Missouri Can Company

(A Hypothetical company)

The Missouri Can Company (MCC) was a firm with a long and uneven history. At one time or another it had been a competitor in more than two dozen industries with varied success. Each of the several CEOs had developed a different strategy and over the decades the firm had had many manifestations. The only real constant in MCC's strategy had been a commitment to the packaging business in its several forms. But, even in this business there had been any number of changes in direction which diluted the impact of capital spending and had the effect of MCC never achieving a strong position in any of the packaging segments although, briefly, in the early years MCC's total packaging revenues made it the largest packaging company in the world. The lack of a competitive advantage in any of the large packaging segments resulted in MCC being pushed into producing commodity products, which had them penned between powerful steel and tinplate suppliers and powerful food and beverage producers as customers. Also, as its large customers grew there was pressure for them, especially in the low margin food business, to build their own packaging facilities, especially can plants. The long term effect of this was to cause MCC's packaging profitability to lag its better positioned competitors.

At one time or another, the company produced auto parts, electrical equipment, power equipment, electric motors, metal alloys, airplane wings, furniture, appliances, communications equipment, specialty chemicals, and consumer products, to name only the most important of its many businesses. MCC also bought several regional retail chains. None of these businesses worked out well and all were either sold or liquidated at a loss. The financial and human capital devoted to these businesses was largely lost. Further, the problems they caused diverted capital and management attention from better opportunities.

NEW STRATEGIES FOR THE COMPANY

Under still another new CEO, a management consensus had developed. The consensus was to (1) reduce holdings in operations that fall short of performance goals or do not fit the long-term strategy of the company, and a target of realizing $600-$700 million from the sale of such assets was established, (2) reinvest these funds in areas promising profitable growth, (3) improve return on equity over the long term as a consequence of this reinvestment strategy, and (4) strengthen MCC's balance sheet and credit standing. The new benchmarks for the firm included having a well-balanced BCG matrix that considered fast growing industries to be those that were growing at more than 10% per year. The end result would be a firm with four main businesses: financial services, energy, packaging and forest products. The latter was primarily a paper, fiber drum, and cardboard business that also generated about 25% of revenues from selling lumber and wood chips.

This strategy was followed and many businesses were sold, although the amount of money received for the businesses fell short of the $700 million target by almost $250 million. The businesses sold were all either small competitors in their industry or were in industries that suffered from overcapacity and low returns.

The New Missouri Can Company

Once the sales were complete, most of the realized funds were redeployed into MCC's four main business groups, resulting in a firm that management thought met their goals. The Chairman stated in the *Annual Report* that MCC was ready to move on to a new phase:

> "Our primary task is now the efficient production of quality goods and services within our restructured business segments: packaging, forest products, insurance, and energy. Further details on MCC's posture are contained in the attached operating and financial statements. Our overall strategy is to achieve the competitive advantages that can result from increased productivity, market focus, and innovation."

By the beginning of year five, following the new strategy, management believed that it was well positioned strategically for future growth and profitability. They had pared their operations to four main businesses: Financial Services, Energy, Packaging, and Forest products. The review for each segment was done by top management with the assistance of outside consultants who were all experienced top-level executives in each industry. Some of the consultants were retired and some of them were still active, but they all had long and successful experience in the industry they were consulting on. There is also an outlook section for each industry segment that includes estimates of profitability, cash flow, and needed investment in the next 10 years. The outlooks were done entirely by the consultants.

Financial Services

MCC's first foray into financial services came in the beginning of the 21st Century when a large investment bank brought the opportunity to buy the Kansas City Financial Corporation to the attention of the firm. MCC had hired the investment banker to help with the sale of the unwanted businesses and the banker knew that MCC was looking to redeploy the assets generated from the sale of the assets. Initially MCC was cool to the idea because it was so far removed from the company's expertise, but on examination it appeared that the insurance business had good profitability and cash flow characteristics so when the existing management of the target company was persuaded to stay on the purchase was made. From this base the Financial Services group added more insurance operations to include Northern Life Insurance Company, with its 49 master brokerage general agents and 13,000 independent brokers and agents. The firm also added a mortgage company, a mortgage insurance company, a number of title insurance companies and several title companies to form the core of the real estate-related financial services area. Within two years after entering into this segment the Financial Services division underwrote insurance in three broad segments: life and real estate as well as property and casualty insurance. The firm was strongly positioned in the Financial Services business, but competition was tough.

MCC's Financial Services division was not large by national standards, but the firm was a surprisingly nimble and successful middleweight in the industry. The management of this business had done an efficient job of integrating their many acquisitions into the financial

services operation, had proven its ability to pick their target markets, and avoided serious head-to- head competition with bigger and more powerful rivals. The future prospects of the division looked good.

Financial Services Outlook. The consultants that looked at the financial services business believed that business would be a good one for a long time. It was, relatively speaking, a low capital intensity industry with improving returns and strong positive cash flow characteristics. Although MCC invested more capital per dollar of sales than most of the competitors, the consultants thought this problem would be solved by increasing the size of the operation. They believed that MCC could increase their sales in the division by about 15% per year and increase returns on segment assets to between 15% and 18%. They also expected division sales to increase by at least 15% per year for the next decade if they made the needed investment in the business. They recommended that the firm invest heavily in the business because they were small and would benefit from additional size. MCC's largest competitor was about double the size of MCC and growing at about 10% per year. The consultants believed that for the firm to remain successful in the business which means increasing the segment earnings to assets ratio from the current 13% to 18%, MCC would need to invest at least, and they stressed at least, $250,000,000 per year in the business initially and increase gradually to $300,000,000 in 5-7 years at which time investment could probably decline to $100,000,000 per year. This investment would more than double the assets committed to the business within five years. The consultants forecasted cash flow from the division, assuming the recommended investments are made by the company, to be negative $250,000,000 per year for years 1-3, negative $50,000,000 in years 4 and 5, positive $200,000,000 in years 6 and 7, and positive $300,000,000 in future years. The consultants believed that MCC could sell the financial services business for about $1,000,000,000 if it were put up for sale and if the firm was patient.

Energy

In the fourth year with this new strategy, MCC made its first major acquisition in the energy business when they bought Atlas Energy which became the core of its Energy Division. This acquisition allowed MCC to enter several areas of the energy business. Atlas was active in exploration, development, and production of oil and gas, operated an interstate natural gas pipeline system extending from the Texas-Mexico border to the southern tip of Florida, and also extracted and sold propane and butane from natural gas. Prior to the acquisition of Atlas, MCC had small working interests in offshore and onshore gas and oil properties in the Gulf of Mexico and in Mississippi which it purchased in the late 20th century to try to develop a better understanding of the business. These were merged into the new energy division. Atlas was the sole supplier of natural gas to peninsular Florida and was one of only six U.S. companies selected by PEMEX, the Mexican National Oil Company, to purchase gas from that prime source. The company's pipeline operations offered a strong cash flow at relatively low risk.

Prior to the purchase of Atlas, MCC's nascent energy division had begun investigating a number of major and very expensive projects including a 1,500-mile slurry pipeline that would transport coal from Eastern Appalachia and the Illinois basin to the Southeast. If approved, this project would call for $2-3 billion in financing over seven years. The company was also considering joining with Shell and Mobil in the construction of a 502-mile carbon dioxide pipeline in which

the company would have a 13% interest at a cost to MCC of $50,000,000 per year for 5 years, and was considering converting an 890-mile segment of its 4,300-mile natural gas pipeline to petroleum products (while maintaining its natural gas deliveries to the Florida market), at a cost of $100,000,000 spread evenly over 5 years. MCC was also considering participating in four major offshore natural gas pipeline projects in the Gulf of Mexico to connect into the Florida Gas Transmission system. Its share of these projects would cost about $400,000,000 spread over 10 years. The senior management of the firm was reluctant to curb the enthusiasm of the pipeline managers, but they were worried about the possible risks of such large ventures and were counting on the management of Atlas, who had agreed to join MCC and run the Energy Division, to advise them on these possible investments.

Exploration and Production. MCC undertook a joint acquisition (with Bass Corporation) of Sudden Energy Corp. at a cost of more than $400 million. This acquisition increased the company's proven reserves of oil and gas by approximately 50% and its undeveloped acreage by 50%. Sudden's emphasis on development drilling also complemented MCC's activities and strengthened its position in domestic natural gas. In joint ventures with Shell Oil, MCC acquired additional offshore leases and participated in extensive exploratory drilling activities. In year six it spent some $400 million on exploration, but was now focusing on developing existing fields to improve the firm's cash flow to try to offset the impact of all the investments in the energy business. An industry analyst said of MCC's energy business:

> "Although the company is a baby to the industry giants, it has a strong position in some segments. It is the largest supplier of energy to the State of Florida, one of the nation's fastest growing states and that is a good business. However, in exploration and production they have no such protected position in an industry that is rapidly consolidating into giant firms with the financial resources to make, and lose, big bets in exploration. With the looming oil shortage proven reserves is where the money will be and MCC is probably just too small to make the needed investments and, more importantly, take the risks associated with exploring in deep water and/or hostile environments like Siberia. They have the right idea, but their small size, their major competitors were 8 to 10 times the size of MCC's exploration and production unit, makes an inherently risky business even more risky. A loss that would be immaterial to an Exxon Mobil could sink MCC's exploration business."

Energy Outlook. In year eight the future of the energy business looked pretty bright and this view was emphasized by the consultants that MCC brought in to review its energy business. Growth in China and India practically guaranteed that worldwide demand would grow much faster than was true in the past. The supply problem for the U. S. was exacerbated by the fact that China was negotiating long-term contracts to buy oil and gas from countries that had traditionally been U. S. suppliers;-- Canada, Mexico, Venezuela, and Norway. China was rapidly ensuring its future access to oil and the effect could be to cause future shortages for everyone else. The consultants believed that the long-term, worldwide supply and demand picture for oil and gas was extremely favorable for those firms that had either reserves or the cash flow to find and develop them. They felt that oil prices would not drop below $50 per barrel for very long and 10%-15% annual price increases was a minimum estimate and the possibility of much larger

price increases was also more likely than anyone could have guessed even in year seven. They stressed that this forecast did not envision any significant disruption in supplies from the middle-east or elsewhere. In the event of a major disruption prices could easily exceed $175 per barrel. Their view was that only a really huge new oil field discovery, which was unlikely, or a world-wide recession of major proportions would derail their forecast and even the recession would only delay the increase in the price of oil. They also mentioned that U. S. oil production had peaked many years ago and that one reasonable estimate was that worldwide oil production would peak in the early twenty first century. If this latter prediction were true, future increases in the price of oil would be hard to predict but could be ruinous until a transition to some other energy source was complete. The consultants stressed that given its size MCC could never hope to grow to a competitive size in the industry, but its existing proven reserves and promising land holdings would only become more valuable as time passed and the supply/demand situation became tighter and tighter. The consultants did not recommend major new investment in either exploration or production for the reasons given by the analyst quoted above.

Florida Pipeline. They felt that for MCC to prosper in the new energy environment it would need to build pipeline capacity into Florida because of the tremendous population growth in the state. Their estimate of capital investment needs in the Florida market was about $50,000,000 per year for the next 4 years. Beyond that time the investment needs would be determined by the longer term population growth. Some demographic and real estate experts believe that the recent rapid increase in housing prices in Florida would cause population growth to moderate from the current 365,000 people per year to a more sustainable rate of maybe 150,000 per year. If these estimates proved to be true the consultants expected cash flow to be negative $50,000,000 per year for years 1-4 and increase slowly to positive $300,000,000 from a positive $100,000,000 in year 5.

Exploration and Production. The experts believed that MCC was too small to compete long term in the exploration and production area unless it was willing to build oil reserves and production capacity simultaneously. This would be an expensive undertaking that could easily take $500,000,000-$600,000,000 per year for the next decade, but the impact on earnings and cash flow could be expected to be dramatic, but probably not for 5-7 years because of the long lead time for investments in reserves and refinery capacity to come on line. And, they noted, investments in exploration were risky investments and there could be many dry holes. They thought that returns on assets would improve from the recent 5% level to the 8%-12% level at best. They also felt that the value of the proven reserves could easily increase from the present $500,000,000 to the $1,000,000,000 to $1,500,000,000 level over the next 8-12 years. The entire division could probably be sold for about $1,560,000,000 at the present time and could be worth as much as $2,000,000,000 within 5 to 6 years. They expected revenues to increase by about 8% per year in the absence of the major investment outlined for the exploration and production division. If the recommended investments were made they expected revenues to increase annually from the 10% range to the 15% range during the next 10 years. The company was further advised against frittering away capital on non-energy enterprises and focus on building supplies of both oil and gas. Given the needed investments the expert consultants expected the exploration and production operation, assuming the needed investments were made, to be cash flow negative by at least $400,000,000 per year for the next 6-9 years after which it would turn

cash flow positive within 2-3 years and generate cash flow of about $150,000,000 per year for the foreseeable future.

Packaging

In December of year two, the MCC Packaging Division had been reorganized to facilitate a new strategy stressing market rather than product orientation. As the Packaging Division Vice President told *New England Business:*

> "We will start to look at our franchise not as the manufacture of blow-molded bottles, or two piece aluminum cans, but as our relationship with the big package group marketers. Hitching Packaging's wagon to big customers like General Foods makes more sense than latching on to a particular technology or shape or structure that will inevitably change. We do understand that such a relationship will require substantial capital expenditures every time a new packaging technology is demanded by our customers but we believe that the firm will generate cash flow adequate to the division needs."

The new packaging organization operated in three major markets: Food and Beverage, Specialty Packaging, and International. Its cost reduction and productivity programs included closing a number of plants, which were unable to meet long-term profitability standards, while improving capacity utilization and line efficiencies at other facilities. Basic research expenditures were reduced and emphasis directed towards business development and marketing. MCC Packaging had a major position in the fastest growing segment of the can industry the-two-piece aluminum can. However, both the short and long-term results of the packaging business would be determined by (1) the success of new product introductions, (2) continued emphasis on cost cutting even after demand reaccelerated, (3) whether or not metal cans would be besieged by another fundamental change in design and (4) the bargaining power of its customers. Those 7 issues were very uncertain and hard to forecast especially given the strategic focus on a relatively few very large customers who would have substantial bargaining power.

Packaging Outlook. The packaging business was, in the main, an economically sensitive oligopolistic industry that mainly sold commodity products. It was very difficult to establish any kind of long-term competitive advantage other than cost and delivery reliability and other firms were positioned to do this as effectively as MCC. The firm's decision to tie itself to large customers while understandable and probably wise was likely to create serious pressures to reduce price and also make the packaging division less flexible because of the location decisions needed to cater to large customers. The consultants did not believe that either sales growth or profitability would grow much faster than GDP in the future and felt that the cash needs of the division could be very high when the customers demanded new technology. Building the new technology into the plants would not reduce the push for lower prices by customers. The consultants felt that profitability would not increase over the next 10 years but would decline by about 50%. The consultants also believed the Packaging Division's cash flow would decline rapidly, from about $230,000,000 currently to zero by year five and be negative $100,000,000 in year 6 and get worse by about 20% per year thereafter. They forecast revenues to increase at the

recent rate for the next decade. If the entire division were to be sold, it would probably bring about $1,200,000,000 or about 70% of book value.

Forest Products

The Vice President of the Forest Products Division told *The Wall Street Journal* at the time some of the lumber operations were sold off:

> "Our forest products business will be reduced in scale but will now be made up of specialty businesses in which we are competitive and we will work to develop world class and to some extent proprietary positions backed by a natural resource of immense and growing value."

MCC was a large producer of bleached folding carton board and ranked sixth in total production of bleached paperboard in the U.S. Its largest competitors in this business had more than twice the sales of MCC. MCC's bleached paperboard plants had an annual capacity of 430,000 tons and were carried on the books at $500 million. The firm thought it could sell them for about $650,000,000. MCC was also a major factor in the production of fiber drums with 12 plants which had a book value of $120,000,000. It still owned 1.45 million acres of timberland located in the Southeast (of which 868,000 acres were in pine plantation targeted for continuing harvest that began in ten years ago), carried on the books at $115 million but with a market value (conservatively estimated by management) of at least $600 million. MCC's *Annual Report* noted that the timberland which previously supplied the divested mills could now be managed as a non-integrated profit center.

Forest Products' activities were balanced as follows:

Fibre Drum 25%	Fibre drum shipping containers, steel drums, plastic pails, laminator paper, fiber partition and DualPak (polyethylene bottle in corrugated box) for the chemical, pharmaceutical, plastic, food and other industries.
Bleach System 46%	Bleached Folding carton grades for folding carton manufacturers; coated bleached bristols and cover stock for the domestic and international printing industry; and cup and other stock for the food service industry.
Woodlands 29%	Wood raw materials for paper mills and sawmills.

Forest Products Outlook:
Paperboard. The experts hired by MCC had some reservations about this rosy outlook. In their report, they wrote that they had visited the bleached paperboard plants and concluded that many of them were using near-obsolete technology. They further said that MCC's plants showed signs of poor preventive maintenance practices and some signs of inadequate training. They doubted that the plants could produce 430,000 tons per year. In their opinion the plants would do well to produce 380,000 tons on a consistent basis. Based on this, they believed that the market value of the plant was overstated by at least $200,000,000 and that the value would decline by about

$8,000,000 per year for the next five years and then decline even more rapidly as plants in the planning and design neared completion. The consultants said that competitors were building two paperboard plants in the south with expected completion dates within the next two years and two more in the planning and design stage that should be on line by within four years. All of these plants would produce higher quality products at costs 10%-20% lower than MCC's plant. When these plants and two more planned for the western U. S. came fully on line in the next 10 years, total paper board capacity in the U. S. would be increased by at least 50% or much more than the expected increase in demand of 35%. They did not consider that the fiber drum and cardboard box businesses would be able to maintain either their current level of profitability or cash flow. In fact, their estimate was that ROI would rapidly decline to near zero over the next 5 or 6 years, and decline rapidly afterwards and would become uneconomic and would need to be closed. The cost to build a new, competitive plant at that time would total about $1,000,000,000 and would take about 6 years from the initiation of planning until the plant went on line. Under any decision scenario the consultants expected the paperboard business to be a drain on cash of about $50,000,000 per year for the next five years after which the expectation was for cash flows in the range of negative $100,000,000 to negative $125,000,000. If the paperboard operations were put up for sale, they would probably bring about book value or $600,000,000.

Timber. All of the experts consulted thought that the timberland was a valuable asset as long as the firm was in the paperboard business because the availability of timber from MCC's own holdings would help to protect it against fluctuations in timber prices. In the event MCCexited the paperboard business the consultants did not think MCC was large enough to wring sufficient returns from the timber in the face of competition from its much larger competitors some of them being more than ten times the size of MCC's timber business. These firms and some smaller ones would have advantages of scale economies and much greater market power with customers. In any event the consultants saw revenues growing at 3%-6% per year. They also thought the market value of the timber assets of the division were overvalued by about $100,000,000, but they did think they could be sold for $300,000,000 compared to a $200,000,000 book value. They estimated that the value of these assets would increase by about 20% during the next six years and by about 60% in ten years.

Some Financial Notes.

1. The firm's debt is structured so that at least 40% of the net sale price of any capital assets must be paid to the debt holders.

2. In the most recent 4 years, the corporate overhead costs have been about $200,000,000.

3. Remember, no strategic plan is complete without some form of financial analysis. Interest rates hover around 10%.