3.3.2 Financial Strategy Examples

Unit: Unit 1 – Treasury Strategy

Module: Module 3 – Financial strategy

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Summary: Examples of financial strategy, or elements of financial strategy

Keywords: credit rating, target, degrees of freedom, options, flexibility

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Learning outcomes:

1. Leverage is the key component of a financial strategy.
2. Leverage can be measured in different ways.
3. Financial flexibility is a key ingredient of many strategies and can be viewed in terms of real options theory.
4. Liquidity and its access is the purpose of a financial strategy.
5. Venture ownership is rarely mentioned as a part of financial strategy but is important for many reasons.
6. Return on equity is a powerful driver of strategy.
7. Peer group grouping is an influence on strategy.
8. Some elements of strategy may not often appear sensible.

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1 Introduction

This reading comprises a set of examples of financial strategy, set out in brief and simple terms. They are not meant to be a description of a complete financial strategy but to give the flavour behind the design of the strategy.

One way to look at these examples is to think in terms of real options – i.e. options to do something, to change what is being done, or to cease doing something. By adopting a certain strategy, how much has the firm surrendered real options or acquired real options in terms of its ability to carry out further corporate actions.

2 Strategy examples

Example 1: Targeting a credit rating

Many firms target a credit rating to ensure access to capital and to give comfort to customers and suppliers, especially in sectors where the product is based on long term contracts, such as capital goods, or long term service contracts.

The target might be in the BBB range which is often considered a sweet spot for many corporations because it is investment grade but not at the A level which may be considered too demanding and inefficient in terms of cost of capital.

Some larger firms may target an A rating so that they can access the cheaper debt markets such as commercial paper, or have the financial flexibility to make a large acquisition or other large investment. The value of the real option of accessing additional debt markets or making the acquisition is greater than the cost of maintaining the A rating.

Part of the policy here needs to consider how far below the requirements of that rating they might go on a temporary basis. If a BBB borrower, for example, makes an acquisition that raises gearing to levels that are more appropriate for a BB borrower, then as long as there is a plan to get back to the BBB levels within say 2 years, they will probably keep their BBB rating.

This can apply at any level. In the High Yield market, for example, there is more liquidity at B than CCC. Designing the capital structure to achieve this will increase debt capacity and reduce the need for equity.

A deep understanding of the financial ratios and a good forecasting record and model are important here. Vodafone used rating targets at one time in its history.

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Example 2: Allow access to funds for acquisitions

In a similar vein to example 1, firms operating in consolidating sectors need firepower to acquire, failing which they might be acquired themselves. Such firms may hold surplus cash or have a strong rating. This is an abridged extract from an interview with the CFO of Google. (Source: McKinsey Quarterly, August 2011)

Interviewer: To what extent do considerations about capital structure factor into your thinking?

CFO: Capital structure matters a lot, and degrees of freedom matter immensely. The debate that I hear a lot is do you have too much cash? Do you not have enough cash? My answer is always the same: look at how much change has occurred in the digital space in just the last 48 months - 48 months ago, who knew about Netflix or Facebook? Look at the degrees of freedom needed to continue to lead in this space. Yes, there are rumours of bubbles, but setting those aside, there's a company that we all know very well that bought another company that we know very well for $8.5 billion a few days ago. Not $150 million, but $8.5 billion. Make the case, for one minute, that it would have been strategic for us to make that acquisition instead. We would have needed more than $8.5 billion because that's what the acquirer was willing to pay. If the acquisition had been really strategic for us, we would have needed to be able to pounce.

If we could predict the strategic flexibility we'll need in such an uncertain environment, we could optimize the balance sheet perfectly. But consider the constraints: leverage, dividends, and so on. Then call me the next day and say, "Hey, I need something. I'm inventing X." But I can't help—I don't have the flexibility—and end up giving up what could be the most important asset the company needs in order to change over the next ten years. We believe there's an opportunity cost of not having that flexibility.

Now, if we were in some other industry we'd probably have a completely different conversation. Your industry is really what drives your degrees of freedom, and because those degrees of freedom are so wide in the digital space, the cost of not having flexibility can be absolutely crucial.

Interviewer: So how does that factor into the way you think about investor relations? What's your philosophy about what and how to communicate with investors?

CFO: One of the most important documents in the history of Google is the original founders' letter. It's a seminal document because [Google cofounders Larry Page and Sergey Brin] and Eric are still here—and the fundamental premise that actually led the company to success has not changed. They see the future in a way that you and I have a tough time seeing. They see the world with their own time frames, and they are willing to invest at that pace. Think of Android. Android was a very small project five years ago. Larry and Sergey said, "Yes, that's going to work." But read the press articles four years ago; everyone was asking, "What is that? Another distraction from Google." Yet look at the resounding success.

It's really about finding the right audience and the right investors. It's important to have investors match your risk profile and your company philosophy. So a short-term hedge fund manager using a formula that says, "If trigger X happens then I do Y"—that's probably not a good match for us. But thoughtful, long-term investors who are actually patient because they believe the digital economy is going to change?

Example 3: Minimise WACC by targeting debt / equity

This approach is of course the classic Modigliani and Miller type approach and remains an important tool for many. For many firms the logic feels right. It is right to have some gearing because debt is cheap and has tax benefits, but not so much that raising debt gets difficult or flexibility is lost so that opportunities are not able to be taken. The Capital Asset Pricing Model provides a formula here to help the treasurer decide the best level for debt.

Many firms use this approach.

Example 4: Maintain dividends, and buy back shares with cash above a set gearing level of debt / equity

This could be considered a derivation from the "minimise WACC" approach. Dividends are set at a certain level to ensure that certain classes of investors are attracted to the shares, but a gearing level is targeted to ensure balance sheet efficiency and the existence of some debt. This approach is probably only possible in a strongly cash generative firm that knows the level of capital expenditure and acquisitions for which it needs flexibility.

This policy was adopted by BP for many years and perhaps will be adopted again after its recovery from the 2010 Gulf disaster.

Example 5: Maximise debt to maximise return on equity

If equity investors want the potential for high returns and are therefore prepared to take high levels of risk on their equity investment, then this can be achieved with very high leverage. This, of course, is the traditional private equity model that has been used successfully for even very large businesses. High levels of debt have the advantage of providing strong discipline for management and, in the private equity model, also reduce the agency problem, as management will usually own shares as well.

High yield or 'Junk' debt markets must exist to provide the high levels of debt required and while appetite has decreased in the aftermath of the credit crisis, the principle will probably not die completely.

Example 6: Target loan to value to drive expenditure plans

This type of strategy might be found in a property company. Property companies are usually highly geared and components of property portfolios are often financed individually with the debt secured by mortgages. If property values rise, then more debt is available to make more

property acquisitions (capital expenditure). If property values fall, then capital expenditure is cut, or in extremis, properties might be sold.

Example 7: Borrow up to a cash flow multiple

Borrowing up to a multiple of e.g. X times EBITDA (implying roughly X years to repay debt from operational cash flow) could be considered another way to find the ideal level of leverage, but where leverage is described in terms of cash flow rather than the classic CAPM approach of debt as a proportion of equity. It could also be considered a description of the private equity model, where debt levels suitable for each provider of finance are described in terms of multiples of EBITDA.

Note that EBITDA is not a good measure of cash flow because it ignores capital expenditure, tax and working capital but is nevertheless a commonly used proxy; and the multiplier X should be chosen appropriately to allow for such items.

We have seen that Yule Catto target a ratio for Net debt / EBITDA.

Example 8: Don't have any debt, ever

This is perhaps a little tongue in cheek but is rumoured to be the policy of Berkshire Hathaway, Warren Buffet's investment vehicle. It was for a long time also the policy of the supermarket chain William Morrison plc. Having no debt avoids any issue of any control by any lender over the business. It is probably a little extreme but in today's markets of post credit crisis uncertainty, it does have merit. There is no guarantee that any debt market will be there for a business that relies on borrowing when it comes to refinance that borrowing as for example, Northern Rock, the UK mortgage bank found to its cost.

Example 9: Match debt to product / market cycle

Most businesses today are made up of a portfolio of several different product lines or indeed businesses. However, the observation that we have made that a product has a certain life cycle and that it is only really cash generative and non-risky in its maturity phase is a cue to a financial strategy whereby debt is raised during the expansion phase to finance the expansion and production of the product during maturity.

Car manufacturers (and their parts suppliers) are businesses where such a policy might be found. Producing a new model is expensive, requiring capital expenditure, which can be repaid during the maturity phase of the product. While many car firms may analyse leverage according to different methods, this analysis of product portfolios is valuable as well.

Transport companies using expensive transport assets (e.g. aircraft) could take a similar approach.

Example 10: Don't drift more than 20% from peer group

This policy is based on the premise that investors may well shun a stock that is very different from its peers, but also could be based on the view that if the rest of sector takes a certain view, they must be right.

Our investigation of different sectors can also lead us to this conclusion. For example, property companies are usually highly leveraged, as are transport companies.

Rank Corporation, in the mid 2000s, decided to leverage up and become a sub- investment grade borrower after it became the only firm in its sector to be investment grade. Its competitors adopted extra financial risk, making their stock more attractive. Being the odd one out was a disadvantage.

Example 11: No more than 25% of debt maturing in any one year / market

This practice is probably well known to many treasurers and is a standard approach for normally financed firms with a diversified approach to funding, i.e. one that has not come about from a structured approach. It will probably be found in firms which target a BBB rating or above and is perhaps heavily encouraged by the rating agencies, who will like to see a low risk refinancing profile.

Example 12: An inner circle of top banks are very close to us

This of course is merely a description of a relationship approach to banks and lenders but has been used to describe a financial strategy, the logic essentially being that liquidity is supported because a group of banks can be relied on to finance the firm.

This does of course have many weaknesses and cannot be considered a strategy unless combined with other elements to ensure that the borrower remains creditworthy.

Example 13: Investments only made in joint ventures, but under common branding

This policy is around corporate structure. A parent company makes investments with equity stakes around 20% to 25% in various ventures, but licenses its brand so that each venture can exploit its marketing potential. This policy reduces risk at the parent level.

This strategy approaches that of private equity or perhaps even of an investment house, with the exception of the branding concept (Private Equity houses maintain original branding). There is, of course, risk that failure of one venture might affect the brand name and cause

issues in the other, completely unconnected ventures. This strategy is adopted by the Virgin Group, although in fact some of their businesses are 100% owned.

Example 14: Whatever pays the wages, then suppliers, works

Many treasurers have spent at least some part of their career in a company where events (usually disasters, but good things too) happen so quickly that there is simply no time to think about strategy or it is impossible to plan far enough in advance for one particular strategy to stick. Usually in these cases, there are not enough investors in any one type of capital to build a strategy around.

The only approach in these cases is to shorten the planning horizon and concentrate on the liquidity crises as they happen, which are usually wage and supplier payments.