CCP

SECTION 6
PAPER NO: 17

CORPORATE LENDING

STUDY & REVISION PACKS

ANALYSIS OF CORPORATE STRATEGY IN RELATION TO LENDING

A. BUSINESS STRATEGY.

A business strategy, which defines or sets out the business objectives of the company, should precede the financial strategy (the financial strategy implements the set out objectives). These objectives are not the mission statement which establishes the general aspirations of the company. A business strategy specifies the current thinking on how the general aspirations will be achieved.

A firm may have the following objectives envisaged in its mission statement:

- To be a leader in its chosen markets.
- To be the first choice for the customers.
- To reduce on the day-to-day operational costs to enable it to further invest in its business franchise.

The objectives to meet these objectives may include a number of options as but not limited to:

- Growing to a strategic size for better control of trading in the markets.
- Growing and becoming a public quoted company to ease raising of finances.
- Expanding into new markets overseas to gain advantage of better trading margins
- Expanding into new markets to dilute the risk of trading downturn area of business.
- To diversify into other products.
- To gain better reward for the owners of the business whether in dividends, greater remuneration or capital value improvement.
- To remain at the forefront of technological changes to safeguard the company's future trading interests.

It is important to understand where the business is in its life cycle so as to be able to know where to place the business in the trading market(s).

The embryo/start-up stage

- Is the business a niche player where completion is modest and the competence of the management is sufficient to exploit the product(s) offered?
- Will the business be in a very competitive environment where the marketing prowess or existing competence of the management will be heavily relied on for success?

In the first case, the lender will be asking whether it's likely that competition will materialize in the future. i.e. is there a risk that the business will not achieve the results expected due to lack of demand or failing in the product when it's produced?

The survival stage.

Here the business strategy has not been well developed and the entrepreneur is relying on the three H's:

- *Happiness* in the chosen occupation.
- *Hard work* to establish the business.
- *Hope* that the business will be a success.

There is an immediate need to conserve cash and extend the time that the firm can continue trading without becoming insolvent.

A strategy to cut costs and concentrate on the products that are selling well and to offer the best financial returns is inevitable.

There can also be the raising of more capital to help trade out of the difficulty and over a long period of time. The lender will be frequently asked to assist.

The expansion stage

The funds for this programme may be sought from the bank which must be careful to ensure that the debt can be repaid within the agreed period. The following questions need to be answered:

- Are there sound reasons behind the strategy?
- Have all probable trading scenarios been assessed correctly?
- Are the financial projections reasonable?

Note: Expansion may be from internal or external. External factors such as fiscal regulations, price wars, major competitor closing etc. may have positive or negative effects on expansion plans.

The mature life stage

No further investment should be needed in plant or specific marketing for expansion.

The company should be mindful to maintain its profit margin and market share.

A defensive strategy is employed ready to combat any trading moves by any competitor.

The bank should be looking to the firm to reduce the outstanding loans especially those specific to the mature product(s).

As well, where the company has a good credit history, the bank may be considering increasing of its exposure.

The decline/end of life stage

The strategy is to concentrate on promoting the brand name to retain sales and to use the greater profitability on the product(s) sold to invest in research and development of the next generation of products.

The lender will have to assess how long the existing product sales can remain, at what level and whether there will be a gap before the new products make an impact after the expected rundown.

NB. It is also very important to answer the extra two questions:

- How profitable should the business be?
- How is the business best able to achieve its objectives?

B. FINANCIAL STRATEGY.

This is primarily aimed at keeping the business in operation in the way its management had laid down. It may include adopting a borrowing policy both in the short run and long run and ensuring that the business does not run out of funds. It must be flexible and adaptive to changes in internal policy and external events as well as envisaging a risk scenario to cater for uncertainties.

A financial strategy is designed for use by:

i. The management of the company.
ii. The staff of the company.
iii. The company's owners/shareholders.
iv. Lenders.
v. The government (where the case requires).

In laying down a financial strategy, the following steps are followed:

- Adopt a business plan for implementation.
- Project the trading results based on approved sound assumptions.
- Forecast future profit & loss accounts and balance sheets.
- Calculate a cash flow picture from these forecasts.
- Re-appraise the assumptions and compare with target returns.
- Revise any forecasts as necessary.
- Review the future cash requirement to attain these forecasts.
- Decide on how tis cash requirement is to be met.

- Provide a sensitivity analysis of the final model.
- Incorporate a risk assessment to account for the unexpected.
- Consider reducing risks through derivatives.
- Finalize the cash amount to be raised and give it timing.

C. CORPOATE GOALS.

The corporate goals to attain may be financial or regulatory based. Public quoted companies must report annually on corporate responsibilities separate from the ones related financial accounting and IFRSs, GAAP etc. These are:

- Corporate governance as set out in the CMA Act 2002 guidelines.
- Directors' remuneration; the company's policy as reported to te board of directors.
- Statement of the directors; that the financial statements give a free and fair view of the state of affairs of the company.
- The independent auditors' report.

The CMA Act 2002 guidelines cover;

- The working of the board of directors and the powers of the CEO.
- The company's internal controls in place.
- Investor/shareholder relations.
- The auditor's independence and fees.
- The directors' satisfaction that the company has adequate resources to act as a going concern.

D. COMPETITIVE ENVIRONMENT.

There are five forces that affect the competitive environment of a business entity as described in Porter's five forces model. These are industry competitors' rivalry, buyers' bargaining power, suppliers' bargaining power, the threat of new entrants and the threat of new substitutes. The entity is required to have a strategy of combating competition from whatever force but of further essence is the specific market in which the entity operates.

Trading in perfect market equilibrium.

In this, the demand of a product or service is equal to the supply and no entity can improve their position once equilibrium has been reached. Sellers and buyers have no incentives to change the status quo and this ensures profit maximization. The equality of demand and supply will alter with regard to customer preferences, buyers will tend to pay more if demand rises and sellers will tend to lower their prices if there is lack of demand. It is important to note that the perfect market is not a common situation.

Trading in an imperfect market.

This is a situation where the market forces of demand and supply cannot control the pricing of products. This is because of the influence of some sellers and buyers whose capital adequacy and competitive edge makes them to dictate the trading in the market. The different kinds of imperfect market are monopolies, duopolies and oligopolies. The entity is supposed to have good timing and placement of products by:

- ✓ Being ahead of the game and dictating the take-up of the product(s) to the optimum speed of production and optimum profitability.
- ✓ Offering the market with what it requires other than raising a product and then trying to create demand and sell the product to the market.
- ✓ Placing the entity in the right environment at a time when market demand appears.

How to combat competition.

The following choices are available for an entity to fight completion:

- ❖ Pricing.
- ❖ Product quality.
- ❖ Niche services.
- ❖ Extensive marketing.
- ❖ After sales services.
- ❖ Rapidity in supply of the product.
- ❖ Strengthening the market share.

E. STRATEGIC ALTERNATIVES.

These are conjectures of scholarly work on entrepreneurial and corporate success believed to work when employed. It is worth noting that the propositions may and may not work for every corporate. Here are some of the paraphrased postulates:

- ❖ A successful company has been one where the share price has been less than two thirds of its quick assets (Assets that can be realized within approximately one month without the diminution in value) – *Benjamin Graham*.
- ❖ Go to five significant companies in an industry and ask each about the strengths and weaknesses of the other four – *Philip Fisher*.