Free-up Lazy Balance Sheets

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OPINION

This week, the Productivity Commission launched its inquiry into how to improve the productivity and results of Government spending on things like social housing, employment and crime reduction.

The productivity push is intriguing – they're measuring whether those tasks could be done cheaper. What they should be interested in is whether the return is the most productive use of the investment.

Most business owners equate productivity with profitability. Productivity gains are sought by tweaking operational performance – doing things cheaper. Reducing overheads or introducing a new piece of technology or higher margin products are the kinds of improvements that businesses are familiar with.

Owners of businesses, as well as owners of social enterprises, should apply the same level of rigour to improve the productivity of their invested capital.

New Zealanders – directors, senior managers and even some investors - aren't paying enough attention to the balance sheet. Profitability and rising share prices are important, but neither explain whether a company is using its assets productively. That's what we should be asking: can a company deliver current and sustainable profitability and acceptable levels of return on invested capital?

Return on Capital Employed, or ROCE, shows a company's total return from the money that is utilised in it. It measures the efficiency and profitability of a company's capital investments by multiplying a company's operating margin with its capital turnover. In doing so, investors can tell how well a company uses its working capital - inventories, receivables, and payables - and its fixed assets.

That information is vital because it provides a much clearer a picture of what a company's total returns are. Companies can prop up their profit margins by cutting costs, but there's not much you can do to hide the fact that the extra money being invested isn't generating the same amount of sales.

The ROCE technique is widely used internationally. Yet, surprisingly, most New Zealand businesses seem reluctant to focus on it.

Our own analysis of the ROCE of 200 New Zealand companies found there is little to no growth in capital activity. Globally our companies rank well in terms of operating profit margins (earnings before interest and tax divided by revenue), but are generally keeping too much capital locked up on balance sheets.

Last year, the median profitability for NZX 50 listed companies was 15.3% which is almost on par with those in companies which comprise the USA S&P 500. That's a good result for shareholders, until you consider that the equivalent ROCE for those New Zealand companies is about half that of our American counterparts.

The inescapable conclusion is that New Zealand business owners aren't working their assets enough to generate better returns to shareholders.

Some sectors in the New Zealand economy do remarkably well at turning over their assets. Large Fast Moving Goods Companies like Briscoe Group, Restaurant Brands, and Hallenstein Glasson Holdings all consistently recorded strong ROCE for the last 3 years. They were able to do this through low levels of investment in working capital, plant and equipment and turning over the equivalent value of their asset base numerous times per year.

There are plenty of ways for New Zealand companies to squeeze more utilisation from their assets. Leasing capital plant and equipment rather than owning it is one obvious course of action. That doesn't come so easy to New Zealand business owners - we're a country that likes to own things.

Being more aggressive in collecting debtors and managing inventories can have a huge impact on improving the productivity of a business's assets.

The lock up of cash caused by debtors not paying their bills on time is not insignificant. A Kiwibank survey of small and medium sized enterprises last year found that each month, more than $2.5 billion in invoices are not paid on time. (Further they estimate that businesses are collectively spending 18 million hours a year trying to get invoices paid – is that productive?)

The lock up in capital on balance sheets in general is an enormous waste in capital productivity. The deferred cash in the hand and man hours lost would clearly be far better deployed to generating more revenue or freed up for reinvestment in other activities.

And there's the rub. Return on Capital Employed can easily be determined with a relatively straightforward look at a company's accounts. The reality is that many organisations aren't looking where productivity gains can really be made.

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