Six-Shot Economics

How many shots do you have at shareholder value creation?

BY CHRISTOPHER H. VOLK

Perhaps it's because I've been living in Arizona for many years, but the analogy between business leaders and Old-West quick-draw artists appeals to me. Of course, gunslinging has a bad connotation in business, where planning and strategy are nouns more prized. But the analogy doesn't lie simply in the speed of firing the shots—it's in the number of shots themselves. As fast as the quick-draw artist was, he was no match for the present-day business leader. Today's business leaders not only have six shots at shareholder value creation, but they can all be fired repeatedly and simultaneously.

The First Shot: PLANT EXPANSION

Typically, the first shot for a business to create shareholder wealth is plant expansion. I use this term very broadly because it can refer to factories, distribution facilities, and retail or service locations. The amount of planned plant expansion will depend on the operating leverage of the business. The prime driver of operating leverage is the ability of a business to get new customers or to grow existing customers with minimal new plant investment. Businesses with little operating leverage include retailers, restaurants, and movie theaters. For such businesses to meaningfully grow their customer bases requires sustained new store development. Businesses having greater operating leverage may include manufacturers, where individual plants can be run longer or be efficiently expanded to add new production lines. For such companies, plant expansion may accompany entry into new markets that can't be served by existing facilities. A secondary form of operating leverage is the ability of a company to expand with minimal incremental operating costs, which offers the potential for increased profitability. Expense operating leverage is a part of cost control, which is illustrated in the Fourth Shot.

Barista Expansion — Starbucks Corp. (SBUX)

It's hard to believe that almost 10 years ago there were only 1,412 Starbucks coffee shops worldwide. Today there are more than 14,000 Starbucks operating in all 50 U.S. states (plus the District of Columbia) and more than 41 countries. During the tenfold increase in store count, Starbucks Corp.'s pre-tax equity returns have actually risen, which has contributed to a 725% increase in net income and helped catapult the company's equity market capitalization from $3.5 billion in 1997 to more than $25 billion by the end of its 2006 fiscal year.

The Second Shot: INCREASED FOOT TRAFFIC

The First Shot may be to add new plants, but the Second Shot is to increase the business at existing plants by adding new plant customers or increasing the repeat business from existing customers. As companies and industries mature, their focus moves from demand creation to market share gains. These two means of raising customer counts (which can be parts of both of the first two shots) bear different risks. Opening new markets can take time and accompanies more uncertainty of shareholder reward, which is partially offset by greater shareholder reward potential. Achieving market share gains offers the reduced risk of knowing that the market is there, and it probably describes where most business leaders find themselves today. It's in the execution of market-gaining strategies—from pricing policy to managing marketing budgets—where the most identified market share gaining risks lie.

Mining Golden Arches — McDonald's Corp. (MCD)

Since 2002, McDonald's has focused principally on improving the productivity of its existing assets while limiting new store growth to around 0.6% annually. Initiatives undertaken by the company to improve same-store performance include extended store hours, cashless payments, and a wave of new menu item introductions. The success of this focus is reflected in the company's fourfold increase in earnings since 2002 and three-percentage-point improvement in its pre-tax equity returns. As a result, the company almost tripled its equity market capitalization by the end of September 2007.

The Third Shot: PRICING POWER

In today's global and highly competitive world, pricing power is generally elusive, and this shot is apt to misfire. I included it, though, because, at some point in their life cycle (usually early), businesses may have pricing power. This may be especially so if they benefit from intellectual property protection. All other things equal, if prices can be raised, shareholder returns will increase. Knowing how to judiciously fire this shot so as not to diminish customer counts (the Second Shot) is key.

Priced to the Core — Apple Inc. (AAPL)

Apple has been able to use branding, innovation, and design to maintain premium price levels in the markets for personal computers and digital music players. Since the introduction of the company's iPod music player in October 2001, Apple has sold 110 million premium-priced units. At the same time, partly as a result of its strong pricing power, the company's operating profit margin increased threefold to nearly 15% for its 2006 fiscal year. With a record pre-tax equity return of more than 20% and a more than fiftyfold increase in net income, Apple Inc.'s market capitalization increased to nearly $134 billion as of the company's fiscal year ended September 2007 from only $5.2 billion at the end of fiscal year 2001.

The Fourth Shot: COST CONTROL

Business leaders always take a close look at cost control as a tool to create shareholder wealth. For growing businesses, a prime source of cost control lies in expense operating leverage, which was mentioned as a benefit of a successful First Shot. That said, the notion of cost control seems to loom largest in seasoned businesses and industries. Tools of cost control range from better scheduling of hourly staff to outsourcing to lower real estate rents to improved purchasing to greater energy efficiency to the control of frivolous waste. A final means of cost control is actual business and expense contraction, which is what we are witnessing in the domestic automotive manufacturing and airline businesses. Dramatic corporate reorganizations, either in or out of a bankruptcy court, offer examples of reactive, rather than proactive, cost control. As such, they generally reflect poorly on the abilities of prior business leaders to hit the mark with their six shots.

Counting Peanuts

Southwest Airlines Co. (LUV)

In 2006, Southwest Airlines recorded its 34th consecutive year of profitability, a record unmatched in the commercial airline industry. With the industry's most consistent operating profit margins and most conservative balance sheet, the equity capitalization of Southwest approximated almost 40% of all of the other public airlines combined as of September 2007. As impressive as this is, Southwest's share of the industry's market capitalization formerly averaged more than 100% of all other airlines combined between 1996 and 2002. Since then, bankruptcy reorganizations at four of the other major domestic carriers have helped them shed costs and improve their respective equity returns and capitalizations.

The Fifth Shot: INVESTMENT CONTROL

The first four shots are associated with the profit and loss statement of the business. The last two shots at shareholder wealth creation are associated with the balance sheet. "Investment," as used in this article, is a defined term. It refers to anything a company must buy and carry on its balance sheet that is funded with interest-bearing debt or shareholder equity. All businesses should seek to minimize this amount, keeping in mind that they also have to focus on the Fourth Shot as well. For instance, a store or plant that is constructed for less is a good thing. But it may be less of a good thing if lower construction costs result in higher maintenance costs down the road. Likewise, it's better if a business can have its inventory funded by noninterest-bearing trade accounts payable, but perhaps not at the expense of trade discounts or lower prices. Examples of investment control are numerous and include Just-in-Time (JIT) inventory controls, manufacture outsourcing, tight receivables control, and plant construction cost controls. All else being equal, the fewer the assets that have to be funded with shareholder equity or interest-bearing debt, the more that shareholders stand to make.

Merger Time

Time Warner, Inc. (TWX)

Investment control is most generally thought of as a company's ability to control plant or working capital investments relative to revenues. But corporate acquisitions can have an immediate and profound impact on corporate investment efficiency. In 2000, Time Warner merged with America Online (AOL), increasing total investment by a factor of 15. With a far smaller commensurate increase in sales, the company's pre-tax equity return fell approximately 90%, contributing to a 62% drop in share price by the end of 2002 and erasing $95 billion in shareholder value. Almost six years later, in June 2007, the company's equity market capitalization and share price still stood approximately 50% and 40%, respectively, below where they were prior to the merger.

ILLUSTRATION: MARK BREWER/WWW.MARKBREWER.COM

The Sixth Shot: COST OF CAPITAL

Reducing a company's cost of capital is the final shot. Cost of capital refers to the weighted cost of interest-bearing debt and shareholder equity. The idea is that, by achieving the lowest cost of capital, the company will be worth more and existing shareholders will be the beneficiaries. The logic sounds circular since lower costs of debt and equity raise equity returns and equity value. This is partially why Franco Modigliani, the 1985 Nobel laureate in economics, essentially proposed that capital structures, or the apportionment between interest-bearing debt and shareholder equity, don't (under certain assumptions) matter to the cost of capital.

Going Supersonic

Sonic Corp. (SONC)

After a solid six-year expansion run, which saw the company's share price rise nearly sevenfold and equity market capitalization rise twentyfold, the management team at Sonic turned its attention to lowering the company's cost of capital. Preempting activist shareholders and electing to not follow peer companies that had been taken private, Sonic decided after 2005 to engage in its own recapitalization strategy to reduce its cost of capital. The company accomplished this through the investment-grade securitization of its royalty stream and applying the proceeds from this debt issuance to repurchase 15.9 million shares in a Dutch auction. Sonic also purchased another 6.1 million shares on the open market. As a result, the company's pre-tax equity return rose more than sixfold while its share price held stable, creating nearly $150 million in shareholder value by the company's August 2007 fiscal year-end.

Such constraining "certain assumptions" are far fewer in the 21st Century. Today, capital costs can be lowered in many ways. Diversified loan conduits can offer businesses real estate mortgage, credit line, or term financing at interest rates that are lower than would otherwise be implied by the company's effective credit rating. This recent technology is akin to the ability of the average American to obtain a low-cost home mortgage because of the diversity of residential mortgage loan pools. Likewise, preferred stocks today can often be funded by diversified structured finance means. Corporate real estate locations can be efficiently leased rather than owned. This will impact cost control (since lease expense will rise), but it lessens the amount of assets that have to be funded with interest-bearing debt (the Fifth Shot). At the same time, real estate leasing enables the deployment of less shareholder equity since there's no need to commit equity to lower-returning passive real estate. Generating higher risk-adjusted returns on equity increases shareholder wealth and is what the Sixth Shot is all about.

THE BALLISTICS TEST

The basic idea behind the six shots available to a business leader is to produce greater shareholder returns. Higher returns on equity virtually always mean that a business is worth more, making shareholders richer in the process. So, a few years back, I developed a formula to compute current pre-tax shareholder rates of return. The idea behind the formula is this: If a business can realize pre-tax current rates of return on the equity invested that exceed the rates of return available to shareholders from investments with similar risk and growth prospects, then the business will be worth more than what it cost to create. Likewise, if a business can realize pre-tax current rates of return on the equity invested that exceed the rates of return available to shareholders from competing companies, then the business stands to be the sector leader in shareholder value creation. The formula, called the V-Formula, also has six variables and is shown in Figure 1.

The V-Formula, like the notion of Six-Shot Economics, is a financial rather than an accounting concept. It does a good job of illustrating the relative values of the shots at the disposal of business leaders. It is also (trust me here) simple. Each of the six variables has a different impact on each potential shot. For example, "sales" reflects plant expansion, increased foot traffic, pricing policy, and cost control (expense operating leverage). In turn, operating profit margins are driven by sales (expense operating leverage) as well as by pricing policy and cost controls. The remaining four variables relate to shots four through six.

FIRE AT WILL

Technology changes and, along with it, the ability to reexamine and refire shots. JIT inventory control (which impacts investment control) was made possible by more efficient delivery mechanisms (overnight shipping) and was later improved upon through Internet connectivity and computerized inventory controls. Outsourcing and offshoring impact both cost and investment control and have grown widely through the support of Internet connectivity and telecommunications. Other popular

Figure 1: The V-Formula℠

$$\frac{\text{(Sales/Investment x Operating Profit Margin – Portion Financed x Interest Rate – Maintenance CapEx/Investment)}}{\text{Portion of Equity*}} = \text{Current Pre-Tax ROE}$$

** Portion of Equity is equal to 1 – Portion Financed*

	V-Formula Variable	Shot Number
1	Sales	1, 2, 3, 4
2	Investment	5
3	Operating Margin	1, 2, 3, 4
4	Portion Financed	6
5	Interest Rate	6
6	Maintenance CapEx %	4

notions, such as "reengineering" or "right-sizing," have also reflected a revised focus on shots in the gun. Today, with the prevalence of a sophisticated structured finance marketplace, companies are reassessing means of reducing their costs of capital. They are moving away from traditional corporate debt to syndicated debt conduits and asset leasing and securitization strategies. All of these capital markets innovations place the Sixth Shot as a leading means of shareholder wealth creation today. It bears remembering that corporate bond issuance represented a paradigm shift in cost of capital efficiency away from traditional bank financing. Indeed, business leaders constantly have their fingers on their triggers, looking for the next shots to fire and the new technologies that can make those shots possible.

The six shots at shareholder wealth creation represent the essential financial toolkit for every business leader. In turn, Six-Shot Economics is driven, at least in part, by constant innovation. Within a highly competitive, increasingly capitalistic global marketplace, the pace of innovation has quickened, placing greater demands on business leaders and their teams to constantly reload and fire. At the same time, as with any economic concept, the implications of Six-Shot Economics span from the micro corporate level to have macro implications for economies as a whole. In this light, it bears mentioning that taking more shots at corporate efficiency has contributed to strong economic growth over the past decade, accompanied by comparatively little inflation. So, more than just a financial toolkit for business leaders, Six-Shot Economics represents a financial toolkit that contributes meaningfully to our overall prosperity and economic health. ■

Christopher H. Volk is CEO and president of Spirit Finance Corporation in Scottsdale, Ariz. You can reach him at (480) 606-0820 or cvolk@spiritfinance.com.

Note: The author would like to thank Robin Mora and Joseph Volk for their contributions to the article. If you want a more extensive discussion of the V-Formula, you can read Chris's article, "V-Formula," from the October 1999 issue of Strategic Finance, *available online at www.strategicfinancemag.com.*