

Invested capital

For the first time ever, Australia's 25 top performing supply chains are ranked based on the calculation of their Cash Flow Return on Investment (CFROI).

"Companies that invest in improving their competitiveness enjoy a higher market cap"

by Anna Game-Lopata



Welcome to Logistics Magazine's annual Top Supply Chains issue, proudly sponsored by GRA. We are very excited to be presenting a methodology which captures the essence of supply chain performance, attempted for the first time in Australia.

The methodology used in selecting the top performing Australian ASX listed companies is described in detail in *Living Supply Chains* (FT Prentice Hall, London, 2006), written by internationally renowned supply chain thought leader John Gattorna. It is based on research of over 30,000 companies which found that

CFROI correlates well with share price, one of the best external indicators of success in a well informed market.

"Given that in many companies, the up to 80 per cent of invested capital is in supply chain related assets such as factories, distribution centres or warehouses, and the working capital related to supply chain activities can be as high as 80 per cent (inventories; accounts receivable) it stands to reason that we have to look at what ratios are best to reflect this situation," Gattorna says.

In other words, CFROI is the key to start assessing enterprise supply chain performance in dimensions other than traditional accounting ratios or narrow operational ratios.

To calculate CFROI, three aspects of a company's operations are taken into consideration: Is the company generating free cash-flow? Is this free-cash being invested wisely in competitive-building capabilities? And is this all being reflected in the share price as investors reward the companies for sound leadership and good stewardship?

"In this respect, even the best companies have had their share prices discounted if investors don't like management's investment plans," Gattorna asserts.

"In layperson's terms, our rankings indicate that the companies with the highest CFROI spread have generated free cash that has been re-invested in competitive-building capabilities, with the assumption that supply chain related dimensions are dominant."

Essentially, companies that generate free cash and invest this into improving their

competitiveness, enjoy a higher market cap than those that don't.

CFROI calculations have been made using published data available for Cash Flow from Operations and Capital Employed. "As there is no published data available for 'Capital Charge', the third essential component in CFROI, we used 'WACC' methodology to calculate it,"

Gattorna explains. "This comprises risk free rate, risk premium, debt on equity ratio, Beta (Business risk indicator) and cost of debt. As we've analysed performance for 2008/2009, the average risk free rate (10-year government bond) has been adopted using data for 18 months (from 01/08 to 06/09). The same risk free rate, which is 6 per cent, has been applied to all companies."

"Risk premium is calculated using the ASX All Ordinaries minus the 10-year Australian government bond equals 6.25 per cent. Debt on Equity Ratio is derived from financial statements taking into consideration each company's particular D/E structure. The business risk indicator is available from published sources. In order to calculate the Cost of Debt, we've averaged the Australian Interest rate (cost of debt) using data for 18 months from 01/08 to 06/09, and applied the risk free rate."

Logistics Magazine would like to thank John Gattorna and Maslada Nobhandhu for the energy put in to this pioneering report, and GRA for its support.

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