

# Costs are Key in Strategic Planning

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For seven months of last year, I advised six students who had been asked by the NCFE to conduct a study of the asset-based lending industry. The students were asked to shed light on the recent dramatic changes in the industry and to consider the possibility of a shakeout. The students interviewed 84 executives around the country. It was clear by all accounts that the industry is price competitive. When this is true, strategic advantage depends on costs and the existence of a segmented market. The students' report gives some useful insights into the relationship between market segmentation and strategic behavior. But the 84 executives could offer little information about their costs. We concluded that asset-based lenders generally haven't considered the effect of costs on the strategic behavior of themselves and their competitors.

The failure to understand costs is a serious deficiency. In this paper, I want to provide an illustrative example of how costs can be used to understand competition, and suggest ways for an asset-based lender to begin a necessary self-examination.

## **How Costs Lead to Differences in Competitive Behavior**

To see how costs can be relevant to analyzing competition, consider this fictitious example. Exhibit 1 presents the revenues, costs and profits of two firms at various volumes. Both firms charge the same (prime + 2) as would be the case under price competition. But Firstcorp has higher funds cost (9% versus 8.5%) and lower overhead (\$90 versus \$140 thousand) than Secondcorp. At a loan portfolio of \$10 million, both firms have the same amount of profits, \$210,000.

Let's suppose that both firms endure a recession, and see what happens if their portfolios shrink 10% from \$10 million to \$9 million. Firstcorp's profits shrink \$30,000 or 14%. On the other hand, Secondcorp suffers a decrease of \$35,000 or 17%.

Now let's turn the tables and see what happens in a recovery. Suppose both firms start with a \$10 million portfolio, and it swells 10% to \$11 million. Firstcorp's profits grow 14% to \$240,000. However, Secondcorp's profits grow 17% to \$245,000. Secondcorp benefits more by growth than Firstcorp.

What causes Firstcorp and Secondcorp to experience the recession differently? The reason is that they have different cost mixes. Secondcorp has substituted fixed costs for variable costs, and has achieved greater operating leverage. For instance, the displacement of clerks by automated equipment substitutes fixed costs for variable costs. Operating leverage is similar to financial leverage in that the substitution of fixed costs increases the variability of income with respect to revenues. Firstcorp may be said to have relatively low operating leverage, while Secondcorp has relatively high operating leverage.

The fact that firms in the same industry have different degrees of operating leverage means that a downturn will affect firms differently. Therefore, competitors will respond to the same downturn in different ways.

Returning to our example, we see that Secondcorp's earnings are greatly affected by little swings in the volume of business. Secondcorp's logical response is to cut price in an effort to maintain volume and thus cover its fixed costs.

Firstcorp, on the other hand, is much less affected by a decrease in loan volume. However, Firstcorp is relatively more worried about changes in profit margin. Its profits swing greatly with changes in prices and costs. Therefore, faced with a downturn, Firstcorp will seek to maintain

prices and will sacrifice volume—up to the point of its breakeven.

Does either firm have a strategic advantage? Not necessarily. Secondcorp, if it is successful, will emerge from the downturn with an enhanced market share. It is generally true that firms with high operating leverage play a volume maximizing strategy. But the risk of this strategy is that volume might drop below this breakeven level despite the utmost efforts. The Achilles Heel of the high operating leverage strategy is the typically higher breakeven volume.

Firms pursuing a low operating leverage strategy would appear to be hurt by their loss of market share. But they have lower breakeven volumes and can sustain competitive setbacks. Having the flexibility to live to fight another day is of enormous strategic significance. Furthermore, because these firms aren't as pressed to maintain volume, they can be choosier about the loan risks they assume in the downturn. Nevertheless, relinquishing share of market is generally painful for lenders whose goal is to build business.

## Conclusion

The example shows that:

- Cost differences among asset-based lenders lead to differences in competitive behavior.
- Firms with high operating leverage are sensitive to changes in volume; firms with low operating leverage are sensitive to changes in margins.
- Differences in operating leverage lead to different behavior in a downturn.

As an asset-based lender strives to understand his own industry, it will be important to study costs of his own firm. Firms constantly make choices that commit them to a mix of fixed and variable costs. Knowing the competitive implications of that mix is essential in strategic planning. These choices prepare ABL's for seizing new opportunities or surviving setbacks in periods of competitive turbulence.

So study costs. But don't get fooled by the debate over whether a cost is fixed or variable—your instinct will be the best guide. Fundamentally, mix is a convenient way of anticipating total costs at any volume. And it is total cost which links cost mix to competitive behavior. **NSA**

Exhibit 1

<u>Loan Portfolio</u>	<u>Revenue (P + 2)</u>	<u>Funds Cost</u>	<u>Overhead</u>	<u>Total Costs</u>	<u>Profit</u>
Firstcorp.					
1,000,000	\$ 120,000	90,000	90,000	180,000	(60)
5,000,000	600,000	450,000	90,000	540,000	60
9,000,000	1,080,000	810,000	90,000	900,000	180
10,000,000	1,200,000	900,000	90,000	990,000	210
11,000,000	1,326,000	990,000	90,000	1,080,000	240
15,000,000	1,800,000	1,350,000	90,000	1,440,000	360
20,000,000	2,400,000	1,800,000	90,000	1,890,000	510
Secondcorp.					
1,000,000	\$120,000	85,000	140,000	225,000	(105)
5,000,000	600,000	425,000	140,000	565,000	35
9,000,000	1,080,000	765,000	140,000	905,000	175
10,000,000	1,200,000	850,000	140,000	990,000	210
11,000,000	1,326,000	935,000	140,000	1,075,000	245
15,000,000	1,800,000	1,275,000	140,000	1,415,000	385
20,000,000	2,400,000	1,700,000	140,000	1,840,000	560

With a portfolio of \$10 million, both firms earn the same profit.

### Breakevens

Breakeven portfolio sizes are calculated by dividing fixed costs (overhead) by the profit contribution per dollar loaned. In Firstcorp's case, the contribution is \$.03 (i.e. \$.12—.09). Secondcorp's contribution is higher, \$.035 (i.e. \$.12—.085).

Firstcorp B/E =  $90/.030 = 3$  Million

Secondcorp B/E =  $140/.035 = 4$  Million