



THE DEVIL YOU KNOW

Classical versus modern risk management techniques

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Finance has become a highly sophisticated science of recent years, but when correctly managed in conjunction with tried and tested basics it can bring even greater value to corporations. The question is, as always, whether the devil you know is better than the devil you don't – or can the two be happily married?

Take Dell for example, whose success is often attributed to its fancy business model. The real root of its resounding success, however, has been the amazing cost discipline that Michael Dell has put into the company.

The questions are where classical finance has brought the most value and where classical mistakes are being made. It is clear in a corporation like Dell, finance has made a great difference to its thinking and to its ultimate success.

Classical principles of finance

There are four big classical tenets of finance of which cost discipline is just the first. Second on the list is that cash is king - a simple thing, but one that people still get fooled by. Profits as we all know are nothing but profits - an accounting number but it is cash we want, not numbers!

Third on the list is capital awareness. Capital costs. Whether it comes from shareholders, banks or other investors – it costs. Successful tax engineering in finance and the need to change capital structures will have a bearing on this and should be carefully monitored. Should one move into more debt or more equity? This will affect the cost of capital and is something to think about.

Last but not least on the list are the facts around the time value of money. Quite simply, the faster you make it and the more you make, the better it is for obvious reasons.

These are simple principles driving good decisions in many corporations but surprisingly often overseen.

Innovation is a classic case in point of this. Innovation is all about risk but the best R&D programs are those that cut down the loser before they become too deep a loss. As financial discipline needs the success of innovation programs, so it is essential to have some discipline here.

Not everyone thinks the same way

Not everyone is of the same opinion, however. The CEO of one of the largest companies in the world recently said he would have no capital cap on R&D innovation, which has to be worrying for his CFO.

Where increased sophistication in finance techniques can help is in picking the right time to invest. The huge capital expenditures that are spent today by the oil industry are a key area of concern, with amazing wealth being invested by the large oil majors as well as the State-owned companies, at a time when it costs about triple to actually develop a barrel of oil. The justification for this is availability of funds but this is the wrong answer.

The correct answer is to pick the right time rather than when everybody else is investing. This indicates that the discipline of classical finance can be hard to implement. Increased sophistication could improve on the "yes" or "no" decisions of the past which sometimes – like in the oil company example – are not enough.

Common mistakes

There are a number of other common mistakes linked to the tenets of classical finance. These include the misconception that value is created once equity returns outweigh the cost thereof, risk thinking that requires further development, and excessive dependence on the opinion of financial analysts and financial markets, despite their undoubted use as a benchmark.

Additionally, like anything, finance follows trends and trends that with hindsight are sometimes ill-advised. Examples of this include increased leveraging and massive share buy-backs such as Exxon, who in 2005, had 18 billion dollars of share buy-backs.

For some players this may be a valid answer. But for others today, with interest rates low – leverage may not be the right choice. The bottom line is that having a better awareness of these tools and others – such as "short-termism" or hedge funds or credit derivatives – is a pre-requisite of being a good CFO today.

Acquisitions - think risk

One of the major issues is how to grow further and the easy answer is acquisitions. Nobody, however, said acquisitions are easy and the only way to achieve good acquisitions is to think risk. And for that, the tools of classical finance are not enough. This is where financial acumen is a must and where sophisticated modern techniques come into their own.

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