Performing to Industry Norms: Easier Said Than Done

By Gerald M. Sherman

Case studies show how difficult it can be for borrowers to meet or exceed industry norms.

The Risk Management Association's (RMA) Annual Statement Study report, and the statistical information published by various trade association groups, have been valuable sources of industry-specific financial statistics, or norms, for decades. Using the ratio information these resources provide, a lender can quickly get financial metrics for use as a baseline for analyzing most of the companies they see. Is leverage too high? Is working capital adequate? Is the gross profit percentage where it should be? Is capital adequate? Using these norms, it's relatively easy for a lender to spot a company's weaknesses and to gain an understanding of needed *financial* improvements. At the same time, this type of analysis doesn't shed any light on the *operational* steps a company may have to take to achieve these improvements. Further, given that a lender's training and experience is primarily focused on corporate finance and lending practices, it's understandably difficult for many lenders to fully grasp the challenges an underperforming borrower has to overcome to improve performance. This article will present a number of actual cases detailing several representative challenges borrowers typically have to address to meet or exceed norms. In many of these cases, the challenges ultimately proved to be insurmountable.

Why Industry Norms Really Do Matter

In broad economic terms, a free market economy forces companies toward the efficient delivery of goods and services. To be efficient, a company must use its financial resources wisely. Accordingly, industry-specific statistics, particularly those focused on superior performers, reflect key financial decisions these *successful* companies have made. How many dollars are invested in inventory? How much equity is needed to support operations? How many dollars can be spent on selling, general and administrative costs? What should profit as a percentage of sales be? If a borrower or prospect has been *chronically* below industry norms in one or several key areas, this clearly indicates that the company has not or can not use its financial resources efficiently. As a consequence, over time, the company is much more likely to lose its ability to compete or, on a worst-case basis, fail. To summarize, today's highly competitive economy just doesn't allow companies to misuse their financial resources, as indicated by a chronic deficiency relative to industry norms. Companies that do almost invariably pay a high price.

What If Good Industry Statistics Just Aren't Available?

On many occasions, good industry statistics won't be available. Some companies have product lines in multiple industries and report in a manner that doesn't allow for a direct comparison to available data. On other occasions, the company may be in a niche too small to justify the research costs associated with developing focused data. In those cases, the lender has two complementary courses of action. First, a search for similar industries can be under-

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taken. For example, while there may be no statistics for the manufacturing of replacement parts for paper mill equipment, there will be statistics available for various aspects of metalworking.

Typically of greater importance, the lender has to review a company's income statement and balance sheet and ask some basic questions. Can the company meet its needs with less inventory? Should the company be able to turn its receivables more quickly? Does the company have enough equity to support long-term success? While this approach won't have the certainty of solid industry data for comparison purposes, every experienced lender should be able to identify the areas where a company might be able to improve its performance.

Successful Corporate Change: What's Required?

Countless books have been written on the topic of successful corporate change. Most start with a fundamental premise that successful corporate change is a process involving a number of critical components. Effective leadership, internal competence, outside expertise, group buy-in and support, accountability, appropriate technologies, training for new skills and an appreciation of cultural issues are among the key factors that are typically discussed. It's important to note that for the family owned and operated companies many lenders work with, family dynamics need to be considered since they often can make effective change difficult or even impossible. To summarize, a broad range of issues can affect a company's ability to improve performance. Accordingly, every lender will be well served to consider, as fully as possible, all the factors a borrower or prospect may have to address in order to implement lasting improvements.

Case Studies

The "Discipline Issue" of the Second-Generation Manufacturer

It's common for lenders to look at the weak aspects of a borrower's performance and attribute the problem to a lack of "discipline." The most common example of the discipline issue with smaller companies is an owner's high spending on compensation and perks, often leaving the company overleveraged and cash poor. While the lender may be quite correct that more discipline would solve the problem, the lack of discipline is often much more deep-seated and difficult to overcome. This company had been successfully operated by its founder for close to 50 years. It enjoyed a strong position in a niche industry and decades of strong profitability. During that time, the owner brought three sons into the business directly from high school. Two were given jobs in sales and the third was put into operations. The father was conservative financially and micromanaged every aspect of the business. He also placed *little or no importance* on training his sons for increasing responsibilities. Amazingly, when they took control of the business, the three sons had close to 70 years of combined working experience and had never taken a single training course of any kind. Further, the father hadn't exposed his sons to all aspects of the business. Rather, they had stayed focused in their respective areas throughout their entire careers.

When the father retired, he truly stepped away, leaving the area and showing little real interest in the business. The oldest son, who assumed the presidency, quickly increased his compensation almost threefold; the others doubled their pay. They charged personal expenses to the company freely, and all spouses and children got company cars. At the same time, manufacturing controls diminished, and the company's gross margin slipped by more than eight percent of sales within two years. Overall, the company lost $4.0 million in the first two years under the sons' control. During that time, the three sons didn't fully grasp the business problems they had created, let alone any solutions for them.

Going beyond family businesses, a chronic lack of "discipline" is still a complex problem. About the only thing that can be assumed is that it's a manifestation of deep-seated personal issues that are interfering with a business owner or senior executive's ability to make good business decisions.

The Chronic Excess Inventory of the Outdated Outsourcer

It's widely believed that many business owners "fall in love" with their inventory and just can't let it go. While this is often the case, other factors are sometimes more critical. This 100-year-old company was one of two U.S. manufacturers of a specialty consumer product. With annual sales of $10 million, it was believed to have a 50-percent U.S. market share. Sales had been slowly declining for years. In the effort to boost revenues, the company developed a line of complementary items it could sell to its existing customer base. Very different in nature from the core products, the new items were largely outsourced. In most cases, the company did final assembly and packaging.

Inventory management in this new area was complicated by the fact that virtually all of the SKUs (stock keeping units) were private-labeled for the customer. So, for example, the company carried more than 15 SKUs of the same exact product in the same exact size. All that differed was packaging and labeling. Using approaches to inventory management and purchasing that carried over from its manufacturing operations, the company soon found itself carrying $1.5 million in inventory turning fewer than three times a year—all to support a relatively low-margin business with less than $5 million in annual sales.

It's important to note that the company was owned by a professional investment group that had little day-to-day involvement and wasn't prepared to put more money into the company. Further, the CEO, who had previously been CFO, was ill-equipped for his new role, having inherited it by default when the prior CEO left. He lacked management experience, people skills and exposure to all facets of the business. Nonetheless, he did know that inventory had to be reduced dramatically and also understood that he'd need a better systems infrastructure to do it. Ironically, the company did not have the resources to invest in system upgrades because they were tied up in the inventory!

The CEO was a major roadblock to improvement because he wasn't team oriented in the least. As a result, his modest efforts to address the problem failed entirely. Rather than form a project group of people from key areas—purchasing, sales, assembly, distribution and finance—he dealt with each of them individually in the effort to reduce inventory. The effort was never coordinated and never had buy-in.

A further complication was the purchasing manager, a 30-year employee. He was focused on making sure the company never was out of stock of any item. Why, you might ask? The common belief at the company was that he found stock-outs to be a personal inconvenience because it created more work.

To summarize, this company's failure to reduce inventory had little to do with "falling in love" with it. Rather, it was a combination of old approaches to a new situation, insufficient systems and ineffective management. Overall, it's an excellent example of the hurdles that can keep performance far below the industry norm.

A Billing Breakdown Ties up Critical Cash

Slow receivable turn is typically attributed to loose credit terms and weak collection practices. There can be circumstances, though, when a company can do well in these two areas and still have significant and even extreme receivable problems. This marketing service company provided promotional services for major national companies seeking to increase exposure for their products. Compensation for the marketing company's services was based on hourly fees or commissions for sales generated. In any given week, the company typically had 100 to 200 field representatives throughout the United States working for various clients.

In this company's business, four challenges make billing and collecting difficult. First, all of the field representatives are contract employees and are, by definition, less likely to comply with company rules and regulations. Second, marketing programs typically changed in midstream as circumstances evolved. Accordingly, the program contracted for was usually not the program delivered. Third, the company's clients all had stringent requirements for the billing documentation. Fourth, clients tended to be very particular about when and how often they would accept a bill.

These receivable management challenges were increased exponentially by internal company issues. First, internal systems and procedures weren't adequate to keep the finance department current on either billable activity in the field or change orders from the initial contracts. As a result, department personnel had to spend days each month working to get the bills as accurate as possible. Second, one senior employee was the primary contact person with clients regarding change orders, and she didn't share this information with the finance group. Rather, once bills were drafted, this employee would review them and make needed corrections, typically adding up to one week to the time needed to issue a bill.

Given the information issues, clients often rejected bills upon first submission because of errors. Further, the company's internal issues were compounded by weak senior management. The owner/CEO was, by his own admission, not a detail person, and the COO lacked the capacity to create or implement systems improvements. All in all, the company's internal issues increased *potential* collection time by about 30 days. This lag increased borrowing costs by more than $10,000 monthly and left the company chronically cash poor. This was all happening at the same time that clients paid within terms (upon receipt of a bill) almost 100 percent of the time with bad-debt expense of less than 1/10th of one percent. This is a striking example of non–credit-related issues that can dramatically reduce receivable turn.

A Comprehensive Change Program Produces Vital Labor Cost Reductions—and More

This company had been acquired out of bankruptcy by a very successful family owned manufacturing company. It was acquired for two major reasons. First, it complemented the company's core business of building large, highly engineered custom machinery. Second, the acquisition created the opportunity for each of the founder's sons to be the CEO of his own business. Located in different parts of the country and operated as separate entities, they were only tied by the fact that the original business held the other as a wholly owned subsidiary.

It's important to note that the opportunity for each son to be a CEO didn't eliminate family issues. The son that held the CEO position at the acquired company, while bright, held only a high school diploma. His father, who had planned to mentor him intensively at the company for several years after the acquisition, died suddenly shortly after the acquisition. Given these circumstances, while respected for his personal qualities, the young CEO was considered unprepared to truly lead his company.

After a period of modest success at the acquired company, things didn't go well. With two years of losses, each in excess of $1 million, the family mobilized. First, they hired several consultants to help. One, a clinical psychologist, focused on making sure that the family members were able to communicate effectively on critical and *sensitive* issues. With this assistance, the young CEO came to *accept* the help he was being given, a crucial first step. Simultaneously, a business consultant assessed the viability of the acquired company and its prospects for future success. His report, while decidedly mixed, provided some optimism that the acquired company could be saved.

As a first step toward revitalizing the acquired company, a more active board of directors was formed with a mix of family members, senior executives and nonfamily outsiders. The business consultant also helped the CEO form a group of key managers to provide support and leadership for a program of comprehensive change. Previously, the CEO had *never* held staff meetings for the purpose of identifying problems or developing plans for solving them. Meeting with the consultant twice a week at the outset, the group quickly focused on labor costs and decided that the company couldn't afford to hold on to skilled workers when business was slow. The group also developed a weekly and monthly forecasting system focused on assuring that the factory had only as many workers on the factory floor as were needed at that time. Given that the machinery the company built usually took six to 12 months to complete, this was actually a relatively easy task.

The management mantra became "a dollar's worth of work for a dollar of pay." While this was only a part of the overall program for change, it was a crucial one. First, it eliminated excess labor costs. Second, it reinforced the senior management team's newfound process of working together to solve problems. From there, the company tackled a variety of issues, including workforce training, new product development and incentive pay systems. One of the group's new product initiatives ultimately became the new core of the business.

It would have been difficult to predict the eventual success of the company's efforts to reduce labor costs and, eventually, revitalize the entire organization. At the same time, every thoughtful lender should have been able to recognize that the company was greatly improving its chances by taking a comprehensive approach to solving its problems.

Final Comments

Industry statistics can make a borrower's financial issues exceedingly clear. Recognizing a material variance from industry norm, however, should never be confused with an understanding of the likelihood that a company can achieve needed improvements. Put another way, industry statistics can help a lender determine if, and where, he or she has to further investigate a borrower. When such investigation is merited, the lender then has to make the best assessment possible about the company's realistic chances for true improvement. In the final analysis, the company's goals for change are important but its ability to execute those plans is far more crucial. As difficult as it may be, that's where the lender ultimately has to make the most critical evaluations.