Interview Q&A

Boosting Cash Flow & Shareholder Value

V Rory Jones

Interview Questions

1. **Why did you write this book?**

2. **In the book you say that financial accounting information today is inappropriate and often misleading. That's quite a charge, isn't it?**

3. **Rapidly boosting the value of the business sounds like the Holy Grail of business management. What is it that today's business leaders are missing?**

4. **Business leaders need to manage cash profit expectations *in the next 15 years*? Surely, expectations that are decades ahead is just guesswork?**

5. **Is boosting value all that matters in business?**

6. **You also say in the book that today's businesses aren't configured to boost value; how does that manifest itself, and how is that possible in this day and age?**

7. **If a business uses the idea of Profit Pool management to set market direction, what sort of results are realistically possible?**

8. **If what you are suggesting is so intuitive, why aren't companies already doing all these things already?**

9. **Who should read your book?**

Interview Transcript

1. Why did you write this book?

Management techniques that successfully drive business value have been discovered over the course of the last twenty-five years, but the word has been painfully slow in getting out to today's business leaders in a distilled and prioritized format. Remarkably, the same issues and questions come up time and again in the C-suite, and it struck me that there must be a better way to get the knowledge out than one company at a time.

Business executives are rising through the ranks and into the C-suite all the time. They need a view on the new mandate they are assuming – of managing to grow the business' value – and this book will help that transition.

In many ways, this book pushes back against the myriad of shareholder value books that have been published since the seventies. In fact, all it does in cut to the chase for business leaders, answering the question – what can I do to boost the value of my business? Rather than delving into the financial engineering in the way other books do, it simply prioritizes what matters, and sets out solutions. The idea is to get the word out – and hopefully it'll accelerate the economy and make society wealthier.

2. In the book you say that financial accounting information today is inappropriate and often misleading. That's quite a charge, isn't it?

You bet it is. It's the dirty secret that everyone on the inside knows, but don't talk about. Look at what accounting standards make us do. You filed a tax return for last year, and in it was probably a deduction for a computer. Now, there's a good chance you didn't buy a computer last year; the deduction you took was actually depreciation for a computer you bought years ago. You have something in your personal P&L statement that is simply a made up number. It's not your fault, it's just what the system demands you do.

It's the same for business. Accounting standards decree that computers lose their value in even increments over five years. Of course, that doesn't reflect reality at all. A business pays for things and sees cash go out the door; each transaction has a direct and immediate impact on returns and performance. Accounting standards, however, try to smooth the impact of investments in an attempt to give a picture of business in steady-state. How? They do things like apply arbitrary depreciation schedules – as for computer depreciation over five years – and completely reshape all the numbers.

It is as though accounting regulators believe investors and others are not smart enough to understand the idea and longevity of investments. The accounting industry is substantially build up on arcane adjustments like depreciation; millions of FTE hours are spent compiling these numbers, and then, analysts in investments houses spend hours trying to unwind them to divine cash profits. It's a silly game with one very bad outcome; within businesses, managers are misled in their decision-making by fictional numbers – investing in negative-return areas, and fully driving at highly-attractive ones. Rarely does a business build a parallel system giving real cash profitability, let alone one that looks at future prospects, and so business leaders rely on systems made for regulatory reporting.

As a result, business leaders are directing investments around their businesses using profit measures that are based on artificial adjustments, and expenses that have been allocated to parts of the business using inappropriate schemes. They are misled into growing unprofitable areas, and not emphasizing attractive ones. It's a serious problem.

3. Rapidly boosting the value of the business sounds like the Holy Grail of business management. What is it that today's business leaders are missing?

Yes – driving for increases in business value is the principal deliverable for all business managers, no matter where they are in the organization. Managers are the agents of business owners, and in most companies, their role to manage for value is clear-cut.

What is the value of a business, anyway? While you wouldn't pay anyone for a stream of cash that has already come to you in the past and is now in the bank, a future cash stream does have value. It's the same with business; a business' value rides on the prospect that it will deliver a stream of cash in the future. The greater the cash flow expectation, the greater the intrinsic value of the business. In fact, for most businesses, three-quarters of their intrinsic value is in the cash flow expected in the next fifteen to twenty years – and that's an established mathematical phenomena.

So, of course, that is what business leaders should focus on; cash-based profits in the next fifteen to twenty years. Which brings us to the Holy Grail of business management; what must business leaders do to maximize cash flow in that period? It turns out that the answer is not difficult to see, and is even patently obvious to anyone that stares at a P&L statement for a while. The fact is that changes to top-line factors (which are external-facing – sales volumes and price) impact cash flow to a degree that far outstrips changes in all other factors (which turn out to be internally-oriented – such as controlling COGS and the like). In short, it means managing market moves, using "market strategy," with the specific objective of maximizing long-term cash flow and value.

That means choosing which markets to focus on and what differentiation to adopt in each market based on what the cash flow prospects are; market targeting and differentiation are the two components of market strategy that drive sales and price. While this may sound rudimentary, it turns out that 20% to 40% of the capital invested by the average *healthy* Fortune 500 or mid-cap business serves markets that don't even earn their cost of capital, and 10% to 20% actually drain cash.

This is why it is so important for business leaders to use reliable economic information – and the shortcomings of using the financial accounting system, discussed earlier, result in an enormous amount of destroyed value. Without reliable economic information negative-return market positions are allowed to remain, and in most cases business leaders continue to invest and grow them unabated, and increasing the destruction of value. Moreover, other areas in the business with high positive returns don't receive growth investments they deserve, as investments are spread around evenly like butter.

Rectifying this can boost near-term cash flow by well over 10% - to say nothing of re-deploying some of that invested capital and re-directing growth investments to positive-return areas. Admittedly, it's not always easy to clean such issues up, but the first step is in seeing the issue; which existing accounting systems simply don't. Business leaders have to go though their markets – looking at segments like offerings, customers, channels and geographies – and create a picture of cash-based profitability at a granular level. Tough work, but easily worth it.

Dealing with the near-term is only the start, however. While it's critical to get the business on a solid footing as early as possible, it is the long-term where the value game is really won and lost – knowing where the pools of profit will be in the next couple of decades. This means that business leaders have to spend time understanding the market's future, and deciding how to invest the owner's capital using their own vision of the future and forecasting where cash profits will be, rather than allowing serendipity to decide. That sort of proactive leadership means you actually have a chance of spotting and creating opportunities. In fact, it's interesting to look at this issue in the reverse; given such a large proportion of business value is in the fifteen year timeframe, what are business leaders doing now to manage it? It could be seen as reckless not to develop thoughtful and fact-based view of long-range market Profit Pools.

Business leaders are alone in being responsible for doing this. Their job is unique. Even if the leader's tenure at the top is just a few years, getting the business on a trajectory well beyond that tenure is critical to valuations. The more fact-based and rationally thought out are the long-range cash flow expectations, the more investors will bid up value; investors are already comfortable with the idea that value is driven by future cash flow expectations.

4. Business leaders need to manage cash profit expectations *in the next 15 years*? Surely, expectations that are decades ahead is just guesswork?

And that's the point – it doesn't have to be guesswork, there are solid techniques for understanding a business' future prospects.

Today, most businesses are managed using a three, perhaps five, year horizon. The implication is that only about twenty percent of their value is being managed; the rest is being left, more-or-less, to chance. Now, clearly someone believes cash flow is there longer-term or they wouldn't be including it in the business' valuation. All we're advocating is that business leaders look thoughtfully into that five to fifteen year timeframe, and set their plans according to what they see. In our experience, there is both a lot that can be predicted in that period, and there is a lot to be decided about where the business will go, and how much cash flow and business value will be captured.

For example, back in 1999 one marketing executive scoffed at the idea that market profitability could be planned for up to 2010. We were looking at the printer market, and the unknowns included the prospect that technology would substitute printing out almost completely – something akin to the paperless office. After only an hour or so, we were able to sketch out a reasonably solid forecast for the market together with several contingencies – enough to place some very serious bets.

How could that be done? The answer is by using a system of constraints. What are the Market Inflexion Events? We knew, for example, that eBooks would be technically feasible in the next few years, and that to commercialize the idea – that is, to get them at a price that approached that of paper books – would take at least another five years. From there, the contents of books would have to become available is a way that protected copyrights (using Digital Rights Management systems) – another likely delay to a large market opportunity. The book printing market, it became clear, was largely protected for at least a decade. After that, however, it was also clear that eBooks would likely be an attractive proposition for customers – though not as a stand-alone device, but as a add-on to cell phones and PDAs. In that one afternoon, we sketched out a high-value strategy of exploiting the book printing market in the next decade, while positioning the business to take advantage of an upcoming electronic book market – books locked in a memory stick.

Its not worth dwelling on eBooks, except to say that it is often surprising how much can be forecast, and how much future market Profit Pools can be found and sought after. Those businesses that are not using this sort of approach are simply not drawing a robust picture of what the future offers, and are missing vast amounts of business value.

5. Is boosting value all that matters in business?

Value has to be the overriding objective for business leaders. Of course, a business must act ethically, and within the bounds of the law and regulations, but within these constraints the objective is to grow future cash flow and intrinsic value aggressively.

In doing this, the interests of all other stakeholders, employees, debt holders, customers and others, are also maximized. Only an economically strong business model can afford to give employees the best conditions in the industry, if that is part of their employment proposition, or give customers the best value trade-offs. As soon as business leaders tamper with this prioritization, a whole field of unknowns is unleashed in decision-making. The business subsequently gets weaker and its ability to give all stakeholders the maximum in value diminishes. Ultimately, the business fails economically, and it brings all stakeholders down with it.

The value maximizing business will seek to get the most out of its employees – and in the employee markets it needs to deliver a sustainable attractive proposition in return. The same applies to customers. Even the environment and sustainability will receive the maximum from the company that prioritizes the creation of value.

Now, if the current configuration of the market and the competition in it is delivering outcomes that are not acceptable to society – such as pollution, or customer service levels, or even pay – than it is up to society to put conditions on the market as a whole in the form of new regulations. Managers must be free to focus on their own mandate of maximizing value. With that said, in many circumstances the business that voluntarily heightens standards often improves brand positioning and adds to business value.

6. You also say in the book that today's businesses aren't configured to boost value; how does that manifest itself, and how is that possible in this day and age?

This is a major problem, and it has its roots in the day-to-day needs of business operations. Most businesses are organized in functional groups, usually including a Finance group, and a separate Marketing group. This silo structure results in a lack of cross-skills; Finance recruits accountants, Marketing recruits product managers (for the most part). Insightful dissections of markets to find cash profitability require a blend of both skills; cutting through GAAP is itself a challenge, to say nothing of properly segmenting a market in a measurable and actionable way. Layered on top of these problems are the other usual inhibitors, differing motives (GAAP reporting in Finance, revenue in Marketing), incentives, turf-stakes and others. Furthermore, management generally focuses on immediate and near-term issues, which are difficult enough to get resolved in the day without sorting out cross-function and long-term issues.

Without being organized to understand the long-term economics of markets, it is no wonder that businesses have such a poor understanding of cash profit potential and drift into a market strategy governed by serendipity. A conscious effort is needed by business leaders to continuously develop information and orient decisions around Profit Pools.

Functional managers become engrained with their silo's views and skills over time (reinforced by incentives schemes) as they work so well at the tactical level. Their ability to shift to a broader, longer-term perspective can be very difficult. In one case, the Sales/Marketing lead of a pharmaceuticals manufacturer, whose incentives were based on revenue, expended enormous amounts of energy over the course of a year attacking information that roundly demonstrated that a large revenue earner would never return a cash profit. Initially, the use of cash profits was disputed, and when this was resolved, the discussion moved to how allocations were done (primarily sales expenses), despite the possible scope of error being well within what was needed to make the axe decision. The last point of contention was in the course of action (whether any was needed at all).

Unfortunately, since the only place where high-level cross-function decisions come together is at the every top, just a very limited number of people have exposure to what really drives value. When business leaders get to the C-suite, the mandate to drive for business value is not entirely familiar. It demands a mind-set shift on many levels; from specialist to generalist, from honing current performance to growing future cash flow, and from mostly inward-facing issues to mostly outward-facing ones.

7. If a business uses the idea of Profit Pool management to set market direction, what sort of results are realistically possible?

Market strategy can use Profit Pool management to boost shareholder value in two timeframes. In the near-term, a focus on internal Profit Pools gets the existing capital invested in the business working on all cylinders. Again, we have found the typical healthy Fortune 500 Division and mid-cap business has 20% to 40% of invested capital in business areas that don't even support the cost of that capital, while half of that is actually draining cash. Once a company has looked through its business areas and created a granular picture of cash profitability – looking at offerings, customers, channels and geographies – it is in a position to limit some of the cash drains and certainly stop growing them. Of course, many business areas are interconnected, so its often not desirable to simply cease operations – but cash drains can almost always be neutralized. More often than not, this results in immediate cash flow increases of 10% - and usually much more. The impact to shareholder value is rapid, and has a more pronounced magnitude as investors see the existing business model delivering more cash flow to shareholders, and expect it to continue to do so into the future.

Long-term gains are much more industry and market specific – and reliant on the ability of business leaders to characterize their business vision in tangible strategies and fact-based reality. It also depends on the opportunities available. With that said, the probability that opportunities will be identified increases by orders of magnitude when a process to characterize future market Profit Pools is used, as is the likelihood of fully exploiting those opportunities. There is simply no comparison with approaches that manage market strategy to a three to five year horizon and focus on sales – that's a model mostly based on chance.

8. If what you are suggesting is so intuitive, why aren't companies already doing all these things already?

It turns out that there are powerful forces causing business leaders not to deploy much resource into what's needed to boost value. First and foremost is the mind-set shift we discussed earlier; on entering the C-suite, and the CEO's office in particular, business leaders face a completely new environment and set of success factors. Unfortunately, it takes time to relinquish what has made functional leaders successful, and adopt a focus on shareholder value – and all that comes with it; a long-range view, an orientation around cash flow, and a more outward-facing perspective. Since it is so new, there is also little experience of what must be prioritized to achieve value growth – something this book addresses directly.

Moreover, the siloing of skills within the organization exacerbates the problem. Not only are business leaders the only ones in the organization accountable for such market moves, but they are unlikely to find appropriately skilled support on staff to carry out the work needed. Indeed, support staff typically operate from within the silos, and more often than not, they are drawing attention away from long-range market strategy issues in order to get some very visible near-term challenges resolved.

Finally, the reliance on financial accounting information to measure the business and its parts substantially misleads investment prioritizations, and the temptation to look at something less than a fifteen year horizon is overpowering when that timeframe exceeds the business leader's tenure and near-term distractions are screaming for attention; in these situations, planning long-range market moves appear esoteric.

9. Who should read your book?

While this book is directly useful to the business leaders in the C-suite, accountable for boosting the value of the businesses they manage, other managers coming up in the organization will want to see the business through the eyes of the CEO. In painting this view, rising managers are both positioned to enter the C-suite, as well as equipped to take up the needed and unique responsibilities.

In addition, the rise of Private Equity ("PE") in recent years has brought large numbers of businesses into private ownership – ownership that is inherently focused on driving value growth. In tandem with this however, the increase in business acquisitions has resulted in an increase in acquisition prices, which, in turn, puts pressure on PE investment firms to increase the value growth of businesses they acquire. Going forward, PE firms will have to extend beyond parachuting in big-name managers and using financial engineering to achieve value growth; systematically adopting the sorts of technique outlined in this book will be a useful addition to their tool set.

Other external stakeholders, such as public company shareholders, debt-holders and board members, will find the insights on value creation useful as they guide business leaders and conduct their oversight responsibilities. It will also tune in and focus their demands for business information.

Furthermore, regulators and policy makers interested in upgrading financial reporting standards will find this book useful in setting out what is needed by business leaders. Similarly, information systems vendors, particularly ERP and individual business process software providers, will find greater insight into specific information needs of C-level business leaders, so they are able to enhance the utility of their offerings.

Other professionals will find the prioritized view of business management set out in this book a useful additional arrow in their quiver, and helpful in the design their services. Finally, business management educators will find the Profit Pool approach pulls together key business management topics in a highly useful and refreshingly prioritized way. Generally, shareholder value texts are heavy reads and somewhat theoretical, oriented to the needs of finance practitioners. In contrast, this book is pragmatic, and oriented to deliver rapid results to the highest of business objectives – boosting value.