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Why Managers – Now More Than Ever – Need to Understand Corporate Finance

Sound business strategy isn't about shareholders vs. stakeholders, but about holistic vs. narrow value creation.

With the recent re-intensification of the **shareholder vs. stakeholder debate**, the concept of value creation has become more ambiguous. On whose behalf should organisations generate value? For owners, employees, upstream and downstream partners, or local communities immediately affected by organisational activities?

Both shareholders and stakeholders have solid claims. Financial managers are understandably fixated on share price as an index of market value. A stubbornly slumping share price means the loss of real wealth for the firm's owners, and less ability to attract capital to fund the firm's activities. Without some form of equity capital, a company cannot survive.

At the same time, the increasingly urgent global war for talent raises the stakes for companies that pursue narrow financial objectives at the expense of employees. Further, customers and civil society groups have a louder voice than in the past, thanks to social media and other online tools enabling the far-flung masses to mobilise quickly and effectively.

Still, pleasing external stakeholders is no guarantee of success. Consider the Saturn Corporation, a subsidiary of General Motors founded in 1985 with the aim of creating "a different kind of car" that could keep up with nimble overseas competitors. Throughout the 1990s, Saturn was consistently top-rated in customer satisfaction. Employees were so happy with their working conditions that they rejected the standard labour contract from their international union. To top it off, Saturns were flying off the lot; in 1995, there were just 400 unsold from the previous year. But all that approbation could not make up for the US$6 billion GM spent to develop, manufacture and market the Saturn. The brand never really had a chance, due to poor financial management from day one.

It is ironic, therefore, that so much ink has been spilled on a putative shareholder/stakeholder divide at the moment when this divide has never been more tenuous. Indeed, evidence shows that firms that please customers and employees also generate value for their owners. Across all industries, the companies atop ***Fortune*'s Most Admired Companies ranking for 2019** – criteria include innovativeness, quality of management, social responsibility and ability to attract talent – significantly outperformed S&P 500 averages over the preceding ten years. The least-admired companies on *Fortune*'s list produced negative returns for their owners during the same ten-year period.

What does all this mean? Sound financial management looks beyond short-term share price increases and cost control. It entails a holistic approach encompassing all relevant stakeholders. And given today's enormous business challenges – environmental issues, equality and diversity concerns, and growing dissatisfaction with capitalism are just a few – I would argue that business executives need to understand corporate finance now more than ever.

Basics of corporate finance

Giving managers a basic grounding in corporate finance is the purpose of the textbook I co-wrote with the late Claude Viallet, ***Finance for Executives: Managing for Value Creation***, now in its sixth edition. As we describe in the book, making optimal financial decisions for your firm can be a complicated art, but the basic principle is as simple as it gets. Ultimately, it concerns just two numbers: the cost of capital (i.e. what it costs to finance your firm's investments) and the return on those investments. The extent to which the latter number *exceeds* the former is the key to *value creation in the form of a higher firm value*. If, however, return on investment is consistently *lower* than the cost of capital (as happened with Saturn), value is destroyed and the firm value falls. The concept is completely straightforward, yet you would be surprised at how many clever, experienced managers take it as a revelation when it's explained to them.

Where the complexity comes in, of course, is that cost of capital is not always easy to calculate. It consists of the average of two components: the cost of *debt* capital (borrowed money) and the cost of *equity* capital (money invested by owners in the firm). The former is not usually difficult to estimate. If your firm has taken on debt, the interest rate of the loan(s) basically equates your firm's cost of debt. Determining the cost of equity is the challenging part. It is the return – either dividends or higher share price – that shareholders demand in exchange for the investments they have put into the company. It is a risk-based calculation because the more risk investors are exposed to, the greater the return on investment they will expect. As such, any shift in business conditions (within or outside the firm) that raises or lowers risk will also affect the cost of equity, which requires that this cost be continually revisited.

Managers who are familiar with the various models of corporate finance will be better able not only to engage with the CFO to determine the cost of capital, but also to collaborate with him or her to create a system that keeps track of its fluctuations going forward. For the CFO, the main challenge becomes structuring the firm's finances in order to minimise the cost of capital. From a value creation perspective, this can be as impactful as the usual managerial preoccupation of minimising the cost of operations – e.g. supply chain, labour costs and so on.

When managers know their way around corporate finance principles, they are plugged into the primary source of value creation, rather than its secondary, often-distorted reports such as quarterly sales figures and short-term earnings. They can then make smart decisions with confidence as to the likely outcomes for all stakeholders as well as for the firm's financial prospects. This ability gives managers the strategic flexibility they need to respond effectively to our ever-less-predictable world.

*The original version of this post can be found at Cengage's **Unstoppable Minds** blog.*

***Gabriel Hawawini** is a Professor of Finance at INSEAD and the former Dean of INSEAD from 2000 to 2006. Professor Hawawini spearheaded the school's expansion from Europe into Asia with the opening of the INSEAD Asia Campus in Singapore in 2000. He is the author of **The Internationalization of Higher Education and Business Schools: A Critical Review**.*