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Sascha Haghani
Alfred Kötzle
Kurt Reding
Klaus Spremann
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Current Challenges for Corporate Finance

A Strategic Perspective

Springer

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Editors
Prof. Dr. Guido Eilenberger
Lehrstuhl für ABWL
Bankbetriebslehre und Finanzierung
Universität Rostock
Ulmenstrasse 69
18051 Rostock
guidoeilenberger@t-online.de

Dr. Sascha Haghani
Partner, Roland Berger
Strategy Consultants
Karl-Arnold-Platz 1
40474 Düsseldorf
sascha_haghani@de.rolandberger.com

Prof. Dr. Alfred Kötzle
Lehrstuhl für Allgemeine
Betriebswirtschaftslehre
Europa-Universität Viadrina
Große Scharrnstraße 59
15230 Frankfurt/Oder
koetzle@euvfrankfurt-o.de

Prof. Dr. Kurt Reding
Lehrstuhl für Finanzwissenschaft
Universität Kassel
Nora-Platiel-Straße 4
34109 Kassel
reding@wirtschaft.unikassel.de

Prof. Dr. Klaus Spremann
Schweizerisches Institut
für Banken und Finanzen
Universität St. Gallen
Rosenbergstr. 52
9000 St. Gallen
klaus.spremann@unisg.ch

ISBN 978-3-642-04112-9 e-ISBN 978-3-642-04113-6
DOI 10.1007/978-3-642-04113-6
Springer Heidelberg Dordrecht London New York

Library of Congress Control Number: 2009936963

Cover design: WMXDesign GmbH, Heidelberg

Printed on acid-free paper

Springer is part of Springer Science+Business Media (www.springer.com)

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Introduction

Klaus Spremann

Corporate finance means responding to the financial markets. Strategy, on the other hand, aims to change and shape the environment. Strictly speaking, therefore, "strategic corporate finance" is a contradiction in terms. It is a paradox, something completely different to traditional corporate finance. Financial strategists do huge deals and consciously break the laws of the market. Precisely this approach is at the heart of strategic corporate finance.

The Paradox of Strategic Corporate Finance

The very notion expressed in the term "strategic corporate finance" appears self-contradictory. In the past few decades, the capital markets have become significantly more sophisticated and advanced. Information about what is happening on the market – about share prices, interest rates, investment yields, you name it – is permanently on tap. The financial markets appear to possess an almost magical quality: The liquidity of securities traded on secondary markets allows financial investors to dissolve positions at a moment's notice. No-one wants to miss out on the benefits of the capital market. Securities and yields have become the measure of all things. In the face of such an omnipresent market, individual investors and companies often appear as insignificant and impotent as a mouse next to an elephant. Corporate finance in the traditional sense thus leaves them no choice but to respond to the financial markets. Why? Because it is these markets that set prices, determine the returns on investments and define the cost of capital. At the same time, the market cost of capital serves as the benchmark when companies cost and appraise potential investment projects. Will these projects pay off? Will they increase the value of the company in the long term? Companies that fail to address these issues are punished by the capital markets for their negligence. In the long run, no company can sidestep the mechanisms of the financial markets.

Companies thus become "price takers" and "quantity adjusters", as an economist would put it. They do not presume to have any tangible influence on the market and market conditions. Simply responding to the dic-

G. Eilenberger et al. (eds.), *Current Challenges for Corporate Finance: A Strategic Perspective*,
DOI 10.1007/978-3-642-04113-6_1,

tates of the market involves no element of strategy, however. It merely involves applying a one-dimensional cost/benefit calculation. Prevailing market conditions lead to individual decisions, each of which constitutes an optimal response in its own right.[1] In most cases, a number of minor adjustments are sufficient to maximize value within the given parameters. In other words, to think in terms of corporate finance is, by definition, *not* to think in strategic terms.

Strategic thinking is, however, appropriate in situations where a company can shape the environment in which it operates and possibly even influence the reactions of other market players. Strategies are sequences of actions that influence the environment and other parties in a way that changes the prevailing conditions.[2] In other words, to think in strategic terms is to be aware of how your behavior affects the world around you. It may even enable other players to be sidelined. Strategic thinking can lead to the formation of coalitions whose shared market power can influence prices. One aspect can be attracting attention, becoming the focal point of a group and thereby attracting the participation of others. Strategic thinking therefore embraces all areas, including communication. Strategic thinking can involve engaging in decoy maneuvers that throw other market players off your track. Military generals have always sought the opposite of merely responding (or subjecting themselves) to the prevailing conditions. In China especially, wile and craft are part and parcel of any strategy. Chess players, generals and game theoreticians[3] all think strategically and, in so doing, consciously *avoid* responding to the given conditions. Such strategic thinking is inappropriate in environments that cannot be

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1 In microeconomic theory, suppliers or demanders are referred to as "quantity adjusters" if they accept market prices as given and adjust the volumes they supply or demand to these prices in a way that maximizes their personal benefit or profitability. In a "perfect" market, all market players are quantity adjusters. This is because the market is infinitely large and no players have sufficient market power to influence prices. It is therefore also assumed that, in a perfect market, different players do not collude in order to achieve monopolistic (i.e. price-setting) power.

2 The word "strategy" derives from a Greek term that literally means the art of leading an army. The works of CARL VON CLAUSEWITZ (1780-1831) laid the theoretical foundation for the subsequent adoption of strategic elements in the business realm.

3 The film "A Beautiful Mind", produced several years ago about the life of game theorist JOHN NASH (*1928), can be regarded as popular science's attempt at an introduction to game theory and strategic thinking.

influenced – such as in the case of the mouse and the elephant. In a huge market in which coalitions are not an option, any attempt at strategic action is doomed to failure. This happens where the capital markets work well or "efficiently" and thereby prevent the emergence of power blocks. In such contexts, all market players have to take decisions with a view to how they will be perceived by capital markets and analysts. Over the past 30 years, traditional financial theory textbooks have taught this doctrine with a mantra-like credulity that borders on the fatalistic: The financial market is always right. We can only respond to it.

The Transition to Strategic Corporate Finance

Practice nevertheless shows that individual players again and again achieve stunning successes that bypass the market or even flatly contradict prevailing market opinion.

The following examples substantiate our contention that strategic corporate finance is both possible and successful:

1. In 1992, GEORGES SOROS made a fortune by launching a speculative attack on the pound sterling. Although the market predicted that he would fail, his venture succeeded.
2. WARREN BUFFET repeatedly stresses that the only way to make money on stock markets is to hold carefully selected assets for long periods. Constantly buying and selling is counterproductive. This too is a strategy that pays little attention to the market situation at any given time.
3. Between 1990 and 2000, the Executive Board of Mannesmann guided the company in their charge to great financial success and then sold it, leading to the breakup of the group. Beforehand, however, the spectacular steps taken to this end had caused analysts to shake their heads in disbelief.
4. Back in 1995, market observers predicted the rapid demise of the biggest merger in Europe's banking sector. A reverse takeover nevertheless merged Zurich-based Union Bank of Switzerland and Basel-based Swiss Bank Corporation to form UBS. Today, UBS is the world's largest asset manager.
5. Hedge fund managers today behave less and less like traditional financial investors. In defiance of general meetings and the democratic