

## Chapter 27

# Competitor Cash Flow Analysis



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# Ch27. Competitor Cash Flow

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- Strengths & Advantages
- Weaknesses & Limitations
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# Ch27. Competitor Cash Flow

## Short Description

- Cash flow is the prime measure of viability and also is a major determinant of operating flexibility — the ability to fund new initiatives and to defend against competitive attacks.
- Cash flow analysis is not sufficient in itself to understand a business or its competitors, however, it can significantly enhance the overall analysis and provides a useful cross-check on the reliability of other analytic techniques.



# Ch27. Competitor Cash Flow

## Background

- Not much study of cash flow analysis to date.
- 1990s 'statement of cash flows' added to annual reports in response to banks and investors being misled.
- Divided into **three sections — operations, investing, and financing.**
- Early cash flow analysis based on accrual accounting statements—current ratio.
- Winaker and Smith, 1930 found that the benchmarks for ratios were industry specific.



# Ch27. Competitor Cash Flow

## Background

- Post 90s recession, cash flow analysis (specifically, discounted cash flow (DCF) analysis) became the preferred method of valuation.
- 2001 McKinsey and Co. post .com bust “Investment values always revert to a fundamental level based on cash flows. Get used to it” (Koller, 2001).
- Banks are becoming ‘cash flow lenders’.
- Today principles of cash flow are well recognized, the practice still has far to go.



# Ch27. Competitor Cash Flow

## Strategic Rationale and Implications

- Cash flow analysis is not just about viability.
- Free cash flow is a determinant of:
  - Financial flexibility
  - Strength (recognized by BCG matrix)
- Historic cash flow not indicative of future performance.
- Ward's cash flow theory: firms need to maintain cash flow stability (between operations, investing, and financing) to achieve financial health and stability.
- Cash flow analysis is less susceptible to the manipulations of creative accounting and timing issues.
- 'Sustainable growth rate' calculation.



# Ch27. Competitor Cash Flow

## Strengths and Advantages

- Cash flow analysis provides insight into the financial viability of a business.
- Cash flow analysis is less susceptible to the manipulations of creative accounting.
- Future cash flow analysis is the most valid tool for assessing a firm's viability.
- Cash flow modeling can calculate the effect on sales, prices, and so on, and show the resulting effects on cash flow.
- Useful for assessing the severity of risks.



# Ch27. Competitor Cash Flow

## Weaknesses and Limitations

- Done rarely and poorly.
- Complex future cash flow modeling is difficult, time-consuming, and prone to error.
- Building a model from scratch provides greater insight but requires more skill and usually more time.
- The validity of any model rests on the validity of the assumptions on which it is built.
- Not done as often as required despite availability of software.



# Ch27. Competitor Cash Flow

## Process for Applying the Technique

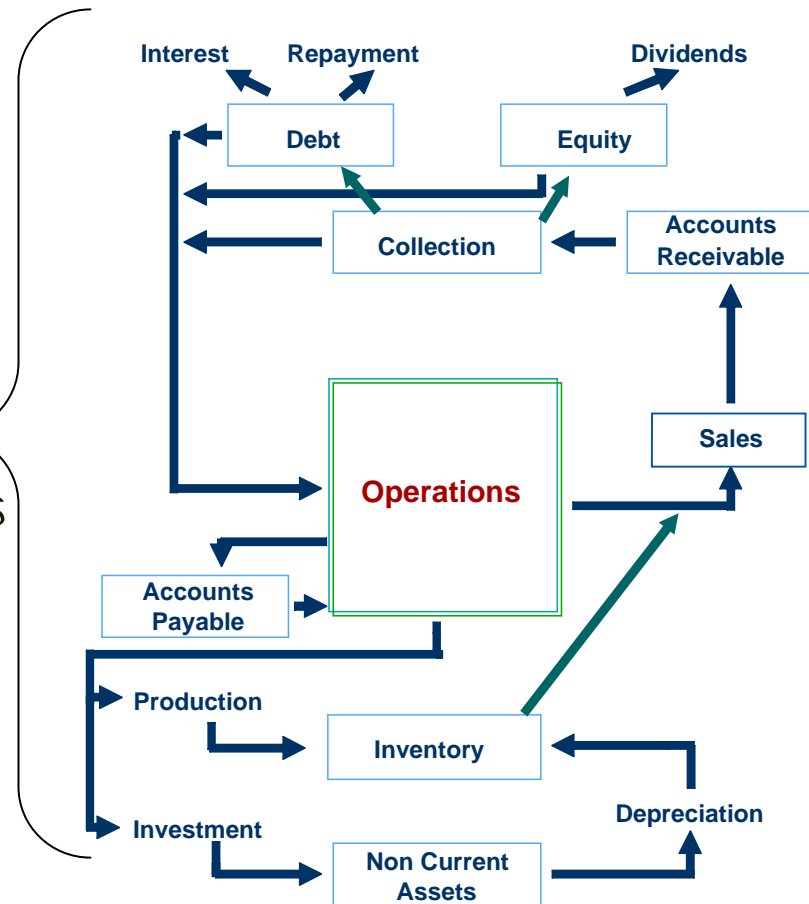
- Quantitative: How much cash is there?
- Qualitative: Where is the cash coming from and going to, and is it sustainable?
- Must look beyond just operations if we are to understand cash flows.
- Profitable companies can fail!

# Ch27. Competitor Cash Flow

## Cash Flow For A Practice (Simplified)

### Process for Applying the Technique

- The basic cash flows in a business (diagram).
- In terms of risk, want to see stable operating cash flows from year to year.
- Have different expectations of companies at different stages.
- Like to see a balance of funding from financing activities.





# Ch27. Competitor Cash Flow

## Process for Applying the Technique

- Qantas: refurbish its fleet of aircrafts.
  - Cash flow from investing activities has been running negative by several billion dollars a year.
  - Most of this investment has been debt funded.
  - 2003, debt to equity ratio had risen from 100 percent to 121 percent.
  - During the next few years, Qantas changed its operational tack, slowing reinvestment in its fleet and increasing its operating cash flow surplus to nearly AUD\$2 billion a year.
  - The excess cash was used to repay debt.



# Ch27. Competitor Cash Flow

## Process for Applying the Technique

- Qantas: Financial Ratios

Ratio	2002	2003	2004	2005
Gearing (L/E)	247 percent	226 percent	201 percent	182 percent
Debt Ratio	104 percent	121 percent	101 percent	86 percent
Sales Margin	3.9 percent	3.1 percent	5.7 percent	6.0 percent
Return on Investment	2.9 percent	2.0 percent	3.7 percent	4.2 percent
Return on Equity	10.1 percent	6.6 percent	11.1 percent	11.9 percent
Asset Turnover	\$0.74	\$0.67	\$0.64	\$0.70

- Analysis of a firm's historical cash flow is improved if it is compared, if not actually benchmarked, against its industry peers.



# Ch27. Competitor Cash Flow

## Process for Applying the Technique

- Future cash flow analysis
  - Builds a model that is a reasonable (but not precise) approximation of the operations of the business.
  - It is used for strategic analysis, valuation, and risk assessment.
  - Gaining knowledge of the business and its competitive environment is crucial.
  - Model needs to be built with flexibility.



# Ch27. Competitor Cash Flow

## Case Study: Historic Cash Flow, Burns Philp

- Burns Philp:
  - Original South Seas Trader.
  - 1980s became involved in yeast manufacture and made subsequent acquisitions in spices.
  - Faced competition from entrenched competitors.
  - 1997, firm was in breach of its loan covenants and its life was only maintained by the banks not foreclosing.
  - The share price plunged from AUD\$1.50 to just 6 cents.
  - The financial statements reviewed are from 1992 to 1995.
  - Objective analysis shows some issues of great concern in a supposedly strong firm.



## Ch27. Competitor Cash Flow

### Case Study: Historic Cash Flow, Burns Philp

- The profit and tax figures for 1993 to 1995 are tabled below.

	<u>1993</u>	<u>1994</u>	<u>1995</u>
Profit before tax (\$m)	147.8	155.6	131.4
Tax (\$m)	<u>-27.6</u>	<u>-21.3</u>	<u>-9.1</u>
Profit after tax (\$m)	120.2	134.3	122.3
Tax as a % of profit	18.7%	13.7 %	6.9%

- Yet the corporate tax rate in these years was over 30 percent.
- Treatment of slotting expenses.



# Ch27. Competitor Cash Flow

## Case Study: Historic Cash Flow, Burns Philp

- The cash flow statements offer more items of interest and concern.
- In summary form, cash flows were:

	<u>1993</u>	<u>1994</u>	<u>1995</u>
<b>Net from Operations (\$m)</b>	151.6	101.1	113.9
<b>Net from Investing (\$m)</b>	<u>-483.3</u>	<u>-432.8</u>	<u>-200.3</u>
<b>Net from Financing (\$m)</b>	250.8	186.6	188.2

- The firm was obviously on a growth binge.
- The operating cash flows have fallen from over AUD\$150 million to just under AUD\$114 million.



# Ch27. Competitor Cash Flow

## Case Study: Historic Cash Flow, Burns Philp

- Superannuation fund.
- Sale of Burns Philp's BBC Hardware.
- Financing cash flows show most of the funding was coming from debt.
- In the end, it survived.
- Major shareholders invested another AUD\$300 million into the firm to try to turn it around.
- Objective cash flow analysis shows the disaster in the making several years before the supposed 'sudden collapse'.



## Ch27. Competitor Cash Flow

### **Case Study: Future cash flow analysis: Power Brewing**

- Early 1990's computer based cash flow modeling was in its infancy.
- Alan Bond buys Castlemaine, Tooheys, and Swan Breweries in Australia.
- Bond quickly alienates pub owners and customers.
- In retaliation, pub owner Bernie Power launches Power Brewing which was quickly selling at capacity.
- Power Brewing borrowed AUD\$48 million from the bank to triple its capacity.



# Ch27. Competitor Cash Flow

## Case Study: Future cash flow analysis: Power Brewing

- The bank developed a spreadsheet to look at future cash flows. (AUD\$)

Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
-\$40.7m	\$24.9m	\$27.5m	\$28.7m	\$29.6m	\$30.4m

- Unfortunately, the spreadsheet had an error.
- Working capital movements were ignored.
- The effect was an additional negative A\$10 million in the first year of expansion.
- Assumptions were simplistic and not reasonable.
- The model was inflexible.
- Market conditions due to these moves produced a price war.

# Ch27. Competitor Cash Flow

## Case Study: Future cash flow analysis: Power Brewing

Year 1	Year 2	Year3	Year 4	Year 5	Year 6
Sales volume down 10 per cent from after year 1					
-\$40.7m	\$13.3m	\$14.4m	\$14.7m	\$14.6m	\$14.4m
Sales volume down 20 per cent from after year 1					
-\$40.7m	-\$1.6m	-\$1.7m	-\$1.6m	-\$1.4m	-\$1.3m
Prices down 10 per cent after year 1					
-\$40.7m	\$12.1m	\$17.3m	\$18.0m	\$18.0m	\$18.0m
Prices down 20 per cent after year 1					
-\$40.7m	-\$6.5m	\$4.4m	\$4.9m	\$5.5m	\$6.2m
Scenario: Prices and volumes down 20 per cent, working capital included					
-\$43.3m	-\$28.2m	-\$23.8m	-\$25.2m	-\$26.7m	-\$27.5m



## Ch27. Competitor Cash Flow

### **Case Study: Future cash flow analysis: Power Brewing**

- Such negative cash flows are not sustainable.
- Power Brewing formed JV with Foster's.
- The case shows that a well constructed model with reasonable assumptions and sensitivity testing would have shown the strategy and business plan to be fatally flawed.



# Ch27. Competitor Cash Flow

- FAROUT Summary**

	1	2	3	4	5
F					
A					
R					
O					
U					
T					

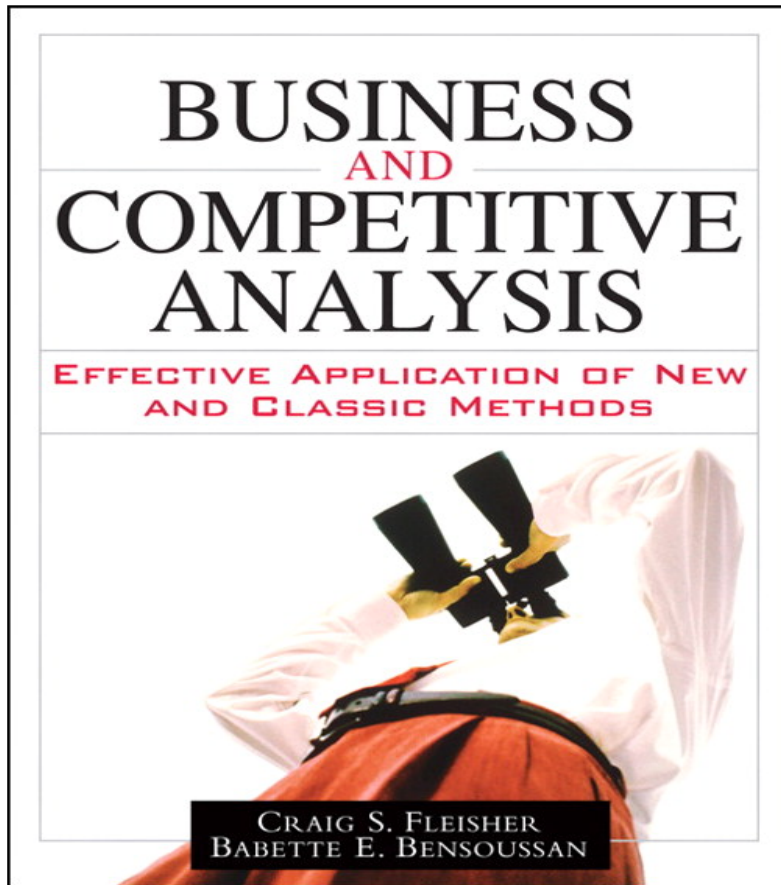


# Ch27. Competitor Cash Flow

## Related Tools and Techniques

- Industry Analysis
- Competitor Analysis
- Market Forecasting
- Financial Analysis
- Cost/Benefit Analysis
- Sustainable Growth Rate
- Historic Trend Analysis

# Ch27. Competitor Cash Flow



For More About **Competitor Cash Flow** and 23 Other Useful Analysis Methods, see:

Fleisher, Craig S. and Babette E. Bensoussan

*Business and Competitive Analysis: Effective Application of New and Classic Methods*

**FT Press**  
FINANCIAL TIMES

Upper Saddle River, NJ  
2007