

Introduction

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Welcome to the case method. To analyze a case successfully, you must do two things—put yourself in the position of the manager making the decision, and make the decision.

Within each case you must assume the role of the manager whose job it is to analyze alternatives for the company. In most instances it will be an easy task to determine who is the decision maker, since that person will be identified by name in the case and his or her position and role will be described. In the few instances where the decision maker is not identified by name, your point of view will be that of the company's top management.

Once you have identified the person or group of persons whose role you will assume, you need to gather the information that you, as the manager described in the case, would naturally have. Managers, even young analysts, have considerable knowledge about their company, the industry in which it competes, and the economic environment in which it operates. Since, as a manager, you would have that information, as the case analyst assuming the manager's role, you must acquire it.

Once you have the background necessary for your role, your task is the same as the manager in the situation would have—to identify, understand, and analyze the problems the company faces. As would the manager, you will define the problems and the available courses of action, and you will gather the information needed to determine the appropriate course. The steps you will take in assuming the manager's role and in confronting and solving problems are listed below.

- I. *Assume the manager's role*
 1. Understand the environment in which the company operates:
 - The worldwide socioeconomic and political environment
 - The domestic environment
 - The industry situation
 2. Know the company's history, current condition, and future prospects
- II. *Solve the problem facing the company*
 1. Identify the problem
 2. Define the alternatives
 3. Gather information about the alternatives
 4. Analyze the risks and returns of the options
 5. Make a decision and develop a plan of action

Assume the Manager's Role

As you develop as a case analyst, you will refine your own approach and develop a sense of the depth and breadth of analysis appropriate for the particular situation described in a case. Depending upon the situation, one or more of the areas discussed below could receive more attention than the others.

Understand the Environment in Which the Company Operates. Perhaps the best way to begin to understand the milieu in which the company operates is to investigate the general economic environment. Frequently the case analyst looks only at the domestic environment; however, with the increased integration of the world's economy, the *worldwide environment* cannot be ignored. Certainly some decisions described in this book are less affected than others by worldwide socioeconomic and political events. However, the isolation of countries and industries from events in the rest of the world has greatly diminished, and, as U.S. managers found after the oil price rises in the 1970s and early 1980s, to ignore events outside the local economy can be dangerous. Since most of the cases in this book are set in periods when events profoundly changed the nature of the environment in which all countries, industries, and companies operated—worldwide considerations are particularly relevant.

Because different factors are important at different times and to different companies, the manager, and thus you as the case analyst, should be aware of the relative robustness of the worldwide economy at the time of a particular case, and should sense what concerns for and predictions about the future might have prevailed at that time.

In cases where the company or the decision is, or can be, directly affected by worldwide events, the cases will provide information that you as the manager would have had. Because of the necessary brevity of the cases, however, some of the data you might like to have, or believe the manager would have had, may not be included. You must decide on the basis of the information you have. Some basic data about international events are contained in the last section of "The Business Environment: A Retrospective, 1929-1993."

The strength and nature of the *domestic economy* are certainly of more obvious concern, and this is an area in which managers often have more personal and professional experience. Although certain factors and events in the economy will affect some companies more than others, nevertheless there are universal touchstones of concern. The analyst should consider such things as (1) the robustness of the economy and its expansion or contraction because it can affect the company's sales, profits, and cost and availability of funds; (2) the level of unemployment because it affects the potential for strikes as well as the sales of certain products; (3)

cyclical upturns because they can increase the sales of products such as consumer durables while increasing the potential for strikes and prices of other resources; and (4) cyclical downturns because they can decrease the need for productive capacity and the likelihood of protracted strikes in many industries, can decrease resource costs, and because they hurt firms whose sales depend upon the level of consumers' disposable income.

Most cases contain a brief description of the environment in which

the firm operates. For more information about the U.S. environment—the setting for the majority of the cases in this book—a background note, “The Business Environment: A Retrospective, 1929–1993,” is presented in the last section of this book. The information in this note can be used in analyzing many of the cases.

While the analyst will want to understand the current state of the

domestic economy and the future directions it might take, of particular interest is the effect changes in the economy have had and will have on the particular industry and company featured in the case. Just as some economies are more sensitive than others to worldwide events, some industries and companies are influenced more than others by domestic events.

Many industries seem relatively immune to ongoing economic

changes, while others are so sensitive that managers spend much of their time and effort developing ways to forecast and insulate their firms from probable changes. The relationship of companies to suppliers, customers, and other companies in the industry, as well as the nature of the industry's products, seems to influence how strong an impact outside economic events have on a given industry. The sources of return and the factors that affect the predictability of that return are quite different in each industry.

Know the Company's History, Current Condition, and Future Pros-

pects. Interestingly, most of the tools and techniques of financial analysis concentrate on the company—its past, present, and future. Moreover, this is the form of analysis with which most students of finance have some experience, and with which many case analysts start and finish their work. Clearly, it is very important; the history and current situation of the firm are of considerable interest to the practicing manager as well as the case analyst. These subjects will occupy the greatest part of the case analyst's time and skill. Keeping in mind the possible effects of changes in the environment, both domestic and worldwide, the analyst will want to review the success of the firm's past investment and financing strategies by analyzing financial statements, market share and competitive product market information, and stock and bond market results.

Typically, the analyst will look first to the way the company has managed its assets, and is likely to be able to manage them, by asking such questions as:

1. Is the company capital-intensive? Does its productive capacity come from plant and equipment, people, and/or a franchise in the market bought with product reputation and/or advertising? How expensive is it to add capacity or enhance a product's reputation? What is the lead time needed to increase or modify any factor of production? If the company is capital-intensive, how old is the equipment, and for how long will it continue to be useful? If it is not capital-intensive, what is the source of the company's productivity, and how readily available are additional resources?

2. To what degree are company assets subject to obsolescence or migration? In a capital-intensive business, do technological innovations change processes slowly or rapidly? If it is not capital-intensive, how firm a grip does the company have on its source of productive capacity? For example, genetic engineering companies with large investments in the expertise of their research staffs can suffer if those research staffs are likely to move from firm to firm. How much of the firm's assets are long term and difficult to redeploy, and how much can be changed rapidly? Firms with significant investments in short-term assets often have much more flexibility in dealing with rapid changes in the economic environment and/or the industry. How well has the firm coped with changes in the recent past—has it managed to maintain control of its assets in both good and bad times—and how likely is it to be able to maintain control in the foreseeable future?

4. What opportunities for new products and processes are on the horizon? Is the company in a position to identify and take advantage of these opportunities?

Second, the analyst will consider where and how the firm has financed itself and how it will be able to finance itself in the future by asking such questions as:

1. How much of the firm's investments have been financed from profits, and how stable are its profits (do they fluctuate widely from year to year, or are they relatively steady)? Companies that have relatively stable profitability are better insulated from the vagaries of the capital markets.

2. Do the shareholders have a call on some portion of the current profits? How important is the dividend level to the stock price, how close is the firm's current dividend policy to what is common in the industry, and how secure are dividends from fluctuations in profits (does the company raise funds to maintain its capital investment program and/or dividend payments)?

3. How much of the funds used, and those likely to be used, have been and will be raised from outside sources?
4. Are the firm's liabilities short or long term? How secure are the sources of capital? Do lenders place any restrictions on the firm by virtue of their position? Are the restrictions by custom or by contract? Is the firm able to deal easily with the restrictions and the costs of its debt?
5. Is the company's equity capital closely held or is the stock publicly traded in the capital markets? If the stock is closely held, what are the objectives and needs of the owners? If it is publicly held, are any large blocks held by individuals or groups, and what is their interest in the firm? What is the degree of institutional interest in the stock? What is the stock price, the relative level of the stock market, and the interest in trading equities in general, both in this industry and in this company? How easy would it be to sell new equity and at what price could it be sold?

Finally, the analyst will want to determine the company's unique strengths and weaknesses.

The above questions are not meant to be exhaustive, nor would the case analyst seek to answer each question or set of questions in depth for every case. They are meant solely as an indication of the form analysis may take, and as a guide to the areas in which the analyst should have an interest and in which he or she should acquire at least cursory information. Once the company's history, current situation, strength in the industry, and current corporate goals and strategies are coupled with an analysis of the industry and the economy, the case analyst is ready to assume the role of the decision maker—the manager.

Solve the Problem Facing the Company

Obviously, the first task is to understand the situation and to identify the problem or problems facing the manager. Many cases present more than one problem, and some of the problems will be more important than others. As with any real situation, there are times when real problems are obfuscated by concerns of the company or manager that are not critical to the firm and its success. It is up to the analyst to sort through the issues described in the case and to determine which are actually important.

The decisions managers face fall into one or both of two categories. The problem may require (1) investing assets to replace old products or processes, to increase sales, or to decrease costs, and/or (2) securing funds to support the growth of the firm or to replace old processes and products.

For funding the firm, the manager has only four choices. Funds can be raised by (1) increasing the liabilities of the firm—with either short-term obligations such as accounts payable or one of a variety of long-term debt instruments; (2) increasing the equity in the firm by increasing the amount of common stock or retained earnings; (3) increasing the firm's profits or decreasing the dividends paid to its shareholders; or (4) establishing relationships with other companies. On the basis of the traditional accounting definition of the firm, the following diagram shows where decisions that change the firm can be made.

$$\begin{array}{c}
 \text{Assets} = \text{Liabilities} + \text{Equity} \\
 \Downarrow \\
 \text{Equity} = \text{Common Stock} + \text{Retained Earnings} \\
 \Downarrow \\
 \text{Retained Earnings} = \text{Profits} - \text{Dividends}
 \end{array}$$

Another way to look at the same problem is to use the sustainable growth rate formula.

$$\begin{aligned}
 \text{Sustainable Growth Rate} = & \text{Return on Sales} \times \text{Total Asset Turnover} \times \text{Leverage} \times \text{Profit Retention} \\
 = & \frac{\text{Profit}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Assets}} \times \frac{\text{Assets}}{\text{Equity}} \times \left(1 - \frac{\text{Dividends}}{\text{Net Income}} \right)
 \end{aligned}$$

If changes are made in one factor, changes need to be made in at least one other factor to keep the formula in balance. Thus, for example, the firm cannot increase its assets without augmenting its profits to sustain the increase or acquiring additional outside funds.

Identifying the most important problems is often easier if the analyst has determined the objectives and goals of the corporation (or division or subsidiary, if that is the level at which the decision is being made) and of the manager. There are instances where the personal position and goals of the manager may conflict with the objectives held by the firm on behalf of its owners. The importance attached to the problems and the decisions that will be made often reflect the goals of the strongest participant rather than those of the owners. Since these conflicts arise in almost every situation, the analyst must recognize them and make decisions on the basis of that recognition.

Define the Alternatives. Once the problems have been identified, the next task the vicarious manager must undertake is to define the options—the

alternative courses of action for dealing with the problem. Many of the cases in this book define some or all of the options or describe the situation so that the alternatives can be identified. In some instances the analyst may want to identify options that are not available in the particular case—options that would have been available to other managers and companies or at different times. These options, alternatives for which there is little or no information, are hard to evaluate. These courses of action often have to be relegated to the realm of “strategies that should be explored” as the case analyst proceeds with consideration of the options that *are* available for analysis.

Developing options is often the most important step in the process of making the decision about the problem the manager and company face. Untried and unidentified options often turn out, in retrospect, to have been the plans that might have spelled success. Industry and corporate custom can constrain the creativity of managers in determining possible solutions and, as a result, can limit the company's potential for success. Analysis and understanding of the current situation and future direction of the economic and industry environments can open avenues that were never available when traditional paths were followed almost without thought. Unlike textbook problems where there are few alternatives, the real world provides many alternatives, and so do case descriptions of it.

Gather Information about the Alternatives. Here the case analyst has an advantage over the manager described in the case. The case usually provides a summary of the information the manager and his or her staff gathered to analyze their options. Much of that data is summarized in the exhibits at the end of each case. One of a manager's frustrations, and one that case analysts feel as well, is the lack of certain information that would be useful in deciding on the appropriate plan. Rarely would that information be omitted from the case unless it was unavailable when the manager sought it or was deemed unnecessary by the manager in making the decision. In either case, the manager, and thus you as the vicarious manager, would have to make the decision based on the information available.

Analyze the Risks and Returns of the Options. This is the heart of the problem facing the case analyst and manager. All the information about the economic environment, the industry, the company, and the problem has to be utilized to estimate the potential risks and returns of alternative solutions to the problem. The task is to find the strategy that will create the most value for the firm's owners over the long term. Value depends upon three things: (1) the size of the returns expected, (2) the *time* it takes before the returns are expected to be received, and (3) the *risk* taken to obtain the expected returns. We know that investors, and thus corporate owners and managers, prefer larger returns received sooner

and with less risk. The question is what trade-offs must be made in the size, timing, and riskiness of the expected returns for each alternative course of action. Those trade-offs are presented graphically on the following page.

Value is created when the returns from a given strategy more than offset the risk being taken, that is, when the net present value of the option is positive. Value-creating investments and strategies are difficult to find. When real economic value is available (for instance, when a company has a new product, process, or product source), competitors usually follow rather rapidly and drive out excess profits—unless the firm has some franchise or barrier that keeps competitors at bay. Managers forecast unusual and sustained excess profits (unusual returns) for one of three reasons: the returns really are likely to occur because of some special circumstance, the manager has ignored competitive realities, or the manager's forecasts are simply overly optimistic. As the manager, the case analyst should examine any forecasts to make sure that when value is expected to be created, it is not because of unwarranted optimism.

Value is maintained (the net present value is zero) when the expected returns are just sufficient to compensate the investor for taking the risk inherent in the project. Typically, most investment and financing strategies provide the prospect of a fair return—a return with which the shareholder would be satisfied—that would keep the stock at its current price.

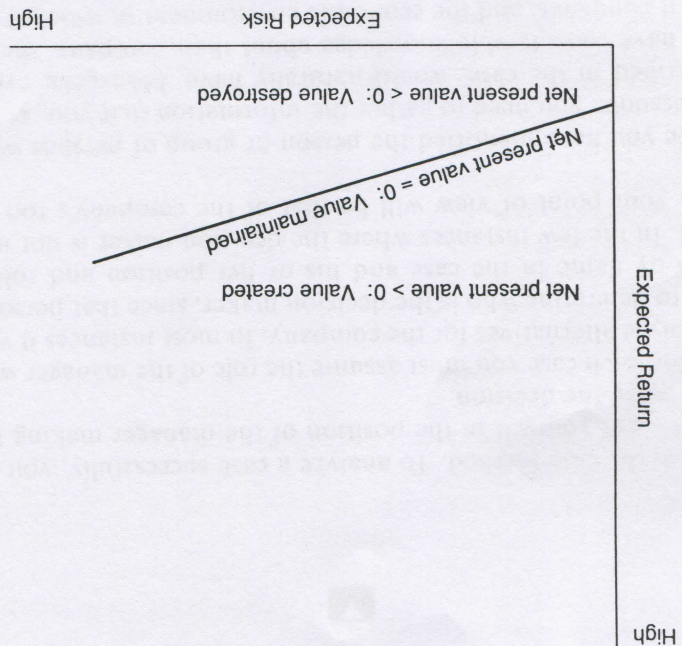
Value is destroyed when the company pays too much, gets too little, or takes too much risk relative to the returns. These are the things that the manager would like to avoid at all cost—they are investments or financing schemes for which the net present value is negative. As hard as value-creating options are to find, suffice it to say that most managers think they can be found; they do not believe that the product markets (and perhaps capital markets) are fully efficient. Thus managers usually believe they can find real sources of value for the firm's shareholders—investment and financing plans that will increase the price of the common stock.

Make a Decision and Develop a Plan of Action. Just as the manager must weigh all the information available and come to a decision, so must a case analyst. While it is often difficult to decide among alternative courses of action, the analyst, taking the information developed from the analysis or provided in the case, must weigh the evidence before reaching a conclusion. It is helpful if the analyst has developed the assumptions upon which the analysis is rested and detailed the conditions under which each decision would be appropriate. The consistency and reality of the assumptions are critical to making a good decision.

After the decision has been made, the analyst should follow with a plan of action to implement it. The plan is usually sequential in nature and describes what must be done, by whom, and when.

The goals, concepts, and theories of finance will help you, in the manager's role, to guide and focus the analysis. Using the framework of value creation to appraise the options presented in the cases in this book will help you to decide which is the appropriate course of action, given the firm, its strengths and weaknesses, its industry, and the environment in which it is likely to operate.

Note: For those using internal-rate-of-return methodology, the value is created when the IRR exceeds the hurdle rate, maintained when the IRR equals the hurdle rate, and destroyed when it falls short of the hurdle rate.



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