Corporate Strategies & Financing Planning & Financial Health

Dr. Ram Chandra Rai

Sr.Professor (Finance Management)

Railway Staff College,

Vadodara, 390004

Corporate Growth Strategies

- Sustainable growth strategies
- Sustainable value creation strategies

Growth Strategy Features

- Growing investments/Plan size/Planned expenditure
- Growing asset size/size of balance sheet
- Growing sales
- Profit can decline due to increment cost of service being more than incremental price.
- Urge to grow fast (higher turn over, larger asset base, more products/ services) is human temptation

Growth strategy –features-contd.

- Assumption-more sales, lead to higher return on equity
- Focus-Growth in sale
  - ✓ 20% increase in loading
  - ✓ 10% increase in track kms.
- Investment policy-may reject value adding investments just to maintain growth targets in sales/net work

Growth strategy –features-contd.

- Planning-Volume based (More sales, larger net work, new technologies-state of the art)
- Pricing-Concession below cost to capture market to improve utilization of capacity created without adequate demand.
- Financial Results- may erode financial strength.
- Competitive Advantage-may not lead to sustainable competitive advantages.

Sustainable Value Creation Strategy-Features

- Focus-Continuous improvement in value of the organisation.
- Planning-Comprehensive Planning with specific value addition target during corporate planning period.
- Methodology-operating margin planned to be always above break even operating margin duly incorporating all risks.
- Financial analysis-Value oriented Break even analysis

Break Even Sales

- This is the quantity of products/services produced /sold at which the firm is able to just recover all types of cost but has no profit for a given cost & price structure. Financial break even should be achieved.

Break even Operating Margin

- It represents the operating profit margin at which business will earn exactly its, average cost of capital.
- Neither value addition nor value destruction
- Financial health remains unchanged.

Break Even operating Margin-contd

- Essential Ratio-Operating Profit/Sales
- Can be used to evaluate past performance.
- Fixing performance target while making corporate plan.
- Incremental BE margin-percentage margin required on incremental sales.

Break Even operating Margin-contd

- Can be expressed as
  - ✓ Margin required on incremental sales(incremental BE margin) or
  - ✓ Margin required on total sales(BE margin)

Value Creation Strategies-Operational Aspects

- Operating managers must select strategies having operating profit margin covering average cost of capital.
- They should be able to assess the value creating potential of alternative strategies.
- BE margin concepts is suitable to link strategic decisions with value creation

Strategies for Value Creation

- Need to have properly designed performance measurement and executive compensation schemes during operation phase so as to motivates managers to create value by rewarding them for value.
- Operation phase performance measurement to be consistence with those established during planning phase to get results as per plan.

Strategies for Value Creation--contd

- Difference, if any, will force managers to take decision as per operations phase evaluation system expectations and not as per plan and plan will fail to deliver.
- Economic value of a strategy to stakeholders can be assessed by estimating future cash flows associated with it.
- Firms in the same industry perform differently due to different strategies.

Strategies for Value Creation--contd

- Strategic planning process results in formulation of projected financial statements.
- Projected EPS over 5 year period indicate attractiveness of strategy adopted.
- We should know
  - Which units are creating value
  - Which units of destroying values
  - How alternative strategy would affects shareholder value.

Strategies for Value Creation--contd

- Planning has to be linked to operational realities.
- Ability to borrow depends upon projection of additional cash flows generated in future from incremental investment.
- Risks are excluded in accounting figure but incorporated in DCF techniques.
- Accounting figures exclude investment requirements and time value of money

Strategies for Value Creation--contd

- Suitable strategy can be selected by
  - Analyzing alternativeness of industry and competitive position
  - Assessing impact of alternative strategies a attractiveness of the industry and competitive position
- Incremental value can be estimated by quantifying the change in value of the firm over forecast period.

Strategies for Value Creation--contd

- Change in value of the firm over forecast period.
- Value creation results from corporate investments at a rate in excess of cost of capital rate required by capital market.
- Corporate mission statement of public enterprises must be to
  - Maximize net contribution to national exchequer
  - Be a self sustaining organization to discharge stated duties.

Strategies for Value Creation--contd

- Strategies must detail,how to accomplish it?
- Business must generate free cash flows in excess of investments from all sources including national exchequer.
- PSUs must be net contributor than net consumer of national resources.
- Employee of PSUs being rewarded for improved turn-overs but financial position may deteriorate so no incentive for value creation.

Strategies for Value Creation--contd

- Net financial results, is no body's concern
- No effective financial control system in place to ensure value creation.
- National Audit entangled in procedures & system deviations failing to audit the results or investment strategy results.
- Need to have sustainable competition advantage for commercial enterprises competing with private enterprises.

Strategies for Value Creation--contd

- Sustained competitive advantage not feasible without strong financial strength.
- Customers will withdraw their supports if their interests (good quality, reasonable price and good after sale service) is not met.

Need of Long term Financial Planning (LTFP)

- Involves development of financial models to look into future
- Helps in anticipating future financial performance.
- Comparing expected financial performance with corporate targets and investors expectations.
- Anticipates effect of proposed change in operating strategies

Need of LTFP- contd

- Anticipates future cash flows & financial needs
  - Capital investments(Long term)
  - Working capital(short term)
- Anticipate future value of firm
- Facilitates proper management of funds
- Supported by marketing strategy & production plan

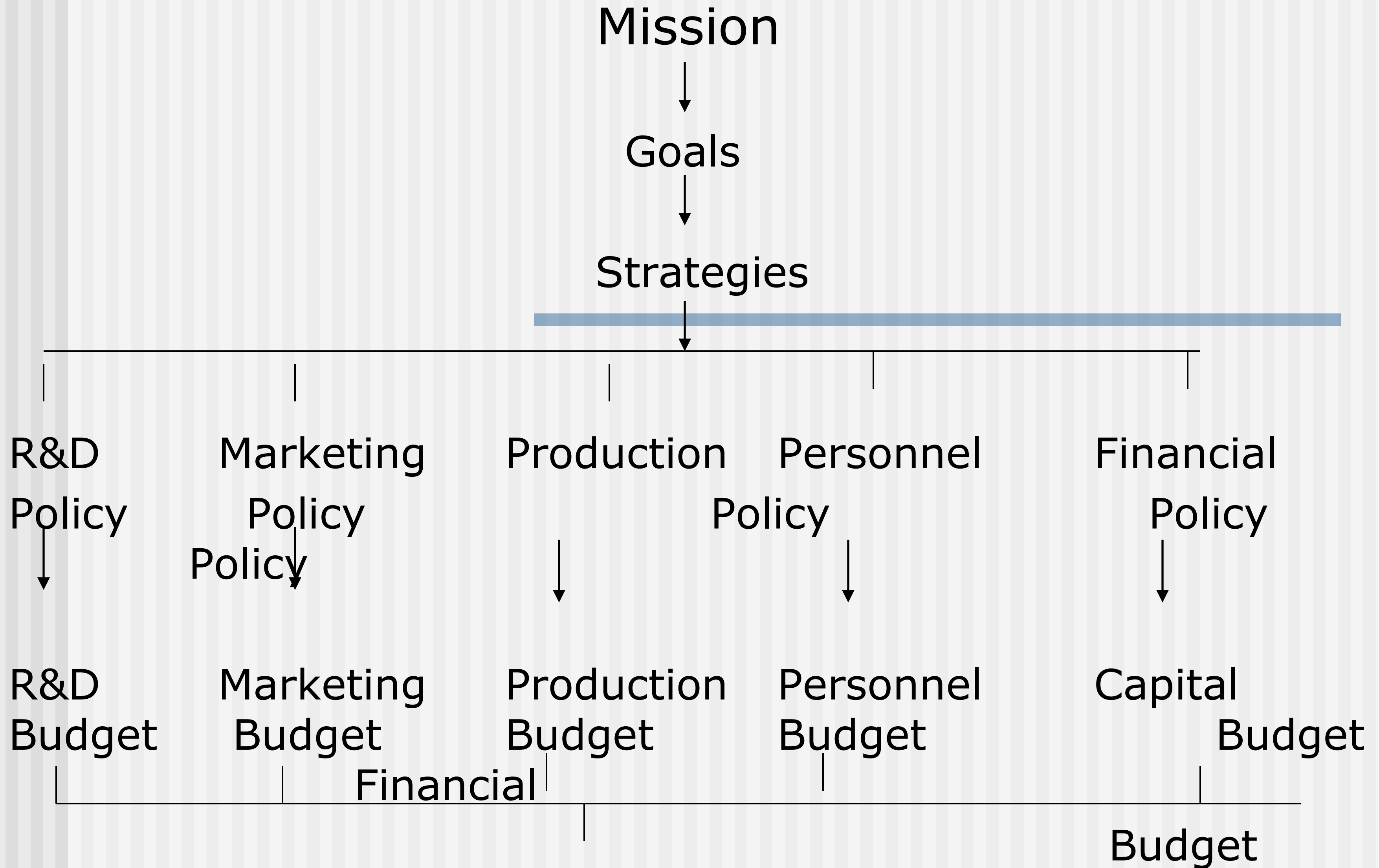
Planning System

- Part of corporate plan
- Corporate plan begin with corporate mission and goals in qualitative form
- Strategy derived from mission and goals.
- Related policies and budgets developed in various areas to support strategy

Planning System--contd

- ✓ R&D
- ✓ Production
- ✓ Finance
- ✓ Marketing
- ✓ Personnel
- All developed into financial plan

Planning System--contd



Long Tern Financial Plan (5 to 10 years)

- Represents blue print of what firm proposed to do in future.
- Elements of LT Fin. Plan
  - Economic assumptions
  - Interest Rate
  - Inflation Rate
  - Growth Rates
  - Exchange Rates

Element of Long Term Financial Plans- contd

- ✓ Sales forecast
- ✓ Performa financial statements
- Profit and loss account
- Balance sheet
- Cash flow statement.
- ✓ Proposed capital investment requirements
- ✓ Proposed working capital requirements
- ✓ Proposed sources of financing
- ✓ Cash Flows

L.T.Financial Plan-Advantages

- Identities advance actions to be taken in various areas.
- Seeks to develop options for various conditions.
- Facilitate exploration of interaction between investment and financing decisions
- Clarify links between present and future decisions

L.T.Financial Plan-Advantages--contd

- Helps avoiding surprises
- Ensures financial viability of corporate strategic plans.
- Provides bench marks (standards) to measure future performance.

Sales Forecast

- Done by marketing deptt.
- 3 to 5 years period.
- Base year forecast most crucial (share of firm in total demand)
- Use of qualitative (Judgment of experts) and quantitative techniques (time series, percentages etc.)
- Knowledge of market, segments, consumer behaviour essential.

Sales Forecast – contd.

- Forecast the sales volume (number of units to be sold) and price to be realised for the entire planning period.
- Bifurcate domestic & export sales wherever applicable

Preparing Pro-forma Profit & Loss Account-Percentage of Sales Method

- Assume that future relationships between various elements of costs to sales will be similar to their historical relationships (No change in Ratios)
- Ratios are to be decided by taking average of two/three years actuals)
- Affected by operating leverages.
- Some items like dividend etc. require managerial decisions.

Projected P&L Account-Ascertaining the ratios

.	Historical data					
Sl. No	Item	2004	2005	2006	Average % of sale	
1	Net sales					
2	Cost of goods sold					
3	Gross profit					

Projected P&L Account- Ascertaining the ratios- contd

.	Historical data					
Sl.No	Item	2004	2005	2006	Average % of sale	
4	Selling exp					
5	General & Adm.exp					
6	Depreciation					
7	Operating profit					
8	Non-optg surplus					

Projected P&L Account- Ascertaining the ratios- contd

.	Historical data					
Sl.No	Item	2004	2005	2006	Average % of sale	
9	Profit before interest & tax					
10	Interest on borrowings					
11	Profit before tax					

Projected P&L Account- Ascertaining the ratios- contd

.	Historical data					
Sl.No	Item	2004	2005	2006	Average % of sale	
12	Taxes					
13	Profit after tax					
14	Dividend					
15	Retained earnings					

Projected Profit and Loss account-Budget expense method(BEM)

- Estimate value of each items based on expected development in future.
- Such items do not vary in proportion to sales such as.
  - General & Administrative Expenses.
  - Depreciation
  - Interest
  - Tax
  - Dividend

Project P&L Account-BEM_ contd

- Continue both the method
- Percentage method for variable cost element
- Budget expense method for fixed cost element.

Pro-forma Balance Sheet

- Percentage method to obtain value of assets, current assets, liabilities and provisions.
- Estimate value of reserve and surplus by adding projected retained earnings.
- Loan on net of payment base(Repayment schedule)
- Balancing item to be set..

Projected balance sheet example

Sl.no	Item	Basis
1.Assets		
a.	Fixed assets	% of sales
B	Investment	No change
c	Current assets	% of sales
i)	Cash	% of sales
ii)	Receivables	% of sales
iii)	Inventories	% of sales
D	Prepaid tax	% of sales
E	Misc exp & loss	% of sales
Total		

Projected Balance sheet-contd

Liabilities		
a.Share Capital		
i)	Equity	No change
ii)	Preference shares	No change
iii)	Res. & Surplus	Old balance plus retained earnings
B. Secured Loan		
i.	Debentures	No change
Ii	Bank borrowings (long term)	% of sale or Repayment Schedule

Projected Balance sheet -- contd

C. Unsecured Loan	Bank borrowing	% of sale
D.Current liabilities		
	Trade creditors	% of sales
	Provisions	% of sales
	Eternal funds	Balance funds

Guidelines Semi-variables/fixed costs

- Wages & Salary category over heads administration retaining and distribution overheads being generally fixed in nature, do not change much hence are to be forecasted.
- Ending equity=beginning equity + estimated retained earnings for the year+ share capital issued if any.

Guidelines Semi-variables/fixed costs--contd

- Interest to be calculated on outstanding loan amount as per repayment schedule.
- Current assets requirement as percentage of sales
- Individual component of current assets given below as percentage of current assets.
- Cash
- Debtors
- Inventories (based on past ratios)

Guidelines- contd

- Current liabilities to be estimated as percentages of current assets
- Individual components of current liabilities as percentages of current liabilities
- Depreciation schedule of fixed assets needs to be drawn to estimate the amount of depreciation in each year.
- Use marginal tax rate (If applicable) to calculate tax liability and profit after tax.

Cash Flow Statements

- Estimate net cash flows from
  - Operating (Cash surplus)
  - Investing (Cash outflow)
  - Financing (Cash inflows)
- Forecast cash proceeds and cash disbursements(Outflows) during the period.
- Prepared from two balance sheets.
- Forward looking planning tool.
- Excess of cash out flow over cash flows is external funds requirement.

Fund Flow Statement

- Country cousin of cash flow
- Indicates
- Sources from which funds were raised (source of funds)
- Items on which deployed(applicable or funds)
- Also called statement of change

Simulations

- Alternative strategies
- Alternative strategy-mix
- Calculate revised ratios for each strategy/strategy mix
- Prepare projected P&L account and Balance sheet and cash flow statement for each strategy

Strategy Formulation

- Decide best strategy/strategy mix
- Issue detail policy statements/guidelines
- Issue operational quantitative targets and financial targets to various units
- Decide evaluation criteria
- Monitor and take remedial action.

Conclusions

- What a financial statement does not reveal is even more interesting than what it reveals.
- Must ensure value creation financially, economically and socially
- Must be precise
- Keep away from the glamour of blind growth
- Corporate mission should incorporate the pre-condition of viability.