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Leading Ideas

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Booz & Company

from **strategy+business** issue 46, Spring 2007

Too Much Money

by Justin Pettit

Companies are sitting on mountains of cash, much more than they need. Holdings at NYSE- and Nasdaq-listed companies topped a record $2.7 trillion in 2005, and they are growing at 24 percent annually. By industry, the largest cash increases in the past decade were in media (1,700 percent), utilities (1,360 percent), and telecommunications (1,300 percent).

Until recently, excess liquidity seemed like a smart strategy. It was insurance against risk and provided capital for growth. But now, with balance sheets largely mended, cash flow volatility easing, the outlook for corporate earnings generally improving, and interest rates on the rise, the benefits of keeping large amounts of cash on hand are less easy to discern. This leaves many companies facing a troubling dilemma: Just when the actual need for excess cash has decreased, they have too much liquidity. They're hoarding capital instead of putting it to good use, wasting critical opportunities to benefit from it. And they're making themselves vulnerable to corporate raiders — private equity firms and hedge funds that would like nothing better than to move in on an organization with large sums of money in the bank.

In this environment, a so-called decapitalization strategy that reduces the cash on hand to a sufficient amount for day-to-day business and growth — an approach that in turn can simultaneously enhance creditworthiness and return on equity — offers the most compelling economics. The purpose is not purely to minimize cash, but also to realistically determine how much liquidity is required for both routine and strategic operations and to wisely earmark the rest of the money for shareholders and debt reduction programs.

Indeed, there are periods when more rather than less cash is necessary. For instance, cash can be a competitive advantage, especially in an industry prone to aggressive pricing, like retail or airlines. Wal-Mart and Microsoft have famously used their financial strength and excess liquidity to cover deep discounting that competitors are often unable to match. Manufacturers typically have a different reason for accumulating cash: It provides bargaining strength for dealing with suppliers and labor unions. And startups such as biotechnology companies may have to depend on liquidity to acquire a new technology or launch an unanticipated research and development effort.

So whether decapitalization is intended to minimize cash on hand or to allot it wisely, an evaluation of organizational needs and industry imperatives must first be conducted to identify short-term and long-term priorities. From there, a balanced capital structure that allocates cash among these spending and debt categories can be fashioned:

Operating Liquidity. A minimal amount of cash should be designated for work in process, sufficient to ensure continued operations without undue risk of financial distress. Operating liquidity needs to rise during periods of industry volatility, lower expected cash flows, and higher fixed costs, including dividends and debt servicing.

Growth Capital. Also called dry powder, this money is set aside for research, expansion, design, development, and acquisition opportunities. In other words, it's the cash disbursement with the greatest potential upside. However, reserving excess cash for long periods of time to cover prospective (but unidentified) growth opportunities can drag down a company's performance and profitability, a condition that may worsen as interest rates rise and it becomes more expensive to rely on debt to fund growth. The need for dry powder increases as growth prospects rise or the challenges associated with raising capital worsen.

Share Repurchases. Buying back company shares is an efficient way to reroute excess capital not needed for liquidity and growth. Share repurchases are a positive sign to capital markets and to investors, signaling fiscal discipline and confidence in future earnings. Moreover, empirically, share prices tend to increase in value after a repurchase because there is less outstanding equity. However, the share float at some companies is too small for a significant share repurchase program.

Pension Funding. This use of cash is attractive because it improves a company's credit profile, and in some countries, including the U.S., it is also tax deductible. Moreover, accounting changes are under way to categorize net underfunded pension positions as debt rather than as a mere footnote on the balance sheet; this accounting change will make pension funding even more desirable. To limit the risks of overfunding, pensions should be endowed to only about 80 to 90 percent of their total.

Dividends. Especially in today's more dividend-friendly tax environment, this is typically the first decapitalization option for a company with too much cash. However, most companies' dividend level is dwarfed by the amount of excess capital, making this an inefficient route to redeploy cash. And because they are a fixed cost, large dividends impair operating liquidity and credit quality, making them especially inappropriate for cyclical or volatile sectors such as mining, pulp and paper, and automotive.

Notwithstanding media attention and investor interest, market gains from most dividend increases are small, at less than 1 percent. However, new or higher dividends can improve share performance for those companies with low volatility, low valuations, high margins, and dividends that are well below those of others in their industry. In a balanced capital structure, dividends should not exceed recurring and stable quarterly cash flow. Volatile or uncertain excess cash flow may be better distributed through share buybacks.

Debt. As a tactic that is similar to holding cash for growth, debt reduction is a source of financial strength by freeing debt capacity. However, debt reduction is not always possible: Many companies have illiquid or noncallable debt, and the cost to unwind it can be significant. Also, during the recent period of low-rate loans, many organizations refinanced their most costly debt with new debt under attractive terms.

Optimally capitalized companies should balance share repurchases with debt reduction to maintain the ideal mix of debt and equity. If debt reduction outpaces share repurchases, a company's credit profile may improve; but because equity is more expensive than debt, its average cost of capital will be higher.

Triggered by analysts, investors, and heightened public concern about corporate governance and proper management of capital, interest is growing among companies in the possibilities of balanced capital structures and corporate decapitalization. Indeed, since July 2004, when Microsoft announced a massive $75 billion decapitalization that included a special dividend, a doubling of the regular dividend, and a $30 billion share repurchase, corporate boards around the world have begun to reevaluate their own cash positions.

There are many rules of thumb for cash allocation — setting aside a percentage of revenue or of fixed costs, for instance — but one-size-fits-all solutions are a mistake. Decapitalization is an extremely complex endeavor, requiring deep analyses to produce an effective allocation plan. However a company approaches the issue, though, one

Just when the need for excess cash has decreased, companies are hoarding capital instead of putting it to good use.

fact is undeniable: Too much cash is a wasted asset. +

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The Favoritism Test

by Marshall Goldsmith

I have reviewed custom-designed leadership profiles at more than 100 major corporations. These documents typically feature boilerplate language that describes the leadership behavior each company desires. Such chestnuts include "communicates a clear vision," "helps people develop to their maximum potential," "strives to see the value of differing opinions," and "avoids playing favorites."

Not one profile has ever included a desired behavior that reads "effectively sucks up to management." Although given the dedication to fawning and sucking up in most corporations — and how often such behavior is rewarded — it probably should. Almost every company says it wants people to "challenge the system," "be empowered to express their opinion," and "say what they really think," but there sure are a lot of companies that are stuck on sucking up.

Not only do companies say they abhor such comically servile behavior, but so do individual leaders. Almost all the leaders I have met say that they would never encourage such a thing in their organizations. I have no doubt that they are sincere. Most of us are easily irritated, if not disgusted, by derriere kissers. Which raises a question: If leaders say they discourage sucking up, why does it dominate the workplace? Keep in mind that these leaders are generally very shrewd judges of character. They spend their lives sizing people up: taking in first impressions and recalibrating them against later impressions. And yet, they still fall for the super-skilled suck-up. They still play favorites.

The simple answer is: We can't see in ourselves what we can see so clearly in others.

Perhaps you are now thinking, "It's amazing how leaders send out subtle signals that encourage subordinates to mute their criticisms and exaggerate their praise of the powers that be. And it is surprising how they cannot see it in themselves. Of course, this doesn't apply to me."

Maybe you're right. But how can you be so sure that you're not in denial?

I use an irrefutable test with my clients to show how we all unknowingly encourage sucking up. I ask a group of leaders: "How many of you own a dog that you love?" Big smiles cross the executives' faces as they wave their hands in the air. They beam as they tell me the names of their faithful hounds.

Then we have a contest. I ask them, "At home, who gets most of your unabashed affection? Is it (a) your husband, wife, or partner; (b) your kids; or (c) your dog?" More than 80 percent of the time, the winner is the dog.

I then ask the executives if they love their dogs more than their family members. The answer is always a resounding no. My follow-up: "So why does the dog get most of your attention?"

Their replies all sound the same: "The dog is always happy to see me." "The dog never talks back." "The dog gives me unconditional love." In other words, the dog is a suck-up.

I can't say that I am any better. I love my dog, Beau. I travel at least 180 days a year, and Beau goes bonkers when I return home from a trip. I pull into the driveway, and my first inclination is to open the front door, go straight to Beau, and exclaim, "Daddy's home!" Invariably, Beau jumps up and down, and I hug and pat him and make a huge fuss. One day my daughter, Kelly, was home from college. She watched my typical lovefest with Beau. She then looked at me, held her hands in the air like little paws, and barked, "Woof woof."

Point taken.

If we aren't careful, we can wind up treating people at work like dogs: continually rewarding those who heap unthinking, unconditional admiration upon us. What behavior do we get in return? A virulent case of the suck-ups.

The net result is obvious. You're encouraging behavior that serves you but not necessarily the best interests of the company. If everyone is fawning over the boss, who's getting work done? Worse, it tilts the field against the honest, principled employees who won't play along. This is a double dose of bad news. You're not only playing favorites, but also favoring the wrong people!

Leaders can stop encouraging

this behavior by admitting that we all have a tendency to favor those who favor us, even if we don't mean to.

We should then compare our direct reports on three measures.

First, how much do they like me? (I know you can't be sure. What matters is how much *you* think they like you. Fawning is acting, and effective suck-ups are good actors.)

Second, what is their contribution to the company and its customers? (In other words, are they A players, B, C, or worse?)

Third, how much positive personal recognition do I give them?

What we're looking for is whether the correlation is stronger between measures one and three or measures two and three. If we're honest with ourselves, our recognition of people may be linked to how much they seem to like us rather than how well they perform. That's the definition of playing favorites.

And the fault is all our own. We're encouraging the kind of behavior that we despise in others. Without meaning to, we are basking in hollow praise, which makes us hollow leaders.

This quick self-analysis won't solve the problem. But it identifies it, which is where change begins. +

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Tourism: China's New Diaspora

by Ronald Haddock, Kevin Ma, and Edward Tse

The global travel industry is bracing itself for a new wave of tourists out of China. Like the droves of Americans who explored Europe in the 1960s and the Japanese who traveled the world in the 1980s, the tastes and preferences of China's new international tourists will have an enormous influence on the entire tourism ecosystem.

Currently, only about 2 percent of the Chinese population travels outside the mainland — well below the 15 percent of Americans who travel abroad. But China is catching up. The International Air Transport Association predicts that the mainland's international passenger traffic will grow at an annual rate of 9.6 percent between 2005 and 2009, while various other agencies estimate that China will be included among the top four sources of outbound tourists by 2020.

What is unclear, however, is the quality and cost of the experiences that these tourists will seek: bus tours of Paris's outer arrondissements, or private tours of the Louvre? Spanish street food, or tasting menus at El Bulli?

The earthier options seem to be more popular thus far. Ask for a description of the typical Chinese tourist, and observers from the industry are likely to use such words as *value-conscious, shopping, gambling,* and *chain-smoking.* Or, as the *Economist* put it in a June 2006 article, "Typically, a Chinese tour group will choose the cheapest hotel — even if it is 50km (30 miles) outside a city — travel by bus and eat only Chinese food…. Posh hotels, resorts and restaurants will have to wait for their Chinese windfall."

These descriptions contain elements of truth, but they don't offer a complete picture. As the *New York Times* recently noted, a significant subset of the overall population of Chinese tourists will be quite affluent and willing to spend accordingly. Consider this: China's 31 million international travelers spent US$15.2 billion in 2005. At nearly $500 per person, mainland travelers spent more per capita than international tourists from the United States, France, or Japan.

Successful tour operators are offering upscale packages that promise deeper knowledge of a city, region, or country. They are also introducing lifestyle-oriented products, like fine-dining and wine tours that have proven popular with other nationalities, and adapting them to the increasingly sophisticated tastes of mainland travelers. Current offerings include a six-day winter trip to Kyushu, Japan, for skiing and visits to the hot springs, at a price of RMB9,000 (approximately $1,155) and a seven-day "ancient civilization exploration" tour of Egypt for RMB11,000 (approximately $1,410).

Shopping continues to be popular among mainland travelers. But China's growing manufacturing muscle poses a challenge for overseas retailers: How do you sell to a tourist from a country that makes just about everything? One option is to appeal to Chinese consumers' brand-conscious nature, with a focus on items with labels that can be shown off. Smart sellers will remember the trend in China in the 1980s and 1990s of leaving tags on sunglasses and jackets to show off the brand. Thus, Louis Vuitton handbags, Swiss watches, and Chow Sang Sang gold are popular. Service will also matter: Hong Kong retailers often provide service in Mandarin and accept the renminbi (the official language and currency, respectively, of the mainland).

Gambling is also a top travel pastime for Chinese people. Australia, North Korea, and Singapore are launching or intensifying efforts to attract mainland high and low rollers. However, the profitability of this business will be hit by higher marketing costs and greater competition. Larger construction and maintenance costs will also play a role as customers come to expect a luxurious, Las Vegas–style experience.

Companies within the travel and tourism industry stand to benefit from an abundance of opportunities, but must remain cognizant of the significant pitfalls. Hotels will need to keep costs down to meet mainland travelers' value expectations. At the same time, opportunities exist both for hotel groups that can migrate customers from the lower and middle tiers into more expensive properties, and for chains that can develop a strong brand in China and use it to attract mainland tourists when they travel abroad.

Like hotels, cruise lines must gain an understanding of the Chinese market, as well as educate Chinese travelers about the concept of cruising. Because this is a new vacation option for mainland tourists, cruise lines will need to sell the market on the romance of the sea and the ship as a destination, and give consumers a sense of the entertainment and other diversions available on board a modern ocean liner. And they'll need to figure out where Chinese tourists want to voyage, for how long, and at what time of year. Industry leader Carnival Corporation entered the mainland China market in 2006 with its Costa brand: an up-market offering sailing from Shanghai and from southern China. Royal Caribbean, playing catch-up, recently announced plans to begin sailing from Shanghai in 2007.

How does a retailer sell to a tourist from a country that makes just about everything?

Airlines will face their own challenges. Strategically, they must serve profitable markets, either directly or through alliances and networks. This means obtaining and retaining access to attractive routes and landing slots at key airports, as well as ensuring that the government and regulators maintain an equitable operating environment. International airlines can expect competition from private domestic carriers, such as Hainan Airlines Company, which will use their internal routes as springboards to international markets. They should also anticipate a competitive environment that features one or more mainland-based mega-carriers.

The relative inexperience of mainland travelers offers a significant opportunity for travel agents, currently mostly small, local businesses. The mainland market represents an opportunity for an organization with sufficient vision and resources to establish a national presence that enhances service standards, increases professionalism, and achieves economies of scale. However, the growing popularity of the Internet poses the same threat to travel agents — and the same opportunity for e-travel companies — in China that it does elsewhere.

Finally, financial-services providers such as insurance companies will be watching the development of this market. Travel insurance and credit cards are closely linked to the travel industry and have been important revenue and profit generators in markets around the world.

Companies looking for growth in China's outbound travel sector will not be disappointed. Pent-up demand is considerable, disposable incomes are rising, and travel restrictions are being eased. In many ways, the market is still in its infancy, with few clear leaders. However, companies can benefit from this trend if they anticipate the immense changes in China's outbound travel sector and build their business accordingly. +

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Marketers, Meet the Millennial Generation

by John Jullens

Even with decades of practice communicating with young consumers, marketers may not know what they are in for with Generation Y. Most companies have had little exposure to this cohort. In the U.S., more than 60 million consumers were born between the launch of MTV in 1981 and the commercialization of the Internet in 1996; they have about 140 million counterparts in Europe and almost 20 million in Japan. The older members of the group are only now moving into the mainstream adult arena of reliable cars and mortgages.

Complicating matters is the very nature of Gen Y. Gen Ys, also known as millennials or echo boomers, are the first consumers to be shaped by interactive media. They're plugged in constantly, and the companies that have targeted this young cohort have bombarded them with come-ons in every conceivable medium for products that seem to change as quickly as new technologies emerge. Consequently, Gen Ys are adept at screening out most traditional marketing.

"Gen Y cannot be marketed to," says Peter Kang, creative director of interactive and emerging technology at Saatchi & Saatchi LA. "They're just too astute in the ways of advertising."

Perhaps. But maybe something else is revealed by how hard it is to attract Gen Ys: Namely, marketers cannot merely tweak traditional techniques, as they have in the past, to reach this group. Instead, a radically new approach is needed, one that takes advantage of updated tools and updated thinking. For starters, take these three steps:

1. Learn the ways of the Millennial Generation. Coming of age in the most brand-crazy period in history, Gen Ys expect a constant rush of new brands and new iterations of their favorite products; their tastes don't stay still very long. "By the time we recognize the wave, it's already crashing," says Venkatesh Kini, former chief of Coca-Cola's Sprite and flavors brand business unit and now Coke India's vice president of marketing.

To forecast what Gen Ys want, leading youth marketers increasingly either push the existing boundaries of consumer research or abandon traditional approaches altogether. "We don't do [conventional] market research. We spend time with people," says Jean-Pierre Petit, who heads Nike's soccer business in Europe. "Our designers and product people go to soccer games, or to the in-line skaters at Trocadero, to connect with the kids. You can learn a lot from just watching and talking to them." In other words, smart Gen Y–leaning companies are focusing their information gathering efforts on direct insights into youth "tribal" behavior and attitudes, as opposed to the more superficial insights that emerge from typical customer surveys.

Out of this type of research, for example, Volkswagen produced its extremely creative, against-the-grain ad campaigns for the Jetta, which graphically touted the automobile's safety features — and hit an elusive sweet spot among Gen Ys. After a similar type of exploration, Sprite was able to play to Gen Y's cynicism and sense of irony by running ads mocking the pretentiousness of celebrity endorsement with the tag "Image is nothing. Obey your thirst."

Using "ethnographic" studies, similar to those pioneered by VW, Motorola discovered that although cell phone makers had been stressing new technology as the key differentiator, Gen Ys cared more about style and personalization. The fabulously successful RAZR phone, whose cutting-edge design comes in a variety of colors, grew out of this finding. Because of Motorola's technology focus, the company could create the RAZR only by detouring around its traditional innovation process and setting up a separate project team that was focused on Gen Y behavior.

2. Integrate all your communications. Whereas Gen X spent a lot of time in front of the TV, Gen Y is always "on." They're consumers of every imaginable means of communication: TV, radio, cell phone, Internet, video games — often simultaneously. But they pay attention selectively. Marketers traditionally divide their resources between "above-the-line" mass media campaigns and "below-the-line" direct marketing efforts, often conducted in isolation from each other. But because Gen Ys move rapidly among media, product marketing targeted at them should be interwoven so that an ad in one venue feeds off a different form of advertising in another. For example, moviemakers seeking Gen Y audiences have promoted their films with text messages containing trivia questions sent to cell phones; trailers, actor interviews, lost scenes, and other video goodies on the Web; and longer, costlier advertising on television. "Above-the-line/below-the-line — that's a 20th-century distinction that no longer makes sense," says Murat Yalman, executive director of marketing services at Ford Motor Company.

Integration of communications should not stop with advertising, however. In fact, to truly connect with Gen Y, the entire marketing mix should be realigned. For example, the retail environment must have the same appeal to Gen Ys as the marketing materials that drove them there. Apple has taken this path in its computer stores, which mirror Gen Y kinetic energy and the group's distaste for formality by offering a blend of workshops, tutorials, places to "chill" and get comfortable with products, and salespeople who can close a transaction by typing a customer's e-mail address into a handheld computer and using the information on file in his or her iTunes account.

3. Accept that your product and advertising may have a short shelf life. Instant communication, constant media use, and the desire for individualization have greatly limited the life cycle of popular Gen Y brands and the campaigns that sell them. "Gen Y is growing up in an instant-gratification era, when music, news, and entertainment of any kind is available almost free, almost instantly, and in unlimited variety," says Coke's Kini. "That drives an extreme lack of patience with anything that doesn't appeal to that need for instant gratification."

> "Even as we launch a campaign," says an ad executive, "we've got teams upstairs trying to outdo it and replace it."

Put another way, classic multiyear marketing campaigns, in which a character like the Energizer Bunny can keep going and going and going, are not likely to appeal to Generation Y. A better option is advertising that evolves but is built around a consistent marketing platform. For example, Burger King's Gen Y marketing effort includes rotating versions of its "Have It Your Way" ads with continually updated leading figures like Subservient Chicken, the King, the Whopperettes, and Dr. Angus.

"We talk a lot about idea obsolescence versus idea extension," says Tom Birk, director of research and planning at Miami-based Crispin Porter + Bogusky, Burger King's ad agency. "Rather than extend the existing campaign and try and give it legs, even as we launch a campaign, we've got teams upstairs trying to outdo it and replace it."

Transforming a company's marketing philosophy to fit the needs of a demographic like Generation Y is an extraordinary commitment, but it can pay off for decades and generations to come. Marketers who attempt to understand Gen Ys now will have the jump on competitors as this group matures. After all, some of the biggest brands on the market today bonded with baby boomers early and rode with them from youth into middle age. Who will be the winners of tomorrow? Will the brands that grew up with the baby boomers reinvent themselves for Gen Y, or will the big brands of the new millennium be names most of us haven't even heard of yet? +

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strategy+business magazine
is published by Booz & Company Inc.
To subscribe, visit www.strategy-business.com
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Originally published in Leading Ideas,
strategy+business, issue 46, Spring 2007 by Justin
Pettit, Marshall Goldsmith, Ronald Haddock,
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