

---

---

HITTING A FINANCIAL HOME RUN IN 2010:  
IT STARTS WITH SPRING TRAINING!

---

---

March 17, 2010  
CORPORATE AND EXECUTIVE EDUCATION  
DREXEL UNIVERSITY, LEBOW COLLEGE OF BUSINESS



PRESENTED BY  
Ed Nelling, Ph.D., CFA  
PROFESSOR OF FINANCE

SUMMARIZED BY  
Jody van de Sande

## Executive Summary

The Philadelphia Phillies won the World Series in October 2008, but they did not win in 2009. Why did they win one year and not the next? It comes down to basics – how well the team did with their pitching, hitting and fielding. For a team to win, they must outpitch, outfield and outhit their competition. Let's examine the basic issues you face as CFOs, in order for your organization to hit a “financial home run” in 2010.

We are coming out of the economic crisis, but we are not out of the woods yet. One advantage of a crisis – it often helps you to focus. In the movie *Cinderella Man*, Russell Crowe's character, the boxer Jim Braddock, knew what he was fighting for – milk. During the recent financial crisis, many organizations fought their own personal battles – they were just trying to survive.

In the current “post-crisis” economic environment, is your organization thriving or simply surviving? It is time to reconsider a basic measure of financial performance to help position your organization for long-term value creation.

Let's examine performance using the framework of return on invested capital (ROIC). In algebraic form, ROIC is

$$\text{ROIC} = \frac{\text{operating income} \times (1 - \text{tax rate})}{\text{debt} + \text{equity}}$$

or

$$\text{ROIC} = \frac{\text{operating income} \times (1 - \text{tax rate})}{\text{fixed assets} + \text{working capital}}$$

What can be done to deliver enhanced performance – in other words, how can you hit a financial home run? More specifically, what are the drivers of performance, and how can you increase ROIC? Do you increase the numerator (after-tax operating income), decrease the denominator (reduce fixed assets or working capital) or do you do a little of both? Ask yourself these critical questions when you revisit your organization's strategic and tactical plans. Let's dig a little deeper.

### **The Numerator in ROIC:**

Assuming that we cannot do much about tax rates, we'll turn focus on operating income. We can represent this as

$$\text{Operating income} = \text{revenues} - \text{operating expenses}$$

$$\text{Operating expenses} = [\text{Cost of goods sold (COGS)} \text{ and } \text{Selling, general and administrative expense (SG\&A)}]$$

Let's ask ourselves some important questions about revenue and expenses.

Questions to ask about revenue:

To survive an economic crisis, you need revenue. When you make another sale, revenue goes up. However, is every sale a good sale? Do you have the "right" customers? Indeed, the organization's top line increases, but that creates a burden in terms of receivables, fixed assets, and other issues. Looking at your organization's sales now and during the crisis, ask yourself whether that is the customer base you want to have going forward. Is it time to end any current customer relationships?

If your organization weathered the economic crisis, but your competitors did not, has a competitor's weakness in the recent economic downturn provided any opportunities for your company? Are there potential sales waiting in the wings, and do you have the resources to go after them?

Questions to ask about operating expenses:

In the economic downturn, how was your organization's relationship with your suppliers? Did any of the suppliers go out of business? Do you now have the right "mix" of suppliers, or should you diversify your supplier base?

Is your compensation expense (and, more importantly, compensation policy) appropriate in the current economic environment? In an economic downturn, everyone in the organization is usually just grateful to have a job. As we come out of the economic crisis and additional opportunities emerge, do you need to rethink your compensation model to attract and retain the best talent? You may have "doubled down" on training resources during the economic crisis, but are you now making strategic investments in marketing or training to build your brand and strengthen the company?

### **The denominator in ROIC:**

To increase ROIC, you need to think about the fixed asset base and your working capital situation.

Questions to ask about assets:

Have you overlooked any opportunities for strategic investments in assets? Think of the people you hire as a strategic investment. Again, a weakness on the part of one of your competitors may present strategic hiring opportunities.

Consider your possible "exit" decisions – are there any assets you can live without? Is it time to divest a business unit, or part of a business unit?

Questions to ask about working capital:

Are you dealing with your customer and supplier base appropriately? During and after the crisis, it is a delicate balancing act, and your organization is caught in the middle between your suppliers and customers.

As you emerge from “survival” mode, think about whether you are managing receivables, inventory, and payables as efficiently as you could.

### **The challenge to CFOs:**

Make 2010 the “Year of the Decision” by choosing one or more key drivers of performance and deciding to do something about it!

---

### **Feedback from the Roundtable Discussions**

The audience at the March 17<sup>th</sup> CFO Alliance Roundtable chose one or more of the following questions and discussed the opportunities that they see to increase their organization’s return on invested capital. Each table presented their findings.

#### **Revenue:**

- Do you have the “right” customers, i.e., is every sale a “good” sale?
- Is it time to end any current customer relationships?
- Has a competitor’s weakness in the recent downturn provided any opportunities for your company?

#### **Expenses:**

- Do you have the “right” suppliers, i.e., should you diversify our supplier base?
- Is your compensation expense (and thus compensation policy) appropriate in the current environment?
- Are you making strategic investments in marketing or training to build your brand and strengthen the company?

#### **Assets:**

- Have you overlooked any opportunities for strategic investments in assets (from hiring one or more people to make an acquisition)?
- Is it a good time for renovations to existing assets?
- Has the recent recession highlighted any assets that you can live without?

#### **Working Capital:**

- Are you “walking the fine line” in dealing with our customers and suppliers appropriately, i.e., how well are you managing receivables and payables?
- Are there any “inventory bargains” out there?

#### **Table Comments:**

- Compensation - twice a year bonus metrics seem to motivate employees
- Training - stimulus funds are available
- Assets - taking care of existing clients and acquiring new assets
- Working capital - consolidate collection of receivables and centralize collection processes
- Margin improvement - choosing the right customer - low margin customers present a fixed cost
- Consider your fixed and variable cost structure
- There is a cost to acquire new customers

- Price pressure in service industry - hard to increase prices in better times
- Morale and motivation issues result if you have pay cuts
- Centralizing processes wherever possible
- Compensation - Generation X and Generation Y think differently than traditional employees about compensation
- Long-term equity performance is the focus of compensation policy
- How to retain talent - people are not leaving until the dust settles
- Marketing and training efforts have increased
- Consider the “return” on your client when developing business
- Working capital - risk management policies are receiving attention
- Offering a bonus at end of the year to lower management employees may foster loyalty and improve morale



PHILADELPHIA  
**BUSINESS  
JOURNAL**

Jasmine Rea  
Advertising & Circulation  
215.238.5123  
jrea@bizjournals.com



**Corporate and Executive Education**  
Kristin M. Risi, MBA, Ph.D., Senior Director  
215.895.6606  
krisrisi@drexel.edu

**RSM! McGladrey**

Nick Araco, Esq., Director  
Consulting Services  
215-648-3021  
nick.araco@rsmi.com