

STOP OBSESSING ABOUT THE NEXT BLACK SWAN AND INNOVATE

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Financial models have been hailed as the ultimate investor and management tools for decades but may have lost some of their shine following the unpredicted crisis and the onset of an "innovate or die trying" paradigm.

Financial modelling is done by companies, investors and financial intermediaries in the context of investment projects. Financial forecasts are used by management teams to ensure that a project's returns are adequate and that all the critical aspects have been covered. Financial intermediaries use financial models to decide whether, for instance, a loan should be extended to finance a project or an acquisition.

The popularity of financial models has grown in line with the increase and easier access to data. Modelling the complex reality of an investment project (or an acquisition) makes it easy for everyone involved to understand the critical drivers. In doing this, the analysts behind the models use a minimum number of assumptions that are supposed to capture the key elements of the project or the company being analysed. This is an appealing concept which often leads to dangerous simplifications.

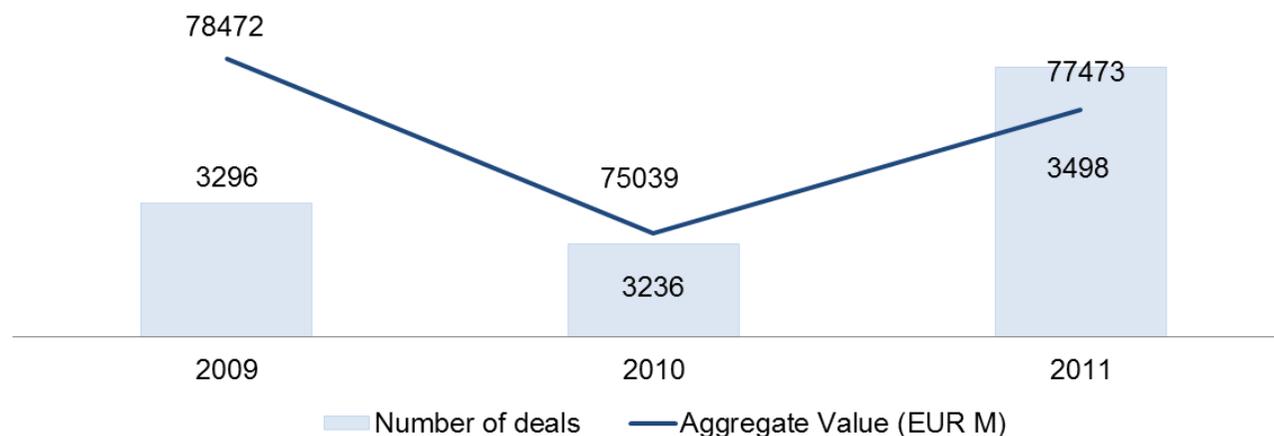
In the case of innovative projects, there are various drawbacks to building financial models and forecasts to support an investment decision. Innovation (and in particular disruptive innovation) is tough to measure. Either the market does not exist or the company's cost structure is changed in a profound way. Models usually lack the flexibility to reflect the changes that take place when a company innovates. Many innovative projects are abandoned due to the inability to show their benefits in a financial model.

Financial models can also give a false sense of stability to a company's management team. Even in the absence of innovation, the current economic and even political conditions make it difficult to use financial models as a tool to predict future developments. What happened in Europe since 2007 was unprecedented and strategies that assume that market conditions will be stable in coming years may be a recipe for disaster. Reality will be more volatile and the conclusions that result from a financial model always depend on the validity of assumptions (often time series). If these are wrong or change over the projection period, conclusions will no longer hold.

In reality, few companies manage to build perfect forecasts or make steady profits over a number of years. Even established companies experience unexpected changes in their markets. Strategy must take into account these fluctuations, which can result from demography, technology, competition or any other market factor. Addressing innovation - whether on an incremental or disruptive level, looking for it in-house or on the market - is increasingly a matter of survival.

This has obvious implications for M&A situations. Acquisitions can happen for a number of reasons. Usually the acquirer is looking to increase size, obtain synergies and economies of scale. In other cases, the target company is an innovative firm acquired by a larger rival. The chart below shows that acquisitions of small and mid-sized European companies in the Telecom, Media and Technology sectors (by larger acquirers) have been steady since 2009, which confirms that we are dealing with a long-term trend which has proven resilient to the crisis. Larger businesses are interested in smaller, innovative companies which provide the top line growth which they often lack.

ACQUISITIONS OF EUROPEAN TELECOMMUNICATIONS, MEDIA AND TECHNOLOGY COMPANIES WITH REVENUES <EUR 100M BY LARGER FIRMS ⁽¹⁾



Source: Bureau van Dijk Zephyr, March 2012.

(1) Data for all targets located in Western Europe in the technology, media and telecommunications sectors with revenues < EUR100 M acquired by companies with revenues > EUR500 M, between 1 January 2009 and 31 December 2011

Acquiring smaller innovative companies offers various advantages from the perspective of larger, more established companies: breaking into a new market, gaining access to new technology. In these cases, the financial model that supports the decision to acquire should include not only the returns from the transaction but also the positive impact of the target's integration. These aspects are difficult to measure and a number of acquisitions do not reach a conclusion as a result of the acquirer's inability to quantify these positive outcomes.

Management teams, banks and investors may have relied too much on soothing financial models and management metrics and may have taken unintended risks. No-one questions the importance of using good numbers to take business decisions, but it can be argued that complicated quantitative models did not prevent European banks and investors from taking substantial and unwanted risks in the years that preceded the financial crisis.

What the crisis has shown is that European companies need to innovate to thrive. Investors and banks in Europe will benefit from supporting innovative companies (their US counterparts already do) and while financial models provide a good basis for discussion, overall their credibility is questionable. We can only hope that innovative companies will find a way to finance themselves without being too constrained by spreadsheets.

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