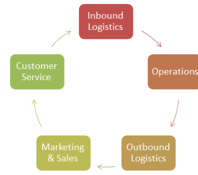


Don't Blindly Follow the NPV Rule: The Business Model and Strategy Matters

Coca-Cola Company (NYSE: Ticker KO) reversed their 24-year old business strategy on February 25, 2010, by confirming its agreement to acquire the North American operations of its largest bottler in a deal valued around $13 billion. A day after the announcement the market slashed KO's market capitalization by just over $6.8billion by trading down from around $54.39 to $51.46 per share. Almost 1-year later, February 9, 2011 KO announced strong 4th quarter results and net revenue growth that beat the analyst consensus. A major driver being structural changes related to Coca Cola Enterprises (Ticker: CCE). After this announcement KO opened at $64.01 resulting in many more billions of dollars being added since the original announcement.

To gain some insights into what is driving KO's share prices we will consider some finer points associated with the interactions between business strategy and the net present value rule applied to an investment decision.

Net Present Value (NPV) Rule

In standard corporate finance textbooks the Net Present Value (NPV) Rule provides the underlying foundation for evaluating the firm's investment decision relative to its opportunity cost of capital. For example, in Principles of Corporate Finance by Brealey, Myers and Allen discuss the investment decisions using the NPV Rule, and stress "Only cash flow is relevant." However, exceptions to this rule will arise when a corporate's business model and strategy is taken into account because the incremental cash flows now need to be interpreted from the larger perspective. This poses a difficult problem to the price discovery problem facing the stock market, in the light of a newly announced investment decision. Prices are discovered, individual positions are adjusted relative to these prices, and billions of dollars of additional value are immediately added or destroyed.

Background

In the current case the Coca-Cola company made an investment decision announcement that arguably has short term negative cash flow implications but longer term strategic implications. For the case of Coca-Cola the initial response was consistent with applying the NPV rule followed by a re-evaluation phase

Under the terms of what the two companies called a “substantially cashless” deal, Coke will take over the North American operations of the bottler, Coca-Cola Enterprises. Coca-Cola Enterprises, or C.C.E., would then acquire Coke’s bottling operations in Norway and Sweden, becoming a European-focused producer and distributor of Coke products. It will also have the right to buy Coke’s 83 percent stake in its German bottling operations within 18 months to 36 months after the deal’s closing. After the deal’s closing, expected in the fourth quarter, Coke will own about 90 percent of its North American bottling operations.

In the deal, valued at more than $13 billion, Coke will give up its 34 percent stake in C.C.E., valued at $3.4 billion, and assume about $9.5 billion of C.C.E. debts and other obligations.”

(NY Times By MICHAEL J. de la MERCED) February 25, 2010.

The above announcement reverses a 24-year old strategy for Coca-Cola and has both short and long term implications for both KO’s investment and financing decisions which had significant valuation implications.

NPV Rule and the Stock Price Reaction

Around the time of this announcement KO shares declined relative to PEP stock.

Stock Prices: Announcement Date Feb 25, 2010					
	KO	PEP			
4-Jan-10	55.68	59.89			
19-Feb-10	54.39	61.28			
26-Feb-10	51.46	62.09			

That is, KO’s market capitalization reduced by about $6.8 billion by announcing a deal that was valued around $13 billion. From a NPV rule interpretation this was a negative $6.2 billion NPV project relative to an implied$13 billion outlay.

This market reaction reflects the relative weaker financials for CCE versus KO:

	2009	2008	2007	2006	2005
KO's Operating Income	8,231.00	8,446.00	7,252.00	6,308.00	6,085.00
CCE's Operating Income	1,518.00	-6,299.00	1,470.00	-1,495.00	1,431.00

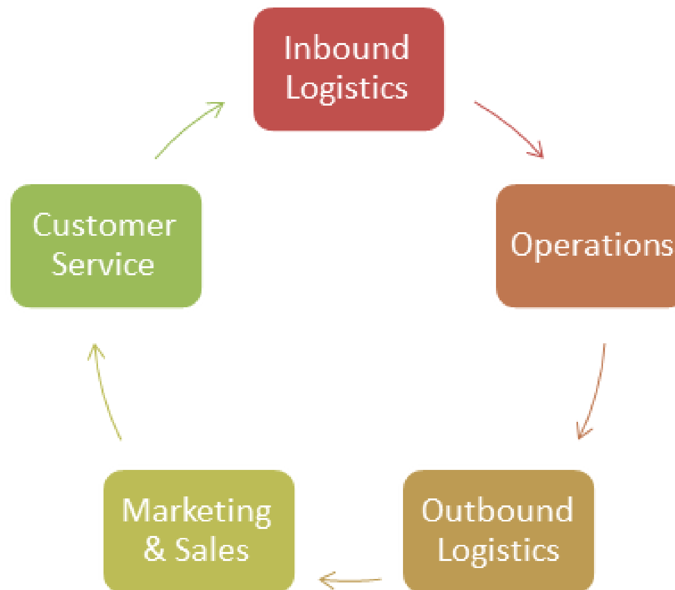
Interpretation From the Perspective of KO's Business Model and Strategy

First, consider applying Porter's Value Chain to cover Coca Cola pre and post this announcement. We will keep this chain simple to provide an overview of KO's business model. Briefly a firm's business model describes how it plans to create value from the set of economic resources under it's control. For the case of KO it's business model requires producing and distributing syrups and for bottling non-alcoholic beverages. KO also aggressively markets it's non alcoholic beverages under its widely recognized "Coca-Cola" logo. It is noted that this is reinforced in KO's 10-K Item 1 where they emphasize being: "the world's largest manufacturer, distributor and marketer of concentrates and syrups used to produce nonalcoholic beverages." However, post the announcement KO's Operations, Outbound Logistics and Marketing & Sales are planned to undergo significant change. Operations will include not only manufacturing syrups but bottling. This will serve to align Coca-Cola's business model more closely with the parts of PepsiCo's business model described in their 10-K under the section titled "Our Distribution Networks." (see appendix).

Coca-Cola's Marketing & Sales will also change in two significant ways. Coca Cola will have a lot more flexibility over bottling/labels/local pricing promotions. They will also be able to exploit Supply Chain Management (SCM) to a much greater degree than prior to the announcement. This is because first, KO gains control over an important source of real time information – that is how their products are moving in different parts of their North American operations. The significance of this point was recently demonstrated by the fact that on 9/27/2010 it was announced that the FTC put conditions on the acquisition (in response to a complaint filed by the Dr Pepper Snapple Group) and in particular that Coca-Cola agreed to restrictions on its access to competitively sensitive information of Dr Pepper Snapple Group Subsidiary. This involves creating a "firewall" to restrict access to Dr Pepper information.

Second, KO will be better able to integrate their inbound logistics and outbound logistics with their suppliers and retailers. These last points have implications for the two additional links Customer Service and Inbound

Logistics. In other words every link is impacted by the announcement which should enable KO to squeeze additional efficiencies out of their system by more efficiently implementing SCM practices.



KO's traditional business strategy involved choosing not to perform bottling activities that are currently performed by its rival PepsiCo.

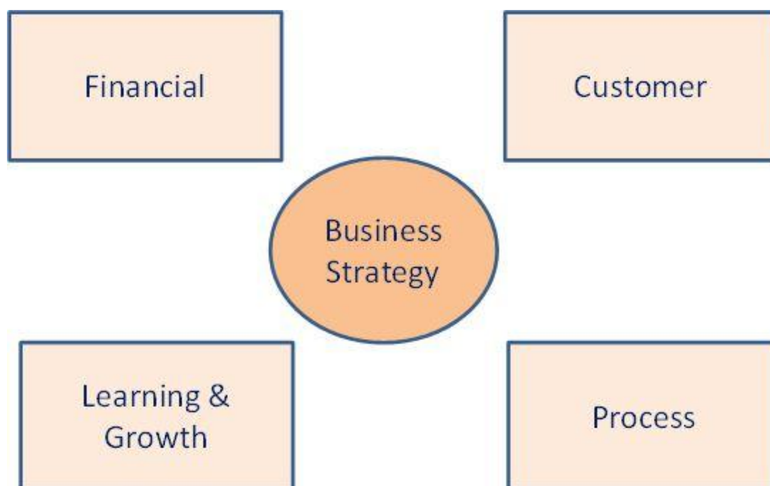
Clearly post the announcement KO has announced it's intention to shift to a strategy that actively embraces these activities. Post the announcement their strategy would appear that KO is better positioning itself to compete with PepsiCo along this dimension in arguably similar ways. From the announcement it would appear that KO is going to attempt to differentiate by aggressively embracing SCM principles (see Chapter 1 Valuation Tutor) to engineer some significant longer term cost savings. For example, KO will control 72% of the US markets and 100% of Canada. This will generate rich information which already drew the immediate attention of Dr Pepper Snapple with respect to their own business. In the report KO estimates it can achieve around $350 million in cost savings over the next four years and this was later revised up. KO will presumably attempt to separate itself by exploiting information as a source of value as opposed to a support activity, that is exploit activities in "MarketSpace" as well as the "MarketPlace" as discussed in Chapter 1 of Valuation Tutor.

It is clear from the PepsiCo description of CSD (Carbonated Soft Drinks) that KO will initially have an informational advantage to work with given it is the market leader in this area. This is an intangible asset that is a source of value.

In addition the SCM principles will enable KO to exploit efficiencies on the cost side. As a result, to communicate their business strategy requires adopting a multidimensional approach for which the balanced scorecard is relevant.

The balanced scorecard as discussed in Chapter 1 of Valuation tutor, provides a method for communicating business strategy in terms of four important dimensions:

Financial, Customer, Process and Learning & Growth.



- Financial Perspective focuses upon bottom line ratios – ROE (Return on Shareholder's Equity), ROA (Return on Assets), EPS – Earnings per share, FCF – Free Cash Flow and Stock Price ---this perspective may exhibit short run adverse effects as the deal is a cash and debt deal. The company has suggested that it will be "accretive" to diluted earnings per share in 2012, in other words the positive impact is not likely to kick in until 2012. This suggests the short term impact will be negative. In addition, the KO's financial leverage will increase with the additional debt. So likely impact on the financial perspective is negative short run and positive in longer term.

- Customer Perspective focuses upon Sales Revenue. This should be positive because KO is taking over local marketing to grocery stores etc.,. In combination with its control over bottling it can be a lot more responsive to change conditions in the US and Canada across regional areas. This combined with the more efficient utilization of information

by SCM should allow KO to compete more aggressively with PEP at the local supermarket level. So impact here should be positive soon after they have implemented the SCM. Again this is likely to spread out over four years given the cost efficiencies will take four years to materialize.

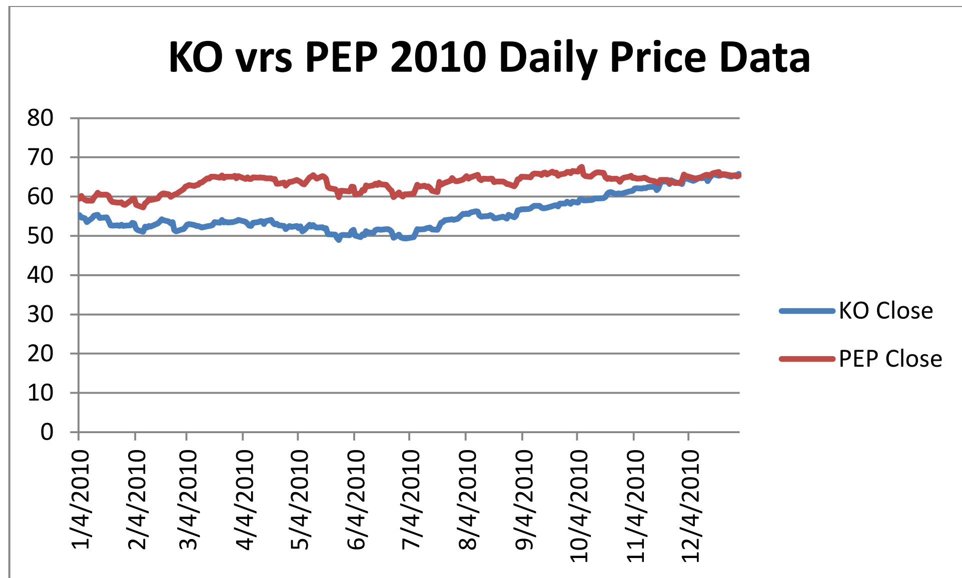
- Process focuses upon the cost side and efficiency ratios e.g., inventory turnover, asset utilization, accounts receivable turnover. Initially these types of ratios will be adversely affected until the cost efficiencies from implementing SCM kick in.

- Learning and Growth focuses upon human capital and growth behavior This is likely to have the least noticeable effect. However, by having employees work through all parts of the business will permit some efficiencies to be extracted in the longer term. Growth will be positively impacted in the longer term by exploiting the sales flexibility and operational flexibility.

The acquisition will have an immediate impact will be on the financial dimension and probably adverse. However, if the impact upon the other two dimensions Operations (cost efficiencies) and Customer (Revenue Growth) evolve as expected the initial negative impact should evolve into a positive impact. The benefits are expected as early as 2012 by the company.

Overall the strategy appears to be sound especially if they exploit the potential efficiencies available from SCM. A primary potential dividend from this is that KO has the chance of controlling information in real time regarding product movement, labeling preferences and other properties that influence local supply and demand. This information is exploitable via SCM and their extended value chain to squeeze out cost efficiencies and exploit revenue opportunities. So overall the two dimensions Customer and Process are likely to feed into stronger ROE numbers in 2012 and beyond.

The stock market performance between KO and PEP for 2010 reinforced the business strategy implications as KO pretty much closed the gap with PEP by year end, even though there was an initial decline after the an announcement of the investment decision in February.



In a subsequent blog we will apply Valuation tutor to perform the ratio and related economic analysis of KO's investment decision including a comparison to PEP especially as the 2010 figures become available.

Conclusions

The investment decision clearly has first order importance upon a stock's price and therefore when a major new announcement that reverses past decisions is made deserves close scrutiny. For the case of KO the market's initial response appeared to follow the NPV rule that only cash flow matters relative to the stock's opportunity cost of capital. This was because the operating results from KO were a lot stronger than the operating results for CCE. However, when viewed from the perspective of KO's business model and strategy there were a number of synergistic effects, one of which attracted FTC attention relative to a competitor. As a result, the decision when viewed in this broader context looks to be very sound. In addition, as the markets receives reinforcement of this billions of dollars of shareholder value are being added back in the form of higher stock prices.

A second, important conclusion to draw from this case is that to be able to perform financial statement analysis effectively requires understanding the stock's business model and business strategy. In the Valuation Tutor we illustrate this important point and we will further reinforce this with the future Coca-Cola blog.