Driving Growth with Finance

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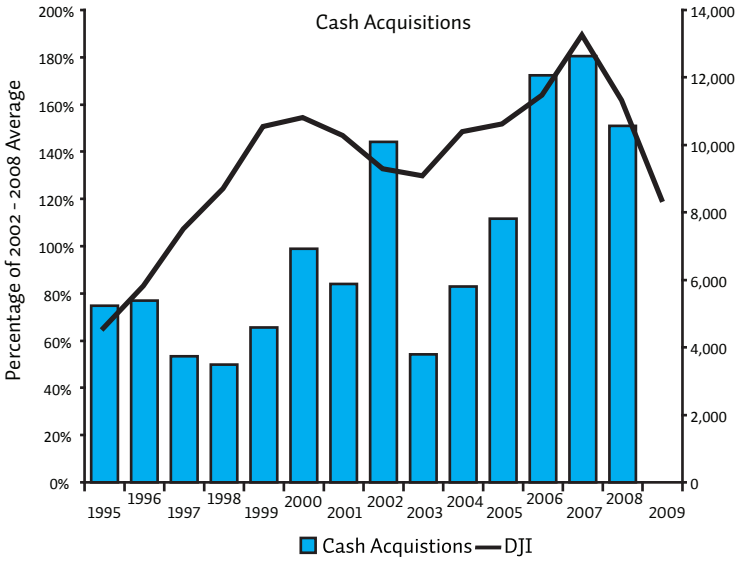
Some of the greatest growth opportunities exist at the bottom of the business cycle. Unfortunately, an obsession with preserving a high rate of return often stands in the way of making such investments, according to Gregory V. Milano, CEO of Fortuna Advisors LLC, a leading strategic and valuation advisor. He argues that by understanding how the market trades off growth versus efficiency and by embracing the idea of "Internal Capitalism," finance executives can advocate for investments that can deliver shareholder value in any cycle. Speaking to senior finance executives gathered in Las Vegas for the fourth annual CFO Rising West conference, Milano explained the trade-off between growth and efficiency, discussed new analytical tools to aid companies in their investment decision-making, and offered an overview of Internal Capitalism. This is a summary of his remarks.

Contrary to popular belief, most companies don't "buy low and sell high." In fact, says Gregory V. Milano, CEO of Fortuna Advisors LLC, "companies do almost the exact opposite: they invest when prices are high and are reluctant to invest when prices are low."

If you examine statistics on most corporate expenditures—capital expenditures, mergers and acquisitions, marketing, research and development—over time the pattern of missed opportunities becomes clear. Take acquisitions, for example. "If you look at dollars spent on M&A as a function of where the Dow Jones Index was at any given point since 1995," says Milano, "you'll find that the amount of M&A when the market was above average was more than double the amount when the market was down." (Figure 1)

Figure 1



Studies consistently show that companies that invest at the bottom of the cycle create more value for shareholders as the economy recovers. Moreover, says Milano, "while companies seem to be very concerned with not making too many investments, more companies need to recognize that Investing too little can constrain value as much as investing too much."

Obstacles to Growth Investing

Unfortunately, says Milano, there are several obstacles to growth investing at the bottom of the cycle. One of them is finance itself. Frequently, he says, "the finance department gets in the way of growth, sometimes in an excessive sort of way," by playing the role of gatekeeper.

The other obstacle is the reluctance of companies, especially high-performing ones, to dilute their rate of return, whether it be return on equity, return on net assets, or return on capital. "These companies are overly protective of that high rate of return," says Milano, "and it gets in the way of good investments"—investments that would grow future shareholder value.

For proof of the power of growth investing, examine the stock prices of some of the best performers in the current downturn. The companies (with a market capitalization greater than $500 million) that have appreciated the most since their 52-week low are up an average of 42 percent. If you examine how much they have spent on capital expenditures as a percentage of EBITDA, says Milano, the emphasis on growth is clear. "The best companies are also the ones that have plowed a greater percentage of their EBITDA back into their business," he adds. "Growth investing seems to matter."

Tools for Evaluating Trade-offs

To implement a growth-investing strategy, companies have to understand how the market trades off growth versus return. "Ultimately it is the most important trade-off you need to make in developing strategic ideas inside a company," insists Milano. Doing so requires a comprehensive set of tools for strategic analysis—and a corporate mindset that focuses on value creation.

While there are many performance analysis tools available, Fortuna Advisors has developed a set that simplifies the process, says Milano. The starting point is a generic measure— Business Returns—that links to the capital markets and, unlike traditional measures, encourages growth because it doesn't penalize new investment. (See www.fortuna-advisors.comfor a full explanation.) As business return improves, a company's market-to-book ratio goes up. "So the higher the return you earn, the more that [investors] will mark up the value of your business to a higher multiple of the amount of money you put in," says Milano. Additionally, higher growth companies tend to trade above peers with similar levels of Business Returns.

Fortuna also has a proprietary analytical framework, based on discounted cash flow (DCF), that is linked to observations in the capital markets and driven by sales growth and RIM, or Residual Income Margin (the cash flow that a business generates less the cost of capital employed, shown as a percentage of sales). RIM is an efficiency measure of growth: the higher the RIM, the more value is added by growth. It can be used to help determine when and how to invest in a company's most profitable businesses, no matter what the cycle.

The Need for Internal Capitalism

But merely deploying such tools is not enough. Making the right growth-investment decisions requires the adoption of a culture that Milano calls "Internal Capitalism."

"The stock market is merciless," he explains. "But a lot of times, senior executives do not bring that merciless treadmill inside their companies. They allow assets to be allocated based on politics, not economics; they allow for forgiveness and excuses. But it's like sports—either you win or you lose. And if you bring [market discipline] inside your company, you will have many more wins."

Achieving true Internal Capitalism involves taking several steps: understanding investors' perspectives, evaluating the business portfolio, aligning strategies with shareholder interests, and adopting sound management practices. For example, says Milano, "if you make management decisions based on [net present value] and measure people based on operating profit, you are not going to get good accountability."

Even more important is to make Internal Capitalism pervasive in three areas:

1. Culture. "It must be clear that the corporate objective is value maximization," says Milano. Moreover, there needs to be an emphasis on both continuous improvement and crucial sources of differentiation. "Employees need to think and act like owners," he adds.

2. Strategy and Decision-Making. Strategy must be defined for today and tomorrow, says Milano, but "the emphasis must be on the long term, even if short-term earnings suffer. That's what is so hard about investing in the bottom of the cycle."

3. Performance Assessment. The trade-off between efficiency and growth has to be constantly top-of-mind, says Milano. "The more efficient you are, the more valuable growth is; the faster you are growing, the more valuable efficiency is." Knowing that tradeoff will help every strategic decision you make, he says.

Equipped with the right tools and the right cultural mindset, growth-investment decisions can be made in any cycle. In times like these, adds Milano, finance executives must keep a level perspective. "We have cycles. They happen," he says. "If you keep this in mind—and most companies don't—you will make different decisions about buying more assets when they are cheap and fewer assets when they are expensive, and over time you will produce better returns for your shareholders."

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