



When performance is an issue, executives focus mainly on the income statement and cut costs. But tight management of the balance sheet often liberates more cash, preserves a company's options and drives value for shareholders.

Right-sizing the balance sheet

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When the pressure builds to improve performance, most business leaders adopt measures that affect the income statement

They cut discretionary spending. They centralize support functions. They lop off unnecessary layers of management, eliminate low-value projects and so on, all with an eye to “right-sizing” the cost structure. And of course they do what they can to increase profitable sales.

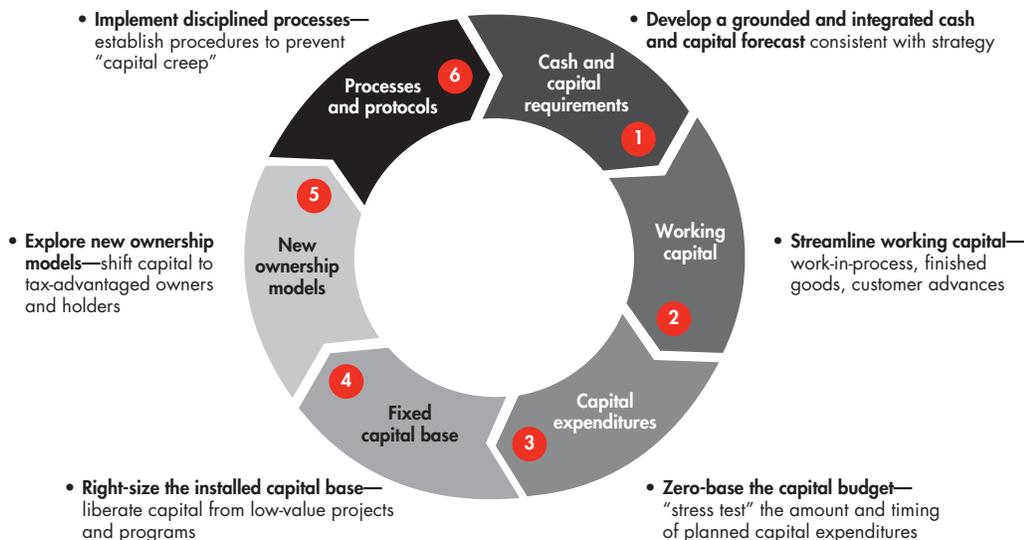
While all these efforts can boost results, they overlook one of the largest sources of value: the balance sheet. Companies often hold far more working capital than they need to. They make ill-timed or ill-advised capital investments. They own unnecessary or unproductive fixed assets. When management teams focus disproportionately on the profit and loss statement (P&L), they often miss those issues. In

fact, some measures designed to manage costs can actually inflate the balance sheet, consuming cash and destroying value.

But a handful of high-performing companies pursue a more evenhanded approach to financial management. They manage the balance sheet as tightly and as assiduously as they manage the P&L, and they reap outsized rewards for their efforts. While these companies approach it differently, they usually have six common imperatives (see Figure 1). The companies:

1. Track the current deployment of capital
2. Actively manage working capital
3. Zero-base the capital budget
4. Liberate fixed capital
5. Consider alternative ownership models
6. Create processes and systems to prevent “capital creep”

Figure 1. The most effective companies use a six-step approach to cash and capital management



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Measures like these typically free up significant amounts of cash, which can then be redeployed to generate the greatest returns. The result is increased shareholder value at a lower cost than efforts focusing on the P&L alone. There is no magic here, just a different frame of reference and a series of practical, well-honed disciplines—disciplines that any company can use to improve its performance.

1. Track the current deployment of capital, mapping capital to each business, product, customer, geography and activity.

Few companies track balance sheet information deeper than the company level. In our experience, fewer than 15 percent of CFOs from companies in North America and Western Europe have routine visibility into the balance sheet of any unit or area below a division. It seems the vast majority of CFOs have only a limited understanding of where their capital is currently invested. And their managers can't know the true economic profitability of the products and services for which they are responsible.

John Deere is different. The big-equipment manufacturer compiles detailed balance sheet information business by business, product by product and plant by plant. "Granularity is essential," says former CFO Mike Mack, now president of the company's worldwide construction and forestry division. So, he adds, are transparency and consistency. "We use the same measures for every business everywhere in the world."

Once capital use is measured at that level, executives can manage it closely. At Deere, every division, product and plant in the company has what's known as an "OROA line"—an annual target for operating return on assets. Managers have quickly learned what actions are required to hit their targets and have been remarkably successful in boosting Deere's performance.

Companywide, Deere's return on invested capital (ROIC) rose from negative 5 percent in 2001 to nearly 40 percent in 2008.

Without a visible balance sheet, operating managers are encouraged to play the game of making the best case for their business's allocation of capital—because once the allocation is made, the resources will carry no costs. Companies with granular balance sheet information, in contrast, can assign appropriate capital costs to each unit and product, assess true performance and take appropriate action. When Northrop Grumman began compiling detailed balance sheet data and assessing return on net assets (RONA) results, for instance, it found that some areas of the company were "capital hogs" with low RONA. Senior executives were then able to reduce capital use, drive profit improvements and de-emphasize units that weren't able to generate adequate return on capital.

2. Actively manage working capital, limiting the resources tied up in funding other people's businesses and using others' money where possible to fund your own.

Beginning in 2001, Deere mounted a multi-pronged attack on working capital. First it honed its information technology systems, to the point where it had good, easily accessible data on fill rates for each product by week and by SKU (stock-keeping unit). That allowed it to shorten terms for dealers while giving them confidence that the company could replace inventories fast enough to avoid lost sales. Between 1998 and 2008, Deere tripled its sales but kept trade receivables flat, avoiding a \$7 billion increase in working capital. The company also took bold measures to reduce work-in-process inventory. One drive-train assembly line, for instance, cut production time over a four-year period from 44 days to just 6 days by modernizing production facilities and introducing lean manufacturing techniques.

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Cisco Systems is another company that focused intensely on working capital. Earlier in the decade, the company improved days sales outstanding every year for three years—“We were maniacal about collections,” says one executive. Inventory turns also improved, and the company began tracking purchase commitments closely to keep payables under tight control. Cisco even began examining its customers’ working capital levels. Bottlenecks in a customer’s operations, the company found, often led to slow collections on the customer’s part and slow receivables for Cisco. Helping customers fix their problems benefited both parties.

3. Zero-base your capital budgets, setting an implicit (or explicit) limit on capital expenditures based on the performance of the business.

At most companies, of course, working capital represents a relatively small percentage of total capital requirements. For the average company in the Standard & Poor’s 500, investments in fixed assets account for more than 40 percent of total investments. Therefore, right-sizing the balance sheet requires companies to challenge conventional assumptions about fixed capital. ITT is a prime example of a company that does just that.

ITT develops detailed capital budgets by value center and by group. The company’s rule of thumb is that any business should be able to sustain its position by investing at a rate equal to 70 percent of depreciation. But ITT doesn’t assume that every business is entitled to that much. And it doesn’t spread capital like peanut butter across its various units, giving each a proportionately equal amount. Instead it analyzes the strategic position of each business—its market attractiveness and its ability to win—and applies differential targets for investment. Thus highly advantaged businesses, those with high ROIC and good growth prospects, might receive investment at 90 percent or more of

depreciation while disadvantaged businesses might get only 50 percent. The process allows the company to fuel its growth without over-investing in unattractive businesses.

ITT also stretches out its capital plan when appropriate. During the recent downturn, the company asked several of its businesses to reschedule their facilities and slow down orders to prevent the buildup of excess inventory. ITT corporate management then held back half of the capital it had budgeted in order to ensure sufficient liquidity, pay down debt and reduce borrowing costs. Thanks to such measures, the company wound up with a stronger liquidity position than many of its peers and was able to make more strategic investments.

One key to effective capital budgeting is to set targets for asset productivity. Like individuals, capital should become more productive over time. Yet many companies don’t have explicit capital productivity targets, and so they spend more capital without requiring more output. Companies such as Deere, in contrast, set explicit, granular productivity targets for their assets and use these targets to reverse-engineer the appropriate level of capital expenditures for each business.

4. Liberate fixed capital, identifying low-hanging fruit and redeploying your capital accordingly.

Many companies have paid so little attention to their balance sheets that 20 percent of their invested capital accounts for 100 percent or more of the company’s value. Even better-managed companies typically have their share of unprofitable products, customers and businesses. The capital devoted to those areas is essentially wasted, and liberating it can lead to significant value creation.

That’s why many companies—particularly those with new owners or those facing a cash crunch—

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Allocate resources differentially based on the strategic position of each business

The allocation of scarce resources—time, talent and money—should be distinctly un-egalitarian, reflecting the different strategic position of each business in a company’s portfolio.

Businesses that compete in attractive markets (top half of the matrix at right)—where the average player in the market creates value—can support more profitable investment than those that compete in unattractive markets. Likewise, businesses with strong competitive positions (right side of matrix at right) can support more profitable investment than those with follower positions.

Assess each business

	High	Identify roadmap to leadership or harvest	Extend and protect niche leadership: evaluate opportunities in broader market	Extend and protect leadership position; drive to full potential profit and growth
Market attractiveness	Low	Manage for cash to fund other priorities	Sustain segment leadership; pursue attractive adjacencies in broader market or manage for cash	Sustain leadership; pursue attractive adjacencies or manage for cash
		Follower	Leader in defensible segment	Leader in market

Competitive position—ability to win

Many companies employ simple heuristics that take into account each business’s strategic position in allocating resources—capital, most notably. Businesses with strong competitive positions in attractive markets are expected to grow their investment base. Accordingly, capex in these businesses should be a multiple of depreciation, margin targets should be set higher than market averages and revenue targets should also exceed market rates. For follower businesses, resources should be allocated more selectively and performance ambitions should be more modest. Capex for follower businesses should be set at (or below) depreciation; margin targets should be set at or above market averages, and revenue expectations should be at or below the market.

Set differential targets for each business

Differential	Overall portfolio	Full potential growth	Balance growth and profit	Roadmap to leadership	Prep for sale	Harvest	Fix now or divest
Revenue growth	10%	1.5x mkt.	1x mkt.	2x mkt.	.75x mkt.	.75x mkt.	Economic profit >0
Operating margin %	20%	+50 bps	+100 bps	+0 bps	+150 bps	+200 bps	
Capex as % depreciation	95%	>100%	100%	>100%	<80%	<70%	

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go on “liquidity hunts” to identify underutilized capital that can be converted into cash. Meatpacker Swift & Co. is an example. Beef gross margins were negative at points during 2005 and 2006 due to declining herd sizes and the continued closure of foreign markets as a result of the mad cow scare. With close to \$1 billion in debt and declining free cash flow, management became concerned about future liquidity squeezes and launched a balance sheet review to find “trapped” capital that could be redeployed. It sold its cow division, liquidated excess real estate, sold water rights in Colorado, tightened working capital and divested a distribution business in Hawaii. Raising \$60 million through these and other measures, the company got out in front of a possible liquidity crunch, avoided problems and maintained flexibility. Its owners eventually sold the company in 2007 for a 20 percent return.

In companies that have never managed capital, such as Yahoo! until just recently, executives may be unfamiliar with the balance sheet or the cost of holding unnecessary assets. Freeing up capital can entail a substantial change in mindset—executives must rethink the way they run their business. Assets that previously were considered essential for the company to own, such as data centers, can be outsourced, liberating significant amounts of cash and reducing long-term costs. Sometimes entire segments of the business can be outsourced—the search business to Microsoft, for example. That can simultaneously reduce future capital investments and provide customers with a more appealing offer.

5. Consider new ownership models, pursuing strategies that allow your business to own fewer assets or seeking third parties to own your assets for you.

Actively managing working capital, zero-basing capital budgets and liberating fixed capital are

just a few of the steps superior capital managers use to streamline the balance sheet. Over time, the obsession with a lean and efficient balance sheet encourages many executives to explore entirely new approaches to their business. They essentially create a new business model, disaggregating the value chain and shifting fixed capital from their own balance sheets to those of advantaged owners.

The classic example is Marriott, which recognized in the mid-1980s that its core business was managing hotels, not owning real estate. As a result, it began divesting its hotel properties, creating limited partnership arrangements and selling them to tax-advantaged investors. Companies in semiconductors, transportation and other industries have taken similar measures more recently. A logistics company today, for example, may own few warehouses or trucks, and instead contract with companies or individuals who do. Such tactics enable businesses that would otherwise be capital-intensive to generate higher returns and grow more profitably.

6. Establish processes and systems to avoid “capital creep,” putting procedures and protocols in place to reinforce prudent balance sheet management.

If you talk to executives at companies known for their balance sheet management, you immediately hear a different way of thinking. People regularly discuss balance sheet measures. They’re aware of the cost of capital. That kind of culture is typically reinforced by a host of policies and systems that encourage managers to continue taking the balance sheet into account in their day-to-day running of the business.

One such policy—a powerful one—is to reward managers for hitting balance sheet targets, just as most are already rewarded for hitting income statement targets. Deere ties compensation to performance against the OROA line.

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Northrop Grumman establishes long-term incentives for improvement in RONA; it has also created formal training programs to help executives get comfortable with balance sheet measures. ITT ties compensation to performance against all of its “premier metrics,” one of which is return on invested capital.

Some astute balance sheet managers, such as Dow Chemical, create two-way performance contracts. The corporate center agrees to provide a certain level of resources to the businesses; and business-unit leaders commit to a certain level of performance. That is an essential policy for any investment requiring a long time horizon. Most balance sheet investments represent multi-year commitments—the corporation invests now and may not see a return until much later. Without some form of contract, good money can be poured after bad and losing projects will never be cut short.

Ultimately, of course, managing the balance sheet is all about freeing up cash and redeploying it in the best way possible. Most companies that successfully manage their assets find themselves developing cultures that emphasize not just the balance sheet but cash as well. Cash is “in the water here,” says Steve Loranger of ITT. An executive at Ford Motor Co. says, “We’ve changed the culture at Ford from one focused almost exclusively on the P&L to one focused on the P&L and cash.” (See sidebar, “The ‘Cash Lens’ at Ford,” next page.) Managers thus learn to take into account the cash implications of whatever they do—and they strengthen the balance sheet accordingly.

Conclusion

Right-sizing the balance sheet offers most companies an enormous opportunity to create shareholder value, in both good times and bad. Granular measures show where capital is currently being deployed. Aggressive management of both working and fixed capital frees up large amounts of cash. New ownership models enable once capital-intensive businesses to prosper with fewer assets. And processes and incentives that encourage careful balance sheet management help ensure sustainable gains. Over time, right-sizing the balance sheet becomes part of a company’s culture—a culture where managers at every level of the company see the importance of carefully managing assets and liabilities and act accordingly. 

The “Cash Lens” at Ford

“Everyone understands cash in their personal lives,” says Lewis Booth, chief financial officer of Ford Motor Co. “But we didn’t begin to focus on it at Ford until just the last few years. The reason? We had to.”

Facing a liquidity crunch in 2006, Ford executives under new CEO Alan Mulally rediscovered the balance sheet—and the importance of cash. Today, say Booth and other top executives, the company tracks cash balances every day instead of every month or every quarter. And the cash implications of nearly every action are clearly laid out before any decision is made.

A company that focuses on cash, such as Ford, essentially learns to view its business through a different lens. For example:

- **People begin to understand the “physicals” of cash.** When vehicles are on hold, for instance, rather than being released to sales, that creates a cash problem as well as a profit problem for Ford. Therefore, managers do everything possible to plan new model launches to minimize vehicle holds.
- **They come up with new and better ideas for running the business.** Ford’s focus on cash led to a greater focus on the fastest-selling models, enabling dealers to reduce inventories without hurting sales.
- **The company can communicate differently with investors.** When Ford talked to investors almost exclusively about the P&L, some decided that the company wasn’t watching its cash carefully. Today, regular communication about cash levels reassures investors and helps ensure that the stock is fairly valued.
- **Executives approach the capital budget differently.** “When we were capital constrained in the past,” one executive says, “we’d just slash capex. Now we recognize capex is our future.” Instead of cutting capital expenditures, the company emphasizes efficiencies in the way it spends capital, thus doing more with less.

How important is the cash lens? “This industry is going through a revolution,” says Booth. “We wouldn’t have been able to survive had we not gone through this process and improved the company’s focus on cash.”

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