Capital Planning Strategy

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The author outlines reasons for the declining capital productivity in the Supermarket Industry, present cash flow generated inadequate to sustain desired growth rate.

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I. *Introduction*

A. Capital must be productive.
   1. Limited resources.
   2. Competition—other operations, industries.

B. Strategy for capital planning.
   1. Plan capital needs.
   2. Evaluate financial strength.
   3. Determine sources of capital
   4. Establish financial risk policy.

C. Capital requirements.
   1. Working capital.
      a. Cash
      b. Inventory
      c. Accounts receivable
      d. Less accounts payable
   2. Property.
      a. Land
      b. Buildings
      c. Fixtures and equipment

D. Sources of capital

II. *Internal cash flow.*

A. 1.73% sales.

Table 1. Internal Cash Flow

Net Income	.92%
Add-Back Depreciation	.81
	1.73%

B. In the long-run, must cover all financial needs.

III. *Debt.*

A. Leverage vs. financial strength.
   1. Debt.
   2. Return exceeds interest.

Financial Strength
   1. Balance sheet of a $100 million food distributor, in per cent is shown in Table 2.

Table 2. Food Distribution Typical Balance Sheet

	%		%
Current Assets	56.8%	Current Liabilities	31.6%
Property	38.6	Long-term Debt	11.6
Other	4.6	Equity	56.8
	100.0%		100.0%

   2. Balance sheet in dollar terms, Table 3.

Table 3. $100 Million Food Distributor Balance Sheet (000 Omitted)

Current Assets	$ 9,883	Current Liabilities	$ 5,500
Property	6,716	Long-term Debt	2,017
Other	801	Equity	9,883
	$17,400		$17,400

   3. Typical financial ratios of a $100 million food distributor is shown in Table 4.

Table 4. Typical Financial Ratios $100 Million Food Distributor

CURRENT RATIO	
(Current Assets + Current Liabilities)	= 1.8%
INTEREST AND RENT COVERAGE	
(Earnings before interest, rent, income taxes)	
(Interest + Rent + 2 × Current Maturities)	= 1.5
LONG-TERM DEBT %	
(Long-term Debt ÷ Long-term Debt + Equity)	= 17
With Leases Capitalized	= 55

C. Capitalize leases.
   1. Example—50 stores @ 200,000 each Table 5.
   2. Present value concept.

Table 5. $100 Million Food Distributor Balance Sheet (000 Omitted)

	Actual	Leases	Including Leases
Current Assets	$ 9,883	$ —	$ 9,883
Property	6,716	10,000	16,716
Other	801	—	801
	$17,400	$10,000	$27,400
Current Liabilities	$ 5,500	$ —	$ 5,500
Long-term Debt	2,017	10,000	12,017
Equity	9,883	—	9,883
	$17,400	$10,000	$27,400

D. Growth available with food industry cash flow.

1. *Investment per store*—The typical new store according to (SMI) cost about $636,000, Table 6.

Table 6. Typical New Store

Square feet	20,000
Sales	$ 46,300
Investment required	
Working capital @ 4.4% sales	$106,000
Land and buildings @ $14.00 per square foot	280,000
Fixtures and equipment	250,000
	$636,000

2. *Internal cash flow*—Internal cash flow of a $100 million food distributor is shown in Table 7.

Table 7. $100 Million Food Distributor, Internal Cash Flow

	% SALES	$
CASH FLOW		
Net Income	.92%	$ 920,000
Add — Back Depreciation	.81	810,000
	1.73%	$1,730,000
LESS — NORMAL RECURRING REQUIREMENTS		
Dividends @ 25% Net Income	.23%	$ 230,000
Replace present facilities @ 125% of depreciation	1.01	1,010,000
	1.24%	$1,240,000
AVAILABLE FOR DEBT REPAYMENT AND/OR ADDITIONAL EXPANSION	.49%	$ 490,000

3. *Example of 3 forms of financing*—Three forms of financing and the respective percentage growth are shown in Table 8.
   a. No debt—1.9% growth
   b. Lease building—3.4% growth
   c. Lease and borrow 70% of equipment—6 5% growth

Table 8. $100 Million Food Distributor, (000 Omitted)

	No Debt or Lease	Lease Building	Lease Building and Borrow 70% of Equipment
Equity Required for Store			
Working Capital	$ 106	$ 106	$ 106
Land and Building	280	—	—
Fixtures and Equipment	250	250	75
	$ 636	$ 356	$ 181
Number of Stores Assuming $490,000 Available	.8	1.4	2.7
Annual Sales Increase @ $2,408,000 per Store	$1,926	$3,371	$6,502
% Increase in Total Sales	1.9%	3.4%	6.5%

4. Income statement effect, Table 9.
   a. Same net earnings
   b. Return on investment 2.7%–3.7%
   c. Sales per square foot (SMI)
      New 3.44
      All 4.16

Table 9. $100 Million Food Distributor Income from Additional Stores (000 Omitted)

	No Debt or Lease	Lease Building	Lease Building and Borrow 70% of Equipment
Number of Stores	.8	1.4	2.7
Additional Sales @ $46,300 weekly	$1,926	$3,371	$6,502
Store Door Margin @ 17.9%	$ 345	$ 603	$1,164
Building Depreciation	$ 10	$ —	$ —
Building Rent @ 12% Cost	—	47	91
Equipment Depreciation	20	35	68
Interest	—	—	38
Other Expenses @ 14.2% Sales	273	479	923
	$ 303	$ 561	$1,120
Profit Before Taxes	$ 42	$ 42	$ 44

5. Return on investment

Sales per foot (selling)	$3.44	$4.16
No debt	4.3%	5.9%
Lease	4.3	6.9
Lease & Borrow	4.3	9.1

6. Cornell average 9.3%

IV. *Equity.*

A. Strategy.
   1. Earnings per share.
   2. Price earnings multiple.
   3. Public image.

B. Ratios—Market value per share and earnings per share for three companies are shown in Table 10.

Table 10. Equity Ratios

	Jewel	Fisher Foods	A&P
Market Value per Share	$58.25	$13.75	$23.37
Earnings per Share	3.36	.97	2.15
Price/Earnings Multiple	17.3	14.2	10.9
Earnings as % Equity	11.9%	17.5%	8.0%

Table 11. Typical Food Industry Equity Ratios

	TYPICAL	RANGE
PRICE EARNINGS MULTIPLE		
Fortune (20)	12.9	10.4-19.8
EARNINGS AS % OF EQUITY		
Fortune (20)	12.6%	5.6-23.0%
Cornell	9.3%	

V. Income taxes.

A. Defer taxes.

B. Investment credit.

C. Possible to recoup 20% of investment in equipment in first year.

VI. *Summary—Capital Planning Problems.*

A. Decline in capital productivity.
   1. High cost of new supermarkets.
   2. Lower sales per square foot.

B. Cash flow from typical supermarket will sustain 3% growth.
   2. Need higher earnings.

C. Consider other uses for capital.
   1. Vertical integrations.
   3. Convenience stores.
   3. Discount combinations.

D. Growth companies will leverage with borrowing.

E. Bank credit still available for qualified borrowers.