**CENTRE FOR FINANCIAL MANAGEMENT**

# CFM QUARTERLY IN FINANCE

**JANUARY 2014**

**EDITOR : DR. PRASANNA CHANDRA**

**CONTENT**



CFM Quarterly in Finance, a publication of the Centre for Financial Management, Bangalore is primarily a practitioner-oriented journal. It seeks to discuss contemporary developments, analytical concepts and techniques, research insights, perspectives, and state-of-the art practices. By and large, the CFM Quarterly in Finance seeks to convey important developments in the theory and practice of finance in a rigorous, but relatively non-technical, manner.

## A . ARTICLES / CASES

### 1. TESTING A STRATEGY1

## Dr. Prasanna Chandra

Chris Bradley, Martin Hirt, and Sven Smit have suggested ten timeless tests for evaluating a strategy and promoting a meaningful strategic dialogue throughout the company.

**Will Your Strategy Beat the Market ?** Companies operate in markets thronged by customers, suppliers, competitors, substitutes, all competing to advance their positions. Unhindered, this process tends to drive superior returns toward zero. So, to capture economic surplus, a company must control a market imperfection that gives competitive advantage As Chris Bradley et.al. put it, "To beat the market, therefore, advantages have to be robust and responsive in the face of onrushing market forces. Few companies, in our experience, ask themselves if they are beating the market- the pressures of just playing along seem intense enough. But playing along can feel safer than it is."

Often, in war weaker contenders win when they employ a divergent strategy and the same appears to be true in business.

**Does Your Strategy Tap a True Source of Advantage?** There are two sources of competitive advantages: positional advantages and special capabilities. Positional advantages stem from structurally favourable markets which favour incumbents. For example, two beer makers control 95 percent of the market in Australia and their profit margins are three times those of US brewers . This situation was caused by a consolidation of the industry that began in 1980s. The change in structure had a bearing on industry conduct (price increases outstripped general inflation) and industry performance (higher profitability).

Special capabilities represent scarce resources whose possession provides unique benefits. One category of special capabilities are things such as drug patents and mining rights which are tradable assets. Another category of special capabilities consists of things a company does particularly well - distinctive competencies - such as product innovation, project management, talent management, and stakeholder management. Though not easily traded, these capabilities represent a powerful advantage.

Companies often cavalierly claim special capabilities without testing them rigorously. As Chris Bradley et.al. put it, "Companies often err here by mistaking size for scale advantage or overestimating their ability to leverage capabilities across markets. They infer special capabilities from observed performance, often without considering other explanations (such as luck or positional advantage)." Obviously, a company should test its special capabilities before counting on it.

**Is Your Strategy Granular About Where to Compete?** To improve its strategy, a company must segment its market. As Chris Bradley, et. al., put it, "Push within reason for the finest possible objective segmentation of the market: think 30 to 50 segments rather than the more typical 5 or so." A granular understanding of the market will help in identifying the segments where the company should focus. And this is critical because research suggests that 80 percent of the variance in revenue growth is explained by choices about where to compete and only 20 percent is explained by choices about how to compete.

**Does Your Strategy Put You Ahead of Trends?** Many strategies place considerable weight on the continuation of the status quo, although the emergence of new trends is common. So, to remain ahead of the curve, strategies must analyse trends seriously. As Chris Bradley, et.al. put it, "Always look to the edges. How are early adopters and that small cadre of consumers who seems to be ahead of the curve acting? What are small, innovative entrants doing? What technologies under development could change the game?" A company must assess the impact of a new trend that articulate the decisions it would make to cope with it.

**Does Your Strategy Rest on Privileged Insights?** A new strategic insight is a source of competitive strategy. However, developing proprietary insights is difficult and most companies stumble in this respect.

To improve the odds of developing privileged insights, a company must examine the assumptions underlying its existing business model, collect new data through field research, seek novel ways to analyse the data, and go out of its way to experience the world from the perspective of the customer.

**Does Your Strategy Embrace Uncertainty** There are four levels of uncertainty. At level one, there is a reasonably clear view of the future. At level two, there are several identifiable outcomes. At level three, the possible outcomes are represented by a range - and not a set of points - that can be represented as a probability distributions. At level four, there is total ambiguity, and the distribution of outcomes is not known.

Companies seem to assume simplistically that they are operating at level one (and make bold and unjustified point forecasts) or succumb to unnecessarily pessimistic level - four paralysis. What is required is a rigorous understanding of uncertainty that lists the variables that would influence a strategic decision, prioritises them according to their impact, removes as much uncertainty as possible, and then applies tools such as scenario analysis to the remaining, irreducible uncertainty.

**Does Your Strategy Balance Commitment and Flexibility?** Strategy is not just about where and how to compete. It is also about when. Since commitment and flexibility are in inverse proportion to each other, a major challenge in strategy is concerned with the right balance between commitment and flexibility over time. While a premature commitment can be a leap in the dark, too much of procrastination may result in missing valuable opportunities. According to Chris Bradley, et. al., "A market-beating strategy will focus on just a few crucial, high-commitment choices to be made now, while leaving flexibility for other such choices to be made over time."

**Is Your Strategy Contaminated by Bias?** The human brain is a wondrous organ, but it is not a rational calculating machine as neoclassical economists have assumed. Our decision making is affected by a number of biases. The major one are: overconfidence (tendency to overestimate the accuracy of our forecasts), confirmation, bias (overweighting information that confirms our opinions), illusion of control (exaggerating one's control over outcomes), representativeness bias (forming judgments on the basis of stereotypes and analogues), availability bias (relying overly on easily available information), anchoring (linking assessment of something to an arbitrary reference point), loss aversion (feeling much more strongly about the pain from a loss than the pleasure from an equal gain), herding (following the crowd), and affect heuristic (deciding mostly on what feels right emotionally and viscerally).

Since these behavioural biases often remain undetected, a conscious and deliberate effort has to be made to "de-bias" decision making. The following are helpful in this task. (a) Develop multiple hypotheses and potential solutions. (b) Use a checklist for evaluating the quality and independence of information. (c) Specify objective decision criteria in advance and examine the possibility of being wrong. A technique like 'premortem assessment' (imagining yourself in future where your decision has turned out to be wrong and identifying the reasons for the same) can be helpful.

**Is There Conviction to Act on Your Strategy?** Many good strategies flounder because of lack of conviction, particularly among the top management team, where one or two dissenters can stifle the strategic initiative.

CEOs and boards should make sure that the whole team is convinced about the strategy. According to Chris Bradley, et. al., "this requirement means taking decision makers on a journey of discovery by creating experiences that will help them viscerally grasp mismatches that may exist between what the new strategy requires and the actions and behaviour that have brought them success for many years."

**Have You Translated Your Strategy into an Action Plan?** A new strategy involves a change in the company's business model, organization structure, and capabilities. As this change often represents a major transformation, it is imperative to define clearly the shifts involved. As Chris Bradley, et. al., put it, "Develop a detailed view of the shifts required to make the move, and ensure that processes and mechanisms, for which individual executives must be accountable are in place to effect the changes. Quite simply, this is an action plan. Everyone needs to know what to do." Finally, it is critical that the ongoing resource allocation processes are aligned with the new strategy.

## SUSTAINBILITY AND TRIPLE BOTTOM LINE

**Dr. Prasanna Chandra**

WSince business entities have social and environmental impacts as well, John Elkington9 has proposed the triple bottom line (TBL) approach. The TBL approach seeks to measure organisational performance in terms of three criteria viz., economic, ecological, and social. TBL is also known as the "people, planet, and profit" approach, a phrase coined by SustainAbility. "People" refers to fair and beneficial practices toward labour and the community in which the business operates. "Planet" (natural capital) pertains to sustainable environmental practices. "Profit" refers to the economic value created by the company after deducting the costs of all inputs, including the cost of capital tied up.

**Sustainability Initiatives**

Many leading companies all over the world have embraced sustainability. Unilever stated in its 2012 annual report that its vision is to "Double the size of the business, whilst reducing our environmental footprint and increasing our positive social impact." Henkel released its 21st annual sustainability report, which details plans to become three times more efficient in energy and water usage by 2030. Piccolomoni President and CFO of Henkel's North America unit said, "I have really become a convert. Sustainability is a very positive thing, and the right long-term view that all companies should have." Art Hicks Jr., CFO and COO of exercise - equipment manufacturer Cybex International expressed a similar view, "We're good folks and we care about our neighbors. But quite honestly, we get paid to run a successful business, and environmental issues have become bigger business issues in the past few years."

**Sustainability in the U.S** Nearly 80 percent of large U.S. companies now have a sustainability function, if not a chief sustainability officer. Many CFOs have also embraced the sustainability movement. This is not surprising because going green is generally consistent with the finance mantra of doing more with less. Indeed, it is ripe for rigorous analysis that finance does so well. Finance executives are playing major roles in three areas of sustainability: capital expenditures (return on green investment), sustainability reporting, and investor relations.

Capital Expenditures (Return on Green Investments) According to E&Y research, close to 70 percent of the companies require sustainability projects to meet the same financial criteria as other kinds of projects. Of course, tax incentives too provide a helping hand.

Sustainability Reporting Large companies now routinely provide an annual sustainability report. As Mary Rhinehart, senior vice-president and CFO of Johns Manville, the building -materials manufacturer, says, "Being a sustainable company is good business, and it's also good business to help your key stakeholders understand your sustainability efforts. To remain competitive, it is important that our customers are aware of what we are doing in this area."

UPS, the logistics company, is a pioneer in this area. Its sustainability report contains an impressive array of metrics such as gallons of fuel used per ground package delivered, carbon emissions by business segment, and miles logged with alternative fuel. Such quantification naturally calls for heavy involvement of finance function.

Investor Relations: From Fringe to Mainstream In 2012, nearly 50 percent of shareholder proxy proposals related to environmental and social issues, according to Institutional Shareholder Services. Historically, such proposals have come from environment- sensitive fringe investor groups, but of late they seem to be gaining more support from mainstream investors. For example, the pension fund TIAA-CREF, a traditional mainstream investor, though not in the vanguard of filing shareholder proposals on environmental or social issues, is looking for supporting "reasonable" proposals, says John Wilson, director of corporate governance.

**Sustainability in India** It is heartening to learn that an increasing number of Indian companies are realising the importance of environment and the contribution sustainability initiatives can make to the bottom line. They are creating departments within the management structure to focus on sustainability practices that are good for the environment and the business. In many groups the role of the sustainability chief is assuming greater importance. Two conspicuous examples are ITC Limited and Tata Power Limited. ITC has been a leader in environmental-friendly initiatives. A recipient of numerous accolades, ITC is the only company in the world of comparable size to be carbon positive, water positive and solid waste recycling positive. It has the greenest hotel chain in the world. As Nazeeb Arif, Vice President, Corporate Communications, ITC Limited said, "Given that ITC's sustainability initiatives, both in terms of environmental contribution and creation of sustainable livelihoods, are a core and integral part of the vision and business strategy, an effective organisational structure has been put in place to provide distributed leadership and enable efficient implementation of the company's objectives. A member of the senior management team of ITC's Environment Health and Safety function is represented on the Corporate

Management Committee that is entrusted with the task of strategic management of the company's business." Tata Power has been another pioneer. As Avinash Patkar, Chief Sustainability Officer (CSO), Tata Power said, " Tata Power was the first company to have a Chief Sustainability Officer in 2008 in India. Now, many Indian companies are appointing such officers. Since all natural resources are limited, and demand for them is rising, it is important to have a high level person to handle sustainability issues and to ensure that sustainability goals are woven into operational targets."

**Making Sustainability Profitable***

Boston Consulting Group and the World Economic Forum found many visionary companies from emerging economies that have achieved sustainability while generating above- average growth rates and profit margins. They have followed one or more of three general approaches: (a) bootstrapping by making low cost, high return investments that provide funds for more advanced technologies; (b) investing initially in more-expensive sustainable operating methods that eventually lead to significantly lower costs and higher yields in the long run; and (c) extending their sustainability initiatives to the operations of their vendors and customers.

Here are some examples

- Shree Cement, Beawar India, has funded increasingly sophisticated methods to reduce energy use and improve production efficiency from its savings from low-risk, high-return efforts to conserve electricity. During 2005-2009, it achieved a compound annual growth rate of 50 percent in its revenues, while enjoying an EBITDA margin of 39 percent.
- Jain Irrigation Systems, Jalgaon, India, supplier of irrigation systems and wholesaler of produce, helped small customers afford its water- saving devices by agreeing to buy some of its customers' produce at a predetermined price. During 2006-2010, it achieved a 40 percent compound annual growth rate in its revenues, while earning an EBITDA margin of 18 percent." Florida Ice & Farm, a beverage bottler from San Jose, Costa Rica became a water- neutral company. During 2006-2010, it achieved a compound annual growth rate of 25 percent in its revenues, along with a healthy EBITDA margin of 30 percent.

* Based on Knut Haanaes, David Michael , Jeremy Jurgens, and Subramanian Rangan, "Making Sustainability Profitable, "Harvard Business Review, March 2013.

**Plan B** A new global experiment called Plan B seeks to infuse businesses with a new DNA that puts sustainability at the centre - stage of the corporate world. The B Team consists of a group of global leaders such as Richard Branson of the Virgin Group, Paul Pollman of Uniliever, Ratan Tata, Chairman Emeritus, Tata Sons, Nobel laureate Mohammed Younus, and Gro Harlem Brundtland, former Norwegian prime minister. In its inaugural, the Team admitted "the overwhelming confession that we have reached is that businesses have been a major contributor to the problem and we as business leaders have the responsibility of creating sustainable solutions." All members of B Team wish to start at home before they preach to others. Richard Branson observed, "We have to create a new approach to business ... the current way of doing business to broken."

**Appreciation of Sustainability Initiatives** There is a growing appreciation of the sustainability initiatives of companies.For example:

- Dow Jones Sustainability Index identifies industry leaders in different categories every year.
- Corporate Knights names 'Global 100 Most Sustainable Corporations in the World' every year.
- Newsweek magazine puts out 'Green Rankings' of the largest publicly traded companies in the US and the world.

**Sustainability Reporting**

Global Reporting Initiative and United Nations Global Compact are two major initiatives to promote sustainability reporting.

**Global Reporting Initiative** The Global Reporting Initiative (GRI) is a non- profit organisation committed to economic sustainability. GRI provides standards, called GRI Guidelines, which are periodically revised, for sustainability reporting - also known as triple bottom line (TBL) reporting, environmental social governance (ESG) reporting, ecological footprint reporting, and corporate social responsibility (CSR) reporting. GRI Guidelines are widely used. More than 4,000 organisations from over 60 countries use the Guidelines to produce their sustainability reports.

GRI Guidelines concerning the environment are contained within the GRI Indicator Protocol

Set. The Performance Indicators (PI) cover energy, biodiversity, and emissions. There are 30 environmental indicators ranging from EN1 (materials used by weight) to EN30 (total environmental expenditures by type of investment).

**United Nations Global Compact** A United Nations initiative, the United Nations Global Compact, also known as Compact or UNGC was launched in 2000. It encourages businesses worldwide to adopt sustainable and socially responsible policies and report on their implementation. A principles-based framework, the Compact states ten principles in the areas of human rights, labour, the environment and anti- corruption.

The Compact is the largest global corporate citizenship initiative with two objectives: "Mainstream the ten principles in business activities around the world" and "Catalyse actions in support of broader UN goals, such as the Millennium Development Goals (MDGs)."

**Implementation Challenges**
In some ways, the TBL is similar to the balanced scorecard. The same principle undergirds the two: what you measure is what you get, because you are likely to pay attention to what you measure. When companies measure their social and environmental impact, they tend to become socially and environmentally responsible.

There are challenges in using the TBL in practice. Inter alia, these relate to determining the measures for each of the categories ( particularly for the people and planet accounts), obtaining applicable data, and calculating the contribution of a project or policy to sustainability. Notwithstanding these challenges, the TBL and its core value of sustainability enables firms to evaluate the ramifications of their decisions from a long-term perspective. And thanks to accumulating anecdotal evidence that it enhances long-term profitability, the TBL has been gaining popularity in the world of businesses. Firms like General Electric, Unilever, Proctor and Gamble, 3M, ITC, and Tata Power have been exemplars of the TBL.

As stakeholders - consumers, investors, and employees - pay greater attention to the social and environmental impact of business, corporate responsibility efforts enter uncharted management territory. More and more companies are likely to reengineer supply chains to make them "greener," support social causes through voluntary effort by employees, and lobby for human rights. As this movement gathers momentum, many executives will have an uneasy sense of how corporate responsibility initiatives create value, both for their companies and for society. While investments from recycling or from energy- saving manufacturing processes produce immediate and quantifiable gains, social investments tend to produce long-term and hard - to - quantify benefits as engaged consumers buy more, talent gravitates to the company, or a broader investor base develops.

**Bill Clinton**
"Today, being a good corporate citizen requires more than business as usual: it requires investments in society and the environment. Short-term thinking got us into the financial mess, and long-term investments that also benefit the world around us can lead us out of it. Any large-scale efforts to solve the great global challenges that do not include the private sector will fall short. We are all shareholders in our children's future and the future of our planet, and by working together we can build an economy in which everyone can benefit from free markets."
"Creating Value in an Economic Crisis," Harvard Business Review, September 2009

According to the Carbon Disclosure Project (CDP) a watchdog that gathers information on the emissions of over 500 large companies, nearly three-fifths of emission-reducing investments made so far will pay for themselves in three years. More than two-thirds of companies covered by CDP surveyed claimed that they have made global - warming strategy as part of their core strategy.

## B.SNIPPETS

**1. Coming Together of Hardware & Software**
For a long time, building hardware was considered to be a dirty, complicated low margin activity below the dignity of software companies. A la Microsoft, writing a few brilliant algorithms and selling them over and over to rake huge profits was considered to be the smartest thing. Apple's phenomenal success over the past decade has reinstated the value of hardware. By controlling all aspects of the product - physical equipment, design, software, and an online service to connect everything - Apple has churned out iconic products year after year. As Steve Jobs predicted in 2007, "People make their own hardware."

Taking a cue from Apple, Oracle bought Sun Microsystems, Amazon launched e-book reader Kindle, Microsoft introduced Windows powered Surface Tablet, and Google came up with Android-powered Nexus 7 tablet. Highlighting this trend, Steve Ballmer of Microsoft said, "We believe that any intersection between human and machine can be made better when all aspects of the experience- hardware and software- are considered and working together."

**HDFC Bank's Strategy**
HDFC Bank's mission is to be a 'World Class Indian Bank.' The objective of the bank is to achieve a healthy growth in profitability consistent with the Bank's risk appetite. The Bank is committed to do this while ensuring the highest levels of ethical standards, professional integrity, corporate governance and regulatory compliance. The Bank's business strategy emphasises the following.

- Develop innovative products and services that attract its targeted customers and address inefficiencies in the Indian financial sector.
- Leverage its technology platform.
- Maintain high risk standards for asset quality through disciplined credit risk management.
- Continue to develop products and services that reduce its cost of funds.
- Focus on healthy earnings growth and low volatility.

**Quality Management Paradigms**

Vendor management skills, process innovation, and working with a wider eco-system are bringing a paradigm shift in quality management. As Raghavendra Rao of Frost and Sullivan argues, "Today it is not right to label India as a source of low-quality manufacturing. Things have changed in key sectors, from the early 2000s. If speed and the ability to manufacture high volumes have worked in China's favour, the quality and quantity of skilled technical labour has worked in ours." He further adds, "Global manufacturers are worried that if they take confidential product designs to China, they may be leaked and copied by local units. In India, there are no such fears. Secondly, India competes on the lean principle -we don't manufacture in huge volumes, but focus on doing things at lower cost and getting it right the first time." Realising that prevention of quality issues is critical for managing cost, Indian manufacturing fraternity is evolving homegrown quality management paradigms. Here are some examples:

- At Maruti Suzuki which sources about 80 percent of its requirements from about 220-odd vendors, the focus has shifted from 'inspection' to 'involvement' because when quality is checked upstream the cost overruns are much less. For example, each car panel is checked at the sourcing stage itself.

- Godrej Consumer Products Limited (GCPL) follows Goldratt's 'Theory of Constraints' (TOC) across all its processes from ordering raw materials to delivering to the end consumer. Says Rakesh Sharma, COO of Operations," We have moved to a replenishment-based supply chain system and de-linked it completely from forecasting." He adds, "TOC has been extended to vendors as well. In fact, we are the first in the world to fully connect the supply chain to the raw material level."
- When Sundaram Brake Lining decided not to use asbestos, a known pollutant, its R&D department came up with a zero-asbestos innovative composition which is placed competitively with asbestos.
- Thermax has developed a homegrown quality process that it calls the Thermax Operating System (TOS) which covers the entire business spectrum.

**Merck**

Headquartered in the U.S., Merck is a leading multinational pharmaceutical company that does business in more than 100 countries. More than 50 percent of its sales are made abroad and foreign sales are billed in local currencies. Merck spends large sums of money on R&D which is critical for its competitive strength. A major concern for the management is that unexpected foreign exchange losses could curtail its R&D outlays which are essential for its success. So, Merck's risk management programme is designed to reduce to likelihood of such an outcome. Judy Lewent and John Kearney1 explain how Merck addressed the issues in five steps when its risk management programme was put in place.

Step 1 Project exchange rate volatility Merck projects exchange rate volatility to quantify the probability of adverse exchange rate movement.

Step 2 Assess the impact on the 5- year strategic plan Since cash flows are affected by foreign exchange movements, Merck estimates the impact of adverse exchange rate movement on the firm's ability to meet its R&D needs and dividend payments.

Step 3: Decide whether to hedge the exposure Merck examines the desirability of reducing earnings volatility due to exchange rate movement from both internal and external perspectives. The main internal consideration is the firm's ability to finance R&D expenditures and the main external consideration is the firm's ability to sustain dividend growth.

Step 4: Select the appropriate financial instruments While there are several hedging instruments, Merck decided to use plain vanilla options as the principal tool in its hedging programme. The rationale for doing so was that it would preserve potential gains, if the dollar weakened, while providing downside protection.

Step 5 Construct the hedging programme Merck's risk management programme involved hedging on a multi-year basis, avoiding far-out-of-the- money otions, and resorting only to partial hedging, which means self- insuring for the remainder.

## C.WIT AND WISDOM

## 1. Humour

- A man called up his debtor and demanded payment for an outstanding account. As usual, the debtor replied, "I can't give it to you now." The ingenious creditor said, "Pay me immediately. Otherwise, I will tell all your other creditors that you've paid me." The trick worked.
- Louis XIII, known for his petulant behaviour, slapped Cardinal Richebeer who was sitting next to him at the dinner table. To return it was impossible, to protest against it would have meant retirement from court, and to rest under it was disgraceful. Without a moment's hesitation, the cardinal slapped his neighbour and said, "The king wishes you to pass that on."

## 2. Wise Saws

- Security depends not on how much you have as upon how much you can do without.
- Science is proof without certainty while faith is certainty without proof.

## 3. Perspective

In contrast to the materialistic development of western civilization, most of the great Asian civilizations turned inward, emphasizing man's spiritual development rather than is material progress. Some authorities say that this was due to the inherently different nature of Eastern Man. Others maintain that this view puts the cart before the horse, that Eastern Man turned inward because his harsh physical environment compelled him to seek solace in contemplation. Whatever the original cause, it is a fact that in most Asian societies, the study of the past, the observance of the family, tribal, cast or religious customs, and the contemplation of man's nature & his relation to the universe have, until very recently, overshadowed the pursuit of material progress. Broadly the Eastern Man has for the past 500 years been passive & non aggressive relatively. Under the impact of the Asian revolution, this pattern is rapidly changing.