INTRODUCTION TO THE COURSE OF FINANCIAL STRATEGY

1. What are the functions of a financial director ?

A classical view

- to analyze from a financial point of view (risk/return) the main investment projects of a company; so as to check they will lead to an increase in the value of the firm (expected rate of return greater than cost of capital) ;
- to guarantee that at any time, the company has the financial resources to continue as a going concern, which means raising money from banks/investors and placing excess cash. His objective is to obtain a cost of money as low as possible.

A new approach pioneered by Pierre Vernimmen

The classical view of a financial director looking to minimize the cost of money presents two drawbacks :

- by putting the emphasis on minimizing the cost of money, it leads you to forget the other dimension of finance: the risk of a financial resource;
- to put the emphasis on minimizing the cost of money leads you to forget that now, more than 10 years ago, a financial director has customers, i.e. investors, to whom he has to sell his products (shares, bonds,...). By understanding their present needs and requirements he can sell them tailor made products at a higher price because they are tailor made.

We much prefer to describe the financial director as a seller of financial products. His aim is to maximize the price at which the securities are sold to investors (financial markets, banks,...). Obviously in the end, maximizing value is tantamount to minimizing the cost of money :

Markets	**Money**	**Financial products**
Supply	Investors	Firms
Demand	Firms	Investors
Price	Interest rate	Value
Objective of the financial director	Minimize the interest rate	Maximize the value

But :

– as value is a synthesis between risk and return, maximizing the cost of money leads you to take into account both risk **and** return;

– to maximize value the financial director needs to be a good marketer and a good salesman, i.e. he has to understand the needs of his customer, the financial investor.

2. What is a financial product ?

The assets of a company will over time generate cash flows which will be divided according to certain criteria between the various financial investors whose funds have allowed the company to buy these assets. Consequently, a financial product is nothing more than a claim on future cash flows. When a financial director sells financial products to the market (investors, banks) to raise money, he sells nothing more than a stream of future cash flows.

Financial products fall in two different main categories:

– **debt**: the holder of debt has a first priority right on cash flows until a fixed level is paid (interest rate and reimbursement). After that, he has no rights. Consequently, he bears the lowest possible risk but has a limited return;

– **equity**: the holder of equity comes second after debt holders but takes it all once debt is served. Consequently, he supports the highest risk, but in return can enjoy a high return.

3. How do financial markets interact with corporate finance ?

Very simple indeed. Financial investors value shares and bonds using their own return requirements which can be modeled as in the CAPM as :

r_f + ß (r_m - r_f), i.e. the risk free rate plus a risk premium linked to the market risk of the asset.

So the cost of capital for a company is the average rate of return required by the various financial investors holding the financial products it has issued.

4. The theory of the market in equilibrium is the framework for any financial strategy :

- Value will go up if the return on investments is higher than what investors are expecting. Value will go down if the return is smaller than the one expected by investors so that, on this lower value, the poor return on investment will correspond to what investors expect.

- The rule of additivity prevails : 1+2 always equal 3. If an asset is worth 1 given its future cash flow stream and another one is worth 2, a company holding those 2 assets and nothing else has a value of 3.

If a company borrows money to buy back its shares the value of the assets stays the same, the value of equity goes down, the value of debt goes up but the total value of debt and equity is still the same.

If not, arbitrage will take place until equilibrium is restored.

- Consequently, financial decisions (to finance through debt rather than equity, to increase the dividend per share, to buy back shares, to do a demerger; ....) do not create value per se; they only modify the breakdown of the portfolio, not its value.

5. Do not forget the agency theory :

Do not be too naive, if finance is all about how to divide a cake between different categories of investors, and given that a financial director cannot increase the size of the cake, the interest of managers shareholders, and debt-holders can conflict. **A financial strategy is also a tool to solve these conflicts.**

6. On the signaling theory :

Do not be too naive, information is not a widespread commodity available to anybody at no cost. Some (the managers) have more information on the state of a company than others (the investors). **Every financial decision will tend to be seen as signals by which managers try to convey information to the market in a credible way.**

A company which funds investments through debt rather than equity signals to the market that it believes its stock price is too low to issue new shares and will « puts its money where its mouth is » by burdening itself with debt which is always less palatable and more risky for a manager than equity.