3

PRELIMINARY ANALYSIS

The White Rabbit put on his spectacles. "Where shall I begin, please your Majesty?" he asked.

"Begin at the beginning," the King said gravely, and "go on till you come to the end: then stop."

Lewis Carroll, Alice in Wonderland

The first element in the Business Investment Roadmap is the preliminary analysis, as shown in Figure 3.1. The preliminary examination offers six questions to frame your analysis of an investment. A good first step is to ask the proponents of an investment to answer these six questions. Keep in mind that proponents, by nature, tend to be enthusiastic about an investment; they might not be objective enough to see anything that does not support the investment, even if such weaknesses are obvious to an outside reviewer. Also be sure to check the information that they use to answer the questions. As always, be mindful of situations where the proponents are in a position politically where they can drive the decision to make the investment, no matter what the merits of the investment are.

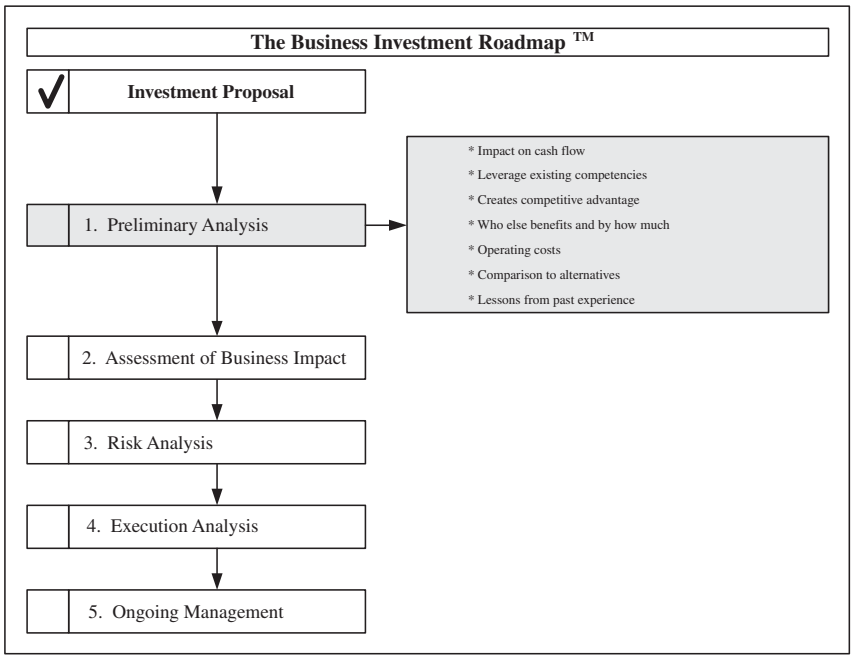

Figure 3.1 Decision Route: The Business Investment Roadmap Preliminary Analysis

Let's proceed through the six questions for the analysis as listed in Figure 3.2.

1. Assume That We Make This investment and It Is Successful. What Will Be the Impact on the Company's Cash Flow?

This question seems so simple and obvious that you might wonder why it is here, let alone as the first question. It is first because it is the most important question; it is the fundamental basis of analyzing investments. For example, imagine that you are considering an investment in equipment that will enable you to reduce your costs of providing customer support by 10 percent through improvements in support staff efficiency and productivity. The vendor shows you that this equipment has yielded an ROI in excess of 200 percent at other

Six Questions to Ask an Investment's Proponents

Assume that we make this investment and it is successful.

1. What will be the impact on the company's cash flow?
2. Will this investment leverage our existing competencies and help to create a competitive advantage?
3. Who else benefits and how much of the benefits from the investment do they receive?
4. What is the long-term committment? How much cash will we need to devote to the investment on an operating basis after the initial investment is completed?

Assume we want to make this investment but cannot.

5. What is the next best alternative?
6. Is there anything we can do differently that gets us nearly the same benefits in cash flow returns to the company?

Figure 3.2 Six Questions to Ask Investment Proponents

companies. This investment appears to be a certain winner, so why not proceed with it right away to ensure that your company can start enjoying the benefits as soon as possible?

Here's why. A quick review of your company's income statement indicates that customer support costs represent about 5 percent of total expenses. Even if this investment works and provides the high ROI exactly as promised, it will, at best, reduce total expenses by about 0.5 percent (customer support costs of 5 percent are reduced by 10 percent; 10 percent of 5 percent is 0.5 percent). The 0.5 percent reduction assumes the *very best* scenario; the investment is implemented without any hitches and it performs precisely as represented by the vendor; even though we all know that the execution of investments seldom goes exactly as planned. Also, you have not even considered whether the returns to the company are easily and objectively measured or more subjective (e.g., increased morale). In addition, the vendor's claim assumes that the benefits in

savings will be in cash outlays, which will have to come from a reduction in the salaries paid to customer service representatives through layoffs, lower wages, or reduced hours for each representative. The vendor's analysis conveniently excludes critical questions related to what happens to the service representatives who cannot find another position in the company. For example what about the costs of the layoffs and decreased morale?

Even putting aside these issues that the vendor doesn't talk about, the bottom line impact to the company is relatively minimal. With this kind of relatively low bang for the buck, why bother? Keep the checkbook closed; your company's valuable resources would be better spent elsewhere. Your analysis is complete; it is time to move on to activities that will provide a better return to your company in higher profits and growing corporate value.

This simple focus on the impact on company cash flows for every type of investment opportunity might be a major reason decision makers at many companies are simply saying no to investments. Their view might be that even if the investments are successful and the vendors' products do provide a high return on the dollars invested, the impact on incremental cash flows just is not enough to make the effort.

Alternatively, assume that the impact on incremental cash flows will be significant. Going back to the example of an investment in equipment that reduces customer support expenses, let's assume that customer support costs represent 30 percent of your expenses and the savings from the investment will reduce spending for salaries and, thus, increase bottom line cash flows. The investment now would result in cutting your total expenses by about 1.5 percent. In today's increasingly competitive marketplace, this investment might be worth making, particularly in industries in which profit margins

are low. In contrast, if profit margins are relatively high in your industry and company, then 1.5 percent might not be sufficient to justify pursuing the investment.

The Incremental Cash Flows Are What Matter: The preceding example focuses on the importance of evaluating investments in terms of incremental cash flows. It is the cash flows that will sustain growth in corporate value, and all investments need to be tracked in terms of the impact on incremental cash flows. This focus applies even for the relatively rare investments that have potentially high returns with low risk "on paper," when the investments are being proposed. When considering these types of investments, you need to determine whether the projected revenue gains are realistic and whether those gains will actually produce incremental cash flows. You also need to determine if the investment returns really are low risk. Consider, for example, Johnson & Johnson, a global company that provides products ranging from Band-Aids and Tylenol to very sophisticated medical instruments used in noninvasive surgery. The investment would be for the development of a new type of bandage that can be used in the home, one that helps to seal minor cuts while providing protection against infection. In this case, they would need to drill down on the assumptions regarding the revenue opportunity (size of the market and its growth rate) and confirm by looking at the income statements of other companies offering similar products that the projected cash flows are realistic. In this example, Johnson & Johnson would have the benefit of using data on sales from its regular Band-Aid products as a reference point when projecting incremental cash flows.

2. Will This Investment Leverage Our Existing Competencies and Help to Create a Competitive Advantage?

Many of us are familiar with the saying that you need to walk before you can run, and crawl before you can walk. The same logic applies when we evaluate investment opportunities. Companies often make investments before their people and processes are capable of assimilating them, and, as a result, they are unable to attain the promised benefits. As an example, think about the massive investments many companies have made in enterprise resource planning (ERP) software without appropriate investments to change their processes and prepare their staffs for organizational changes. Many ERP projects failed, primarily because of the lack of sufficient investments in infrastructure, process change, and lack of staff support for organizational change. (Many companies offering enterprise-level software, including sales force automation software, now provide their products via the Web, significantly reducing the up-front investment in time and resources needed when companies had to load and configure software on their own systems, or else simply would not make the investment in hardware. Seibel, for example, has now begun offering its software as an applications services provider [ASP].)

Most of us are creatures of habit, and it is difficult to get us to change. Changing the procedures and processes in a business is even more complex and difficult, especially because the company has to continue with normal business activities during the transition. Some people describe this challenge as akin to changing the transmission in a car while it is going 60 miles per hour. It is not an easy task, and often is more likely to fail than succeed.

As a manager, you cannot count on the fact that an investment will achieve the returns you expect unless your organization is fully prepared to accept and grow from those changes. You need to have

the infrastructure in place—at a minimum the people and physical assets—to gain the benefits from an investment. For example, many HRM-driven efforts to improve morale and performance of sales staff fail because compensation systems are not realigned to reinforce the messages and reward people for the adoption of the new ways of doing business.

This process is, of course, much easier said than done. Often changes in compensation plans spur many people who were comfortable under the old structure to leave. Recently, for example, one of the nation's leading retailers of electronics products, Circuit City, decided to change the ways that it sold products in response to continued declines in the price and profit margins of electronics products. Rather than having commissioned salespeople work closely with prospective customers, the company decided to move to more of a self-service system. In response to this change, the company altered the compensation structure for its sales representatives from commissions to straight salary. Many of the more successful salespeople under the old system have since left the company.

Similarly, many management and IT consultants seek to have their clients recognize the importance of making investments that fit within the overall corporate strategy or what is often called "business model" or "business design." Adrian Slywotzky and David Morrison with Karl Weber, in their book *How Digital Is Your Business?* focus on this issue.[1] They show that it is not technology that drives higher growth and returns, but business models and the use of technology to support those business models. Other researchers have found no positive relationship between investments in technology and increased returns to shareholders (unless you count the shareholders of the companies making the sales).

1. Adrian J. Slywotzky, David J. Morrison, with Karl Webber, *How Digital Is Your Business?* (New York: Crown Business, 2000).

Think again about the Los Angeles-to-Boston road trip introduced in the last chapter. You are driving on the highway and making great time to your destination. Now, you leave the highway in favor of more scenic, local roads, and quickly fall behind schedule; the local roads simply are not sufficient to handle the traffic. The bottleneck is not the highway, but the local roads. Business works in much the same way. Your company should not make investments if it does not have the infrastructure or corporate capabilities and business model that can benefit fully from those investments.

Wal-Mart provides a great example of matching investments with corporate capabilities. Wal-Mart is the global leader in the use of technology (in fact, a recent study found that a significant portion of the total gains in productivity in the U.S. economy during the 1990s was due to Wal-Mart), but the company will only invest when it can easily integrate the new technologies into its existing infrastructure. Disruptions are minimal, and the new technology acts like a turbocharger, rather than as a replacement for existing business processes.

Obviously, it is difficult to answer directly the question of whether your company has the infrastructure and competencies to support an investment. On one hand, it is easy to say "yes," and assume that your company can leverage the investment into a competitive advantage. That is the answer you will get from the proponents of the investment who will sing its praises to you. Accordingly, you must ask them to define as clearly and succinctly as possible the *unique* capabilities of your organization compared to your competitors and exactly how this investment will create a competitive advantage within your business model.

Consider Apple Computer's recent investment in an online distribution system for music. Steve Jobs, one of the founders of Apple

and once again the CEO, leveraged his relationships in the music industry to enable Apple to establish distribution relationships with several major music labels. In the meantime, the company created an online distribution system for music that provides a way to source and download music at a cost of 99 cents per song. Apple's system is, of course, legitimate and legal as compared with the free services that have been subject to lawsuits and other actions by the music industry seeking to close them down.

Although it is still early in the life cycle of the business, Apple's investment has, by most accounts, been a success. More than a million songs were downloaded during the first week that the Apple system was available to the public. Apple's investment clearly leveraged its competencies, and it has given the company at least a temporary competitive advantage that will add revenue and profits to the bottom line. More important, however, the online music business will likely drive sales of the Apple iPod, which is where the company will gain substantially more revenues and profits in comparison to its online music sales.

On the other hand, Microsoft and the major hardware providers like IBM, Dell, and HP are not likely to go into the online music distribution business on their own. The business of selling music over the Internet is simply too small of an opportunity at this time in terms of potential revenue dollars without having the revenue streams and profits from hardware like the Apple iPod. They might, however, get into the business of selling hardware like Apple's iPod.

If your competitors can easily match the investment you are considering, the investment might not provide competitive advantage. Instead, it might simply be part of the ante required to compete. This fact is particularly relevant in industries with commodity or near-commodity products and services. This leads you to the next question.

3. Assume That We Make This Investment and It Is Successful. Who Else Benefits, and How Much of the Benefits from the Investment Do They Get?

This question prompts you to think about whether the benefits from the investment will really result in an increase in revenues, profits, cash flow, and corporate value. Recall the prior example of the company that invested in a customer support system, and the importance of confirming that savings would result in higher incremental cash flows. If the investment in customer support makes your customer support staff more efficient, what does this mean in terms of tangible expense reductions to the company? Will the customer support staff work at the higher productivity level for the same pay? Can the company assume a reduction in the number of staff personnel through attrition? If so, when will the people leave, and how do you consider those cost reductions in your analysis? Is the market so competitive that your investment in providing more efficient customer support results in your staff devoting more time and resources on average to customer inquiries? This could render the investment worthwhile for corporate goodwill but not create a positive bottom line impact. In other words, would the company attract users that require more service and are, thus, likely to be less profitable customers?

Consider the investment that your neighborhood bank made for automated teller machines (ATMs). A transaction handled by an ATM is significantly less expensive than a transaction handled by a teller, and ATMs are available 24/7. These are direct benefits to customers. Nevertheless, ATMs cannot and will not replace tellers; instead, ATMs are simply *expected* by customers in addition to fast and efficient service by tellers. Several years ago many people associated with the banking industry assumed that ATMs and electronic banking would make branches, those high-cost vestiges of past

banking practices, obsolete. Some banks went so far as to close branches and replace them with a wall of ATMs. More recently, banks recognized that ATMs were not a substitute for branches, but simply another way of doing business. The recent decision by Bank of America to acquire Fleet Bank, the leading commercial and consumer bank in New England, was motivated by Bank of America's desire to gain access to Fleet's branch network. Like branches and electronic banking, ATMs are simply another cost of doing business for commercial banks. Customers have clearly gained from financial institution investments in ATMs, but for the banks, it is an additional investment and ongoing expense.

We see a similar situation with retailers' e-commerce sites. At one time, retailers needed to worry only about the challenges of building and maintaining physical stores. The Internet raised the ante by creating pressure on retailers to establish e-commerce sites. Many retailers invested relatively enormous sums of money and devoted significant amounts of management time to the creation of e-commerce divisions. The threat of being "Amazoned" by retailers that did not have to make investments in physical assets like retail stores added to management pressures. Numerous press reports lavishing praise on Internet pioneers and leaders like Jeff Bezos, the founder of Amazon and *Time Magazine* Man of the Year, likely added fuel to the fire of fear at many retailers.

Today, it is accepted wisdom in retailing that you need both "bricks" (physical stores) and "clicks" (a Web presence), even if your Web site is solely for promotions and background information such as store locations and phone numbers. The e-commerce divisions of some retailers have become profitable, but the vast majority of retailers now see their e-commerce efforts as a cost center that is complementary to and supportive of their physical stores or catalog operations, rather than as a profit center. E-commerce has clearly been a factor to increase customer service and satisfac-

tion. Like ATMs for banks, however, the impact on the bottom line has not been positive for many retailers.

The hotel industry has had similar experiences. Today, a hotel seeking a three-star ranking from either the *Mobile Travel Guide* or the Automobile Association of America (AAA) must provide services and amenities that were considered necessary only for five-star hotels a few years ago. For example, a fluffy bathrobe and comfortable slippers was once standard only at leading hotel chains like Four Seasons or Ritz-Carlton. Today, it is a requirement for earning just a three-star ranking. All of these investments by the lodging chains have made our travel experience better and more comfortable, but the returns to the shareholders of the lodging chain stocks have been minimal.

These are only illustrative examples; the key issue is that you need to determine who else benefits from your investments. As with the investments made by banks in ATMs, investments have to be made for competitive reasons, even with minimal incremental positive impact on the bottom line. It might be, however, that the investments you are evaluating do not provide a direct economic benefit to the company and are not necessarily a requirement to compete.

4. Assume That We Make This Investment and It Is Successful. What Is the Long-Term Commitment? Will We Need to Devote Cash to the Investment on an Operating Basis After the Initial Investment Is Made?

Most investments represent just the down payment on what turns out to be a long-term corporate initiative. Consider General Motors' (GM) investment in Saturn. General Motors decided to create an entirely new car brand in the 1980s. The advertising pitch, both for internal and external purposes, was "a different kind of car company." GM invested more than $1 billion in Saturn

and successfully created a new brand, a major accomplishment for any company, but particularly so for GM.

Unfortunately for GM shareholders, Saturn's success has required more investment from GM, not less. GM still has to subsidize Saturn on an operating basis. In an attempt to try and make Saturn more self-sufficient, GM has extended the line of Saturn cars in hopes of growing total volume. Where once Saturn's offerings were primarily sedans, the company now has a full line of cars, including a sport utility vehicle (SUV).

GM's investment in Saturn and the need for ongoing investment is similar to what Ford faces with Jaguar. After investing approximately $500 million to acquire Jaguar, Ford has subsequently had to invest at least that amount to get the company competitive in terms of technology, styling, and reliability of its cars. Although Jaguars are attractive and fun to drive for many people, Ford is now stuck with a major drain on its capital for the foreseeable future, and the marketplace for vehicles in that class is becoming increasingly competitive. Ford also faces a major dilemma in making sure that the use of Ford components in Jaguar is limited, thus limiting opportunities to gain economies of scale in parts. Who wants to open the hood of their brand new Jaguar and see the same parts that are in a Ford Taurus?

There are many other examples where managers have not sufficiently differentiated between initial cash needs to fund an investment and ongoing cash needs. Consider the now outrageous financial projections for the dot-com companies during the late 1990s. Several analysts argued that one of the ways that the high values of some of the dot-com companies on NASDAQ could be justified was that these companies would not require as much capital (cash) for operations once they had built their infrastructure and acquired customers (their initial capital investment needs). In contrast to traditional companies, Internet-based companies were

expected to acquire positive cash flow very quickly. This was due to the reduced need for capital on an ongoing basis for operations and would thus provide greater returns to their shareholders than comparable traditional "old economy" companies.

The reality, of course, was just the opposite. Among the surviving dot-coms, most have found that there is a need for additional capital in both fixed assets, such as plant, equipment, and warehouses, and to support inventory and accounts receivable, or what finance and accounting people call *working capital*. Amazon, for example, soon found out that it needed significantly more capital than expected when the company began to open warehouses around the country to reduce shipping times and also expanded beyond books to other products. More recently, Netflix, the first company to rent DVDs via the Internet, had to invest in inventory and warehouses throughout the country to reduce shipping times and improve customer service. Without this investment, the company could not effectively compete with neighborhood Blockbuster video stores.

This question is not just applicable to major industrial companies or the dot-coms. Many of us have had the experience of owning a car, home, or other asset that seems to own us because of the need for additional spending and resource allocation. For most businesses, an initial investment will inevitably result in the need to devote additional resources. Investments are rarely one-time events.

5. Assume We Want to Make This Investment, but Cannot. What Is the Next Best Alternative? Is There Anything We Can Do Differently That Gets Us Nearly the Same Benefits in Cash Flow Returns to the Company?

This question forces the champions of investments to rethink and justify their proposals. It helps you to cut to the chase because it requires a thorough analysis of an investment in the context of

other investments that might provide similar benefits. It changes the discussion from a yes or no for a particular investment to a review of alternatives. It will often result in your making a better choice.

The question is applicable for all types of investments. Consider R&D. One of the common refrains in research and development is that "the enemy of good enough is perfect." By investing in the "good enough," you can mitigate some of the risks, such as time to market and development (you will see more about risks in a later chapter), trading off a relatively small part of the financial returns. At General Electric, for example, the new CEO, Jeffrey Immelt, has sought to have the company's research facilities focus on getting products to market faster in lieu of doing too much theoretical research.

Consider this question in the context of mergers and acquisitions. All too often, companies jump into acquisitions when other types of relationships can provide the same benefits without the hassles and costs of putting two companies together. In the AOL Time-Warner deal, both companies should have considered next best alternatives. At the time of the merger, management of the companies stated that a key driver behind the merger was a desire to put Time-Warner media properties on the Web. In retrospect, it is obvious that Time-Warner could have accomplished this objective much more easily and at significantly lower costs to its shareholders (even though its past efforts at putting its media on the Web had been expensive failures) by means other than merging with AOL. The results of the AOL Time-Warner deal are not an exception; studies have shown that most acquisitions are financial failures measured by the returns to shareholders of the acquiring company.

The shareholders of Daimler-Benz should have asked this question when asked to approve the company's merger with Chrysler. Because of the size of the two companies and their different products, cultures, and business models, shareholders should have

asked whether there was a better way for Daimler-Benz to achieve the benefits it hoped to get from the merger with Chrysler. As of the fall of 2003, many of the benefits had yet to result in financial returns to the company's shareholders. The Chrysler senior management team has since left, and Daimler-Benz managers run the operations. Only now, several years after the acquisition, are people from the two predecessor companies beginning to work well together. The stock price for the company tells the story of this deal: The market capitalization for the entire Daimler-Benz Corporation as of late 2003 was much lower than the combined value of the companies at the time of the merger.

IBM provides an example of how asking this question can yield positive results. Several years ago IBM embarked on a program to provide project management training for a large number of its employees. The cost of the program, when travel and time out of the office were included, was significant. Although on the surface it seemed that the company had to either reduce the number of employees that would get the training or cut back on the scope of the training, a third option, the next best alternative, was found. This alternative was distance learning, and the company then made an investment to put many of the project management courses online. The effort has been largely successful both in training and in savings. Even more important, IBM has seen the benefits of the training in employee productivity.

Do not be surprised if the answer you get to the question–"Is there another way?" is no. The answer might even include an element of derision from the proponents for the investment. Keep in mind that managers who questioned investments in e-commerce during the dot-com days were told that they just didn't "get it." This might or might not have been true, but whatever the situation, it is your job to question the proponents and seek alternatives. Accept the statement that you "don't get it" and ask the propo-

nents to explain how you should "get it." The discussion will, hopefully, lead to better alternatives for the company's resources.

6. Assume That We Decide to Make This Investment. What Have We Learned from the Past? What Is in Our Lessons Learned Files?

All of us learn from our experiences, and it is always worthwhile to inquire what, if any, investments your organization has made in the past. Situations change, and you need to be especially careful to take what you hear with a grain of salt, because each person has his or her own perspective and memory of the event. You also need to be wary of people who suggest that the investment you are assessing won't work because "we tried it before and it didn't work." The worst thing that can happen after a company makes a bad investment is for it to become so conservative that investments for future growth are never made or made and then starved. The second worst thing that can happen after a failed investment is that people feel so risk averse that the company suffers from analysis paralysis, the desire to analyze investments to the degree where all uncertainty is eliminated, which is, of course, impossible.

Nevertheless, search for information on past investments. What worked, what did not, what happened, and why? Dig as deeply as you can, not just in your company, but throughout your industry. It might also be helpful to learn from the experiences of companies in other industries that embarked on similar investments. Evaluate the proposed investment against what you learn. For example, the experiences with ERP systems of similar size and complexity in other industries could be of value when you are evaluating a proposal to invest in one at your company.

Summary

The preliminary analysis will help you to eliminate quickly investments that are unlikely to be successful before you have devoted a great deal of resources and time to losing efforts. As many managers will tell you, success often results from the investments that you don't make, rather than the ones you do, because you don't have to waste time and resources on losing causes. You might also find it helpful to provide the preliminary analysis to the managers who develop proposals for your company's investments. Working through the preliminary analysis will allow proponents to develop better business cases for their investments, even before going into the detailed financial analyses. Think back to the trip you would be taking from Los Angeles to Boston; like a global positioning satellite (GPS) navigation system, the preliminary analysis will lead you to investments that will help you reach your destination.

Following the Roadmap

This section, which will appear through Chapter 7 illustrates how the Business Investment Roadmap can be used to help your company make successful business investment decisions that grow revenue, profits, and, ultimately, corporate value. Here's where you will get an opportunity to see the Business Investment Roadmap in action with a fictional company, Fresh Breeze, a composite of several consumer products companies that was introduced in the last chapter. You might want to skip these sections for now, and come back later to dig into the details. You can use the "Following the Roadmap" sections as templates when you are evaluating and executing investments at your company.

Introducing Fresh Breeze Corporation

Fresh Breeze is a Chicago-based manufacturer of detergents, personal cleaning products, and air fresheners. It has a number of manufacturing plants throughout the United States. It manufactures essentially all of its own products from commonly available raw materials. Fresh Breeze had approximately $1.1 billion in revenues in 2002, and it has been growing at about 5 percent per year in recent years, as shown in Table 3.1. The company's competitors include several multinational corporations and regional companies that produce house-brand products for supermarket chains and distributors. Fresh Breeze is slightly smaller in revenues than Dial Corp. (2002 revenues of $1.28 billion), significantly smaller than Colgate Palmolive (2002 revenues of $9.29 billion), and much smaller than Procter and Gamble (2003 revenues of $43.77 billion).

The company has three divisions: Personal Cleaning, Laundry Care, and Air Fresheners. About a third of its revenues come from each division. It sells its products throughout the United States through supermarkets, mass merchandisers, drug stores, and other outlets. The company's largest customer is Wal-Mart, which accounts for more than 20 percent of the company's sales, and its top 10 customers together make up approximately 50 percent of its business. Other major customers include IGA, a national distributor for independent supermarkets such as Costco, Target, CVS, Walgreens, and regional discount stores.

Table 3.1 Fresh Breeze Corporation, Net Sales and Sales Growth Percentages, 1999–2003

	1999	2000	2001	2002	2003
Net sales ($ in millions)	$953	$1,000	$1,050	$1,103	$1,158
Sales growth percentage		*5%*	*5%*	*5%*	*5%*

Preliminary Analysis of an Investment: Would You Like That Super-Sized?

Let's begin putting the Business Investment Roadmap into action with a hypothetical proposal from a marketing team. You'll quickly see that the proposal is not completely realistic, but it is excellent for providing a quick and simple example of using preliminary analysis.

Assume that a group of managers in the Laundry Care division at Fresh Breeze are considering a proposal, introduced by one of the marketing teams, to change the packaging size, presentation, and price points for its Summer Breeze line of laundry detergent. Under this proposal, the company would sell Summer Breeze in much larger, double-sized containers at about the same price as the regular Summer Breeze detergent bottles, a marketing position targeted at value-oriented shoppers. The regular-sized bottles would be phased out, which would leave the super-sized containers as well as smaller, convenience-sized packages.

Summer Breeze is currently priced to be competitive with other midtier major brands. The company realized many years ago that it could not compete for brand-oriented shoppers who almost automatically picked up their bottles of Tide or Wisk. Instead, the company sought customers who are value-oriented, those people who want a bargain, but are hesitant to try a completely unknown brand or label.

The marketing team backing the investment believes that offering customers more detergent at the same price as competitors' products will result in Fresh Breeze gaining market share from its competitors and, thus, increase revenues and profits. The larger containers will be particularly attractive at the discount stores and warehouse clubs.

Summer Breeze detergent currently claims 5 percent of the U.S. market for laundry detergent sold, and the analysis by the marketing team proposing the investment indicates that the new product size could double market share to 10 percent. According to the initial analysis, the super-sized detergent bottle will nearly double revenues by gaining market share from competitors.

How does this investment stack up in terms of the six preliminary analysis questions? Are the prospects as rosy as the proponents suggest? Let's apply the preliminary analysis, recognizing that some of the six questions might be more critical than others in the evaluation of this proposed investment.

1. What Will Be The Impact on the Company's Cash Flow If We Make This Investment and It Is Successful?

For the moment, assume that the marketing team is correct in that if the investment is successful it will increase market share of Summer Breeze detergent from 5 percent to perhaps, 10 percent. What would such a gain mean to cash flows?

First, this product extension is meant to take market share away from competitors, rather than to stimulate demand for additional product. Demand for laundry detergent is expected to continue its historical stable growth rate of about 2 percent, so the result of the increase in market share will be a larger piece of essentially the same pie. People don't wash clothes more often as the price of laundry detergent drops.

This is important because if the volume of detergent in a sales unit is doubled, consumers will need to make only half as many detergent purchases to meet their detergent needs, which remain relatively constant. (You can assume in this case that the larger bottle size will not cause consumers to use significantly more detergent per load, but consumer demand and behavior is an important con-

sideration in any investment.) A consumer who purchased laundry detergent every two weeks would, with the new size, now purchase detergent about once a month.

At the same time, the new double-sized detergent bottles will be sold at about the same price as the original containers, so with the new packaging consumers will pay only half as much to meet their full detergent needs. If Fresh Breeze doubled its market share in this category, twice the number of customers would purchase Summer Breeze detergent, but revenues would remain the same, because Fresh Breeze would have cut its revenue per ounce by about half.

Finally, look at the effect of the new detergent bottle size on the cost of producing and selling (see Table 3.2). Assume that for the current product line, the detergent accounts for 20 percent (80 cents) of the total cost of the product, the packaging adds another 10 percent (40 cents), and distribution accounts for 10 percent (40 cents) of the costs for a unit, which averages a $4.00 wholesale price. Together these costs account for 40 percent of the wholesale selling price. Doubling the amount of detergent would increase the cost of the detergent by slightly less than two times, to $1.50 or 37.5 percent.

Table 3.2 Gross Margin Comparison of Regular-Sized Summer Breeze Detergent Bottle and Proposed Larger-Sized Summer Breeze Bottle

	Regular-Sized Bottle		**Proposed Larger-Sized Bottle**	
	Dollar Amount	Percentage of Price	Dollar Amount	Percentage of Price
Wholesale price	$4.00	100%	$4.00	100.00%
Detergent cost	$0.80	20%	$1.50	37.50%
Packaging cost	$0.40	10%	$0.65	16.25%
Distribution cost	$0.40	10%	$0.70	17.50%
Gross margin	$2.40	60%	$1.15	28.75%

Packaging costs would increase to 65 cents or 16.25 percent. Distribution costs would increase to 70 cents, or 17.5 percent. All told, this investment would increase these costs from 40 percent to 71.25 percent of sales. For a product with a low profit margin to begin with, this would be a disastrous move for the bottom line.

Finally, if Fresh Breeze pursues this investment, it might force its competitors to reduce their prices to adopt Fresh Breeze's strategy. The result of such a reaction would likely be that for all of its efforts, Fresh Breeze's increased market share would be short-lived. This is the bottom line: From the perspective of the effects on cash flow, this investment appears to be an unmitigated disaster.

2. Will This Investment Leverage Our Existing Competencies and Help to Create a Competitive Advantage?

The proposed investment would indeed leverage Fresh Breeze's existing competencies; the larger detergent bottles contain a detergent formula that has already stood the test of consumer acceptance in the market, it would be sold predominantly to the same types of consumers it already targets, and it would be sold through the same distribution channels. This is outweighed by other factors, however. Although on its face, this proposed investment would create a competitive advantage for Fresh Breeze, a closer examination shows that this is not the case. The company would potentially increase its market share solely on the basis of cutting its price. Fresh Breeze does not have any real competitive advantage that would allow it to lower its cost structure, especially relative to much larger competitors that obviously have lower production costs and a much larger volume over which to amortize R&D, marketing, and other general costs. The answer to this question, therefore, is "no."

3. Who Else Benefits, and How Much of the Benefits from the Investment Do They Get If We Make This Investment and It Is Successful?

Under the structure of this particular proposal, the only direct beneficiaries of this investment are likely to be consumers, who would not only benefit from the much lower price of Summer Breeze detergent, but from the general downward price pressure on competitive products that Fresh Breeze's actions would likely cause. (This assumes that the retailers do not raise the price on the larger bottles to gain higher margins.) Fresh Breeze, accordingly, does not stand to gain anything from the investment outlined in this proposal other than profitless gains in market share. Competitors are unlikely to profit from Fresh Breeze's actions in the near term; in the long term, it might weaken Fresh Breeze, which could indirectly benefit its competitors. The investment does not pass muster in this segment of the preliminary analysis, either.

4. What Is the Long-Term Commitment, If We Make This Investment and It Is Successful? Will We Need to Devote Cash to the Investment on an Operating Basis After the Initial Investment Is Made?

The up-front development costs for this investment are fairly minimal and mostly involve developing new packaging, adjusting the manufacturing equipment and costs associated with the fairly minor but notable differences in distribution and shelf space for the larger product. There would be some additional investment and long-term commitment in terms of shipping costs and infrastructure changes to handle the larger containers. Once the new product size is launched, it will require the same sort of operating support as other products. The company already has vast experience supporting laundry products, so the incremental operating costs, if any, associated with this investment would be unlikely to cause many

surprises. What *should* be a concern, however, is that the analysis in question 1 showed that the costs associated with this investment will likely outweigh any benefits received from it indefinitely.

5. Assume We Want to Make This Investment, But Cannot. What Is the Next Best Alternative? Is There Anything We Can Do Differently That Gets Us Nearly the Same Benefits in Cash Flow Returns to the Company?

Especially given the distinctly negative impact this investment is expected to have on cash flows, there are likely to be innumerable other investments that are superior to the proposal currently being scrutinized across many different areas of operation and functions of the company. Even restricting the alternatives to investments in product extensions with the intent to increase market share profitably, the choices are still quite varied, considering the size of the company and the variety of products it manufactures. If the general idea of selling more Summer Breeze detergent has appeal to the managers, they should examine other ways to invest to grow corporate value.

Alternatively, the marketing team might consider placing a series of small "bets" (i.e., small investments) by offering a variety of new products and sizes to gauge interest (assuming that their retailers would support these efforts) and, then, invest more resources in the products that have the greatest initial success. More broadly, Fresh Breeze should consider this and similar proposals in the context of its overall investments and prioritize investments according to their potential and likely impact on incremental cash flows.

6. Assume That We Decide to Make This Investment. What Have We Learned from the Past? What Is in Our Lessons Learned Files?

Given its long operating history and the array of products it offers, Fresh Breeze has a large store of experience in launching product

extensions on which it should draw. Managers should look for similar investments the company has made in the past, evaluate their relative success or failure, and try to determine what caused each success or failure. The managers should also draw on the experiences of other companies that sell cleaning products in the same and similar distribution channels. By incorporating these lessons learned, the company's managers might be able to restructure the investment to provide more attractive returns and, ultimately, grow corporate value.

Preliminary Analysis Results

Taking the time to apply the first element of the Roadmap, preliminary analysis, should indicate to Fresh Breeze management in no uncertain terms that they should not make this investment, at least not in its current form. The first question, about the cash flows the investment is likely to generate, was both the critical question and the showstopper. Decisions on other investments with cash flow prospects that look better might hinge on the answers to the other questions in the preliminary analysis. Thus, you need to repeat the process for every investment you consider.