Financing Food Distribution in the 1970's

Financial Institution Views

Long term financing will be costly and hard to obtain but careful planning can help

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Here is a one sentence summary of what our crystal ball foresees for the '70's: Long term financing for the food distribution industry in the next decade will be costly in comparison to the early and mid '60's and increasingly hard to obtain, but careful planning should make the job a little easier.

The first aspect is the cost of financing. Your principal concern here is probably in the interest rate structure as it will relate to long term borrowing -- loans with a 10 to 20 year maturity or even longer that you will need to finance your new stores and warehouses and their fixtures. If you lease these properties from an outside party, he will borrow the money to finance their cost and pass the interest charge on to you as part of your rental payment, so the problem remains.

Today, long term interest rates are noted to be at their highest levels since the Civil War. There is certainly an artificial aspect to this, as these present rates in part reflect the tightening of the money supply by the Federal Reserve Bank in order to halt inflation. However, there are highly respected economists who do not anticipate rate reductions even after the present policies of the Fed. have been relaxed. To be conservative in your planning, you should not expect any significant relief.

There are reasons to support this view in the financial demand and supply factors that will prevail during the next decade. First, we should consider the short run -- the next year or so after monetary policies are loosened. It is likely that many potential borrowers have stayed away from the money markets during the last several months in hopes of obtaining more favorable interest rates in the future. At the same time, capital spending plans for business in 1970 are still projected at a high rate of growth in both governmental and private surveys. The implication here is that any action by the Federal Reserve Bank to increase the availability of money is apt to attract a substantial amount of pent-up demand for funds back into the markets. It is probable that the demand will exceed the supply of available funds, thereby holding interest rates close to their present levels in the near future.

For the longer term viewpoint, the conclusions of a study made by the Economics Department of Loomis, Sayles & Co. are pertinent. (For the record, let me add that Loomis, Sayles is a highly regarded investment counseling firm which is now a subsidiary of New England Life.) The Loomis study indicates that the supply-demand imbalance will continue at least through the first half of the '70's, and perhaps well beyond. Their expectation is that rates will therefore remain in a high general trend, with some cyclical fluctuations around this trend projection.

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The second aspect of the summarizing sentence is that long term financing will be increasingly hard to obtain in the '70's. One reason for this will be the excess of demand for funds over the supply. Another is the type of investment that financial institutions will be seeking. Try to step into our shoes for a moment to visualize our functions and objectives. In the case of a life insurance company, our policyholders have entrusted their savings to us in the form of the premiums that they pay. These policyholders have the option to withdraw those savings, either by cancelling their policies or borrowing on the cash value of the policy. When these withdrawals take place, we are left with less money to invest. Over the last few years, the increasing rate of inflation has become a threat to the savings that we safeguard. For example, in 1964, it was not unusual for life insurance companies to invest their funds at a rate of 5% in fixed income obligations with a maturity of 15 years or more. Today, we still hold these securities, and we continue to receive a 5% rate of return on our investment. In the meantime, however, the inflation rate as measured by the consumer price index, which averaged 1.3% from 1959 through most of 1965, has grown to an annual rate of 6%, as reported on the basis of September figures. This means that the 5% interest we receive is not presently sufficient to prevent an erosion of the capital we invested only four years ago.

We have been forced to find ways to protect ourselves in this kind of a climate. Now it is the usual practice for the long term lender to require not only a high interest rate by past standards, but some form of equity participation, or share in the profitability of the borrower, as well. This participation can take numerous forms -- securities convertible into common stock; warrants to purchase common stock; a percentage of the sales generated by a given store property; or "contingent" interest rates, which provide for an increase in the interest rates we receive if the profits of the borrower rise above certain levels. By these methods, we hope to obtain incremental yields which will at least keep pace with the declining value of the dollar. This trend is also reflected in the public market, where an increasing portion of new debt issues possess features for conversion into common stock.

Since we as lenders are anxious to participate in the future profitability of our borrowers, it is obvious that we now want to invest our funds in companies with the best potential for growth in sales and earnings. To accomplish this, we try to avoid being prejudiced for or against specific industries. It is the potential of the individual firm that we look to, regardless of the type of business. This is the investment dollar that you must compete for today and in the future to meet your financing requirements.

You may want to know something about the criteria that we use. There are a number of factors that we review in making any investment decision. We start with the record because it is an indication of the future. We like to see a history of growth in sales and earnings, indicating that you are capable and efficient merchandisers. Ideally this will include increasing pretax profit margins and a high return on invested capital. We also have to be sure that your earnings base and depreciation cash flow are sufficient to meet the total debt and lease obligations that you will be undertaking, giving effect to the new financing. Your latest balance sheet is important as a test of financial management capability. We want to see things in balance -- not just that total assets equal total liabilities, but that certain relationships are in order. Working capital should be sufficient to provide you with the capability to withstand some unexpected temporary setback without being jeopardized financially. Inventory should show a reasonable turnover in relation to sales. There is no hard and fast rule regarding the relationship of debt to equity, but the methods you have used to finance the business in the past tell us something of your ability to plan for the future.

Although we still start with the past, we now put considerably more emphasis on the present and the future. We want to see a good historical record, but there are instances where extenuating circumstances should be considered. Also, there are many companies which have turned around for a variety of reasons and become immensely successful. We would be short-sighted if we did not try to delve behind the numbers to see if they really tell the complete story in regard to the company's potential.

When we look at the present and the future, we are really looking at the management group and their advisors. In the final analysis, we are investing in the capability of this team to provide outstanding future performance. The advisory group includes directors and outside professionals such as the accounting firm, the law firm, and the commercial banker, investment banker, or financial consultant. The first person we usually meet is the individual who acts as your financial advisor. A respected and able person serving you in this capacity can be important for a number of reasons. First, he can tailor your plans to your capabilities, impartially telling you whether your goals are too ambitious or perhaps too meager. Next he can determine the most favorable method of financing for your individual situation. Finally, he can introduce you to either the public market or the institutional investor and tell your story in the language that the financial community understands, including the reasons he sees a strong future profit potential in your business.

If your story is a good one, we will want to meet your management group. We are interested in many things, such as their philosophy, business judgement and attitudes toward employees, customers, and the community they serve. We want to know if there is adequate depth of management to meet expansion goals, and whether sufficient authority is delegated to allow the team to function as it should. We want to investigate your plans and projections to see if they are reasonable, and to learn whether you have obtained the advice and counsel of capable directors. We will need to know about your internal financial controls, and how you may have worked with a good accounting firm to improve your efficiency in this respect. Finally, we will want to see your facilities, old and new, and learn about the building plans you have for the future.

This may sound like an inquisition. It is certainly not intended to be one. We hope that your company will be a good investment for us. This is why we will have spent the time in studying you. We also want to be as firmly convinced as possible that we are making the right decisions, since we are taking the responsibility to invest other people's money over a long period of time. Our questions are related to the third aspect of the summary sentence--have you done your planning for the future carefully?

There are indications that your present approach to this question of planning needs more attention, at least in the long range area. An example is contained in the 1969 issue of "The Supermarket Industry Speaks", published by the Supermarket Institute. Their study of long range expansion plans of the reporting companies shows that only one company in six tries to look ahead for as long as five years in considering store expansion.

There are two reasons why this would seem to be a mistake. First, unless you try to look a good distance down the road, you are not effectively working toward your most profitable growth potential. A patchwork quilt of short range decisions cannot possibly be as effective as a carefully thought out program to reach a desired objective.

The second reason deals with your financing costs in attaining these objectives. Good planning will tell you approximately how much outside financial assistance you will need to meet your goals, and the timing of these financial requirements. This information will help you to build your capital structure in the most constructive way by selecting from the various alternatives that may be available. In terms of a new store or warehouse, there are a number of possibilities:

1. Should you lease, and if so, what rights of renewal or purchase options should you obtain on termination? Will this involve the establishment of your own real estate subsidiary?

2. Should you build yourself, and later sell and lease back the property?

3. Should you own the property? If so, a number of other possibilities are involved:

a) Can the property be financed by your internal cash flow (primarily earnings and depreciation)?

b) Should you obtain long term senior debt to finance the cost? Will it be obtainable with or without the kind of participation features discussed earlier? Should it be mortgage debt or unsecured debt?

c) Can subordinated debt or preferred stock be effectively used? These instruments are more likely to require participation features, most probably the right of conversion into common stock.

d) Should you sell common stock to raise the required capital?

This array of alternatives should be considered from two different standpoints: The preservation of flexibility in choosing methods of future financing and the maximization of future earnings. The two can be interrelated. What happens if you fail to maintain needed flexibility so that several choices are not available the next time funds are required? A common mistake is to overload with debt and lease obligations, which are another form of debt. A company which does this eventually finds no takers for future debt offerings. When this occurs, management is forced to sell common stock to obtain new funds. If market conditions are unfavorable, this can be the most expensive type of financing of all in terms of earnings per share.

If you do maintain a good balance between your equity, debt, and lease obligations, you have the advantage of choosing the most favorable form of financing at any particular time. Perhaps there is a brief cyclical downswing in interest rates which will make it advantageous to consider senior term debt or mortgage money. Or it may be that a strong stockmarket makes the sale of common stock or subordinated debt convertible into common attractive. The point is, this type of planning can definitely work in your favor.

In summary, the purpose of planning is not to please the investor. If you know what it will cost to modernize and expand to stay ahead of your competition and then plan your financing realistically to accomplish this objective, the pleasure should be all yours.