Managing for the Next Quarter (Century)

Take a look at these strategies for successful long-term growth.

BY D. SCOTT DAVIS

American companies are sometimes accused of thinking in the short term, of focusing on meeting financial expectations for the current quarter at the expense of long-term strategy. Of course, the people making this charge aren't around to feel the white-hot glare of stock analysts and investors when your company fails to meet quarterly estimates. Still, we who are charged with maximizing shareholder value instinctively know investors reward companies that grow profitably over the long term. The short term presses us, but the long term makes or breaks us.

I work for a company that knows a little bit about the long term. UPS was founded 96 years ago in a little office under a saloon in Seattle. We've survived two World Wars, a depression, changing business models, and countless economic cycles. So our time horizon can't help but be a little longer.

What we've discovered over the past century is that the best way to ensure your company is around for the long haul is to look beyond the next quarter. Manage for long-term, profitable growth. But I'm stating the obvious. Every company wants to do that. The question is: How?

Each company is different, but there are six key growth principles that have worked well for UPS. Perhaps they might give you some ideas for your business.

Don't Pull Back

The past three years have been a time of economic stagnation in the United States. Layoffs are up, investment in technology is down, and capital spending is sluggish. Signs are growing that the economic fog is lifting, though we're not out of the woods yet. Many economists are still looking for a spike in business spending for proof that growth will take hold.

Economic downturns come and go, but companies with a long-term perspective don't pull back from investing in future growth. At UPS, where much of our revenue is closely tied to the health of the general economy, we try to take a consistent approach to business investments regardless of the current economic conditions. We neither spend wildly in good times nor turn off the spigots in bad times. We continue to develop new services, acquire new capabilities, and invest in technology and infrastructure that will yield greater efficiencies over the long term.

For example, during the four years ending 2002, UPS made some 24 acquisitions—mostly small companies with capabilities beneficial to us. The economy wasn't performing well during most of this period, but we wanted to position the company for better times ahead. Another example: Last year, we completed construction of our expanded air sorting facility in Louisville, Ky. At a price tag of more than $1 billion, it was the largest capital project in our company's history. More importantly, the highly automated hub lets us sort international and domestic express packages more quickly and efficiently—up to 84 packages every second. Although the recession put a damper on total package volume, we think that express shipping will continue to accelerate as global supply chains increase the pressure for just-in-time delivery.

Long-lived companies live in the present but constantly plan for the future.

Don't Just Diversify—Reinforce

Long-term growth companies sometimes have to expand beyond their core business as customers change and the marketplace evolves. But diversification for diversification's sake can be a big trap. Whole new lines of business can carry with them different competitors, different distribution strategies, different pricing structures, and different customers. These new issues can divert management attention away from the core business, and long-term earnings can suffer.

The best kind of diversification involves new lines of business that reinforce the core business. Reinforcing businesses are those that leverage the core infrastructure, including distribution and marketing channels. Or they could be businesses that use similar technology or similar manufacturing processes or address the same customers. Reinforcing businesses can help spread fixed costs, and they don't require a whole new set of management skills. In short, reinforcing businesses are businesses complementary to the core.

Sometimes, logical extensions of the core business work beautifully. Other times, they don't.

A few years ago, UPS launched a service that seemed to be a natural fit with our core package-delivery business. We were seeing a lot of growth in our express document-delivery business, but we also weren't blind to the impact of the Internet. People were beginning to attach electronic documents and send them via e-mail. We figured that we could create an electronic document-delivery service that offered the immediacy of the Internet without all the security risks. So UPS Document Exchange was born—a new line of business that was complementary with our core business and addressed the same customer base. But we discovered that, except for security-conscious vertical markets like law and real-estate, people weren't willing to pay a premium for something they were already getting for free, even if it meant guaranteed transmission security.

A more successful reinforcing business we entered in recent years is supply-chain financing. It makes sense for us because a typical commercial transaction involves three flows: goods, information, and funds. We were already involved in the first two flows. What if UPS helped speed the payment of international transactions by offering electronic transfers of funds from buyers to sellers? With our Exchange Collect service offered by UPS Capital, sellers can get paid in 10 days or less—vs. as many as 90 days or more—and in the process free up cash flow for investment in even more international commerce. Here's how it works. An importer and exporter agree to purchase and sale terms and specify UPS Exchange Collect for financial settlement. The exporter ships the goods by UPS and fills out just five extra lines of data in our shipping system. UPS notifies the importer that goods are in transit and that payment must be made before delivery. The importer then wire transfers payment to UPS. After we receive the payment, the shipment is delivered to the importer. When delivery is verified, UPS remits funds to the exporter.

While there are no guarantees, your best bet for profitable, manageable growth in new lines of business is to diversify by reinforcing.

Buy Capabilities, not Revenue Streams

A lot of buzzwords are thrown around to justify corporate acquisitions: synergies, economies of scale, market penetration, revenue growth. While these are good reasons to consider buying other companies to grow your business, acquisitions can be risky. We all know of well-publicized acquisitions that have turned into train wrecks for reasons varying from conflicting cultures to incompatible business models.

At UPS, we don't buy companies to bump up revenue—

or even to gain economies of scale. Our overriding criterion is: Does this acquisition give us capabilities we don't already have or that would be too expensive to develop?

Look into most of the 24 acquisitions UPS made in the past four years, and you'll see how we've added capabilities in order to grow our business. The acquisition of the Mail Boxes Etc. franchise gave us better access to residential and small-business customers through 4,500 retail outlets in 40 countries. Because of the rise of online retail and home-based businesses, we wanted to strengthen our presence in this future growth market. Likewise, our acquisition of the freight forwarder Fritz helped fill a hole in our strategy to be engaged with every segment of our customers' global supply chains. Fritz gives us the opportunity to offer our customers a broad, integrated portfolio of services for moving everything from small packages to heavy freight. And we can use any mode of transport—air, ground, or ocean freight—to anywhere in the world, with one contact.

Our acquisition of First International Bancorp, which specializes in international credit, trade, and financial solutions for the same customer base UPS serves, accelerates UPS Capital's growth and extends UPS deeper into the more than three billion global transactions in which we participate each year.

We think the best acquisition strategy is to buy capabilities rather than revenue streams. Spikes in revenues don't always last. Capabilities do.

Stick Your Toe in the Water

It isn't always necessary to buy a company to add new capabilities. You can stick your toe in the water by investing in companies that have technologies and capabilities you want to learn more about.

The results of these kinds of investments shouldn't be measured in financial returns but in "knowledge" returns. By investing in companies that are strategically relevant to your business, you learn more about emerging technologies, infrastructure requirements, market conditions, and competitive conditions.

In 1997, we created our Strategic Enterprise Fund (SEF) to invest in a variety of mostly pre-IPO start-up companies with capabilities and technologies of strategic interest to UPS. We invest directly in private companies as a co-investor, most often with the help of professional venture capitalists. From some of the companies, we're still learning about new technologies like perishable-goods packaging, e-commerce engines, and supply-chain planning software. From others, such as a company that developed wireless package-tracking technology, we've purchased and integrated the new technology into our distribution network.

Growing over the long term requires keeping up with emerging technologies and capabilities. Investing in start-ups is an ideal way to learn without taking on a lot of risks.

Find New Customers at the Core

Smart companies not only investigate complementary lines of business—they also look to the core for growth. This is the least risky growth strategy, and it can offer some satisfying rewards.

One way to grow your core business is to expand your core—ensure that products are offered to all users of your service, not just existing bill-paying customers. By offering value-added services to previously overlooked users, you can bring new paying customers into the fold while broadening the scope of your customer base. We see examples of this approach in the telecommunications and credit card industries. For traditional long-distance telephone companies, the customers who do the dialing pay the cost of the call. The recipients connect for free, except that they have to have a line and some equipment on their end. But telephone companies also offer services like caller ID and call waiting that are designed to make life easier for call recipients. These value-added services create incentives for call recipients to use more telephone services and ultimately make more calls themselves.

Likewise, merchants foot the bill for credit card transactions, yet credit card providers offer value-added incentives to consumers to encourage them to use their cards. Frequent-flyer miles and cash-back rewards lure consumers to increase the number of transactions, which benefits both the merchants and the credit card companies.

In years past at UPS, we directed our services to the companies that paid the bills—the shippers. But there are at least two parties involved in every shipment: the shipping customer and the receiving customer. Research shows us that delivery customers often influence which carrier the shipper uses. Delivery customers also are important because they very likely ship packages themselves. To keep our core business growing, we need to offer more services and incentives to this customer group as well.

So we're developing new delivery customer initiatives that incorporate rolling out value-added services to recipients. For example, we will provide proactive, Web-based tracking information that gives consignees precise details of where their packages are, who sent them, what the contents are, and when they will arrive. With this kind of inbound visibility, we expect that these consignees will encourage their suppliers to use UPS services and, in turn, ship more of their own outbound packages using UPS.

For sustainable growth, don't forget to look first to customers and prospects at the core.

Grow Liberally, but Manage Financials Conservatively

A long-term growth strategy is inherently risky. Whether you choose to develop new products and services, add new lines of business, acquire other companies, or just expand your core-business penetration, change involves risk. You can't control all these risks, but you can at least minimize financial risks by managing financials - conservatively.

To be fair, UPS follows a conservative financial approach in part because of the unique makeup of our shareholder base. Before we went public in 1999, UPS was 100% employee owned. Our shares were owned by company managers, UPS retirees, the heirs of the company's founders, and charitable trusts. Although ownership is spread a little broader today, former and current employees still own the majority of a large proportion of the stock. They hold the stock for a long time, so their time horizons are longer. And they are very clear about what they expect: long-term profits, cash flow, and growth. They have little patience with speculative investments that can dilute long-term profitability.

Regardless of the risk profile of your shareholders, prudent financial management for growth companies should include three strategies. First, balance growth with return on investment. Second, leverage judiciously. Third, keep your accounting transparent.

Companies tend to focus on growth in revenue and earnings per share, but they must be careful not to chase growth at the expense of return on investment. Establish clear hurdle rates, and don't pursue investments or acquisitions that fail to adequately exceed the cost of capital. If you make acquisitions, don't bite off more than you can chew and imperil the financial health of the company. These are basic financial principles that all of you know and probably practice, but it's easy to forget them in good economic times.

Leverage judiciously. At UPS, our cost of debt is low. Our primary source of capital comes from operating cash flow, and we use debt sparingly. That makes sense because we have a conservative risk profile. But even though debt is riskier, it can often be a cheaper source of financing than cash or equity. Generally speaking, the cost of equity is higher than the cost of debt. And as you add more debt, it reduces your weighted overall cost of capital. You have to examine your capital structure carefully to determine the optimal mix for your company—a balance that will optimize return on investment for your shareholders.

In the wake of recent accounting scandals, it's more important than ever to communicate your financial results clearly to shareholders and analysts. High-growth companies can sometimes attempt to mask risky growth investments by hiding debt off the balance sheet, recognizing revenue in creative ways, or otherwise obfuscating results.

At UPS, what you see is what you get. We're fortunate that we have a relatively short revenue cycle from pickup to delivery. We don't have significant inventories, and our revenue recognition procedures are well established and reliable. Our use of arrangements such as special-purpose entities is extremely limited. Our debt is on the balance sheet, and we use operating leases sparingly.

It isn't complicated: To ensure long-term growth, your investors have to understand what you're doing. They should be able to look at your financial statements and quickly understand your sources of revenue and expenses. They should be able to grasp your balance sheets without advanced accounting degrees. In short, they should be able to see how your business model translates into earnings and cash flow.

I'm not telling you anything you don't already know. The six growth principles I just described are grounded in time-tested management and financial theory. And we know that companies that don't grow eventually die. If you want your company to be around years from now, you'll resist the temptation to focus on the next quarter and instead manage for the next quarter century. ■

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