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Cash flow management and strategic responses that create corporate value: Some observations

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ABSTRACT:

The purpose of this paper is to explore the extent to which cash flow management, the value of the organisation, and strategic decision making are correlated. A cash flow model is proposed based upon four levels of strategy decisions. The business press has been monitored for a period of twelve months to find evidence of linkages between cash flow management and strategy decisions. There is sufficient evidence to suggest that a number of organisations do consider cash flow management and strategy decisions as related and that both have an impact on the value of the organisation. This project was designed to validate the notion of an awareness of the links between these important aspects of corporate decision making. The scope of the findings has been limited by the number and content of the material; however further research using case studies as a primary method of approach is justified. The evidence presented suggests a logical approach among a number of companies when seeking to increase their value. It suggests an increasing awareness of the importance of cash flow by senior management. As the concept of network based business structures expands the role of the NPV of future cash flows generated from strategic and structural decisions is likely to become the preferred measure of potential performance criteria.

KEY WORDS: ***Cash flow management, strategic and structural decisions, corporate value***

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1. Introduction

Few would argue with the proposition that managers on a day to day basis should be principally concerned with creating value. The problem however is what exactly does the term "value" really mean. It seems the word is often used on the presumption that there is some single objective standard or measure of value that everyone understands and which all companies should strive for. But is this true?

The aim of this paper is to contribute to the discussion on the importance of cash flow management in the strategy development decisions of businesses. An important aspect of globalisation has been the development of a need for *strategic flexibility*. In this context we consider *flexibility* to be the ability to respond to a wider range of opportunities, and quicker than was possible not too many years ago. The implications for manufacturing have been explored but the responses of business organisations in the context of strategic decisions present some interesting examples.

This paper assumes the notion of "value" in the context of the firm to be based upon positive cash flow. It suggests that a broader perspective is needed than historical accounting measures and looks at the operational and strategic decisions that are implicit in generating free cash flow.

2. Traditional organisational measures of value – Why profitability will no longer suffice

Key to understanding notions of value in the context of the firm is an appreciation of what the firm is and why it exists at all. At its simplest a business is operated by a sole trader. As groups of people come together to pursue common business objectives the law has over time accommodated more complex forms of organizations to facilitate this – agencies, partnerships, trusts and now most commonly the limited liability company. As a generalization the principal objective of these organizations has been to build the wealth of its owners. It is true that business organizations have other legitimate objectives and this is discussed further below, but generally for the purposes of this discussion it will be assumed that the "profit motive" is paramount.

Wealth creation has then been traditionally been reduced to money terms and measured by accounting practices and standards. As firms have grown larger owners have become increasingly simple passive providers of capital, indeed to the point where that capital is freely traded via share markets. That capital is increasingly deployed not by the owners themselves but by a class of professional managers. To protect the owner and allow him to understand what is happening to his capital these accounting measures have grown more complex as has the legal framework surrounding the operation of the firm.

While no doubt some mastery of accounting measures is a necessary prerequisite to understanding notions of value in the context of the firm, this chapter explores whether they are adequate alone. Certainly there have recently been some spectacular failures of accountancy as a reflection of underlying value – Enron, Worldcom, Tyco and others have been glaring examples where the accounting value of the company presented to its owners through audited accounts was clearly misleading. These may of course be examples of blatant manipulation and inadequate policing and accountants at least may argue that they are not inherent shortcomings in methodology.

The question remains however whether even a properly prepared and audited set of accounts tell you all you need to know about the creation of value in a company. It is suggested that other perspectives are required. As Ballow et al (2004) point out of accountancy: "Its world view was formed during a time when businesses created value through tangible resources, such as buildings, equipment, or the transformation of raw materials into intermediate and finished products. In today's knowledge-based economy, companies are much more likely to create value by using intangibles and intellectual capital resources such as proprietary processes, brands, relationships and knowledge" - none of which are adequately accommodated by traditional accounting measures.

3. P/E Ratios can be misleading

It is interesting to note that increasingly fund managers are questioning the traditional measures. For example the assumptions underlying P/E ratios are suggested to be: "a misleading simplification of a company's value and one that is too focused on short-term performance" (Eyers: 2004). Eyers cites Macquarie bank equity strategist, Tim Rocks, who argues that the: "Some of the changes in the Australian corporate landscape have driven a wedge between P/Es and other valuation of stocks." Rocks suggested these include structural forces that include cash flows that are growing faster than earnings in many companies and reductions in capital expenditure that also result in increasing cash returns. Another influence is the decrease in debt. It is argued that most of the assumptions made when assessing P/E ratios are very likely to change in the future. An interesting suggestion, made by Rocks, is to use a ratio of Enterprise Value to free cash flow as a measurement. For Rocks, enterprise value is calculated by adding debt to the market value of equity, while free cash flow is defined as operating cash flow less investing cash flow.

A focus on earnings-per-share was dismissed by Kerin (2007) who demonstrated that "Boards in acquisition mode should focus on cash and strategic logic". Kerin argues that acquisition decisions are often justified on the grounds they are "EPS accretive" – they are expected to raise the earnings per share. He produces empirical evidence to show there is; "no correlation between a deal's EFS and shareholder value", citing Bain. Kerin suggests; "Unfortunately, the high dependency of many CEO's compensation on meeting EPS growth hurdles creates incentives to make value destroying but EPS-accretive decisions and ignore value-enhancing but EPS dilutive opportunities." Examples are made of companies such as Enron and WorldCo (above) who used acquisitions to generate impressive EPS growth for years while masking poor operating performance. The impact on shareholders was well publicised! For Kerin the solution for boards is relatively simple: "Drop EPS growth as a company goal, EPS accretion as an executive compensation hurdle. Focus instead on cash and strategic logic." adding ""That'll require boards/CEOs to better communicate their strategic thinking to the market – another good reason to do it".

The foregoing paragraphs are not suggesting that profitability measures should be abandoned; rather they should be replaced in terms of priority as performance metrics. A "measure of the "returns spread" generated by an organisation, or perhaps a project, offers a valuable means of evaluating potential and ongoing performance and associated risk. Risk and return are usually positively correlated; projects offering high returns are typically accompanied by high levels of risk. A reliable measure of risk is often implied by a lending institution's response to funding requests; perceptions of high risk are matched with high levels of interest rates, i e the cost of borrowing. It follows that the "returns spread" – return on assets managed *less* the cost of capital – is both a performance measure *and* an indication of risk.

Even within the confines of traditional accountancy it is clear that the notion of "profit' is quite an artificial one, being derived from the application of various rules, and having potentially different meanings in different contexts. In this text it is generally proposed that to the extent "value" is measured in purely monetary terms then, as has often been quoted, "profit is a matter of opinion, cash is a matter of fact". Ellis (1999).

Simple cash measures have however often failed to take into account the fact that cash is generated in different manners over different timeframes. This has particular implications when considering what a firms key success factors are and how these should be managed.

4. Matching cash flow and strategy decisions

In what has become known as the *New Economy* the generation of revenues and the view of cost and generally resource input management have developed interesting perspectives. An effective value creating strategy takes an organisation beyond its own boundaries. It involves identifying the core capabilities necessary to compete and to produce and deliver customer value expectations and to *coordinate* the value production process by collaborating with partner organisations that have the necessary complementary capabilities. The well-known examples, such as Dell and Nike have established models that are being implemented by a number of industries through a value chain approach. It follows that a number of strategies are possible for increasing strategic flexibility while simultaneously improving cash flow; for example:

4.1 Operating cash flow comprises:

Revenues may be enhanced by partnerships that result in more effective responses to key customer value drivers (such as time-to-market, Quick Response (logistics responses), flexibility, and customized service packages). Revenues may also be improved by such initiatives as cooperative R & D and product-market development with complementary and competitive organisations.

Less

Labour cost profiles are influenced by outsourcing to obtain specialist skills or preferential labour rates. 'Capitalising' production processes is also a well-used alternative. Becoming more important is the use of design (for example by designing around 'platforms') to reduce intra and inter-organisational costs and in some circumstances eliminating duplications of process, activities and, therefore, costs.

+/-

Materials and services are also influenced by inter-organisational cooperation. The automotive, pharmaceutical and chemicals industries have pioneered web based supply chain partnerships. "Elemica" is a global electronic network comprising 22 of the largest international chemical corporations. By forming a negotiations/transactions hub, interactions and transactions costs are significantly reduced and asset productivity throughout the "organization" improved by the elimination of unnecessary inventories, automated transaction systems, reduced transportation costs (not to mention a vast improvement in 'mode' utilization) and storage costs.

+/-

Short-term capital costs are optimized or reduced by improving the productivity of tangible assets such as manufacturing facilities and distribution systems by developing partnerships with organisations that have excess capacity. Working capital productivity may be improved by optimizing inventory allocation and location supported by applying electronic systems to intra and inter-organisational interactions. The objective here is to increase overall productivity and decreases unnecessary investment.

+/-

Cash flow from "Asset Management" takes into account the short-term working capital and capital structuring or investment costs, required to perform the firm's activities. Increasingly individual organisations are seeking to improve asset base performance by working with partner organisations to achieve aggregate "returns". For example, the virtual wineries in Australia and New Zealand integrate the production assets of specialist processors in the value chain network; this synergistic approach reduces the capital intensity of individual organisations by limiting their investments into *relevant assets* that are very productive returning high levels of utilisation. Similarly the manufacturing/operations networks established by Li and Fung are based upon the integration and coordination of specialists within a value chain network

+/-

Strategic cash flow management includes the cost of fixed assets, long-term working capital requirements and "entry and exit costs" associated with decisions to expand the organisation. These may be the "hard costs" of funding R&D, plant and facilities expansion, or perhaps the costs of making an acquisition. Similarly shared investment in product-market development or with the application of product innovations (e.g., the biotech industry) can increase overall productivity, decrease unnecessary investment and, therefore, risk

+/-

Transformational cash flow management is the capital required to make changes to the long-term strategic perspective of the organisation through its structural organisation by developing inter-organisational response capabilities that achieve long-term strategic competitive advantage and growth through partnership opportunities requiring resources

+/-

Equity & Debt funding requirements and costs may be obtained from a number of sources. Retained earnings are probably the lowest cost funds with debt and equity each presenting issues concerning costs, risk, availability, and organisational concerns such as control. A "strong" balance sheet showing very little debt maturities and large cash balances offers *strategic flexibility*

+/-

Equals: Anticipated Free Cash Flow (or Enterprise Value)

5. Some observations based on business media reports

Certainly a strong cash balance facilitates growth. Ahmed (2008) reports on Ansell (suppliers of professional, occupational and consumer products – surgical gloves, gardening gloves and condoms). Ansell has an enviable balance sheet (more than $A160 million in cash with no debt maturities until 2010). CEO Doug Tough is quoted as saying: "The balanced capital management strategy we have employed for several years is to look at what is the best way to get shareholder return from the pretty positive cash flow that Ansell generates". Tough comments that because asset values have increased "extremely dramatically" in recent years the result has been an increase in buybacks and dividend increases in an attempt to maintain the growth of shareholder value. Tough has introduced a shift in attitude towards growth-oriented risk-taking; an important shift was to become much more customer focused and to move away from a culture of; "here's what we can manufacture, go sell, to one of focusing on what does the customer need and coming up with a model to deliver those needs".

Figure 1 'plots' the observed activities of a number of organisations whose operational and strategic decisions can be seen to be oriented towards enhancing cash flow management *and* business model management. There is a mix of decisions demonstrating actions to increase ***operating cash flow*** (and working capital productivity) by implementing cost efficiency programs *(David Jones – Australian department store group),* to outsourcing expensive processes *(Lego transferring manufacturing to low cost wage centres in Eastern Europe),* leveraging payables *(Fosters),* and using financial services to expand growth *(Easy Flow guttering – Australian SME).*

Cash flow management from asset management is demonstrated by the divestment of assembly plants to a network of partners to free up cash to focus on its core business *(Airbus/EADS)* and divesting "brands" to pursue a similar objective *(Ford Motor Co).* ***Strategic cash flow management*** to expand growth is exampled by acquisition of a related business *(Fisher and Paykel, a NZ based white goods manufacturer),* a "transfer of tangible assets into intangible assets to focus on product consistency and to optimise supply chain management *(Tetley Tea – Tata Group).*

Some examples of ***transformational cash flow management*** can also be seen in figure one. A response to the growth of the importance of knowledge management has resulted in *Lego* collaborating with a US university to develop the "Classroom of the Future" and as a response to declining energy resources *Exxon* is investing $US300 million into an alternative energy project. *Bega Cheese* has restructured itself (from a farmers' cooperative into an incorporated entity) to facilitate growth from potential M&A opportunities in the dairy industry. And *General Electric* are reported to be considering the sale of their appliance division which now accounts for only $US7 billion of the $US173 billion total revenues – the company's growth will be fuelled by healthcare and energy businesses.

As figure one suggests there are a number of examples of the strategic management/cash flow management interface working to create corporate *and* stakeholder value.

6. One organisations outsourcing is another's insourcing

Given that network cooperation and collaboration are becoming an accepted component of business strategy the notion of outsourcing and insourcing typifies the collaboration that exists in the twenty first century business model. Thomas Friedman (2006) described a set of circumstances that resulted in the World becoming "flat". Friedman, an inquisitive journalist, identifies a number of events (flatteners) responsible for changing attitudes and behaviour patterns. The significance of "flat" is the ease with which organisations can "interact" (communicate with each other concerning resource transformation, exchange transactions, and information communications) using ICT (information communications technology.

Insourcing is Friedman's the eighth of ten "enablers" that facilitate business development. . Friedman suggests that insourcing is best described as a process (external to an organisation) that synchronises global supply chains. He offers a number of examples using services provided by United Parcel Service Inc. In the logistics and SCM glossary, UPS would be described as a very large and efficient 3rd and perhaps 4th Party logistics and supply chain services provider. UPS' services are extensive ranging from the typical logistics and transportation services to those that can be described as *strategic processes* that enhance corporate productivity effectiveness (in other words that are integrated strategically and structurally into a corporate business model), or they are *operational processes* that have short term productivity performance objectives. In some respects UPS could be regarded as an organisation that provides *transformational resources* (assets, processes, and capabilities) that enables both small (and some large) organisations to operate as *large organisations* in large global markets. Essentially UPS is offering its customers an opportunity to focus its investment and management efforts into developing their core businesses and the UPS services portfolio is available for organisations to "bolt on" essential resources.

Examples of operational and strategic partnership applications include:

- Managing all of the repair service processes for Toshiba in the US - *Strategic cash flow management*
- Managing distribution processes for Nike and Jockey (under wear products) - *Operational cash flow management*
- Collecting customers' accounts receivable (domestic and overseas) - *Operational cash flow management*
- Linking up eBay and PayPal with UPS processes to enable purchases to be tracked during delivery - *Strategic cash flow management*
- A complete redesign of Ford Motors' distribution system in North America to reduce inventory holding reducing the inventory cycle from one month to ten days and improving the accuracy of orders/deliveries - *Strategic cash flow management*
- The design of a distribution system for a Canadian company (that sells tropical fish throughout North America) including a process in which the fish were sedated to 'ease' their transportation stress! - *Strategic cash flow management*

These examples suggest that partnerships are reached on a mutual basis. Organisations seek to restructure (or transform) themselves in order to meet the dynamic challenges of the market place and typically this is a two-way process. The examples given above tend to be permanent and as such result in organisational structures that: "develop inter-organisational response capabilities that achieve long-term strategic competitive advantage and growth".

There other requirements. For example the acceptance of the notion that *flexibility*, even *agility* is becoming essential characteristics of current competitive business structures and it is likely these features appear will be more effective in emerging partnership structures. Traditionally, organisations and their environments were conceived as quite distinct from one another in relatively simple and undifferentiated markets. More recently groups of interrelated organisations now occupy niches or 'resource spaces' such as industries and markets (Cameron & Zammuto, 1983) and form strategic alliances to pursue joint ventures. Under these new organisational arrangements, temporary networks exploit new market opportunities, and shared costs, skills, and access to emerging global markets (Byrne & Brandt, 1992). The *virtual value business organisation* is at a further step along the evolutionary scale. It does not enter a pre-existing market arena: rather, boundaries between stakeholders merge and shift constantly as interdependent enterprises respond dynamically to changing patterns of consumer demand.

7. Integrating strategy and cash flow management decisions

We move on to consider the responses that these changes have influenced**. Figure 2** describes an approach taken by a major multi-national organisation. It describes a process in which the company explores all aspects of its strategic and operational processes from product-service concept, through the design, manufacturing and distribution processes, and finally an evaluation of the financial impact of the identified alternatives. As can be seen its focus is on the net present value of the generated anticipated cash flow.

It is important to note that the model considers the detail of the processes required for the new product-service opportunity, the cash flow implications, *and* the organisational implications that adoption of the "opportunity" would require. As figure two suggests the organisational implications on the response may have far reaching implications. One of the implications concerns the role of partnership alternatives; in recent years the attraction of working with partners in "distributed resources" structures has been to improve asset utilisation and to improve cash flows. This development has had a significant impact on emerging organisation structures.

8. Comment

The examples provided in figure one have been the result of a logical process that has explored the interface issues between cash flow and strategy decisions. In some examples managements' comments clearly point to this but others suggest a strong inference. What emerges is evidence suggesting this interface *should* be explored as part of the strategy decision process. This point is given emphasis by Vella (2008) when discussing the possible sale by GE of its appliance business as it ponders a future in healthcare and energy businesses, much of which is from outside of the US, furthermore Vella comments that the industrial division (of which appliances are a large part accounts for only 10 percent of overall earnings and the sales are largely in the US. Vella also offers examples of IBM, Intel, Kodak and Corning having taken these decisions and making them successful. Waugh (2008) provides another example; GUD a diversified industrial organisation sold an Australian icon, Victa lawnmowers, to provide capital for two acquisitions in order to stabilise earnings. Ian Campbell, managing director, comments: "I think in listed businesses like ours, investors expect a consistency in earnings and it's very hard to deliver that consistency when you've got the vagaries of the weather determining profitability". The recent dry weather in Australia had resulted in a 13 percent reduction in lawnmower demand; the company had also owned a sheep shearing equipment business that shared the erratic pattern of results.

Equity & Debt funding: Requirements & costs for funding alternative strategies and structures.

Pacific Brands (branded under and outerwear) intends using debt to fund the Yakka acquisition.

Golden Circle (Canned fruit) is listing on the NSX (Australia) following a successful cost cutting exercise, lower debt and an improved capital base; this will facilitate brand growth

Operating Cash flow = Revenues less discounts less wages and salaries less materials, components and services, and the cost of capital servicing and maintenance costs, less overhead expense +/-

David Jones (department store group, Sydney) has implemented over 70 cost-efficiency programs aimed at reducing operating costs.

Easy Flow Guttering (Australian SME) uses inventory financing service to expand growth by facilitating prompt payment to its suppliers – supplier service and discounts increase operating cash flow and efficiency

Fisher & Paykel (NZ based white goods manufacturer) has opened a procurement activity in PRC to reduce costs

Fosters (Alcoholic beverages) increased its 'payables' to "non-contracted" suppliers from 30 days to 45 days

Fosters uses discounts in Western Australia to increase beer sales volume

Lego moved manufacturing to low wage centres in Eastern Europe; reduced colour options; rationalised low performing 'secondary' product ranges; and reduced the number of suppliers

GE Money Australia suspended low performing mortgage partners

McPhersons a consumer products distributor planned program of cost reductions, eliminating underperforming range items *and* innovation in higher margin products in response to declining sales

Transformational Cash flow = Capital adjustments required to make changes to the long-term strategic perspective of the firm.

Coca-Cola invested $US4.1 billion acquiring Glaceau "enhanced water" producer to re-establish sustainable growth in C-C's "home market".

Pacific Brands (branded under and outerwear) acquired the "Yakka Group" (work wear) for $A250 million. The acquisition adds synergy and significant revenue volume to Pacific Brands own work wear unit, *King Gee*

Lego launched a "Classroom of the Future" project with US university to teach children about science & technology; launched "LegoFactory.com" a "Lego Digital Designer" that offers an opportunity to design and order a unique Lego model, and; a joint venture with the MIT Media Lab that introduces robotic Lego *(Capital expenditures not divulged)*

Exxon is investing $US300 million into a manufacturing Facility in Korea into further development of a battery separator film component for lithium-ion batteries

Flight Centre (Australian travel agency) acquires Australian distribution rights for bicycle brands as part of a strategy to diversify revenue streams.

Bega Cheese gained approval of its farmer shareholders to transform itself into a company in order it might position itself for future M&A activities; a public float. It has issued A class and B class shares as part of the restructuring.

General Electric are reported to be considering the sale of Their appliance division which now accounts for only $US7 bill of the $US173 bill – the company's growth will be fuelled by healthcare and energy businesses

Creating Corporate and Stakeholder Value
(NPV of Anticipated Free Cash Flow)

Cash flow from Asset Management = Short-term working capital requirements +/- Capital structure (restructuring) costs +/-

Airbus/EADs divested 6 assembly sites and began the creation of a network of partners to allow Airbus to focus resources on core activities.

Ford Motor Co is divesting brands purchased in the late 1980s/1990s (Jaguar and Land Rover to the Tata Group, India) to enable the company to focus on the company's core Ford brand

Lego sold its majority holding in four theme parks – a move that provides cash to re-focus the Company on its core activity; education.

Tetley (Tata Group) divested itself of tea cultivation assets to optimise the worldwide management of bra *and* to avoid the possibly damaging impact of climate change.
and they (*Tetley (Tata Group))* have also divested five blending plants to ensure consistency of blends and to optimise supply chain management

GUD (Australian diversified industrial group) sold Victa (lawnmower business) to its US engine supplier to make acquisitions that would ensure more stability of earnings

Strategic Cash flow = "Entry and Exit" Costs +/- Fixed assets (tangible & intangible) +/- Long-term working capital requirements +/-

David Jones (department store group (Sydney). $A400 million to build 8 new stores and refurbish up to 14 stores. Reinforcing brand positioning and expansion into high margin categories is also planned.

IKEA plans to invest $1 billion to build 7 new outlets and a warehouse in Sydney and the along the east coast

Fisher & Paykel (NZ based white goods manufacturer) invested $NZ133 million acquiring Elba (Italian cookware) as part of its plan to expand European sales.

Endo Pharmaceuticals avoided a large investment ($US1 – 2 Billion) in strategic assets (necessary to meet US regulations) by partnering with UPS's healthcare division

Midas Australia's (vehicle accessories) new chairman and a private equity company (Lazard Carnegie Wylie) combine to introduce $A10 – 20 million to enter related, high margin, market segments

VW acquires control of *Scania* for $US 4.3 billion leading to a potential alliance between VW, Scania and MAN

Figure 1: Creating corporate value through effective strategic and cash flow management decisions

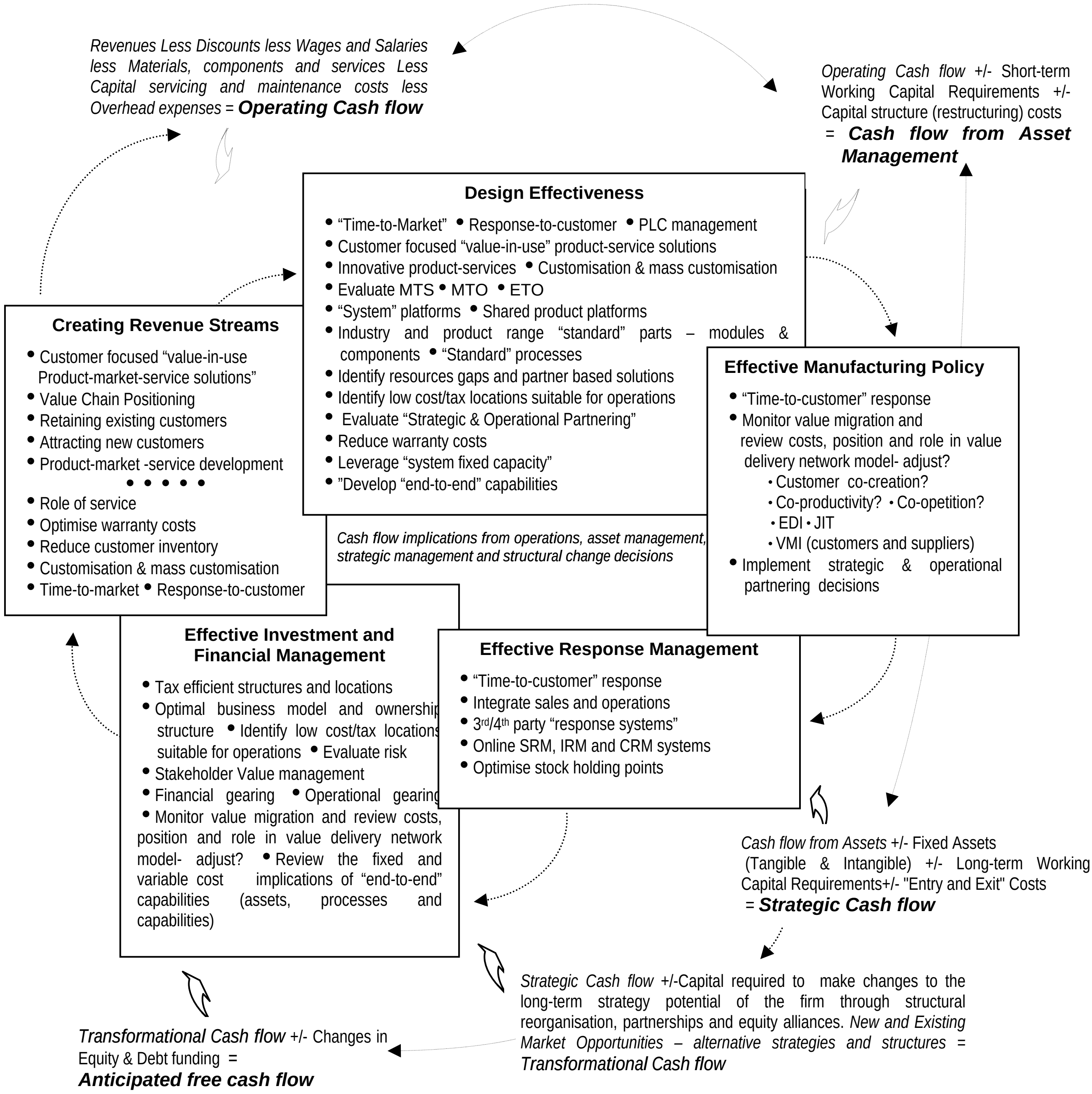

Figure 2: Appraising the cash flow and organisational implications of "opportunities"

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