PART ONE

Strategy

CHAPTER ONE

Articulating a Strategic Plan

EVERY COMPANY HAS A STRATEGIC PLAN. It may not be documented or well-defined, but it can be seen in the accumulated actions of employees, management, and the board of directors.

At the other extreme, a company may have extraordinarily detailed strategic plans that are scattered throughout the various business units and geographic locations, but no clear understanding that unites everyone around core objectives.

And then there's the "Goldilocks" company that gets it just right—a plan that achieves alignment around an overarching strategic framework, with detailed strategies that are developed and implemented throughout the company. This should be the CFO's goal.

Whatever the status of a company's planning efforts, CFOs can play an important role in helping to articulate a strategic plan and analyze its effectiveness. In particular, the CFO can help answer such big picture questions as:

- Will the plan deliver the company's *shareholder return* objectives?
- Can it be executed successfully by the company's *management* team?
- Is it consistent with the company's core *values* and tolerance for *risk?*
- Does the company have the *financial wherewithal* to execute the plan?

- Can it be effectively *communicated* to shareholders, customers, employees, and other key stakeholders?

Most important, CFOs can help to articulate the plan's business objectives; strategic themes; financial objectives; acquisition strategies; and target investors.

BUSINESS OBJECTIVES

The CFO's first task is to define and confirm the business objectives that form the building blocks for creating shareholder value. This typically encompasses a systematic review of the company's historical performance, its positioning against the competition, and the strategies being emphasized by each of the company's business units and product lines.

The goal is to sift through the information—which usually is voluminous—and condense it into a top-down overview, describing the company as it is today and predicting what it will look like at the end of the planning horizon.

The business objectives should summarize the company's strategic positioning, financial characteristics, and business and geographical mix—answering basic questions that broadly describe the current and future company. Some examples of questions are provided below, but CFOs will want to determine the questions that are most relevant for their company.

Typically, these questions will have been discussed in various strategic and operational reviews and the answers will be generally well understood by the management team and board of directors. Nevertheless, the discipline of defining and confirming the consensus in a summary format can be a useful exercise, helping to ensure clarity and consistency in the objectives being pursued.

- **Strategic Positioning.** What is the mission or vision statement? What is the competitive positioning? What are the areas of competitive advantage? What are the critical factors for success? What are the key criteria for entering or exiting a business or product line?
- **Financial Characteristics**. What is the cyclicality or volatility of results? What is the capital intensity? What is the underlying growth rate? Is the profit margin likely to increase, decrease, or stay the same in the next five years?
- **Business and Geographical Mix.** What is the current business mix? What are the sources of growth? Which businesses will grow faster than average

and which will grow more slowly? What is the projected business mix at the end of the planning period? What is the current percentage breakdown by geographical region for revenue and operating profit? Which countries will be emphasized for growth? What is the projected geographical mix?

STRATEGIC THEMES

In addition, CFOs should distill the business objectives into their thematic essence, establishing a shorthand communication for the way that the company is going to create value. A company may have one overriding strategic theme, but more likely it will focus on three or four.

Some examples are provided below, but by no means do they exhaust the possibilities—which should be tailored for each company. The key point is that it's usually helpful if the CFO can boil down the company's business strategies into a few bullet points that can be communicated succinctly and remembered easily. It's a good way to ensure that everyone's on the same page.

- **Develop Superior Products:** Offer products or services that are considered superior to those of competitors.
  Example: *Toyota*
- **Establish Brand Leadership:** Maintain a marketing and pricing advantage through a superior brand image that translates into new markets.
  Example: *Coca-Cola*
- **Achieve Operational Excellence:** Offer quality products or services through management focus on flawless execution.
  Example: *FedEx*
- **Maintain Market Leadership:** Achieve and sustain a significant market share in a large and growing business.
  Example: *Google*
- **Invent New Products:** Invest in research and development to produce new products that establish market leadership or develop new markets.
  Example: *Apple*
- **Develop Line Extensions:** Use market research to develop line extensions in an existing product category.
  Example: *Colgate-Palmolive*
- **Expand in Emerging Markets:** Market a company's products in developing countries that have superior growth potential.
  Example: *Caterpillar*

- **Lower Cost Structure:** Achieve a competitive edge and higher operating margins through cost reductions and efficiencies.
  Example: *Walmart*
- **Sell More Products to Customers:** Expand the breadth of products or services that are offered to the existing customer base.
  Example: *IBM*
- **Exploit Economies of Scale:** Invest in major projects that require significant capital expenditures and diversification of risk.
  Example: *ExxonMobil*
- **Introduce a Better Distribution Model:** Use Internet or other distribution technologies to change the industry dynamics.
  Example: *Amazon*
- **Leverage a Disruptive Technology:** Expand the customer and revenue base through a new technology that is transforming a business.
  Example: *Netflix*
- **Create More Consumer Demand:** Invest in marketing and advertising to generate more customers for products or services.
  Example: *Capital One*
- **Anticipate a Cyclical Upside:** Position a business to reap the benefits when economic conditions improve in the future.
  Example: *Alcoa*
- **Effect a Turn Around:** Take decisive actions to improve a company's financial results, often with a new CEO and management team.
  Example: *Ford*
- **Make Accretive Acquisitions:** Establish a track record for executing acquisitions that enhance growth and earn superior returns.
  Example: *Danaher*
- **Consolidate an Industry:** Rationalize a fragmented industry to achieve economies of scale and greater pricing power.
  Example: *International Paper*
- **Maximize Free Cash Flow:** Manage a mature company to maximize free cash flow for paying dividends and repurchasing stock.
  Example: *Altria*
- **Transform the Company:** Transition to a new business with better growth prospects and greater long-term profitability.
  Example: *Kodak*
- **Break up the Company:** Gain greater focus and higher stock market valuations by spinning off business units.
  Example: *Kraft*

LONG-TERM FINANCIAL MODEL

The CFO's next challenge is to translate the business objectives into long-term financial projections, converting the strategic framework into a tangible financial plan. These projections can confirm whether the business strategies will produce shareholder value and can help to formulate the company's financial objectives—including a target for delivering total shareholder return and a tentative plan for allocating capital.

Modeling Methodologies

In contrast to an annual budget, a company's long-term financial projections usually involve more top-down assumptions and a longer time period (typically three to five years). The modeling also is more oriented toward "finance" rather than "accounting" perspectives, which means that it relies more on mathematical formulas—such as historical and expected revenue growth rates and projected changes in operating margins—and focuses more on cash flow assumptions and metrics.

For example, the model usually calculates the amount of capital expenditures and working capital requirements as a percentage of revenue growth for each of the company's product lines rather than through a full bottoms-up analysis of specific investment plans.

Modeling Formats

In developing their models, CFOs can either adapt sophisticated software packages that are available from technology vendors or else develop their own in-house version from scratch. Whether purchased or home-grown, the model should encompass the following attributes:

- *Sufficiently detailed* to capture the key drivers of the company's performance in each of its businesses and product lines.
- *Easily updated* through automated calculations that are based on correlations and interdependencies that are both logical and verifiable.
- *Analytically oriented* to show a wide range of accounting, cash flow, and rate of return measures, including estimated stock prices and total shareholder return.

CFOs also may want the financial model to be relatively consistent with the formats used by the sell side and buy side financial analysts in the company's industry. This conformity can be especially valuable to investor communications, helping to foster congruity with investor expectations concerning the drivers of future performance and the types of returns that can be generated.

Valuation Measures

The model's output should include agreed-upon valuation measures to determine the amount and the sources of shareholder value creation over the planning horizon. The stock prices usually are estimated by performing discounted cash flow analyses or by employing valuation multiples used by industry analysts.

For example, the market values may be estimated using a multiple of earnings per share, free cash flow per share, or book value per share. Another common technique is to assume a multiple of EBITDA (earnings before interest, taxes, depreciation, and amortization) to determine the company's *enterprise value* and then to subtract debt less cash (net debt) in deriving the market value for its equity.

In addition, the model should show other valuation benchmarks that are used in the industry or that are incorporated in the company's incentive compensation plans. Some examples include:

- **Market Value Added:** Market value of the company's equity securities in excess of their book value.
- **Organic Revenue Growth:** Year-over-year change in revenue excluding the effects of currency and any acquisitions or divestitures during the latest 12 months.
- **Net Income Growth:** Year-over-year change in after-tax earnings (or earnings per share) from continuing operations (either generally accepted accounting principles [GAAP] or "adjusted" earnings).
- **Free Cash Flow Yield:** Cash flow from operations less capital expenditures as a percent of market value.
- **Return on Capital:** Net income plus after-tax interest as a percent of book capitalization (shareholders' equity plus net debt).
- **Economic Profit:** Net income plus after-tax interest less a capital charge on average book capitalization.
- **Return on Equity:** Net income (GAAP or "adjusted") as a percent of book equity.
- **Operating Margin:** Earnings before interest and taxes (EBIT) as a percent of revenue.
- **Net Income Margin:** Net income as a percent of revenue.

Strategic Metrics

In addition to the valuation benchmarks, CFOs should include some performance drivers that relate to the company's business strategies. Examples might include:

- **Cost Reduction:** General and administrative expense as a percent of revenue.
- **Emerging Markets:** Revenue from Asia-Pacific, Latin America, and Africa as a percent of total revenue.
- **Innovation:** Revenue from new products as a percent of total revenue.
- **Technology:** Research and development spending as a percent of revenue.
- **Market Leadership:** Marketing and advertising spending as a percent of revenue.
- **Cross-Selling:** Revenue or products per customer.
- **Superior Products:** Gross margin on revenue.
- **Operational Excellence:** Number of customers.
- **Cyclical Upside:** Pricing on key products.

Sensitivity Analysis

The model should also permit a fulsome understanding of the sensitivities to the primary external and company-specific performance drivers. Therefore, CFOs will want the model to have the capability to vary these assumptions.

For example, the model might contain the ability to change assumptions for economic conditions, interest rates, foreign exchange rates, product pricing, and raw material pricing, and it might be useful to build in variables related to the inflation rate and assumed wage increases.

While the strategic plan should focus primarily on factors within management's control, CFOs will want to develop an appreciation for the exogenous variables that may overwhelm their efforts. Moreover, the sensitivity analyses can inform their preparation of contingency plans and their assessments of enterprise risks.

Potential Acquisitions

Although unidentified acquisitions typically are not included in a company's base case projections, CFOs should analyze the sensitivities to alternative acquisition scenarios. For example, they may want to examine the potential impact on the company's revenue and earnings growth rates, its return on capital, and the availability of cash to pay dividends or repurchase shares.

These sensitivity analyses can help CFOs to understand whether the company's financial objectives are attainable given different acquisition assumptions and the extent that they may need to raise additional long-term funding—either debt or equity financing.

TOTAL SHAREHOLDER RETURN

In parallel with their financial modeling, CFOs also should be defining and confirming the company's target for total shareholder return (TSR), which is the ultimate measure of the shareholder value created per share of common stock. It's equal to the annual percentage growth rate in the stock price plus the value of dividends received (including any shares distributed through a spinoff).

For example, a company might deliver an annual TSR of 12 percent, of which 9 percent is derived from stock price growth and 3 percent from dividends.

Analysis of Projections

The long-term financial projections will largely determine the TSR target, providing CFOs with answers to key questions such as:

- **Earnings Definition:** How will the company's earnings growth rate be defined (for example, by GAAP net income, "adjusted" net income, or free cash flow)?
- **Earnings Growth Rate:** What growth rate in earnings (however defined) can be achieved over the planning period?
- **Sources of Earnings Growth:** What is the expected contribution to the earnings growth rate from organic revenue growth and the expected contribution from margin improvements (growing costs at a slower rate than organic revenue)?
- **Earnings Multiple:** What is the expected valuation multiple on earnings (market value divided by earnings) and is it likely to increase, decrease, or stay the same?
- **Shares Outstanding:** What is the projected annual increase or decrease in shares outstanding (the net of share issuances and share repurchases)?
- **Acquisitions:** What is the possible impact from potential acquisitions (accretion or dilution to earnings per share)?
- **Dividend Payments:** What is the expected return that will be derived from dividend payments (current yield, plus dividend rate increases)?

Alternatives for Delivering Total Shareholder Return

The total return to shareholders can come from various combinations of earnings growth, dividend payments, and share repurchases, as well as by changes in a company's earnings multiple. For example, consider three companies with the following characteristics:

- Company A is a relatively high-growth company that does not pay a dividend. It expects to grow its earnings at an average 16 percent rate over the next five years and to maintain a constant price/earnings multiple of 20X over the planning period. It anticipates that shares outstanding will increase at a rate of 2 percent per year due to issuances through its incentive compensation programs.
- Company B is a moderate-growth company that expects to grow its net income by 10 percent per year and to maintain a price/earnings multiple of 14X over the planning period. It plans to maintain a dividend yield of 3 percent and to reduce its shares outstanding by 1 percent each year through share repurchases.
- Company C is a cyclical company that expects to maintain a dividend yield of 2 percent and maintain a constant amount of shares outstanding. Its net income is presently depressed due to a cyclical downturn, but the company expects it to double over the five-year period as the economy recovers. However, it also expects to see a decline in its presently inflated price/earnings (P/E) ratio of 15X (due to its low earnings) to a more normalized 12X.

A simplified comparison of the components of their total shareholder returns shows the following:

	Company A	Company B	Company C
Stock Price Today Stock-Price Impact From:	$100	$100	$100
-Earnings Growth	+80%	+50%	+100%
-Change in Shares	–10%	+5%	—
-Change in P/E Ratio	—	—	–40%
Stock Price in 5 Years	$170	$155	$160
Average Annual Increase	14%	11%	12%
Plus Dividend Yield	—	3%	2%
Total Shareholder Return	14%	14%	14%

TSR Considerations

CFOs should seek to define a TSR target that is aspirational but attainable. Usually, they will establish an internal target that is at the high end of, or even above, a range that is communicated externally. For example, they might set a goal of 12 to 14 percent internally, but state a public goal of 10 to 12 percent. This conservatism reflects a strong desire not to overpromise and underdeliver—which is anathema to stock market analysts.

The lower bound of the range should be equal to or greater than the company's cost of equity (which is estimated through the capital asset pricing model). For example, if the company's cost of equity is 10 percent, the bottom end of the target range should not extend below this number.

The target range should reflect realistic estimates of the earnings and cash flows that will be produced by the company's business and financial strategies, taking into account expectations for key macroeconomic or company-specific economic variables (including assumptions related to gross domestic product (GDP) growth rates and the key supply/demand assumptions that affect product pricing).

The long-term financial model is an invaluable tool for analyzing the possible range of outcomes under alternative scenarios. The sensitivity analyses can affect the level of target that is established or the way that it is communicated—perhaps adding a caveat such as "assuming normalized economic conditions."

CFOs should also analyze their company's historical track record for delivering TSR—on an absolute basis and in comparison with both a market index (such as the S&P 500) and an industry peer group. This historical perspective can provide insights concerning the market's expectations and the credibility of the company's projections.

In analyzing TSRs, CFOs should be aware of the alternative methodologies for computing the impact of dividends. In a conventional discounted cash flow model, dividends are implicitly assumed to earn the company's cost of capital. In contrast, calculations of stock market TSRs usually assume that dividends are reinvested in the company's stock; this methodology implicitly ascribes more value to dividends when the company enjoys strong stock price appreciation and less value when its stock price declines.

Finally, CFOs should strive to establish a TSR target that will remain valid over an extended period. Maintaining a consistent target reinforces the strategic plan's focus on long-term objectives and not on reactions to transitory conditions.

Example of TSR Target

After analyzing the historical and projected financials, CFOs should be in a good position to recommend a target for TSR, including its assumed components. For example, the annualized target might look something like the following:

Organic revenue growth	5.0–6.0%
Margin improvement	3.0–4.0%
Earnings growth	8.0–10.0%
Reduction in shares	1.0%
Earnings per share growth	9.0–11.0%
Change in P/E multiple	—
Dividend payments	3.0%
Total Shareholder Return	12.0–14.0%

The range could be communicated publicly as 10 to 12 percent, giving the company some cushion for unforeseen events. Or, alternatively, the company could communicate a less precise target—such as a "double digit" return—or choose not to make a public pronouncement.

In this example, the price/earnings multiple is assumed to remain constant, which is the assumption that CFOs normally use in their long-term financial modeling. However, if the company is in a cyclical business, the CFO may want to assume a more normalized valuation.

In addition, CFOs may consider a higher valuation multiple to be a potential upside from achieving greater consistency and growth in earnings. For example, increasing the price/earnings ratio from 12X to 15X would be equivalent to around 5 percentage points of annualized total shareholder return over a five-year period. However, the potential leverage from a change in the valuation multiple also highlights the downside if the company fails to perform up to expectations.

The example also does not include any incremental earnings accretion or dilution due to acquisitions, which implicitly assumes that any impact is subsumed in the earnings growth target. This is the typical assumption, except in cases where acquisitions are integral to the company's business strategies, such as private equity firms or certain industrial conglomerates.

Private Company TSRs

Although the calculation of TSR is based on stock price movements, the basic conceptual framework is applicable to private as well as public companies. The only difference is that the value of a private company's stock must be estimated.

Many private companies compute estimates of their share prices in connection with equity compensation programs or their share values may be indicated by a secondary market. If these estimates do not exist, private company CFOs can calculate their estimated market values based on discounted cash flows or extrapolations from comparable public companies. Alternatively, they can engage a third-party advisor to analyze their historical and projected TSRs.

CAPITAL ALLOCATION STRATEGIES

The long-term financial model also will highlight the amount of cash flow from operations that the company expects to generate over the planning period. CFOs can help to define tentative priorities for allocating this capital among capital expenditures, dividend payments, share repurchases, and acquisitions.

For example, CFOs may want to depict the targeted allocation in a simple pie chart such as the one shown in Figure 1.1.

They then can analyze the tentative allocation strategies through the long-term financial model, showing the pro forma effects on the financial results and valuation measures. Furthermore, this analysis can help them to determine the reasonableness of the company's TSR target.

CFOs can also employ a similar format in analyzing the company's actual allocations of capital over an historical time period (say, the past three or five years). This analysis can indicate whether the target allocations are consistent with, or a departure from, the company's capital allocation strategies in the recent past.

The strategic plan should incorporate an assumed dividend policy—whether the company intends to pay no dividend, pay a token dividend, achieve steady increases in the dividend rate, establish a target payout ratio, or focus on a target dividend yield. In most cases, the CFO will assume a continuation of the current policy.

In addition, the plan should highlight whether the company intends to make regular share repurchases—perhaps to offset any dilution due to incentive compensation programs—or pursue share repurchases opportunistically, depending on the availability of surplus cash and the relative valuation of the company's stock.

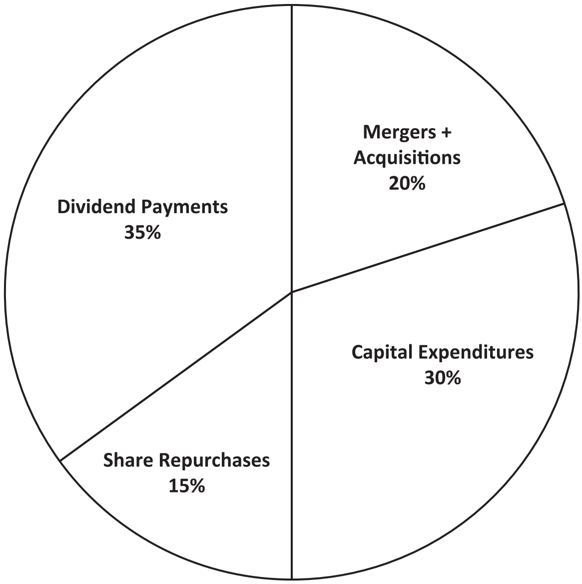

FIGURE 1.1 Capital Allocations

ACQUISITION STRATEGIES

The strategic plan should include an overview of the expected role of acquisitions in fulfilling the company's business and financial objectives. Obviously, the specific transactions will not be known, but CFOs can help to clarify the types of acquisitions that will be considered—especially if they are an essential rather than a discretionary component of the strategic plan.

In addition, a company's acquisition strategies may have a profound effect on its growth potential, cash allocation priorities, and risk profile—which can influence the types of investors to target for the company's shareholder base or even whether the company should be publicly or privately held.

Acquisition Parameters

Some of the questions to be addressed should include: How big are the acquisitions likely to be? What is the estimated range of outlays for acquisitions over the planning period? What are the strategic purposes likely to be? For example, will they be vehicles to add new customer bases, enter new markets, obtain new technologies, realize cost savings, or enhance market leadership?

It also helps if the CFO can articulate the types of acquisitions that the company will be targeting—including the extent to which the company intends to emphasize:

- *Consolidations* that involve mergers or acquisitions in a mature or fragmented industry, usually to strengthen market leadership, reduce costs, or expand products and services to existing customers.
- *Bolt-ons* that involve the swift and complete integration of a target into an existing business, usually to obtain cost synergies or to save time and expense in adding customers, technologies, products, brand names, or geographical presence.
- *Platforms* that involve a target that facilitates entering a business or product line with good growth prospects, usually to obtain the target's management knowhow, market presence, brand name, or customer base.
- *Transformations* that involve major transactions that shift the company's focus toward a new business with greater growth prospects, usually to transition from a business that is stagnant or in decline.

Most important, CFOs should relate the acquisition strategies to the company's business objectives: Acquisitions should not be pursued as financial transactions, but rather as ways to accomplish business objectives more quickly, more cheaply, or with less risk.

As a rule, CFOs should not be too specific in communicating their acquisition strategies to the investment community. However, investors will appreciate reassurances that acquisitions will be pursued only if they fulfill business objectives, make economic sense, and compare favorably with alternative uses of capital—especially versus dividend payments or share repurchases.

Acquisition Financing

In addition, investors will be interested in the potential impact to the company's capital structure. Therefore, CFOs should have some tentative thoughts concerning acquisition financing—in particular, whether the company plans to issue equity in connection with the acquisition program (and if so, will it repurchase the shares?). Another important question is whether the acquisitions can be funded without impairing the company's debt ratings.

Obviously, the actual financing transactions will be largely dependent on the size and nature of the acquisitions that are ultimately undertaken, as well as the availability of other possible sources of cash, such as the proceeds from a divestiture. Nevertheless, the strategic plan should reflect the CFO's best preliminary thinking about the potential impact on the company's capital structure objectives.

TARGET SHAREHOLDERS

In articulating a strategic plan, it usually helps if the company has a target shareholder profile in mind. The business and financial strategies should be viewed through the lens of current and potential shareholders in the company—answering the question: Will they perceive the stock to be an attractive investment? CFOs should view investors as their customers, who will need to buy into the company's strategies for delivering shareholder value.

For private companies, focusing on target shareholders involves learning the investment objectives of the specific individuals or institutions who directly own the company. CFOs of private companies usually can engage in a direct dialogue with their shareholders—gaining an understanding of their rate of return objectives, liquidity needs, tax situations, and risk tolerances.

For CFOs of public companies, the process of targeting shareholders is usually more nebulous. Although they can communicate with investors directly in many cases (e.g., in one-on-one meetings), they also will be marketing their investment story to a large number of existing and potential investors with whom they may not have had much, if any, direct contact in the past. Therefore, CFOs typically will classify target shareholders in much the same manner that a company focuses on customer segments in its marketing strategies.

Institutional Investors

Most institutional investors—such as mutual funds, money managers, and pension funds—will adopt investment styles that strongly influence and constrain the types of stocks in which they invest. By analyzing the investment styles of institutions in their existing shareholder base, CFOs can gain a pretty rich understanding of the criteria that these shareholders will consider in deciding whether to retain or add to their holdings.

In addition, CFOs can determine the types of institutional investors that are likely to be interested in their stock. They then can identify segments and institutions that are currently underrepresented in their stock ownership, comprising a fertile field to cultivate new shareholders.

As another technique, CFOs can compare their shareholder composition with those of peer group companies—thus identifying institutions that may be predisposed to embrace their investment thesis. It is a useful exercise to examine the shareholder bases not only of competitors, but also companies in other industries that have comparable investment characteristics, such as similar growth rates, P/E ratios, and dividend yields.

Investment Styles

The investment styles can vary significantly among institutional investors—and even among portfolio managers within an institution—making it difficult to categorize them with much precision. However, in an admittedly simplified model, the alternative investment styles can be defined by the following stock preferences:

- **Growth:** Stocks that offer above-average growth in earnings relative to the market; these stocks typically have relatively high price/earnings multiples and usually pay no or relatively low dividends.
- **Income:** Stocks that pay steady dividends and offer a relatively high dividend yield in comparison with other stocks in the market.
- **Value:** Stocks that tend to trade at low valuation multiples in comparison with the market and that are viewed as potentially undervalued due to company-specific issues or as a result of industry or macroeconomic conditions.
- **Growth at a Reasonable Price (GARP):** Stocks that offer a combination of consistent earnings growth at above market averages and valuation multiples that are considered reasonable in comparison with other stocks in the market.
- **Growth and Income:** Stocks that offer balanced returns from stock price appreciation and dividend yield; these stocks are relatively stable and often serve as core holdings in a portfolio.

Furthermore, the investment styles can vary by degree (such as “high” growth or “deep” value) and there are subcategories within each (such as “tax advantaged”).

Hedge Funds

The growth in the size and influence of hedge funds is one of the most important developments in the investment world over the past decade. While few companies have purposely set out to cultivate hedge funds as their preferred investor base, CFOs should recognize that they are a powerful and growing force in the market—especially influencing stock valuations over the short term—and account for a disproportionate percentage of the liquidity in most listed stocks.

Unlike traditional institutional investors, hedge funds usually are unabashedly focused on short-term gains—with a year being a relatively long time for them to hold a position—and they are as prone to be short as long a stock. They typically seek to understand not only the fundamentals of a company's business, but also the potential near-term "catalysts" that can cause a meaningful upside or downside to the stock price. If a company is considering a significant change in its business or financial strategies, the CFO should be acutely aware of the potential reaction of this investor group.

Given the extraordinary expansion in electronic trading and derivative transactions in recent years, hedge funds are playing a larger role in providing liquidity to the market—and thus can serve as a buffer that may temper wild swings in a company's stock price. Consequently, CFOs are increasingly including hedge funds among the investor segments that they are targeting through their investor relations strategies. They simply are too important to ignore.

Index Funds

Index funds are becoming a larger percentage of most public companies' shareholder base—largely due to the increase in investors who have adopted the philosophy that it is better to pay lower fees for average returns than to pay higher fees for returns that may or may not exceed the average (and usually don't!). Furthermore, the amount of shares held by passive investors is increasing due to the explosive growth in exchange traded funds (ETFs), which offer investors a basket of stocks that reflect market or industry indexes.

Index funds and most ETFs are passive managers of their portfolios—simply reflecting the price movements in their baskets of stocks. Therefore, CFOs should not focus on them as a priority investor segment. However, CFOs should explicitly consider them if contemplating a change in a business or financial strategy that will cause their company not to qualify for the index or ETF in the future.

For example, a company may no longer fit a fund's criteria due to a significant change in its business mix, dividend yield, trading volume, or debt ratings. And if the company is removed from an index or ETF, the CFO should be prepared for some short-term downside pressure on the stock as the fund sells its shares into the market.

This market dislocation likely will dissipate over time. Nevertheless, CFOs don't want to be caught unawares by this potential volatility and will want to inform the CEO and board of directors in advance of the proposed action.

Individual Investors

CFOs historically have not emphasized individual investors in their marketing efforts. However, they can be a source of relatively stable holders. In addition, more retail investors are investing directly in stocks and ETFs through online brokerages, which continue to gain market share versus the traditional brokerage community.

Because the worldwide web has greatly facilitated the ability of companies to communicate their story directly to individual investors—rather than relying on brokerage firm analysts—targeting retail investors has become a more viable strategy, especially for companies with a well-known consumer franchise.

Investor Relations Programs

Of course, the actual mix of shareholders in a company's stock will be a composite of several different investment styles and is largely outside the company's control. Nevertheless, by focusing on target shareholders, CFOs can enhance the effectiveness of their investor relations programs.

For example, establishing a target mix can help determine which investor conferences to attend and which institutions to emphasize in road show visits. Moreover, having target shareholders in mind can guide the preparation of investor communications, indicating message points that should be highlighted and reinforced.

ELEVATOR PITCH

After determining their target shareholders, CFOs should tailor a succinct investment story—an "elevator pitch"—that piques investor interest in their stock. In particular, they should craft answers to the three questions that investors seem invariably to ask in one-one-meetings. To paraphrase these questions, they are:

- How will I make money in this investment?
- What will be the catalyst for a higher stock price?
- What are the risks to my realizing the expected return?

As described by Malcolm Gladwell in his book *Blink* (Little, Brown, 2005), people often make snap judgments based on limited information—but are amazingly accurate in their assessments. Investors epitomize this phenomenon, quickly forming first impressions that determine whether they will take the time and make the effort to learn more about a company. CFOs should acknowledge this short attention span and be ready to make a compelling argument that will induce investors to perform a full investigation of a potential ownership stake.

PLAN REVISIONS

Although the strategic plan is intended to be enduring, it also should be a "living" document that adapts to changing conditions and shifting priorities.

As a best practice, boards of directors usually revisit the strategic plan at least annually, often via an offsite retreat. This provides the board members an opportunity to assess management's progress in implementing the plan—highlighting what is going well and what is proving to be a challenge. It also gives the board members an opportunity to make suggestions and voice concerns, which may cause some revisions in thinking.

In addition, the plan will evolve in response to specific strategic decisions. In a process that is analogous to the way that courts will interpret and shape the law in response to specific cases, the consideration of potential strategic actions—such as an acquisition opportunity—can bring clarity to a company's priorities. For example, a bank that has a business objective to increase cross-selling might consider whether acquiring an insurance company would make sense. It likely fits the broad strategic criteria, but it may be too expensive for the value created or too difficult to implement successfully.

Finally, the plan will be reviewed thoroughly in response to landmark corporate events such as the appointment of a new CEO, significant changes in the competitive environment, the introduction of a disruptive technology in the market, the loss of a major customer, a precipitous decline in the stock price, a takeover offer, or a shareholder activist proposal.