new rules for strategy and planning

In efforts to survive fundamental dislocations in the economy, companies are shifting from the goal of all-out growth to an operational philosophy emphasizing strenghened cash flows and rock solid balance sheets. Smart management thus is taking a long, hard look at the...

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The "cash crisis" faced by many companies in the latter par of 1975 has abated, and businesses are turning their attention away from problems of survival toward more welcome problems such as expansion and growth in an economy that seems to be on the upturn. Unfortunately, overdue rethinking of business strategy and planning remains undone in many cases.

Some of the fundamental conditions that set the stage for the difficulties of 1975 also remain. In a sense, recent unpleasant experiences were really only symptoms of more fundamental problems that were present prior to 1975 and, to a great extent, persist today. The gathering strength of the economy has provided breathing room for perceptive companies to reexamine their business strategies and planning.

Fundamental economic dislocations continue to have profound implications for business. In the growth toward a trillion-dollar economy, price-earnings ratios of stocks soared, balance sheets became more and more leveraged, and increased consumption was underwritten by a confluence of factors including negative trade flow, deficit spending, and underpricing of products by companies to gain market share. Growth was the central thrust of strategy and planning —growth in sales, earnings, and earnings per share.

Toward the end of this period, business attempted to maintain performance by accepting greater and greater risks, thereby increasing the instability of earnings at a time when economic fundamentals in themselves were becoming less stable.

Need for strategic belt tightening

These conditions, among others, set the stage for the business uncertainty of the mid-1970s in which the earlier planning frameworks dedicated to growth proved inadequate and dangerous. Volatile interest rates, persistent inflation, a flattening in real-income growth, deterioration in consumer confidence, and the more pronounced hand of government in business created an environment of business instability in which the flaws of the earlier period have been highlighted. Unstable profitability and deterioration in businesses' ability to attract capital have been two of the unfortunate results. Increased capital requirements to finance inventories and receivables have outstripped the cash throw-off from base businesses. The new reporting rules requiring profit adjustment for inflation must also be considered.

Because ofthese problems, companies in all industries have been forced to reevaluate their strategies and planning. Much has been said about the necessity for belt tightening in industry, and it is an appropriate subject for management attention. For strategic planning, however, the focal point is a diminution in importance of the income statement and a resurgence of concern for the cash-flow and balance-sheet statements as mechanisms for guidance and control of the development of the business entity. Stockholders and other sources of capital have found new interest in these statements as well. Earnings without cash flow are suspect; high balance-sheet leverage that leaves little borrowing cushion and places significant debt-servicing requirements on the corporation further compromises the corporation's sability to raise capital.

Cash- flow benefits vs. profits

In an economic environment in which sales are uncertain, profits are uncertain, the ability to roll over short-term notes at predictable rates is uncertain, and the prospects for raising additional capital from equity and long-term debt markets are poor or the penalty for such actions is unacceptable, businesses are inevitably pushed toward a more self-sufficient stance in their ability to survive and grow. This is being manifested in two ways:

Balance sheets are being strengthened. Companies are attempting to reduce their working-capital needs and are reducing their dependence on short-term debt. They are also attempting to revise the long-term trend of increasing debt as a proportion of the capital structure of the firm.

Corporate strategies regarding acquisition, growth, and divestiture are becoming attuned to cash flows rather than profit flows. Companies are reluctantly accepting the premise that their intermediate term opportunities for growth will be based largely on their ability to finance new business from internally generated cash flows. This will inexorably lead to revised corporate objectives regarding cash flow, growth in sales, net worth, profit, and earnings and to acceptable levels of returm on equity and invested capital.

Growth in the new strategic framework will be limited to essentially an average rate equal to or below that of the return on equity for the corporation as a whole. During a period of balance sheet upgrading the rate growth will be significantly lower. This may have significant strategic ramifications for the corporation, particularly where a corporation participates in businesses that have a rate of growth above its return and competes with companies that can provide capital to sustain market share. The kind of growth will also be important to understand, as the impact will differ by type of business. The growth can be real, inflation-based, or, more likely, a mixture.

Determining "true" financial characteristics

The charts following outline how the future cash and profit characteristics of different businesses can differ under different assumptions of growth. Basically, capital-intensive businesses producing homogeneous products (Case B) can be better cash generators during infationary periods than highly leveraged low-value-added businesses (Case A). The example makes no provision for replacement of initial plant and equipment. Obviously, in an actual situation, plant and equipment replacement would run at various levels depending on actual life of the plant and equipment and the inflation rates. Business A and Business B will also have different impacts on the corporate balance sheets over time.

Most corporations have a mix of businesses, and the analysis og businesses A nad B points up that the different cash, profit, risk, and capital requirements and the competitive environment for each separate business within the corporation necessitate that each be treated individually in any overall strategic plan. Some businesses should obviously be force-fed capital, while others should be milked.

The determination of the true financial characteristics of the individual businesses must be done, however, before any strategy decisions can be made.

The previous analysis of businesses A and B was presented as if each were a separate corporation. Evaluation of businesses within a firm on a "stand-alone" basis is more complex. The evaluation should begin with an analysis of the true cash-flow characteristics of each business. This cash flow should be calculated after all expenses, both those relating directly to the subject business and those that are borne by corporate. This means that dividends, interest on long-and short-term debt, corporate management and staff overhead, debt payback, corporate liquidity requirements, and all other expenses required to function and provide support for the individual business must be taken into account.

Operating managers usually will resist this allocation procedure, but it is absolutely necesary it a clear picture of the stand-alone cash flow of the individual businesses is to be determined. Similary, corporate managements are reluctant to allocate corporate costs because they believe that it can be damaging to line support of central functions. Nevertheless, corporate expenses must be justified in some way or judged unnecessary for the business enterprise. This cash-flow analysis should address the cash impact not only for the base stand-alone business but also for incremental or decremental sales. In some cases, it is dramatically evident that commitments to further growth, even viewing incremental profits, will lead to unsupportable cash demands.

Reallocation of assets

This analysis will allow the reallocation of assets and rechanneling of cash flow in a way that best realizes the goals the firm concerning issues such as dividend levels, profit levels, and cash-flow levels, now and in the future. Asset reallocation will probably mean:

1. Maximizing the use of working capital through inventory and receivables management—actually squeezing more use out of funds tied up in inventories and receivables.
2. Releasing and reallocating working capital from one business to another on a one-time basis.
3. Reallocating assets from one business to another on some intermediate or long-term timetable through depreciation, use conversión, or other methods.
4. The reallocation of assets through acquisition and divestiture.

In overall corporate planning, acquisition and divestiture will continue to be a viable avenue for corporate development. The price, however, will have more relationship to the actual anticipated value of the cash flow from the existing business, hather than the value plus a "fee for entry" into a new business. Acquisitions will tend to be valued on the basis of fit within the business matrix. Companies with a substantial portion of assets in high-growth businesses will probably not be interested in acquiring a business that has the same characteristics.

Other implications

This new thrust in strategic planning will have implications in other areas as well. Diividend policies will be affected. Corporations continue to be concerned about the value of their stock as much because of their responsibility to existing stockholders as because of the effect on the firm's ability to obtain new equity capital. "Total return" has been widely discussed, and newinterest has developed in the stability and predictability of increase in the dividend. The case for an increase in the dividend must be balanced against the need for cash for reinvestment.

The firm's sensitivity to risk is heightened in a cash-oriented planning framework. The element of risk exists, of course, in every business enterprise. In an era of uncertainty such as now, however, long-term commitments are more difficult to justify. Business that have negative cash flows because of the need for reinvestment to hold position are always exposed to the risk that some discontinuity may change the fundamental profit characteristics of the business, thereby locking assets in unsatisfactory profitability when the time eventually comes for them to generate cash, as is expected of mature businesses.

The strategy of self-sufficiency

The corporate strategy of the 1970s must be developed in the light of all of these considerations and must be the composite of business strategies for each business the corporation participates in. Some businesses must be cash generators, some perhaps should be cash users, and rates of growth for the individual businesses should probably vary. Dividend levels and the planned rate of dividend increases will require careful thought by corporate managements. In all cases, they must fit together in a way that recognizes the new reality of the economic environment. That is, they must be run in a way that maximizes the self-sufficiency of the firm. It is getting late.

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