Cash Traps

The majority of the products in most companies are cash traps. They will absorb more money forever than they will generate. This is true even though they may show a profit according to the books of account. Continued investment sends good money after bad. Escape from the trap requires extreme measures. Either stop investing and manage solely to maximize cash withdrawal, or invest so heavily that a leading position is reached in the market.

Reported profit always exceeds payout to owners in any business over time. Much of the reported profit must necessarily be reinvested just to maintain competitive position and finance inflation. If the required reinvestment, including increased working capital, exceeds reported profit plus increase in permanent debt capacity, then it is a cash trap. Cash is rarely ever recovered from a cash trap unless relative competitive performance is improved by obtaining a superior market share.

Historically, the typical manufacturing company with typical growth rates and asset turnover had to have a pretax profit of about 7 percent on sales, or the entire company became a cash trap. Fast growth sectors of the economy required even higher margins. So did capital intensive businesses. At any lesser margin, the required increase in assets exceeded the reported profit. This cannot continue, unless the permanent debt also increases in the same proportion, or new equity is constantly added.

With higher rates of inflation, the minimum required return is increased in proportion. Inflation of assets must be financed and will never be recovered in dividends or liquidation.

Real cash traps are worthless because the owners will never receive a payout. Instead, the owners will put in cash. Reported profit is not payout. Even if you escape from such a cash trap eventually, you have still lost. The longer it takes to escape, the greater the loss in present value of your investment.

It is a fact that most of the net cash generation of virtually all companies comes from a very few products which have a clearly dominant share of their relevant product-market segment. This is inevitable.

Pareto, an Italian economist, discovered this effect many years ago while trying to determine why most of the wealth was concentrated in a few families. It is a familiar pattern: approximately 20 percent of the items produce approximately 80 percent of the margin. However, when a constant reinvestment requirement is subtracted from all margins, then that 20 percent may well represent 120 percent or more of the actual net cash generation.

Pareto's Law alone would lead to most of the net cash generation coming from only a small number of products. The experience curve effect compounds the relationship and couples cash generation to market share. The experience curve effect causes your relative cost to decrease about 20 to 25 percent each time your market share doubles. Both margin and volume increase with increase in market share. The converse is true also, of course. That is why there are many cash traps, and most of them are low market share products.

Reported profit is really irrelevant to the shareholder who actually holds the shares. All he will ever receive is a cash payout of either dividends or liquidation value. This is all a corporation receives internally from a product: either net cash throwoff or net liquidation proceeds. Regardless of reported profit, a business or product is worthless unless it compounds and returns the cash invested in it.

In a dynamic economy almost every business, even slow growth ones, require reinvestment of a substantial proportion of reported profit. Inflation

… Cash Traps

alone requires financial growth to compensate for inflation in asset values as they turn over. Additional growth in assets employed is required in order to maintain market share as the industry grows with the economy. Consequently, only a portion of the reported profit can ever be available for distribution unless the business is liquidated. If it is liquidated, many assets will prove to be unconvertible into cash at book value.

When profit margins are low, the required reinvestment will often exceed the reported profit indefinitely, even in mature stable businesses. Do nothing and such businesses trap cash forever. The longer the delay until liquidation, the greater the loss. If eventual liquidation will produce only a portion of book value, then the reported profit until then is being overstated in proportion. If the company's required threshold on investment return is higher than this deflated profit, then the difference represents the company's annual opportunity cost.

Fast growth products are even more dangerous cash traps than slow growth products. Growth compounds the cash input required. But growth alone does not improve relative cost or profit compared to competition. Yet the eventual payout depends on a superior cost compared to competition whose margin is just sufficient to finance growth needed to maintain their own market share. Superior margin is rarely achieved without superior market share. Consequently, growth just compounds the cash drain unless it also leads to superior market share.

The only advantage of a growth product is that share can be shifted more rapidly from one competitor to another by preempting the share of the growth itself. The disadvantage of a growth product is that it usually requires a large negative cash flow just to hold position in the market. Yet failure to achieve a leading position before the growth slows can be fatal to any hope of a cash payout later.

The critical market share seems to be a level about twice that of the largest competitor. At about that point, debt capacity increases with market share even faster than the assets required. The cost level which can be achieved makes it possible to service debt equal to total net assets employed even though competition is selling at cost or below. When this condition is reached, the entire reported profit and more can be withdrawn as cash and reinvested elsewhere or paid out. It is a highly desirable position. This leads to a competitive rule of thumb.

Take at least twice as much of the growth as your leading competitor in any relevant product-market segment. If you cannot, then plan the process of extricating your investment as expeditiously as possible.

Only the largest two or three competitors in any product-market segment can reasonably expect to avoid being a cash trap. There are usually several times that many active competitors. *Therefore, the majority of the products in the average company must be cash traps. This means that a majority of the products in the average company are not only worthless but a perpetual drain on corporate resources.*

Prices could be lower to customers and profit could be higher at the same time if all competitors would recognize their cash traps and stop wasting money on them. Anytime there are more than two or three active competitors in a given product-market segment, then someone is making a mistake. The leader may be failing to compete by holding an umbrella over higher cost competition at his own expense. Or, it may be that competitors are caught in cash traps. Either way, there are major opportunities being lost.

Bruce D. Henderson