

Logistics Finance, At Internet Speed



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BY BRIAN FLOOD

UPS sets a record by raising \$5.5bn with its IPO. Ford and Oracle announce formation of AutoXchange, an e-business integrated supply chain for suppliers. Amazon.com starts to build its own distribution facilities. Netship offers an innovative means for web merchant distribution. It is an exciting and turbulent time in the logistics field, and where the industry is headed is unclear. But one thing that is certain is that as companies pursue various alternatives in supply-chain strategy, understanding financial consequences and using appropriate financial measures will be imperative.

To define this phrase — appropriate financial measures — one should begin with the stock market. Over the past five years, companies in the top quartile of returns generated five times the value of those in the bottom quartile. With capital flocking to the internet sector, demonstrating the potential to be in that top quartile in order to attract growth capital, will become more challenging. One key to attracting capital is to focus on the following measures that have been proven to be strongly correlated with stock return: ROA, or return on assets; EVA, for economic value added; and cash-to-cash cycle, or C2C.

While companies have traditionally used profit margin as the barometer of financial performance, ROA is a more complete measure, in that it factors not only profit margin (profit/sales)

but velocity (sales/assets) to generate profit relative to investment. In today's disinflationary global environment, there is continued squeezing of margins, meaning that velocity has become the more critical measure to generating adequate returns and remaining competitive. Supply-chain performance has a tremendous impact on velocity, thus moving logistics way up on the list of strategic priorities.

Velocity has become a clear competitive weapon in business performance, as companies strive to grow revenue faster, distribute products sooner and utilize assets more efficiently. The measure that may best demonstrate how velocity contributes to value is cash-to-cash cycle time (C2C). Over the long term, generating positive cash flows is the ultimate objective of business, and C2C repre-

sents the time duration between payment for materials and cash received from a customer. The number of days inventory is on hand is a large component of C2C, and many of the companies at the top of the stock performance list have best-in-class inventory turnover.

Like ROA, EVA is also a measure of investment return. EVA is defined as after-tax operating profits less the cost of capital. Many companies are using EVA as their primary measure of financial performance, since it factors not just profits generated but the costs to finance the investment in the business.

Using these measures means focusing on the balance sheet as well as the income statement. If investors in Lucent Technologies had noticed that the rate of growth in receivables and inventories had exceeded the growth

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in sales over the past few quarters, they may not have been so shocked by the recent drop in the stock price. In evaluating logistics improvements, managers must estimate the impact of any changes on financial statements and these key financial measures. As more customer-centric requirements rule, such as product returns, web-based sales,

and rewards will facilitate that strategy, and make the leap less risky. Software tools that project effects of supply-chain decisions on processes, costs, ROA, EVA and C2C will be critical. More empowered and informed logistics managers will be much better prepared to proactively change tactics in order to achieve financial objectives.

and beat up providers on cost. The lowest-bidder approach has shown to be more costly in the long run, and damaging to service capabilities.

As software vendors compete to provide supply-chain optimization and logistics management applications, they also must supplement these offerings with financial tools. Many software products recommend facility locations, transportation routes and resource requirements. Few translate these supply-chain decisions into value-based measurements, such as EVA impact. Logistics managers need software that allows them to simulate supply-chain improvements that disclose estimated impacts on cycle time and costs, and also measure the impact of various investment and risk scenarios on economic value and stock price.

Compensation is another financial issue in the fast-paced logistics environment. Intellectual capital may be the most important investment to measure, as professionals flock to the internet sector for higher pay and equity participation. Logistics organizations must find ways to attract and keep their top professionals with stock options, phantom stock, value-based bonuses and even spin-offs of higher-value business segments.

As consumers weigh the various product delivery options now available, retailers must make it easier to know the costs of those options. Certain providers, such as UPS and FedEx, have facilitated this knowledge with information on their web sites. As logistics information increasingly becomes a competitive weapon in the market, companies must ascertain that this real-time pricing is contributing to overall financial value. A sophisticated link of activity drivers with economic value will be a critical component of e-business strategies.

Just as the velocity of logistics is imperative to business success, so is the velocity of decision making. Group consensus meetings must be replaced with a business model that enhances informed, rapid decision making. Providing managers with tools to reasonably predict financial risks and rewards of their decisions is critical. As Yogi Berra once said, "Prediction is never easy, especially when it comes to the future." Automating the impact of logistics changes on the right financial performance measures will facilitate decisions, and allow logistics managers to focus on what is really important: making business easier and more profitable for their customers. ○

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auction-based pricing, just-in-time deliveries and customized product design, logistics decisions become increasingly complex. Today's business environment requires acceleration in the supply-chain process and also in the decisions that determine how the supply chain operates.

Every participant in the supply chain must consider financial implications of supply-chain trends and respond appropriately or face difficult consequences. In his book "Clockspeed," Charles Fine refers to supply-chain design as the ultimate core competency, with the greatest rewards going to those who can anticipate which functions to invest in, and which to outsource. As organizations focus more on supply-chain strategy, they will need to foresee not only how this improves their ability to compete but also what tactical approach is needed to maximize EVA and operate the supply chain efficiently.

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As customers personalize purchases, and establish prices they are willing to pay, companies must respond instantaneously, deriving the customized cost and value for each customer transaction. Winners will not be those that analyze, contemplate and seek consensus, but rather ones who take the daring leap and improvise along the way. With the need to make ever quicker decisions, estimating and simulating the financial risks

E-fulfillment is shifting supply-chain channels and creating a new business model, as Dell illustrates with its 223 percent annual stock return the past three years, corresponding with its 34 percent ROA. Outsourcing and supply-chain acceleration are generating much higher returns on investment than traditional vertically integrated companies. While changes are occurring rapidly, with leading companies setting the standards for future financial expectations, overall measures of inventory turnover and logistics costs as a percentage of revenue have not changed over the past few years. This means that the gap between the best-in-class and all others is widening. This gap presents a challenge not only to those that compete against the best-performers but also to the organizations that facilitate and support these changes: logistics service providers and supply-chain software companies.

Innovative Financing

Supply-chain service providers must enhance their standard offerings with innovative, C2C services to distinguish themselves from the pack, such as inventory and working capital financing, logistics network design, e-based invoicing and cash collections, expedited delivery, systems application hosting and demand planning. Companies are looking to outsource not only transportation and warehousing but all forms of financial risks. Manufacturers and retailers must collaborate with service providers to improve the cycle time of the overall chain, not just simply pass on risks