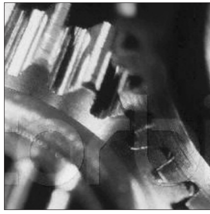

case two

Laura Ashley Holdings plc: The Battle for Survival

Teaching Note

Synopsis

In 1999, Laura Ashley Holdings, the UK clothing and home furnishings designer and retailer, is facing the abyss. This icon of the 1970s and 1980s, which rediscovered and popularized traditional English floral designs and pastel colors in clothing and furnishings, has experienced a decade of deteriorating financial performance and top-management turmoil.

In 1998, MUI, a Malaysian conglomerate, purchased a controlling interest in Laura Ashley and installed a new management team. Despite an injection of fresh equity, Laura Ashley's decline appears to have accelerated. MUI has appointed a new CEO, Mr. Ng Kwan Cheong, who is considering options for the future.

The case requires a careful analysis of the financial and strategic data available for Laura Ashley to determine:

- How serious is the present situation?
- What are the causes of Laura Ashley's poor and deteriorating performance?
- What can be done to turn the company around?

This note was prepared by Robert M. Grant.

TEACHING OBJECTIVES

This is a case study in problem diagnosis. The challenge for students is to use the data in the case – both quantitative and qualitative – to identify the causes of Laura Ashley's current problems, and to use this analysis to develop recommendations for how performance can be improved in the future.

The key objective of the case is to encourage students to link financial and strategic analysis. The case is designed to emphasize the message that strategic management is not all "big picture stuff" focusing upon vision and bold strategic initiatives. Strategic analysis requires meticulous examination of performance – including careful analysis of a company's financial statements (the key indicators of a company's health).

Bringing students face to face with a company in crisis also serves important learning objectives. While many (most?) strategy cases focus upon highly successful companies, the Laura Ashley case challenges students by placing them in the role of management consultants having to deal with a company facing terminal decline.

The case emphasizes the limitations of strategic options that most companies face. For Laura Ashley, lack of financial resources imposes a tight constraint upon strategic options. Students typically recommend introducing new designs, reformatting retail stores, upgrading IT systems, repositioning the brand, and bringing in new managerial talent. However, the seriousness of Laura Ashley's cash flow situation means that virtually all these options are closed off – Laura Ashley is in a battle for survival in which avoidance of short-term insolvency must take priority over long-term competitive advantage.

Finally, the case is useful for delivering the message to students that financial analysis is fundamental to strategic assessment. Students who do not explore carefully the financial statements almost inevitably come up with inappropriate or poorly reasoned strategy recommendations.

POSITION IN THE COURSE

I often begin my strategy course with this case, or I introduce it after a case that deals with the nature and meaning of strategy. The case is useful in drawing upon the tools students have (or should have) gained in their prior accounting and financial analysis and hammers home the message that strategy recommendations must be built upon a careful and systematic diagnosis of a company's performance problems.

ASSIGNMENT QUESTIONS

1. Assess Laura Ashley's recent performance. How serious is the company's present predicament?
2. Identify reasons for poor and deteriorating financial performance.
3. What strategy recommendations would you offer to Mr. Cheong that would best serve the interests of Laura Ashley's shareholders?

READING

R. M. Grant, *Contemporary Strategy Analysis* (5th edn), Blackwell Publishing, 2005, chapter 2.

CASE DISCUSSION AND ANALYSIS

I typically set the students a homework assignment prior to discussion of the case in class. This is to ensure that the students have worked through the financial numbers. Otherwise there is a danger that students will get bogged down in referring to case exhibits and calculating ratios during the class discussion.

I organize class discussion around the following sequence of themes.

1. How Serious Is the Present Situation?

Fundamental to the development of a viable turnaround strategy is appreciation of how serious is the current situation. I begin by asking students: "How close is Laura Ashley to death?" This discussion quickly takes us from the conventional profitability indications (ROE, ROS, ROCE) to cash flow and balance sheet measures. Cash flow is key – Laura Ashley (LA) is generating a substantial negative free cash flow and the banks are reluctant to offer any further finance. Unless the operating cash flow drain can be eliminated, or new sources of equity finance can be found, LA will slip into bankruptcy.

Overall performance has been dire, as indicated by all profit and rate of return measures. This is shown in the table below.

	YEAR TO END JANUARY			
	1999	1998	1997	1996
Net income (£ millions)	(33.0)	(49.3)	16.2	7.0
Net cash flow (op. cash flow – capex) (£ millions)	(5.6)	(13.4)	(18.8)	n.a.
ROE (net inc./av. shareholders' equity) (%)	(73.3)	(74.0)	15.2	9.9
ROCE (net income + interest/equity + debt) (%)	(50.3)	(50.6)	15.3	11.2

A few points to note:

- It is useful to look at multiple profitability measures – just to see consistency. Also, cash flow data are revealing. For example, the profits of the year to January 1997 don't look so good in terms of operating cash flow or net cash flow – maybe they were artificially boosted by earlier write-offs and exceptional items.

- Where accounting losses are being earned, there is little benefit in calculating economic profit (e.g., EVA). However, it might be worth observing that, even in the "good" years, LA was barely making any "real" profit – thus, in 1993 and 1994, LA was certainly failing to cover its cost of capital; in 1997 it appears that LA was earning a small, positive EVA.[1]
- Look at revenue growth (or the lack of it). There is nothing unusual about firms making persistent losses: look at most Internet and biotech firms. The difference is that LA is not a growth business. During the 1990s, LA's revenues have been flat – in real terms the company has been declining. During the past year, sales have declined sharply.
- Look not just at recent performance, but also over the longer term. LA's financial problems are not of recent origin – crummy profitability and low revenue growth have existed for the whole of the 1990s. This suggests that Laura Ashley is not a candidate for a quick fix. Indeed, the inability of five CEOs and several alternative strategies to have any significant impact suggests that problems may be intractable.

Given the poor profitability, we need to look too at solvency and liquidity: just how close is LA to bankruptcy? During the last financial year, debt was almost eliminated as a result of the equity injection from MUI. However, this is not really a sign of health – the banks are unwilling to extend further credit. The current ratio is an apparently healthy 1.7, but current assets are mainly high inventories whose actual market value may be much lower than their balance sheet value. The key problem is cash flow. Before financing, LA suffered a negative cash flow of £5.6 million in the last financial year. It has cash and short-term investments of £8.6 million to cover these outgoings. But what then? Either losses need to be cut or MUI needs to put in new finance – otherwise LA faces bankruptcy.

I am always surprised by the number of students who fail to grasp the seriousness of the financial picture. This is not necessarily the result of naivety. LA's "Wonder-CEO" Ann Iverson may also have underestimated the fundamental weakness of the business when she launched her strategy of repositioning and expansion during 1995–6. If students fail to recognize that LA has "one foot in the grave" they are likely to make all sorts of inappropriate recommendations (e.g., those that involve significant expenditures that will worsen the short-term cash flow).

2. Diagnosing the Sources of Poor Performance

The key here is to disaggregate the financial data (in order to pinpoint key areas of poor performance with regard to particular business areas, geographical regions, and operating ratios), then to link the results of the financial analysis with the qualitative information on problems in management, marketing, logistics, and brand development.

A useful start is to disaggregate ROCE (= net margin × capital turnover), and then to break down sales margin and capital turnover into as many specific items as possible.

Thus, in relation to margin, we can look not just at trends in net margin, but also gross margin and various cost ratios (e.g. overhead costs/sales):

	YEAR TO END JANUARY			
	1999	1998	1997	1996
Operating margin (op. income/sales) (%)	(7.3)	(6.8)	4.5	2.7
Gross margin (gross profit/sales) (%)	56.1	37.9	48.4	n.a.
Operating cost (expenses/sales) (%)	64.2	48.4	48.4	n.a.

In relation to capital turnover we can look not only at asset turnover but also at more specific capital productivity ratios:

	YEAR TO END JANUARY			
	1999	1998	1997	1996
Fixed asset turnover (sales/av. fixed assets)	14.0	7.53	6.91	5.31
Inventory turnover (sales/av. inventory)	4.09	4.46	4.01[e]	n.a.
Receivables turnover (sales/av. debtors)	11.46	15.15	13.42[e]	n.a.
Sales/av. sq. ft. of retail floor space (£)	228	327	361	427

[e] Estimated

To evaluate these ratios and numbers it would be helpful to have comparisons with similar specialty retailers. Table 2.A4 provides some limited comparisons. The main point is that although LA's gross margins are quite high, these margins are primarily a reflection of LA's very high operating costs (SGA). Virtually every efficiency ratio for LA looks abysmal. Comparisons over time show little improvement. Although fixed asset turnover has increased, this is primarily the result of substantial asset write-downs. Also, although inventory turnover has improved in 1998, this reflected the sell-off of the inventories built up during the year to January 1997. Running down these inventories through mark-downs was responsible for the reduction in gross margins in the following year.

Looking at the regional picture, the main observation here is the dismal recent performance in North America where contribution has been negative and sales are declining sharply. By contrast, Continental Europe and the UK and Ireland show better performance in relation to both contribution and sales (see tables 2.4 and 2.5).

The key problem in this analysis is distinguishing between manifestations of problems and the problems themselves. Taken together, the problems of sluggish sales, declining sales/sq. feet, and high inventories point to a weak market for LA products. Is LA a style that has seen its day? Certainly none of the efforts at repositioning and bringing in new designers has shown any revitalization.

What about the balance between furnishings and clothing? The Iverson strategy had greater focus on furnishings – less subject to fashion swings. While UK sales of furnishings have been comparatively strong, US furnishings sales have fallen despite the greater emphasis given to them.

Where are LA's "core competencies"? Traditionally, LA was a design-based firm. LA was a leader in small volume, high quality manufacture, but now UK-based production is high cost. What about in retailing? If LA is a crummy retailer, then it needs to think about lowering its retail involvement – e.g., more emphasis on wholesaling, switch from own-retailers to franchised retailers and license arrangements. It is interesting to note that LA's contribution/asset ratio is much higher in non-retail business than in its retail business (table 2.6). "Non-retail" comprises manufacturing and licensing (primarily). We know that LA's manufacturing operations are loss making; the implication is that LA is doing well in its licensing and franchising business. Maybe LA can do better by focusing upon design and brand development while franchising/licensing most of its retail operations.

3. Recommendations

Class discussion typically produces a wide array of suggestions. The key to keeping this discussion focused and productive is to ensure that strategy recommendations build upon diagnosis of the problems.

Recommendations *must* also take account of the financial situation – Laura Ashley is in a cash flow crisis, and must begin generating positive cash flow. Closing loss-making operations, selling off assets, minimizing investments in fixed and current assets are essential in the short run. If cash flow before financing is likely to be negative into 1999, then provision for financing must be made.

In the short term, the critical issue is survival. LA must cut costs and eliminate the most heavily loss-making parts of its business. The case for closing or selling the North American retail business looks overwhelming. What about manufacture? Despite the declared intent to shrink or exit entirely from manufacture, there are still 582 employees in production. On the cost side there appears to be considerable scope for economies: LA appears to be grossly overstaffed. Despite all the store closures, there has been very little reduction in retail employees, and there is also a very big admin staff.

Nevertheless, it looks highly unlikely that LA can staunch the cash outflow during the current year. How will LA finance the continuing negative free cash flow? There seems to be only one option – the parent company MUI. Mr. Cheong is going to have to approach his parent board for a further equity injection. One problem is that as MUI increases its equity stake, it may run foul of rules that require MUI to buy out all the minority shareholders.

Longer term, what type of company should LA become? Traditional core competencies no longer deliver value. In addition, LA appears never to have developed excellence as a retailer. So what strengths are left to work with? If it's just the brand and Laura Ashley's continued appeal to a comparatively small customer segment, mainly in Europe, then this suggests a very different type of operation from the present one.

4. Extension: Valuing Laura Ashley

The case can also be used to explore issues of valuation. To approach this issue, I sometimes ask: *If you were a private equity investment group, would you consider acquiring MUI's equity stake, and, if so, what valuation would you place on LA and what potential would you see for increasing LA's value?*

Instead of (or in addition to) making recommendations to Laura Ashley's management, another approach is to consider what value would LA have to a group of investors seeking to impose a restructuring and turnaround strategy on the company?

A starting point would be to look at the present market value. The March 1999 stock market price per share of 13 pence (292 million shares issued) gives us a company valuation of £38 million (see the *Financial Times* for price quotes). Given that current cash flow is negative, clearly the market is expecting either a modest turnaround of cash flows, or a positive value on breakup.

The challenge is to figure out whether there is a reasonable chance of creating a valuation significantly greater than the current market valuation. The McKinsey "Pentagon Framework" (see Grant, *Contemporary Strategy Analysis* (5th edn), chapter 16, pp. 482–4) offers a systematic approach to determining the potential to generate value from restructuring. A simplified approach could be along the following lines:

	£ MILLIONS
Start with free cash flow during the last year	–5.6
Consider cash flow impact of different measures:	
Withdraw from N. America: (assume cash flow from asset sales covers closures costs), offers annual saving of negative contribution of	7.1
Cut operating costs by 10%: annual saving of	14.6
Cut capital expenditure from £3.9m to £2.0m annually	1.9
Result: annual net cash flow of £18 million which after tax is about	11

Assume 12% cost of equity capital, and assume continued improvements in sales revenues and cost efficiency give an increase in cash flows of 3% per annum. NPV = cash flow (into perpetuity)/(discount rate – growth rate of net cash flow) = £11m/(0.12 – 0.03) = £122 million. Hence, there is the potential to add £84 million to LA's value.

NOTE

[1] A rough-and-ready EVA calculation for 1997 suggests EVA of around £2 million:

		£ MILLIONS
	Operating profit	14.4
Add	Profit from associate	2.0
Less	Tax	(6.1)
Less	Av. capital employed (71.5) × WACC (11.4%)	(8.2)
	EVA (roughly) =	2.1

The WACC can be calculated as:

Cost of equity = Risk-free rate + (beta × stock market risk premium)

$= 8.5\% + 0.8(14.5\% - 8.5\%) = 13.3\%.$

Cost of debt = $1 - T$(nominal cost of debt) = $0.6 \times 13.5\% = 8.1\%$.

WACC = $(0.64 \times 13.3\%) + (0.36 \times 8.1\%) = 11.4\%$