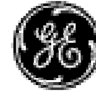

Optimizing Your Balance Sheet for Sustainable Growth

Can growth be harmful to your company's health? The pursuit of growth, as measured by higher sales, is usually taken for granted in business. But growth for its own sake may not always be in a company's best interest, according to John Percival, a professor of finance at Wharton, and Scott Parker, a vice president of financial planning and analysis at GE Capital.

Percival believes that many companies that have either filed for bankruptcy or have had close encounters with Chapter 11 are victims of trying to do too much, too fast. Like the proverbial tortoise that plodded its way past the hare to win the race, a strategy that emphasizes profits over sales gains may yield positive long-term results.

The battlefield of commerce is littered with companies that overemphasized sales growth beyond sustainable levels. Consider, for example, the high-profile flameout of the dot-com sector, whose stock prices plunged 75% from their peaks as of May 2001, according to *The Industry Standard*, a national magazine that covered the New Economy and related issues. For Wharton's Percival, though, the dot-com debacle merely scratches the surface.

Percival points out that companies like Lucent Technologies, which saw its debt ratings cut to "junk" status by Standard & Poors, and Winstar Communications, which filed for Chapter 11 bankruptcy protection (and also filed a $10 billion lawsuit against Lucent), can trace at least part of their problems to fast-growth strategies.

Part of the challenge is to understand the necessity of managing growth, which can force CFOs to balance the long-term health of their companies against the demands of Wall Street analysts who often look for quarter-to-quarter expansion. Instead of a blind commitment to growth at all costs, however, Percival suggests an alternative known as Sustainable Growth.

An Emphasis on Profit Instead of Sales

"Simply increasing sales may not lead to long-term success because the growth in revenue carries a corresponding increase in variable costs for such things as production equipment, labor and inventory," explains Percival. "Instead, a company should concentrate on sustainable growth, which is characterized by first increasing profit and then retaining the earnings within the company."

Finding a company's maximum sustainable growth rate doesn't have to be a hit-or-miss proposition. Percival says a formula can quantify a company's growth potential by considering the relationship between the return a firm generates on its

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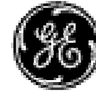

shareholders' equity and the portion of its earnings that it plows back into that equity.

"Sustainable growth boosts a company's net equity, making it more attractive to both capital and equity markets," notes Percival. "Carefully streamlining a company's balance sheet, including shedding certain debt, re-allocating assets and elimination or reduction of non-earning assets, is one way to achieve sustainable growth."

But before taking steps to optimize a balance sheet, finance executives should thoroughly comprehend the finances of their company, the environment in which it operates and the types and cost of capital available to it. And rather than taking a knee-jerk position against debt, Percival suggests that companies recognize the positive role that debt can play in the value creation that underlies sustainable growth.

"Depending on the company's circumstances, some types of debt are better than others," he says. "It is important to align the nature of your assets with similar liabilities. For example, short-term assets should not be financed with long-term debt. The savings and loan industry borrowed short and lent long, but an uptick in interest rates doomed the industry."

Pairing off your assets and liabilities, however, may involve making some counter-intuitive moves.

Breaking Up May be the Right Thing to Do

Percival cites Marriott, the worldwide hospitality company, as an example of an organization that charted an effective strategy. In 1993 the company split its operations into two companies — Marriott International and Host Marriott — and loaded Host Marriott with most of the firm's real estate holdings and debt. Marriott International went on to engage in structured financing transactions, selling off substantial assets to passive equity investors and then securing contracts to manage those very assets. While the sale of assets brought cash in through the front door, the management contracts provided for a revenue stream over a longer period.

The principle behind the actions is what's important, says Percival. "Optimizing a balance sheet through a structured financing strategy may enable a company to identify business segments that may be of limited value to itself, but for a variety of reasons may be worth a premium to other entities."

In Marriott's case, the company correctly determined that depreciation and other tax benefits associated with its hotels would be worth a premium to high tax-bracket investors.

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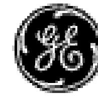

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Debt and Taxes

Of course, asset disposal may not always be the best way a company can raise capital. For a variety of reasons the market may not be right for a sale, or, in the case of service providers, there may not be much of a tangible asset base to tap into. In such cases, debt or asset financing may be an appropriate vehicle to spur sustainable growth, says GE Capital's Parker.

"The cash provided by debt financing can open up expansion opportunities for a business," he says. "But a CFO needs to consider the relationship between the company's debt and equity and whether cash flow and earnings can cover debt charges."

Parker adds that the following issues should be considered within the context of balance sheet optimization and cash flow:

- How much liquidity a company has (Cash on hand can be considered an offset to debt, and a firm can leverage its cash position by taking on a controlled amount of debt.)
- The cash flow impact of the tax deductibility of interest charges
- Alternative debt financing, such as a balloon-payment or other interest-deferred loan that matches cash outflow with cash inflow

"For many companies, especially in the middle market, there's a gap between the need for capital and the ability to tap into secured financing or capital markets," says Parker. "They need to be able to connect with Wall Street and match up their needs with the return expectations of capital providers. Often, companies that are new to the market will need to gain financial credibility, and a strong balance sheet can play a significant role in the process."

But the traditional methods of shaping up a balance sheet may not always be the right ones.

"Consider the example of Marriott," he says. "The timing worked out favorably for the company when it decided to spin off a portion of its assets. But what if the market wasn't so favorable? Marriott might have missed an opportunity."

He says this is an example of a potential drawback to owning instead of leasing assets.

"Part of a company's approach to balance sheet management is deciding how to best deploy its capital," observes Parker. "Buying assets outright may be favorable if the opportunity cost of the funds is lower than a lease alternative. On the other hand, if a decision is later made to dispose of the assets before their useful life is extinguished, it may be more economical to finance or lease them".

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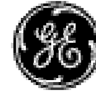

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According to studies conducted by GE Capital, the ability to dispose of assets -- particularly non-core assets -- is becoming more important as companies seek to shore up their balance sheets through decreasing their excess leverage.

Dispose of Non-Core Assets, But Retain the Revenue Stream

According to Andrew Good, the strategic pricing leader at GE Capital's Commercial Equipment Financing business unit, over-leveraged companies can choose from a variety of solutions, including optimizing their balance sheet and raising funds by monetizing non-core assets, often through a sale-leaseback transaction, or they can eliminate overhead costs through an outsourcing agreement. In some cases, he adds, a combination of both approaches may be appropriate.

"A CFO often faces a decision tree, where he or she will consider a number of options," observes Good. "Deciding on the best strategy involves considering the company's current position and where management wants it to be in the long term."

Good notes, for example, that a company that must remain in compliance with financial covenants may wish to manage its financial ratios by monetizing non-core assets.

"Often, the book value of a company's assets are significantly lower than fair market value," he says. "The company may therefore realize a gain on the sale of those assets, which would strengthen the balance sheet and improve financial ratios by transforming a fixed expense into a variable cost. Additionally, leasing the assets back from the buyer may enable the company to continue to maintain control over production or other processes."

A recent *Wall Street Journal* article notes that McDonald's, which has extensive real estate holdings consisting of the land on which its franchised units were built, is considering this strategy through the potential sale of many of its properties.

"McDonald's core business is food, not real estate management," says Good. "The company could choose to unlock the value of a non-core asset, real estate, by selling selected properties to a real estate investment trust in a sale-leaseback transaction. Meanwhile the entire process is transparent to franchisees."

In some cases, however, a CFO may recommend outsourcing non-core processes to a third party.

"CFOs have to ask if their companies should continue to perform certain functions," says Good. "Outsourcing operations to a third party that can manage those functions more efficiently and at a lower cost -- while maintaining the quality -- may make sense."

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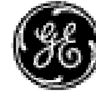

While Good distinguishes between monetization and outsourcing, he adds that a mix of the two strategies may also make sense.

According to Claudia Stone Gourdon, managing director at GE Capital's Structured Finance Group, in this 'blended' approach, non-core assets are generally sold to a third party (the owner), and then a contract is signed with another company (the operator). Because of its own balance sheet considerations, the operator does not want to own the asset but wishes to operate it under contract.

While the form of the contract will depend on the operator's goals, the owner will establish a Special Purpose Entity (SPE) and the company will sell the asset to the SPE. "The company and the operator then enter into a long-term contract that typically includes a base fee that covers the capital charge and the services costs," explains Gourdon. "Properly structured, the transaction enables a company with a non-core asset to realize a monetary gain, while outsourcing the product enables the company to retain a benefit from the sold asset."

"Monetization and outsourcing, used either separately or, in some cases together, represent a growing trend and can benefit companies in the industrial sector by reducing excessive debt levels and fostering growth in their core businesses," says Gourdon.

"Companies today have a heightened awareness of the need to optimize their balance sheet as a component of achieving sustainable growth," adds Percival. "Now it's a question of whether they will take the steps necessary to implement it."

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