Course on Entrepreneurship
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Lecture 35
Raising Finances and Developing Financial Strategy-Part 5

Hi Friends, welcome to the NPTEL course on Entrepreneurship. In this module, we will talk about certain aspects of financial strategy as part of the overall course on raising finances.

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The financial strategy of a firm is a set of integrated financial activities that need to be planned for, and that need to be executed. So, that the firm can achieve its goals and the goals are usually in terms of maximizing revenues, maximizing profits and maximizing the value for shareholders. This goal of maximizing value for the shareholders has overtaken the earlier goal of maximizing the profitability for the firm. And tomorrow, quite possibly the goal of maximizing the value for the shareholders would be overtaken by the need for maximizing value for the stakeholders.

So, and there are different theories that if a company is able to maximize the value for the nation, it will be able to maximize the value for the shareholders. While those philosophical discussions would be there, from a point of view of developing the financial strategy, we have to keep in mind that a financial strategy or a model is just not expression of the strategy in financial numbers, financial strategy has got its own peculiar and essential features and it has its own pros and cons in terms of developmental challenges.

And the financial strategy has its own set of factors which needs to take into account to be able to input itself very effectively into the business strategy. Like business strategy financial strategy also covers a long term horizon of five years, and in case of infrastructure companies maybe 10 years or 15 years. And the financial strategy of a company directly impacts the financial position of the company and the financial position of the company in turn impacts the financial strategy of the company.

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Again, a recap of how business strategy comprises key functional strategies of which financial strategy is one.

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Like other strategies, there are certain core questions that need to be answered by the financial strategy, fundamentally, what are the assets and liabilities of the firm. When you talk about start-up, for example what are the assets of the firm and what are the liabilities are they firm? Liabilities are essentially in terms of the investments taken, and assets are in terms of the product technologies and the patents the start-up has.

And when we talk about an established firm, the list of assets and liabilities grows substantially longer. And what is the profit and loss arising from the operation. So, the income statement and the balance sheet of the company provide a very good picture of the financial health of the company, but most importantly to have a good financial strategy, you should understand the price and cost structure in respect of each of the products in the product portfolio.

One should understand the price and cost and therefore, the viability of each of the products in the product portfolio because the decisions as to what products to manufacture for what regions is very much dependent on the product wise profitability that exists. And this is an important driver of both the tactical as well as strategy operations of the firm.

And the financial strategy should also understand the implications of adopting a particular type of operation strategy, should I have decentralized production or centralized production? Should I have production which is fully integrated or quasi integrated or completely non-integrated? What are the implications of different types of manufacturing and operational options that I would have?

And how should I fund my business, should that be through equity, should it be through debt or a mix of both of these things. And how will the firm maximize its value to the shareholders, what are the singular measures of firms performance and which performance measure would be more appropriate for which type of industry. So, these are some of the basic questions which the financial strategy of a firm tries to address, and the answers are important for developing a business strategy.

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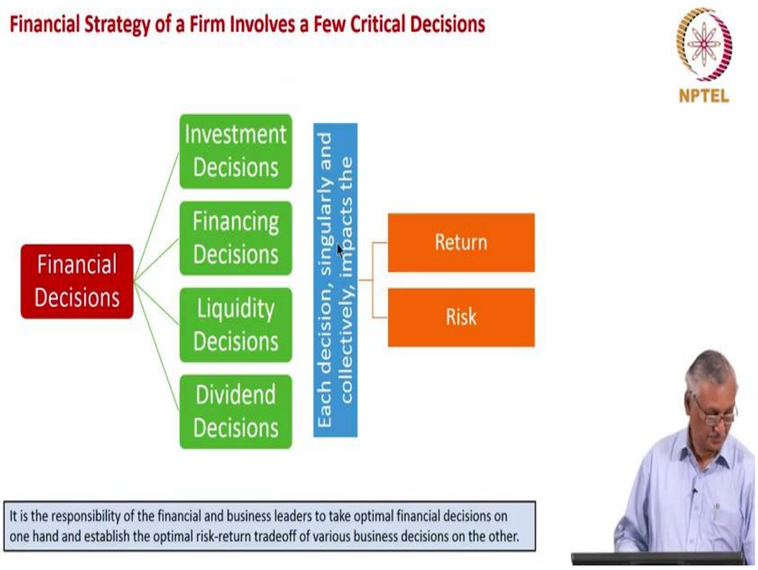

The financial strategy of a firm involves few critical decisions, these are the investment decisions, the financing decisions, the liquidity decisions and the dividend decisions. Investment decisions means, how much money I should invest and on what projects, financing decisions means how do I provide the funds for these kinds of investment decisions. Liquidity decision means, how should I fund my operating cycle, and what level of liquidity I should provide for in the system and how do I pay out of my profits for the wealth of the shareholders this is the dividend decision.

Each decision singularly, as well as together carries its own set of risk and reward mechanism for the company, and it is a responsibility of the financial and business leaders to take optimal financial decisions, not just one a good investment decision not one good financing decision, but a combined set of all these decisions so that the risk return profile of the company is in a stable situation.

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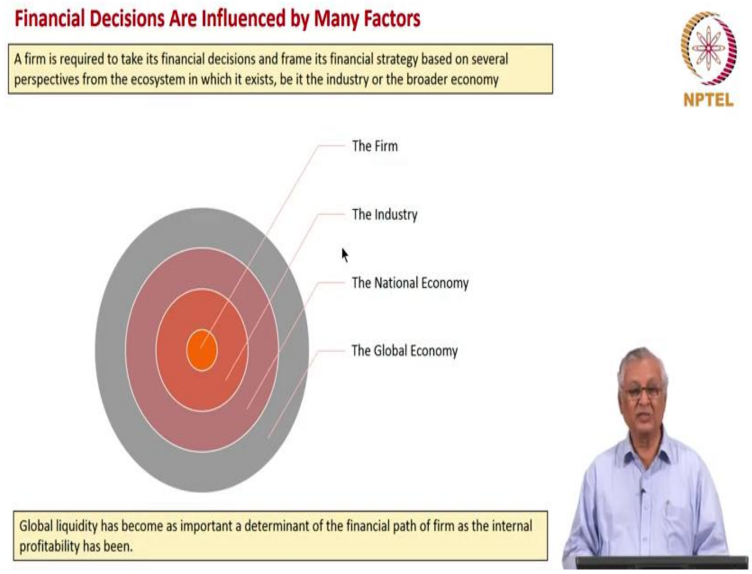

Again, financial decisions are influenced by many factors, at the core is the firm, that is the impacted by the industry, the nature of the industry dictates the kind of financial parameters which with the firm operates. Then we have the national economy and finally we have the global economy. As I said earlier also, global liquidity has become a very important determinant of financial health of the company, the flexibility a company would have depends on the global liquidity.

If certain telecommunication firms have been able to get billions of dollars to be able to fund their past dues, it is because global liquidity has been available which again is in turn related to the fundamental management strength of the firm by assuming that the strength of the firm is there, the economic factors the global economic factors determine whether the company will be able to implement a particular type of financial strategy. Therefore, the overall perspectives of the industry and economy are also vital in developing a firm level strategy.

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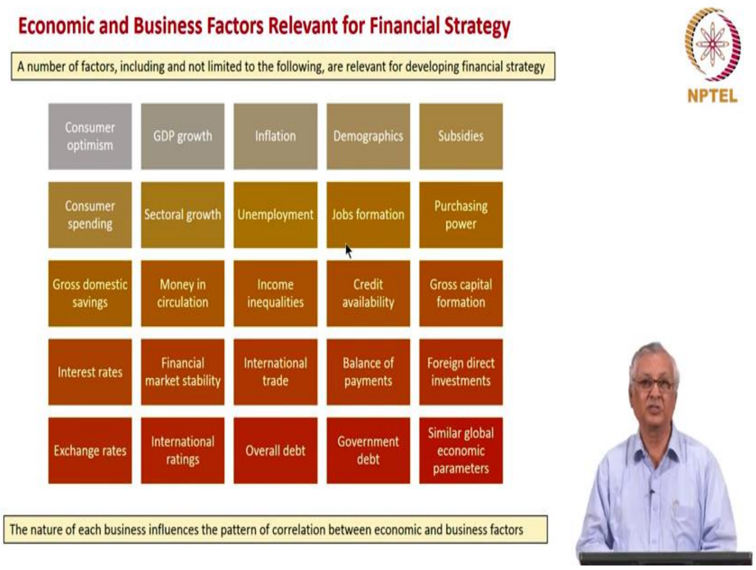

There are a number of factors which are used and which are relevant for understanding the financial strategy of the firm and also developing it as well. So, at a consumer level, what is the level of consumer optimism? What is the pattern of consumer spending? What is the gross domestic savings in the economy or what are the interest rates? What are the exchange rates? These are all some of the factors.

Then similarly, the GDP growth rate, the sectoral growth rate, the money in circulation, the CRR ratios, the statutory ratios which the banks have to have. The financial market stability, the international ratings of the economy these are again important for the financial strategy. Inflation levels, unemployment, income inequalities, international credit, overall debt these are another set of important factors, the demographics how young is the population or how aged is the formulation?

What is the level of job formation in the economy? Availability of credit, the balance of payments, the governmental debt these are again important. Subsidies, the purchasing power, gross capital formation, foreign direct investment important. Similarly, what we analyse at the national level, we should be able to analyse at the global level. So, the financial strategy when we talk about the environmental factors has a set of very economically driven numbers that are very relevant for formulating the financial strategy of the company.

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Financial strategy is far more than just forming a set of numbers, in finance function today is expected to take care of three other important aspects, one is corporate governance to ensure that the companies run on prudential line, we do not have excess debt, we do not convert our running assets into non performing, assets we make sure that any deviations to the systems are reported at an appropriate time to the board of directors. So, corporate governance in the overall, that is one of the goals of the financial strategy.

Second, ethics and compliance, to ensure that the company is an honest corporate citizen, it is the responsibility of the finance function of the company. And also, the business continuity and risk management, what happens if the data is lost? What happens if we have server hacking? What happens if we have somebody getting into our system and saying that I am the CEO of the company, I am giving you this instruction, so how do I ensure that the risks that the company faces due to the increasing international operations are taken care of, that is also the role of finance management.

And finance strategy has to have appropriate structures and organizational support, such as having an internal audit function, having an external internal audit function and a compliance audit function to be able to fulfil these requirements. And in essence, the operational integrity and also the business continuity of a business, even more than business strategy is dependent on the financial management and leadership of the company.

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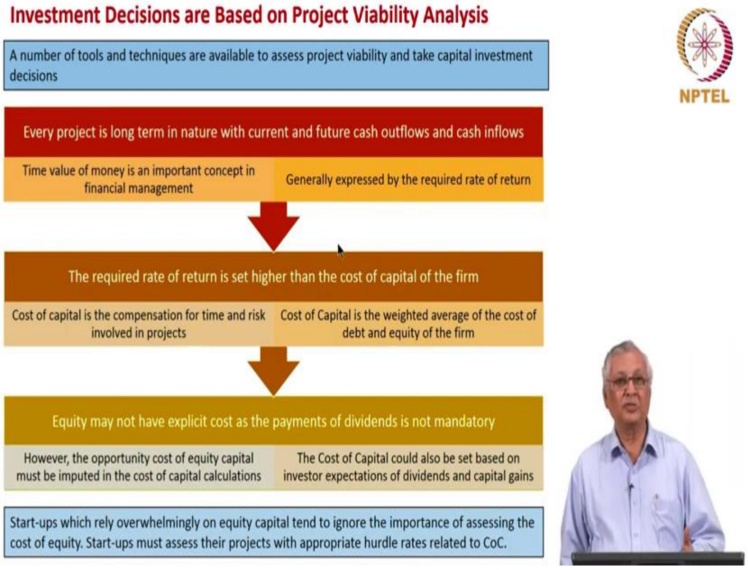

Now we know that the investment decisions are based on project viability analysis, and project viability analysis is having its own peculiarity because projects are of long-term in nature, typically you have cash outflows over one to three years and you have got revenue streams occurring after three years and going on to a long period of time.

Therefore, the time value of money is extremely important in a management sense and that is expressed by the required rate of return and cost of capital is there, even if you have funded completely by equity, it has its own opportunity cost of capital, so the financial strategy of the firm has to understand the operating cost of capital of the firm and then analyse each of the projects in terms of the compliance to the operating cost of capital.

And start-ups which rely overwhelmingly on equity tend to ignore the cost of capital and they believe that the capital is available cheap and it has no cost because we are not paying monthly interest or yearly interest, nothing can be farther from the truth because there is a cost which is imputed by the investor to the investment which he is making or she is making into this company.

If I were not to make this investment in this company, what other opportunity I do have? Similarly, you have a cost to the equity investment, you have taken because it dilutes your future value generation. Therefore, the cost of capital should be imputed regardless of the company's equity funded or the debt funded.

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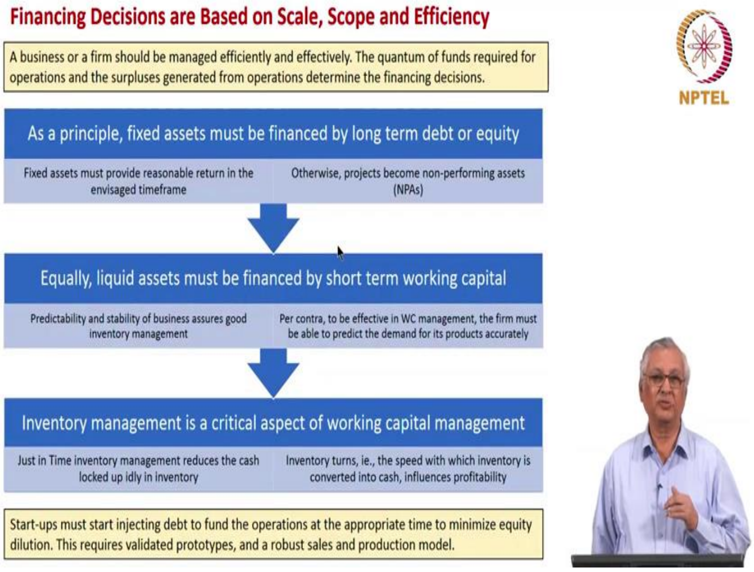

The financing decisions in general, have to be based on the scale, scope and the time span. One of the good principles of financial strategy is that the capital structure should be so established that the fixed assets are funded by long-term sources of finance are more by risk capital and the liquid assets must be financed by short-term sources of finance or working capital offered from the banks.

And to be able to do this effectively, you need to good inventory management. Therefore, the start-ups how to make sure that the product that is being established has got an established operating cycle, so that we'll be able to separate out the long term nature of financing versus the short term nature of financing. So, typically if you are making, for example a smartwatch which requires five crores of money for scaling up and if you have so far taken five crores as your equity investment to do this R&D development by resorting to further equity financing to handle this scale-up, you are diluting yourself substantially.

On the other hand, if the product is well developed and the banks are in a position to understand the requirement for this kind of operating cash protection, then the weekly dilution would be less and the operating cycle will be well funded by the financing. Therefore, the financing decision in terms of liquidity management also has to be very well thought through by the companies.

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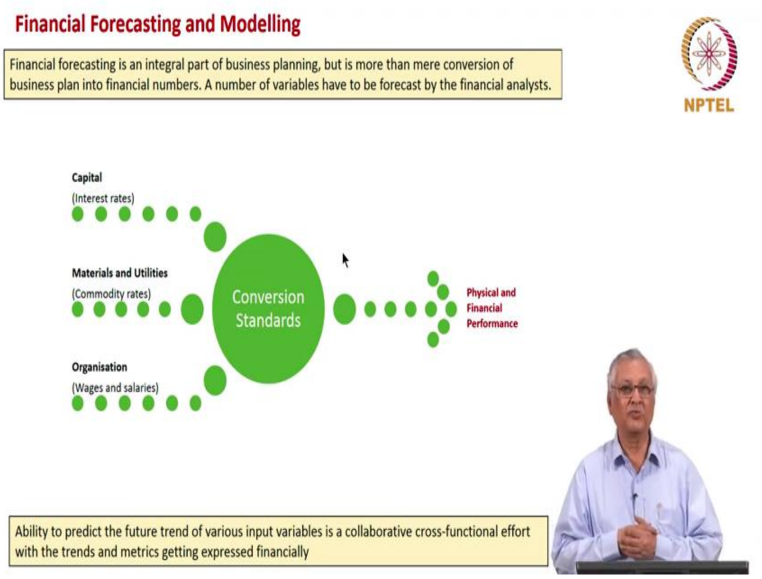

When we look at financial forecasting and modelling, we tend to get inputs from different sources and we have certain conversion standards which are there in the company and the variability is externally are the capital, the interest rates, the materials and utilities which is the commodity rates and the organization which is wages and salaries.

These are common for every firm, but what is not common is the conversion standard, the efficiency with which these inputs are converted by the company into output, that is very unique to the company. So, the financial strategy also has to aim at not merely adding these inputs at the prevailing prices and costs and making a product cost, its role is more than that its role is to establish optimal conversion standards for the inputs that have to provide the output for the company.

And the second aspect of national strategy is in predictive ability, how would the capital cost move, how would the material cost and utility cost move and how would the wage and salary cost move. So financial strategist has got these two challenges, how to establish the trending profiles for the cost parameters and how do I establish the conversion standards for the inputs.

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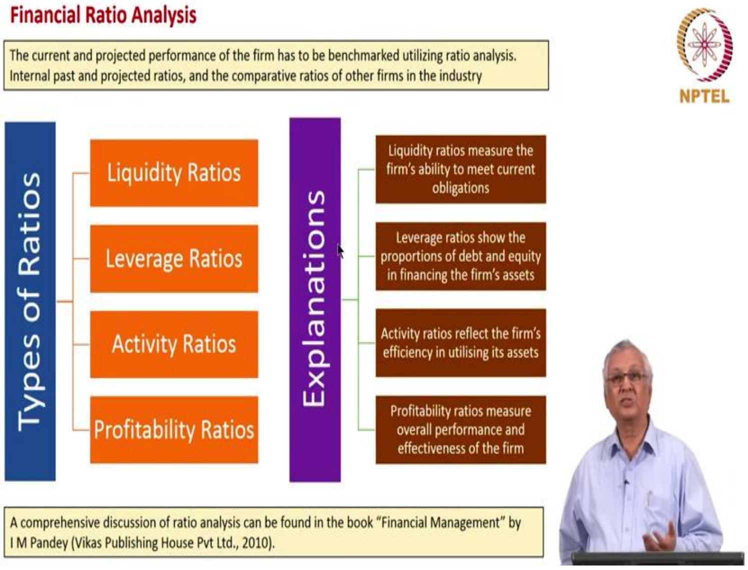

Then the financial strategy is also very much dependent on the ratio analysis and there are four types of ratios which are available and first set of ratios are the liquidity ratios, they measure the firm's ability to meet current obligations, we also have leverage ratios which try to ensure that the debt and equity are in a balanced manner in the company's capital structure.

The third set of ratios activity ratios, they reflect the firm's efficiency in utilizing the assets and finally, we have got profitability ratios which determine how profitable with reference to the sales or with reference to the assets the company's operations are. I would recommend the participants to go through the book on Financial Management by I.M Pandey, to discuss not only financial ratio analysis but several aspects of developing financial models for different types of companies.

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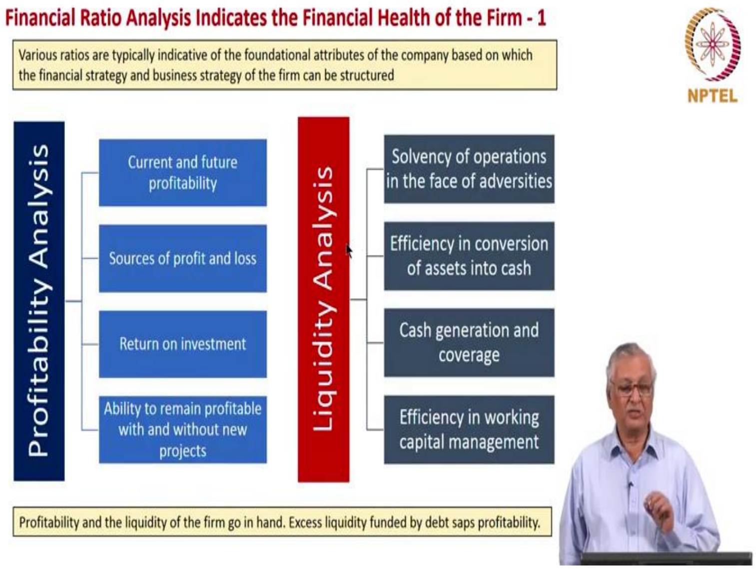

Financial ratio analysis indicates the financial health of the firm and whether we are a start-up or whether we are an established company, it is important to measure our current and future profitability through profitability analysis and understand more importantly what are the sources of our profit and what are the sources of our loss and what kinds of returns we are getting on investment and our ability to remain in the business with or without new projects that comes out of the profitability analysis because every project is expected to lead to certain stream of cash inflows to the company.

So, with projects how would my profitability be and without projects, how would my profitability be. So, this is a profitability analysis as a foundation of future project development but liquidity determines the solvency of the company, how solvent are my operations, what is the interest coverage? What is the asset coverage that I have? How much of cash I am generating? And how much cash coverage is there for my operations if the money was not to be available for six months, would I be in a position to run this operation without any problem?

Again, for start-ups, liquidity analysis is an extremely important because we think of several rounds of financing for the company, starting from the family savings and the angel funding which we discussed to different rounds of venture capital funding and quite possibly some other rounds could be delayed and how solvent are we, will we be able to meet our obligations while going through the liquidity crunch? That is again important and for that these ratios are extremely important.

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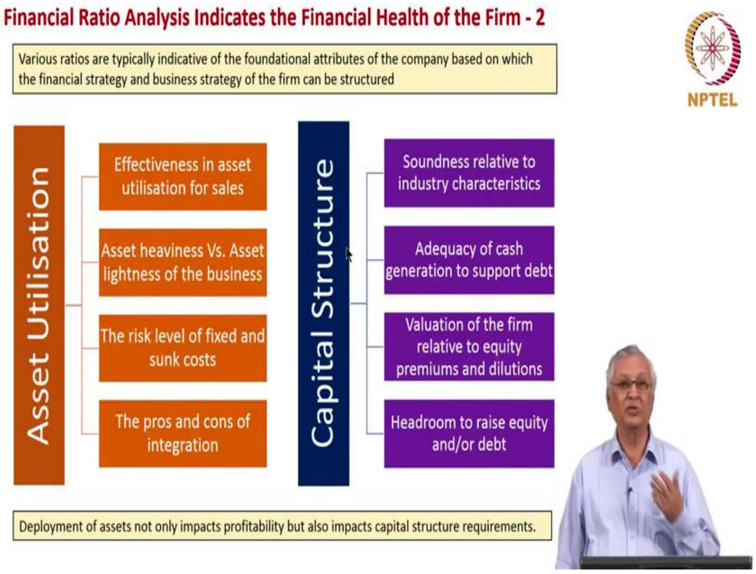

Then we have ratios which help us understand, how we are utilizing our assets and are we going to be an asset light company or are we going to be asset heavy company and what are the risk levels which are implicit in the fact that, we have got certain hidden cost, certain sunk cost and certain fixed cost and how much of our operations should be integrated, how much should be non-integrated.

Then we have got the capital structure decisions, again very important, what is the soundness relative to industry characteristics? If you are in an infrastructure industry or capital structure could be entirely different, probably four times debt for a one of equity. On the other hand, if you are in a consumer facing industry, probably one is to one or even better than that is required.

So, margins the company has, has got an impact on the kind of capital structure you would like to have, if you are working in a low margin industry, you would be better off having more of risk capital and less of debt which needs to be serviced on a very regular basis. So, what is the level of adequate cash generation that can support debt and what is the valuation of the firms so that I can get equity at an appropriate premium or evaluation.

And what is the headroom available to raise equity and or debt. Companies frequently talk about having a war chest to be able to go on mergers and acquisitions or expansion drives but what is the headroom available to be able to raise equity and debt at favourable terms. So, deployment of assets and the turnover of assets impacts not only profitability but also impacts the capital structure requirements of a company.

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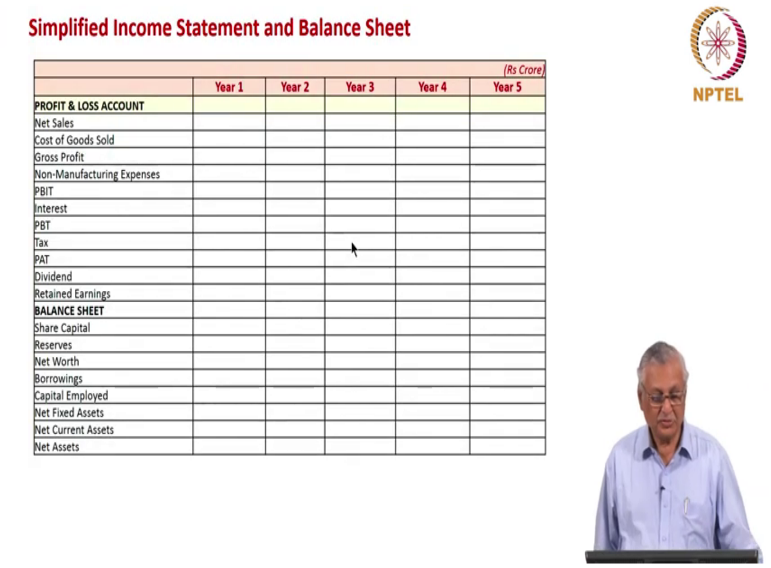

So, in the next few slides I will just go through the various formats and as you can appreciate understanding finance and accounting is a full-time course, probably as long as twelve week program and it is nearly impossible to capture all the nuances of financial modelling in this short session, but there is obviously very fixed way of doing this.

Fundamentally you should have the net sales worked out and from net sales you remove the direct cost of materials, then you get what we call gross margin and we also define as EBITDA and from the gross margin, if you take away the manufacturing cost the operational cost you get the EBITDA. Then you will remove the depreciation, then you will get EBIT earnings before interest and taxes, then you provide for payment of interest then you get to PBT then you provide for tax and you get PAT.

Then out of the available profit flow, you apportion between dividend and balance is retained earnings. And in terms of the balance sheet, we have the share capital, reserves, the net worth, the total debt, the capital employed, gross fixed assets, net fixed assets and then how do we deploy these things for funds flow is another aspect.

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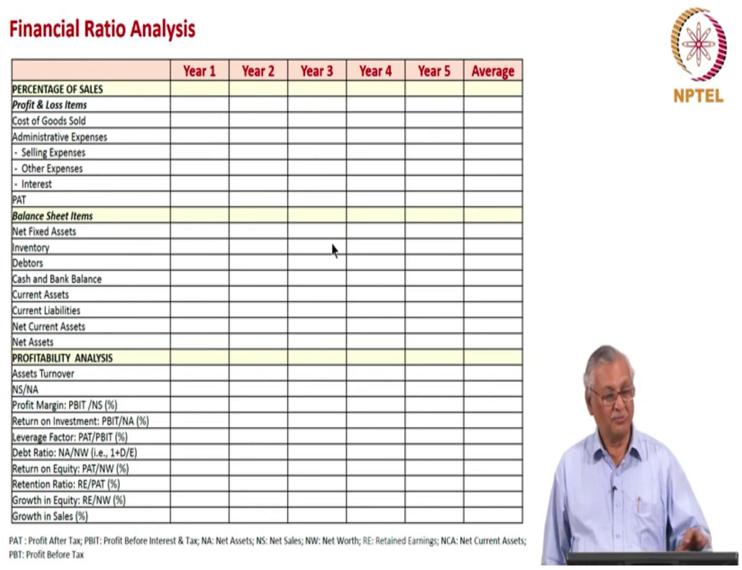

Based on these balance sheet items and as also the income statement items, you can develop various ratios the popular ratios are: asset turnover ratio, net sales to net assets, profit margins, debt ratios, growth in sales et cetera, et cetera. The level of financial analysis you can do for understanding the financial health of the company is almost countless but it is also important that you do not miss the wood for the trees, and it is very important to understand the overall financial landscape while developing models of financial analysis.

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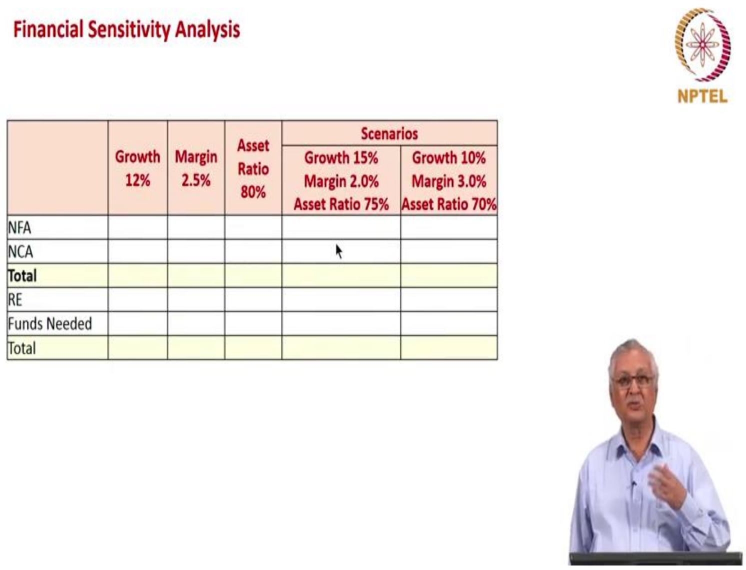

Similarly, understanding the sensitivity or model for different growth margin and asset utilization percentage is that could be one example.

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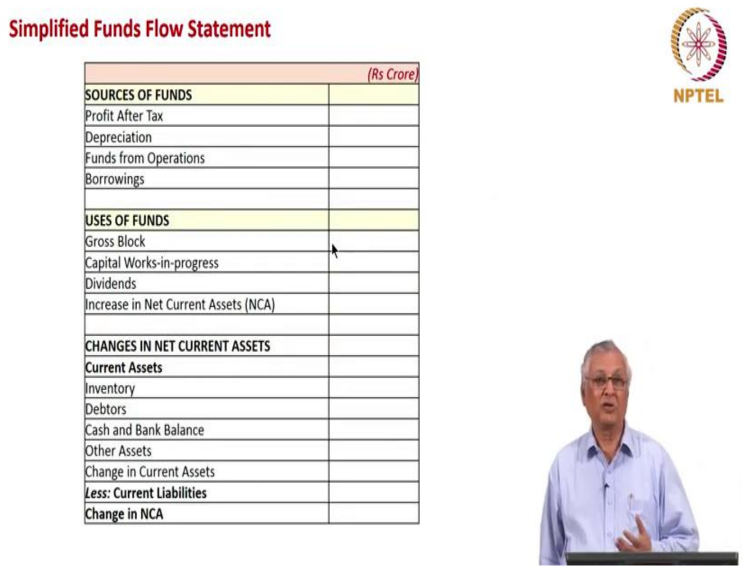

And then you need funds flow statement, how am I deriving my funds and where am I deploying the funds. What are these sources and use of the funds and how the funds are impacting each item of my balance sheet, that is another analysis.

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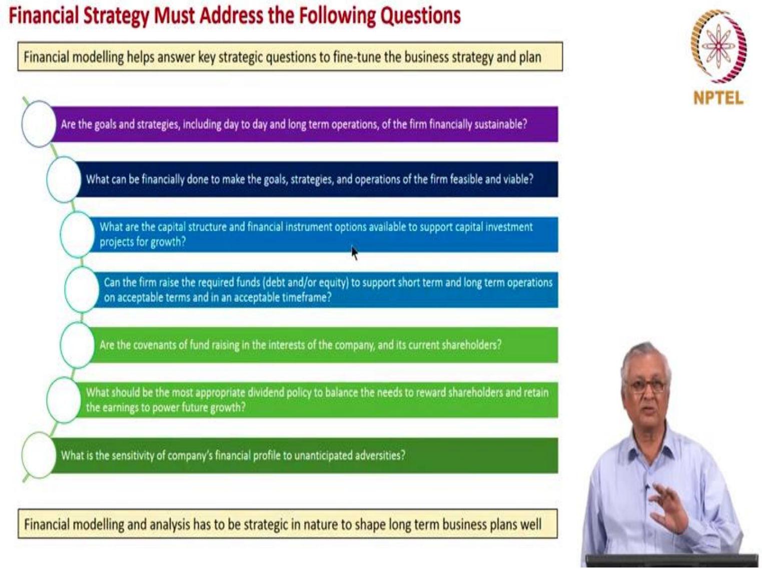

But quite apart from the financial models, there are several key strategic questions which a financial strategy must address and those questions and the answers to the questions determine how the business strategy and plan can be fine-tuned. First, are the goals and strategies including day-to-day and long-term operations of the form financially sustainable? You can plan for this task, but if the ground is shaky you will not be able to do that, therefore how viable are my fundamental operations and in case of start-ups, how strong is my capital structure.

Second, what can be financially done to make the goal strategies and operations of the firm feasible and viable? There are experts in business strategy, they are experts in operations who have to make their strategies executed well and effectively but financially what can a financial leader the chief financial officer do to make sure that the goal, strategies and operations are made more robust by certain financial decisions, by certain strategies of finance that could be adopted.

Which are the best ways of accessing finance, what financial instruments do I have and what kind of capital structure I should have to support the capital investment projects. Is the firm in a position to raise finances debt or equity to support both short term and long term goals and what would be the cost thereof, are the costs going to be acceptable, are there going to be any covenants of fundraising which will limit future degrees of freedom for the company, am I tying myself down.

For example, you are raising let us say global depository receipts and if there is a covenant that you cannot raise the next tranche of funds unless the first GDR is completely extinguished, then you are putting yourself into a constrained situation. Similarly, if you take private equity and the conditionality is that the next round of equity should be blessed by the existing round of investors, then you are having a covenant which is going to be limiting for the company.

So, what are the covenants of fundraising and which is exactly dependent on the strength of the company in terms of its operations, technology and business strategy. And dividend policy being an extremely important aspect of the strength of the company for the present as well as for the future, what kind of dividend policy must be adopted to make sure that the investors are happy as also the company's operations are self-sustaining.

What is the sensitivity of the company to unanticipated exigencies that could occur but financial modelling and analysis has to be strategic in nature as far as the long-term business strategy is concerned, there is one aspect of finance which has to be very rigorous, metricized and rather unforgiving as far as the day-to-day operations are concerned.

But as far as the business strategy is concerned, financial modelling analysis has to be more strategic in nature and we should not lose the perspective or the overall business which the company is committing itself to.

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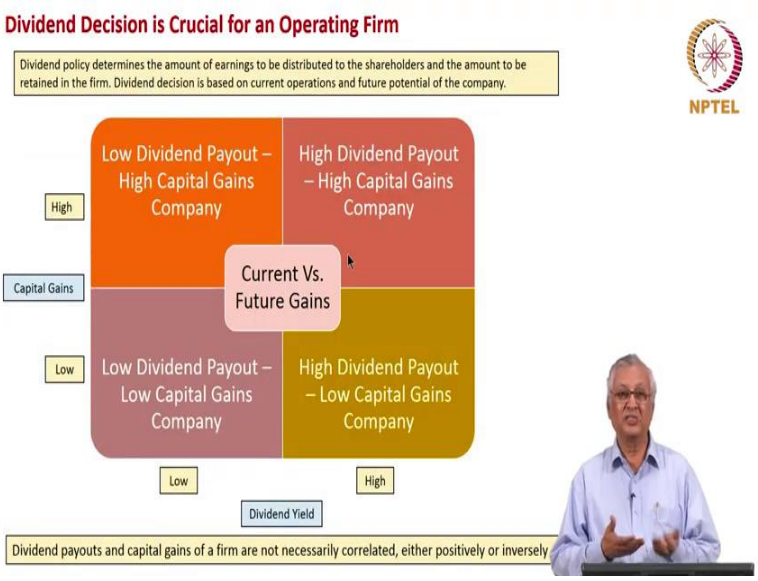

As I said dividend position is crucial for an operating firm, there could be two types of dividend decisions, one is low pay out another is high pay out which determines the dividend yield. Then you can have companies expecting capital gains, the capital gains could be low and capital gains could be high. Obviously, a company which is in low dividend pay-out, low capital gains territory it is not a winner, it is a loser.

On the other hand, a company which is having high dividend pay-out as well as high capital gains, that is the winner and people would like to make investments in such companies and that company will also be able to fund its future projects very well. On the other hand, you also have in the industry companies which pay high dividend but capital gains are low. For example, commodity companies like you have some public sector undertakes like Coal India, Indian Oil Corporation and oil refineries, gas companies which provide high dividend pay out but capital gains will not be very high.

On the other hand, there could be low dividend pay out companies which conserve cash for future project development and they appreciate in their market capitalization quite fast. So, investors are also of different types depending upon the dividend policy you have adopted companies may choose to invest or shy away from investment.

However, that said there is no relationship correlation either positive or inverse between dividend pay-out and capital-gains, it does not mean that a low dividend policy automatically provides high capital gains or that high dividend pay-out means low capital gains, no. It is dependent on the firm's strategy as well as the industry structure.

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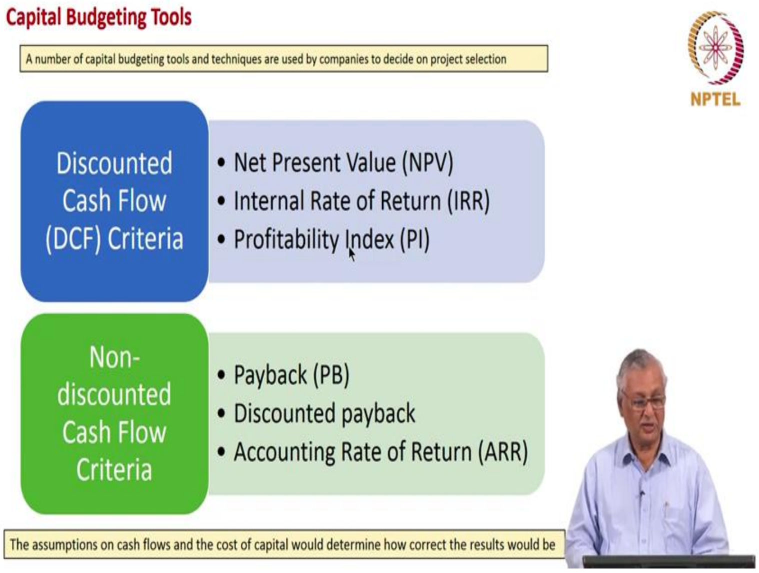

So, we can think of certain capital budgeting tools as well at this point of time. The discounted cash flow criteria, we talked about net present value the internal rate of return the profitability index and there are certain non-discounted cash flow criteria like payback, discounted payback and accounting rate of return.

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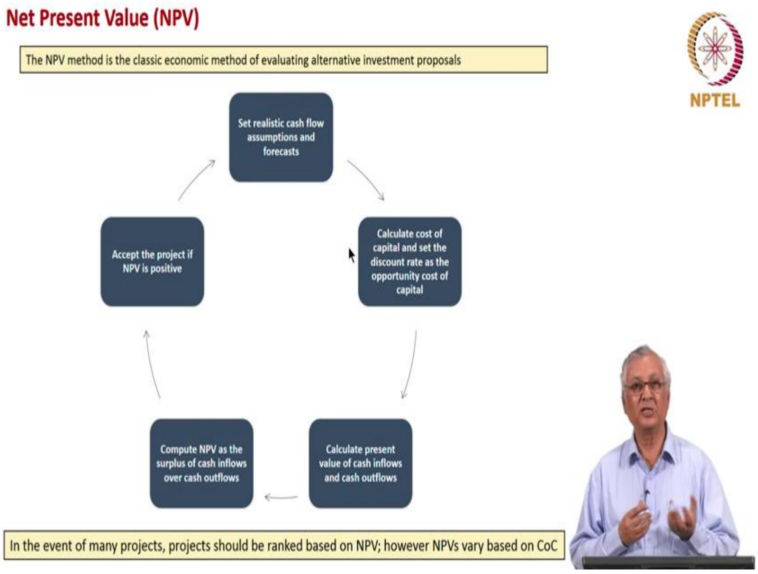

But key to this analysis is setting the realistic cash flows, and how do the realistic cash flows come? By understanding the business and understanding the customer requirements. So again, we get back to the understanding of the product, the technology and the customer segments very intimately, by understanding those things very clearly, we will be able to provide the cash flows in a reasonable manner.

Then you calculate the cost of capital, set a hurdle rate, then you calculate the present value and depending upon the NPV as the surplus of cash inflows or your cash outflows, you decide to accept or reject the project. If your NPV is zero or positive you tend to accept the projects and if it is negative, obviously you reject the project unless there are very strong strategic reasons why this project should be implemented and you may take up a project because having this project enhances your overall company's goodwill or enables other projects to be accepted by the customers or by the government.

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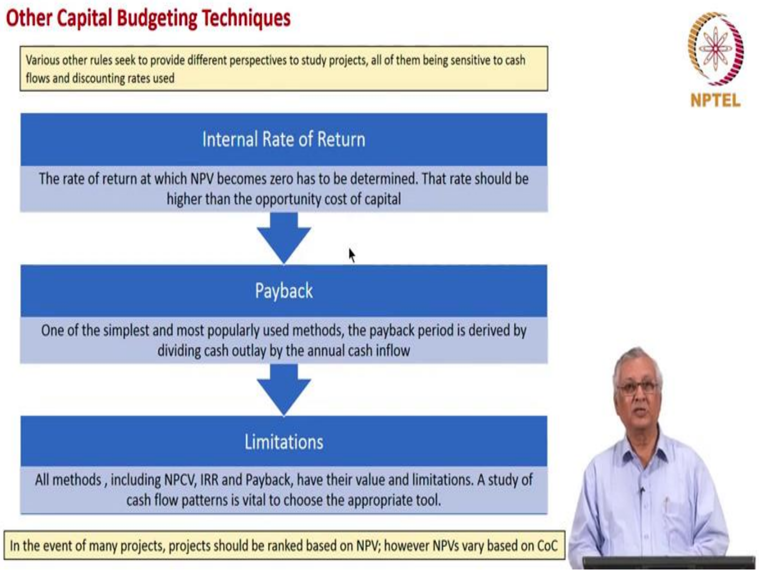

Similarly, internal rate of return is another discounting technique wherein instead of calculating the NPV you find out at what rate which is internal to the company, the NPV becomes zero, so it is looking at the same cash flow technique in a different way. Even today, in spite of the strength of computer and the algorithms, payback is the simplest and quickest way to see how a project is appropriate for a company.

It is nothing but the total cash flows divided by the annual cash of outlay. And if the payback period is low, then you say that the project is viable and let us go forward it does not care that much for the time value or the money but it also looks at how distant the returns are going to be from the start of the project. All these techniques have got their own limitations and the cash flow pattern is the one which will determine.

Even if the cash flow is high in the later years NPV may give a different result compared to a project where the cash flows are higher in the initial years. So, discounting has an impact in terms of measuring the NPV and therefore the over optimistic projection of cash flows in the initial years was a kind of taking easily the cash flow projections for the later years that will have an impact on how the cash flow as well as the NPV of a project is computed.

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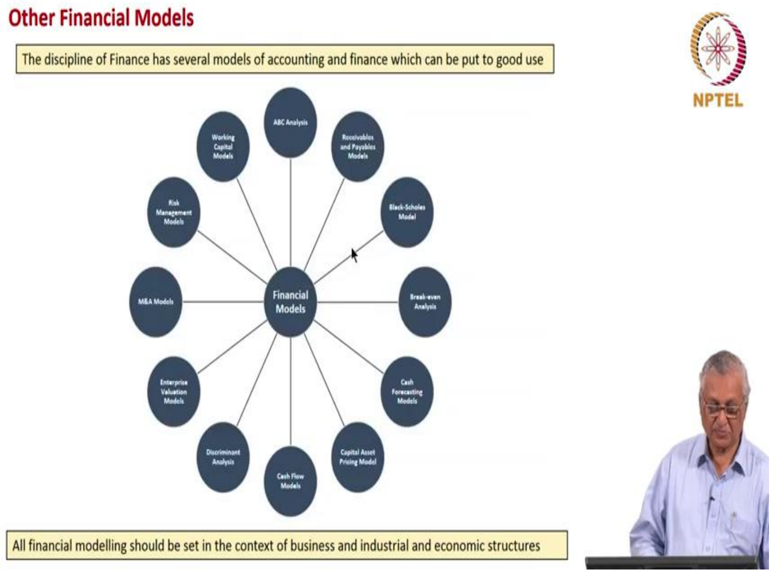

There are various other financial models which are available, the toolkit is really vast, ABC analysis, receivables and financial models, Black Scholes model, break-even analysis, cash forecasting models, capital asset pricing model, cash flow models, discriminant analysis, enterprise valuation model, M&A models, then risk management models and working capital models a whole set of financial models are available for the financial strategist to develop his or her financial strategy.

However, all these financial models must be set in the overall context of business and industrial and economic structures. Many times, companies accept projects which are only passing through this filter of NPV or IRR, yet the companies face losses, mainly because the cash flows have not been projected properly or the projects have not been course corrected when environmental changes have taken place. So, while the models are extremely important the business context the strategy context must never be lost sight of.

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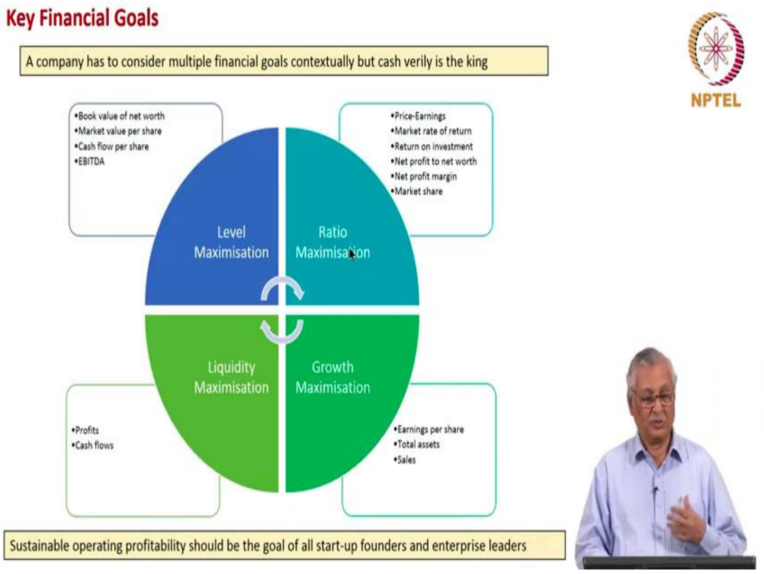

So, in terms of the financial strategy again there are four foundational parameters. One is the level maximization, that is in absolute terms I should maximize my sales, my profits, my wealth generation, cash flow per share, EBITDA per share that has to be done. And the ratios should be optimized, price earnings ratio should be good, market return should be good, return of investment should be leading the industry benchmark.

Then you should have growth maximization, my market share should grow, my sales should grow and rates of growth should be higher than the industry. And there should be liquidity maximization goals with reference to the profits and cash flows. Sustainable operating profitability has to be the goal of all start up founders and enterprise leaders and that is where this strategy actually converges with the business strategy in ensuring that whatever is done is in line with the business strategy goals and objectives.

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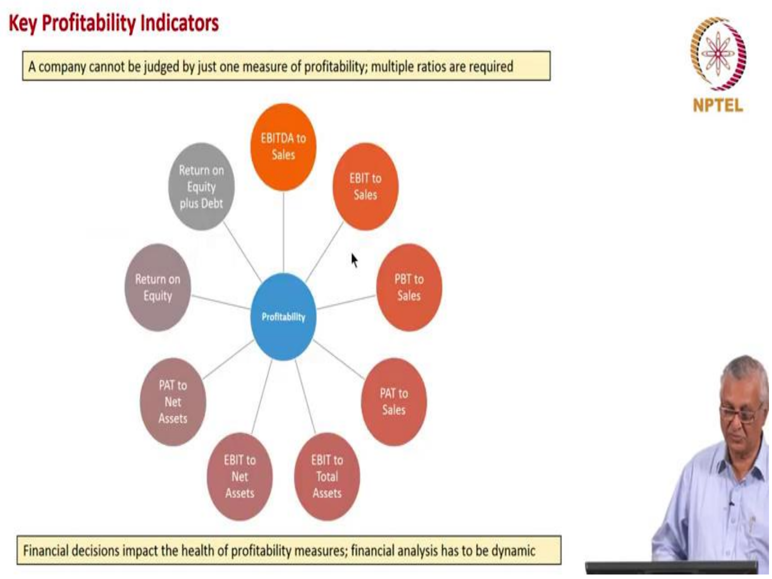

And there are many profitability indicators that are used and not all are relevant in all aspects, EBITDA to sales, EBIT to sales, PBT to sales, PAT to sales these are all operating profitability measures, but when you compare your business which is asset light with a business which is asset heavy certain of the parameters may not be appropriate, you need to go for certain other parameters which provide return to equity or NOPAT to equity etc etc.

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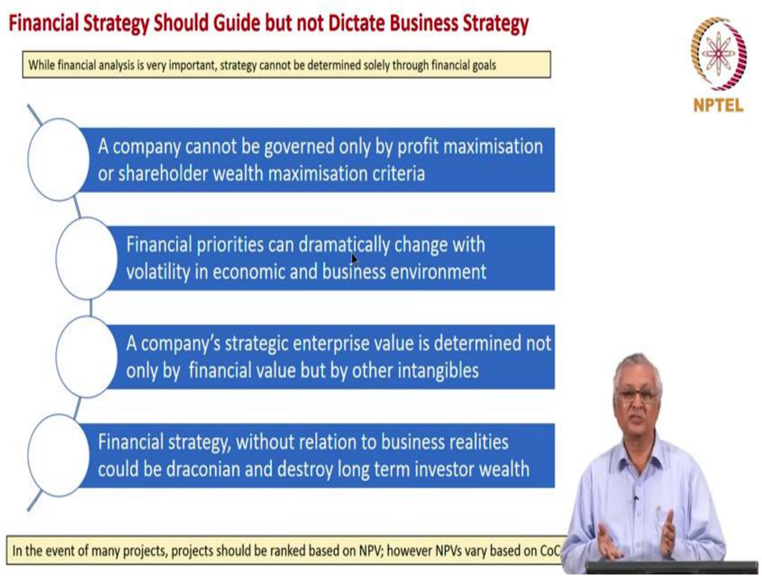

I would say that in summation, financial strategy should guide but not dictate business strategy because business strategy has got certain qualitative element, certain technology driver which cannot be expressed in financial terms. Financial analysis is very important but strategy cannot be determined only by financial goals.

Profit maximization or shareholder wealth maximization criteria which are very well applicable for large established companies cannot be applied to the same measure in start-up companies or even established companies. Then, financial priorities can dramatically change year to year based on the volatility in the external environment, whereas the strategic direction may not easily change.

Therefore, it is important to keep to the course even when the financial numbers are not exactly the same as what we have predicted. And a company's strategic enterprise value is determined not merely by the financial value, but also by other intangibles like brand value, the goodwill value and other things. And financial strategy if it is unrelated to business realities can be very draconian and even destroy long term investor wealth.

There have been cases where very good projects have been mothballed or rejected because they did not meet the capital budgeting criteria. On the other hand, had the companies invested in those projects, the shareholder wealth would have been very high very much higher than what it is today. Similarly, when the industry goes through recession, it is quite possible that the cash flows will be muted and you will not have the level of payback period that you would like to have but investing in those kinds of recessionary environments could well be the mantra for the company to become profitable when the demand goes on an uptick.

So, making this business decision independent of the financial decision is also an art as much as science. And while projects are ranked as per NPV, again the number alone cannot determine whether this project should be taken or not, a bundled approach to the projects may also need to be taken.