VALUE ADVISORY GROUP, LLC
DRIVING PERFORMANCE AND VALUE
WWW.VALUEADVISORYGROUP.NET

Expand View Of "Business Model" To Drive Value

By Jack Alexander

The concept of business models has been used extensively for a number of years. Used properly, this concept provides a useful framework for a number of business decisions ranging from pricing to setting expense levels.

The common view of a business model really represents a target P&L model. The manager thinks of the business in terms of the P&L captions and the related percentage of each line item compared to sales as illustrated in **Figure 1**.

Figure 1	Business Model Illustration Traditional View	
Simple Co.		
	2006	**% of Sales**
Sales	$ 100,000	100.0%
Cost of Sales	45,000	45.0%
Gross Margin	55,000	55.0%
SG&A	32,000	32.0%
R&D	8,000	8.0%
Total Expenses	40,000	40.0%
Operating Income	15,000	15.0%
Other Income (Expense)	605	0.6%
Taxes	4,894	4.9%
Net Income	9,501	9.5%

Using this conceptual framework, managers will set prices, establish business plans, evaluate business proposals, set expense levels and make other critical business decisions. For example, a company that is developing a product with a cost of $450 would likely set a selling price of $1,000 to maintain the 55% gross margin. In setting next year's R&D budget, this company may set spending at 8% of projected sales, and so forth.

The traditional P&L-business model framework, while useful, is an incomplete view of the economic performance of a company since it does not reflect other critical aspects of business performance. Most importantly, it does not consider sales growth rates, capital requirements and cash flow. Two critical determiners in building long-term, sustainable value are Growth and Return on Invested Capital ("ROIC"). Therefore, any comprehensive business model framework must incorporate these elements to be a useful decision support tool.

A broader, more comprehensive view of the business model is illustrated in **Figure 2**. By including the additional measures reflecting invested capital and growth, we present a more complete picture of the company's performance. For example, managers or investors should not reach a conclusion on the reasonableness of R&D levels without considering the potential sales growth rates.

In addition, the profitability measures alone are incomplete for evaluating the performance of the organization. Only when we include the capital levels employed in a business can we assess the financial performance of that business. The inclusion of a balance sheet and key metrics will allow us to determine the Return on Invested Capital. Many companies, and entire industries, generate significant returns despite relatively low profit margins due to low capital requirements or high asset turnovers. A great example is Dell Computers. By building a business model with a focus on ROIC, they have been able to record superior returns with relatively thin after-tax margins. With after-tax returns of only 6%, they have consistently achieved ROIC in excess of 30%.

Figure 2		**Business Model Illustration Comprehensive View**	
Simple Co			
		2006	**% of Sales**
Sales Growrth Rate:	8.0%		
Profitability Model			
Sales		$ 100,000	100.0%
Cost of Sales		45,000	45.0%
Gross Margin		55,000	55.0%
SG&A		32,000	32.0%
R&D		8,000	8.0%
Total Expenses		40,000	40.0%
Operating Income		15,000	15.0%
Other Income (Expense)		605	0.6%
Taxes		4,894	4.9%
Net Income		9,501	9.5%
Asset Utilization			
Days Sales Outstanding			73.0
Days Sales Inventory			146.0
Operating Capital Turnover			3.4
Fixed Asset Turnover			5.0
Intangible Turnover			9.1
Total Asset Turnover			1.3
Leverage			1.4
Debt to Total Capital			15.3%
Returns			
ROE			17.2%
ROIC			15.2%

Mr. Alexander is President of Value Advisory Group LLC and a lecturer at Babson College. He can be reached at jalexander@valueadvisorygroup.net or (508) 481-1552