CHAPTER 1

FINANCE STRATEGY

1. Corporate mission and strategy

Mission

What do you want most in life? Children are often asked this question from a young age: those that want to help people may grow up to be nurses or policeman, whilst those who want to express themselves may grow into actors or artists. Well, all companies ask themselves the same question, and the answer becomes their mission. This is a sort of raison d'etre which the entire company is focused on, and which informs their future in the same way as children making that early decision.

A **mission** is a company's overall purpose and is defined by CIMA as a **"Fundamental objective of an entity, expressed in general terms"**. Most large companies have mission statements, which can vary from the very general:

"To embrace the human spirit and let it fly."

Virgin Atlantic (2017)

To being about world domination:

"To be the Earth's most customer-centric company where people can find and discover anything they want to buy online."

Amazon.com (2017)

Not all mission statements are as succinct, however, as Avon's is a whopping 249 words long! Similarly, others fail to inform you of anything at all, such as American label manufacturer Avery Dennison's promise to "Help make every brand more inspiring, and the world more intelligent." Whilst ambitious, both statements fail by not providing a clear enough focus for strategy.

Objectives

In order to focus an organisation, the mission must be translated into specific objectives. After all, if you were a director of Virgin Atlantic, what exactly does 'embrac[ing] the human spirit and let[ting] it fly' really mean for the business? It's simply not clear. **Objectives,** on the other hand, **are clear, focused and specific.**

An airline might, for example, have objectives in areas such as:

- Profitability
- Revenues
- Cash flows
- Return on investment
- Customer service
- Service quality
- On time arrivals
- Innovation
- Staff satisfaction
- Productivity measures (e.g. average percentage occupancy of flights)

These will give a clear and specific focus for the managers and directors of the business to work towards. From this a strategy can be created. Critically, **many objectives have a financial focus** and are known as financial objectives. **These set clear targets for the financial results and funding for the business.**

Can you see the examples of financial objectives in our list above? They are profitability, revenues, cash flows and return on investment.

Going back to Virgin Atlantic, we could translate the mission statement of "embrace the human spirit and fly" into a specific financial objective such as generating $10 million in profit per year.

Corporate/business strategy

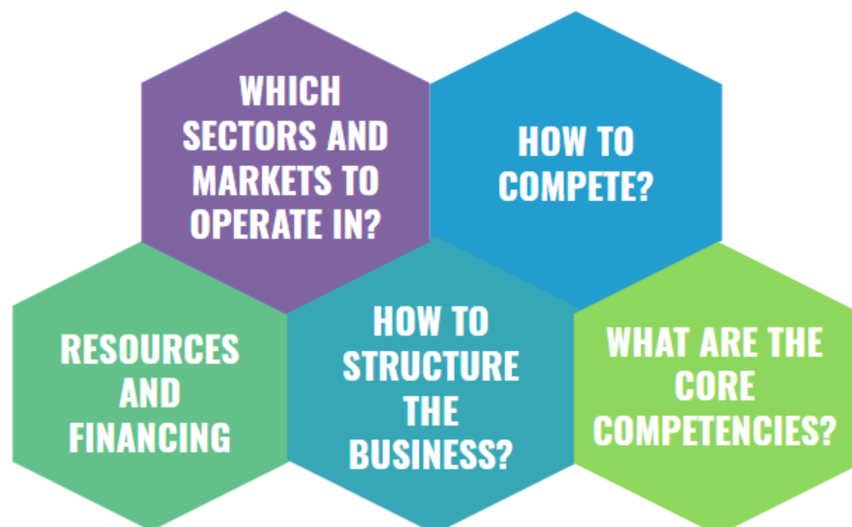
A strategy can be seen as the vehicle which drives a company to meet specific objectives, and CIMA phrase this quite simply:

"A strategy is a course of action, including the specification of resources required, to achieve a specific objective."

(CIMA Official Terminology, 2005)

Whilst objectives provide the answer to the question "What is the company trying to achieve?" A strategy provides the answer to "How will the company achieve it?". For example, it's all very well setting a target to generate that $10m of profit, but we need to have a plan in place in order to achieve this!

The corporate strategy provides the direction for the business as a whole, including all parts of the business.



It includes consideration of:

- Which business **sectors and markets** should the organisation operate in? - Should it focus on one type of customer, one type of product and one location, or many?
- What are **the core competencies** – The skills that provide competitive advantage - and how should they be maintained and increased?
- **Resources and financing** - What resources do we have? What do we need and how can we fund them? Will we use loans or equity?
- **How to compete** - How can we gain and maintain an advantage over our rivals?
- **How to structure the business** -The way we build and organise our activities will have an effect on the way things get done. Should we divide the company up by function or in some other way?

Going back to Virgin Atlantic (2017) for a moment; they aim to be successful by creating an airline with a very particular vision:

"Our objective is to fly a profitable airline that people love to fly and where people love to work. Our focus is on further improving customer services for our business and leisure travellers, as well as setting new standards for the rest of the industry to follow. Our strategy is to ensure we offer the best business product in the air, grow our leisure business even further, and run an efficient but effective global airline."

Of course, that's just their published strategy. Internally they would break that down into a lot more detail to focus on how each of the key objectives would be hit. **In many businesses each separate business unit will have their own strategy, known as their business strategy.** It could be, for instance, that an airline has a different business strategy for growth in Asia compared to the US or Europe; one which takes into account the different markets, cultures, competition, pricing, politics, laws and economies.

2. Finance strategy

Example

Let's look at this journey from mission statement to finance strategy through an example company, Jubbly Juice. Jubbly Juice manufacture small cartons of juice for lunch boxes, and they are hoping to double their revenues by launching a new range of smoothies.

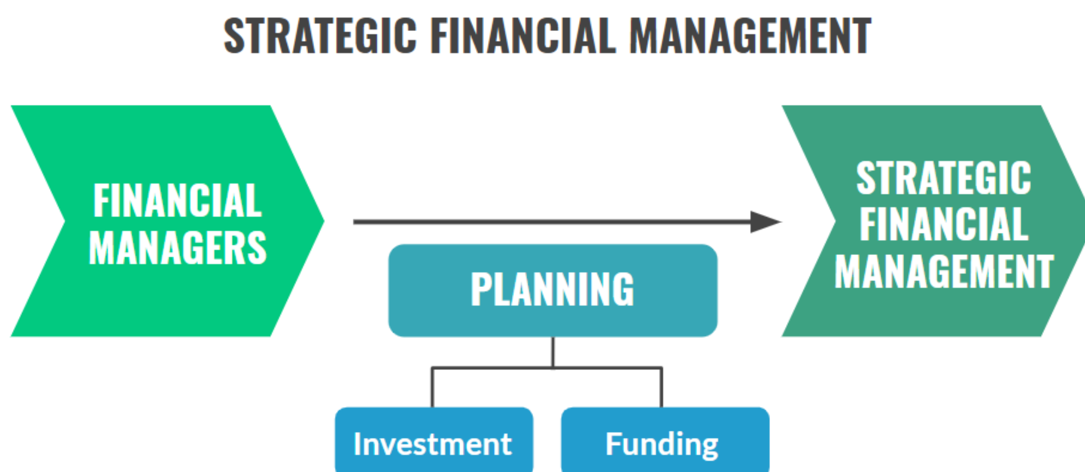
Here's how this flows down to the financial strategy:

This is, of course, just one small element of the Jubbly Juice overall plan. There will be other objectives too - each with their own strategies for success. However, this example clearly demonstrates the hierarchy of business planning and how those elements at the top lead down to the plans at the bottom.

3. The key decisions of financial strategy

Strategic financial management

Developing a financial strategy requires planning and making decisions on investments, funding, and payments to the providers of finance (e.g. interests or dividends). This **planning is the realm of strategic financial management and is undertaken by financial managers**. It is their skills that can turn financial objectives into financial reality!



CIMA provide us with a formal **definition of strategic financial management for private sector organisations**:

"**The identification of the possible strategies capable of maximising an entity's net present value, the allocation of scarce capital resources among the competing opportunities and the implementation and monitoring of the chosen strategy so as to achieve stated objectives**".

(CIMA Official Terminology 2005)

Let's break that down piece by piece:

Identifying strategies - This is where the possible strategic projects (e.g. new products, new markets, diversification strategies) that the organisation can take, are identified. This is often done as part of the organisation's corporate and business strategy development process.

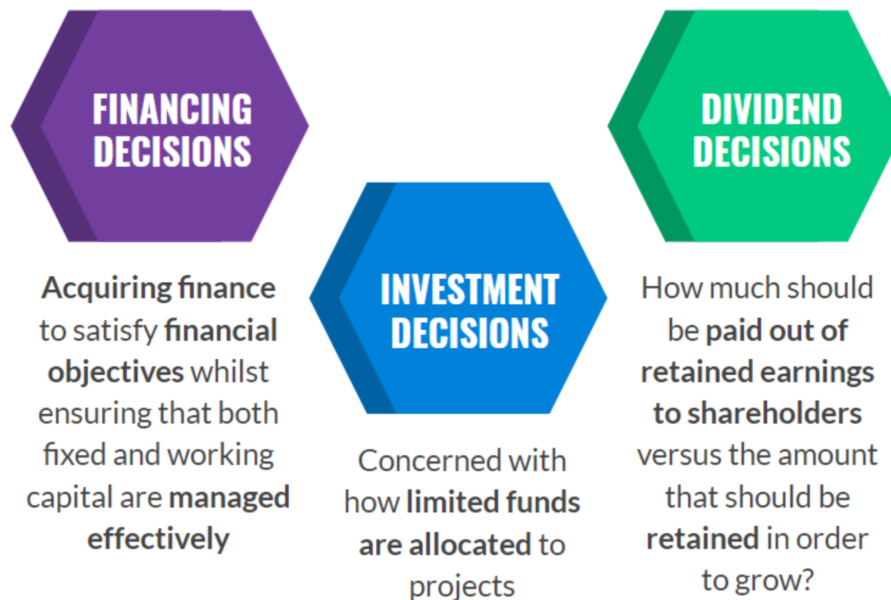
Maximising an entity's net present value - The higher the NPV of the organisation's future cash flows the higher its value. As a result, this element is designed to ensure that the strategy aims to maximise shareholder wealth – the primary goal of most private sector organisations.

Allocation of scarce capital resources among the competing opportunities - Funds will always be limited and this process decides on the projects that will help to maximise the benefits (in NPV terms) of those limited funds. In practice, this means evaluating the NPV of new projects which are being suggested as part of the organisation's overall corporate strategy and recommended those which are the best.

Monitoring the chosen strategy - This process evaluates whether the projects will work out as expected and includes making appropriate adjustments and changes. For example, abandoning an existing product which is no longer profitable.

The three decisions of strategic financial management

In practice, strategic financial management can be achieved by making decisions based on three key decisions: investment decisions, financing decisions and dividend decisions.



These decisions are interrelated:

Investment decisions

If your company only has £10m, and you have three projects which each need £5m, how would you decide which ones to fund? This is an investment decision, and **investment decisions are concerned with how limited funds are allocated to projects**. These could include investments in fixed assets, working capital, mergers and acquisitions, sell-offs and divestments. As we've seen from our definition of strategic financial management the best way to appraise decisions like this is through the Net Present Value (NPV) method since the higher the NPV the greater the value of the investment.

A key part of the financial manager's role is to understand the short, medium and long-term capital requirements for investment that fits the overall strategy.

Financing decisions

There are currently over fifty banks operating in the UK, and so for UK companies, deciding which is best for their finance requirements can be tricky - especially with all of them having a wide range of products! This is one of many financing decisions, which are to do with acquiring the appropriate finance to satisfy financial objectives whilst making sure that both fixed (long-term) and working (day-to-day) capital are effectively managed.

Financing decisions are based on:

- **The level of funding that is sourced from internal sources, i.e. from the business operations**. As such, a company with higher profits (and lower dividends) will be able to finance itself to a greater extent from cash retained in the business or which will be generated in future periods.
- **The long-term capital structure of the company**. This is whether new external funding is sourced via **debt or equity**. A company may choose debt due to lower costs, as it is the cheaper form of finance, or equity as it is lower risk (as there are no compulsory repayments). Equally, they may have high levels of outstanding debt and decide to finance using equity to create a good balance.
- **The level of shorter term working capital funding required to pay debts as they fall due**. This could come from long-term finance or short-term credit such as using an overdraft**.** Companies aim to have a balance of long- and short-term debt, such that the long-term debt covers most day-to-day requirements (as it is often lower cost) and short-term debt (such as an overdraft which has high levels of interest) is used occasionally when there is a short-term cash requirement.

Dividend decisions

How much do you pay your shareholders and how much do you retain in the business to invest?

Shareholders and owners seek returns from their investment in two ways: income in the form of dividends and capital growth through an increase in share price. Thus, **dividend decisions are based around how much should be paid out of retained earnings to shareholders versus the amount that should be retained in order to grow**.

Interrelationship between the three decisions

The three decisions are closely linked. Let's look at 3 ways in which this is the case:

1. Investment and raising funds - An entity cannot make a decision to invest without considering how the funds will be raised – be that through the finance decision, raising debt or equity, or the dividend decision, reducing dividends to retain cash in the business.

2. Dividends paid to shareholders reward them for the risk they have undertaken in investing. Investors will demand a higher dividend as a reward for

investing in more risky projects. The greater the risk of the project the higher the return that is required therefore – this is part of the investment decision.

3. Finally, the nature of funding which a company chooses greatly impacts both of these decisions! **If a project is financed by significant amounts of debt, then the company is exposed to more financial risks as interest has to be paid each and every period**.

If cash flows are short, the company may not be able to afford this. As a result investors may require a higher dividend. Equally, given that debt means that the bank must be repaid, this could decide whether or not a company gambles on a potentially risky investment affecting the investment decision.

4. Stakeholders and the three financial decisions

So, we know that our three key financial decisions, **investment**, **finance and dividend decisions**, **have a direct relationship on a range of stakeholders**. Let's say, for instance, that were about to invest in a new factory costing £10m, **the stakeholders affected could include**:

- **Staff** – more available jobs
- **Banks** – an opportunity to fund the project
- **Shareholders** – may provide funding, but also benefit from the returns through profits generated
- **Suppliers** – there's a new opportunity for builders and equipment manufacturers at first and then ongoing suppliers longer term

Let's see the typical impacts of the three financing decisions on a variety of stakeholders:

Stakeholder	Investment decision	Finance decision	Dividend decision
Shareholder	Using internal funds means that this money can not be paid as dividends so shareholders will demand investments have a positive NPV.	Debt finance could introduce financial risk. Compulsory interest payments may mean dividends are not paid.	The level and frequency of dividends paid will determine whether shareholder needs are met.
Employees	Job security as entity is investing for growth. Long term promotion prospects. Mergers and acquisitions could result in job losses.	Debt finance could introduce financial risk resulting in corporate collapse and job losses e.g. Enron.	The more dividends paid, the less funds for pay increases or bonuses.

Stakeholder	Investment decision	Finance decision	Dividend decision
Banks and lenders	Opportunities to provide funding for the project. May require security to support any loans provided, e.g. building or equipment.	Increased debt finance may mean higher financial risk resulting in interest not being paid or paid late. Debt covenants (limitations on new debt imposed by previous debt contracts) may restrict new lending. Lender ratios (e.g. limits imposed on gearing levels) may not be met after new funding and banks ask for loans to be paid back.	Dividends paid may breach lender ratios e.g. by reducing gearing ratios.
Suppliers	New opportunities.	Payments to lenders may affect ability to pay suppliers resulting in harsher payment terms.	Dividend payments may affect ability to pay suppliers.

Example (key decision linkages and stakeholders interests)

Bull's Construction Plc is a large construction company listed on the London Stock Exchange. It is undertaking a three-year project to build a suspension bridge in Xenland (currency X$), linking a small island with the mainland. It is its first bridge building project. The small island is where the country’s only airport is located.

The bridge is two miles in length and will be financed by 30% equity and 70% debt. Revenue will be earned from the bridge by charging users a toll. This is the first time BC has undertaken such a toll project. A financial analysis carried out by by BC's senior accountant, Mr. Tightrope, forecasts a substantial profit of X$50m after five years.

Analysis

The interrelationships between the decisions are as follows:

- **Investment** – The investment chosen is a profitable project but is complex and risky due to the company being inexperienced at building toll bridges and relying on the toll as a future form of income. The company requires external finance for the project.

- **Funding** – The funding is based on the project profile (three-year duration and the project risk of inexperience and complexity). BC therefore needs a long-term loan for this long-term project as returns will not be generated for some years to come. Given the project's risky nature, a high interest rate will be charged due to the potential risk of the bank not being repaid.

- **Dividend** – The dividend to be paid to shareholders needs to compensate them for two things: investing in a high risk project, and the financial risk incurred by the funding (i.e. a commitment to pay a high interest rate over the project's duration).

The impact of the investment, finance and dividend decisions on stakeholders is as follows:

- **Shareholders** – The substantial profit from the investment will increase shareholder wealth. They will be concerned with the financial risk of the high debt funding. They will be seeking rises in the share price in the short term to reflect the project's profitability and ideally higher dividends in the long term or otherwise they will sell their shares.

- **Banks** – They will require security for the loan that they provide for the project. Debt covenants are restrictive rules imposed by the bank on the borrower that will ensure that they do not do anything to jeopardise the likelihood of the bank being repaid.

  For example, a bank may stipulate that BB cannot have a gearing level of above 50%, or cannot p ay dividends above a certain total financial amount. They may also prevent BB from taking out any additional debt until they have been repaid.

- **Employees** - Those involved on the project will have job security. Their union may need some reassurance that the high level of interest payments does not lead to the company collapsing. In addition, they may expect bonuses for delivering the project on time.