

## A Framework for Developing Your Financial Strategy

Financial strategy – the set of policies that determines capitalization, the sourcing of funds and distributions to shareholders – has a significant impact on a company's ability to invest for value creation, provides important signals to the investment community, and can capture for shareholders the value created in the company.

Yet financial strategy frequently receives limited critical review by management. While key components of operations are frequently scrutinized and updated, our experience reveals that, despite its impact on value, many organizations do not have an overarching framework for systematically assessing their financial strategy to ensure it is internally consistent and aligned with the operations of the company. As a result of a number of converging factors, however,

we have seen a rise in demand by boards of directors and management teams to reassess their financial strategies.

To illustrate the issues involved and a framework for establishing an aligned financial strategy, we examine how the senior management team and the board of directors of "Willow, Inc.,"<sup>1</sup> worked with L.E.K. Consulting to realign its financial strategy to address the company's growing balance of cash.

### Willow, Inc. – A Case Study

Willow is a mid-cap industrial services company that operates in an industry where it and its three top competitors collectively have 70% market share. This leaves very few significant acquisition targets in an industry that was once rife with consolidation opportunities.

Over the previous 24 months and just prior to beginning its work with L.E.K., Willow had focused on extracting operating efficiencies from its past acquisitions and was at the point where significant, steady cash flows were being generated. Revenues, however, were expected to grow only in line with the GDP. The company's expressed strategy was to remain focused on its core business in the domestic market (i.e., no growth was planned from vertical integration or acquiring businesses outside its core industry).

L.E.K. was engaged to help Willow's management develop a customized financial strategy that best suited the organization's circumstances and to create a framework for the board to judge both short-term financial tactics and the evolution of the strategy over time.

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To achieve these goals, the following process was used:

**Step 1: Establish an appropriate capital structure**, after which a determination would be made of the magnitude of its cash surplus. It was apparent that Willow was a victim of its success, being both under-levered and generating significant excess cash flows that could not be profitably reinvested into the business.

**Step 2: Understand whether Willow was undervalued or overvalued in the market** by examining investors' expectations from growth, margins, investments and other financial measures, in order to define the options Willow could exercise with its excess cash.

**Step 3: Develop a financial strategy** to be proposed to the Board for approval, ensuring that Willow's operations are sufficiently funded, that financial balance is achieved, and that its growing cash reserve is deployed appropriately.

## Step 1: Establish an Appropriate Capital Structure

Capital structure is often viewed as a minefield of finance theory. Because of this, many executives default to the status quo, which, given changing circumstances over time, rarely results in full value creation.

An important key to solving the capital structure puzzle is remembering that equity funds (even for private companies) are not free – in fact, they are very expensive. While there is not a contractual obligation to pay shareholders in the same manner as there is for debt holders, there is a very real opportunity cost inherent in equity funds. The cost of equity is high because shareholders bear the systematic risks of being in a particular industry and will suffer the most in a bankruptcy.

In comparison, debt financing is less costly because, being subject to contractual obligations – paying interest and repaying principal – debt holders exchange more certainty for a lower expected yield. Additionally, debt is in a preferred position in a bankruptcy and is tax-deductible, further reducing its cost to the company. While this favors using leverage, doing so increases financial risk, the cost of debt, and the cost of equity. How do these and other factors interact to determine an appropriate capital structure for a company?

At Willow, we relied on three methodologies to shape our recommendations on the appropriate capital structure:

- **Downside cash flow scenario modeling** – A capital structure is derived from a set of downside cash flow scenario forecasts. By definition, this yields a capital structure that can withstand the shocks of the downside scenarios.

- **Peer group analysis** – Peers' current capital structures and trends are analyzed for insights into operating characteristics that might indicate the ability to support more or less debt.

- **Bond rating analysis** – The debt capacity within given debt ratings is assessed.

Establishing base-case and downside scenario cash flows changes this exercise from a theoretical discussion to an intuitive one because it permits the inclusion of risks, management preferences, and cash flows into the decision.

To understand the magnitude and volatility of cash available for debt service, the first step is to build a base-case cash flow forecast for the next three to five years. In Willow's case, a year-four base-case forecast was used (see Figure A on next page).

Collaborating with management, a number of key risks were identified and quantified to develop a series of downside cash flow scenarios. In each scenario, decisions were made about the level of capital investment that would be made and whether the dividend should be changed in order to work from a realistic set of forecasts. Willow decided that, under all but the most severe downside scenarios, it would seek to maintain at least 80% of its base-case capital expenditures. Under no downside scenario would it increase dividends.

**Figure A: Base -Case Forecast**

(\$ Millions)	Year 4
Revenues	\$1,754
Operating Expenses	(\$1,419)
Operating Profit	\$335
Taxes on Operating Profit	(\$94)
Add Back Non-Cash Items	\$138
Incremental Working Capital	(\$11)
Incremental Fixed Capital	(\$175)
Cash Available for Distribution	\$193
Dividends	(\$12)
Cash Available for Debt Service	\$181

With the downside cash flow scenarios quantified, the next steps were to:

- Identify repayment terms for debt that were realistic in a downside scenario. It was agreed to use repayment of 50% of the initial debt outstanding within five years, reflecting the expectations of Willow's bankers.
- Value the potential for making acquisitions and keeping some "dry powder."
- Discuss with management the safety margin that would appropriately balance shareholder value with the risks in the business. Given the steady nature of the industry, management chose to use 75% of the downside cash flows to support its debt (separate from seasonal needs).
- Calculate the amount of debt that met the cash flow constraints and made full utilization of the interest tax shield. The results of the analysis suggested that Willow should target a capital structure with \$762M of debt, which added \$117M more debt to Willow's existing capital structure. As a consequence, Willow now had \$117M of additional capital to manage.

Analysis of the peer group proved not to be insightful, as most meaningful competitors continued to struggle with overleveraged balance sheets as a result of past acquisitions. Synthetic bond rating analysis, on the other hand, was instructive in outlining the debt levels at which Willow's debt rating might be watch-listed and possibly downgraded. The \$762M target for debt fell within those levels, which precluded, in this case, the debate over whether to accept a lower debt rating in exchange for the benefits of higher debt levels.

In discussions with bankers and rating agencies, L.E.K. also identified additional debt capacity that could be borrowed, should it be required for unexpected investments. Willow's management decided that, while not optimal over a long period of time, it would be acceptable to borrow an additional \$300M of debt for the right investment. This did not include the cash flow contribution from an acquisition, which could potentially support additional debt as well.

## Step 2: Understand Whether Willow Is Undervalued or Overvalued in the Market

For share repurchases to be a viable option, it was important to understand whether the company's stock price was appropriately valued to avoid repurchasing overvalued stock. To make that determination, the performance expectations embedded in Willow's stock price were quantified and compared with management's forecasts. Through research of investment reports, interviews with sell-side analysts, and discussions with institutional investors that held Willow's stock or that of its peers, a consensus forecast of investors' expected value-driver performance was created that explained Willow's \$12.50 stock price at the time.<sup>2</sup>

By comparing investors' expectations of performance of a company's value drivers – sales growth, operating profit margins, cash tax rate, and incremental fixed and working capital investment – to management's expectations, it is possible to pinpoint the areas where they differ and investigate how they can be addressed.

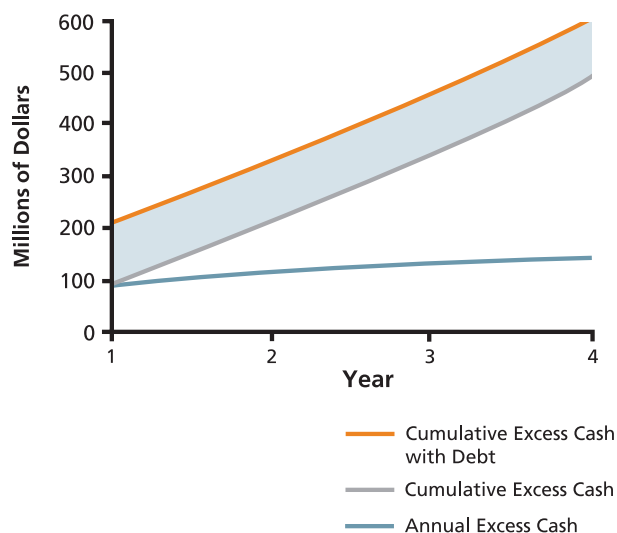
The key difference between investors' expectations and those embedded in management's forecast was the operating profit margins. Willow's management maintained a strong belief that the recent changes it had made to reduce costs and gain efficiencies would add noticeably to operating profit margins. In addition, the aggressive pricing strategies applied by competitors seemed to have abated (although this formed the basis for one important downside cash flow scenario).

A discounted cash flow valuation of management's base-case strategic plan yielded a value of approximately \$15.00 per share for Willow, indicating the stock was undervalued by 20%. Scenario analysis, where different outcomes for the business are captured in the value drivers, was conducted with particular attention paid to the impact of growth, pricing and efficiencies on the operating profit margin. This analysis identified the range of undervaluation to be between 15% and 25%.

L.E.K. also gathered commentary from investors indicating that they were pleased with the fiscal discipline that Willow's management had demonstrated. As a result, they expected Willow either to find acquisition opportunities or to begin returning cash to shareholders.

In summary, the conclusions from the market expectations analysis were that Willow was undervalued by up to 25% and that investors supported a gradual realignment of the firm's financial strategy to reflect its continued strong cash flows.

**Figure B: Excess Cash Flow Forecasts**



### Step 3: Develop a Financial Strategy

The scenarios developed in the capital structure phase served as the basis for quantifying the amount of excess cash Willow expected to generate from operations.

Excess cash is defined as:

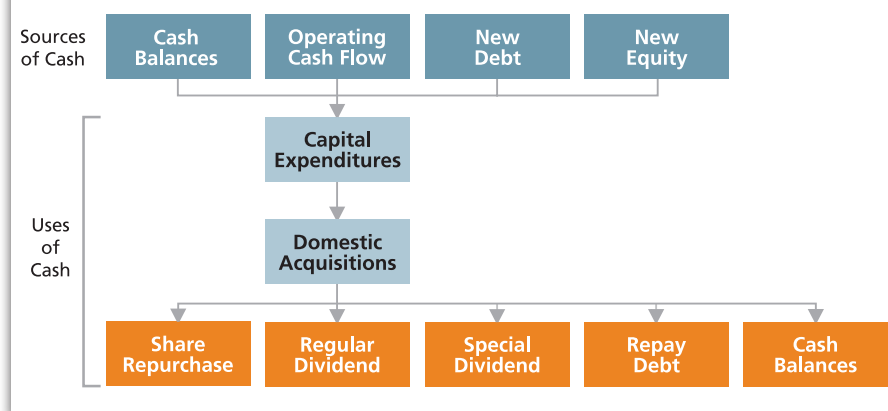
$$\begin{aligned}
 &\text{Net Income} \\
 &+ \text{Depreciation \& Amortization} \\
 &+ \text{Difference Between Book Tax and Cash Tax} \\
 &- \text{Incremental Working Capital} \\
 &- \text{Capital Expenditures} \\
 &- \text{Acquisitions} \\
 &- \text{Dividends} \\
 &+ \text{Proceeds from Exercise of Options} \\
 &= \text{Excess Cash}
 \end{aligned}$$

This definition incorporates not only operating and finance expenses (in net income), but also includes expected outlays for capital expenditures and acquisitions. Excess cash is money for which Willow currently had no immediate use. Management's base-case forecast indicated that Willow would generate \$489M in excess cash over the next four years. With the

addition of \$117M in new debt, Willow expected to have \$606M in excess cash to dispense over the next four years (see Figure B below).

Senior management recommended to the board that Willow return a significant portion of the excess cash to shareholders. To help decide the exact amount and the manner in which it should be done, L.E.K. and Willow's management created a financial strategy framework that defined the elements of the company's sources and uses of cash. The framework illustrated how those elements could change over time – but remain balanced – as the company evolved (see Figure C on next page).

Preferably, the first use of cash from operations is to invest in capital expenditures and acquisitions. In Willow's case, however, the investment opportunities possible at the time could not absorb the available cash. Thus, the other options for the monies were to return it to shareholders through various mechanisms such as dividends or share repurchases, repay debt, or accumulate the cash on the balance sheet.

**Figure C: Financial Strategy Framework**

## Balancing Willow's Sources & Uses of Cash

### Cash Sources

#### Cash Balances

Willow had \$92M in cash balances. An analysis of Willow's seasonal needs and cash collection cycle determined that \$74M was a sufficient amount to maintain, leaving \$18M as excess. The board's debate about this amount centered on the need to keep "dry powder" in the event of an adverse event or an acquisition opportunity. However, there is a cost to keeping cash on hand.

As with any other asset the company employs, cash must earn a return for shareholders. A simple measure is to multiply the excess cash by the cost of capital ( $\$18M \times 9\% = \$1.6M$  for Willow). This annual "carrying cost," and Willow's ready access to debt capital, drove consensus of the required cash balances to \$74M.

#### Operating Cash Flow

As shown above in the excess cash flow analysis, which incorporates capital expenditures and acquisitions, Willow was expected to generate more than \$489M in excess cash over the next four years.

#### New Debt

From the capital structure phase, L.E.K. determined that Willow should borrow an additional \$117M to move toward an appropriate capital structure. This added to the amount of excess cash destined for distribution.

#### New Equity

Given Willow's undervaluation, it was deemed the wrong time to issue new equity. However, at some point in the future, an issuance of equity could be an appropriate mechanism to balance Willow's sources and uses of cash. Presumably, that point would occur when Willow is overleveraged, overvalued, in need of cash unavailable from other sources, or some combination of the above.

### Cash Uses

#### Cash Balances

One option for employing Willow's incoming cash flow was to keep accumulating cash on the balance sheet. However, accumulating an additional \$489M over four years was clearly excessive. Once management and the board assessed the carrying cost of unneeded cash, they decided to return the cash to shareholders if it could not be invested at attractive returns in the business.

#### Repay Debt

It seems natural that, if a company is cash rich, it should free itself from the burdens of debt. However, as the capital structure analysis demonstrated, the opportunity cost of equity capital should instead lead to increasing Willow's debt levels to better balance the benefits of leverage with its costs.

The board agreed that Willow should make use of this low-cost form of financing, while still maintaining sufficient access to the debt markets to finance an unexpected acquisition that could create a competitive advantage for the company.

#### Share Repurchase

Another option was to initiate a share repurchase program and establish it as the main instrument for distributing cash to shareholders. The key reasons were that a share repurchase program:

- Creates value for remaining share holders if the stock is undervalued.
- Signals to the market that the stock is undervalued, helping to raise the stock price closer to management's valuation.
- Returns cash to the shareholders who want to sell their stock, thereby not imposing a possible taxable event on those who do not want one, as would be the case with a dividend.
- Provides flexibility to distribute cash as fits the company's circumstances.
- Can return larger amounts of cash to shareholders than an increase in regular dividends.



Repurchasing shares also shows a continuation of management's fiscal discipline. There was little concern among investors that Willow would be perceived negatively if it openly acknowledged, through a repurchase of shares, that attractive acquisitions or investments were not available. It was understood that there were few acquisition targets and that their prices likely made them value destroying. Hence, returning cash to shareholders was seen as a sign of strong fiscal discipline.

when, if, and to the degree it chooses, within established boundaries.

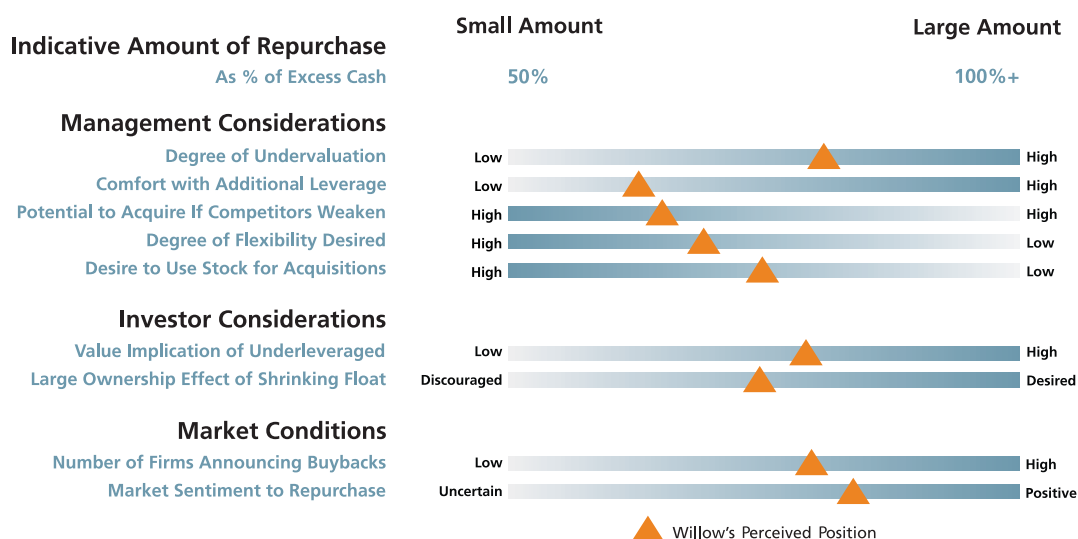
The magnitude of the repurchase program was largely defined by the capital structure and excess cash flow analyses. However, to determine repurchase amounts for the future, L.E.K. created a mechanism to make explicit the key considerations (see Figure D below).

This framework allowed management and the board to discuss the amount of

two years earlier but had not planned on it being a regular element of returning cash to shareholders. However, new changes in the tax treatment of dividends had removed significant tax disadvantage compared to capital gains.<sup>3</sup>

In addition, investors have come to appreciate and to a certain degree expect cash-rich companies to issue dividends. A nominal dividend is generally not sufficient for a company such as Willow. The decision was made to increase the

**Figure D: Considerations for Amount of Repurchase**



While Willow believed it was undervalued in the market, it wanted to approach share repurchases cautiously. This, together with the fact that it felt its shares were potentially only mildly (as low as 15%) undervalued and the amount of shares it sought to repurchase was relatively small, led them to favor an open-market repurchase program. One of three approaches to repurchasing shares, an open-market program permits the company to buy back shares without a premium (as it must with the two other methodologies)

excess cash that could be returned to shareholders, specific management issues to consider, investor considerations and market conditions, all of which served to help decision makers reach consensus on the size of the repurchase program.

#### Regular Dividend.

Dividends communicate a strong, continuing commitment to return cash to shareholders and indicate the company's comfort level with its ability to generate sufficient cash to do so in the future. Willow had initiated a nominal dividend

dividend moderately to yield 1%, which was approximately half the S&P average dividend yield at the time but signaled a step in the right direction.

#### Special Dividend.

A special dividend can be considered a pressure relief valve when other avenues for utilizing cash are deemed inappropriate. It is used by companies that have significant excess cash (after investments and acquisitions) and overvalued stock, and who do not want or need to repay debt or increase the regular dividend. In those circumstances, repurchasing shares would destroy

value, so issuing a special dividend would relieve the pressure of cash accumulating on the balance sheet. Since Willow's stock was undervalued, a special dividend was not considered.

### Implementation and Results.

Ultimately, Willow decided to increase its financial leverage by \$117M over an 18-month period, leave its dividend payout untouched, and undertake a multi-year open-market share repurchase program, starting with an amount up to \$75M in the first year, to be revised annually. As expected, the announcement was well received by investors and created a small but important abnormal increase in the value of the stock during the week following the announcement. Willow went on to repurchase the full amount of stock it had targeted and, within nine months, the board agreed to raise the dividend to a yield of 1% with the intention of gradually increasing it to 2%.

The following year, Willow increased its share repurchase program because excess cash flows exceeded original estimates and, with experience, management and the board gained a level of comfort that their financial strategy was appropriate for the company's situation. Willow's stock continues to rise, outperforming both the S&P500 and an index of its peers.

The company's performance targets also continue to rise. When L.E.K. values management's internal plans on a semi-annual basis, we note that, while the value gap is still present, it is shrinking. Clearly, Willow's strong financial results, its self-declared focus on cash flow and its financial strategy have led investors to re-evaluate their expectations of future

performance to be more in line with those of management. The existence of a value gap indicates that open-market share repurchases continue to be an appropriate tool for Willow to manage its excess cash position, especially as it provides the flexibility to act in the event that a significant investment opportunity is revealed.

### Applying the Lessons

Willow's case, while specific to its conditions and needs, provides important lessons for companies that are looking to align their financial strategies with their operations in the ongoing effort to maximize shareholder value.

First, boards of directors and management that are sharply focused on maximizing the value of the firm will recognize the importance of reviewing and adjusting their financial strategy just as rigorously and frequently as their operating strategy. The latter supports the former, but many companies stop after having addressed only their operating strategies, leaving on the table the opportunity to create even more value.

Second, the perceived shroud of complexity surrounding financial strategy can be lifted by analysis that is well grounded in finance theory but made intuitive to decision makers. Without sufficient financial data, relevant frameworks, and effective decision-making processes in place, critical financial decisions can be misguided and/or next to impossible to execute.

Third, a measured and deliberate approach to changing financial policy can provide

sufficient time for the company and investors to digest the significance of changes. It is rare that all cards need to be played at one time. Directionally correct moves toward an appropriate target, combined with an approach that avoids the costly mistakes of hoarding unneeded cash, not utilizing debt capacity, etc., can create significant shareholder value.

Fourth, communicating both internally within the company and externally to investors can help refine a financial strategy and possibly avoid costly missteps. Creating a common framework within which Willow's board could discuss financial strategy in a holistic manner proved to be constructive and avoided endless debates.

Shareholders have benefited from Willow's realignment of its financial strategy through an increasing share price, having an appropriate amount of leverage and exercising ongoing fiscal discipline. These benefits continue to add significantly to the firm's shareholder returns and to the overall health of the organization.

While financial strategy is just part of a broad arsenal of tools available to enhance shareholder value, it is an important one because it provides a number of levers that can be fine-tuned on a regular basis. Its effectiveness relies on management teams' and boards' willingness to evaluate and adjust those levers as frequently as they do those of their operating strategies.

*1. "Willow, Inc.," is a disguised corporation. All values have been disguised.*

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and analytical rigor to help clients solve their most critical business problems. Founded more than 25 years ago, L.E.K. employs more than 900 professionals in 20 offices across Europe, the Americas and Asia-Pacific. L.E.K. advises and supports global companies that are leaders in their industries – including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. L.E.K. helps business leaders consistently make better decisions, deliver improved business performance and create greater shareholder returns. For more information, go to [www.lek.com](http://www.lek.com).

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