

Strategic and International Management

– 3. Strategic decision making and performance

Strategic and International Management

Agenda

- 1 Foundations of management
- 2 Stakeholders, objectives, and governance
- 3 Strategic decision making and performance**
- 4 Strategy analysis
- 5 Competitive strategies
- 6 Strategy implementation

Strategic and International Management

Agenda

3 Strategic decision making and performance

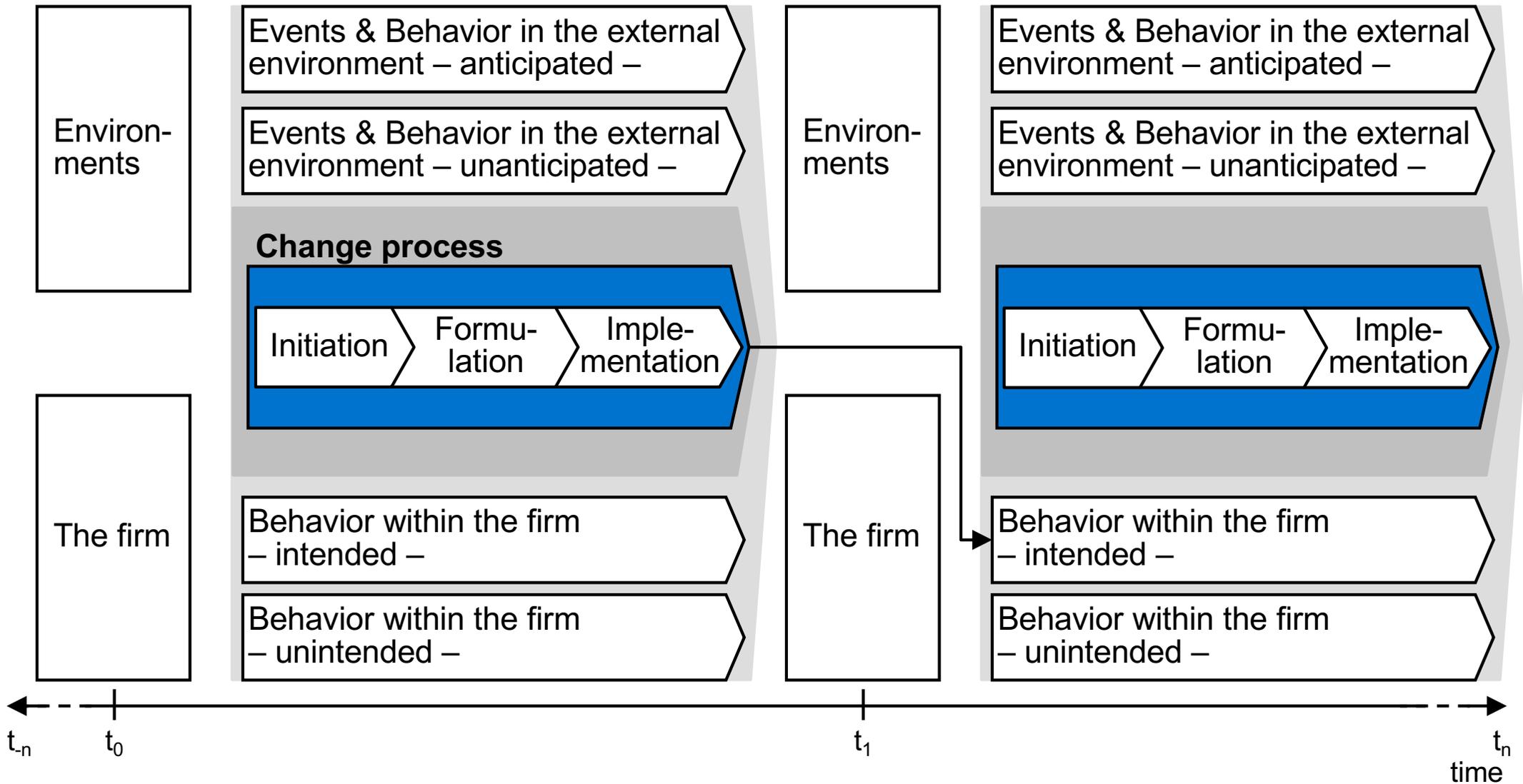
3.1 Strategic decision making

3.2 Performance and performance components

3.3 Financial success measurement

Learnings

What changes the firm?



An idealized process of strategy making includes three phases

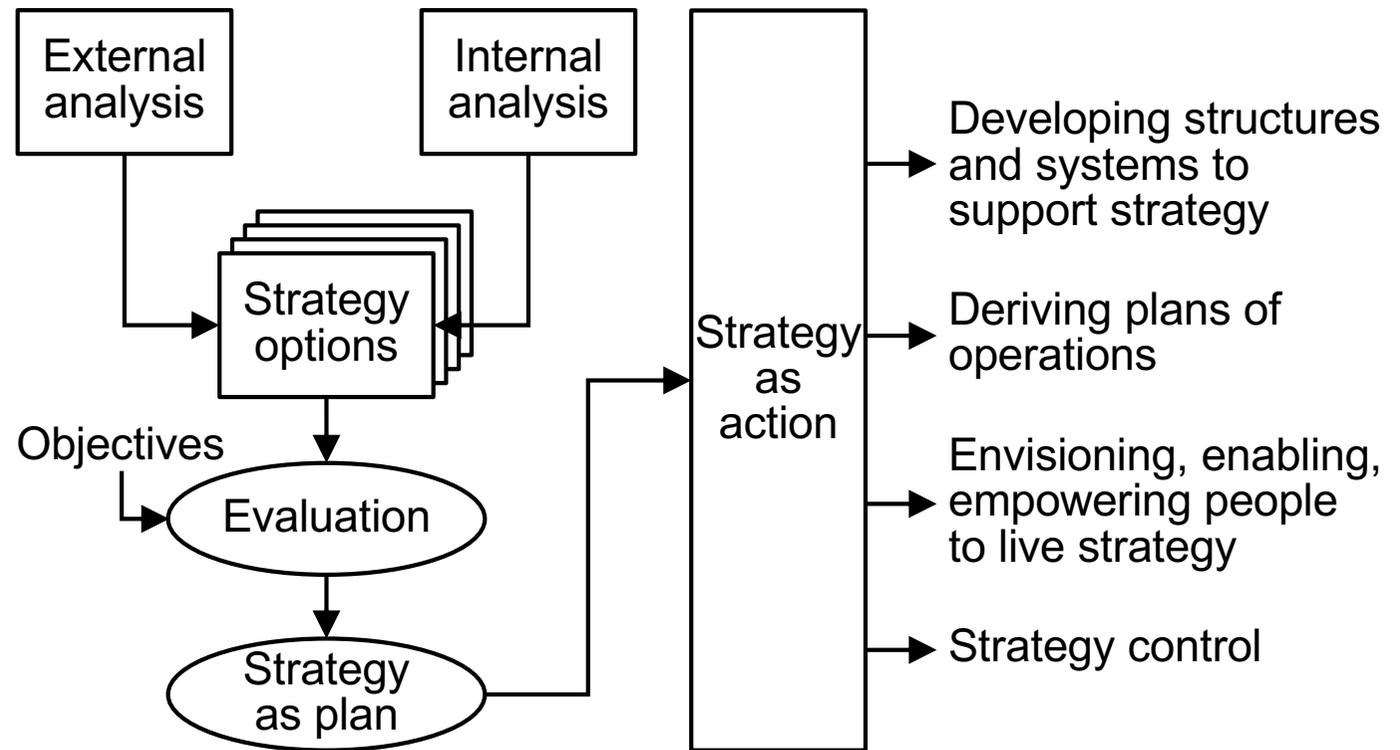
Process of strategy making

Chapter 4 + 5

Chapter 6



- Perception: What is going on?
- Identification: Do we have a problem, and what is it?
- Structuring: What are sub-problems that we can work on?
- Processing: What do we have to do to come to a strategy?



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3 Strategic decision making and performance

3.1 Strategic decision making

3.2 Performance and performance components

3.3 Financial success measurement

Learnings

Profit is king!



“Management must always, in every decision and action, put economic performance first.”

Peter F. Drucker, US-American economist



“For a public company, profit is everything, but in order to be profitable it must be a happy company, and I will do everything in my power to make us a happy company again.”

Hasso Plattner, Chairman, SAP AG (02/08/2010)

So, what is profit?

Income statement Copyfix AG (in mio. €), 2024

Sales revenue	136.58
± Increase/Decrease in finished goods inventory	18.24
- Material expenses	29.63
- Personnel costs	
- Wages and Salaries	48.55
- Hiring/Dismissal-costs	5.84
- Pension reserve	2.43
- Misc. personnel costs	19.42
- Depreciation	8.05
± Other expenses/income	38.23
= Operating income	2.68
+ Investment income	0.00
- Interest expenses	5.09
= Income from regular business operations	-2.42
Extraordinary income	0.00
- Extraordinary expenses	0.00
= Extraordinary profit/loss	0.00
- Income taxes	0.00
= Net income/loss for period	-2.42



Profit = Income - Expenses

Why to distinct profit and cash?

Information content of income and cash

What profit tells...

- Whether to make profits or losses (in/decrease of equity)
- Flow figure between two periods in time
- Profitability compared to
 - ... past
 - ... others

Profitability

What cash tells...

- Whether to be able to pay bills
- Stock figure at a certain point in time
- Liquidity for
 - ... current operations
 - ... investments

Liquidity

We distinguish two different reasons for bankruptcy

Reasons for bankruptcy

Over-indebtedness

Fixed and current assets	Liabilities
	Negative total equity

Bankruptcy because of ratio between liabilities and assets

Illiquidity

Fixed assets : : : : :	Equity
Current assets : : Cash 0 : :	Liabilities

Bankruptcy because of structure of assets

Illiquidity is not an option

Cash imperative and sources of cash

Cash imperative

You have to have cash / have to be liquid in each point in time!

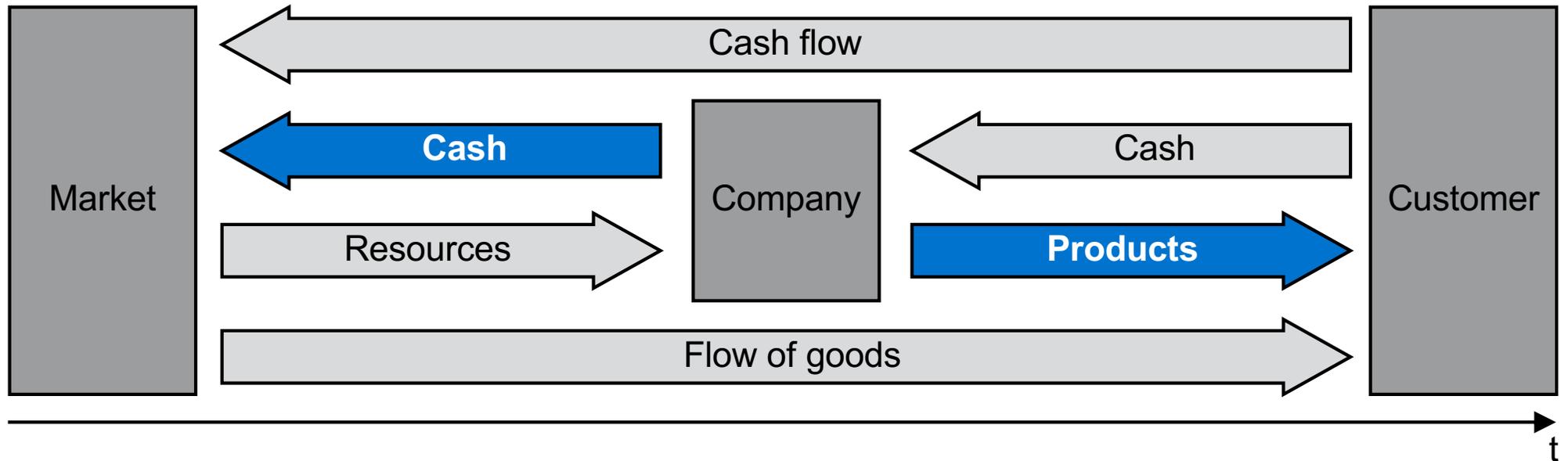
So, where does cash come from?

- 1 Operating cash flow
- 2 Asset structure
- 3 Cash in from external equity increase
- 4 Cash in from external debt increase

▶ Cash determines the space of managerial discretion.

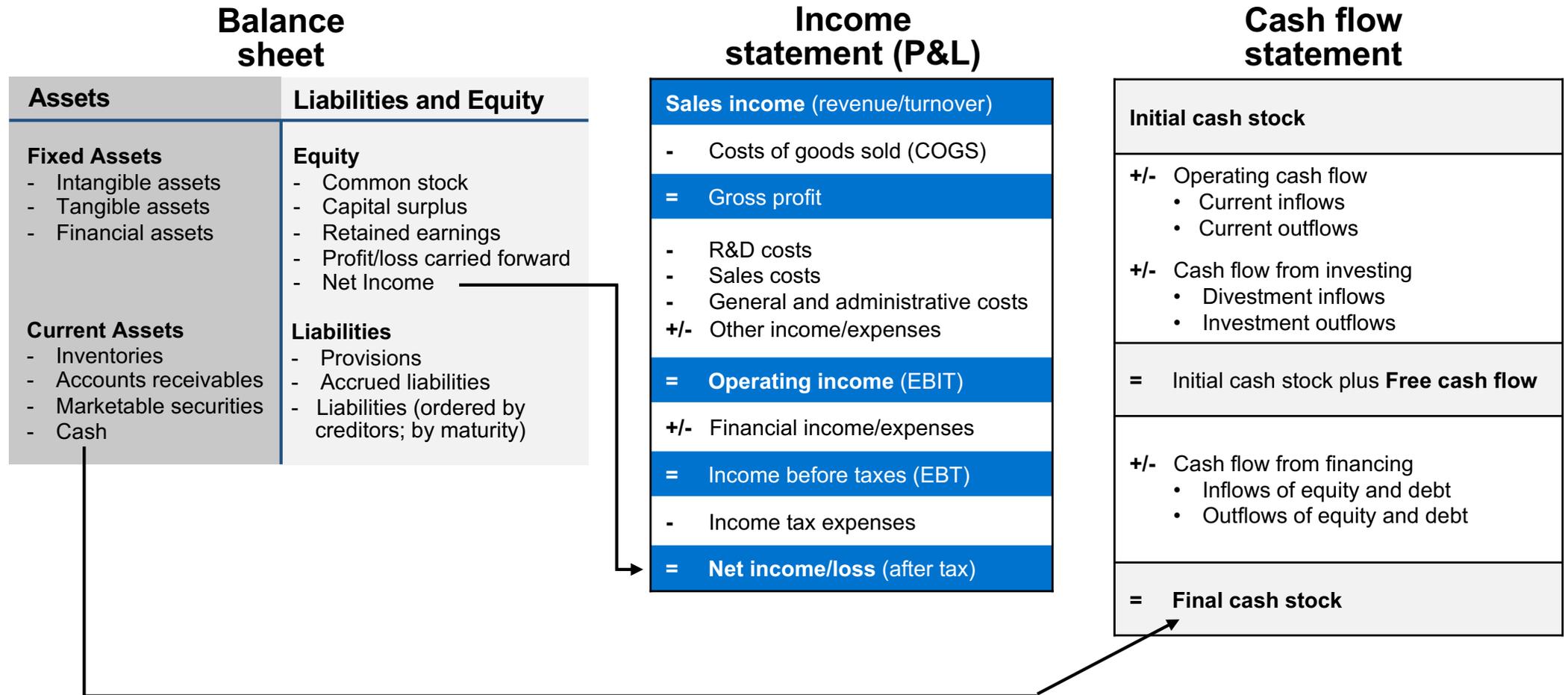
Why is cash a problem, at all?

Cause of financing and investment



The balance sheet, the cash flow statement, and the income statement show different aspects of financial health

Balance sheet, income statement & cash flow statement



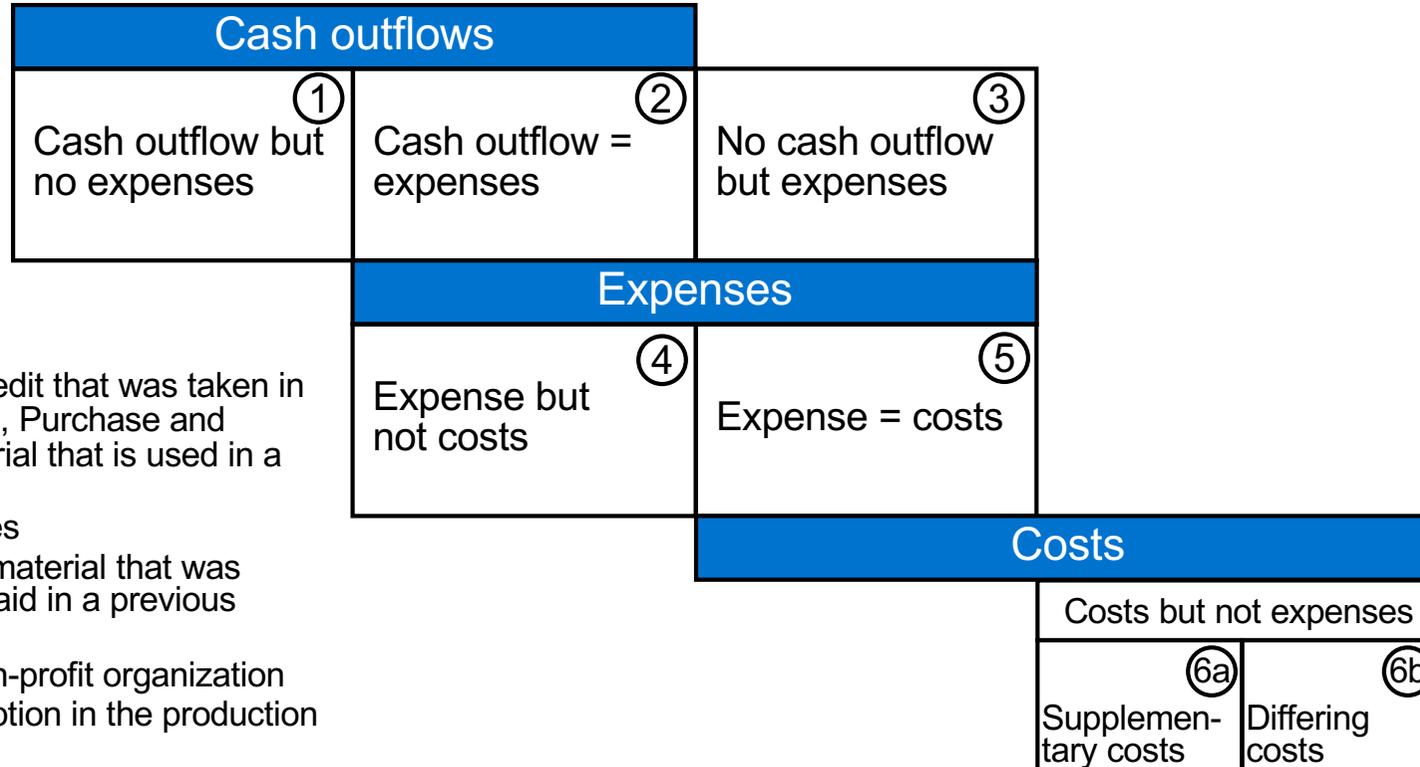
Financial instruments are built on three distinctive accounting spheres that correspond to each other

The three dimensions of accounting

	1 Managerial Accounting	2 Financial Accounting	3 Cash-Flow Accounting
Recipient	Internal firm	External stakeholders	Internal, external
Function	Internal planning and controlling activities	Reporting to stakeholders	Internal planning and controlling activities
Focus on (time)	Past, future (Year, month, day)	Past (Year, month, day)	Past, future (Year, month, day)
Regulation	Internally	e.g., IFRS, US-GAAP	Depending on legal form
Publication	Typically not	Obligated	Depending on legal form
Financial health/performance indicators	Benefits, costs, profits	Earnings, expenses, income; Composition of assets/liabilities	Cash in-/outflow components; Cash flow concepts
Instrument	Income statement based on benefits/costs	Income statement, balance sheet	Cash-Flow-statement

Accounting vocabulary must be thoroughly understood (1/2)

Distinguishing cash outflows, expenses, and costs

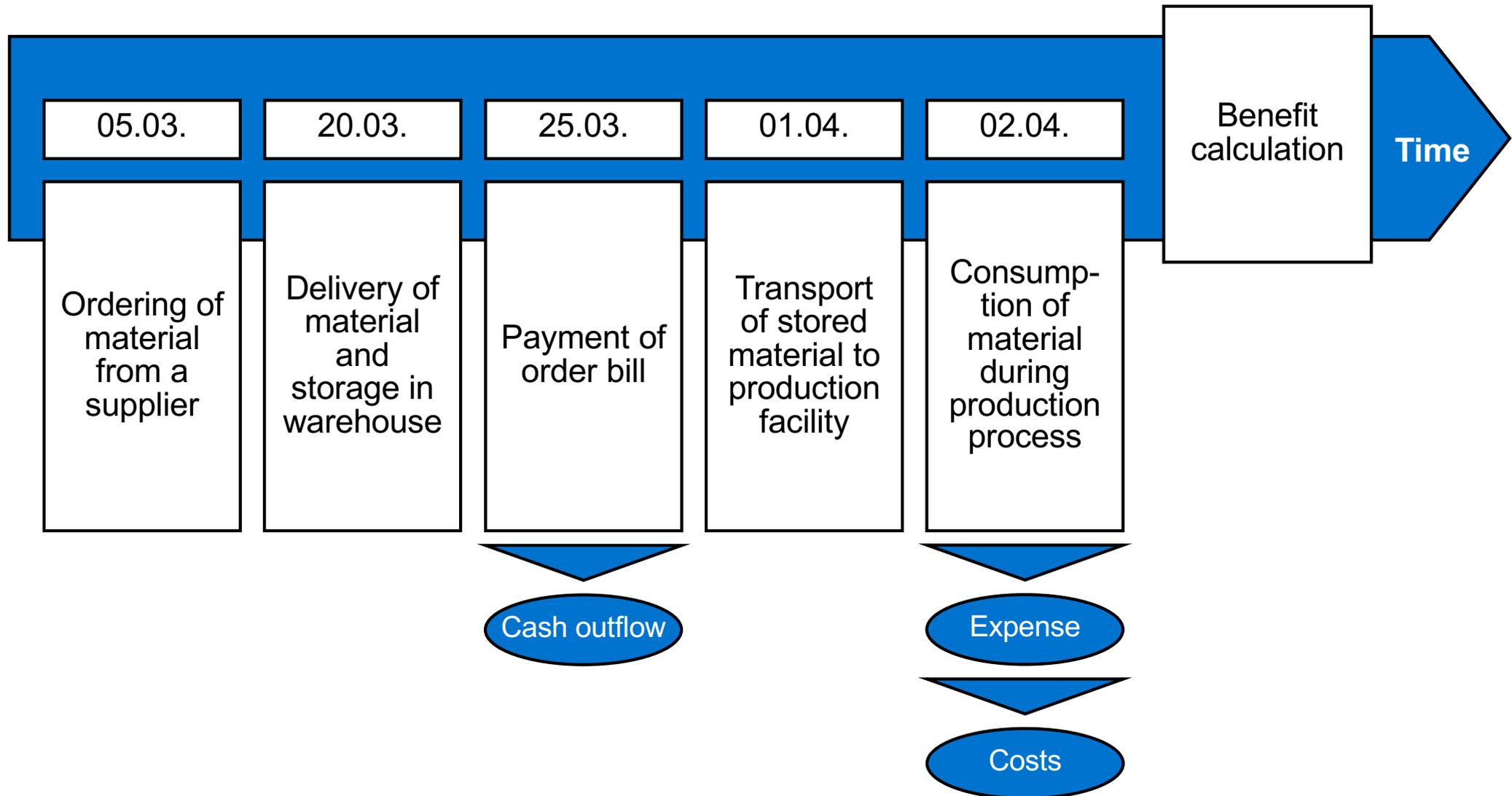


Examples:

1. Repayment of credit that was taken in a previous period, Purchase and payment of material that is used in a future period
2. Payment of wages
3. Consumption of material that was purchased and paid in a previous period
4. Donation to a non-profit organization
5. Material consumption in the production facility
- 6a. Calculative interests on shareholders' equity
- 6b. Asset depreciation that differs from a calculative depreciation

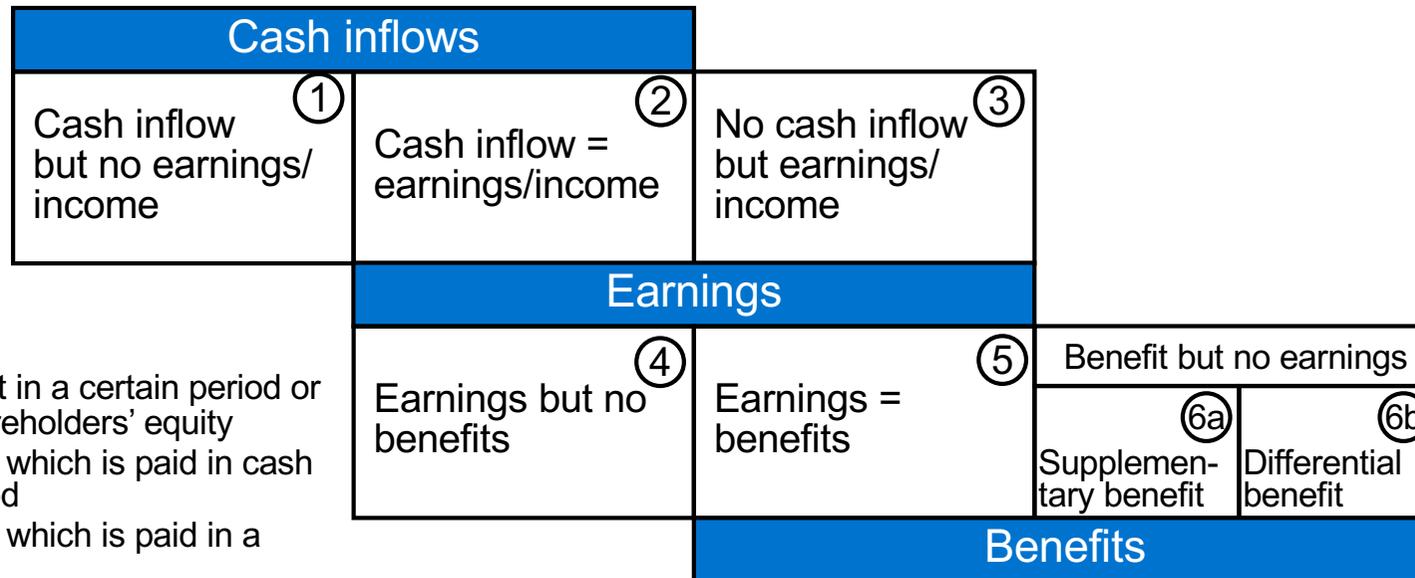
Cash outflow, expenses/costs are differentiated along the life cycle of real-business processes (1/2)

Business process example



Accounting vocabulary must be thoroughly understood (2/2)

Distinguishing cash inflows, earnings/income, and benefits

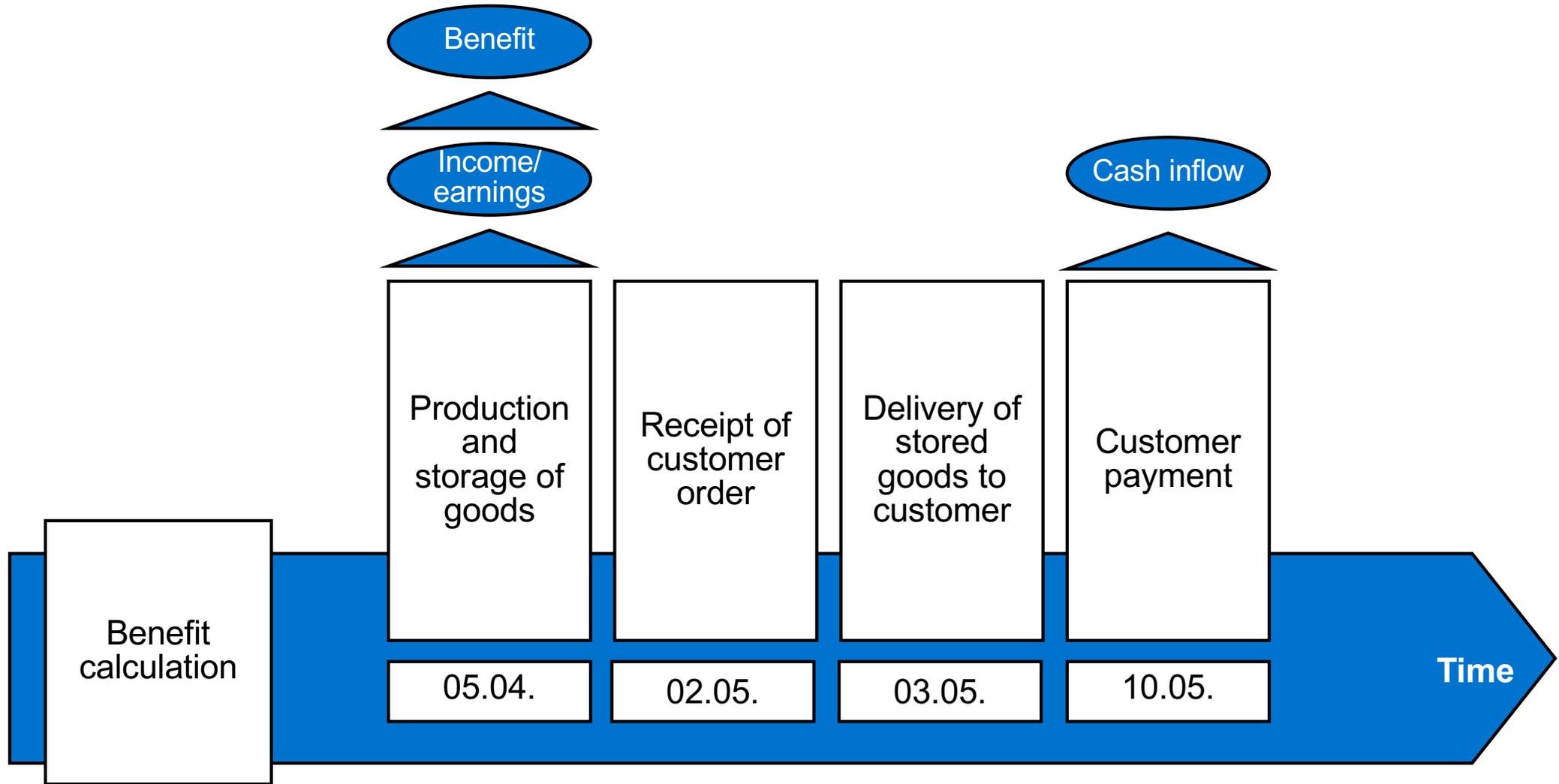


Examples:

1. Taking on a credit in a certain period or raising fresh shareholders' equity
2. Sale of goods for which is paid in cash in the same period
3. Sale of goods for which is paid in a future period
4. Profit from financial investment in capital markets, e.g., bonds
5. Sales/turnover from produced goods
- 6a. Self-generated intangible assets that are not allowed to activate (e.g., branding)
- 6b. Internal activation of operational benefits other than those prescribed by accounting standards

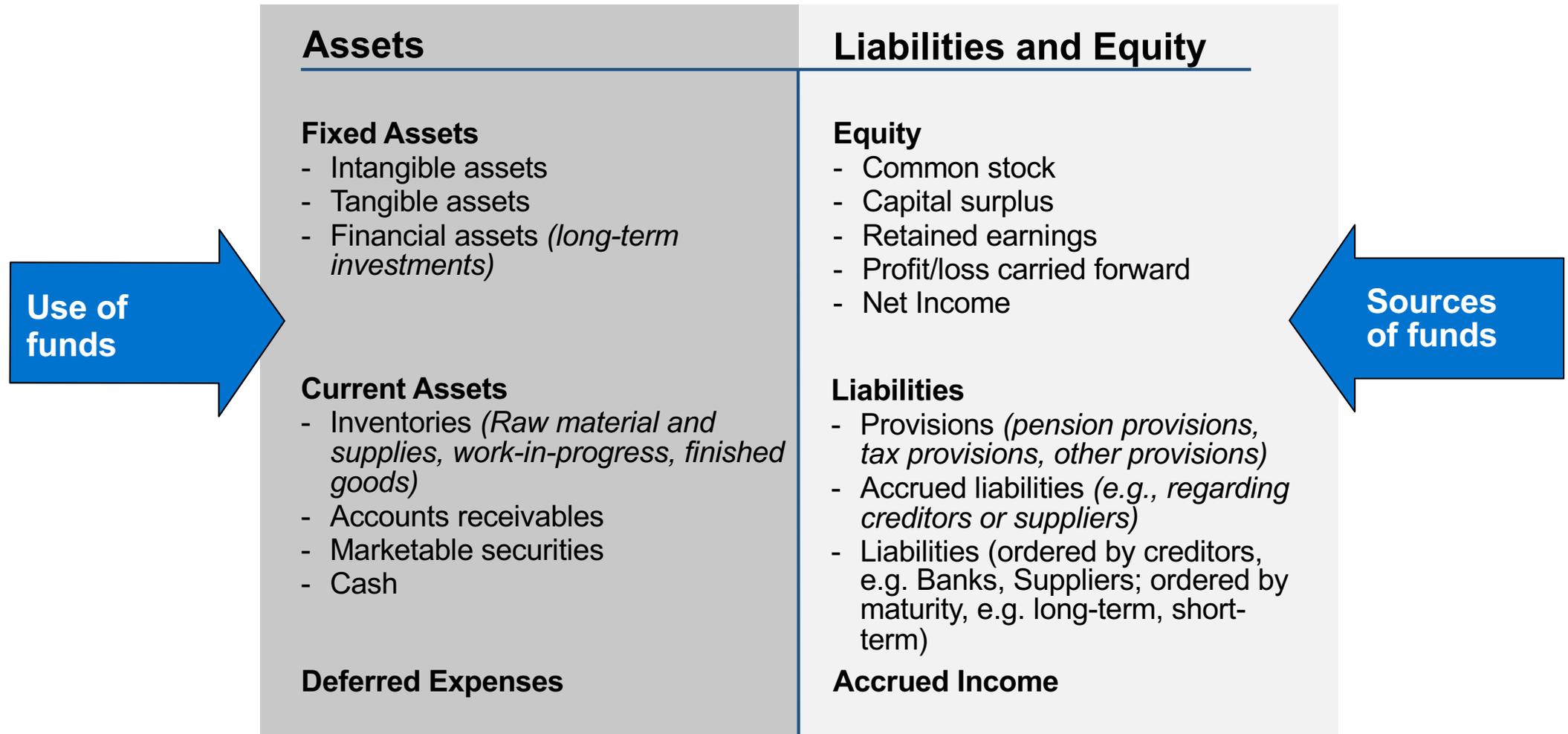
Cash inflow, earnings/income/benefits are differentiated along the life cycle of real-business processes (2/2)

Business process example



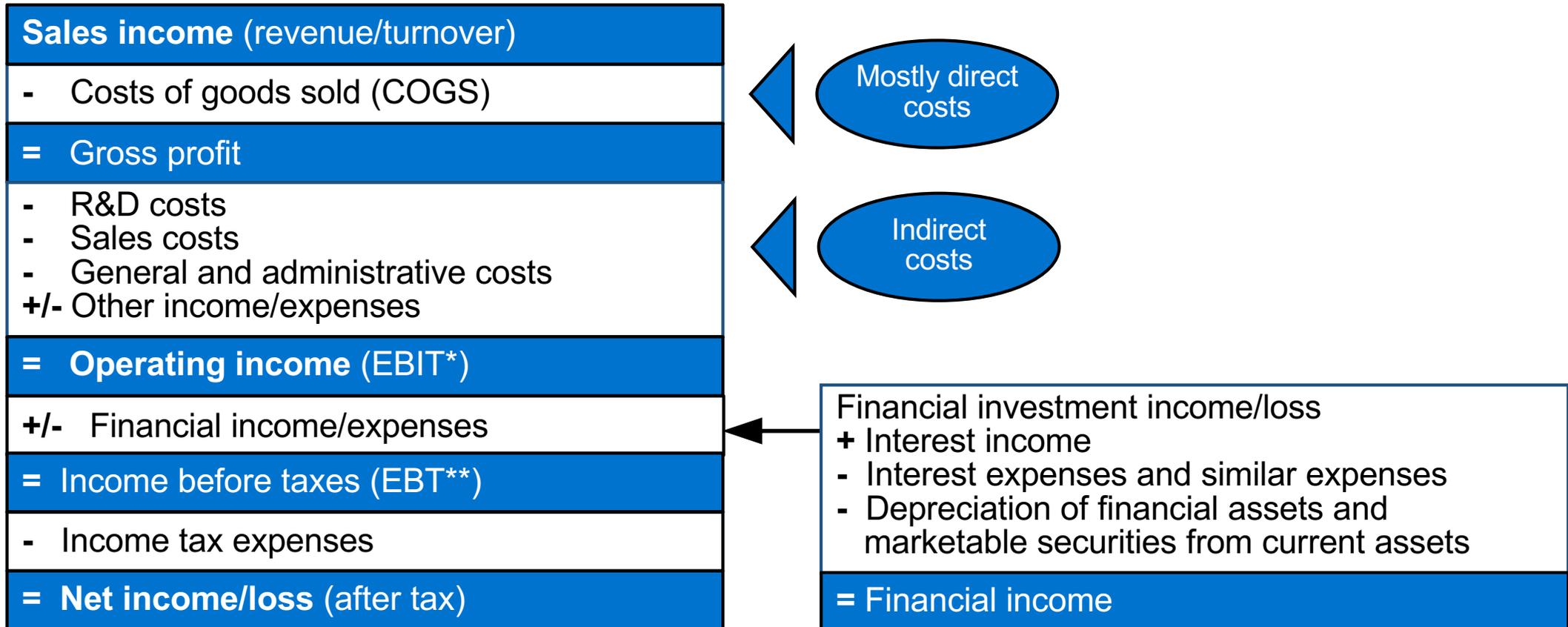
The balance sheet contrasts the sources of funds (right side) and their use (left side)

The two different but related perspective reflected in a balance sheet



The income statement provides interested parties with information on the success of a company in one period

The structure of an income statement (= profit and loss / P&L statement)



*EBIT = Earnings before interests and taxes

**EBT= Earnings before taxes



Reminder: In contrast to expenses, costs express here the direct consumption of production factors.

Without sufficient financial liquidity, organizations can immediately fall into bankruptcy

Categories and positions of cash flow statements

Initial stock	Initial cash + financial assets (short-term)	
Current inflows & outflows	+ Inflow from sales + Other inflow (subventions, subsidies, tax refunds, etc.)	- Outflow for goods, labor, and taxes - Other outflows
Disinvestment inflows & investment outflows	+ Inflows from property sale, machine sale, etc. + Inflows from financial assets	- Outflows for purchase of property, machines, etc. - Outflows for financial assets
Inflows & outflows of equity and bonded capital	+ New equity inflow (e.g., by founders, shareholders, subsidies, etc.) + Inflows from bonded capital (i.e., credit payments by banks shareholders, subsidies, etc.)	- Outflows for equity (dividend payment, back-payment, etc.) - Outflows from bonded capital (amortizations, etc.)
Final stock	= Final cash + financial assets (short term)	

Operating Cash flow

+

Cash flow from Investment

=

Free Cash flow

+

Cash flow from Financing

=

Liquidity (reserves) planning

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3.1 Strategic decision making

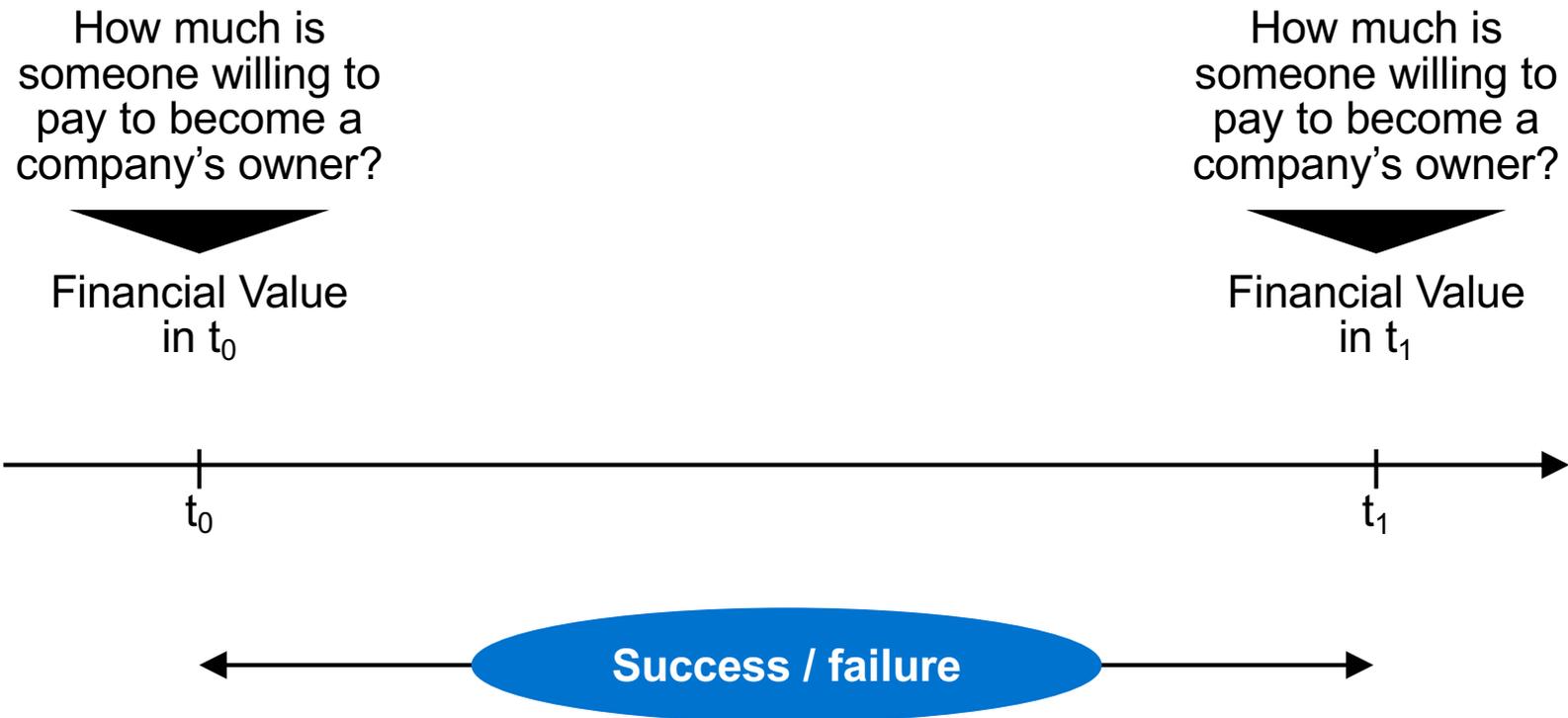
3.2 Performance and performance components

3.3 Financial success measurement

Learnings

Financial success is, if financial value is increased

Change of financial value



How much increase in financial value is a success?

Success/failure threshold



What is success?

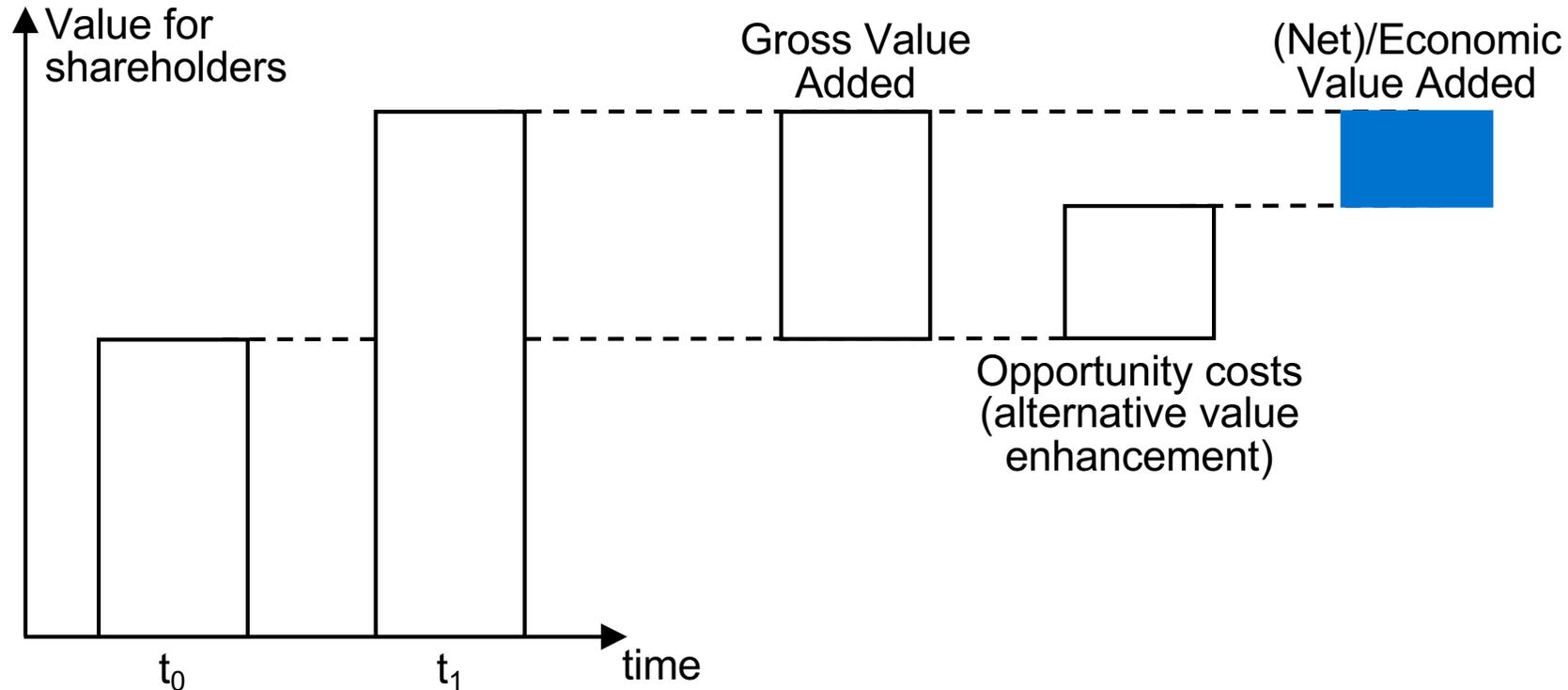
Δ Financial value = 0

Δ Financial value > 0

Δ Financial value > ?

Success of strategy is measured across time

Determination of the success of strategy



Note: Here, we look at financial objectives of shareholders. This does not neglect that a) other objectives of shareholders exist and that b) objectives of other stakeholders are also of relevance.

There are two general alternatives to evaluate financial value

Financial valuation approaches

Cash-based

- Financial value as capitalization of future cash inflows
- Financial value as sum of discounted free cash flows

$$FV = \sum_{t=0}^{\infty} \frac{FCF_t}{(1 + WACC)^t}$$

Free cash flow principle

Discounting principle

Cost of Capital and opportunity cost principle

Profit-based

- Financial value as capitalization of future excess capital income
- Financial value as sum of discounted economic value adds in addition to invested capital

$$\begin{aligned}
 FV &= IC + \sum_{t=0}^{\infty} \frac{EVA_t}{(1 + WACC)^t} \\
 &= IC + \sum_{t=0}^{\infty} \frac{(ROI - WACC) * IC}{(1 + WACC)^t}
 \end{aligned}$$

Capital productivity and efficiency principle

Economic value add principle

ROI and profit concepts

FV = Financial value, FCF = Free cash flow, WACC = Weighted average cost of capital, IC = Invested capital, EVA = Economic value added, ROI = Return on investment

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Operating Cash flow

+

Cash flow from Investment

=

Free Cash flow

+

Cash flow from Financing

=

Liquidity (reserves) planning

Discounting makes payments out of different periods comparable, addable, substitutable

Discounting principle

Problem: Value of identical nominal payments out of different periods not comparable

Solution: Transforming the value of a payment out of later periods in what someone would invest today to exactly get this value in this later period



Discounting: $V(FCF_t) \text{ in today} = \frac{FCF_t}{(1 + \text{interest rate})^t}$

Which interest rate to choose in order to discount future payments?

Cost of capital and opportunity cost principle

Problem: Assume you are investing in a company. If you choose an alternative investment, what would you earn? Are both investments comparable?

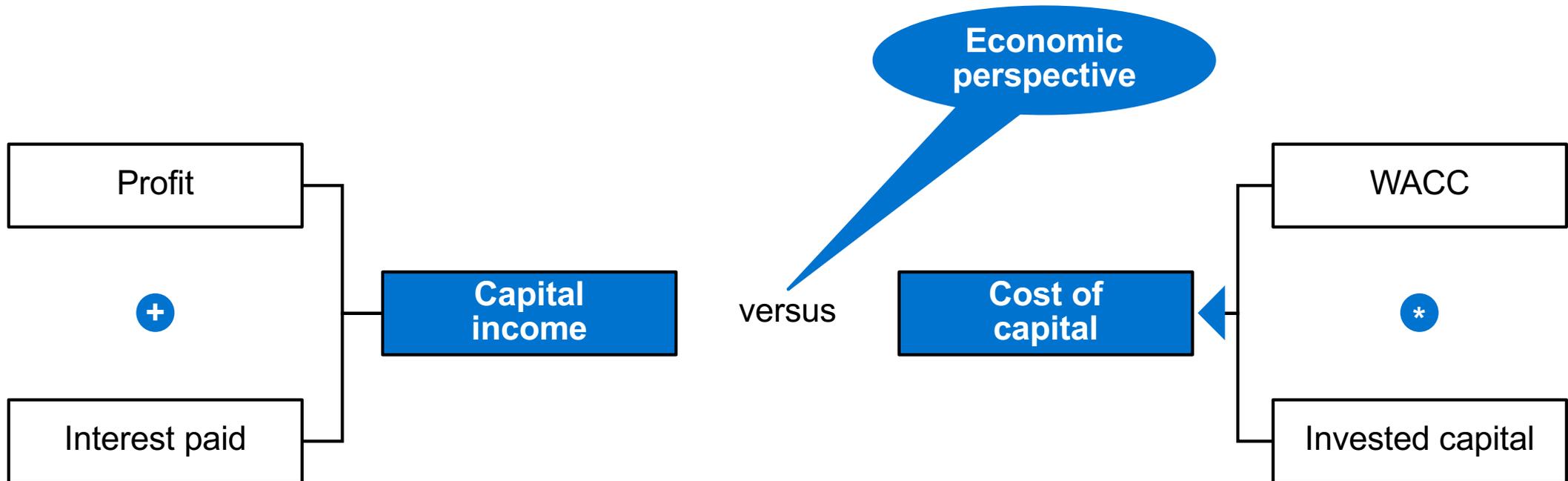
Solution: The return rate of an alternative investment that comes with the same risk can be seen as opportunity costs. Costs, because not investing in this alternative makes you losing the return on this investment alternative.
The cost of capital represent the opportunity cost of investing in a company.

Measure:
$$WACC = i_E * \frac{E}{TC} + i_D * \frac{D}{TC}$$

WACC = Weighted Average Cost of Capital, i_E = cost rate of equity, i_D = cost rate of debt, E = Equity, D = Debt, TC = Total Capital

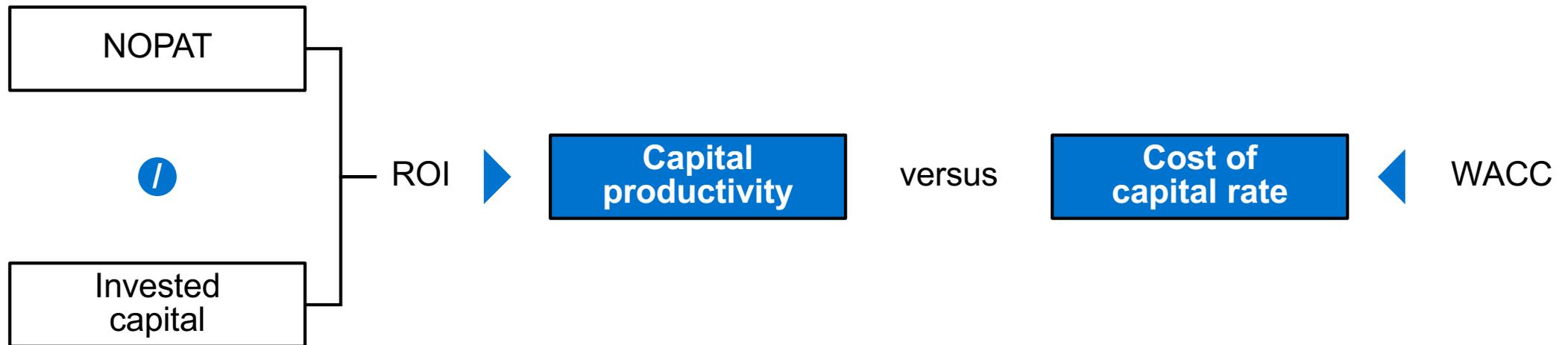
Economic value add asks whether capital income exceeds cost of capital, ...

EVA logic



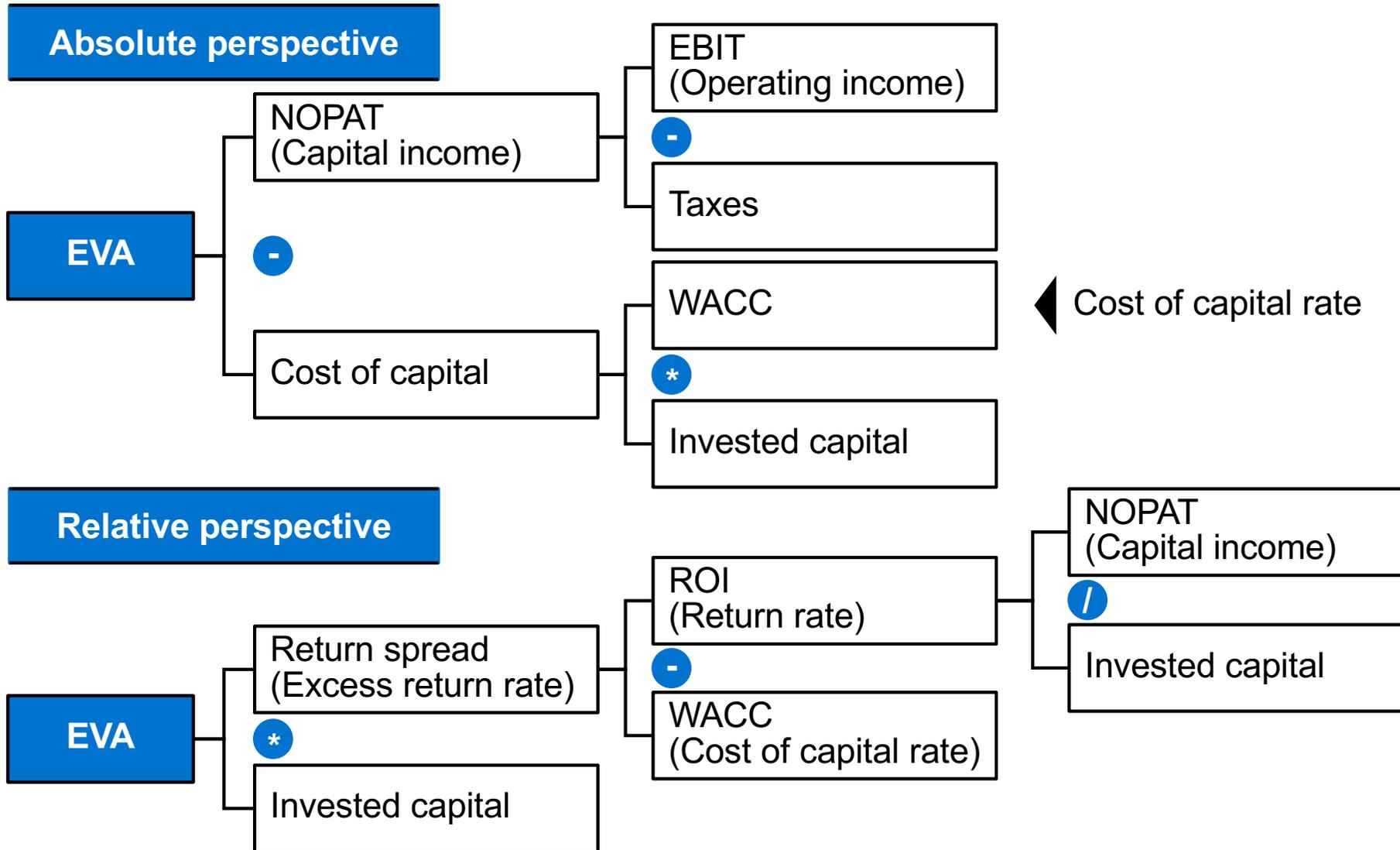
... or you could say, whether capital productivity exceeds cost of capital rate

Capital productivity and efficiency principle



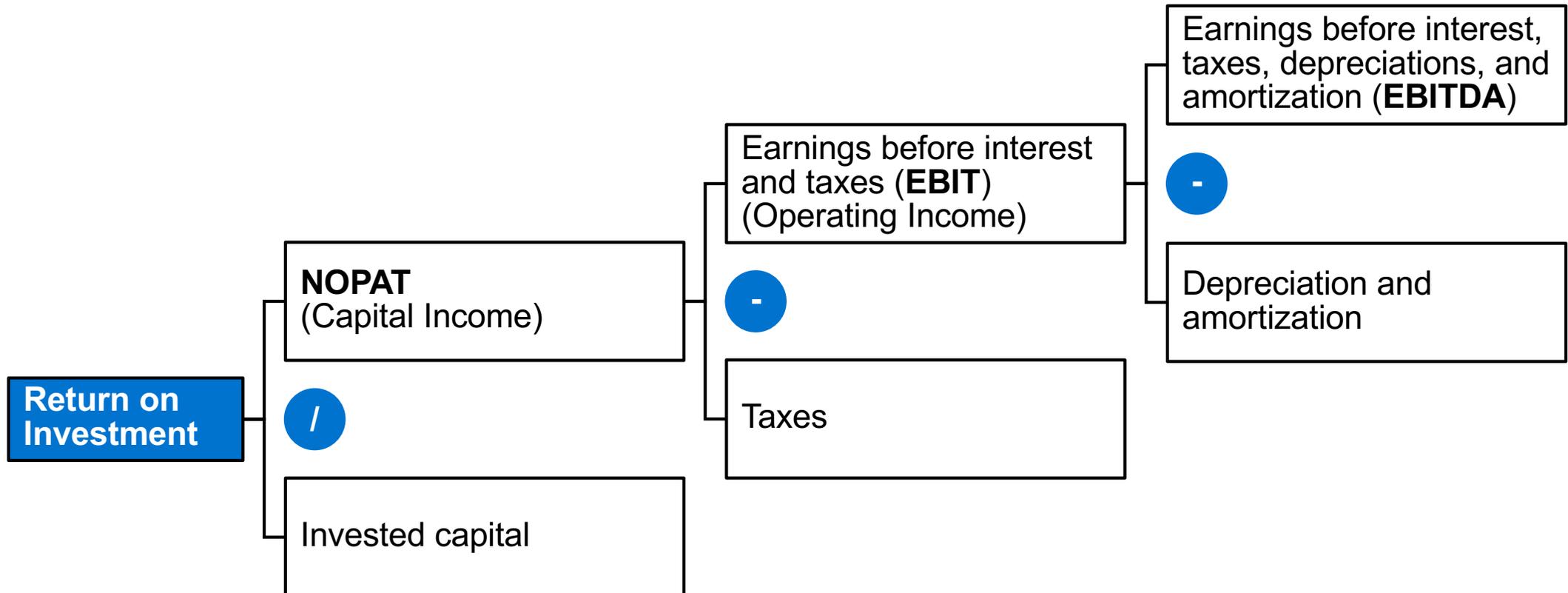
Economic value add is if capital income exceeds cost of capital

Economic value add principle



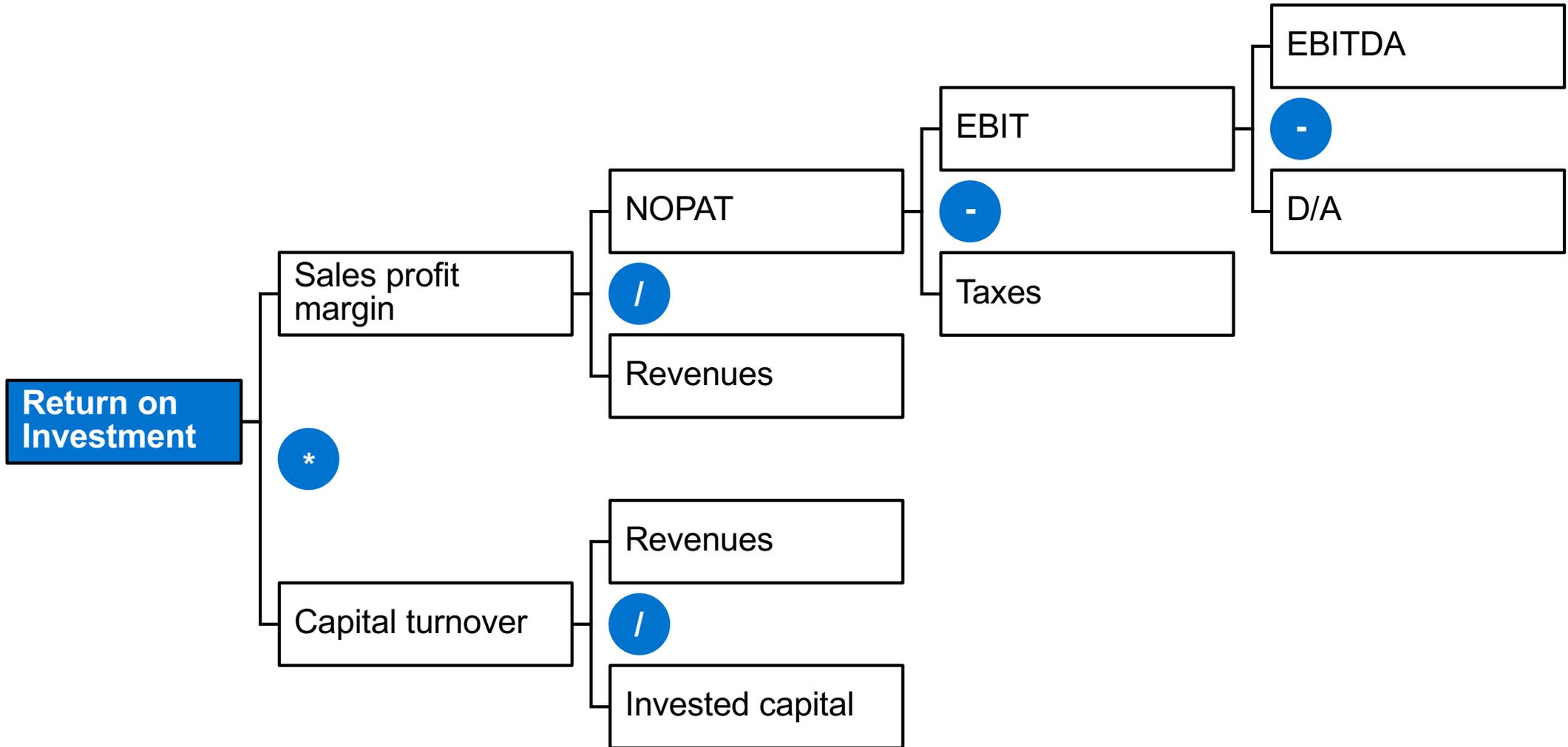
The ROI scheme lets identify various profit concepts (1/2)

ROI and profit concepts



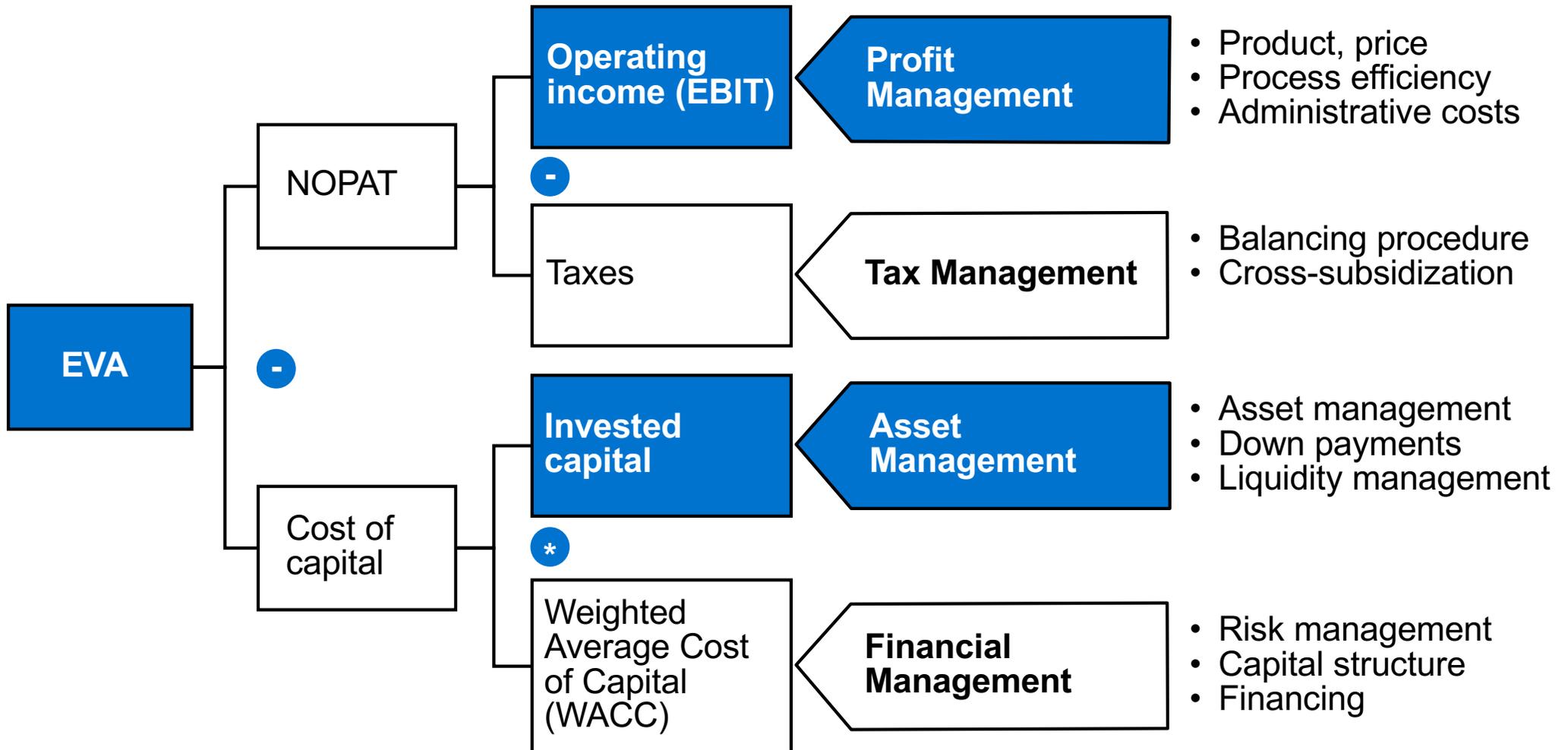
The ROI scheme lets identify various profit concepts (2/2)

ROI and profit concepts



Measures for increasing value and four dimensions of financial value creation

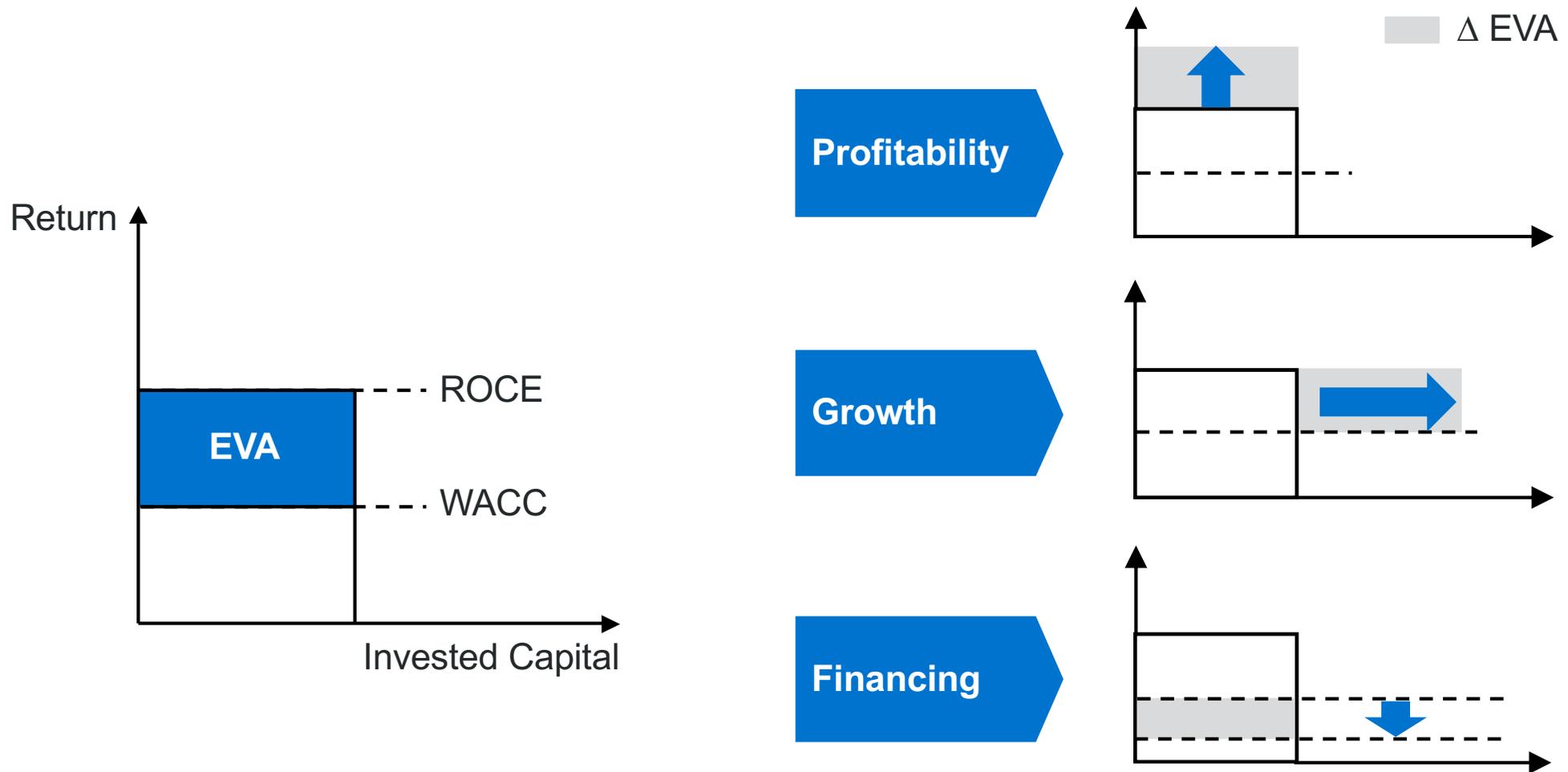
Financial value management components skipped



The financial value of corporations can be created based on three main financial value measures

skipped

Financial value measures



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