

GUIDE TO FINANCIAL MANAGEMENT

Understand and improve the bottom line

Third edition

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BOOKS

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Preface

EFFECTIVE FINANCIAL MANAGEMENT is essential for a business to succeed; many have failed for want of it. All too often a career aspiration falters, not for lack of effort or ability in a chosen field, but for not being able to understand the financial impacts of decisions and ultimately a failure to “deliver the numbers”. Managers who find themselves in a senior role unable to ask questions of others – which might imply their own ignorance – have wished that they had got to grips with really understanding financial matters earlier in their career.

This guide to financial management is designed to take you through financial principles and illustrate their application, providing a toolkit for managing financial responsibilities. Each chapter is written from an operational perspective in establishing and running a business. Before the index is a glossary of the financial terms used in the book. There is also a list of companies used in examples. The names are those in existence at the time of writing; merger and acquisition activity will inevitably change this.

All books are not just the work of the author but the results of contributions of many others. I am grateful to clients and colleagues who provided the opportunity to explore aspects of business, complete research and develop my thinking. In particular I would like to thank my colleagues at Corporate Edge for their insights and contributions, and Mandy Aston for her work on the original script and many of the diagrams; Mike Samuel for his support and the time he dedicated to reviewing and commenting upon the first edition; Nick Insall for his review of this and the second edition; and Profile Books for the help they gave me, particularly Ed Lake, Stephen Brough, Penny Williams and Jonathan Harley.

Special thanks to my wife, Angela, and my two sons, William and George, who have supported my enthusiasm for writing, even on holidays. Also to my parents, particularly my father, a chartered accountant, who always encouraged my career, and gave me the passion and interest in business.

I would welcome feedback and can be contacted on the following e-mail address: John-Tennent@CorporateEdge.co.uk

John Tennent
February 2018

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Defining a successful business

EVERY ENTREPRENEUR ASPIRES to create a successful business, and investors certainly want management to run successful businesses. So what determines whether a business is being successful? Before answering this question, it is helpful to define what a business is and the various forms it can take.

A business is a commercial operation that provides products or services with the aim of making a profit for the benefit of its owners. The significant point is “for the benefit of its owners”, which differentiates it from a government or not-for-profit organisation, such as a charity, where the activity is conducted for the benefit of the people it serves.

A profit is an essential element of running a successful business. It is a trading surplus whereby the revenues earned exceed the costs. This surplus belongs to the owners of the business to use as they choose: to take for themselves, to reinvest back in the business, or a mixture of the two. For a government organisation or charity, any surplus is reinvested in the activities to further benefit the people it serves.

Business structure

A business can take many forms, ranging from a sole trader to a large multinational company. The principal aim of making a profit for its owners is still the same.

A person starting out and setting up a business will take all the risk and reward as the venture gets under way. As the business grows it can be advantageous to share the risk with others and separate the business activities from those of the owner by establishing a company.

A company is a legal entity in its own right that is separate from its

owners. An investor is risking only the money paid for buying some shares in the company. If the company ceases trading, the shareholders (owners) are not liable to make up any shortfall between the value of the company's assets and its liabilities.

There are five broad categories of business:

- **Sole trader.** Someone who sets up a business alone and takes all the risk and reward of running it, and who may employ staff.
- **Partnership.** Two or more people who set up a business together. The partners have joint ownership and share the risk and reward of running the business. Like a sole trader they may employ staff.
- **Limited liability partnership (LLP).** A hybrid of a partnership and a company which provides the owners with the limited risk of a company and the shared ownership and tax status of a partnership.
- **Private company.** Usually a small organisation raising its money from a few private investors. The shares may be difficult to trade as they are not listed on any stock market. Investors' liability in private and public companies is limited to the amount of their investment.
- **Public company.** Typically a large organisation that is usually listed on a stock exchange. Because of its size it may require significant investment, and hence it may need to draw investment from many investors.

In this book the focus is mainly on companies, though the principles can be equally well applied to a sole trader, a partnership and indeed not-for-profit organisations.

The role of the board

The directors of a company are people hired (and at times fired) by the shareholders to be stewards of their investment. However, they need to balance this with their primary fiduciary duty as a director, which is to act in the best interests of the company. Collectively, a board of directors has overall responsibility for running a company successfully. This is achieved by setting and implementing its strategy.

In fulfilling the strategic aims of the company, the board will be responsible for making sure not only that the company has the necessary resources in terms of investment, assets and people, but also that there are appropriate operating controls and procedures for managing business risk and making sure that all monies that flow through the business are properly accounted for.

What is a successful business?

The media love to report on successful entrepreneurs and tell of how they beat the odds as they built their business and became household names. The media also enjoy revelling in the collapse of mighty organisations and unpicking the journey to their downfall. So what is it that defines business success or failure?

Many descriptions are used to describe success, including “the business is profitable”, “revenue is growing” and “the share price is rising”. All these attributes are elements of success, though individually they do not embrace the totality. To be successful in business is to “create a sustainable superior return on investment”.

The core element of this definition is “return on investment” (ROI). The business, having been built from money provided by investors, has a responsibility to reward those investors for risking their money in the venture. The ROI is a measure of the reward being generated. The concept is similar to a savings account, where an amount of money is placed on deposit with a bank and the investor earns interest on it. Despite the banking crisis of 2008 and its aftermath, the investment in a savings account is still seen as low risk and consequently the return that the investor will make is similarly low.

$$\text{ROI for a savings account} = \frac{\text{Interest}}{\text{Investment}} \%$$

Therefore, if a deposit of \$1,000 is placed in a bank and the gross interest earned over a year is \$30, the ROI can be expressed as being 3%.

For a business to be successful it needs to reward investors by making them wealthier than they would have been by putting their money in a savings account. Why should they accept the greater risk of investing in a business, with all the uncertainty it faces, if they are

not going to be any better off? The return that investors would require might be double or more than a savings account, depending on the perceived risk, which will be related to factors such as the nature and maturity of the business.

The return in a business is derived from the profit it generates compared with the money invested to achieve that profit.

$$\text{ROI for a business} = \frac{\text{Profit}}{\text{Investment}} \%$$

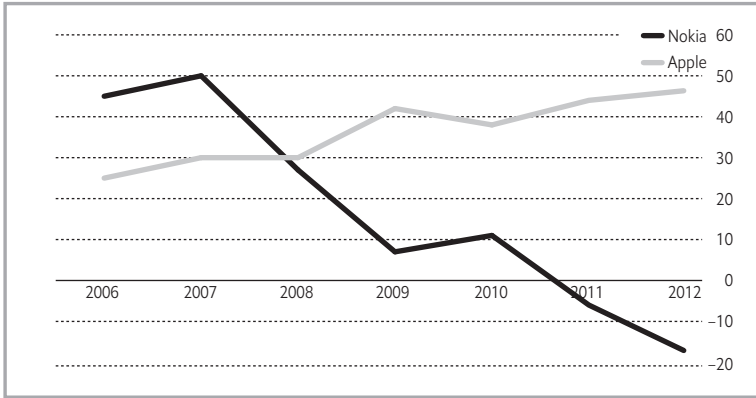
Therefore, if investors place \$1,000 in a business and the operating profit over a year is \$200, the ROI can be expressed as being 20%. Some examples of the returns achieved by companies in 2016 and stated in their annual reports are Walmart (a retailer) 15.5%, ExxonMobil (an oil company) 3.9% and Anglo American (an international mining company) 11.0%.

Generating a “superior” return is to achieve a ROI that is greater than the rate achieved by businesses running similar activities in similar markets, and so to be successful is to generate a return that is at least as good as that achieved by your competitors, but ideally better than them.

A “sustainable” superior return is perhaps the most difficult objective to achieve. It means generating a superior rate of return year in, year out. A business may be flying high when its products or services are in fashion. But the fall can be swift when its products or services are no longer in vogue and the business has gone from producing superior returns to producing inferior ones. To be sustainable is to continuously develop the business proposition in a way that keeps customers buying the company’s products or services in preference to those of its competitors. Innovation, technology and cost reduction are all activities that can help maintain a sustainable return.

For example, the returns generated by the mobile phone company Nokia in 2006 were almost 46%. They resulted from a pre-eminence in a growing market coupled with an ability to continue to introduce new technology and ignite passion for the company’s latest products. Subsequently, Nokia failed to offer leading technology and was late in offering smartphones. As a result, it lost customers and the superior returns declined; in 2012 Nokia reported losses of €2.3 billion and was finally bought by Microsoft in April 2014.

FIGURE 1.1 Return on investment, %



At the same time as Nokia was declining, Apple, its American rival, was rising. The two companies' ROI between 2006 and 2012 is shown in Figure 1.1.

On creating a superior ROI the directors of a company have two choices. They can either distribute the wealth to the investors or retain it in the business. The second option depends on whether the directors can identify further investment opportunities that will create even more wealth in the future. Profits can be retained in a company while investment opportunities are identified. However, this is only in the short term as investors (particularly in public companies) will demand the cash be “earning or returning”.

Wealth is created for investors in a business in two ways:

- annual income – a distribution of profit to the investor (by way of a dividend);
- capital growth – a reinvestment back in the business to increase its value (share price).

Shareholder value

The term “shareholder value” is also used to describe success. Two definitions of shareholder value are:

- a concept that focuses strategic and operational decision-making on steadily increasing a company's value for shareholders;
- maximising shareholder benefit by focusing on raising company earnings and the share price.

These definitions focus more on increasing the value of a business in the long term rather than delivering a profit in the short term. An example would be Amazon, one of the best-known online retailers, where the initial strategy was to invest in building the distribution network and customer base as the foundation of the business. Once customer numbers grew the profits would emerge. Throughout its early years the company was creating long-term value while making large losses. During this period Amazon's share price was volatile as it reflected changing views on the future benefits that would arise for investors.

For a mature business, an example would be its investment in research and development to provide the products and revenue streams of the future. This investment can create shareholder value because of the potential it is judged to provide. However, the danger is that success is built on a future promise, and in a fast-changing world the future is always uncertain. For example, AstraZeneca, a pharmaceutical company, had taken years to develop a new lung cancer drug only to find in July 2017 that the trials had failed: its share price fell 16% in one day.

For a company that is quoted on a stock market, there is the expectation to achieve a sufficient ROI every year while also investing to create future value. Once the business has started to make profits, any performance that is worse than the previous year is likely to meet with an adverse reaction from analysts and investors, which in many instances can lead to a forced change of management.

In February 2017 Unilever, a food company, defended a hostile bid from Kraft Foods on the basis that it would complete a "comprehensive review of options available to accelerate delivery of value for the benefit of our shareholders". Like all other global companies, it battles to produce the ever more superior results that stockmarket investors look for.

The details of the measures used to monitor ROI and shareholder value creation are explained in Chapter 14.

Describing success

Although the definition of success given above may be at the heart of a business, many companies prefer a softer approach to defining what they are in business to achieve. For example, Microsoft, a software giant, states that its mission is: “To enable people and businesses throughout the world to realize their full potential.”

There is no mention of the investors here. Among the exceptions are:

- FedEx, a logistics company, states: “We will produce superior financial returns for shareowners by providing high value-added supply chain, transportation, business and related information services through focused operating companies.”
- Avon, a cosmetics company, states: “We will deliver superior returns to our shareholders by tirelessly pursuing new growth opportunities while continually improving our profitability.”

A business as a corporate citizen

An increasing preoccupation in business is corporate social responsibility (CSR), whereby a business’s pursuit of success should benefit its shareholders in a way that respects (and benefits) the other stakeholders that make it possible: employees, suppliers, customers and the wider community. Being a good corporate citizen is also about a business taking responsibility for the impact it has on the world in areas such as the environment, including the consumption of global resources, pollution, carbon footprint and the generation of waste. For example, Citigroup, a financial services corporation, said in its mission statement: “Like any other public company, we’re obligated to deliver profits and growth to our shareholders. Of equal importance is to deliver those profits and generate growth responsibly.”

The CSR argument is that only by working in harmony with all these external influences can a business achieve true success and contribute to an ethical goal of prosperity for all. A company to overtly embrace success within this context is Ben & Jerry’s, an American ice-cream company that is now part of Unilever. It has three interrelated parts to its mission:

- Economic – To operate the company on a sustainable financial basis of profitable growth, increasing value for our stakeholders and expanding opportunities for development and career growth for our employees.
- Product – To make, distribute and sell the finest quality all-natural ice cream and euphoric concoctions with a continued commitment to incorporating wholesome, natural ingredients and promoting business practices that respect the earth and the environment.
- Social mission – To operate the company in a way that actively recognises the central role that business plays in society by initiating innovative ways to improve the quality of life locally, nationally and internationally.

The third part is perhaps the most altruistic in recognising that the role of a business is to “improve the quality of life”. Cynics might say that this is just good marketing: by giving the business strong ethical credentials it attracts certain types of loyal customers and boosts sales. Whichever view you take, there is growing momentum behind the desire for businesses to balance their duty to shareholders with their responsibility to other stakeholders. Paying insufficient attention to the latter, especially if that results in adverse media coverage, will undermine the long-term sustainability of the business and ultimately shareholder value.

Marks & Spencer, a retailer, makes a clear statement, saying in its 2017 annual report, “We are committed to delivering sustainable value for stakeholders.” This recognises its need to balance shareholders with all others that are in any way touched by its business.

Setting up a new business

When starting a business, the founders need to raise money to cover the costs of setting up and running the business until it is generating sufficient revenues to cover its costs. To get this initial capital the directors must convince potential investors and other providers of finance of the robustness of the business proposition and the returns that can realistically be expected. There are two options to raise the money to set up in business:

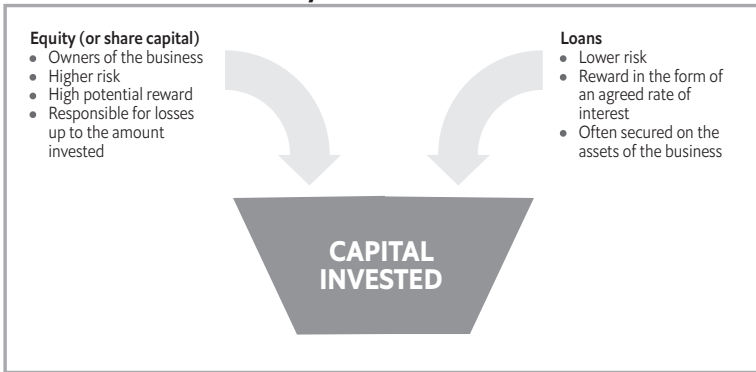
- **Loan.** The founders could put together a business plan showing how they anticipate being successful, making enough money to pay interest on a loan and ultimately repay the principal. However, if the business has just started there will be nothing to provide security for the loan should the venture fail. The risk to the provider of the loan is high and repayment depends on the founders being able to carry out their business plan. The loan provider would therefore want the founders to put some of their own money into the business, not only sharing the risk but also demonstrating their belief and commitment to the venture. Alternatively, it would require some security from them – a charge on their homes, for example, which could mean the founders losing their homes if the business cannot repay the loan capital.
- **Equity (or share capital).** A company is owned by its shareholders, so if the founders want to part own the business, they need to invest some of their own money to buy shares in addition to attracting outside investors. Any profits that the business generates belong to the shareholders (the owners) and any losses are borne by the shareholders (up to the amount invested). The shareholders are therefore the ones that take the highest risk in a business, but they also have the potential for the highest reward. Should the business fail, any assets it owns will be sold to pay the creditors (in the first instance secured lenders and then unsecured creditors such as suppliers and other payables). Only after all debts are satisfied will the shareholders get any of their investment back.

With a significant amount of share capital invested to take the primary risk of the business, a bank will be more willing to provide loans and on more favourable terms.

Weighted average cost of capital

In Figure 1.2 the business has a pool of money, the “capital invested”. To invest this wisely, the first stage is to determine what the average dollar in the pool costs as derived from the returns that the various investors are seeking. Knowing this average rate enables the directors to make choices about the activities and projects they select to invest in.

FIGURE 1.2 Sources of money to establish a business



For example, a business has raised \$70,000 of share capital and a \$30,000 loan. If the shareholders require 20% return on their money and the bank wants 8%, the average dollar would cost the business 16.4%, which is calculated as follows:

		<i>Annual cost (\$)</i>
Shareholders	\$70,000 @ 20%	14,000
Debt	\$30,000 @ 8%	<u>2,400</u>
Total	<u>\$100,000</u>	<u>16,400</u>

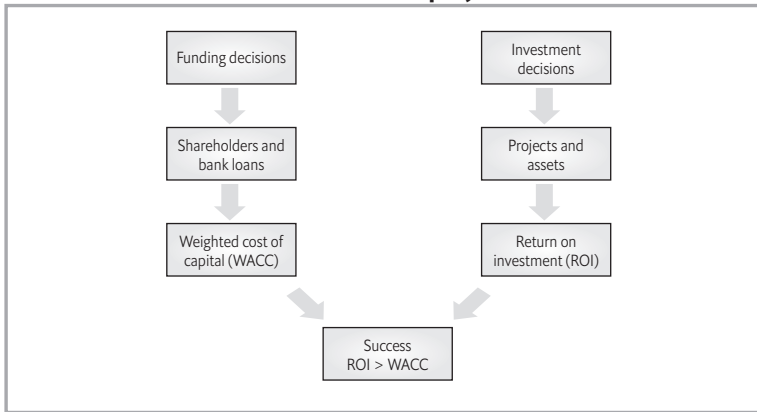
Therefore the average cost of a dollar = $16,400/100,000 = 16.4\%$

This is known as the weighted average cost of capital (WACC). For a business to be successful and satisfy its investors it must earn at least this rate on its operating activities.

A combination of the two sources of finance provides an optimal way to raise funds and build a business. A business with debt usually has a lower WACC than one without. A low WACC can therefore create more value for the shareholders out of the projects it chooses to invest in.

This is a simplified formula for the purposes of illustrating the concept. To calculate the actual returns required for shareholders and banks, the optimal proportions of each source and the effect of tax are explained in more detail in Chapter 6.

FIGURE 1.3 The selection of investment projects



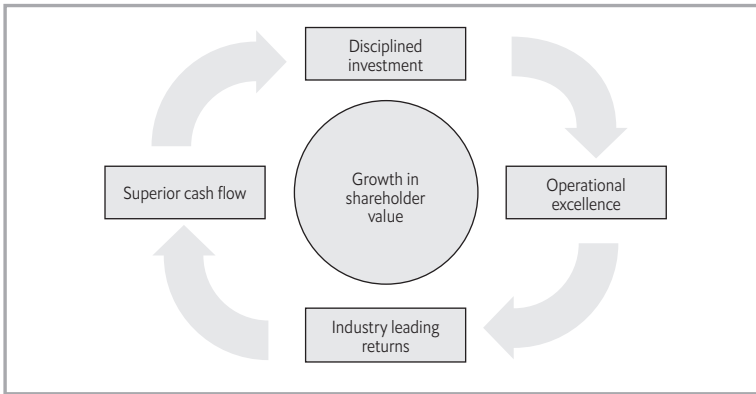
Selecting successful activities

Any project that can earn a business a ROI that is greater than the WACC will help the business be successful.

It is rare that a business will publicly quote its WACC, as it is the determinant of investment selection and therefore valuable competitive information when bidding against others for opportunities. However, some years ago Coca-Cola, an American drinks company, said in its annual report: “Our criteria for investment are simple: New investments should directly enhance our existing operations and generally be expected to provide cash returns that exceed our long-term, after-tax, weighted average cost of capital, currently estimated at between 8% and 10%.”

An executive of British Airways, part of the IAG airline group, once described the business as “a group of investment projects flying in close formation”. This is an apt description of a business, illustrating that any organisation is a collection of business decisions, all intended to generate returns that exceed the cost of funding them.

As anyone who has worked in business will know, the returns anticipated by business plans are not always achieved and it is the shortfalls that cause businesses to fail. The WACC is a fairly constant and predictable percentage compared with the volatility of a project’s performance in which the investment is placed. For example, an

FIGURE 1.4 **Growth in shareholder value**

Source: ExxonMobil, analyst meeting, 2010

ice-cream business excels in a hot summer, but in a cold and wet summer sales volumes are much lower. The WACC for both scenarios will be the same.

Once a project has been selected (see Figure 1.3) the implementation needs to be managed well to achieve the expected returns. Shareholder value is created by following the cycle in Figure 1.4. Starting at the top, select projects that are rigorously evaluated and promise high returns. Manage these projects excellently to fulfil their promise. Combining the first two items should enable superior returns on investment to be achieved. The superior returns should generate substantial cash flow, which will provide the resource for future investment opportunities.

Overall success

Success can therefore be achieved by understanding and satisfying investors' requirements, which can be interpreted as "creating a sustainable superior return on investment". To do this, directors need the vision, business sense and confidence to invest in ideas and opportunities that they believe will produce a ROI that is greater than the WACC.