Strategic Financial Planning

A Manager's Guide to Improving Profit Performance

- Four approaches to financial strategy and their strengths and advantages
- Two methods of planning
  - Management By Objectives versus Management By Fundamental Analysis
  - and which is best for you
- Strategies for decision making under inflation
- Strategies for capital budgeting decisions
- Strategies for financial leverage

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A Manager's Guide to Improving Profit Performance

Harold Bierman, Jr.

with epigraphs by Florence M. Kelso

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Preface

This is a book on corporate financial strategy. The objective of a corporation is assumed to be a maximization of the well-being of its stockholders, taking into consideration the interests of its employees.

The style of the book is qualitative rather than quantitative, though at times symbols are used and frequently numerical examples are used to illustrate the argument that is being made. Generally, absolute statements are not made unless proofs are available for backing up the statements, but the proofs are not presented in this book.

Frequently in finance we do not know and cannot prove that one decision is better than another. We can always point out the relevant considerations, and occasionally we can make definite recommendations.

If a firm currently has a capital structure with 35% debt and if a bond rating agency has promised to change the bond rating of the firm's debt from a double A to a single A if more debt is issued, we can describe the costs of adding more debt. We can describe the financial consequences of issuing preferred stock rather than adding more debt. It is very unlikely that we can prove that it is more desirable to issue preferred stock than to add more debt.

Frequently in the strategy area the world is simplified so that the "correct" decision seems to be obvious. A conclusion follows naturally that a product which dominates a rapidly growing market should receive investment funds rather than a product which has only 10% of a nongrowing market. But a conclusion such as this (which is intuitively appealing) may be completely wrong, if significant considerations are omitted.

Strategy decisions are important. They are too important to be left to excessively simplified generalizations.

My thanks to Larry Hastie, Bill Straight, Bill Strong, and Paul Tregurtha for many solid lessons in practical business finance and strategy.

Harold Bierman, Jr.
Cornell University
Ithaca, New York

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If you're running out of time,
Just skip the text and read the rhyme.
FMK

Chapter 1
Strategy and Decision Making

Though BCG would milk the "cow"
In point of fact no one knows how.
FMK

In discussing corporate financial strategy, the question can well be asked as to how strategy differs from more modest decision making. There is no completely satisfactory answer to this question, since there is an extensive intersection between those activities that we label decision making and those we label strategy formulation. We could resort to a distinction and have decision making become the application of the basic strategy, but generally decision making has a broader interpretation. Peter Drucker has stated, "The effective executive does not make many decisions. He solves generic problems through policy."[1]

Let us consider an actual business situation that illustrates the point Drucker is making. A university administrator was spending a lot of time approving or disapproving requests for travel. This was a nuisance to professors who had to wait for approval and who resented the requests that were rejected, and a waste of time for the administrator. In addition she was using up her good will with the professors. After several months of this situation it was decided to change the travel *policy* so that requests would be submitted only for a reduced list of eligible trips and the professor knew the approval was automatic as long as the request was consistent with the policy. A well-thought-out policy was substituted for a series of ad hoc decisions. Good policies and strategies can greatly reduce the number of decisions that have to be made.

Elements of Strategic Planning

We shall consider five elements of the strategic planning. There is no question that the list to be presented is not unique. In fact, before reading on, you might well want to prepare your own list of five elements of strategic planning and compare your thoughts with the items to follow.

The number one element in developing a strategy is the identification of the problems and opportunities that exist. A successful firm will have a fertile idea-generating environment. What problems and opportunities are there? Problem and opportunity identification is one of the more important outputs resulting from good strategic planning. You cannot solve a problem or seize an opportunity unless you know it exists.

The second element is to set goals (objectives). Goal setting is not independent of the identification of opportunities. If the goal is to achieve growth in sales of 15% per year, it will be necessary to spend more resources generating ideas than if the goal is to avoid growth. Some would argue that top management should stop with the setting of the goals and leave everything else to the operating managers. For example, top management might set the goals to earn at least 25% return on investment (ROI), to maintain a 15% growth rate per year, and to corner 20% of the total market as the firm's profit goals. Operating management would then establish the details as to how the goals would be achieved. A popular form of managerial style is to "manage by objectives." If one manages by objectives, the goal is set by the top, but the specific method of getting to the goal is not controlled. The results are important, not the method of getting to the results. Performance measurement is substituted for detailed supervision. Thus goal setting becomes a crucially important element in the strategic planning.

We now have problems and goals defined. The next step is to have a procedure for providing possible solutions, or "paths" the firm can follow to find a solution.

For example, the current energy situation can be defined as a problem or an opportunity. The goal might be to achieve energy independence or to make a given return on investment. Assume a firm has decided to enter the energy industry and has to decide what kind of energy it will develop and how it will go about it. For example, it might consider solar, wind, tide, and fossil and then decide to go with solar.

Having decided to enter the solar energy industry, the corporation might decide to spend large sums on research or alternatively might decide to acquire a firm that already has valuable know-how and thus accelerate its entry into the industry. The setting of tactics follows the setting of the basic strategy for entering the industry.

The basic decision is to "enter the solar energy industry." The goals that are set can be to earn 25% ROI, increase earnings 15% per year, and gain 20% of the total market. Top management of the corporation might then leave the details of how this is to be achieved to the managers operating the solar energy division. This is an extreme form of decentralization and "bottom line management." The more normal procedure is for top management to oversee the more important decisions that are made, especially those involving large investment outlays or other large commitments.

Now we have problems, possible solutions, and the goals defined. The fourth element of strategic planning is to choose the best solution, given possible solutions and the firm's objectives. On what basis will the best solution be chosen? The goal might have been established to maximize the well-being of the stockholders. This is easy to state, but given a large number of ways to enter the energy industry, which method should be chosen? It might be decided to choose the path with the largest net present value. But then risk considerations should enter analysis. Choosing the best solution, even with well-defined goals established, is a difficult job.

The fifth and final element of strategic planning is to have some type of review procedures to check how the best solution has actually performed. How this review function is executed will depend on the preferences and style of management.

The above five elements of strategic planning do not reveal anything about the style in which they (and the resulting plans) will be implemented. They are broad enough to encompass a wide range of financial decisions. For example, if the goal is to have reasonable growth but little risk, the amount of risk that is acceptable to the owners of the corporation (or in their absence, to the board of directors) will greatly affect the amount of debt that is used to finance the corporation.

A major planning question not yet answered is to what extent the interests of the organization come ahead of the interests of the different groups of employees. If you were a college president, would you fire your football coach on Christmas eve? What sort of performance measures will be used, and what happens when goals are not met? Will excuses (explanations) be listened to, or will there be an insistence on performance? Managerial style will circle back and affect things like idea generation.

Strategy Is Not Fun

Herbert Simon has written that there is a Gresham's law of planning: "Programmed activity tends to drive out non programmed activity."[2] The decision to buy a new energy-saving piece of equipment is a lot easier to discuss and analyze than strategic investment decisions. In the case of the energy-saving equipment, cash flows can be estimated and the decision to buy or not to buy can be made based on well-known capital budgeting techniques. The basic capital budgeting techniques are "programmed activities" in Simon's law. Strategy issues are a lot softer and a lot less satisfactory to write about and to read. However, it may well be that strategy issues are much more important, even if they are not fun to consider.

Strategy leads a firm to enter the energy business. That is the first and most important decision. The firm might then have to value a prospective acquisition as a means of accelerating the entry into the industry, but without the strategy decision it would not be necessary to value the acquisition.

Abstractions

All business decision making is based on abstractions from reality. We have to simplify in order to make decisions. We can delay decision making by insisting on more information, but when the more information is obtained, there will still be more information that could be obtained if you were willing to defer action. Sooner or later one has to resist the opportunity to get more information, and one has to make the decision.

Herbert Simon has said this best:

> Administrative theory is peculiarly the theory of intended and bounded rationality—of the behavior of human beings who *satisfice* because they have not the wits to *maximize*.[3]

And as additional explanation:

> Whereas economic man maximizes—selects the best alternative from among all those available to him, his cousin, administrative man, satis-

fices—looks for a course of action that is satisfactory or "good enough." Examples of satisficing criteria, familiar enough to businessmen if unfamiliar to most economists, are "share of market," "adequate profit," "fair price."[4]

The substitution of the word "satisfice" for "maximize" is not necessary if we are willing to consider the costs of information, search, and delay in the decision to maximize. In a sense we can conclude that Simon is suggesting that it is better to make decisions, even imperfect decisions, than to endure the long wait until the perfect information and perfect decision processes are available. "In an important sense, all decision is a matter of compromise."[5]

An Important Assumption

While Simon's "satisfice" description is an extremely useful device for describing how managers operate, we shall find it convenient to collapse Simon's "satisfice" and profit maximization into one expression.

Throughout this book profit maximization (where profit is defined in terms of risk-adjusted present value) is deemed to be the primary objective of the firm. More is better.

You can assume that the profit maximization objective includes the information cost and cost of search so that it is consistent with Simon's satisfice (we are not rejecting the "satisfice" concept).

The assumption is that decisions should be made from the point of view of improving the well-being of the stockholders. This is a reasonable point of departure, but it cannot be the entire message. Managers, employees, customers, and society in general have interests in the results of a firm's operations. We must also consider the impact of decisions on the well-being of these groups. You might object to this conclusion, but realistically such considerations are being included by successful firms.

No manager submits an investment or other decision proposal without carefully considering the impact of the decision being reviewed on his or her well-being. Even the board of directors will consider the well-being of managers if for no other reason than that managers are likely to be on the board. Employees also must be considered, since an obvious and continuous disregard of their interests will cause them to insist on the right to protect their interests. Customers also gain their right to be considered by the economic power they wield, not in the board room directly, but indirectly via the right of a consumer to avoid buying a corporation's product.

The rights of society can to some extent be ignored by a corporation for a short period of time, but continuous implementation of a "public be damned" philosophy is likely to bring forth a string of government legislation. The interests of society must be respected if only to avoid such legislation. A corporation should do "right" either because it is the proper thing to do or because it is in its own best interests to behave in such a fashion.

Approaches to Strategy

We will consider four approaches to strategy. The first uses brilliance and is unstructured, while the second uses dramatic simplifications and broad generalizations. The third relies heavily on statistical data, and the fourth is a theoretical approach that is correct, but may not always be practical.

Approach 1: Brilliance

Under this approach each situation is unique and the problem solver applies brilliance in arriving at a strategy. There is an unstructured analysis. A systematic approach to thinking about strategy can be learned (one can practice strategy decisions via cases and games), but there are few if any generalizations. A listing of the five elements of strategic planning described above is an illustration of an attempt to systematize thinking about strategy.

One can read a strategy recommendation for a firm and admire its wisdom, but still not be able to tell a computer how to do the next analysis.

Approach 2: Broad Generalizations

The Boston Consulting Group (BCG) has developed an amazingly simple to understand and attractive approach to strategy (this is not to imply that this is the group's only contribution to strategy development). Figure 1.1 shows the basic classifications used by BCG.

The best of all worlds is for a product to have a high market

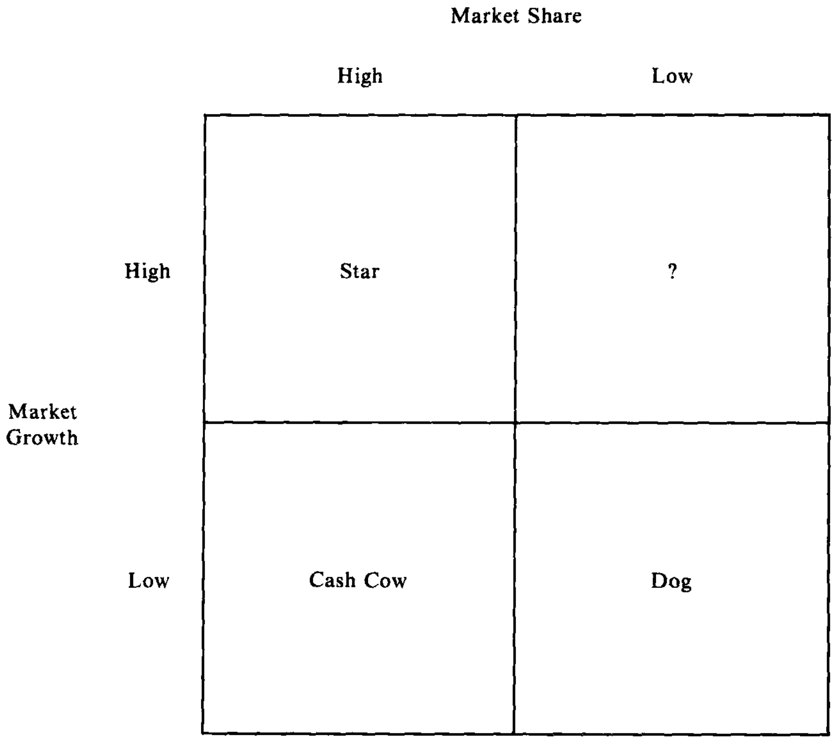

FIGURE 1.1

share in a high-growth market (be a star). Thus the implication (recommendation?) is that a firm should maintain dominant market position in a growing market (the market segment may be very limited) or the firm should abandon the activity.

To some extent this recommendation is based on theory. To be in a monopolistic position is a desirable state from the point of view of profit maximization. Secondly, if you are producing more than your competition, you are apt to be further along your learning curve, and thus your costs are likely to be less than those of your competitor.

It is assumed that the incremental costs reduce with the number of units produced, and there is evidence to substantiate this assumption.

If you have a high market share but slow growth in the market, you have a cash cow. Do not invest in this market, but drain off the cash.

If both the market share and market growth are low, you have a dog, and the advice is to find some fool who will take it off your hands.

If the market growth is high but the market share is low, the box contains a question mark. Strategy will depend on the expectation of being able to move from a low market share to a high market share. The firm should either spend to achieve stardom or get out of the market.

Several recommendations follow from this strategy format in addition to the basic strategy of trying to achieve stardom. A firm should plan on growing with the market. Also, a "balanced portfolio" of cash cows and stars is desirable. The cows are used to finance the growth of the stars.

The basic attraction of the BCG approach is that it is simple, it is understandable, and it seems to make sense. It does not bog down in the details of complex models and massive sets of numbers, but rather focuses on the broad strategic considerations. What firm does not want to have essentially a monopolistic (dominant) position in a growth market?

With the BCG system resources are allocated to stars and discounted cash flow calculations are largely meaningless. One establishes a growth strategy instead of evaluating individual investments spread over many different product lines.

There are many questions unanswered. What happens if three firms in the same market all spend massively to achieve a dominant market position?

Would BCG advise Wendy's to challenge McDonald's? Or Toyota to challenge Fiat, Volkswagen, and General Motors? Or Avis to challenge Hertz? Certainly, it is reasonable to enter a market and compete if you have some "edge." Consider a strategy of a business that is defined in terms of earning a satisfactory return on investment (this is consistent with General Motors' strategy). If the return is satisfactory or better, do it. Otherwise the activity should be terminated. This is a clearly defined, theoretically correct strategy.

Approach 3: Statistical Analysis

The third approach is to perform statistical analysis using industry data. Regressing the data, one draws conclusions as to the optimum strategy to be followed.

For example, one might conclude that quality is very important in slow-growth markets. This conclusion is intuitively appealing.

Customers are apt to become choosy in a situation where there is excess capacity (the market is growing slowly).

The difficulty with this basic approach is that one can determine associative relationships (quality is shown to be important when there is low growth) but not causal relationships, and certainly there is no reliable implication as to the decision that should be followed. If high quality is desirable in a low-growth market, one does not conclude that low quality is desirable in a high-growth market (you might be better able to get away with low quality, but it might still be a bad long-run strategy).

The statistical analysis and comparisons should be of some use in setting profit goals. The profits of the other firms can help set the profit targets of your firm.

Can the data be used to judge the effects of changes in strategy of a firm? Can the data be used to determine the strategies and decisions that will lead to optimum positions? There are many firms that are betting that the statistical analysis of industry data can be used for these purposes.

Approach 4: A Theoretical Approach

The final approach is a purely theoretical approach. It is consistent with widely accepted economic and financial theory. It bypasses the broad generalizations and focuses on the details of the decisions. The basic strategy is to insist on detailed facts and evaluation of the alternatives, using conventional profitability measures.

Consider the resource allocation decision. Expansion of production in a given market is desirable as long as the marginal revenue of a product is larger than the marginal cost of producing and selling it. A project is undertaken as long as the discounted cash flow is larger than the cost of money (the net present value is positive).

Yes, it is nice to be further down the learning curve than your competitors. That is to say, it is better to have some sort of advantage (a good position on the learning curve being one) that leads to your having lower costs than your competitor. This preference is a fact, not a strategy consideration.

In addition to exploiting marketing cost advantages, a firm should take into consideration a wide range of institutional factors. These include the tax laws, trade arrangements, the availability of tax-exempt bonds, and government programs aimed at helping your industry (sometimes the legislation is not aimed at helping an industry but is interpreted in such a manner that it does help).

It is recommended that the definition of diversification be extended by us from the limited interpretation of obtaining cash from cows to supply stars to a consideration of risk factors arising from different mixes of product lines. This type of risk analysis is a complex subject that will be considered in more depth later.

Based on the details of decisions, one can consider a wide range of different strategy factors. For example, we can focus on the identification of a gap in the market and set out to supply a product to fill the need. The need may be in the form of better service or better quality. The strategy is to identify situations where such needs exist.

Which Approach Is Best?

If we interpret the BCG strategy as exemplified by Figure 1.1 as a systematic approach to the type of theoretical considerations described in approach 4 as well as the brilliant insights of approach 1, maybe all four approaches can be reconciled and we do not have to choose a best method of formulating strategy. If BCG were to only use Figure 1.1 and the naive conclusions that follow when a product is a dog or a question mark, we would then reject the approach. But we should not attribute that degree of naiveness, because even if it existed at one time, it would not be a stable position. In like manner the brilliant insights of the first approach have to be based implicitly on theoretical considerations. Basic principles of economics, finance, marketing, etc., must apply, if not for all situations, then enough so that the so-called brilliant insight approach is not completely isolated from the more conceptual theoretical approach.

The theoretical approach without an occasional stepping back in order to see where specific decisions are taking the firm would merely lead to a series of decisions without form or purpose. The decisions would not necessarily be consistent with each other. Thus the theoretical approach is not being recommended here in its pure form.

Any strategy that ignored statistical evidence concerning the financial affairs of its competitors would be deficient. It was useful for Wendy's to note the profitability and scope of McDonalds before entering the fast food market. We tend to project the past into the future.

Evaluation of a Strategy Plan

The first question to be asked about a strategy plan that has been prepared is whether it is understood by the managers who have to implement it. Just because something is said or written does not mean it is understood.

The second question is to determine whether the plan is consistent with the firm's resources (e.g., money and managerial talent) and consistent with the objectives of the firm and the capabilities of top management. Recognize that the objectives can range from profit maximization (and there are many ways of measuring profits) to just plain survival.

The final step in the evaluation is to determine whether any crucial information or consideration has been omitted. For example, is the action legal?

It is easy to fall into the trap of too simple generalizations. Assume a glass fiber factory has excess capacity and the plant manager is using the plant to process cotton textiles. This additional activity generates incremental business and incremental profit.

Should top management terminate the contract to process textiles since the corporation is in the glass fiber business and does not want to dilute the specialization and expertise that is its competitive advantage? Or should top management recognize that marginal revenue exceeds marginal cost and accept the textile business as long as there is excess capacity? One position is that the firm is in the "processing business" and it does not make any difference what it is processing as long as it makes profits and the product is legal.

In a real case like the above situation the plant manager was told to cease the activity. The textile business was thought to be inconsistent with the broad corporate strategy. The plant manager, whose salary was affected by the amount of profits made by the firm, was extremely upset by the loss of profits that resulted.

Extreme Strategies

Extreme strategies are not likely to be sustained through time. They are apt to change either because management changes its mind or because the composition of management changes.

A one-product firm might be a reasonable strategy if resources are limited and if the market for the one product is growing rapidly. The existence of rapid technological change might require that management focus its entire attention on the one product.

Sooner or later the threat of product obsolescence, a slowing down in growth, or even the accidental discovery of a new product or technique will lead to the firm expanding its product line. But as important as the above factors is the fact that a corporate strategy of producing one product is likely to be rejected by the next generation of managers who want new worlds to conquer. A chairman of the board who had a bad experience with a bank may resolve never to use bank debt, but when that person is replaced, you can expect to have banks used as a method of financing.

Extreme strategy positions are frequently the result of one very unusual talented person heavily involved in the organization of the firm. When the genius is replaced by the professional managers, they are more apt to employ normal strategies similar to those employed by other firms in the industry.

Just because the extreme position is not likely to be maintained, a firm should not necessarily move to a so-called normal position. Drucker said it well:

> The job of management, therefore, is never to be concerned with restoring or maintaining normality, because normality is the condition of yesterday. The real task of management in the effective business is that of re-directing and re-focusing activities towards what are the right economic realities for today and for tomorrow.[6]

Two Styles of Planning

Let us consider two different styles of planning.

Style 1

The first step is to set a growth goal. The second step is to inventory the tools that will enable you to reach the growth goal. Will the present set of products and markets do the job? If so, the plan is simple: ride the growth curves of the present products. If more growth is needed, the second possibility is to expand the technologies and markets of the firm. Again, if this satisfies the growth objective, the search is stopped; if not, we proceed to the next step. This final