

Strategic considerations for investment decision-making

Bankers are finding it increasingly difficult to evaluate loan requests. Investors face similar difficulties in deciding between alternative investment opportunities. The basic cause of these difficulties stems from the fact that the tried and trusted financial investment analysis methods are being used when these methods are no longer suitable for the task at hand.

The loan or investment decision maker, in using the traditional balance sheet, profit and loss account analyses methods, is committing the fundamental error of applying outdated techniques in a situation which requires a more sophisticated approach. The analyst, using the traditional methods, is persistently employing three fallacies in tandem, that when taken together, and without the assistance of a more rigorous approach, can lead to bad judgement and financial loss.

FALLACY NUMBER ONE

The first fallacy is the belief that the balance sheets of a company are a reliable measure of the company's situation. This may have been true in the past, but the inflationary conditions that have prevailed in recent years and which are likely to continue, have made a mockery out of the balance sheet. For example:

- 1 Assets are usually entered at historical cost and not at replacement cost.
- 2 The balance sheet does not provide any idea of the economic environment and outlook that faces that particular industry.
- 3 No measure of the key corporate asset of 'management ability and depth' is provided and many other weaknesses exist.

FALLACY NUMBER TWO

The profit and loss statement is a good indicator of financial strength. This is not true. There is almost no correlation between profits and cash. Making profits and having money in the bank are two very different things. The profit (or loss) account also has certain important weaknesses:

- 1 Are the stock figures which are used to calculate gross profits accurate? In many cases those stock figures are distorted.
- 2 The depreciation figure, especially in a period of inflation, is almost always inadequate.
- 3 Other problems regarding the allocation of expenses and write off of assets can also complicate the analysis.

FALLACY NUMBER THREE

Ratio analysis is able to reveal a company's strengths and weaknesses. The ratios are only able to tell a very

small part of the story, as these ratios are based on the profit and loss statement and balance sheet which have numerous deficiencies as discussed above.

Much of the difficulty associated with the use of the financial statements as tools to assist in the managerial decision-making process, stems from the fact that the accounts are embedded in the past. Managers, shareholders and financiers cannot use reports of past profits or losses and asset values as the only input for decision-making. Their requirements must be future orientated. The information provided by financial statements is not what is needed to make sound managerial decisions.

Discussions with bank managers has revealed that they are expected to make loan decisions based on balance sheets that are 'on average' six months old and often only become available one year after financial year end! This information is limited and may be useless from a decision-making point of view.

These facts are best illustrated by an example. In March 1969, the Penn Central Railroad Company reported a profit of \$4,4 million. On 19 June 1969, less than three months later, the company sued for bankruptcy. The 'numbers' were recalculated and the actual loss was estimated to be as high as \$120 million. A 'turnaround' of some \$125 million! Another interesting aspect of this corporate disaster is the fact that the accounting procedures adopted were perfectly legal yet the actual vs reported profit and loss figures differed by some \$125 million. Loving puts the point neatly when he states that "thanks to some unique bookkeeping, the parent Penn Central Company was able to report remarkable profits, figures that lulled creditors, shareholders, directors and managers. Many of the bookkeeping techniques conform to what the auditing fraternity calls accepted principles of accounting."¹ The Penn Central financial statement were obviously of limited assistance to the investor or lender.

How then can financial decisions be made more reliable? The answer to the problem revolves around the identification of a firm's situation with respect to the economic environment, the competitive climate, the firm's relative strength vis-à-vis its weaknesses and any threats or problems which it may encounter.

The objective of this article is to provide a framework for strategic analysis which can be used by the decision-maker to assist in the evaluation process. Obviously, the financial strength of the firm must be measured in some way, but the analyst must be aware of the inherent weaknesses of the financial accounts and the 'illusion of accuracy' that the generally accepted accounting principles impart to those statements and to any subsequent analysis of those statements.

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THE CONCEPTS OF STRATEGY AND STRATEGIC POSTURE

The strategy of the firm could be described as the way that the firm intends developing itself over the long term. Strategy has been defined as “the determination of the basic long term goals and objectives of an enterprise, the adoption of courses of action and the allocation of the resources necessary for carrying out these goals.”²

These goals, the courses of action adopted and the direction in which the firm expends its efforts, will in the final analysis determine the survival capacity and the success of that firm. The performance of the firm is dependant on how the business is managed and organised and the ‘kind’ of markets in which it operates. The profit (or loss) figures and balance sheet data will be a result of these actions. Thus the lender/investor must make some attempt to analyse the strategy of the firm because the strategy employed will be the final determinant of the success or failure of that firm.

The strategic posture of the firm is the relationship between the firm and the environment. Certain firms will be able to take advantage of certain opportunities in an environment while another firm in the same environment will face a threat. The strength/weakness/opportunity/problem/threat configuration that the company faces determines that firm’s ‘posture’.

COMPONENTS OF STRATEGY

The environment that each firm faces is changing very rapidly. Technological advances, rapid consumer taste changes, political, social, legal and economic conditions all combine to exert pressure on the firm. It is the task of management to translate corporate abilities and functions into a system that will enable the firm to adapt to environmental changes.

Katz has identified seven strategic policy variables which taken together produce strategy and overall posture.³

The variables are :

- 1 Product policy – which products will the firm produce.
- 2 Customer policy – which customers have the greatest need for these products? What is the target market?
- 3 Distribution and promotional policy – how will the firm inform these customers that it is producing these products and how will it reach the customer with the product?
- 4 Pricing policy – what price should be charged?
- 5 Competitive advantage – what aspect of the firm’s product will be emphasised to appeal to the target market?
- 6 Investment policy – where should funds be spent? Improving existing products, developing new products or diversifying?
- 7 Financing policy – where will the funds required to achieve objectives be obtained? Profits, loans, new equity capital?

Analysis of these strategic components will determine such aspects as :

- 1 The size of the market available to the firm and overall profitability.
(Products that can and will be produced, features that can and should be stressed will determine the market size and growth rate, the segment(s)

catered for and who the competitors will be. Promotional and distribution requirements can be assessed. The prices that can be charged and profits and returns can be estimated.)

- 2 The resources required to exploit the market opportunities that can be identified.

(If the market is expected to produce growth of say 20 per cent per annum in sales, what will financing needs be? When will new plant be needed? What additional investment will be needed in debtors, stocks and raw materials. Are there sufficient experienced managers available to produce this growth?)

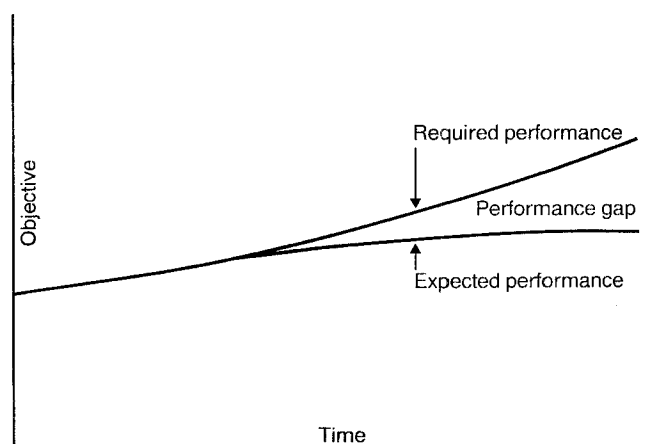
- 3 The corporate cash flow profile.

(Investors and bankers are becoming increasingly aware of the fact that cash flow is the critical determinant of corporate solvency and not profits as reported in the profit and loss statement. Cash inflows and outflows can only be calculated once detailed marketing and capital expenditure plans have been completed. Cash peaks and troughs can be reasonably accurately estimated at this stage. Management should be able to provide plans which reveal how the company intends to develop and grow in terms of products, markets, capacities and how these developments are to be financed. The expected return and repayment of the capital invested will depend on how management intend overcoming these problems. Unless the investor/lender knows the answer to these questions he will be unable to assess the risks involved in the decision.)

The analysis of the firm’s plans should not be limited to the short term but should also be extended into the medium and long term. Management’s objectives should be compared with expected performance over a three to five year period. This relationship is shown in Figure 1.

The ‘expected performance’ curve is the extrapolation of current performance under the assumption that no changes are made to the current strategic posture. This forecast will generally show a curve which falls off the further the projection is made into the future. Most products have a ‘life’ of between five to twenty years depending on how ‘product’ is defined.

Figure 1 : Gap analysis



The 'required performance' curve, on the other hand, is a compounded extrapolation of management's growth objective, however this is defined. If sales revenue is the objective, and management believes that sales will rise at a compounded rate of 15 per cent per annum this curve can be plotted after being adjusted for price increases. Management are often surprised at the magnitude of the 'gap' that is revealed between objectives and expected performance.

The question that must now be posed is: "How will this gap be filled?" Management's reply is often - 'new products' ! This seemingly simple answer to the question is, however, very much more complicated. The lender/investor should then expect answers to such questions as:

- 1 Which new products ?
- 2 Which markets will need these products ?
- 3 What is the growth rate of these markets ?
- 4 How will existing competitors react to entry ?
- 5 What reason (competitive advantage) will you be able to provide that will justify a customer's switch to the new products ?
- 6 What production/plant facilities are required ?
- 7 How will the products be marketed? With an existing or a new sales force ?
- 8 What additional investment in working capital and fixed assets will be required over the next few years to back the expected sales growth ?
- 9 Where will these funds be obtained? Additional debt? Retained earnings? New share capital ?
- 10 What effect will these activities have on cash flows ?

The lender/investor in many cases may not expect precise answers to such questions but will no doubt expect that the management have at least considered these problems. If these questions have not been considered and possible alternative solutions have not been identified and evaluated, this will suggest that management are not planning the future of the firm - and if they are not planning the future direction and needs of the firm the possibility of an investment being sound, or the obtaining of interest and loan repayments, are remote and risky.

Failure to answer the above questions is not confined to small companies. Large companies, with their so-called sophisticated management teams and techniques have made what appear in hindsight, to be elementary mistakes.

The much publicised withdrawal of RCA from the mainframe computer market is a good example of the failure to assess the impact of a new product on corporate profitability and cash flows. In 1970 RCA management concluded that they would expand their market share in mainframe computers from 3,2% to 10% by the mid-1970's.⁴ At this time it was estimated that IBM, the leading manufacturer, held a 69% market share. RCA thus adopted a market-share building strategy. Analysis of the computer industry shows that this industry is very capital intensive with roughly \$1,2 of assets being required to finance \$1,00 of sales.⁵ Industry sales projections and projectors of RCA's market share improvement and capital requirements for this company division are shown in Table I.

Table I: Computer industry and RCA share projections 1969 - 1974
(Dollar figures in millions)

Year	Projected industry sales	% RCA share	Capital required by RCA	Increased capital required
1969	\$7 170	3,2	\$276	\$0
1970	7 720	4,0	371	95
1971	8 940	5,0	536	165
1972	10 300	6,3	778	242
1973	11 800	8,0	1 135	357
1974	13 400	10,0	1 610	475

Source: W. Fruhan. *op.cit.* Page 102.

From Table I, the increased capital required to fund the projected sales growth using the 1,2:1 asset/sales ratio are seen to be enormous. In one year, 1970, the increased capital required is estimated at \$95 million. What must seem an obvious question must now be posed: "Where will these funds come from?"

Table II is a summary of the capital generation ability of RCA in 1969. The table shows that in 1970, the computer division would absorb some 80% of RCA's 1969 generated capital. Yet this division accounted for only 7% of RCA revenues in 1969. Obviously, RCA would be hard pressed to allow a division accounting for some 7% of sales to absorb 80% of funds available.

Table II: RCA's capital generation - 1969
(figures in millions)

Profit after tax	\$151
Dividends	68
Retained earnings	83
Debt/equity ratio	0,45
Thus: new debt available	37
Total capital generated	\$120

Source: W. Fruhan. *op.cit.* Page 102.

The computer division was closed a few years later. Clearly the basic strategy was unsound due to the inability of the company to generate capital. Analysis of historical financial statements would not have improved the investment decision. An analysis of marketing strategy and corporate financial capability would have improved the decision. The basic questions posed earlier were not asked by RCA management.

CONTINGENCY PLANNING AND THE CASH FLOW PROFILE

The lending/investment decision maker should not be naive concerning the effects of rapid growth or slump conditions on the security of his investment. Too rapid a growth rate generally requires increased investment to fund the growth in debtors, inventory and other assets which accompanies sales growth. The rapid-growth firm is invariably 'cash hungry'. Too often these firms experience cash difficulties, not because they borrow too much, but because they do not borrow or attract share capital in sufficient amounts to perform the tasks necessary for success.

A sudden slump in market demand can be disastrous to a firm with a heavy fixed cost burden as a result of high

operational leverage. In many cases a sales drop of 10 per cent means that the firm is operating at below break-even. Thus the decision maker should also expect some form of contingency plan, which will show the likely impact on the cash position in the event of actual performance being above or below forecasted performance. The sensitivity of the cash position of the firm to performance variations are of vital concern to the decision maker. The analysis of the 'cash cushion' at different levels of performance will be of considerable assistance in evaluating the risk associated with the decision.

SUMMARY

One of the most significant changes in investment decision-making over the past few years has been the drift away from the analysis of the financial statements as the key criteria. Recently the emphasis has been shifted to that of the cash position of the firm. This move, although in the correct direction, is not sufficient. With a rapidly changing and hostile environment, the analysis must be more penetrating to be of any real assistance. By stopping the analysis at the 'projected' cash position the decision maker is examining the 'symptoms' and is not getting to the 'causes' of the situation. What is expected to generate those cash flows is the crucial aspect that must be examined.

The strategy to be employed is the 'name of the game'. The soundness of an investment, the security of a loan and the cash flows of the firm, all depend on what the firm wants to do, what it must do to survive, what it can

do, and what it will do. The historical financial statements should be seen for what they are – outdated, inaccurate and often misleading scorecards.

The firm's ability to survive and prosper will depend on how well it is able to adapt to environmental conditions and how effectively it is able to satisfy segments or markets. To provide for sound investment, this ability to develop must be a part of conscious attempts by management to control the destiny of the firm and to guide the company along a path which takes advantage of strengths, overcomes weaknesses and mitigates against threats. Investors and lenders should demand that management demonstrates that the firm has a sound strategy and that the posture of the firm is such that opportunities are exploited effectively. This approach by management will ensure that the firm does not merely react to a situation but rather adopts a purposive attitude and 'makes the future happen'.

References

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