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Corporate Strategy: Key Business Drivers – Getting to the bottom of what really drives revenue, earnings and cash flow in a business.

Written by Peter Deans, Director of Notwithoutrisk Consulting, and first published in February 2012.

In November 2011, Tony Webber, an economist formerly with Qantas, wrote an interesting article on the airline in the Sydney Morning Herald ('The quandaries facing Qantas'[1]). In the article, Webber identified "six key financial exposures of airlines - the economy, oil prices, the exchange rate, inflation, interest rates, jet-crude refining margin…".

The article highlighted the fact that for many businesses there are usually only a handful of Key Business Drivers.

This led me to consider whether we do always understand the Key Business Drivers of the businesses we are managing, working for, investing in or lending to ? Are growth strategies, change management initiatives and rapidly changing external environments distracting us from a sound understanding of the true fundamentals behind a business ? Do we really understand the Key Business Drivers when we are undertaking risk assessments, preparing strategic plans or looking to invest in or lend to businesses ?

In this article I will cover four aspects:

- What are Key Business Drivers ?
- How to identify Key Business Drivers ?
- Implications for risk management and strategic planning
- Considerations for equity investors, debt providers and other creditors.

What are Key Business Drivers ?

Key Business Drivers are the small group of key factors that are fundamental, significant economic, social or business factors that drive the underlying revenue, earnings and cash flow of a business. Key Business Drivers go beyond simple sales or revenue line items. For a single asset oil or gas producer, Key Business Drivers will usually be the volume of oil (or gas) produced and the benchmark price of oil (or gas) applicable. Other factors such as the cost of production, shipping and handling costs, deviations from the benchmark price will be important and impact revenue and profitability from period to period. However, these are not Key Business Drivers. They are not the primary drivers of underlying revenue, cash flow and earnings.

For a steel producer there will usually be three or four Key Business Drivers: the iron ore price (if purchasing iron ore from third parties), coal / energy costs, a benchmark steel price and the foreign exchange rate. The volatility of these Key Business Drivers in turn drives the volatility in the earnings and cash flow of steel companies globally. Changes in other business variables usually have a negligible impact.

For some businesses, the Key Business Drivers whilst easy to identify, can be hard to measure and quantify. I was once involved in financing a bio diesel project that converted palm oil to transport-grade diesel. The Key Business Drivers were the palm oil price (the key input), the exchange rate (palm oil was purchase in USD), the local diesel price and the volume of biodiesel produced / sold.

The profitably (as measured by both margin and EBIT) was however heavily dependent on the first three drivers. The volume of biodiesel produced / sold was not the most important of the four Key Business Drivers. The project was relatively new, and all product produced could be sold. In the end the project was deeply unprofitable (and cash flow negative) as the price of the key input (palm oil) increased significantly and the exchange rate depreciated – further increasing the local cost of the USD denominated palm oil purchases. The project was mothballed less than two years after commissioning.

Unfortunately, in that instance the project sponsors had not fully understood the Key Business Drivers and potential downside scenarios

Key Business Drivers do not however necessarily need to be economic or financial drivers. It can often be a product or specific product lines. It can also be demand from a specific demographic or customer segment.

For banks, Key Business Drivers are usually credit growth (or credit demand) in the particular segment or geographic region within which the bank operates, the availability and cost of funds, and the level of bad debts.

How to identify Key Business Drivers ?

In some businesses and industries, it can be very easy to identify Key Business Drivers. The example of an oil or gas producer also applies to many other single product or commodity business lines. Agribusinesses have similar characteristics but with the additional overlay of production (or crop) variability due to weather variations.

It is easy to identify Key Business Drivers for regulated infrastructure businesses such as pipelines or electricity distribution networks – it will usually only be tariffs, volumes handled (or shipped), capital expenditure and interest rates.

Other infrastructure businesses such as airports or rail businesses become somewhat more complicated as there will be a number of specific revenue drivers, which will vary in nature and behaviour. Airports for example will derive revenue from a variety of sources: rental income, passenger charges (possibly regulated), freight related transport businesses and revenue streams, and car parking revenues.

For equity investors and debt providers it can be a challenge fully understanding what Key Business Drivers are and how they impact earnings and cash flow. This can be even more difficult when looking at diverse organizations with multiple business units, products and geographies. Folklore in the 1980s and 1990s was that Ford generated all of its profits from only one line of vehicles, the F Series pickup trucks in the US. I don't know if this was the case, but the anecdote highlights the need to understand the potential dependence on one Key Business Driver.

Some businesses such as retailers are also hard to identify Key Business Drivers for, other than at a very generic high level i.e. consumer confidence or the economy. There will often be a complex set of variables and drivers.

Think of a fashion retailer with a number of brands servicing different consumer segments. How easy is it to identify segment profitability, store profitability and/or product lines profitability ? Does a fashion retailer have identifiable Key Business Drivers or perhaps just a large number of variables and factors that need to go right (product decisions, seasonal factors, consumer confidence/economic conditions, the absence of new competitors)?

Implications for risk management and strategic planning

The identification of Key Business Drivers has a place in both risk management and strategic planning.

The identification of Key Business Drivers and those where 'downside' risk exists (which may or may not be mitigated) will be an important part of the discussion on the key Strategic and Financial Risks within an organization.

Whilst risk managers must be across the full spectrum of risks to be identified and managed, it is imperative to ensure focus on areas affecting Key Business Drivers. These will be the sources of the most downside / maximum risk impact.

For strategic planners, the insights can assist highlight diversification needs, key strengths to capitalize on or areas for defensive strategies (for example acquiring supply security).

Considerations for equity investors, debt providers and other creditors

For external parties, such as equity analysts, investors and financiers, the focus should be two-fold. Firstly, endeavour to understand what the Key Business Drivers are. As some of the examples above have illustrated they may not be easy to identify.

Frequently, management may not have the data or management information systems to provide the information. Focusing on general economic activity or industry sales will not assist understand businesses operating over a wide geographic area.

Four steps that can assist the assessment and understanding of Key Business Drivers are:

- Seek to identify the Key Business Drivers (or have management tell you)
- Assess management's depth of understanding of the Key Business Drivers
- Look for any potential future changes in each Key Business Driver (upside and downside), and
- Model and stress test the Key Business Drivers.

1. For Tony Webber's Qantas article go to: **http://www.smh.com.au/business/the-quandaries-facing-qantas-20111128-1o335.html#ixzz1f57hyGv3**

About

Notwithoutrisk Consulting, founded by former Chief Risk Officer Peter Deans, is an Australian based firm. It offers a range of strategy, business and risk advisory services to banks & financial institutions, corporate and government clients.

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