BACK TO REALITY

Lessons From the Crisis for Corporate Finance

By JOSÉ M. CAMPA

Financial management has come to occupy a central role in the strategy and execution of day-to-day business. However, this leading role is not necessarily all good news, especially given the protagonism of the financial sector during the boom years, which precipitated the global economic crisis. The failings of corporate finance have given the financial sector serious pause for thought and led to growing concerns about the state of corporate balance sheets. The centrality of finance that enabled companies to do things prior to the crisis is the same reason why so many companies are now finding it difficult to implement their strategic business visions.

Financial executives are facing a host of challenges: divestitures, asset sales, debt restructuring, significant losses and expanding capital costs, often leading to equity dilution for shareholders. In many cases, these challenges are the natural byproducts of inadequate financial risk management, and in some cases are a direct consequence of blatant financial mismanagement, during the boom years, which has left companies with financial structures unsuitable for the tasks ahead.

The lack of business opportunities due to declining demand is not enough to explain the severely weakened state of our financial structures and institutions. There are other more plausible explanations. In many companies, the financial function was inordinately relaxed as funding became more easily available, at ever lower costs and for virtually any project,

regardless of any potential profitability. The Finance Department became a de facto profit center, with many projects geared exclusively toward generating value using creative financial engineering.

The global economic crisis serves as a "teachable moment," affording everyone – not just the financial sector, but also governments and regulators – an opportunity to reformulate financial management afresh.

In this article, I will discuss how the activities of the Finance Department exposed our current vulnerabilities. I will also propose a set of new attitudes and obligations that Chief Financial Officers (CFOs) should adopt to help companies recover from the economic crisis and hopefully prevent the recurrence of another one.

The Triple Role of Corporate Finance – and Where It Went Wrong

The functions of a Finance Department are many and varied. They are not set in stone and can change rapidly as a reflection of the company's business cycle or the personal characteristics of the CFO and other members of the management team.

That said, the typical functions can be boiled down to three main areas: auditing and control; treasury and fund-raising; and strategic planning and forecasting. Let's examine each of them in turn, and consider some of the major shortcomings detected in the management of each, in light of the crisis.

1. AUDITING & CONTROL. This area has to do with examining and reviewing the company's records, its compliance with budgets and business plans, its performance in relation to prior forecasts and its ability to reduce operational risks. The most common deficiencies here were:

- **Lack of control in the execution of financial activities.** Negligence in the performance of certain functions and requirements may constitute legal offenses. The most prominent examples are those stemming from inadequate audit counterparty risks (e.g., the Madoff case), illegal remuneration schemes (e.g., Siemens and Thyssen) and the mispricing of key reference rates (e.g., Barclays' role in the Libor rate-fixing scandal).
- **Inconsistencies between company activities and the strategic guidelines set by management.** This often results in a rise of financial risks, many of which go unanticipated by the board.
- **Board or senior executives' lack of understanding of the complexities of the risks assumed by the company.** This has been one of the most widespread problems to beset large financial firms, including UBS, JPMorgan and some Spanish savings banks, as well as nonfinancial firms.

2. TREASURY & FUND-RAISING. This is essentially a support function for business. In all companies, funding must be available to support both daily operations and long-term projects, and it is the responsibility of financial managers to make sure this happens. The availability of financing depends on how a company goes about raising funds and on its business prospects. The decline of this activity in the short term gives rise to serious tensions and cash-flow problems.

In making financial adjustments to deal with adverse business conditions, one needs to discern whether it is because of a changed competitive landscape, which, though unknown in its specifics, was adequately accounted for; or whether the company had failed to adequately plan at all for such a scenario in earlier financial planning stages.

In the years leading up to the crisis, the massive growth and proliferation of new financial products and services, off-balance-sheet operations, low interest rates and excess liquidity led many companies to adopt a number of deeply flawed financial planning strategies. The most common of these were:

- **Inappropriate capital structures**, often with excessive dependence on external

EXECUTIVE SUMMARY

As a result of the crisis, many companies have seen their ability to carry out strategic plans greatly reduced due to financial pressures. This article analyzes how the finance function went off track and overstepped its legitimate bounds, leaving many companies exposed and vulnerable. The author proposes three essential attitudes and principles that finance sector professionals must adopt, and the actions to go along with them, to get corporate finance back to where it always belonged – supporting the company's core business activities through financing and sound financial advice.

Financing activities and guidance are there to support a company's core objective, which is to create value by doing what it does best. When the financial role oversteps itself, it's a sign of deficiencies.

financing rather than equity. This occurred frequently in off-balance-sheet operations such as project financing and special purpose vehicles (SPVs) as well as in banks' lending to businesses, particularly small businesses with inadequate working capital.

- **Financing that was misaligned with a company's project cycle.** During the crisis, there was an overreliance on short-term funding, with time spans shorter than the maturation period of the projects they were supposed to be funding. Many companies mistakenly assumed they would be able to refinance the debt in the future with variable interest rates.
- **Excessive risks in treasury management**, with some companies converting this activity into a de facto profit center.
- **Dependence on a single source of funding**, even when working with multiple providers. Crises usually affect all firms within a sector. From banks to hedge funds, private equity funds or even the most robust of funds: all are vulnerable to systemic shocks. Relying on a single source can be very costly in the long run.
- **Weak relationships with finance providers.** When finance is abundant, CFOs and CEOs often neglect their relationships with their companies' finance providers, sometimes to the point of taking them for granted. This can be particularly dangerous when a firm lacks liquidity.
- **Poorly communicated internal and external governance structures**, resulting in an overall lack of awareness or understanding of the company's corporate vision.

3. STRATEGIC PLANNING & FORECASTING. This area includes forecasting macroeconomic indicators or other variables that might shape the company's long-term growth strategies, including products, geographic markets, special projects and new lines of business. It also considers ownership structures to enable that growth, such as capital increases and IPOs.

Admittedly, forecasting is difficult, even during the best of times, and there is considerable inertia in most economic predictions. However, this is no excuse for the serious weaknesses in how these processes were conducted in recent years:

- **Overly positive macroeconomic or sector forecasts.** There are many agencies in the field of macroeconomic forecasting, including those focused on multilateral, national or sector trends. While their forecasts are not perfect, they can usually do a better job than most companies' Finance Departments. There is comparatively little advantage in a single Finance Department making its own forecasts. When it does so, it is often swayed by the prevailing optimism of the company's operational divisions.
- **Pro-cyclical project analysis.** In good times, all projects seem good. As such, finance managers must carefully analyze the basic assumptions of value creation underpinning project investment: growth, margins, cost of capital and leverage.
- **Inconsistencies between the financing structure and the investments undertaken by the company.** This lack of consistency can relate to time issues, flows, risk profiles and funding counterparties. Again, a common mistake is to count on future refinancing with variable interest rates.

A Matter of Principles

Clearly, the finance function will grow in importance, with CFOs playing vital roles in the formulation, communication and implementation of business strategy, while continuing to provide fundamental support to businesses in achieving sustainable value creation.

Playing a *vital* role does not mean that finance directors will play a *greater* role. Financing activities and guidance are there to support a