Investment strategies of Polish large construction companies – selected theoretical and practical problems

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Abstract

Formulation of an investment strategy and implementation of an investment policy in a construction company need to have an objective. There may be a number of reasons for investment. The key objective for a modern enterprise is to maximize value. Investment is crucial for a company to be able to expand and stay competitive. Consequently, these issues are so important for today's construction companies. Therefore, the aim of this paper is to discuss all these issues, based on the examples of the leading construction companies in Poland, as these entities can afford to invest in many directions and at many stages. The risk factor is also taken into consideration here.

Key words

Investment strategy, contractors, real estate, construction project, risk

1 Introduction

A company's development strategy is implemented through investment. It should be emphasized, however, that investment may be carried out in many directions. Companies can invest in numerous assets. Shareholders will not be satisfied unless they increase their wealth. That's why they will be interested in keeping the company in business, and the key objective that they will outline within their selected strategy will be maximising company value. In practice, it's shareholders i.e. owners of companies, who specify the basic objectives of their companies, and management boards are obliged to meet these objectives. When deciding upon the strategic objectives, shareholders will obviously aim at generating benefits in form of dividends. It should be noted that risk should always be taken into consideration when formulating an overall strategy. It's particularly important, when construction companies are operating in the conditions of the financial crisis and when, quite often, their only objective is to survive. In 2009, such companies aren't investing at all or are investing only when and if it's absolutely necessary, which means a stagnation strategy, i.e. in Poland, most of contractors have chosen such an approach. In the period before the crisis, however, contractors in Poland had carried out numerous investments. Nevertheless, every crisis has to end one day so these companies will start to invest largely in the future again. Therefore, the aim of this paper is to discuss all these issues, both in theoretical and practical terms. The author's deliberations are also connected with the problems of risk, since risk is an inherent element of investment activities conducted by construction companies.

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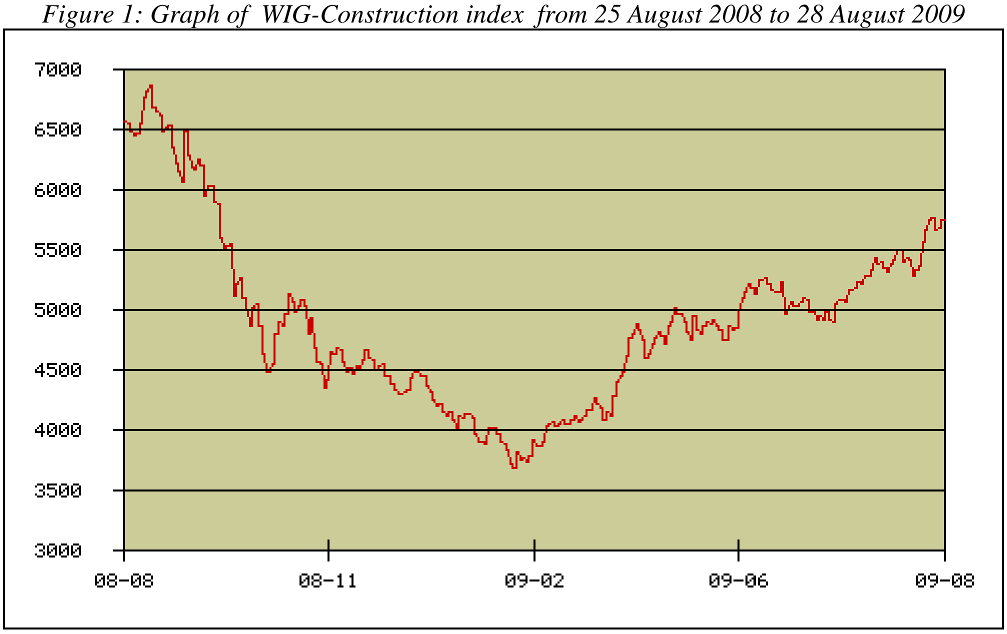
2 Creating value as a main aim of formulating the construction company's investment strategy

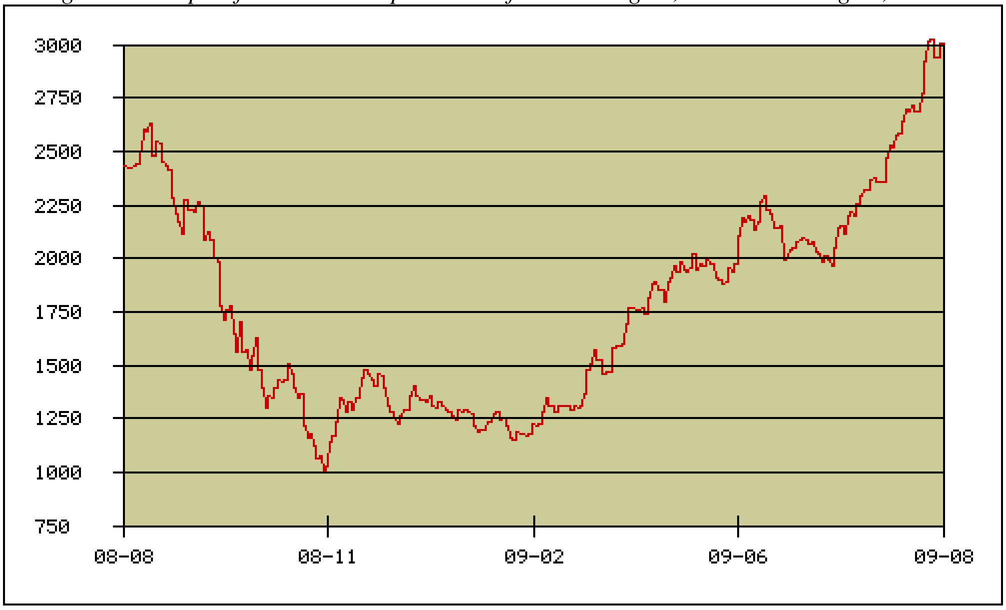
In theory and in practice alike, creation of company value is regarded as „the key financial aim of a company, and its maximizing is tantamount to increasing owners' wealth"[1]. The most typical manifestation of the increase in the company value is an increase in its share prices on a stock exchange. (In Poland, there are currently 29 strictly construction companies quoted on the Warsaw Stock Exchange, and they are covered by so-called WIG-Construction (WIG-Budownictwo) index. The same abbreviation of WIG means Warsaw Stock Exchange Index (Warszawski Indeks Giełdowy). WIG-Construction is included in so-called industry indexes and this is a value based on valuation of shares of construction companies quoted on the stock exchange. Looking at figure 1 we can see that share prices of quoted construction companies have gone down throughout the recent year i.e. in the period from 25 August, 2008 to 28 August, 2009 the index went down. It should also be added that there is WIG-Developers (WIG-Deweloperzy) index in Poland, which comprises 17 developer companies. In practice, developers' activities cover complete execution of construction projects, i.e. there are mainly three types of developers in Poland now, namely developers-investors, developers-service providers and developers-contractors. Furthermore, investing into the real estate market should be looked upon as an integral part of the construction market. Currently the situation of developers in Poland is far from good, due to the economic crisis. As a result of the recession, prices of shares covered by the WIG-Developers index went down dramatically in the period from 25 August, 2008 to 28 August, 2009. The graphs showing both these indexes are shown on figure 1 and figure 2.

Figure 1: Graph of WIG-Construction index from 25 August 2008 to 28 August 2009



Source: [6]

Figure 2: Graph of WIG-Developers index from 25 August, 2008 to 28 August, 2009



Source: [7]

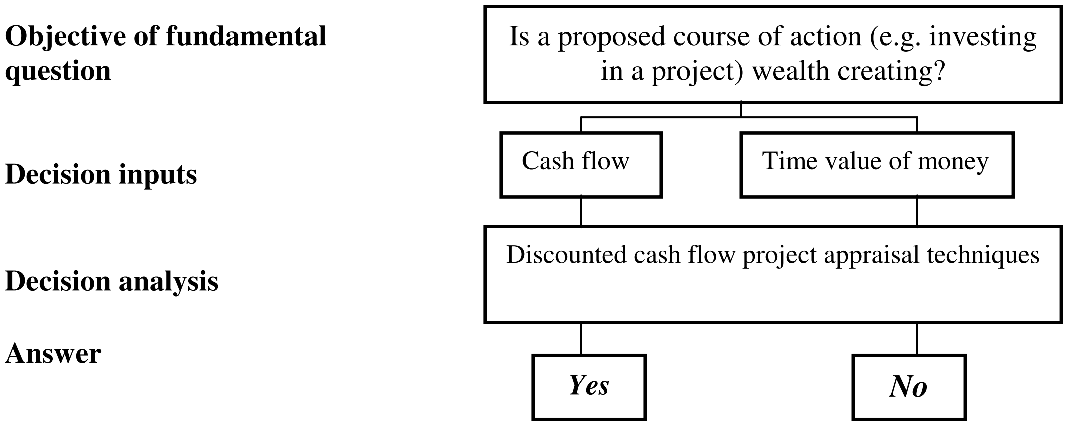
Figure 1 and figure 2 indicate the time when the downturn in the construction industry and the real estate market started in Poland. It's assumed that this happened at the beginning of the third calendar quarter of 2008. „Despite a slump in the economy, the construction sector achieved better growth indicators in 2008 than industry and retail, and the same in early 2009 when the construction sector saw a (slight) increase, while both industry and trade saw a drop"[2]. All in all, in the period of time surveyed, the global value of construction and developer companies in Poland went down.

In broad terms „the company value is built by maximizing generated cash inflows"[3], as well as „creating foundations for added value, which may be defined as a surplus of discounted cash flows over liquidation value"[3]. According to this, a construction company should earn maximum possible income and generate so-called Economic Value Added (EVA), which is now the basic measure of company value and is applied in valuation and appraisal processes worldwide. The essential thing when calculating this value is the operating profit made by the construction company and the price paid for the ability to use the capital, i.e. expressed by WACC. When determining the investment effectiveness, WACC reflects the value of the discount rate, which is taken into account when calculating NPV (Net Present Value) as a primary measure used in financial appraisal of projects. If NPV $\geq$ 0, the project is regarded as viable, and the decision to implement it will contribute to an increase in the owners' (company's) wealth. Hence, the formula:

$$NPV = \sum_{t=1}^{n} \frac{EVA_t}{(1+WACC)^t}$$

where EVA_t means the economic value added, created by the project in a given period of time called *t*. This formula represents a very simple relationship, i.e. the net present value (NPV) of the project equals the updated EVA to be achieved in the future. It's basically the successful investment decisions taken by companies that contribute to the increase in the owners' capital and wealth to the largest extent. Figure 3 should be analysed in this respect.

Figure 3: Investment appraisal: objective, inputs and process



Source: [4].

In broad terms, Fig.3 presents value creation through investment. A particularly important thing here are cash flows generated by projects. This is a key issue when measuring investment effectiveness. However, if the feasibility studies show that the cost of the project is going to exceed the income generated by the project, the investor will make a loss. In other words (in the updated approach) cash outflows (COF) will exceed cash inflows (CIF), i.e. we have the inequality of COF > CIF. As emphasized by R.A. Brealey, S.C. Myers, A.J. Marcus „[…] the net present value rule states that managers increase shareholders' wealth by accepting all projects that are worth more than they cost"[5]. Besides, „if a project has zero NPV when the expected cash flows are discounted at the weighted-average cost of capital (WACC), then the project's cash flows are just sufficient to give debtholders and shareholders the returns they require"[5].

3 Investment strategies in Polish construction companies and their basic types

Owners of construction companies will be interested in determining such assumptions within a global strategy that will maximise value, and an appropriate investment strategy is a means to that end. Its implementation results in concrete projects undertaken by the company. Investment projects determine the growth of companies. Therefore, key decisions taken by the company must comply with the general principles of the investment strategy the company follows. „All projects within corporate development strategies should be analysed in three basic dimensions:

- the macroeconomic dimension, taking into account globalisation of economies, which is international relations affecting the entire domestic economy and its transformation aimed at establishing and improving market mechanisms; on the macroeconomic scale, these relations determine the overall economic, technical, organisational and legal frameworks for operation of business entities in all sectors of the economy,
- the mesoeconomic dimension, which is the dimension of a given sector of the economy and possible policy carried out by the government in this respect,

- the microeconomic dimension, which means strengths and weaknesses of individual companies in their competitive environment"[8].

„A company's strategy is mainly determined by the product/market relationship, meaning the existing one/the new one, and related actions of:

- market penetration and possible increase of the market by launch of a new product offer,
- horizontal, vertical and lateral diversification of production programs (manufacturing of products, provision of services),
- functional areas, e.g. sale of products, manufacturing, research and development, investment, finance, human resources issues,
- cost leadership, differentiation of products and services, sectoral concentration,
- offensive approach, encouraging investment or stabilisation, or withdrawal (reducing production, services) leading to divestment in a company"[9].

It should be noted that no strategy can be implemented without ensuring appropriate finance. Therefore, „an investment strategy specifies projects to be funded with the capital collected by a company"[10]. Companies raise funds on the capital market, which are then allocated for investment. Therefore, there may be different sources of financing for projects in a construction company. For instance, in Poland they may issue corporate bonds in order to acquire funds for implementation of their investment policy. (Similarly, some municipalities and communes in Poland choose to adopt such solutions and Poznań, for example, issued their municipal bonds for the total amount of PLN 500 million). In this context, we can talk about financing strategies, but both these strategies need to coexist. In broad terms, „an investment policy is defined as a framework for investment decisions to be taken and implemented in a company"[11]. H. Towarnicka distinguishes two basic stages of an investment policy, i.e.:
„STAGE I: Formulation of an investment policy, which comprises:

- defining and prioritising investment needs - specifying reasons for and objectives of investment in connection with the company's strategic goals,
- identifying potential financial possibilities of one's own company, as well as external ones (analysis of the capital market and the structure and the cost of the company's financial capital),
- negotiating and acquiring financial, material and performance resources,
- specifying a target investment policy,
- formulating investment strategy options and their interrelationships within the overall strategy of the company (including investment choices, taking into account the cost-benefit analysis and non-economic criteria),
- developing investment project versions,
- selecting the future investment strategy"[12];

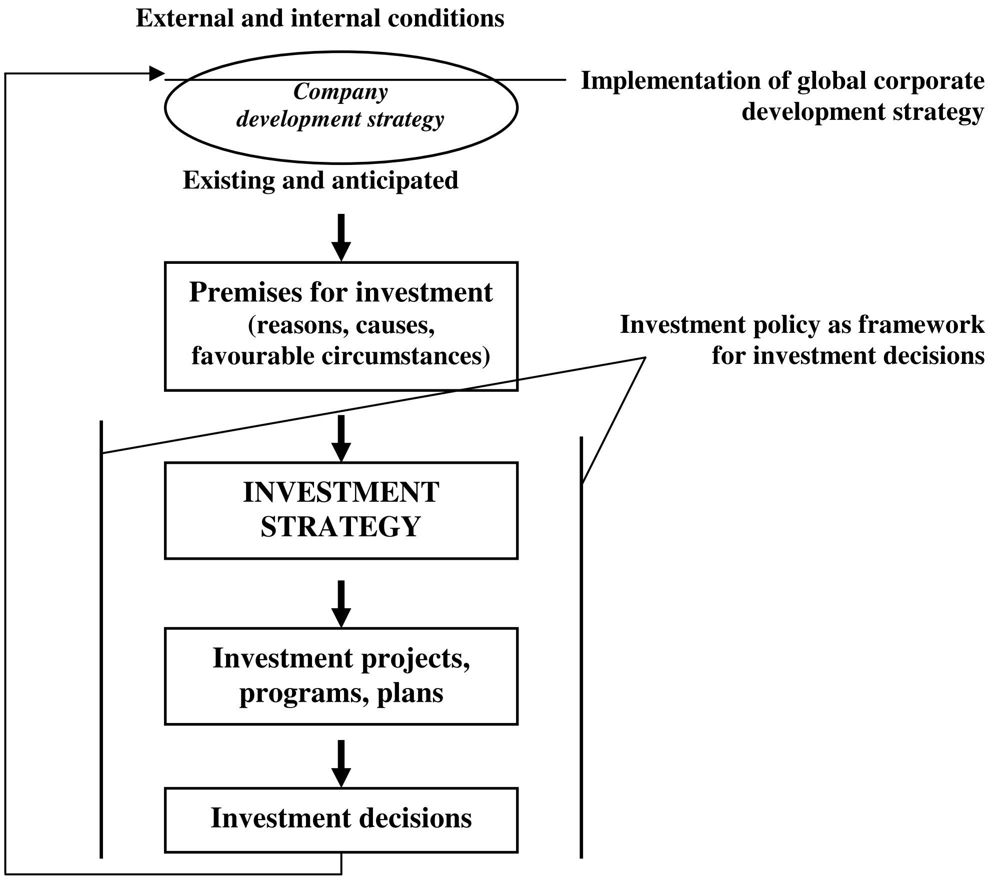
"STAGE II: Implementation and possible modification of the investment policy, which comprises:

- taking an investment decision,

- implementing the accepted investment strategy (including controlling, a guarantee system, partial acceptance, supply marketing, transactions on the capital market etc.),
- if needed, developing another investment version and its implementation procedure under new conditions"[12].

This is illustrated on figure 4.

Figure 4: Idea diagram: strategy - investment policy - investment planning



Source: [11].

Figure 4 shows the relationships between an investment strategy, an investment policy and investment decisions taken by a company. A development strategy is implemented through the accepted investment policy, which is then carried out through investment projects, based on the methodology of project planning, implementation and evaluation. All this takes place against the background of the construction company's environment. Figure 4 shows also the division into various investment strategies which, in turn, are described in more detail in table 1.

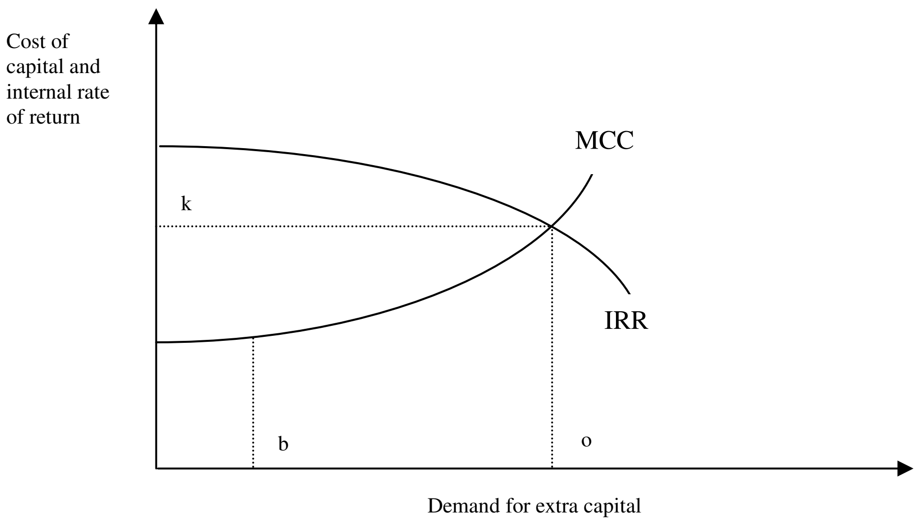
Type of strategy	Attitude to operational risk	Scale of investment
Expansion strategy	High risk accepted	Implementation of numerous investment projects highly exceeds the value of depreciation charges **(depreciation < investments)**
Moderate development strategy	Risk limited	Investment expenditure for such an activity which ensures high gains in short time; it's most frequently assumed that an amortisation fund determines the level of investment **(depreciation = investments)**
Stagnation strategy	Risk minimised	Minimum investment expenditure or even sell-off of the company's fixed assets **(depreciation > investments)**

Table 1: Strategy and investment activity

Source: [13]

As can be seen in table 1, not only does it show the division into three basic types of strategies which are most frequently implemented in a construction company, but it also takes into account the company's owners' attitude to risk. In particular, in a company where the owners accept high risk, an expansion strategy will be implemented, which means investment on a large scale, by creating a portfolio of projects and, then, managing them. The situation will look quite differently for a contractor which is unwilling to take a risk. In such a company there's little investment and, consequently, little risk (due to lack of investment). All that's affected by availability of potential sources of capital to fund the company's development program. It should be noted that such programs tend to be financed by a number of sources at the same time. An optimal investment program will be a program covering all the projects where the Internal Rate of Return (IRR) is higher than the cost of capital needed to fund these projects (WACC) [14], which is presented on figure 5.

Figure 5: Selection of an optimal investment program



Source: [14].

The internal rate of return (IRR) is one of the basic measures of effectiveness of projects and it reflects the return on a given investment (expressed by percentage). In particular, this is such a value of a discount rate for which the NPV of a project equals 0. This means that the construction company's development program should be based on implementation of the projects located on figure 5 above the intersection of the IRR curve and the MCC curve which, in turn, shows the demand for employing extra capital. „An optimal investment program, from the point of view of the accepted selection criterion (maximization of company value) is the one marked by the intersection of the IRR curve and the MCC curve"[14].

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Summary

As any other businesses, construction companies also carry out investments aimed at e.g. enhancing competitiveness of these entities. Innovation may lead to a competitive advantage and ensure a success, i.e. attracting new orders for implementation of projects in the construction sector. Furthermore, shareholders (owners of these companies) want to gain benefits in form of dividends. That's why an effective investment policy (strategy) is needed to meet these goals. All these issues are analyzed in the paper. In particular, it aims at discussing the problems related to formulation of investment strategies in leading construction companies in Poland. The article deals with these issues from a theoretical perspective but also in terms of some practical solutions.