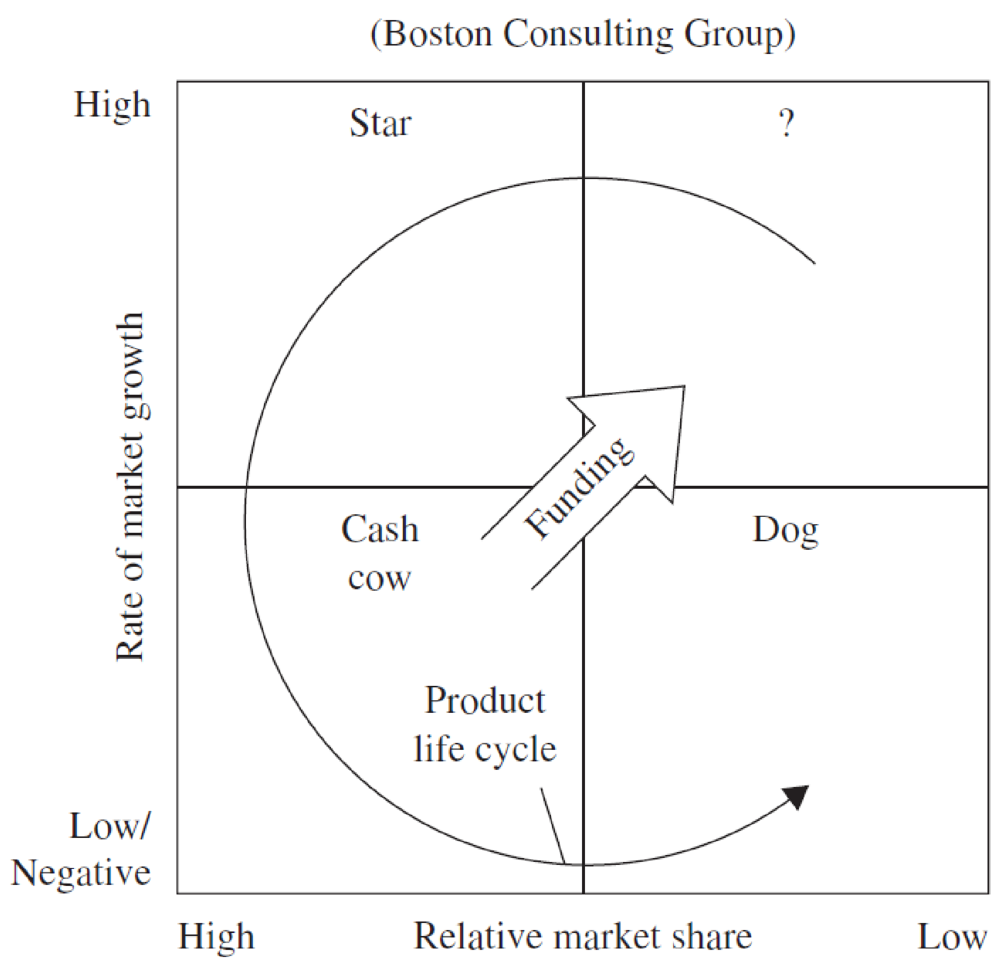
Growth and Shake-Out



- Fast growth in demand attracts **late entrants**…
  - Product risk reduced since accepted by the customers
- … as continuing growth indicates opportunity for attractive returns

- New entrants and existing players – both trying to increase market shares - **increase** total industry **capacity**, even though demand stabilizes
- Fierce **price competition** may be the consequence **until** a more stable **equilibrium** position is established

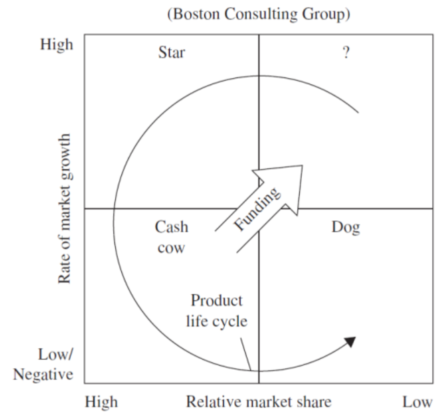
The Boston Matrix



Business Risk over the Life Cycle

LAUNCH	GROWTH	MATURITY	DECLINE
• Product risk • Market acceptance • Market share • Size of market at maturity • Length of maturity period • Maintenance of market share • Rate of eventual decline	• Market share • Size of market at maturity • Length of maturity period • Maintenance of market share • Rate of eventual decline	• Length of maturity period • Maintenance of market share • Rate of eventual decline	• Rate of eventual decline

Business risk



Growth High	**Launch** Very high
Maturity Medium	**Decline** Low

Net Cash Flows at Different Stages of Development

Growth	Launch
Cash inflow:	**Cash inflow:**
Sales **High**	Sales **Low**
Cash outflow:	**Cash outflow:**
Marketing, fixed assets, working capital, etc. **High**	R&D, launch marketing, fixed assets, etc. **High**
Net cash flow ?	**Net cash flow Negative**
Cash flow starts negative, becoming neutral or positive	

Funding

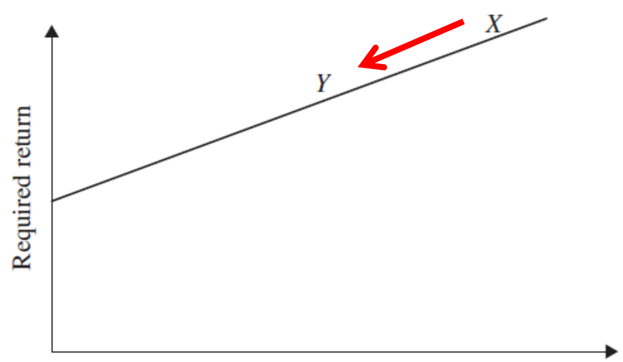
Maturity	Decline
Cash inflow:	**Cash inflow:**
Sales **High**	Sales **Low**
Cash outflow:	**Cash outflow:**
Ongoing cost base **Low**	Maintenance. **Low**
Net cash flow Positive	**Net cash flow Neutral**
	Cash flow starts positive, becoming neutral

Changing the Financial Strategy over the Life Cycle

Growth	Launch
Business risk high Financial risk low	*Business risk v. high* Financial risk very low
Maturity *Business risk medium* Financial risk medium	**Decline** *Business risk low* Financial risk high

Growth	Launch
Business risk high *Financial risk low* Equity (growth investors)	*Business risk v. high* *Financial risk v. low* Equity (venture capital)
Maturity *Business risk medium* *Financial risk medium* Debt and equity (retained earnings)	**Decline** *Business risk low* *Financial risk high* Debt

The changing risk profile of equity investment



Debt Profile

How much should be borrowed short-term, and long-term?

- Depending on company's business, assets, structure of operations
- **Matching**
  - Long-term (short-term) assets with long-term (short-term) finance
  - However, e.g.: A company´s permanent working capital should be regarded as part of long-term needs …

- **Long-term** finance "**cannot be taken away**" …
- … whilst **short-term** debt **needs** to be **refinanced** at regular intervals
  - May be serious, if – e.g. – a company's financial situation deteriorated or the credit market tightened …
- Capital Markets **Arbitrage**
  - If short-term interest rates are considerably lower than long-term ones, and the company believes that long-term rates will fall …
  - May be worth using short-term finance to start, with the intention of refinancing later …

Dividend Policy

Growth	Launch
Business risk high *Financial risk low* *Funding equity* **Nominal dividend payout ratio**	*Business risk v. high* *Financial risk v. low* *Funding equity* **Nil dividend payout ratio**
Maturity	**Decline**
Business risk medium *Financial risk medium* *Funding debt* **High dividend payout ratio**	*Business risk low* *Financial risk high* *Funding debt* **Total dividend payout ratio**

Potential for Agency Theory Conflicts

- Senior **managers** normally prefers to **retain surplus funds**
  - Provide **operational flexibility** should an attractive opportunity be identified …
  - … and also act as a **buffer** in case there is an unforeseen economic downturn or adverse change

- Concept of maximizing **shareholder wealth conflicts with** concept of **reducing** either managerial **risk or accountability**

Dividend Policy - Example

- A **reduced risk profile** results in investors demanding a **lower total rate of return**
  - The sort of relationships which can apply between dividend yields and capital growth

Stage of Maturity	Launch	Growth	Maturity	Decline
Investor yield demand	**40%**	**25%**	**15%**	**12%**
Dividend Yield	0%	2%	12%	18%
Capital Growth	40%	23%	3%	-6%

The Impact on P/E

- The **capital growth component** of the total expected shareholder return **reduces** as the product passes through its **life cycle**

- A company's P/E ratio reflects its expected future growth prospects: the higher the growth expectations, the higher the P/E. Accordingly, the **P/E ratio might be expected to fall** over the company's life cycle

Growth *Business risk high* *Financial risk low* *Funding equity* *Divd. payout nominal* **High growth**	**Launch** *Business risk v. high* *Financial risk v. low* *Funding equity* *Divd. payout nil* **Very high growth**
Maturity *Business risk medium* *Financial risk medium* *Funding debt* *Divd. payout high* **Med/low growth**	**Decline** *Business risk low* *Financial risk high* *Funding debt* *Divd. payout total* **Negative growth**

Growth *Business risk high* *Financial risk low* *Funding equity* *Divd. payout nominal* *Growth high* **High P/E**	**Launch** *Business risk v. high* *Financial risk v. low* *Funding equity* *Divd. payout nil* *Growth v. high* **Very high P/E**
Maturity *Business risk medium* *Financial risk medium* *Funding debt* *Divd. payout high* *Growth med/low* **Med/low P/E**	**Decline** *Business risk low* *Financial risk high* *Funding debt* *Divd. payout total* *Growth negative* **Low P/E**

Impact on Required EPS of a Declining P/E Multiple

- **To deliver value from a current, stable share price, eps must rise**
  - (Very) **high real growth in eps** is already **included in** the **share price** when a (very) high P/E multiple is applied to a company
  - The actual delivery of expected growth will not make the share price increase because this has already been taken account of in the current share price
  - The **share price** will **only rise if growth exceeds expectations**

Stage of Maturity	Launch	Growth	Maturity	Decline
Investor yield demand	**40%**	**25%**	**15%**	**12%**
Dividend Yield	0%	2%	12%	18%
Capital Growth	40%	23%	3%	-6%
Assumed appropriate P/E	40	20	10	4
Share Price	100	100	100	100
Required EPS	2,5	5,0	10,0	25,0
Required EPS Growth		100,0%	100,0%	150,0%
Example: Actual EPS	2,5	5,0	9,0	15,0
Actual EPS Growth		100,0%	80,0%	66,7%
Resulting Share Price	**100**	**100**	**90**	**60**
Actual Share Price Growth		0,0%	-10,0%	-33,3%

Impact on Required EPS of a Declining P/E Multiple: The Uphill Struggle

- The **need for eps to grow at a faster rate than the share price …**
- The growth in share price required to give shareholders their expected total annual return (including the capital gain element) is dramatic
- Due to declining P/E multiple the required increase in eps needed to generate this final share price is even greater

Stage of Maturity	Launch	Growth	Maturity	Decline
# Years in Stage	2	5	10	7
Investor yield demand	**40%**	**23%**	**3%**	**-6%**
Stage Yield Factor	**196%**	**282%**	**134%**	**65%**
Share Price Dynamics				
Beginning of Stage	100	196	552	742
End of Stage	196	552	742	481
Share price Growth	**96%**	**182%**	**34%**	**-35%**
Assumed appropriate P/E	40	20	10	4
Required EPS (Beginning Stage)	2,5	9,8	55,2	185,4
EPS Growth		**292,0%**	**463,1%**	**236,0%**
Required EPS (Beginning Stage)	4,9	27,6	74,2	120,2
EPS Growth		**463,1%**	**168,8%**	**62,1%**

Example: The Truth Hidden by IBM's Buybacks

October 20, 2014 8:58 pm

- "For many years, the International Business Machines Corporation's earnings glided smoothly upward. **Every quarter, IBM would report higher earnings per share**. Even Warren Buffett invested in the company, disregarding his long-held aversion to technology companies as too challenging to forecast."
- "Virginia M. Rometty, IBM's chief executive — and recently anointed the most powerful woman in business by Fortune magazine — has talked a good game about focusing on "shareholder value." For the first several years of her tenure, she managed to prop up the stock by buying back shares by the cartload. In the first six months of this year, the company spent more than $12 billion — that's billion with a "b" — on its own shares. She's also been sending shareholders thank-you presents in the form of large dividends."
- "But all these "shareholder friendly" maneuvers have been masking an ugly truth: IBM's success in recent years has been tied more to **financial engineering than actual performance**."
- "That became readily apparent Monday morning when the company announced its earnings missing analysts' expectations by a wide margin. The stock fell more than 7 percent to $169.10 by the end of the day, below the average price Mr. Buffett paid since he started buying the stock in 2011."
- "The company's revenue hasn't grown in years. Indeed, IBM's revenue is about the same as it was in 2008."

Share Price vs Volatility

- The share price (multiplying P/E with eps) level depends on the proportion of the total shareholders ’ return which must be delivered through capital growth
- The share price should be increasing during the launch and growth stages, and then stabilize during maturity, before declining during the product’s final phase of its life cycle

Growth	Launch
Business risk high *Financial risk low* *Funding equity* *Dividend payout nominal* *Growth high* *P/E high* *Eps low* **Share price growing and volatile**	*Business risk very high* *Financial risk very low* *Funding equity* *Divdend payout nil* *Growth very high* *P/E very high* *Eps nominal* **Share price growing and highly volatile**
Maturity *Business risk medium* *Financial risk medium* *Funding debt* *Divdend. payout high* *Growth medium/low* *P/E medium* *Eps high* **Share price stable with limited volatility**	**Decline** *Business risk low* *Financial risk high* *Funding debt* *Divdend payout total* *Growth negative* *P/E low* *Eps declining* **Share price declining and volatile**

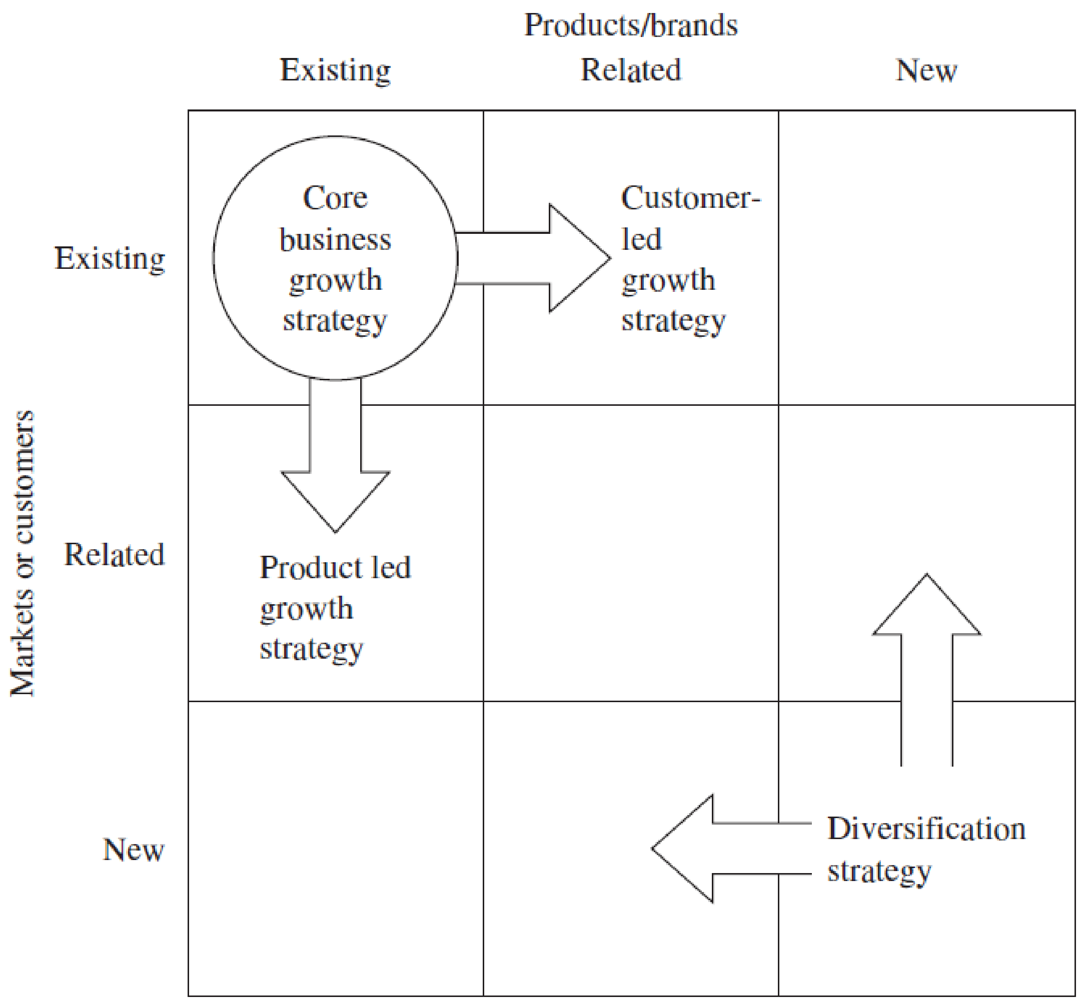
Diversification Strategy to Counter Decline

- Decline is usually not an attractive proposition for managers and some of the stakeholders, but a possible liquidation is not necessarily of great concern to shareholders
  - Shareholders are likely to change-over time as the relative balance in the form of their financial return between capital gain and dividend yield changes

- Most companies regard **diversification** as a **risk reduction exercise** …
  - For the **shareholder**, it is clear that investing in a portfolio of shares spreads, and hence **reduces**, the **risk** associated with any one share
- … but this may mean moving into areas where it has **no experience**

- Also, it is difficult for a company **with businesses at different stages of the life cycle**, to communicate a clear, focused financial strategy to the financial markets via its dividend policy or its debt-to-equity ratio
  - Theoretically such a conglomerate should be valued by the financial markets at a minimum of the weighted average P/E multiple of its component businesses

Growth Strategy vs Diversification Strategy



Consequence of Diversification

- Threat of **takeover** and **break-up** for many large diversified groups

- Target **financial return to be set for each division** based on an assessment of the associated risk
  - E.g.: A start-up division would be treated as effectively having venture capital funding, with a consequently high requirement for financial return

- Clear, specific financial targets for each division helps to focus the attention of divisional managers

Summary

- Risk relates to the volatility of expected results
- The appropriate business strategy takes account of strategic analysis in the light of the seven drivers of value
- Financial strategy covers four decisions:
  - How much to invest in assets?
  - How to finance the business?
  - Dividend policy?
  - New equity?
- A company's choice of financial strategy must relate to its business strategy, its business risk, and the cash flows it is expected to generate
- The life cycle model shows how business risk is to change and financial strategy is to develop
- Start-ups and growth companies are usually high-risk businesses and should adopt low-risk financing structures, primarily equity based
- Mature companies are cash-generative low-risk businesses, which can improve return to shareholders by increasing financing risk (i.e. debt)
- Businesses in managed decline should pay out as much in dividend and borrow as much as they are able

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