

TACTICAL EXECUTION OF CORPORATE FINANCIAL POLICY

Given that a corporate financial policy exists, an analyst or adviser must weigh alternative tactics to implement that policy, and the larger strategy of the corporation. This note presents one framework for evaluating alternative courses of action.

The Basic Challenge

In evaluating alternative courses of action, the “right” choice rarely leaps out. Any alternative is bound to have its strengths and weaknesses. Thus, the basic challenge for the analyst or adviser is to carefully survey the strengths and weaknesses, and identify the *key tradeoffs* associated with each alternative. In general senior managers tend to choose tradeoffs rather than pick the “right” financial alternative. Often, the identification of tradeoffs will raise fundamental questions about the direction of the firm which only senior managers or the board of directors can finally settle. In any event, the helpful analyst or adviser helps the decision-maker by finding and exploring these tradeoffs.

A “tradeoff” can exist between a cost and a benefit, between two costs, or even between two benefits. How many tradeoffs you find often depends on how hard you look. By paying 10 percent interest a year (a cost) you might attract debt capital to use for 10 years (a benefit). Equity capital is perpetual (an even greater benefit) but also has a greater cost than debt. In this example one sees tradeoffs on costs of capital, duration of capital, and cost-for-duration (benefit-cost tradeoff). Many other tradeoffs are possible in an example like this.

The FRICTO Framework

The focus on tradeoffs begs the question, “Tradeoffs among what?” The FRICTO framework raises six elements that practitioners generally agree to be significant.¹ Listed for mnemonic purposes (rather than in order of importance) the FRICTO elements are:

¹The FRICTO framework was developed in the 1960s by Gordon Donaldson, Pearson Hunt, and William W. Sihler. Though the use of this framework has varied over time, it remains the best-known scheme for comparing financing

Flexibility
Risk
Income
Control
Timing
Other

Each of these elements stands for a class of concerns that tend to appear repeatedly across many financing decisions, and thus are a good entre to a survey of tradeoffs. However, the list may not be exhaustive; the analyst is warned to think freshly and critically in each new decision setting.

Each element of the FRICTO framework raises a rich set of considerations relevant to financing alternatives:

Flexibility: the ability to meet unforeseen financing requirements as they arise--these requirements may be favorable (e.g. a sudden acquisition opportunity) or unfavorable (e.g. Source Perrier and the benzene scare). This may involve liquidating assets and/or tapping the capital markets in adverse market environments. Flexibility can be measured by bond ratings, coverage ratios, capitalization ratios, liquidity ratios, and the identification of salable assets. Here, the analyst should ask, “How does this tactic affect our ability to obtain outside financing in the future?” “What flexibility reserves does our firm have?”

Risk: the predictable variability in the firm’s business. Such variability may be due to both macroeconomic factors (e.g. consumer demand) and industry- or firm-specific factors (e.g. product life-cycles, biannual strikes in advance of wage negotiations). To some extent, past experience may indicate the possible future range of variability in EBIT and cash flow. Operating leverage measures the sensitivity of operating earnings to variations in demand. Financial leverage measures the sensitivity of net earnings to variations in demand. Higher leverage tends to amplify a firm’s predictable business swings. The risk associated with any given financial structure can be assessed by leverage analysis, EBIT-EPS analysis, break-even analysis, the standard deviation of EBIT, and Beta. In theory, beta should vary directly with leverage.²

Income: this compares financing tactics on the basis of their effects on value creation and distribution. The key objects of attention should be stock price and dividend payout. The analyst will find useful such measures as DCF value, projected ROE, EPS, and cost of capital.

alternatives.

²This is illustrated by the formula for estimating a firm’s levered beta:

$$B_l = B_u * [1 + (1 - t) * D/E]$$

B_l = levered beta

B_u = unlevered beta

t = firm’s marginal tax rate

D/E = the firm’s market value debt-to-equity ratio.

Control: alternative financing tactics may imply changes in control or different control constraints on the firm as indicated by the percentage distribution of share ownership, the effect on takeover vulnerability, asset security required and the structure of debt covenants.

Timing: begs the question of whether the current capital market environment is the right time to implement any alternative financial structure, and what the implications for future financings will be if the proposed structure is adopted. The *current market environment* can be assessed by examining the Treasury yield curve, the trend in the movement of interest rates, the existence of any “windows” in the market for new issues of securities, P/E multiple trends, etc. *Sequencing* of debt and equity offerings is a difficult test of judgment and relies on expectations about the firm’s future financial performance. Different financing sequences may be laid out with decision trees, and then their effects tested on DCF values of equity, and on various tests of financing capacity (e.g. bond ratings, coverage ratios, capitalization ratios, etc.).

Other: one can imagine numerous other considerations which are too specialized to fit into every situation, but which might loom large in particular situations. For example, a sole owner of a privately-held company might worry significantly about the effect of various financing tactics on the *liquidity* of investment in the event that she decided to sell out, or upon her *estate* (i.e. in the form of taxes and transfer costs) in the event of death. For public companies, equity issues can sometimes enhance the daily trading volume, or “float” which may encourage more efficient pricing of a firm’s shares.

A Hypothetical Example

The “FRICTO” framework can be used to indicate the relative strengths and weaknesses of alternative financing plans. To use a simple example, suppose that your firm is considering two financing tactics: (a) an issue of debt which would adjust the capital structure to 60 percent debt and 40 percent equity; and (b) an issue of equity which would adjust the capital structure to 40 percent debt and 60 percent equity. Suppose that your analysis of the two structures leads you to make this basic comparison:

	<u>Debt</u>	<u>Equity</u>
Flexibility	Lowish, not bad	High
Risk	High	Medium
Income	Good-to-High	Mediocre (too dilutive)
Control	Covenants OK No Share Change	Possible new 5% Blockholder

Timing	Good Today Risky sequence	Not good today Low risk sequence
Other	N/A	Improves trading liquidity

The debt alternative is favored on the grounds of income, control, and today's market conditions. The equity alternative is favored on the grounds of flexibility, risk and the longer-term financial sequencing. This little example boils down to a tradeoff between "Eat Well" and "Sleep Well." It remains to senior management to make the difficult choice between the two alternatives.

Back to Policy

Firms that practice opportunism or myopic decision-making will find the FRICTO framework sufficient for deciding among financing alternatives in any particular situation. However, for firms with proactive financial policies, a fundamental consideration must be the consistency of financial tactics with the underlying policy.