RECOGNIZING THE ROLE OF THE FINANCIAL COMMUNITY IN STRATEGY ...
Kuperman, Jerome C;Athavale, Manoj;Eisner, Alan B
Academy of Educational Leadership Journal; 2007; 11, 1; ProQuest Central
pg. 91

RECOGNIZING THE ROLE OF THE FINANCIAL COMMUNITY IN STRATEGY FORMULATION: JUST HOW INTERDISCIPLINARY IS STRATEGIC MANAGEMENT EDUCATION?

Jerome C. Kuperman, Minnesota State University Moorhead
Manoj Athavale, Ball State University
Alan B. Eisner, Pace University

ABSTRACT

The multi-disciplinary nature of strategic management is irrefutably recognized by both practitioners and scholars. The fields of strategic management and finance both recognize and explain the firm's actions in the context of value maximizing behavior. Given the close association between the two disciplines, this paper investigates whether those of us who write texts and/or teach courses in strategic management are sufficiently recognizing the contributions of the financial community in the strategy formulation process. Our review of five popular texts suggests that neither the role of the financial community nor their perspectives are being adequately incorporated in the teaching of strategic management. We believe this lack of integration hurts the student learning experience but is easily rectified if we understand that the difference in focus is really just a matter of varying perspectives – is increasing shareholder value the primary target of the strategy formulation process or is it a byproduct of a process that is otherwise focused on improving the organization's long-term efficiency and effectiveness.

INTRODUCTION

Hill and Jones (2004) note for the reader in the sleeve of their hardcover textbook titled *Strategic Management: An Integrated Approach* that "the authors draw not only on strategic management literature, but also on the literature of economics, marketing, organizational theory, operations management, finance, and international business to deliver a perspective that is truly strategic in that it integrates these diverse disciplines into a comprehensive whole." It would not be presumptuous to say that this statement broadly reflects the beliefs of most text-book authors, faculty and also students. While strategic management is its own field with its own literature, it is irrefutably recognized that the field is, by its very nature, multi-disciplinary (Stephen, Parente, & Brown, 2002; Schneider & Lieb, 2004). Ireland mentions that, "Strategic management story's validity is a product of carefully integrating research results into [the] treatments of various subject matters" (Cameron,

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Ireland, Lussier, New, & Robbins, 2003:727). Even further supportive of this sentiment is recent trends in AACSB accreditation standards and scholarly calls in journals (Hamilton, McFarland and Mirchandani, 2000) for more integration across the entire business curriculum.

The question that motivates this paper is whether those of us who write texts, teach courses and do research in strategic management, adequately recognize the advisory role of the financial community (i.e., analysts and bankers) in strategy formulation and the types of practical capital market concerns that motivate their suggestions. The specific focus here is not on the use and understanding of financial controls and financial measurements as we recognize that to be addressed in texts and classes, but on the influence of the financial community and how that community's input provides direction to strategic decisions.

The focus of the paper is an investigation of the extent to which the role of the financial community and the arguments used by that community to promote different corporate strategy decisions are being recognized by those who teach and publish in the area of strategic management. We cannot review all teaching, research, and practice but believe that an examination of five widely used textbooks is a valid indicator of biases that may exist more generally across strategic management education. The results of our discussion are intended to highlight the integrative nature of the strategic management discipline and our goal in writing this paper is to initiate greater discussion and reflection among strategic management educators. There is neither the intent in this paper to suggest strategic management as the venue for a review of other disciplines, nor the intent to suggest that teaching and research in strategic management is being done across the field without any awareness of finance related theory. In the broadest sense, the question of whether the role of the financial community is being adequately recognized can never be answered and this paper does not presume to have such an answer. However, the authors believe our sampling of strategic management textbooks supports the assertion that the role of the financial community in explaining managerial behavior is underrepresented and needs to be incorporated and, in fact, may not be adequately incorporated in strategic management education.

The paper is organized into four sections. The first section begins by laying out a theoretical basis for discussion. Specifically, it shows that theory recognizes a role for the financial community in formulating strategy. It then provides a high profile example of how integral the financial community is in the strategy formulation process by exploring the evolution of the E-commerce mania of the late 1990s. In the second section, we survey prominent Business Policy and Strategy text-books to examine the rationale used to support acquisition, divestiture and spin-off strategies. We then list prominent financial theories and explanations for acquisition, divestiture and spin-off strategies. This section mixes theoretical finance reasoning with discussions of recent real-world cases where top managers can be seen to offer finance-based reasons for their strategic choices. Finally, the paper concludes with a discussion of results and offers some explanation and perspective as to why the financial community isn't more of a focus in strategy textbooks.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

THE FINANCIAL COMMUNITY'S INFLUENCE

The process of strategy formulation, as discussed in the strategic issue diagnosis model (Dutton and Duncan, 1987; Dutton, Stumpf and Wagner, 1990; Ginsberg and Venkatraman, 1992) begins top managers recognizing an emerging strategic issue*, i.e., new developments, events or trends that have the potential to affect organizational performance* (Ansoff, 1980). In the strategic issue diagnosis model, once a strategic issue is recognized, top managers begin to assess issue urgency and issue feasibility. Throughout this process of issue recognition and assessment, it is understood that managers seek out relevant organizational stakeholders (Mitroff, 1983; Freeman, 1984) as important sources of information to help them make their decisions. The role of the various stakeholders in the decision-making process varies with context, but it is clear that some stakeholders take more passive roles as solely suppliers of information while others behave more actively as influencers (Donaldson and Preston, 1995). The financial community, investment bankers and analysts, has always had a role in the strategic management process as influencers and recent evidence would suggest that role is only growing.

Investment bankers provide necessary expertise to help firms issue additional shares of stock, spin-off assets or acquire new assets. They have historically been recognized as direct influencers of firm strategy, but only after they have been hired by firms to implement an already formulated strategy. Rolfe and Troob (2000: 106), two former investment bankers, observed that the role of the investment banking house has shifted in recent years so that they are becoming increasingly important as influencers of strategy even while the firm is in the formulation stage. With increased competition for clients, "the new business pitch has gained importance as the bankers' core activity."

> They [bankers] can no longer rely on a relatively small number of loyal clients to generate advisory business for them year in and year out. They now have to spend a much larger portion of their time scrambling to find new clients and new business. To justify their existence, they now have to go out and pitch ideas to whomever will give them an audience in the hope that just a few of the potential clients will sign on for the program (Rolfe and Troob, 2000: 100).

Financial analysts have historically maintained a lower profile than investment bankers and have simply done their job by working 'behind-the-scenes' to provide investors with information (Moyer, Chatfield and Sisneros, 1989). They have indirectly influenced firm behavior through the effect that changes in analyst buy, sell and hold recommendations (Elton, Gruber, and Grossman, 1986; Ho, 1995) and changes in earnings estimates (Benesh and Peterson, 1986; Elton, Gruber and Gultekin, 1981; Imhoff and Lobo, 1984; Stickel, 1991) have on the demand for and prices of the firm's securities. More recently, their importance as influencers of strategy has grown as their visibility in the media has grown. Analysts are becoming increasingly prominent as public figures

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

through television appearances and interviews with financial publications (Kuperman, Athavale and Eisner, 2003). As DeBondt (1995: 13) observed, "we all know that investors chase the celebrities" and firms are aware of which analysts are celebrities. Anecdotally, it is difficult to follow the business press and not have heard of Abbey Joseph Cohen for example. With this in mind, firms are increasingly considering the opinions of analysts more directly in their decision processes (Kurtz, 2000).

While the importance of the financial community is not necessarily news to academic scholars, the increasingly high profile of this community in the strategy formulation process necessitates that students have an even greater understanding of the finance theory and practice if they are to really understand real world phenomena. To highlight this point, consider the E-commerce mania of the late 90s that helped fuel the stock market bubble. In the case of E-commerce, financial community input and support was critically important as firms found funding for their 'new' business models and shareholders found immediate short-term windfalls. While the example is recognized (in retrospect) as an example of questionable long-term decision-making, it does highlight the centrality of the financial community in the corporate strategy formulation process. E-commerce, effectively implemented (consider firms like Amazon, Ebay, and Dell), can allow firms to enhance revenues by creating better customer value and reduce costs by improving supply chain efficiencies. However, as the bubble has shown, many firms embarked on less effective strategies as the 'frenzy' to go online grew. Frank J. Drazka, managing director and head of technology investment banking at PaineWebber Inc. observed in June, 1999 that "It was easy for people up front to dismiss online business as the flavor of the day, but in the last year there have been a lot of board meetings in which management was asked, 'How do we compete against the newbie on the block?' (Byrnes, 1999)." As E-commerce questions became increasingly prevalent in June of 1999, the importance of the financial community in helping provide the answers only seemed to grow. Financial analysts were there to question the competitive strategy of companies that did not incorporate E-commerce in their plans, and investment bankers were ready to offer advice for companies wishing to profit from their E-commerce investments.

The possibility of increasing shareholder value prompted many firms (consider Barnes and Noble and Toys R Us) to embark on online strategies. In response to the threat posed by Amazon, Barnes and Noble created its own online division in 1997 and later spun-off the subsidiary with an initial public offering in 1999 raising more than $430 million (Mateyaschuk, 1999). Similarly, Toys-R-Us responded to a threat from online retailer Etoys by creating its online business unit. In the case of Barnes and Noble, the spin-off and IPO led to sub-optimal business strategy and structure for both the online and traditional Barnes and Noble companies. Separating the two businesses was a big mistake, says Carrie Johnson, an analyst at Forrester Research Inc. She believes it left the chain ''unable to leverage the name and get synergies.'' (Brady, 2000: 63). While Barnes and Noble received considerable cash flows from the IPO of the online division it also lost considerable synergistic opportunities with the core bookselling operations. The development, launch, and

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

operation of toysrus.com turned out to be both a corporate and public relations headache for almost a year, reportedly prompting the resignation of Toys "R" Us Inc. CEO Robert Nakasone. The spin-off decision represented an immediate short-term windfall for shareholders but possibly at the expense of long-term operational considerations. The critical strategy decision to engage in e-commerce and the subsequent spin-off decision were clearly influenced by the financial community. While the appropriateness (or otherwise) of those influences can certainly make the topic of another discussion, and while the outcome of those decisions can long be debated in hindsight; the role of the financial community in influencing business strategy formulation processes cannot be ignored.

A SURVEY OF TEXTBOOKS

We selected and reviewed five popular textbooks (listed in Table 1) that have a track record of academic acceptance as evidenced by the publishing of numerous editions. As the intent of this article to illustrate a potential weakness and engage scholars in a discussion of the need to incorporate the influence of the financial community in the teaching of strategic management, we feel that such a sample is both representative and adequate.

Table 1: List of Textbooks Surveyed

Text	Author(s)	Title	Publisher
1	Michael A. Hitt, R. Duane Ireland & Robert E. Hoskisson	Strategic Management: Competitiveness and Globalization (6th Ed.)	Thomson: South-Western
2	Arthur A. Thompson & A. J. Strickland	Strategic Management: Concepts and Cases (13th Ed.)	McGraw-Hill Irwin
3	Charles W. L. Hill & Gareth R. Jones	Strategic Management: An Integrated Approach (6th Ed.)	Houghton Mifflin
4	Thomas L. Wheelen & J. David Hunger	Strategic Management and Business Policy (9th Ed.)	Prentice Hall
5	Fred R. David	Strategic Mangement: Concepts and Cases (8th Ed.)	Prentice Hall

To gauge the extent to which the textbooks listed above incorporate the relevance of the financial community as stakeholders in the process of influencing corporate strategy, we surveyed the various textbooks for references to the term 'stakeholders' and present a summary of their discussions in Table 2.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Table 2: Stakeholder Discussion	
Text	**Discussion**
1	*Page 22*: Stakeholders are the individuals and groups who can affect, and are affected by, the strategic outcomes achieved and who have enforceable claims on a firm's performance. *Pages 22-26*: Discusses three types of stakeholders including capital market (shareholders and suppliers of capital), product market (customers, suppliers, communities, unions) and organizational (employees, mangers, non-managers). *Page* 24: In the discussion of capital market –"Maximization of returns sometimes is accomplished at the expense of investing in a firm's future. Gains achieved by reducing investment in research and development, for example, could be returned to shareholders, thereby increasing the short-term return on their investments. However, this short-term enhancement of shareholder wealth can negatively affect the firm's future competitive ability"
2	*Page 65*: Mentioned in the context of ethical practices – "Every business has an ethical duty to each of five constituencies: owners/shareholders, employees, customers, suppliers, and the community at large. Each of these constituencies affects the organization and is affected by it. Each is a stakeholder in the enterprise, with certain expectations as to what the enterprise should do and how it should do it."
3	*Page 374*: "A company's stakeholders are individuals or groups with an interest, claim, or stake in the company, in what it does, and in how well it performs." *Pages 374-380*: Discusses two types of stakeholders, internal (stockholders, employees, managers, board members) and external (customers, suppliers, creditors, governments, unions, local communities, general public). In the discussion titled 'The Unique role of Stockholders', the text mentions that "The capital that stockholder provide to a company is seen as risk capital ... Recent history demonstrates all too clearly the nature of risk capital." An example is than provided of how stock prices can fluctuate, but no market-focused explanation is given. Discussion on page 378 notes that some stakeholders compete with each other and therefore may negotiate for resources without thinking of the firm's long-term benefit. Specifically, discussion cites suppliers, customers and employees with examples of when they would not be motivated to maximize the firm's long-term return on invested capital.
4	*Page 39*: "A corporation's task environment includes a large number of groups with interest in a business organization's activities. These people are referred to as corporate stakeholders because they affect or are affected by the achievement of the firm's objectives." *Pages 39-40*: Text in a very general manner points out that stakeholders have competing claims on the organization and that not all claims can be equally satisfied and managers must therefore prioritize (*page 181* has a stakeholder priority matrix). *Page 249*: In a chapter on 'Evaluation and Control', text shows a table with stakeholder categories that include customers, suppliers, financial community, employees, congress, consumer advocate and environmentalists. The table lists possible near-term and long-term measures of success for each category. For financial community, it lists near-term measures of EPS, stock price, number of 'buy' lists and ROE. Long-term measures include growth in ROE and "ability to convince Wall Street of strategy."
5	*Page 64*: Stakeholders include employees, managers, stockholders, boards of directors, customers, suppliers, distributors, creditors, governments (local, state, federal and foreign), unions, competitors, environmental groups, and the general public. Stakeholders affect and are affected by an organization's strategy ..." *Page 64-66*: Text discusses that stakeholders have competing claims on the organization and that not all claims can be equally satisfied.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

There is general agreement among the texts that stakeholders impact and are impacted by the firm's behavior. However, the books do not uniformly identify stakeholder groups. The following is a list of financial community stakeholders listed in the five texts: Text 1 identified shareholders and suppliers of capital, text 2 identified owners/shareholders, texts 3 and 5 both identified stockholders and creditors, text 4 only listed stakeholders by name in a table in the section on control where it did mention the financial community as a stakeholder group.

Both texts 1 and 3 discuss the dilemma a firm faces as some decisions can maximize shareholder wealth in the short-term at the expense of the long-term. We believe that this issue cannot be fully understood without recognizing the forces in the financial community that drive decisions regarding shareholder wealth maximization. Only text 3 though provides any discussion that moves towards recognition of the importance of the financial community as an active stakeholder with an impact on the strategy process. It explicitly mentions stockholders, their function in providing risk capital, and discusses stock market fluctuations in that context. However, even this discussion lacks once again as it fails to fully explore the impact of those stock market fluctuations on the strategy process and the key role played by analysts and bankers in this context. Text 4 identifies the stakeholder group as the financial community and identifies the "ability to convince Wall Street" of the firm's strategy as a possible measure of success. However, this is done in a table with many stakeholders and success measures. There is no independent discussion that builds on this to clearly point out the role of the financial community and its importance. Further, the wording in the table implies that firms 'convince' Wall Street as to the success of their strategy after the fact but does not allow for the possibility that Wall Street can similarly 'convince' firms of the strategy to adopt.

Acquisitions and divestitures are significant strategic events in the life of a company. The five texts were surveyed for content related to each of these strategies, and the theoretical rationales provided to support each of these strategies are summarized in Table 3 (acquisitions) and Table 4 (divestitures).

Table 3 identifies the many stated benefits from an acquisition. These benefits focus on either improving the firm's internal capabilities/asset base or on its ability to manage its external environment, but do not explicitly focus on the role of acquisitions in maximizing shareholder wealth – a focus of finance theory and a primary goal of real world practitioners. Specifically, the concern is not that strategy texts aren't instructing students in terms of running financial numbers (e.g., ROI, ROA, profit margins, etc.), but that the texts are not recognizing how financial community experts will sometimes promote strategies to management solely on the basis of a short-term motivation to generate shareholder return in terms of capital market pricing. This will be made clear in our later discussion of specific finance theories and real-world examples.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Table 3: Acquisition	
Text	**Acquisition Discussions**
1	*Page 204*: "Reasons for Acquisitions" section lists the following sub-headings - 1. Increased Market Power 2. Overcoming Entry Barriers 3. Cost of New Product Development and Increased Speed to Market 4. Lower Risk Compared to Developing New Products 5. Increased Diversification Text here refers back to an earlier chapter that outlined the benefits of related diversification (operational relatedness where activities are shared, corporate relatedness where core competencies are transferred, and market power advantages) and unrelated diversification (efficient internal capital market allocation and restructuring abilities). 6. Reshaping the Firm's Competitive Scope 7. Learning and Developing New Capabilities *Page 251*: Following is a quote from the International Strategy chapter - 1. Can provide quick access to a new market
2	*Page 177-178*: The following benefits are directly quoted from the text - 1. Can dramatically strengthen a company's market position and open new opportunities for competitive advantage. 2. Combining operations with a rival can fill resource gaps 3. Stronger technological skills (this was also cited on *page 228)* 4. More or better competitive capabilities 5. A more attractive lineup of products and services 6. Wider geographic coverage 7. Greater financial resources with which to invest in R&D, add capacity, or expand into new areas 8. Build a market presence in countries where [companies] do not presently compete *Page 303*: In a discussion on unrelated diversification strategies, the text identifies two types of "acquisition candidates that offer quick opportunities for financial gain because of their 'special situation'." They are - 1. Companies whose assets are undervalued 2. Companies that are financially distressed *Page 309-310*: In a discussion on different strategies for entering a new business, the text identifies specific benefits of the acquisition approach, using direct quotes, as follows - 1. A quicker way to enter the target market than trying to launch a brand-new operation from the ground up. 2. An effective way to hurdle such entry barriers as ...
3	*Pages 350-351*: In a section titled 'Attractions of Acquisitions', the text identifies various reasons for using acquisitions as an entry strategy. The following are directly quoted from the text as reasons firms choose the acquisition approach - 1. With regard to diversification (or vertical integration), companies often use acquisition ... when they lack important competencies (resources and capabilities) required to compete in that area [Diversification was earlier noted in the text to provide firms with opportunities for the transferring of competencies, leveraging of competencies, sharing of resources to gain economies of scope, and management of rivalry through multipoint competition.] 2. When they [i.e., acquiring companies] feel the need to move fast 3. Is also perceived to be somewhat less risky than internal new ventures

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Table 3: Acquisition	
Text	**Acquisition Discussions**
	4. The industry to be entered is well established and incumbent enterprises enjoy significant protection from entry barriers
4	*Pages 139-145*: Text identifies mergers and acquisitions as methods for implementing a growth strategy. Growth strategies can be directed towards continued concentration on current product lines (vertical and horizontal integration strategies), diversification into new product lines (related and unrelated diversification) or international expansion.
5	*Pages 180-182*: In a general discussion of mergers and acquisitions, the text summarizes reasons to pursue such a strategy with a bullet point list that is as follows - 1. To provide improved capacity utilization 2. To make better use of the existing sales force 3. To reduce managerial staff 4. To gain economies of scale 5. To smooth out seasonal trends in sales 6. To gain access to new suppliers, distributors, customers, products, and creditors 7. To gain new technology 8. To reduce tax obligations

As can be seen in Table 4, the focus of the textbooks in the case of divestitures and spin-offs is clearly on the firm's internal environment and trying to change the state of that environment. We are pleased to see text 3 clearly recognizing that divestitures occur with stock market as well as internal environment motivations. However, as will be made clearer in the next section focused on finance theories, the choice of divestiture method is complex and very much motivated by expectations for shareholder return. The text does not address the method of divestiture at all.

Table 4: Divestiture and Spin-off	
Text	**Divestiture Discussions**
1	*Page 215*: Text gives one basic reason for divestiture (spin-offs are a type of divestiture in this context) - "Regardless of the type of diversification strategy implemented, however, declines in performance result from overdiversification, after which business units are often divested." *Pages 220-221*: In a discussion on downscoping (term includes divestiture, spin-off and liquidation strategies), text focuses on managerial loss of focus noting that "downscoping is described as a set of actions that causes a firm to strategically refocus on its core businesses." *Page 325*: In a discussion of managerial defense tactics to avoid takeovers, text notes "some defense tactics require asset restructuring created by divesting one or more divisions..."
2	*Page 315*: Text clearly defines divestiture as taking one of two forms including "spinning the business off as a financially and a managerially independent company or selling it outright." *Page 347*: Drawing from terminology used in the BCG matrix, the text identifies a two-stage harvest-divest strategy. It notes that in the divestiture decision, "corporate managers should rely on a number of

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Table 4: Divestiture and Spin-off	
Text	**Divestiture Discussions**
	evaluating criteria: industry attractiveness, competitive strength, strategic fit with sister businesses, resource fit, performance potential (profit, return on capital employed, economic value added, contribution to cash flow), compatibility with the company's strategic vision and long-term direction, and ability to contribute to enhanced shareholder value"
3	*Page 221*: "A divestment strategy rests on the idea that a company can maximize its net investment recovery from a business by selling it early, before the industry has entered into a steep decline." *Pages 358-359*: In a section titled 'Why restructure?' the text identifies exit strategies including divestiture, harvest and liquidation. In the section on divestiture (defined as the outright sale of a unit), it also defines a spin-off and notes that this approach "makes good sense when the unit to be sold is profitable and the stock market has an appetite for new stock issues." No other comments on this approach are offered. *Pages 358-359*: In the section titled 'Why restructure?', the text also notes that stock prices are often lowered by something called the diversification discount and defines it as "the empirical fact that the stock of highly diversified companies is often assigned a lower valuation relative to the earnings of less diversified enterprises." It notes two reasons for this discount - 1. "Investors are often put off by the complexity and lack of transparency in the consolidated financial statements of highly diversified enterprises." 2. "Many investors have learned from experience that managers often have a tendency to pursue too much diversification, or diversify for the wrong reasons, such as the pursuit of growth for its own sake, rather than the pursuit of greater profitability." Additionally, the text notes that "restructuring can also be a response to failed acquisitions."
4	*Page 148*: "If a corporation with a weak competitive position in its industry is unable either to pull itself up by its bootstraps or to find a customer to which it can become a captive company, it may have no choice but to sell out." *Page 150*: "If a company has multiple business lines and it chooses to sell off a division with low growth potential, this is called divestment." *Page 293*: "If both the strategic importance and operational relatedness of the new business are negligible, the corporation is likely to completely sell off the new business ..." The rest of the related text defines spin-offs and leveraged buyouts in terms of their technical operational parameters.
5	*Page 173*: The text identifies in bullet point format the following six guidelines when divestiture may be an especially effective strategy to pursue - 1. When an organization has pursued a retrenchment strategy and failed to accomplish needed improvements 2. When a division needs more resources to be competitive than the company can provide 3. When a division is responsible for an organization's overall poor performance 4. When a division is a misfit with the rest of an organization; this can result from radically different markets, customers, managers, employees, values, or needs 5. When a large amount of cash is needed quickly and cannot be obtained reasonably from other sources 6. When government antitrust action threatens an organization

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

APPLICATION OF FINANCE THEORIES TO STRATEGY

The previous section of the paper discussed rationales listed in strategic management textbooks for the major corporate strategy decisions of acquisitions and divestitures. We obviously cannot review in the context of this paper the full breadth of financial theories that might be relevant to understanding the finance perspective on strategy. However, one thing that is clear in all finance theory is that the primary focus of the strategic management process is to create financial market returns for shareholders. Jensen and Meckling (1976) wrote a particularly well-known paper recognized across a variety of business disciplines that helps to explain why finance literature and practice focuses so strongly on the financial markets as the primary dependent variable in measuring managerial and firm effectiveness. They showed that the separation of management from ownership which is generally inherent in the corporate form of business imposes significant agency costs. These agency costs can be mitigated by expending resources to monitor management and relying on markets (labor and financial) to establish mechanisms for preventing the expropriation of wealth. However, the greater dispersion of individual stock ownership, passive ownership by many institutional investors, weak corporate governance structures, and the increasing use of takeover defense mechanisms imply that proxy fights for management control are rare and often futile, and thus the labor market is not an effective mechanism to discipline and control managerial action. In this scenario, financial markets may act as a mechanism to influence managerial actions. Displeasure at corporate strategy is often immediately evident in the prices of the firm's public financial contracts (for example, stocks and bonds) and expectations of such market reactions serve as the mechanism to influence corporate policy and strategy.

The remainder of this section will show a variety of common practitioner rationales behind the decision to acquire or divest along with prominent examples and a quick review of some of the finance theory that is used to support those rationales.

RATIONALES FOR DIVERSIFICATION THROUGH ACQUISITIONS

Increasing earnings per share (EPS) growth rates. If a stock is recognized in the investor marketplace as belonging in the category of a 'growth' stock, investors will price the stock with a higher price to earnings (P/E) ratio. If growth in earnings is not maintained, the market will no longer consider the investment as a 'growth' stock and will lower the P/E ratio (and consequently a lower stock price) to reflect the lower expectations for earnings growth. Such firms often acquire other firms in order to sustain the earnings momentum. For example, in December, 2004, Johnson and Johnson made a $25 billion tender offer to acquire the shares of Guidant Corporation. Glenn Novarro, the medical device analyst at Banc of America Securities observed that "from a sector point of view, what often drives consolidation in a sector is the need of bigger companies to grow.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

When I look at my sector, internal development is not going to allow many of these companies to make their growth objectives (Herper, 2004)."

Using over-valued stock as currency. Going back to Sharpe (1964), finance theory has relied on the capital markets pricing model in helping to determine the viability acquisitions. This model considers the method of payment used in the acquisition as a key variable. For an acquisition to be viable, the proposed acquisition must generate returns that exceed all costs, including the acquiring company's cost of equity capital. Companies that generate actual returns exceeding the return predicted by the model would be better served using cash as the payment mechanism while other firms would be better served using stock.

Occasional short-term inefficiencies in recognizing and correctly pricing the future may result in stock prices that appreciate beyond the long-term rational price that valuation analysis would warrant. As rational assessors of information, top managers inside these companies are aware that this over-valuation is occurring and recognize as per the capital asset pricing model that they have the opportunity to use their stock as currency to buy more fairly valued assets. High P/E firms are thus often able to 'buy' growth by using stock as a currency in acquisitions.

A perfect example of this phenomenon was JDS Uniphase (JDSU) during the stock market bubble of the late 1990's. JDSU engaged in many acquisitions which were financed with stock, which at its peak stock price in March 2000 was worth 146 dollars per share; while more recently, the stock has sold for less than 2 dollars per share. With the telecom crash and the bursting of the Nasdaq bubble, many of these acquisitions ended up being non-performing assets and had to be written off as goodwill on the accounting statements. The impact was so severe that in the last quarter of 2001, JDSU was indicating a trailing 12 month loss of over 51 dollars per share (for a stock that has recently traded under 2!).

RATIONALES FOR DIVESTITURES AND SPIN-OFFS

Managers of firms that straddle industry classifications often face pressure to focus on a "core" business and divest the other businesses, in order to be "better understood" by investors and analysts. Investors often find it easier to invest in a more transparent company with focused assets, (sometimes referred to as 'pure-plays' on Wall Street). They are more certain of how to value such assets. Zuckerman (1999), as just one example of research in this area of finance, showed that industry specific analysts are unable to correctly value a firm that operates in multiple industries and that this can lead to less coverage by analysts and reduced demand for the stock. He called the resulting loss in market capitalization for the firm the 'illegitimacy' discount as people shy away from products that are not legitimized by industry analysts.

Firms will divest assets to avoid the stock market valuation problems created by having these unrelated, non-core assets. In strategic management terminology, this can be viewed as the equivalent of a negative synergy effect. Whereas synergy is classically defined by the phrase that

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

'the whole is worth more than the parts', the rationale here is exactly the opposite and might be phrased as 'the parts are worth more than the whole'. If synergy is reflected mathematically as 2+2=5, the decision to divest is reflected as 5=2+4. Divestitures can be focused, broadly speaking, on increasing shareholder value in either of two ways as shown below.

Divest non-core assets to recognize the real value of those assets. To unlock value of 'hidden' assets that have intrinsic value not being recognized by the financial markets, companies will often divest (more prominent assets will often be spun-off to shareholders with an initial IPO as well). As an example, there's the cases mentioned earlier in the paper of Barnes and Noble and Toys-R-Us where the sole motivation for spinning off the online businesses was to release the 'hidden' asset value of the spun-off assets. Investment banking firms were known to have "pitched" spin-off ideas by using comparable multiples analysis (relevant comparisons being Amazon and Etoys). Comparable multiples analysis is a finance technique for doing valuation analysis that simply compares "similar" companies/assets to one another and sees what PE ratios and stock prices are being rewarded to competitors (Rolfe and Troob, 2000).

Divest non-core assets in order to fully recognize the real value of core assets. When Target divested its smaller Marshall Fields and Mervyns assets, the purpose was not to raise cash or unleash the value of those assets for shareholders. The analysts made it clear that the benefit to Target would be in the ability of investors to more cleanly compare Target's superior performance against that of its primary competitor, Wal-Mart. Deutsche Bank analyst Bill Dreher had a very positive opinion of the divestitures noting that "now it will be a pure play in the discount stores segment. There will also be a clean discount-store story of Target to Wal-Mart (Waters, 2004)." Basically, while Target owned the other two department store franchises, its financial numbers were on the surface indicating a lower level of performance in terms of the discounter segment than was actually being achieved.

CONCLUSION

The focus of this paper has been to provide strategic management scholars and educators with additional perspective that they may not otherwise have had. By so doing, we hope to help promote a dialogue on the extent to which strategic management courses acknowledge the influence of the financial community in the strategy formulation process and whether we can do a better job in integrating that perspective.

A sampling of prominent textbooks from the field of strategic management shows that, as can be expected, the textbooks place great emphasis, on the key roles of customers, competitors and suppliers as important stakeholder groups; however, they do not adequately and explicitly acknowledge the key role played as well by the financial community as stakeholders who have a great deal of influence on the strategic decision making process. This paper's sampling of textbooks also looked at how the textbooks address the key corporate level strategic decisions of acquisition

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

and divestiture and have once again similarly found the textbooks lacking. In contrast to textbook discussions on these topics, we have also identified various prominent financial theories and rationales which are relevant in real-life decision making and which we believe can be expected to be relevant in strategic decision making.

We believe that these omissions in strategy texts can be understood best in the context of differing perspectives. It is a matter of whether one views increasing shareholder value as the primary target of the strategy formulation process or as a secondary byproduct of a process that is otherwise focused on improving the organization's long-term efficiency and effectiveness.

In strategy textbooks and classes, it is often a taken for granted assumption that shareholder value can only be changed as a result of creating better and more well-conceived strategy. Strategic management largely emphasizes the asset side of the corporate balance sheet, focusing on the firms as a collection of operational assets competing in a product or service market. As an example, a primary theme shared across all strategy texts in their corporate strategy discussions is a focus on the very important topic of relatedness. Since Rumelt (1974), all strategy researchers have recognized the importance of this concept and its ability to explain diversification in terms of a rational motivation to share knowledge/skills between business units. Implied is the assumption that relatedness benefits will produce shareholder value. Hence, shareholder value is a natural byproduct of a well-formulated and properly implemented strategy; but it is never the direct concern of strategic thought. It is simply correlated with successful strategy that provides the 'greatest good for the greatest number' of stakeholders.

Conversely, practitioners in the financial community clearly do not see shareholder value as simply a desirable byproduct of a long-term strategy focused on organizational betterment. For financial community practitioners, shareholder value is the primary dependent variable and all their actions are motivated towards increasing shareholder value. Therefore, real-world financial community experts recommend strategies to firms solely based on expected capital market reactions. The fact that firms respond to these recommendations is a reality not recognized in strategic management texts. On the extreme, this capital markets focus can become so dominant a concern as to cancel all other more 'rational' considerations from view. Berkshire Hathaway Inc., headed by CEO Warren Buffett, noted this problem in its 2003 Annual Report when it stated in its letter to the shareholders:

> "A more common problem is a shareholder constituency that pressures its manager to dance to Wall Street's tune. Many CEO's resist, but others give in and adopt operating and capital-allocation policies far different from those they would choose if left to themselves."

In a professional setting like business and especially in the context of strategic management, teachers must descriptively prepare students for the practitioner's reality as well as to try to

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

prescriptively influence thought and behavior for the future. Strategy textbooks are not wrong if they focus on management theories and recognize finance as far as it concerns financial measurement tools, but they appear to be incomplete in not recognizing the importance of the financial community in corporate strategy decisions and not attempting to explain to students the attendant rationales. Strategic management's "story validity" can be improved by integrating the research results of both management and finance into the textbook treatments of the subject matter (Cameron, Ireland, Lussier, New, & Robbins, 2003).

In terms of both scholarship and teaching, it is essential to recognize business reality as it exists and not as we would like to see it. Competing theories may be complementary in their application, and an understanding of financial market influences on corporate strategy will help us to understand and improve on that reality.

REFERENCES

Ansoff, I. (1980). Strategic issue management. *Strategic Management Journal*, 1: 131-148.

Benesh, G. A., & Peterson, P. P. (1986). On the relation between earnings changes, analysts' forecasts and stock price fluctuations. *Financial Analysts Journal*, November-December: 29-39.

Brady, D. (2000). How Barnes & Noble misread the web. *Business Week*, February 7, 2000, 63.

Byrnes, N. (1999). Internet anxiety. *Business Week*, June 28, 78-82.

Cameron, K.S., Ireland, R.D., Lussier, R.N., New, J.R. & Robbins, S.P. (2003). "Management textbooks as propaganda," *Journal of Management Education*, 27(6): 711-729.

David, F. (2003). *Strategic Management: Concepts and Cases,* 9th ed. Upper Saddle River,NJ: Prentice Hall.

DeBondt, Werner F.M. (1995). "Investor Psychology and the Dynamics of Security Prices." In *Behavioral Finance and Decision Theory in investment management: Proceedings of the AIMR seminar, Improving the investment decision making process: behavioral finance and decision theory*. Edited by Arnold S. Wood. Charlottesville, VA: Association for Investment Management and Research, April 4, pp. 7-13.

Donaldson, T. & Preston, L.E. (1995) 'The stakeholder theory of the corporation: Concepts, evidence, and implications', *Academy of Management Review*, 20(1), 65-91.

Dutton, J. E. & Duncan, R. B. (1987). The creation of momentum for change through the process of strategic issue diagnosis. *Strategic Management Journal*, 8: 279-295.

Dutton, J. E., Stumpf, S. & Wagner, D. (1990). Diagnosing strategic issues and the investment of resources. In R. Lamb & P. Shrivastava (Eds.), *Advances in Strategic Management*, 6: 143-167. Greenwich, CT: JAI Press.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Elton, E.J., Gruber, M.J. & Grossman, S. (1986) 'Discrete expectational data and portfolio performance', *The Journal of Finance*, 41(3), 699-714.

Elton, E.J., Gruber, M.J. & Gultekin, M. (1981) 'Expectations and share prices', *Management Science*, 27(9), 975-987.

Freeman, R.E. (1984) 'Strategic management: A stakeholder approach', Pitman, Boston.

Ginsberg, A. & Venkatraman, N. (1992). Investing in new information technology: The role of competitive posture and issue diagnosis. *Strategic Management Journal*, 13: 37-53.

Hamilton, Diane, McFarland, Dan & Dilip Mirchandani. (2000). A decision model for integration across the business curriculum in the 21st century. *Journal of Management Education*, 24(1): 102-126

Herper, Matthew. (December 20, 2004). "JNJ-Guidant Vs. Boston -Scientific-St. Jude" Forbes.com.

Hill, Charles W.L. & Gareth R. Jones. (2004). *Strategic Management: An Integrated Approach,* 6th ed. New York: Houghton Mifflin Company.

Hitt, Michael A., Ireland, R. Duane & Robert E. Hoskisson. (2005) *Strategic Management: Competitiveness and Globalization,* 6th ed.. Mason, OH: South-Western.

Ho, M.J. (1995) '*The market reaction to security analyst recommendations*', Unpublished Doctoral Dissertation, Colgate Darden Graduate School of Business Administration, University of Virginia.

Imhoff, E.A. & Lobo, G.J. (1984) "Information Content of analysts' composite forecast revisions," *Journal of Accounting Research*, 22(2): 541-554.

Jenson, Michael & William Meckling. (1976). Theory of the firm: Managerial behavior, agency costs, and ownership structure, *Journal of Financial Economics* 3, 305-360.

Kuperman, Jerome C., Athavale, Manoj & Alan Eisner. (2003). Financial analysts in the media: Evolving roles and recent trends, *American Business Review*, 21(2): 74-80.

Kurtz, Howard. (2000). *The Fortune Tellers: Inside Wall Street's Game of Money, Media, and Manipulation*. New York: Free Press.

Mateyaschuk, Jennifer, (1999). Banesandnoble.com IPO a best seller. *InformationWeek*, May 31, 1999, 16.

Mitroff, I. (1983). *Stakeholders of the Organizational Mind.* San Francisco, CA: Jossey Bass.

Moyer, R. Charles, Chatfield, Robert E. & Sisneros, Phillip M. (1989). Security analyst monitoring activity: Agency costs and information demands. *Journal of Financial and Quantitative Analysis*, 24(4): 503-512.

Porter, M. E. (1980). *Competitive Strategy: Techniques for Analyzing Industries and Competitors*. New York: Free Press.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Rolfe, John, & Troob, Peter. (2000). *Monkey Business: Swinging Through the Wall Street Jungle*. New York: Warner Books.

Rumelt, R.P. (1974). *Strategy, Structure, and Economic Performance*, Boston: Harvard Business School.

Schneider, M. & Lieb, P. (2004). "The challenges of teaching strategic management: Working toward successful inclusion of the resource-based view," *Journal of Management Education*, 28(2): 170-187.

Sharpe, W. F. (1964). "Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk," *Journal of Finance* 19: 425-442.

Stephen, J. Parente, D.H. & Brown, R.C. (2002). "Seeing the forest and the trees: Balancing functional and integrative knowledge using large-scale simulations in capstone business strategy classes," *Journal of Management Education*, 26(2): 164-193.

Stickel, S.E. (1991) 'Common stock returns surrounding earnings forecast revisions: More puzzling evidence', *The Accounting Review*, 66(2): 402-416.

Thompson, Arthur A. Jr. & Strickland, A.J. (2003). *Strategic Management: Concepts and Cases,* 13th ed. New York: McGraw-Hill Irwin.

Waters, Jennifer, (March 11, 2004). "Target may sell Marshall Field's, Mervyn's". CBS.marketwatch.com/news/print_story.asp

Wheelen, Thomas L. & J. David Hunger (2004) *Strategic Management and Business Policy,* 9th Ed. Upper Saddle River, New Jersey: Prentice-Hall.

Zuckerman, E. (1999). 'The Categorical Imperative: Securities Analysts and the Illegitimacy Discount', *The American Journal of Sociology*, 104: 1398–1438.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.