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The Role of Finance in Corporate Strategy

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Abstract
Finance allows organizations to quantitatively understand how a corporate strategic initiative affects corporate value. But some empirical studies available suggest that Chief Executive Officers do not find these linkages easily. The main objective of this study is to demystify finance and show how to use economic reasoning to enhance the quality of strategic decision making. The study is organized to focus on a variety of strategic financing decisions designed to maximize shareholder value creation and to revolve around literature review providing answers to the questions that managers frequently ask. This paper makes a deeper understanding of the financial frameworks for the CEO's to monitor the implementation of their strategic decisions and ensure that they create value. Finance is an integral part of decisions. Moreover, since most realistic decisions are complex, any financial analysis is likely to have some limitations. Similarly, the monitoring of past decisions is critical to ensure that future opportunities for shareholder value creation are not missed and adequate resources are directed to promising investments while unpromising ones are reduced in scale or scope

Keywords: Corporate strategy, Decision Making, Finance, Shareholder Value, Chief Executive Officer(CEO), Chief Financial Officer(CFO).

Introduction

With relatively few exceptions, strategic decision making and finance appear to be in a schizophrenic tension, if not in direct opposition (Grundy 1996). Bettis (1983) believes that modern financial theory and strategic management are based on different paradigms resulting in opposing conclusions. The conflicting state of these two knowledge systems might not matter if CEOs could easily make the linkages between strategy and finance in practice (Grundy, 1992). The polarity between finance and strategy, two areas of research that traditionally are studied separately, is apparent. However, these two areas have many connections. Thus, understanding in which these areas interrelate is critical (La Rocca, 2008).

When nonfinancial managers do not fully understand what the numbers show and the theories behind the analysis, it is all too likely that they will make value-destroying decisions. The same lack of understanding on CEOs' part can also limit the usefulness of the CFOs' expertise, since the former may not be able to provide appropriate feedback about the operational aspects of the corporate. Contributing to this lack of information interchange is the fact that CFOs are often viewed as "numbers oriented", unable to comprehend the strategic implications of decision (Narayanan, &Vikram, 2004). Another cause of value destruction is poor oversight of CFOs. CEOs often due to limited knowledge or outright ignorance do not rein in financial managers who, in the guise of managing the risk of the corporate, indulge in speculative investments. It is important for CEOs to understand risk management tactics and their potential for value creation to set risk management policy and put limits on what CFOs can do (Narayanan &Vikram, 2004).More

important, a good understanding of corporate strategy should help uncover new and potentially profitable projects. Only in theory is a corporate fortunate enough to be presented with every available investment opportunity (Shapiro, 1985).

In particular, the link between financial decisions and strategic thinking is largely unexplored. An extremely relevant but controversial topic in the academic and business communities relates to capital structure decisions and their effects on the corporate are creation of value. A corporate capital structure refers to the financing mix used to finance the corporate. Debt and equity are the two major sources of financing. Each of these is associated with different levels of risk, benefits, and control. While debt-holders exert lower control, they often earn a fixed rate of return and are protected by contractual obligations. On the other part, Share-holders are residual claimants who bear most of the risk and correspondingly have more control over decisions.

Another important objective of the study is to eliminate common misconceptions about financial decisions. Many CFOs do not have just enough financial knowledge. For example, most of them know that "debt is cheaper than equity." They intuitively understand that share-holder value is enhanced if capital is raised at the lowest cost. Therefore, a recommendation that the corporate increase debt in its capital structure might sound like a value-increasing decision. But in practice value creation is not simply a matter of substituting debt for equity, and the decision is too costly. This study mainly aims to review different concepts of finance in corporate strategy in the view point of CFOs. Important models and methods are discussed.

Role of Finance in Corporate Strategy

Figure 1 shows the role of finance in corporate decision making and its interaction with corporate strategy. As figure1 shows, CFOs choose value-generating strategies from a set of available choices. These strategies may involve operating decisions and some other financial decisions (Narayanan, &Vikram, 2004).

The role of finance in operating decisions is primarily some sort of assessment and monitoring. Finance helps managers evaluate the operational alternatives available to them, and helps them monitor the decisions implemented. Such monitoring is vital to the evolution of corporate strategy: it helps manager change or adjusts its strategy based on the feedbacks of earlier strategies. The outcome of a well-thought-out and carefully monitored operating decision is a higher future expected cash flow for the corporate.

The role of finance is obviously more significant in financing decisions. Finance plays a key role in developing the financing strategy, assessing the alternatives, and monitoring the results. The aim of the financing strategy is to raise capital at lowest cost, which in turn increases shareholder value. At first peek, it might appear that these decisions are concerns of the CFO and others need not get involved in. However, as operating decisions have an influence on financing policies, so financing decisions have an impact on financing policies. (Narayanan, &Vikram, 2004).

Capital Budgeting Process

How do corporate identify, assess, and choose projects? This activity that is known as capital budgeting is the comprehensive set of activities in which corporate:

- Clarify their long-term strategy and goals.
- Identify and define activities that will help achieve goals
- Diagnose the cash flows for the proposed projects
- Determine NPV or other value indicators
- Choose the optimal mix of projects
- Execute projects
- Track the performance of ongoing projects.

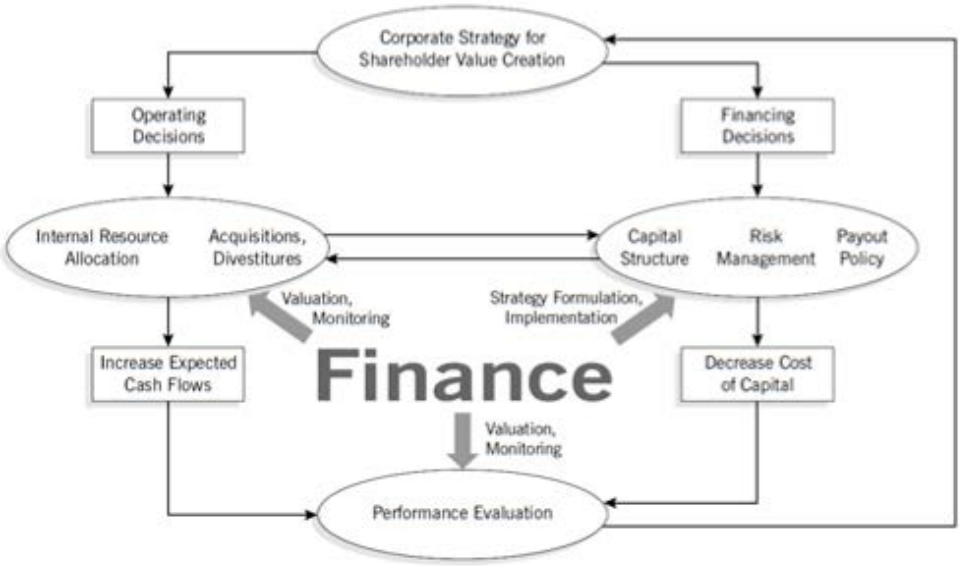

Figure 1. Role of finance in corporate strategy (Narayanan, &Vikram, 2004)

The overall goal of financial management is to increase shareholder wealth. Corporate choose various strategies and business models to achieve this overall goal. (Robin, 2011).

Cash Flow Analysis. Among the various components of the capital budgeting process, cash flow analysis is arguably the most important. This analysis requires corporate to conceptualize the project and forecast future cash flows (Robin, 2011). The most important job for CFO is to create value from the corporate capital budgeting, financing, and net working capital activities. How does CFO create value? The answer is that the corporate should (1) try to buy assets that generate more cash flow than they cost (2) sell bonds and stocks and other financial instruments that raise more cash flow than they cost (Ross et al., 2010).

Role of the Chief Financial Officer. The entrance of the CFO is so vital in the project selection process. By virtue of focusing on the corporate as an entity, The CFO has increased ability to understand how proposed projects interact with the rest of the corporate and to evaluate whether they will generate corporate value. Such examination by CFO is especially valuable in larger projects in which the cost of top management analysis is justified by potential value generation. Smaller projects are more optimally processed at lower levels (Robin, 2011). The CFO acts in the shareholder's best interests by making decisions that increase the value of the stock. The goal of financial management is to maximize the current value per share of the existing stock (Ross et al., 2010).

Portfolio Matrix

During the 1970s and early 1980s, consulting corporate developed the concept of portfolio matrices to help managers in reaching a better understanding of the competitive position of the overall portfolio of businesses to develop priorities for resource allocation. There has been an undeniable impact of these matrices on the process of strategic management.

Portfolio matrices have several elements in common. First, they constitute graphical displays of the overall Competitive standing of the portfolio of businesses of the corporate. Second, each matrix positions the business unit of the corporate according to two dimensions. The factors that

describe industry attractiveness are normally uncontrollable by the corporate; those that contribute to business strength are largely under the control of the corporate (Hax & Majluf, 1996).

The most popular portfolio matrices are:

The growth-share matrix developed by the Boston Consulting Group. The profitability matrix proposed by Marakon, which captures the three most central strategic objectives of each business: profitability, growth, and cash-generation capabilities.

The industry attractiveness-business strength matrix, conceived jointly by General Electric and McKinsey Corporate.

BCG Growth Matrix

In essence the BCG approach views the corporate as a portfolio of businesses, each one offering a unique contribution to growth and profitability. These largely independent units have strategic directions which can be addressed separately (Hax, & Majluf, 1983)

BCG developed the growth-share matrix, in which all the businesses in a corporate are plotted on a four-quadrant grid. The growth-share matrix is useful in three aspects. First, the graphic display offers a powerful and compact picture of the strengths of the businesses in the corporate's portfolio. Second, it identifies the capacity of each business to generate cash and also to reveal its requirements for cash; thus it assists in balancing the corporate cash-flow. And third, it shows the distinct characteristics of each business unit, so it can suggest strategic directions for each business (Hax, & Majluf, 1983).

The New BCG Approach

In conclusion we will describe BCG's new matrix designed to avoid the misleading use of the growth-share matrix, as well as to respond to the changing nature of the competitive environment.

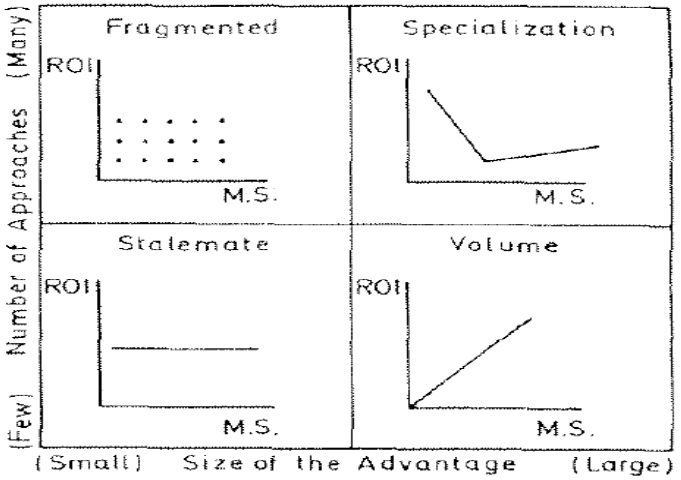

Figure 2.Relationships between ROI & market share in the new BCG (Hax, &Majluf, 1983)

To characterize this new environment, BCG proposes a matrix based on two different dimensions: the size of the competitive advantage, and the number of unique ways in which that advantage can be achieved. The resulting matrix and the new four-quadrant grid recognize four categories of businesses: "Volume," "Stalemate," "Fragmented," and "Specialization." The most appropriate strategy is different in each category and it depends on the relationship between return on investment and market share (Figure 2).

It is only in volume business that the strategies of market-share leadership and cost reduction are still meaningful. In this category, market-share and profitability are closely associated.

Stalemate businesses are those where profitability is low for all competitors regardless of size. There is small difference between the most profitable and the least profitable corporate.

The profitability of businesses in the fragmented category is not correlated with market share. Poor performers can be large or small, and good performers are also independent of size. They differ in which of the very many ways they choose to achieve a competitive advantage.

Finally, in the specialty category the largest profitability is enjoyed by small business able to distinguish themselves among their competitors by pursuing a focused strategy.

With this matrix the size of advantage is definitely linked to barriers to entry; only with high barriers can a corporate sustain a long-term defensible advantage over its competitors. Similarly, the numbers of approaches to achieve an advantage seem to be strongly linked to differentiation. At one extreme of range of differentiation are commodity products and at the other, specialty products (Hax, &Majluf, 1983).

Industry Attractiveness Business Strength Matrix

The industry attractiveness and business strength scores can be used to portray the strategic positions of each business in a diversified corporate. Industry attractiveness is plotted on the vertical axis, and competitive strength on the horizontal axis. As shown in Figure 2eachbusiness unit is plotted on the nine-cell matrix according to its overall attractiveness score and strength score, and then shown as a bubble. The size of each bubble is scaled to what percentage of revenues the business generates relative to total corporate revenues.

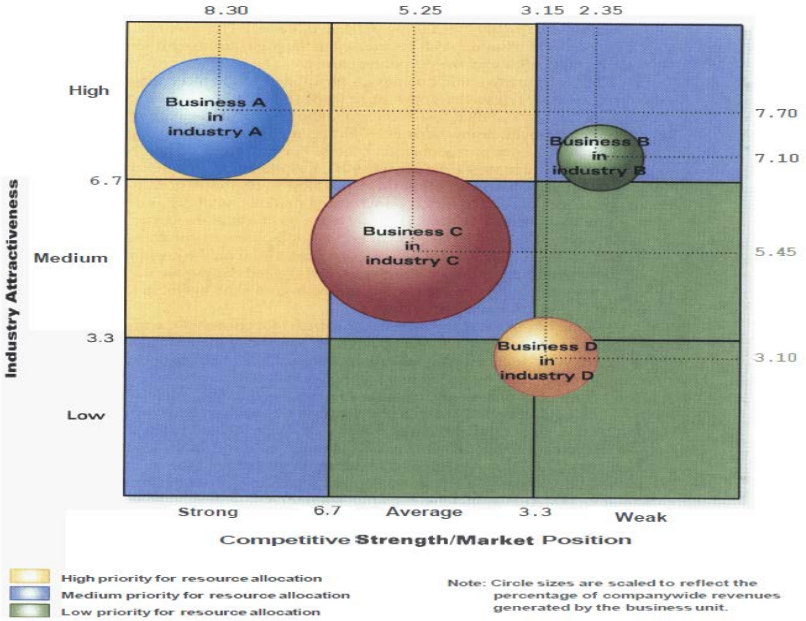

Figure 3. A Nine-Cell Industry Attractiveness-Competitive Strength Matrix (Thompson, et al., 2005)

The locations of the business units on the attractiveness-strength matrix provide valuable guidance in deploying corporate resources to the various business units. In general, diversified corporate prospects for good overall performance are enhanced by concentrating corporate resources and strategic attention on those business units having the greatest competitive strength and

positioned in highly attractive industries-specifically, in the three cells in the upper left portion of the attractiveness-strength matrix.

Capital Structure and Corporate Strategy

Based on the facts about capital structure, many parameters that result in benefits and costs influence the optimal mix between debt and equity. The relationship between a corporate management and their financial and nonfinancial stakeholder generates financial distress and difference between "real" decisions and financing decisions. Therefore the concept of value maximization is important to better understand the potential interrelation between capital structure and corporate strategy.

Figure 4. Overview of the relation between Capital Structure and Financial and Nonfinancial Stakeholders (La Rocca, 2008).

Capital Structure and Competitive Strategy

This topic consist of two broad issues (1) the way market characteristics affect corporate financing choices, and (2) the way a corporate wants to alter its capital structure to affect behaviour of other corporate and the kind of reaction of other corporate due to a certain corporate capital structure. Thus, managers could use capital structure to reduce product market competition, making the corporate stronger against their competitor, or to extract favourable behaviour from other competitors. In this sense, if a corporate leverage influences the investment decisions, the incentive to take on a risky project, the liquidation choice, and thus the action of its competitors, then managers can use capital structure choice as strategic tool that grants a competitive advantage.

A corporate capital structure may affect both market structure and the competitiveness of an industry by strategically changing financial behaviour, depending on a corporate capital structure and that of its rivals. A corporate financial structure can influence production and pricing decisions as well as its pre-commitment to a certain strategic output or price level, but it also affects entry and exit decisions through current predatory behaviour.

The relationship between market structure and capital structure is sensible during an industry recession, when highly levered corporate tend to experience lower operating profits and lose more market share than their more conservatively financed rivals. Product differentiation and industry concentration worsen this effect (Jensen, 1986). Unlevered firms can try to take advantage of the situation by using aggressive behaviour to weaken the financial position of a rival. In an effort to drive out highly levered competitors vulnerable to financial distress, financially strong corporate may make use of distress periods to aggressively advertise or price their products.

Aggressive corporate lose market share to their less levered rivals during industry downturns for several reasons. First, distressed corporate that have underinvestment problems and invest less

are required to sell off assets and reduce their selling efforts. Second, they have difficulty retaining and attracting customers who are concerned about long-term viability and product quality of product. Third, rival competitors can consider highly aggressive corporate as a vulnerable competitor and seize the opportunity to steal customers (Jensen &Meckling, 1976).

Capital structure choice can also alter the incentive of who runs corporate and can modify the behaviour of product market rivals due to predation strategy. To drive a rival out of the market, predators may choose to voluntarily lose money in the short run, relative to the short-term profits they could achieve with a different strategy. By reducing competition, they hope to eventually more than recoup any short-term losses by, for example, increasing prices of their products. This behaviour may affect strategic choices that can hurt their rival's bottom line and prospects based on such factors as low price, intense advertising, and selective price cuts.

Mergers and Acquisitions (M&A)

Mergers and acquisitions are one of the most important and largest investment decisions that companies and corporate strategists face. They are also one of the most complex transactions usually involving simultaneous decisions on how to engage in a merger or acquisition, how to finance and pay for an M&A and how to align the financing requirements with the target capital structure. To persuade stakeholders of the acquisition target to a proposed merger or acquisition, the bidder not only must make a financially attractive offer but also must disclose the terms of the proposed M&A, thereby offering valuable insights for an empirical analysis (Bessler, Drobetz, and Jan, 2011).

A merger is said to occur when two corporate combine to form a new entry (Robin, 2011). A merger is a transaction involving two or more corporations in which stock is exchanged in which only one corporation survives. (Wheelen, &Hunger, 2012). An acquisition is said to occur when one corporate acquires another; the target corporate loses identity and become part of the acquiring corporate (Robin, 2011). Acquisition is a relatively quick way to move into an international area. Synergistic benefits can result if the corporate acquires a corporate with strong complementary product lines and a good distribution network (Wheelen Hunger, 2012). Mergers can be viewed as mechanisms that shift control over assets from existing parties to new parties. A change in control can occur through means such as control over a corporate board of directors (Robin, 2011).

Methods of Payment

Before making an offer, the bidder in a corporate takeover has to decide on the method of payment. Therefore, the bidder faces the dilemma of overpaying for the target or risks the possibility that the offer is too low, which may result in the target rejecting the offer or attracting competing bidders. Method of payment decision is therefore an important issue as cash and stock offers differ regarding these transaction risks. These differences are due to information asymmetries and variation in their pricing mechanisms. Stock and cash offers are also different from a governance point of view because stock offers may fundamentally change the ownership (Bessler, Drobetz, and Jan, 2011).

To persuade the target shareholders to agree on the terms of the takeover and to mitigate competition risk of other bidders, the offer price has to exceed the target's stock price before the announcement by a substantial margin. Theoretically, the offer premium should reflect the potential gains from expected synergies or other factors of the merger and also how these gains are allocated between the bidder and the target companies. The premium will also depend on the relative bargaining positions of bidder and target (Andrade, Mitchell, and Stafford, 2001).

Regarding of the risk and return trade-offs as well as the allocation of control rights, fundamental differences exist between cash and stock offers. The bidding corporate offers a fixed amount which is willing to pay in exchange for the target shares when using cash as the method of

payment. The target shareholders divest from the corporate in exchange for cash when the deal is closed. Though, they are not prevented from investing in the bidder's stock and continue to be shareholders. In contrary, there is uncertainty about the actual price the target shareholders receive when stocks are offered as the method of payment. Typically, they have offer of specific number of bidder shares or of the newly combined corporate in exchange for their shares. When the deal is closed, the target shareholders become shareholders of the newly combined corporate so that their return depends on the performance of the newly created corporate and the potential profits from synergies. Nevertheless, investor always has the opportunity to exit and sell their share at the prevailing market price before or after the deal is closed Bessler, Drobetz, & Jan, 2011).

The bidder has to consider both the benefits and costs integrated with various financing alternatives in deciding on the source of funds for corporate takeover. These may emanate from information agency costs and asymmetries. Sequencing of the takeover and financing decisions is often observed and may be considered as an alternative strategy for a corporate takeover. In these cases, the bidder first starts a takeover attempt and then assesses different financing alternatives. Alternatively, the bidder first gathers cash or secures sufficient financing sources and then approaches a takeover target (Bessler, Drobetz, & Jan, 2011).

Valuation Effects of Takeover Financings

Due to market imperfections, the capital market reaction at the time of takeover announcement will reflect both markets' assessment of the value of the acquisition and the effect of financing decision. This is due to the fact that the use of internally generated funds, on the one hand, and debt and equity financing, on the other hand, differ with respect to information asymmetries and agency costs. This should also have an impact on the market value of the acquiring corporate.

When there is a sequence of first financing and then announcing an M&A, the valuation effects of the bidding corporate at the time of the financing announcement will reflect both the overvaluation signal and investment opportunities. Consequently, the stock price reaction to the M&A decision will reflect the resolution of the markets' uncertainty about the corporate ability to realize investment opportunities and whether the financing decision was merely driven by overvaluation. In this case, the takeover announcement reduces some of the uncertainty about the motivation for a corporate decision to issue equity, which is either overvaluation or the funding of great investment opportunities. In contrast, when the sequence is first announcing M&A and then financing, the use of funds may be credibly signaled, so that raising funds may be less costly.

Strategic Project Risk Appraisal

Project risk appraisal should begin before the organization makes its decision about whether to undertake a project or if faced with several options, which alternative to choose. Timing is important here. In early accounting literature, rooted in economics, project appraisal was seen as part of capital budgeting, defined as the allocation of scarce resources between alternative uses so as to best obtain objectives over time. This covered decisions on the total amount of capital expenditure a corporate should undertake and the financing of projects as well as the decisions about which specific investment projects to accept. The main methods of project appraisal recommended, internal rate of return and net present value, were based on discounted cash flow (DCF) techniques.

The term capital budgeting also implied that capital expenditure decisions might be reutilized into the overall budgeting process, usually within an annual planning cycle. In the case of investment in assets such as manufacturing equipment in established corporate, where life cycles and capacity requirements may have been relatively predictable, this assumption may have been reasonable. However, with the more rapid change and complexity involved in advanced technology

and the emergence of new knowledge-based industries, a fundamental change in outthinking about investment in projects has become necessary.

The need to focus business planning more externally on the competitive environment and the shortening of time available to identify and evaluate new opportunities is well documented in the strategy literature, where investment decisions are more about the formulation and implementation of strategy. Recent research is concerned with strategic alignment of projects (Langfield, 2005).

Strategic investment decisions are still concerned with choosing 'between alternatives so as to best obtain objectives' (Bromwich, 1976), but involve a far broader consideration than the economics of the prospective project. Researching the 1980s and 1990s shows the focus on the fit between the use of DCF techniques for capital expenditure evaluation and specific contingencies of business strategy, external environment, information systems characteristics, reward systems structure, and degree of decentralization (Langfield, 2005).

Strategic investment decisions (SID) are required to deliver a business strategy and allow an organization to meet its business and financial goals. The SID process starts with the identification of a project opportunity or a number of alternative opportunities that compete for the allocation of organizational resources (money, people and capital equipment).

By means of exploratory cases and a survey to investigate risk management practices in UK companies Collier, Berry and Burke (2007) found that heuristic methods of risk management were used much more than the systems-based approach that is associated with risk management in much of the literature, at least at the corporate level and the methods in highest use were the more subjective ones (particularly experience) reinforcing the role of the human actor over analytical techniques. They also found that organizational stance towards risk was important in determining risk management practices.

Conclusion

Strategy and finance are growing closer together, and a strong integration between them can be tantamount to a competitive weapon. In particular, the interaction between financing and investment decisions create a situation in which high or low debt can compromise a corporation's ability to take advantage of strategic options.

Nonfinancial manager should understand what the numbers represent and what assumptions behind analysis exist, so they will not make value destroying decisions. On the other part, general managers could make use of their financial managers' expertise, since they are able to provide appropriate feedback about the operational aspects of the corporate.

Moreover, due to general managers' knowledge, financial managers in the guise of managing risk of the corporate could not indulge in speculative investments and cross the line into criminal activities. General Managers understand risk management tactics and their potential for value creation well enough to set risk management policy and place limits on what financial managers can do.

This study demystified finance for the general manager and explained how to use economic reasoning to enhance the quality of strategic decision making. With a complete understanding of how to evaluate the alternatives, now it is possible for the general manager to make the value-maximizing choice.

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