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LIVING WITH INFLATION

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"You can't live with inflation" is the complaint of a current television commercial. Gold, silver, antiques, art objects and the like are being touted in sophisticated forums as the only reliable protection against inflation. Certainly, for most investors, the stock market has not proved to be a successful hedge against the loss of capital. However, ownership of a well-managed business can be a very productive investment in an inflationary economy. The following remarks explore briefly the opportunities that management has to optimize performance in the present market place.

First, let us consider cash flow. We must minimize the time between fixing the selling price and reapplying the sales proceeds. While the selling effort is being made, costs are rising; while we hold the receivable or the cash, purchasing power is declining. Second, we must maintain liquidity in order to preserve assets and avoid excessive financing costs. This will require effective forecasting, both short-term and in capital budgeting. Finally, we must hold to a minimum the tax bite extracted from the capital we can preserve.

OFFER TO SELL

Establishment of prices in advance of sale and delivery may be necessary in a business, but it results in considerable risk unless costs are fixed or very predictable. Fixed-price contracts may not be practical in periods of high inflation. Where sales are made through catalogs produced annually, or even semiannually, perhaps prices should not be included but furnished periodically as supplements. During my experience in Brazil I observed many companies that quoted prices only at the point of sale or that revised price lists monthly or more often if necessary.

Selling prices that produce a reasonable margin based on actual cost of the inventory may not be adequate in relation to the cost of replacing that inventory. In the fifties this deficiency resulted in the demise of many small lumber companies which cut their stumpage into lumber and sold it at prices that were inadequate to finance the purchase of additional timber.

Ideally, the price should be fixed when the cash is collected. This generally is not feasible, but the period of exposure should be minimized.

TERMS OF SALE AND COLLECTION

Having minimized the time between fixing the price and delivering the product, we must minimize the collection period, which is influenced by billing procedures, terms of payment and collection efforts.

The bill should go out concurrently with the product, or in advance if progress billings are appropriate. Monthly statements as a billing practice can delay collection up to thirty days. This may be an expensive tradition when purchasing power of that receivable is declining at the rate of 1 percent a month. Billing departments that are weeks or even days behind certainly require attention.

In view of the present cost of money and rate of inflation, we need to reconsider payment terms. A 1- or 2-percent cash discount for payment in ten days used to be a strong incentive. Today, delay of payment for sixty or even ninety days may be more beneficial to the customer and more costly to the seller than would the discount. Interest charges on accounts outstanding for thirty days are becoming more common and today may be a necessity. Failure to make such adjustments in payment terms can result in a deterioration in the actual value received that was not contemplated when the sales price was fixed.

A vigorous effort to collect past-due accounts is essential—not only because of the cost of money and inflation, but because of clouds appearing on the economic horizon. The asset may not only be declining in purchasing power; it may also be in jeopardy.

Use of "locked-box" services at banks for direct deposit of collections can accelerate the availability of cash by a day or more.

CASH UTILIZATION

Now we have collected for the sale. What do we do with the cash? Holding it will cost us 1 percent a month in purchasing power. I have observed that well-managed Brazilian companies (and, increasingly, more American companies) operate with little or no cash balances. Some actually have negative balances and operate on the "float," i.e., on the basis of uncleared checks. Bankers are not enthusiastic about this practice, and it involves serious risks which we will consider in discussing the need for maintaining liquidity.

But what should we do with the cash? We can pay off loans or contracts with unattractive interest rates, realize available cash discounts or consider short-term investments (which recently have been very attractive).

Stockpiling sensitive raw materials may be desirable if shortages and/or price increases are likely. If we have freedom to increase sales prices, inventory can be a hedge against inflation. Advance production may be indicated if sales are relatively certain and labor disputes or wage increases are likely.

Plant expenditures may be attractive or, in fact, essential. Improvements that replace rising labor costs with fixed costs (depreciation, interest and property taxes) are particularly desirable. So is maintenance, which may extend plant life in this period of high replacement cost. Income-tax considerations can be important in the timing of plant additions or maintenance.

There are many uses for cash, and holding it is seldom the best practice in the present environment.

LIQUIDITY

We have already said that we should liquidate receivable and cash balances as quickly as possible. We should also delay payments as long as practicable. However, we cannot do these things blindly. Lack of liquidity can quickly become insolvency or result in expensive crash programs to raise working capital. During periods of "tight money" this can be disastrous.

Effective forecasting of cash need and availability has always been important, but it is critical if we are to live with inflation. Short-term requirements should be forecast monthly for a year. Weekly forecasts are generally desirable, and they should be monitored daily. Long-term capital budgets by year for at least five years should be a part of management planning.

An all-too-frequent pitfall for business is the use of short-term financing (suppliers' accounts and bank loans) to finance plant additions. Such financing should be arranged so that the proceeds from increased production can retire the debt. Further, there must be a realistic debt/equity ratio, particularly now when a downturn in the economy is a real concern. Short-term borrowings for long-term commitments may be prudent, but only as a part of a realistic capital budget that provides for refinancing.

In the fifties when building was depressed and the price of plywood declined some mills had no alternative but to increase production to maintain the cash flow required to meet instalment obligations. Lack of liquidity caused them to sell their product below replacement cost.

In view of today's market uncertainties, a strong current position seems appropriate. This may mean paying a fee for a committed but unused line of credit and maintaining costly compensating balances. It may mean carrying short-term investments instead of expanding plant. I am not suggesting overconservatism, because that increases inflation risk. Rather, the businessman should plan ahead carefully and avoid overcommitment.

There seems to be a shift in emphasis among investment analysts—a move from earnings per share to financial position. In other words, liquidity is receiving more attention, and earnings per share (the analysts' main concern for the past twenty-six years) relatively less. Current yield and ability to finance continuing dividends have become focal points. Some analysts have even suggested the selection of equity positions in companies with little or no debt. This is a sharp turn from earlier devotion to highly leveraged companies—that is, companies with high debt/equity ratios which tended to have better earnings-per-share performance in a rising-market economy.

Certainly there is a place for debt in the present environment—both short-term borrowing and long-term financing. The point is that we must have realistic short- and long-term financing plans so that the debt we assume is appropriate and not a burden or a threat to our continuing success.

INCOME TAXES

Now let us look at our tax problem in a general way. If we assume an annual inflation rate of 10 percent, for every \$100 of net worth that we have today we need \$110 next year. However, to have \$10 more we must earn \$20, because about 50 percent of the increase through earnings will go to taxes.

The Brazilian government has recognized that much of what looks like income is really only staying even. Thus, for example, under their tax laws:

☐ Price-level indices are applied annually to depreciable assets, and the increase is amortized as an allowable deduction for income-tax purposes.

☐ Price-level indices are applied annually to working capital, and the resulting loss in purchasing power is allowed as an income-tax deduction, provided that it is added to permanent capital.

This recognition of the economic facts of life has few parallels in U.S. tax law. Nonetheless, opportunities do exist for minimizing or deferring income taxes, and the businessman would do well to explore them with the help of a professional adviser. ●