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How Can Manufacturers Increase Profitability and Grow Business Value

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Introduction

- What are the most important goals of every manufacturing company?
  - Provide an annual return on the capital investment in the business.
  - Provide growth in the value of the capital investment.

Introduction

- Manufacturers often do not focus on these two goals.
  - Companies may establish other goals with no clear link to increased business value.
  - There may be conflicting goals within a company.
  - Many small manufacturers focus solely on profitability with no consideration for long-term increases in business value.
  - Goals may be misunderstood, as they are ambiguous and poorly defined.
  - Owners and Senior Management might falsely believe that everyone shares their understanding of the company's goals.

Introduction

- Management Tools are often not utilized.
  - Financial & performance management techniques are continuously evolving.
  - Fortune 500 companies effectively utilize many of the newest techniques.
  - Techniques can be applied to smaller companies.
  - Most smaller manufacturers do not effectively perform financial & performance management. You must make the time!!
  - Tools should be used to help you establish and meet your goals. They are just a means to an end.
  - We will discuss ten (10) tools that you may be able to use in your business to achieve the goals that you have or will establish.

Introduction

- Objectives of this presentation:
  - Emphasize the importance of establishing goals.
  - Remind you of management tools or business opportunities you haven't considered in a while.
  - Introduce you to some tools you may not know about.
  - Generate interest in tools that you may want to learn more about and potentially implement.
  - Stimulate an action plan to help achieve increased profitability.

Ten Techniques to Increase Profitability

1. Establish an Effective Business Planning Process
2. Determine Your Business Value and Succession Plan
3. Prepare a Detailed Sales and Marketing Plan
4. Consider Activity Based Costing/Management (ABC/M)
5. Perform Customer Profitability Analysis
6. Analyze Pricing of Products
7. Improve Your Supply Chain Management
8. Evaluate Business Acquisitions and Sales
9. Enhance Financial Statement Analysis
10. Upgrade Personnel Management and Compensation Policies

#1 – Establish an Effective Business Planning Process

"If you don't know where you're going, you'll end up someplace else."

- Yogi Berra

Establish a Business Plan

- In today's highly competitive business climate, a comprehensive planning process is essential to achieving company goals.
- If a manufacturer “fails to plan,” it “plans to fail.”
- Business planning involves key management in a strategic process that focuses on defining company goals and objectives.

Comprehensive Planning System

- Develop business goals (strategic planning).
- Quantify the financial impact of those goals (budgeting).
- Obtain commitment to achieve the goals (individual performance planning).
- Evaluate the success or failure of plan attainment (plan review).

The Operating Budget

- The operating budget is an integral part of the business planning process.
- Once a company defines its goals and objectives and the means for achieving them, the budget simply translates the strategic plan into numbers against which a company's future performance can be measured.
- Essentially, if a budgeted expenditure cannot be linked to a business strategy, the funds should not be spent.
- Remember that effective budgeting is part of a continuous planning process, not a once a year exercise.

Linking Planning With Reporting

- It has been said that what gets measured, gets done. An effective strategic plan must have measurable criteria to monitor achievement of goals and objectives.
- The budget converts the financial aspects and goals of the business plan into numbers.
- Most strategic plans include nonfinancial goals that also need to be monitored and reported to senior management.
- Strategic business planning, budgeting, and management reporting should be linked in a circular pattern.
  - Quantify performance measures.
  - Create key reports.
  - Evaluate results. Financial statements <u>must</u> include budget comparisons!

#2 – Determine Your Business Value and Succession Plan

"A nickel ain't worth a dime anymore."

\- Yogi Berra

Valuation of Closely-Held Businesses

- For most closely held businesses, the value of the business is by far the largest investment of the business owner.
- Still most owners have never had a valuation performed for their business and don't have a true sense of its value.
- This would be like putting money in an investment account every month, counting on that money for your retirement, but never opening the monthly statement to monitor the value in your account!

Levels of Value

Strategic Value of Closely-Held Business Sold to Outsider

Synergistic Value
(Investment Value or Acquisition Value)

Premium 10% - 40%

"Deal Zone" – sales price to outsider

Internal Transfer Price
- No premium for control
- No discount for minority interest

Fair Value of Closely-Held Business
(Stockholder's Value)

25% - 50% Discount

Value for Income, Estate and Gift Tax
-Premium for Control and Discount for Minority Interest
-Marketability Discount

Fair Market Value
(IRS Value)

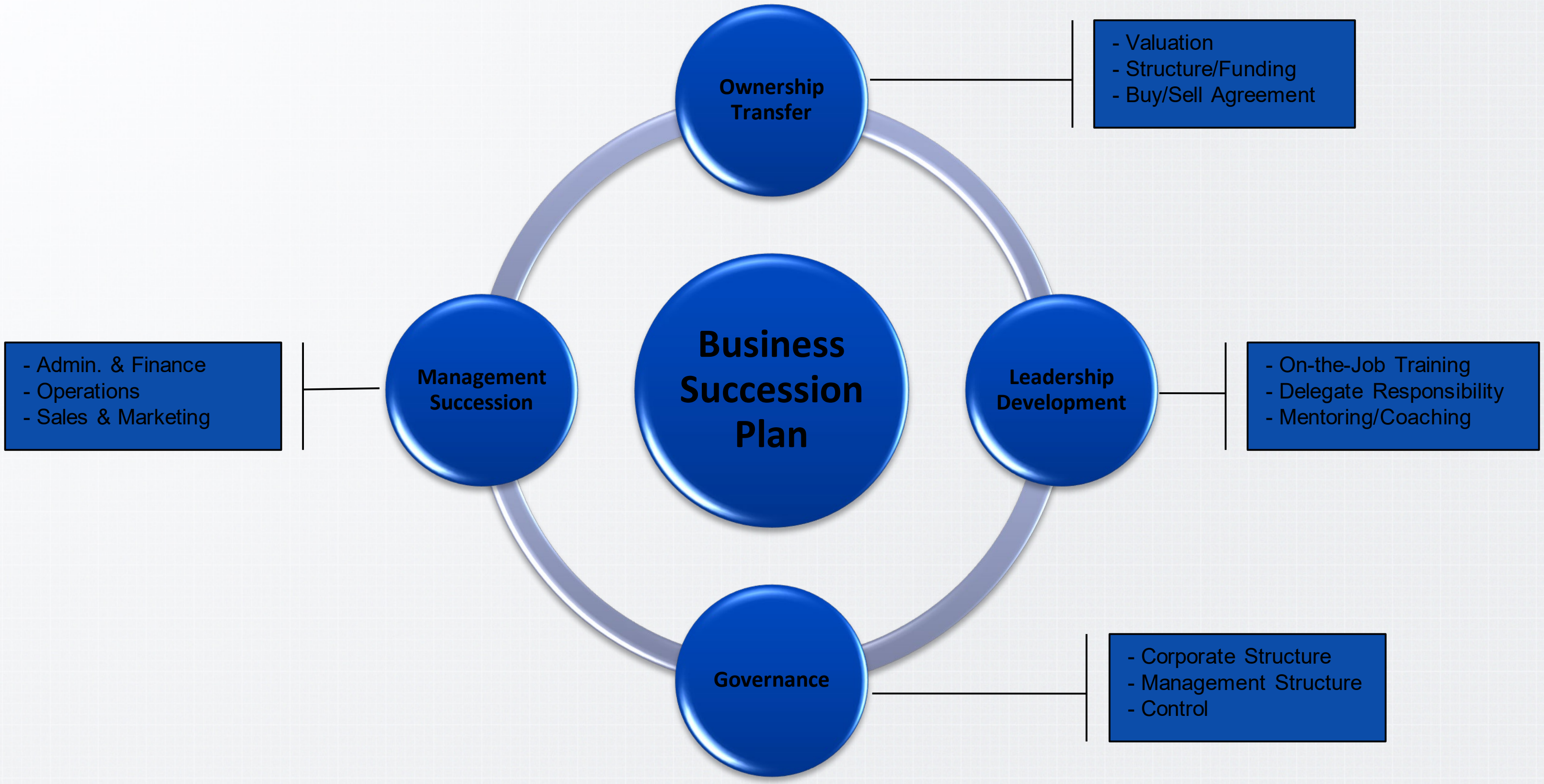
Valuation Approaches

- Valuations of closely-held businesses fall into any one of three (3) general approaches.
  - **Asset Approach** – Value of the business is based solely on the value of the entity's assets net of liabilities, including both tangible and intangible assets.
  - **Income Approach** – Most widely used method of valuing a closely-held business where value is the sum of the present values of the expected future economic benefits attributable to the ownership interest.
  - **Market Approach** – Value of a closely-held business is determined by reference to the market values of comparable companies who are either publicly-traded or were recently sold in the private marketplace.

What is a Business Succession Plan?

"An established framework within a business enterprise which provides for the orderly transition of all aspects of the business upon the occurrence of an event or series of events, whether foreseen or unforeseen."

Components of a Business Succession Plan



Two (2) Types of Transition Plans

- **Internal** – transition of existing ownership to family members and/or key employees who have or will take an active role in the business
  - Common internal ownership transition strategies include gifts, cross-purchases, redemptions, stock bonuses, deferred compensation and employee stock ownership plans (ESOPs).
- **External** – transition of existing ownership to individuals or entities outside the business enterprise
  - Common external ownership transition strategies include mergers, stock acquisitions, asset acquisitions and liquidations.

Internal Ownership Transition Plans

Pros	Cons
• Continuation of the company	• Lack of future owners
• Access to a pool of buyers who are in the company	• Candidates for ownership may be more risk adverse
• Assurance of a reasonable return	• Funding through current operations
• Ongoing control until retirement	• Possible transfer for less than maximum value
• Continuance of salary and benefits	• Greater risk post-transition if management not properly transitioned

External Ownership Transition Plans

Pros	Cons
• Possible transfer for maximum price	• Difficulty in finding right buyer
• Provides for greater liquidity and less risk for existing owners	• Confidentiality
• Shorter time frame	• Post-merger integration can be difficult due to cultural differences
• Add new talent, skills, markets or service offerings	• Loss of control and identity
	• Staff / client retention

3 – Prepare a Detailed Sales and Marketing Plan

"We're lost, but we're making good time."

- Yogi Berra

Detailed Sales and Marketing Plan

- The quantity and quality of your sales drives all else within your business!
- Do you have a written sales and marketing plan defining what you will sell and how you will sell it?
- A sales and marketing plan should provide details for all aspects of your sales process.
- The plan should be updated on a regular basis.
- Consider best practices that should be included in a sales and marketing plan.

Detailed Sales and Marketing Plan

- Instead of competing on price, consider emphasizing the strategic advantages of your business.
- Emphasize the qualities that make your products stand out and refine your positioning in the industry.
- Find out what really matters to your customers by surveying them and give it to them.
  - Dissatisfied customers may not return.
  - However, delighted customers will refer others!

Detailed Sales and Marketing Plan

- Carry out competitive intelligence on your competitors, especially the ones that are successful!
- By researching and monitoring your competition, you will be able to reorganize, improve your products, adjust prices depending on the competition, as well as introduce new product offerings to your customers.
- By knowing what your competitors are up to, you can try to stay one step ahead of them.

Detailed Sales and Marketing Plan

- Develop a strategy for up-selling and cross-selling.
  - Selling additional products or services to your existing customers is often easier than obtaining new customers.
  - Evaluate specific methods for add-on sales, including quantity discounts and discounts for certain items when purchased together.
  - Consider whether there are products or services that your customers currently purchase elsewhere that you produce or could add to your product offerings.

Detailed Sales and Marketing Plan

- Promote your products and services!
  - Marketing and advertising is a key element of any sales plan.
  - Do you have the right promotional materials and are they updated regularly?
  - Is your website effective to help maximize your sales efforts?
    - Portray the right image of your company.
    - Provide necessary contact information.
    - Possibly allow for online ordering.
  - Is there paid advertising that makes sense for your company?
  - Are you making effective use of social media?

#4 – Consider Activity Based Costing/Management (ABC/M)

"You better cut the pizza in four pieces because I'm not hungry enough to eat six."

- Yogi Berra

Activity Based Costing/Management (ABC/M)

- While concepts of ABC/M are being applied to all types of businesses, it is especially effective for manufacturers!
- ABC/M is a concept. It is not necessarily a system that must be implemented and often can work offline from your accounting system.
- ABC/M is a process that assigns overhead costs based on consumption. Key factors for ABC/M include:
  - More accurate cost management methodology.
  - Focuses on indirect costs (overhead).
  - Traces rather than allocates each expense category to the particular cost object.
  - Makes "indirect" expenses "direct."

Activity Based Costing/Management (ABC/M)

- The basic premises of ABC/M:
  - Cost objects require certain activities.
  - Activities consume resources.
  - This consumption of resources is what drives costs.
  - Understanding this relationship is critical to successfully managing overhead.
- When to use ABC/M:
  - Overhead is high.
  - Products are diverse: complexity, volume, and amount of direct labor.
  - Cost of errors is high.
  - Competition is stiff.

Activity Based Costing/Management (ABC/M)

- There are numerous specialized software packages for use in applying ABC/M.
  - Smaller manufacturers that utilize ABC/M often use spreadsheets to perform calculations.
  - Affordable software packages are available that work offline from your accounting system and can be more effective than spreadsheets.
  - Larger companies can most effectively utilize ABC with specialized software that is integrated with their general ledger.

#5 – Perform Customer Profitability Analysis

"You can observe a lot by just watching."

- Yogi Berra

Customer Profitability Analysis

- Why do you need to perform Customer Profitability Analysis?
  - Do you know who your most profitable customers are?
    - Your biggest customers?
    - Your smallest customers?
  - Does higher gross profit margin for a customer always translate into higher profit?
  - Are overhead and administrative costs significantly different for different customers or customer segments? Do costs differ for:
    - Advertising
    - Sales
    - Distribution
    - Returns and allowances
    - Collection

Customer Profitability Analysis

- Customer Profitability Analysis goes hand in hand with ABC/M.
- Performing Customer Profitability Analysis.
  - Quantify customer acquisition costs such as advertising, promotions, and direct marketing.
  - Quantify distribution and administrative costs and identify activities that drive costs.
  - Identify and assess customer behavior and purchase patterns.
  - Evaluate your customer segments to determine cost differences by segment.
  - Analyze specific customer's behavior to determine differences in activity levels for cost drivers.
  - Perform detailed analysis and quantify profitability for customer segments and/or specific customers.

Customer Profitability Analysis

- Effective Customer Profitability Analysis allows you to:
  - Nurture your profitable customers.
  - Work with less profitable customers to make them more profitable.
    - Educate your sales people to avoid inefficient activities.
    - Change customer habits, especially those that provide no benefit to the customers.
    - Provide incentives to customers to promote desired behaviors.
  - The last resort - firing customers.
- When combined with product/service profitability analysis and management of the product and service mix, the impact on bottom line profitability can be significant.

#6 – Analyze Pricing of Products

“They should charge more.”

- Jacob Vaccaro

Pricing of Products and Services

- The price of a product or service is often market driven.
- The target cost of a product or service is the price determined by the market less the desired profit.
- However, many companies determine selling price as a mark up on cost.

Pricing of Products and Services

- Drawbacks of determining sales price using a cost approach.
  - Potential for lost sales when your cost is too high.
  - Potential for lost profits when your cost is too low.
  - Potential for lost sales and profits when you don't know your cost!!
- Benefit of determining sales price using a market approach.
  - Stimulates analysis of internal procedures to reduce costs.
  - Allows for additional sales opportunities when your cost structure can be modified to achieve the target cost.
  - Provides the opportunity to focus on products or services that will produce more profits.

Pricing of Products and Services

- Major factors for determination of market price.
  - Competitors
    - Do you know what the competition is doing?
    - Any information that you can obtain regarding your competitor's pricing should be documented in writing.
    - Maintaining a history of the competition's pricing and price changes will help you anticipate their future decisions and react accordingly.
  - Customer value
    - Adequate feedback must be received from customers.
    - Salesmen should be used as a resource to provide management with information related to customer satisfaction with product quality and product value.
    - Documentation should be maintained of customer reaction to pricing changes.

Pricing of Products and Services

- Major factors for determination of market price.
  - "True" costs of a product or service have only minor importance in final market price determination.
  - However, it is important to know your true costs to determine what products to produce and market.
  - The assumption that if additional sales cover "fixed" costs, then they will add to profit is often false.
    - Are costs truly fixed? Over the long run, almost all costs are variable.
    - Selling products at a discount to some customers may affect sales to other customers.

#7 – Improve Your Supply Chain Management

"It was impossible to get a conversation going, everyone was talking to much."

- Yogi Berra

Supply Chain Management

- What is a Supply Chain?
  - A supply chain is a network of facilities and distribution options that perform the functions of procurement of materials, transformation of these materials into intermediate and finished products, and the distribution of these finished products to customers.
  - Supply chains are most critical for manufacturing organizations that rely on numerous raw materials and component parts for its products.
  - Complexity of the supply chain may vary greatly from industry to industry and company to company.

Supply Chain Management

- Implementing a plan for supply chain management can significantly improve profitability.
  - Companies are more likely to focus on revenue when attempting to improve profitability.
  - However, it is often easier to make positive changes in supplier relationships as in that relationship, you are the customer!!
- If a large portion of the cost of your product or service is purchased from suppliers, your supply base can significantly impact your:
  - Cost
  - Quality
  - Innovation
  - Speed to market

Supply Chain Management

- How well do you know your suppliers?
  - Do you meet with them regularly?
  - Do you speak the same business language?
  - Are you a large customer or small customer for them?
  - Are they satisfied with you as a customer?
- Strategic sourcing.
  - Develop a written plan for the purchasing of your most important materials, supplies, and services.
  - The plan must involve cooperation with your suppliers.
  - You should strive for seamless supplier integration.
  - You must understand your suppliers' businesses.
  - Consider who supplies your suppliers and how this affects you.

Supply Chain Management

- Supplier development.
  - If a supplier is not performing as you would like, have you communicated this to them?
  - Have you worked with them to improve their performance?
  - Do they know your expectations?
  - Is your profitability a consideration for any of your suppliers?

Supply Chain Management

- Logistics management is a critical part of the supply chain.
- Logistics involves the design and management of a system that controls the flow of materials into, through, and out of a company.
- Key functions that must be evaluated in logistics management include:
  - Scheduling the arrival of materials and other inputs.
  - Warehousing and inventory control.
  - Scheduling production.
  - Packaging, transportation, and final delivery.
  - Analysis of transportation costs.

#8 – Evaluate Business Acquisitions and Sales

"When you come to a fork in the road, take it."

- Yogi Berra

Business Acquisitions and Sales

- Successful companies continuously evaluate both possible business acquisitions and sales.
- This can be part of an overall determination of the return on assets (ROI) for assets deployed within the business and other investment alternatives.
- Acquisitions could involve direct competitors or might provide for entry into new markets.
- Selling or closing unprofitable areas of your business should also be regularly evaluated.
- If the price is right, you might also sell profitable parts of your business or even the whole company!

Business Acquisitions and Sales

- Acquiring the competition might be easiest way to gain market share.
- In evaluating a potential acquisition within your industry, you must also consider what will happen if the target is acquired by another competitor or someone entering the industry.
- To learn of companies that are interested in selling, you must keep you ear to the ground and communicate with resources within your industry.

Business Acquisitions and Sales

- You can also seek out possible acquisition targets, either directly or through an intermediary such as a business broker.
- Acquiring a struggling company might be less costly, but remember there are reasons they are struggling and you will need to determine how you can improve their results.
- It is critical to understand the value of your company and how businesses are valued in your industry.

Business Acquisitions and Sales

- Evaluate whether there are areas of your business that could and should be sold. This might include subsidiaries, locations, and product lines.
- If there are parts of your business that are consistently unprofitable or generate a low ROI, you must consider both opportunities for improvement and possibilities for selling or shutting down this area.
- The evaluation should include possible returns if capital were deployed in other areas of the business.
- Should also consider potential “collateral damage” to other business areas, including impact on customers.

#9 – Enhance Financial Statement Analysis

"I knew the record would stand until it was broken."

\- Yogi Berra

Financial Statement Analysis

- You must go beyond the basic statements.
  - The balance sheet and income statement are only the starting point for successful financial management.
  - Applying other financial statement analysis methods is a necessary step in analyzing the success, failure, and progress of your business.
  - Other types of financial statement analysis include:
    - Fluctuation analysis.
    - Common size financial statements.
    - Budgets and forecasts.
    - Ratio analysis.
    - Industry comparison.
    - Use of detailed financial reports.

Financial Statement Analysis

- Improved financial statement analysis can help companies to:
  - Locate and correct accounting errors.
  - Identify areas for business improvement.
  - Identify more problems areas and react to problems more quickly.
  - Better understand the interrelationship of accounts, which in turn will help you to devise better solutions to the problems identified.
  - Monitor success or failure of business initiatives.
  - Help to identify business opportunities.

Financial Statement Analysis

- Improve your basic monthly financial statements.
  - Include comparisons to prior years.
    - Statements should include fluctuations showing both dollar changes and percentage changes.
    - Income statements should present both current month and year-to-date amounts, as well as comparisons to prior years.
  - Provide the appropriate level of detail on the balance sheet and income statement.
  - Prepare reports for all meaningful divisions or locations.

Financial Statement Analysis

- Perform Ratio Analysis and Benchmarking.
  - Financial statements can be analyzed using key financial ratios.
  - Ratios are not ends in themselves, but provide insights into the operation of a business.
  - They serve as "benchmarks" against which the company can evaluate itself and are only really useful when:
    - Compared with the same ratios, for the same company, from previous periods.
    - Compared with some predetermined standard.
    - Compared with the same ratios for other companies in the same industry.
    - Compared with average ratios for the industry within which the company operates.

Financial Statement Analysis

- Industry comparison.
  - Types of industry comparisons.
    - Compare your company to industry average data.
    - Compare your company to selected guideline companies.
  - Data that can be compared to the industry.
    - Financial statement amounts, such as sales volume.
    - Year-to-year fluctuations and trends, such as growth rate of sales.
    - Common size financial statements.
    - Ratios.

Financial Statement Analysis

- Industry comparison.
  - Purpose of comparing your company to the industry in which you operate:
    - In an industry comparison, we look at the company's performance in relationship to its competitors.
    - By comparing the company to others, any differences in their operating efficiency will show up.
    - Once a problem is identified, the company can take action to correct the problem.

Financial Statement Analysis

- Industry comparison.
  - Sources of industry data.
    - Risk Management Association (RMA) industry statistics.
    - Industry publications.
    - Filings for publicly traded companies.
    - Internet web sites.
  - Selecting industry data.
    - Identify comparable industry using SIC or NAICS code or description.
    - Obtain data for companies of a similar size.
    - Verify that guideline companies are truly comparable.

Financial Statement Analysis

- Produce detailed financial reports.
  - The basic financial statements are not sufficient to effectively manage the company!
    - A company must analyze more than just its balance sheet and income statement and the high level ratios discussed above.
    - Detailed reports must be utilized by personnel throughout the company.
  - Accounting software packages are capable of producing countless detailed reports that can be tailored to the specific needs of your company.
  - For all reporting, consider meaningful breakdowns, including by division, location, type of client, and type of product or service.

Financial Statement Analysis

- Timing and distribution of reports.
  - Financial reporting is only effective if the right people get the right reports!
  - Frequency of reports.
    - Reports should be produced at least monthly.
    - Depending on the capabilities of your systems and the nature of your business, more frequent reports may also be appropriate.
    - Revenue, staff utilization and other types of reports may be needed daily or weekly as explained below.
  - Periods included.
    - Current month.
    - Year to date.
    - Any other meaningful grouping, including possibly quarter to date or rolling twelve months.

Financial Statement Analysis

- Effective financial analysis is a four step process.
  - Prepare the proper reports.
  - Distribute the reports to appropriate personnel timely.
  - Perform analysis.
  - Make management decisions based on the analysis.
- It is critical that actual analysis is performed.
  - Unfortunately many companies stop somewhere between the first and second step.
  - Consider how much time is spent producing financial data versus the time spent using that data.
  - Make time to perform analysis and then take action!

#10 – Upgrade Personnel Management and Compensation Policies

"90% of the game is half mental."

\- Yogi Berra

Personnel Management and Compensation

- Performance is created by the quality of the people working for you!
- Take a hard look at your employees, you should continuously evaluate whether changes are needed.
- Reward the performers, even in down times.
- Get rid of the non-performers and bad attitudes.
- Bring a positive culture to your company.

Personnel Management and Compensation

- Review your payroll and benefits package to make sure it is sufficient to attract the best employees.
- Understand employment practices, pay, and benefits in your industry and for your competition.
- Understand what is important to your employees.
- Update your policies and procedures.
- Be more flexible, especially when something is important to your employees but not costly for the company.

Personnel Management and Compensation

- Consider utilizing an incentive based compensation plan.
- Why pay for performance?
  - Motivate employees.
  - Reward performance.
  - Retain/attract employees.
- Expected results of an effective incentive based compensation plan.
  - Increased profits and growth.
  - Motivated workforce.
  - Happier employees with less turnover.
  - Better workforce.

Personnel Management and Compensation

- Elements of an effective incentive program.
  - Align company culture/values. Buy in from senior management is a necessity.
  - Be fair to employees. For a plan to work, employees need to believe they will get substantial rewards from it.
  - Be fair to the company. Few plans pay for themselves immediately, but all should aim to be self-funding after a certain length of time.
  - Start simple and add complexities over time.

Personnel Management and Compensation

- Elements of an effective incentive program.
  - Performance criteria must be discernible, valid, and understandable.
    - If employees can't figure out what they have to do to get incentive pay, it won't work well as a motivating factor.
    - Also, if the criteria are unreasonable for all but the most superhuman of workers, the plan is bound to fail.
  - The program must deliver what was promised – on time and fairly. Payments must closely follow when they are earned.
  - Consider adding subjective adjustment factors.

Personnel Management and Compensation

- Elements of an effective incentive program.
  - Performance measurement plans are crucial. It may take a year to enact an effective incentive plan. At least half the time will be spent on your performance measurement plan. To align performance and reward, you need:
    - A clearly perceived relationship between pay and performance.
    - Visible benefits to the employees and company.
    - Regular performance feedback, both formal and informal.

Conclusion

- Remember what the most important goals are for all companies – To increase profitability and business value!
- Establish short-term and long-term goals for your company.
- Consider which tools you should have in place to help you meet your goals.
- Be certain to analyze the cost versus benefit of any financial management project.
- Remember that change is needed to achieve improved results. Don’t be afraid to utilize new tools and evaluate potential changes.
- Seek assistance when needed.

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