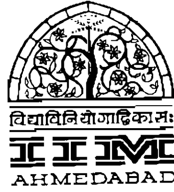

Working Paper

INTERACTIONS BETWEEN CORPORATE STRATEGY AND FINANCIAL STRATEGY: SOME PROPOSITIONS FOR PRACTICING MANAGERS

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WP1153

1993
(1153)

W.P. No.1153
November 1993

The main objective of the working paper series of the IIMA is to help faculty members to test out their research findings at the pre-publication stage.

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I. Introduction

Terms such as 'financial strategy' and 'strategic finance' are much in use today among academicians who are trying to extend their audience beyond financial managers, in an attempt to engage the interest and attention of top managers of corporations. However, it is not at all clear what precisely is meant by such terms, nor is it clear that finance and strategy have anything much to do with each other.

Almost every standard text in corporate finance makes at least an attempt in passing to discuss the implications of corporate strategy for finance theory. For instance, Brealey and Myers (1991, Chapter 36) observe that strategic planning can be considered to be really just an extended form of capital budgeting.

There is also some discussion which concludes that finance and strategy need not clash. For instance Barwise, Marsh, and Wensley, (1989) note that the use of rigorous discounted cash flow (DCF) analysis forces top managers to ask the right questions of their marketing and operations people, which presumably would lead to the right strategic decision.

However, the literature, by and large, remains relatively silent on specifics, such as what kinds of firm strategies imply what kind of dividend policy. (One exception is Myers (1977, 1984)).

In this article, we shall attempt to derive some propositions linking corporate strategy with financial strategy, which may be of direct relevance to top managers of firms.

II. Financial Strategy and Corporate Strategy

Definitions

Financial Strategy

By financial strategy decisions, we shall mean the broad corporate finance decisions such as capital structure and dividend policy.

The essence of the capital structure decision is the decision of what mix of debt and equity the firm should finance its operations with, the desirable level of usage

of internal funds versus external funds, and also the choice of instruments - short-term borrowing versus long-term, public equity issues versus rights.

Dividend policy is primarily concerned with issues such as the proportion of earnings to be paid out to shareholders rather than be ploughed back into the company.

Policies regarding project evaluation include the choice of techniques such as the Net Present Value (NPV), Internal Rate of Return (IRR) and Payback Period. A related policy decision is how to calculate the discount rate to be applied in the analysis, and how often it should be updated.

Corporate Strategy

By corporate strategy, we shall mean the entire set of coordinated policies, systems and procedures, coupled with the central vision which drives the corporation, which together define how the corporation chooses to compete in its business.

We begin by proposing that corporate strategy, <u>by definition</u>, is prior to financial strategy. That is, financial strategy is merely one of the strands in the fabric of corporate strategy - the others being product strategy, R&D strategy, marketing strategy, HRD strategy, and so on.

PROPOSITION 0

Corporate Strategy Defines Financial Strategy

The issue then becomes, what does a given corporate strategy imply for financial strategy? At the same time, what financial strategy must a firm be committed to follow if it wishes to pursue a given corporate strategy?

We shall examine this question systematically, for a small number of major corporate strategy types. This lisy may not be exhaustive, but it will cover a wide range of corporate strategies both observed in practice and discussed in theory. For each type of corporate strategy, we shall derive propositions relating to the firm's capital structure policy, its dividend policy, and the financial tools the firm should use to implement its policies.

III. Types of Corporate Strategy and their Implications for Financial Strategy.

Different firms, often in the same industry, may be seen to be pursuing different kinds of corporate strategies. Generally speaking, a given firm would not employ more than one kind of strategy at a time, since the functional and operational implications of each strategy type are quite different. What does each kind of corporate strategy imply for financial strategy? Table 1 presents a summary of corporate strategy types.

We begin with the typology of corporate strategies suggested by Porter (1980) - differentiation, cost leadership, and focus. Of these, focus may be considered a special case of differentiation.
For each type of corporate strategy, we shall derive propositions about financial strategy and the related financial tools for implementation of strategy, which should hold _ceteris paribus._ While other things are never really equal, these propostions should provide some guidance to top level managers on the kinds of actions and strategies they should pay relatively more attention to.
For instance, when we affirm that firms of a certain kind should constantly update their capital structures, we do not mean that other kinds of firms should not:, the search for a minimum cost of capital is a worthwhile search for any company to undertake. We are merely affirming that firms pursuing a certain kind of srategy should pay special attention to such problems. Given that top management can focus only on a small number of critical parameters, this is a critical parameter for certain kinds of firms, perhaps not so critical for others.

Table 1
Types of Corporate Strategy

1. Cost Leadership: Gaining competitive advantage over other firms by sustaining a lower overall cost of doing business. Prices charged to the customer may or may not be the lowest.

2. Differentiation: Gaining competitive advantage over other firms by offering a superior product and/or service, often, but not always, built around superior brands and brand image.

3. Speed: Gaining competitive advantage over other firms by being able to respond faster to changes in market trends, customer preferences, technology changes, etc.

4. First Mover: Gaining competitive advantage over other firms by virtue of being the first to enter a given business or industry.

1. CORPORATE STRATEGY: DIFFERENTIATION

Differentiation as a strategy hinges on creating 'something different' about the company and its products - distinguishing the company from its competitors by way of better products, better service, or a simply a better image.

To sustain differentiation based on better products, the company must usually invest heavily in R&D. To sustain differentiation through image-building, heavy advertising must usually be resorted to.

FINANCIAL STRATEGY FOR DIFFERENTIATION

a) Capital Structure

Companies pursuing a differentiation strategy would tend to have a very large part of their value in the form of intangibles, which may be viewed as options on future business opportunities.

Such companies would be wise to borrow as little as they can. To summarize the arguments advanced by Myers (1977), if such companies were to acquire fixed liabilities such as debt repayments, their managers may pass up even good (i.e., positive NPV) investment opportunities in the future if the cash flow from such opportunities is not enough to pay off the fixed liability and still have substantial value left for shareholders.. (This argument presumes that managers generally have the interests of shareholders closest to heart, which is quite a plausible supposition, at least in India.).

Since such future investment decisions are not optimal, the value of the firm would be lower if it had a high level of debt than if it did not. This is because , if the firm had no debt at all, for instance, its managers would presumably be free to evaluate future investment opportunities (which are yet unknown) strictly on their merits.

Thus, we conclude that firms with high 'R&D equity' or 'brand equity' should avoid debt. A differentiation strategy calls for largely equity financing.

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PROPOSITION 1

Differentiation as a corporate strategy calls for low debt levels relative to equity.

b) Dividend Policy

Intangibles can be accurately valued only by managers inside the company. To communicate the value of such business prospects to the outside world, the company would be well advised to employ 'signalling' mechanisms of some kind.

Increases in dividends are known in the finance literature to have significant 'signalling' value. Investors appear to regard increases in dividends as a sign of confidence on the part of insiders or managers. Firms which can successfully transmit such signals to the market would see their share prices rising.

Thus, we may conclude that a corporate strategy based on differentiation would call for a dividend payout rate which is both high and frequently increasing, the increases being timed to correspond to major new initiatives like new product launches or major advertising campaigns.

PROPOSITION 2

Differentitation as a corporate strategy calls for high and frequently increasing dividend payout.

c) Financial Tools For Implementation

The value of companies in this strategic segment is composed mainly of intangibles, primarily embodied in people. The scarce resource in such companies is more often good people than money, that is, human capital is the constraint, even more than financial capital.

Capital budgeting techniques like NPV do not usually reflect the required rate of return on human capital. A major èffort is required to determine some appropriate measure of 'required rate on people'. Such exercises, although difficult, are not impossible.

In the absence of a good method of computing such a

required rate, companies will tend not to rely exclusively on NPV and IRR methods, often passing up seemingly positive NPV projects because the required investment in human talent is too high. This is, in fact, correct management practice, and should be encouraged.

PROPOSITION 3

Differentiation as a corporate strategy calls for modification of capital budgeting procedures to reflect a higher cost of human capital.

2. CORPORATE STRATEGY: COST LEADERSHIP

The essence of cost leadership as a corporate strategy is to achieve and sustain a lower per unit cost of production and delivery than any of the firm's competitors. This does not mean that quality, service, or brand image are to be sacrificed - only that the central focus of top-level decision making will be to keep costs low.

There are two major approaches to achieving cost leadership: economies of scale, and minimization of overheads and administrative costs. We shall examine the implications of each of these methods for the financial strategy of the firm.

FINANCIAL STRATEGY FOR COST LEADERSHIP

A. ECONOMIES OF SCALE

Economies of scale are usually achieved through heavy investment in large-scale plant and equipment capable of handling very large-scale operations. In doing this, the firm will acquire significant 'tangible' assets like plant and machinery.

a) Capital Structure

One of the implications of finance theory (Myers (1977)) is that, whenever a large part of the value of the firm is represented by tangible assets rather than intangible investment opportunities in the future, the firm should finance its operations more heavily with debt rather than with equity. This is, ofcourse, merely the converse of the argument employed above in the section on differentiation as a corporate strategy.

This implication also accords with common sense, which

suggests that if the firm has 'mortgageable' fixed assets, it will be able to borrow cheaply and so should finance its operations that way.

PROPOSITION 4

Cost Leadership as a corporate strategy, achieved through economies of scale, calls for high debt levels relative to equity.

b) Dividend Policy

Other things being equal, dividends have relatively little signalling role to play when the firm is seeking competitive advantages purely through economies of scale, since the financial markets may be presumed to have enough information to evaluate the firm's projects correctly, without any special effort on the firm's part beyond its usual corporate communications efforts. At the same time, since a high debt level (see Proposition 4) would necessarily involve a high fixed cash outflow, firms in this strategic segment may be well advised to minimize the cash outflow from dividends.

PROPOSITION 5

Cost leadership as a corporate strategy, achieved through economies of scale, calls for a low dividend payout.

c) Financial Tools for Implementation

Since capital investment is significant here, it is important to use techniques such as NPV and IRR to evaluate investment projects. The special problems of human capital encountered in companies following a differentiation strategy are usually less acute here.

PROPOSITION 6

Cost leadership as a corporate strategy, achieved through economies of scale, calls for consistent use of NPV and IRR techniques.

B. OVERHEAD COST MINIMIZATION

An alternative route to achieving cost leadership is to focus intensively on cost reduction in every possible activity and department of the corporation. Top management attention is focussed on constantly searching for ways to reduce costs and increase productivity.

a) Capital Structure

The firm should consider cost of capital explicitly as a cost of doing business, and should continually adjust its capital structure to keep it at the optimal level which would minimize its cost of capital. Great attention must be paid to estimating the costs and benefits of debt and equity and the balance between the two must be reviewed frequently.

PROPOSITION 7

Cost Leadership as a corporate strategy, achieved through overhead cost minimization, calls for constant adjustment of the firm's debt to equity ratio.

Even among the varieties of debt and equity, the firm should consistently choose the cheapest form of financing, regardless of other considerations. For instance, as Smith (1977) points out, rights issues as a source of equity capital can be substantially cheaper than primary issues to the public at large.

PROPOSITION 8

Cost Leadership as a corporate strategy, achieved through overhead cost minimization, calls for greater use of rights issues relative to primary pubic issues of equity.

b) Dividend Policy

Dividend policy probably has only a minor role to play here. However, to the extent that the firm's single focus is cost minimization, it should seriously consider whether it is worthwhile to incur the costs of paying out dividends with one hand while gathering in funds with the other, to finance its operations. In other words, there would appear to be an argument for as low a dividend

payment as possible.

PROPOSITION 9

Cost Leadership as a corporate strategy, achieved through overhead cost minimization, calls for a low dividend payout rate.

c) Financial Tools to Implement Strategy

Since the target debt/equity ratio becomes of prime importance in the quest for minimum cost of capital, the firm must develop highly sophisticated and accurate models to calculate, several times a year, its cost of debt and cost of equity. Such models are not costly to develop, but the firm must inculcate the discipline of taking such calculations seriously and sensitize operating as well as financial managers to the importance of such numbers.

At the same time, the firm must be able to forecast accurately a number of related future cash flows, such as its depreciation tax shields, since the calculation of optimal capital structure requires tradeoffs between debt and non-debt tax shields in coming years.

PROPOSITION 10

Cost Leadership as a corporate strategy, achieved through overhead cost minimization, calls for the use of sophisticated models for calculation of cost of capital and forecasts of future cash flows, including debt and nondebt tax shields.

3. CORPORATE STRATEGY: SPEED

Going beyond the Porter (1980) categories, one observes that more modern and novel strategic ideas such as speed of response are being invoked by firms to create a sustainable competitive advantage. Walmart and Benetton are two companies who have built their entire corporate strategy around quick response to market conditions (see, for instance, Stalk et al, (1992)). It cannot be doubted that, as the Indian market becomes more and more open, Indian companies too will increasingly resort to such strategies.

To implement such strategies, companies must build in a

great deal of flexibility into their operations. They must be able to grow and shrink at a moment's notice, get information quickly, and be able to act without the slightest delay. The watchword will be 'keeping options open'. Constraints on operations are to be eschewed wherever they may arise.

FINANCIAL STRATEGY FOR SPEED

We propose that flexibility requires large reserves of cash and perhaps even of inventory. For instance, the worldwide leader in mid-fashion woollen garments, Benetton, forces its retail outlets to maintain no inventory at all, in order to get them to pay attention to customer tastes at all times, but ends up holding quite a large inventory itself.

PROPOSITION 11

Speed as a corporate strategy calls for a large investment in cash and inventories.

a) Capital Structure

At the same time, constraints on operations such as liquidity requirements, strict limits on financial ratios etc., should be avoided, since they potentially limit the firm's ability to make large investments swiftly, or exit business areas quickly. Such firms would do best to avoid debt, since debt usually comes with precisely such restrictive covenants which proscribe freedom of action.

Again, rather like the firms which pursue a differentiation strategy, firms which face rapidly changing market conditions and so rely on speedy response to survive, must also ensure that their future investment options are kept as open as possible. This would be another reason to avoid debt.

PROPOSITION 12

Speed as a corporate strategy calls for low debt levels.

A related concern is that the firm must avoid being locked

in to technology or equipment of any specific kind, especially if the technology is changing very rapidly. The very fact that the company has invested a large amount in equipment may act as an impediment to speedy changeover to a different kind of equipment. Such companies may find it worthwhile to lease rather than purchase equipment wherever the option is available.

PROPOSITION 13

Speed as a corporate strategy calls for leasing rather than purchasing equipment.

b) Dividend Policy

At the same time, internal funds should be retained as much as possible, in order to build up the needed cash reserves, which argues for a low dividend payout policy.

PROPOSITION 14

Speed as a corporate strategy calls for a low dividend payout.

c) Financial Tools to Implement Strategy

One of the implications of operating in fast changing markets where speed is of the essence, is that it makes little sense to plan investment projects over very long periods of time. Thus, companies in this strategic segment may well find it more useful to focus on measures such as Payback Period rather than the standard NPV and IRR to evaluate its projects.

PROPOSITION 15

Speed as a corporate strategy calls for use of Payback Period rather than NPV and IRR in project evaluation.

4. CORPORATE STRATEGY: FIRST MOVER

A closely related, but not identical, strategy is to

concentrate on being the first mover in any new emerging business area. The idea here is to grow rapidly and create entry barriers for any potential entrants who may subsequently think of following in your wake. Creation of entry barriers may include seizing a large market share as swiftly as possible, tying up critical suppliers, creating a strong brand name, and so on.

FINANCIAL STRATEGY FOR FIRST MOVER

a) Capital Structure

One key concern if the firm wants to move first into a given business and consolidate its position before potential entrants arrive, would be to avoid disclosing information to the public on your competitive moves.

If the firm were to finance its projects with a large equity issue, or even, in the Indian context, with a large convertible debenture issue, to the public, it would be forced to reveal significant information about the project's prospects and its own implementation plans to the public. Since the public includes the firm's competitors, both current and potential, this kind of deisclosure must be avoided at all costs. When SEBI turns its attention to protecting investors' interests, as the SEC in the U.S. has done for a long time, such disclosure requirements will become more and more stringent in India.

The firm must therefore rely either on internal funds or on private placements of debt, where the information the firm needs to supply to potential investors, is rather limited and can even be kept confidential.

PROPOSITION 16

A corporate strategy of being the First Mover calls for avoidance of public issues of equity and convertible debentures.

b) Dividend Policy

Reasoning along the same lines, if use of internal funds is to be maximized, the firm must conserve its cash rather than pay out as dividends.

PROPOSITION 17

A corporate strategy of being the First Mover calls for a low dividend payout.

c) Financial Tools to Implement Strategy

We have observed above that the essence of the First Mover strategy is to build entry barriers to deter potential competitors from entering the industry. One effective way to build entry barriers is to tie up suppliers and dealers through financing schemes which bind them to the company. A good credit appraisal an rating systems becomes a must for the company to be able to do this effectively.

PROPOSITION 18

A corporate strategy of being the First Mover calls for extensive use of financing schemes, backed by strong credit appraisal systems.

Table 2 summarizes the propositions derived in this paper.

Table 2

Summary of Propositions

Proposition 0: Corporate Strategy Defines Financial Strategy.

Corporate Strategy	Capital Structure	Dividend Policy	Financial Tools	Other
Differentiation	Low Debt (1)	High payout, frequent increases (2)	Use high rate for human capital (3)	
Cost Leadership (scale)	High Debt (4)	Low payout (5)	Consistent use of NPV, IRR (6)	
Cost Leadership (overheads)	Constant adjustment (7) Use Rights Offers (8)	Low payout (9)	Sophisticated models for cost of capital, cash flow forecasts (10)	
Speed	Low Debt (12) Use Leases (13)	Low Payout (14)	Use Payback Period (15)	High cash, inventory (11)
First Mover	Avoid Public Issues (16)	Low Payout (17)	Credit Appraisal Systems (18)	Strong financing schemes (18)

Note: Numbers in parentheses refer to the proposition number in the text.

IV. Condlusion

The disciplines of finance and strategic management have evolved along separate lines, but both are of concern to top managers at the level of CEO, MD and Chairman of corporations. It is not particularly useful to merely tell financial managers that, in the last analysis, corporate strategy rules supreme, or to exhort strategic planners to pay more attention to the numbers.

This paper has attempted to provide some usable propositions for top managers who wonder what 'financial strategy' and 'strategic finance' are really all about.

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