<u>How to Increase Profitability in a Stagnant Market</u>

By Carter Pennington

Increasing profitability is an easy concept: buy low, sell high, pay late and collect early.

Easier said than done – with increasing competition, declining margins, inflating costs and shrinking consumption – the ability to increase profit in today's economy is a challenge. In a stagnant market, increasing profit is an even greater challenge.

As daunting as this may seem, increasing profitability in stagnant or declining market is not impossible. To do so a company needs to adopt management tactics that can effectively address such an environment.

This is where restructuring advisors and turnaround consultants can provide leadership and spearhead change. All too often, client companies are stuck in a mature market and employ management tactics that are specifically geared toward competing in a growth market.

The restructuring advisor needs to steer the client's management team toward adopting strategies that can improve profitability, independent of market or industry conditions. Among the most effective strategies for increasing profitability in a stagnant market is implementing value-focused management.

Value-Focused Management

There's an old saying, "Use it up, wear it out, make it do or do without." It's about value!

Value-focused management is quite similar; however, through the years there have been lots of names used to describe what is essentially value-focused management: lean manufacturing, continuous improvement, just-in-time-delivery, cycle time reduction, economic value added (EVA), total quality management (TQM) and, of course the ever-popular, Six Sigma Black Belt.

If you want to see value-focused management in action, watch the Indy 500 auto race. A racecar pulls into the pit-stop and 15 or so people rush out and, in less than a minute, complete a highly orchestrated car maintenance procedure that would take your favorite auto repair shop a day to accomplish (if you're lucky). Now *that's* value!

Their secret? Nothing is wasted. Every person, every part, every process, every action is absolutely needed. The pit crew wastes nothing; if an action or process is not absolutely required, it isn't done. How many companies do things that are <u>not</u> essential, not intrinsically necessary to run the business?

No company is perfectly efficient; no company operates like a pit crew in a racetrack. However, nearly all companies can improve. Any company can move toward high margin products, reduce waste and decrease cycle time.

A company in a growing or robust industry can easily waste time, resources and brainpower and still perform satisfactorily. A company in a stagnant or declining industry must rely on maximum operational efficiency and high value work to be profitable. By the time a turnaround consultant is brought in, a company in a declining industry that has not addressed waste-elimination issues can be suffering from financial distress.

Among the strategies used to turnaround a distressed company, especially in a declining industry, include value-focused management tactics. Five of the most practical tactics are:

1. Rationalize SKUs, customers and markets. Most mature companies have an eerie similarity: the 80/20 rule: 80% of total product sales are in 20% of the SKUs; 80% of sales are generated by 20% of the customers; 80% of gross margin comes from 20% of the products, and so on. These examples have the same result, lower return on employed assets - a fancy way of saying "lower value." To improve value, these ratios must be improved.

To get rid of the low volume SKUs, say goodbye to the low volume customers and stop selling low margin business. Without a doubt, these are among the most difficult decisions to make. This is extremely painful medicine and requires very reliable information to support.

The most reliable SKU ration information is consumer consumption, i.e., the products actually purchased by the end user. This is also referred to as sell-through data or consumer take-away. While this should be basic and essential data that a client company would possess, many companies simply do not have the information systems to support this data.

If a client company does not have a current database of sell-through metrics, the turnaround consultant should consider employing IT professionals for new programming or investigate external resources, such as A. C. Nielson. For some companies, an in-depth interview or audit of their largest customers may suffice. The client company may not have sufficient IT support but perhaps their key customers do. Rarely would a key customer refuse to supply SKU-level sell-through data.

Rationalization is a widely used tool turnaround consultants rely upon and for good reason: it works! A well-researched, carefully planned and properly executed rationalization program can improve margins, generate working capital and increase profits – regardless of industry conditions.

2. Reduce Waste. This is something everyone can identify with. Waste is easy to notice. It is often visual and everyone can participate in controlling it.

Consequently, the best approach to waste reduction is company-wide teamwork - make everyone responsible and accountable for reducing waste. Form teams, brainstorm waste reduction initiatives and hold people accountable to implement action plans. Develop and use relevant metrics to monitor progress and take corrective actions as necessary.

Don't go for the big wins; rather, have each person responsible for a few small initiatives. This avoids the ever-so-noticeable big failure and will keep people motivated.

Waste reduction tactics generally fall under 3 broad categories: a) eliminate low-value work, b) streamline work processes and c) prepare contingency plans.

Low-value work can be simply characterized as work that does not result in a product or service attribute for which the customer is willing to pay. Obvious examples include duplication of work, work that does not support a strategic process and work that is not necessary to the company's product or service.

A turnaround advisor can identify these areas of waste by mapping the specific steps of a business process and challenging the company to demonstrate how each step of the process achieves the objective. Is each step necessary? Does it add value to the product? Is the customer willing to pay for it? This guided exercise of self-discovery often results in the company finding the low-value work steps and eliminating or reducing it by developing new, creative processes.

Streamlining work is a tactic that reduces the classic form of waste - the kind we tend to see everyday - such as excess inventory, administrative spending and overhead.

Using the same team technique as described above, the turnaround consultant can assist the client company to uncover many areas where a process can be streamlined, reducing it to its essential components. Typical applications include building inventory to meet actual demand, having work activities centered around people rather than a product and training people to be multifunctional by rotating them through different responsibilities. These tactics often result in improved productivity, better use of capital and greater accountability for expenditures.

Contingency planning is an often-overlooked tactic of waste reduction. The fact is that things go wrong all the time. Crisis is a common occurrence in business - particularly in a distressed company. It is unlikely a turnaround advisor can prevent the typical emergencies and "Friday afternoon fire drills." However, the disruptive impact of these events can be significantly diminished.

One of the best tactics a turnaround advisor can implement is preparing the client company to operate effectively when things don't go as planned. Perhaps key shipments fail to arrive on time, the largest customer leaves, a critical vendor stops shipping, a labor union strikes, a governmental agency shuts down a plant or an essential financing facility is called in. All of these emergencies (and many others) need well thought-out contingency plans.

These types of events can increase spending, drain management resources, add work time and often bring productivity to a crawl. The restructuring advisor must organize a series of meetings with senior executives as well as rank-and-file employees and ask the tough question, "What do we do if this happens?"

The best time to deal with a crisis is before it happens, when a company has the time and resources to consider all options and alternatives. Unfortunately, in most distressed environments the opposite is true; companies are often surprised with emergencies. The restructuring advisor needs to get ahead of the crisis, implement contingency plans and be prepared!

It's worthwhile to note that waste reduction is an on going, evolving process; it should never end. Reducing waste should be anchored to continuous improvement and become part of the company culture after the turnaround consultant leaves.

3. Reduce cycle time. The hidden cost of time is a simple yet powerful concept and a source for finding and reducing waste in the operations. For example, if it were to take a business three months to complete an integrated business process, four cycles could be completed in one year. If, however, the process time was reduced to, say, two months, six cycles could be completed in one year. This would allow a 50% increase in capacity with nearly the same fixed resources. Using the same example for a company in a non-growth industry, where extra capacity is not needed, fixed resources can be reduced 33% with no change in capacity.

Make no mistake: time *is* money!

Reducing process time is not easy. Process time reductions can be achieved using the same methodology recommended for waste reduction.

Create time-reduction teams for major cycle-oriented processes; it's best if these are cross-functional teams. Develop a large variety of process time reduction tactics, no matter how small each tactic may appear (again, avoid the potential big failures). Implement an action plan, monitor meaningful metrics and foster a continuous improvement culture.

4. Institute Value-Based Metrics. Obviously, a company needs to regularly monitor many metrics to uncover the critical information needed for effective decision-making. In a stagnant industry, when a company is financially distressed, value-based metrics become critical to decision making: net present value of capital expenditures, return on assets, net cash flow, working capital changes, and EBITDA (earnings before interest, taxes, depreciation and amortization).

With the implementation of product rationalization, waste reduction and cycle time reduction tactics, value-based metrics represent an important barometer of effective management during a turnaround. These metrics need to show continuous improvement and be relied upon for investment and strategic decisions. The turnaround consultant should spearhead the development of these metrics and provide reliable, independent analysis.

5. Move The Strongest Managers to the Weakest Businesses. Many multi-segment, multi-market companies often reward the best managers with leadership positions in the best, most profitable divisions. This makes as much sense as a baseball team using their best hitter only when their team is ahead 10-0.

The under-performing division or business should be led by the company's best manager, as that is where strong management and leadership skills are needed the most. A turnaround consultant is likely to do this quickly upon arriving at the client site. As an independent advisor, the turnaround consultant can objectively assess the company's management skills and make strong recommendations on shifting responsibilities.

Leadership positions are often filled with executives with strong sales and marketing backgrounds. While this makes perfect sense in a robust market, it could lead to disaster for a company in a stagnant or declining market. In tough times, the best leader will have strong operations and finance backgrounds. Sales growth and market share are fundamentally less important when operating in stagnant markets than they are in growth markets.

Conclusion

Increasing profitability and, in turn, enterprise value, is an enormous challenge in a stagnant, mature or otherwise sleepy industry. A company in distress needs to shift focus away from the strategies and management tactics that might have been successful during industry growth periods and instead shift to a different paradigm.

The focus needs to be on value-based management strategies that restore the company's value. The turnaround advisor should provide the leadership and direction to implement new, more effective management tactics.

Increasing profitability sounds easy: buy low, sell high, collect early and pay late. But in a stagnant industry, this may seem nearly impossible. With a change toward value-based management, a company can win at a seemingly impossible game.

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