THE PROFITABILITY CATALYST

Six Mistakes Manufacturers Make That Damage Profitability!

By John Howard, Founder and Principle Adviser

Manufacturing companies make six primary mistakes that damage profitability as they progress from startup to mid-market size companies:

1. Undetermined, ineffective market position.
2. Insufficient funding
3. Undeveloped marketing, sales and brand
4. Lack of systems
5. Undermanaged
6. Insufficient asset management

Moreover, at each stage of development they must deal with different circumstances and requirements. It is more than just looking at the income statement and profitability numbers, the lagging indicators. We must also look at the more subjective issues and leading indicators, such as marketplace positioning and leadership.

To begin, profitability is not a one shot deal and is vital in the long run. A business must have an increasing ability to generate profit and positive cash flow for the owner's benefit and then other stakeholders. Owners, investors and buyers want to see it increase month-over-month. Profit is the one specific measure as the basis for assessing performance over any particular time-period. It is an essential requirement against the risks of the future (economic down turns, change, and growth) and contributing to the community. Profits become the

investment driving future revenue and distribution to the various stakeholders, especially founders and employees.

In addition, we need to have the end game in mind at the beginning in order to cash-out…when it is time to retire, execute a succession plan or sell the business. We want to determine the potential and target equity value upfront…so we can win when we reach that championship game with the highest sales price.

Mistake #1 – undetermined, ineffective market position

At every stage of development and growth, a business needs a strategy process to discover choices, make decisions and reach its objectives: what-to-provide, where-to-play and how-to-win (very rare activities). It must choose the preferred ways to create economic value for customers and itself - a vision of where it wants to go.

A business has two high-level product choices - achieve higher margin through lower cost or higher margin through differentiation. In other words, is there a dominant strategy that can position the company to create more customers and profit relative to the market and rivals?

The purpose is to identify its target market (niche) and position or re-position the company in the marketplace with the big idea, business model and activity system that allow it to reach its objectives. Is the product or service solving a problem in a unique way to benefit the customer and does it resonate?

"*Position*" is the one idea resulting from the strategy process that represents the business in the marketplace and allows a company to communicate a consistent shared vision both internally and

externally. It builds and drives the brand with its messaging and service experience to create loyal customers and help the company operate more efficiently to increase profits.

If it cannot identify or create a unique position, the business will truly be just another commodity. It will have to compete on price not value - a low or no margin result that could be a slow death process.

Skillful strategy work captures valuable ideas, technology and social innovations to help create a unique market position in the mind of the prospect – an incredible product at low price, great quality, a stand out logo, unbelievable service and delivery system, etc. And by applying a robust strategy process to differentiate, select and amplify the most valued choices, they can generate higher margins, i.e. the Japanese car industry applied a low price, high volume strategy to become dominant in the automobile market.

Additionally, strategy work continuously links intelligence and learning to position and performance. It ties together core strengths, focuses leadership attention and drives strategic conversation across the company.

The startup must determine if it can create enough loyal customers, the primary resource, and keep the pipeline filled. Strategy should follow a few simple rules at this early stage. Culture is also part of a company's position and mirrors the founder's mode of operation and energy.

In summary, a business must create a differentiated or low-cost advantage by building those clear connections between the positions it takes and the growth in profits and cash flow that management and investors focus on. The resulting objectives and time-phased action plan determine the critical path and major milestones for navigating into the future.

One client example is from an office products distribution business. It was struggling with the loss of revenue and customers. They needed more focused offerings for changes occurring in the health care industry. We performed market analysis, repositioned them as a "health care solutions" service company, recommended new marketing programs, updated advertising messages and website to increase lead generation and internet sales, and identified 1500 inactive customers to reconnect with and increase revenue.

Mistake #2 – insufficient funding

Obtaining startup capital and future capital needs are critical to getting the company off the ground and funded at each stage of development, but underfunding at startup may be the biggest mistake. The founders somehow must provide this capital from themselves or from outside sources such as banks, suppliers and customers. And they can't ignore angels, family and friends as other options.

Startup credit lines, instead of COD, are crucial for managing the company cash cycle. Without sufficient startup money sources, it becomes a march through the swamp to get milestones completed on time. Another alternative is simply increasing throughput to generate more revenue and profit (if there is sufficient demand) and it doesn't require any capital investment.

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Survival is the important concept at this point to gain traction and momentum toward profitability. The short-term objective is preservation and generation of cash with a low burn-rate, break-even point and faster throughput to make profit generation easier. Future capital needs such as expansion of credit lines are critical sources from preventing missed payrolls to taking advantage of innovative growth opportunities and supporting new customers with the latest technology.

This case study of a technology firm is a classic example. Without sufficient startup and early stage funding, engineering and operating personnel battled with banks, suppliers, customers and investors for increases in credit lines and additional capital. It needed to get parts, hire personnel, meet payroll, buy equipment and get products launched. These delays were stalling customer deliveries, cash flow and growth. The strategy was to keep costs extremely low by performing key in-house process development, outsource other key functions and continually negotiate with money and parts sources to maintain schedules. The business did achieve success along with significant profits and attracted private equity firms that also rolled the entity into an IPO rewarding the founders and stakeholders.

Mistake #3 – undeveloped marketing, sales and brand

Most early stage small businesses are generally unknown, woefully lacking in marketing and winging the sales. There is no marketing system or sales process. The founder is probably the primary sales person. No one else understands the customers as they do or is developing relationships to expand and deepen accounts. It would be wise to add a division-of-labor here and expand efforts to increase the number of touch points as cash flow and profits increase. The long-term objective should be to replace the founder as the primary sales person. In addition, customers appreciate experiences that can add more value and result. Building breakthrough customer relationships at various levels should be a primary objective.

The business must find the early adapters and get their attention. How to deal with the finite universe of potential customers is important to assess, plan and reach them. The cost and time to create a new customer must be reasonable. These are the first efforts at establishing identity and brand to a wider audience by focusing on the solutions provided with better messaging. Eventually, an order entry desk and product management may be required to work more efficiently with the customer base.

Every early stage and many mature small companies I've worked with have experienced this scenario. The key is to make a strategic commitment to these functions by creating a budget and marketing plan with goals and objectives. The plan always includes hiring and training key personnel to free up the founder/owner and then working with an explicit target market. New collateral and marketing programs communicate the differentiated advantages to gain traction and create new customers or grow existing ones.

Mistake #4 – lack of systems

As the company grows from startup to lower mid-market size, more automated and systematic

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approaches are required versus brute force manufacturing. Primary threats to survival come not from hidden events, but from slow, gradual changing situations and processes that go unrecognized. Founders typically get stuck here and need to ask for help. Even job shops can gain significant productivity.

The most important one is the strategy process previously discussed. Operationally, the company should purposefully grow its core competencies, resources and capabilities in a balanced way. And the people need to become loyal to its systems – information systems, functional excellence and processes, especially how they interact. At this point, the company should be moving beyond bookkeeping to a real throughput accounting system that can budget for future needs, accurately determine costs and profit (mix) per line-of-business. This is essential for future decision-making because it is not easy to be smart about money. Additionally, the most important impact on marketing strategy, quality, has been formally implemented to reduce defects, cost of poor quality and enhance the customer experience.

Another client, the owner of an electronics manufacturing company, was incurring quality problems. Defect rates and return costs were too high. We performed an ISO9000 quality audit and developed a strategic quality plan. The company added quality personnel, improved master scheduling, performed value stream mapping, standardized processes, organized, trained and deployed the information at the point-of-work to reduce the cost of poor quality.

At a lower mid-market level of revenue, a company must be generating a consistent profit to sustain itself.

Mistake #5 – undermanaged

Some indications of "under" management are spending too much time in unproductive activities, indecision, trapped in a political culture and lack of information causing inaction or wrong action. In other words, they are not doing enough of the right things or facing the challenges. Resolving these issues is the job of leadership.

As a company moves toward the mid-market revenue stage, the leaders must develop a multi-dimensional management team capable of leading and managing the company by setting the right objectives. Together they must answer this key question, "What is their true leadership strategy for creating more customers and managing a dynamic and profitable enterprise?" Moreover, by creating a leadership "competitive advantage," one that is highly "aware" and able to make decisions, they can overcome limiting mindsets, processes and organizational issues. Then the management team can map out new market positions to exploit the potential of the enterprise and deliver to plan.

This desired leadership advantage drives results from new markets, product platforms and derivative products creating new and loyal customers, generating higher revenues and profits. The market is recognizing the company's products and efforts

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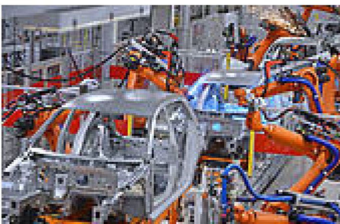
and is conferring a "brand", positioning it as a superior alternative to others. The management team is successfully managing resource flows and building new capabilities in a balanced way as well as its capacity constraint resource. Some commodity or even critical services such as manufacturing have been outsourced to reduce capital and operating costs. Product sales and profitability mix are always being managed for higher quality performance and profit. People "attitudes" from application of skillful human resource strategies are in a great spot for enhancing productivity – sales/employee – and motivators outweigh frustrations.

One critical startup and early stage scenario that requires strong management is in product development. It should be focused to launch products on-time and reduce time-to-market as the company evolves. Otherwise, revenue may be lost and credibility damaged…the company can die. A decision may be necessary to release products before all features are complete, but the customer should receive full disclosure and agree. Engineering perfection may not be an option. Rivals are more than willing to supplant with better products and faster releases. Being a first mover or the first to get it right are important perspectives in the marketplace and this is a crucial area for decision-making.

Mistake #6 – inefficient asset management



Businesses that do not use their assets efficiently are wasting stakeholder resources and are not driving with the balance sheet. If this continues, at some point in time it will stress the cash resource and without corrective actions will jeopardize the company's ability to survive.

Senior management must focus on asset efficiency. A measure of how effectively a company employs its assets to generate profits. These are finished and working assets of great interest to senior management and have a short to long-term impact. This focuses on fast turnover of working capital (keep it low – not tied up in inventories, receivables and payables) and boosting throughput on the factory floor from man and machines to achieve higher gross margin and revenue. Although margin is an important metric, profits cannot be optimized using margin alone. This can only be done by considering production speeds. Combining margin and production speed yields a time-based metric of profitability called "profit per minute." The business can earn more revenue and profit by cycling products through the factory at a higher velocity!

Additionally, this enhances the experience curve effects - a scaling law: sales incur a 10-20% cost reduction every time volume is doubled. Higher velocity optimizes capacity, creates larger economies of scale by reducing costs (more purchasing power) and the learning curve continues to move upward. The learning curve is responsible for gains from improvements such as substitution of creative new product designs, processes and operations - especially increasing automation.

For another electronics manufacturing company, we completed an ROA analysis that looked at the root causes and indicated several courses of action for

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their profitability roadmap. Both production equipment and IT systems needed a significant upgrade. By improving process and transaction capabilities, these upgrades resulted in quality, throughput (reduced takt time), revenue and profit increases while reducing huge cost overruns from excessive purchasing and poor inventory control saving hundreds of thousands of dollars.

NOW WHAT?

At the mid-market stage of revenue generation, the company is leveraging its unique position, management team, funding, branding, systems, and return-on-assets. It is achieving the intended target equity value for a potentially great exit event. The superior management team has eliminated the risk of ownership as the sole source of running the company and the business can outlive the owner.

Systems reign supreme. They have matured and are delivering consistent results with low or no defects. The company is well known and perhaps dominant in its market focusing strongly on increasing sales as they create even more customers.

Of course, there are no simple answers at any stage of development, but remember this. Avoidance of these six mistakes with a spotlight on positioning to create and keep customers and a dynamic leadership function, results in a profitability safety net – a proverbial business blanket protecting against future risks. And positive cash flow provides the business life-blood. Together they keep the company moving forward for the benefit of all.

If you are experiencing these mistakes and need an objective conversation, contact John at 440.759.1915 to schedule your **FREE** and confidential ***PROFIT POTENTIAL Strategy Session***

or learn more at www.theprofitabilitycatalyst.com; ***The PROFIT SYSTEM.***

John Howard is known as "*The Profitability Catalyst*™" due to his tested-and-proven strategies and frameworks for increasing cash flow, profits and ROA…backed-up by his B.S. degree in Chemistry and MBA in Business Systems. He has worked in and with both small and Fortune 500 manufacturing companies for over three decades, including ADC Telecommunications, ABL Canada and U.S. Steel and played key roles in founding or launching four companies. Specializing in turnaround or growth situations, John helps companies respond to rapid change by working with leadership and management to help them become more profitable, flexible and higher velocity organizations; keys to long-term endurance and growth. His advisory insights into the human side of change management provide ***"Game-Changing Guidance for 100% More Profits!"***

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