

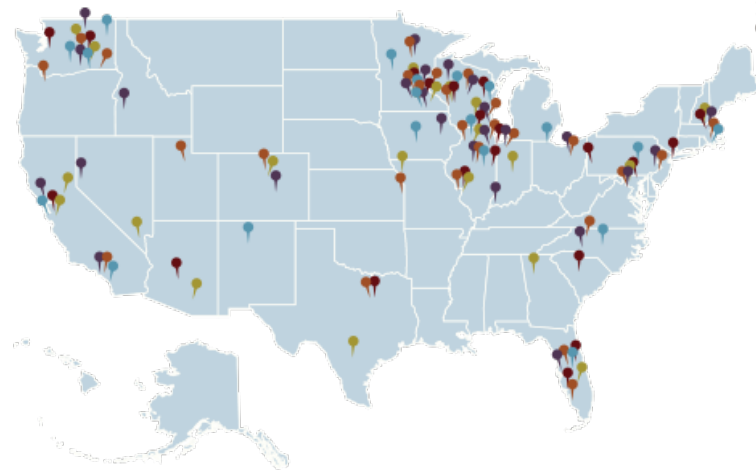
Simple Pathways to Profitability

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About CliftonLarsonAllen LLP

- Professional services firm focused on privately held businesses and their owners / leaders.
- Three integrated service lines:
 - Audit, tax and advisory
 - Wealth advisory
 - Outsourcing
- Industry specialized – we have over 400 professionals serving nearly 6,000 Manufacturing and Distribution businesses.



A Seamless Approach to Serving Clients

We *simplify the complex* and help business owners and leaders:

- *Improve profitability*
- *Reduce risk*
- *Build business value*
- *Plan for transition*

Why this topic?

Profitability is critical to long-term growth and sustainability. We struggle with profitability yet have:

- Available capacity
- Revenue concentrations
- Growing sales with no growth in profitability
- Workforce development struggles

**Our biases about how we make money
impacts all of the above!**

Keeping it simple...



The Facts

- Market price of lemonade \$.25
- Cost of Lemonade / Dixie Cups \$5 /100 cups
- Cost of Lemonade Stand \$15
- Fill rate per day / per person 100 cups
- Big Brother Extortion Labor \$1.50/Hr. (\$12/Day)
- Organized Neighborhood Labor \$1.50/Hr. (\$12/Day)

Let's see how we did...

	Stand Alone	2 Fillers	4 Fillers
Revenues:			
Price of Glass of Lemonade	\$ 0.25	\$ 0.25	\$ 0.20
Glasses Sold	100	200	400
Total Revenue	\$ 25.00	\$ 50.00	\$ 80.00
Expenses:			
Lemonade & Dixie Cups (Direct Material)	5.00	10.00	20.00
Lemonade Stand (Overhead)	15.00	15.00	15.00
Fillers (Direct Labor)	-	12.00	36.00
Total Expenses	20.00	37.00	71.00
Net Profit	\$ 5.00	\$ 13.00	\$ 9.00

The 'cost accounting' view

	Stand Alone	2 Fillers	4 Fillers
Price per Glass	\$ 0.25	\$ 0.25	\$ 0.20
Cost per Glass	0.20	0.19	0.18
Margin per Glass	0.05	0.07	0.02
Margin %	20%	26%	11%
Net Profit	\$ 5.00	\$ 13.00	\$ 9.00

Margin % in this case doesn't necessarily correlate with overall profitability. The same is true in our manufacturing, distribution or service businesses.

What is the best business model?



There are 3 drivers of profitability

- Understanding your cost structure **(Finance)**
- Understanding your capacity **(Operations)**
- Understanding your pricing **(Sales)**

To improve profitability, you must **actively manage** all 3 areas!

We have built in leadership in all 3 areas – ***working together*** can create great outcomes!

Paradigm – How much does it cost?



- Simple question
- Good intentions
- Taken too far, can lead to bad business decisions.

Industry paradigms around profitability

- Pricing drives profitability
- Costs are incurred *per job*
- The higher my job / customer gross margin, the more profitable my business

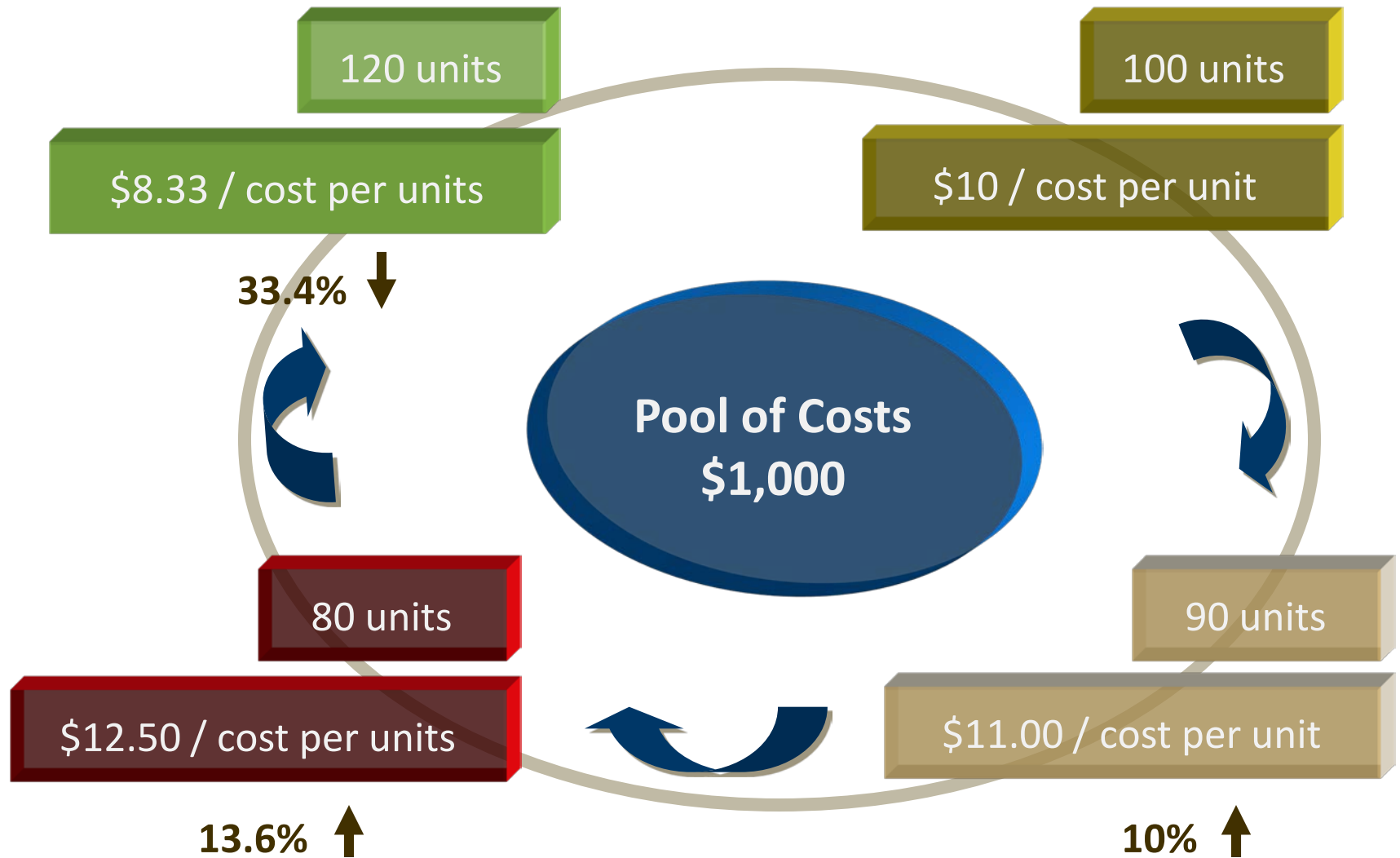
Interesting observation: Where is the paradigm around capacity management?

Impact of biases on decision making...

- High volume versus low volume / Complex versus simple
- Material intensive units are less profitable
- Follow the higher gross margin *percentage*

Do we understand the economic impact of the opportunities we are turning away (or the impact of the ones we are accepting)?

Job Costing vs. Profit Management



But Leslie, the previous examples are far too simple. In the real world, things are much more dynamic and complex!

Let's get real...

- \$31M multi-capability precision metal fabricator
- Located in a rural community
- High mix, low volume work
- Recent losses and significant variability in profitability
- Sophisticated costing system allocated costs by process / capability
- One customer accounted for 24% of volume, ***and that customer was beginning to ask a lot of questions...***

What would you do?

	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Annual Total
Sales	\$ 7,644,000	\$ 8,360,000	\$ 8,128,000	\$ 7,056,000	\$ 31,188,000
Cost of Goods Sold	(7,114,000)	(7,094,000)	(6,991,000)	(6,571,000)	(27,770,000)
Gross Margin	530,000	1,266,000	1,137,000	485,000	3,418,000
Margin %	6.9%	15.1%	14.0%	6.9%	11.0%
Selling, General & Admin Expense	(917,000)	(903,000)	(935,000)	(882,000)	(3,637,000)
Net Income	\$ (387,000)	\$ 363,000	\$ 202,000	\$ (397,000)	\$ (219,000)

Key Observation: Does this information give you the insight you need to make significant pricing, customer or operational decisions?

To improve profitability, we need to understand and manage:

- Our cost structure
- Our capacity
- Our pricing

First, let's understand the Cost Structure...

	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Annual Total
Sales	\$ 7,644,000	\$ 8,360,000	\$ 8,128,000	\$ 7,056,000	\$ 31,188,000
Materials and Subcontract	(2,984,000)	(2,975,000)	(2,897,000)	(2,407,000)	(11,263,000)
Value-Added Revenue	4,660,000	5,385,000	5,231,000	4,649,000	19,925,000
% of Revenue	61.0%	64.4%	64.4%	65.9%	63.9%
All Other Costs	5,047,000	5,022,000	5,029,000	5,046,000	20,144,000
Net Income	\$ (387,000)	\$ 363,000	\$ 202,000	\$ (397,000)	\$ (219,000)

Key Observation: Value-added revenue as a % of revenue is fairly consistent, and all other costs don't vary much with activity.

Next, let's understand capacity...

Hours Applied Each Quarter	71,000	80,000	78,000	71,000	300,000
Hours of Capacity Available	87,500	87,500	87,500	87,500	350,000
% Utilization	81.1%	91.4%	89.1%	81.1%	85.7%

Key Observation: Each quarter the Company operated with excess capacity. Said another way, the Company paid for capacity (people, plant, equipment) that it never used (and the customer was not willing to pay for).

And last, let's understand pricing...

	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Annual Total
Sales	\$ 7,644,000	\$ 8,360,000	\$ 8,128,000	\$ 7,056,000	\$ 31,188,000
Materials and	(2,984,000)	(2,975,000)	(2,897,000)	(2,407,000)	(11,263,000)
Value-Added Revenue	4,660,000	5,385,000	5,231,000	4,649,000	19,925,000
Hours Applied Each Quarter	71,000	80,000	78,000	71,000	300,000
Earned Rate per Hour	\$ 65.63	\$ 67.31	\$ 67.06	\$ 65.48	\$ 66.42

Key Observation: The Company's earned rate per hour was well above what they thought they were quoting, and surprisingly consistent given the high variety of work they were performing.

Once they understood their cost structure, capacity and pricing, they drilled down to look at a customer level and saw some surprising trends...

Customer Gross Margin vs. Earned Rate / Hr

	Revenue	Gross Margin	Margin %	Value-Added Revenue	Earned Rate Per Hr
Customer 1	\$ 7,620,475	\$ 1,915,003	25%	\$ 4,853,289	\$ 60.03
Customer 2	1,364,085	358,733	26%	754,475	69.60
Customer 3	1,773,321	(726,734)	-41%	1,182,914	66.29
Customer 4	1,375,876	(528,337)	-38%	726,278	65.89
Customer 5	1,077,883	(133,331)	-12%	638,871	80.09
Customer 6	786,459	104,248	13%	546,226	60.40
Customer 7	824,034	(42,199)	-5%	535,289	49.45
Customer 8	818,278	(186,552)	-23%	477,579	54.37
Customer 9	653,683	117,218	18%	457,654	62.65
Customer 10	696,180	(15,667)	-2%	453,910	67.08

Key Observation: Very little correlation between margin % and earned rate per hour. Negative / low margins were driven by material mark-up that *artificially* increased costs (and margin).

So what did they do?

- Immediately began analyzing quoting differently
 - Earned rate per hour along with margin %
 - High material content jobs were a focus
- Focus was on filling the shop
 - Capacity was actively monitored in each location and compared with backlog / active demand
 - Targeted areas that were perpetually underutilized
- Reduced certain cost structure (excess warehouse space)
- Targeted expanding relationships with existing customers

The results were pretty impressive...

	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Annual Total
Sales	\$ 8,505,200	\$ 9,943,343	\$ 9,552,661	\$ 9,229,134	\$ 37,230,338
Materials and	(3,154,737)	(3,776,276)	(3,808,129)	(4,066,854)	(14,805,996)
Value-Added	5,350,463	6,167,067	5,744,532	5,162,280	22,424,342
% of Revenue	62.9%	62.0%	60.1%	55.9%	60.2%
All Other Costs	4,836,299	5,121,615	4,872,906	4,392,707	19,223,527
Net Income	\$ 514,164	\$ 1,045,452	\$ 871,626	\$ 769,573	\$ 3,200,815
Hours Applied Each Quarter	83,072	96,446	89,878	84,842	354,238
Earned Rate per Hour	\$ 64.41	\$ 63.94	\$ 63.91	\$ 60.85	\$ 63.30

Lessons Learned

- **Simplifying** the process for managing profitability can make information much more *meaningful and manageable*
- How did they do it?
 - Understood their **cost structure**
 - Understood their **capacity**
 - Understood their **pricing**
- This took a team effort – **finance, sales and operations** working as a team to take advantage of opportunity

Common signs of significant opportunity...

- “I don’t know how my competitors can produce it so cheaply. They must be losing their shirts on it.”
- “We tend to focus on the complicated, highly engineered products, because we can’t make money on the easy stuff.”
 - “We won’t take any business that doesn’t have at least a XX% gross margin.”
- “We need to keep investing in bigger and faster equipment to drive costs down.”
- “Monthly financials are hard to interpret and never seem to correlate with activity on the floor.”
- “Sales, finance and operations all seem to have different opinions on what is profitable work.”

Now, let's try a live example!

You are the Owner / CEO of your shop

- \$12M business
- 65% concentration in automotive industry
- Significant volatility
 - Lost \$1.5M in 2009, made \$580k in 2012
- Very unique capabilities
 - People are hard to find
 - Most profitable work is in limited supply
- Lots of available capacity, but generally in more simple processing capabilities
- ***You need to improve profitability in order to retire!***

Gross Margin View – What Decisions Do I Make?

Customer	Revenue	Gross Margin	Hours	Subcontract	Direct Material
A	\$ 2,535,036	41%	10,597	\$ 313,645	\$ 586,950
B	1,749,424	24%	10,783	2,002	770,644
C	1,164,645	16%	2,792	190,207	664,186
D	718,895	21%	4,081	144,181	364,399
E	611,200	19%	13,617	76,301	228,678
F	552,319	13%	7,472	3,357	314,939
G	248,530	37%	1,583	81,587	43,741
H	246,466	37%	1,886	8,263	69,797
I	294,883	4%	329	34,567	173,789
J	237,768	35%	1,183	23,707	100,598
K	179,197	42%	539	24,220	84,275
L	187,651	29%	1,809	11,898	87,476
M	234,299	26%	508	20,556	52,330
N	192,254	35%	1,759	643	65,607
All Others	3,049,128		25,429	389,496	794,599
Totals	\$ 12,201,694	21%	84,367	\$ 1,324,631	\$ 4,402,006

Value-Added View – Do I See New Opportunities?

Customer	Revenue	Gross Margin	Hours	Subcontract	Direct Material	Value-Added	Value-Added per Hour
A	\$ 2,535,036	41%	10,597	\$ 313,645	\$ 586,950	\$ 1,634,441	\$ 154.24
B	1,749,424	24%	10,783	2,002	770,644	976,777	90.58
C	1,164,645	16%	2,792	190,207	664,186	310,251	111.12
D	718,895	21%	4,081	144,181	364,399	210,315	51.54
E	611,200	19%	13,617	76,301	228,678	306,220	22.49
F	552,319	13%	7,472	3,357	314,939	234,024	31.32
G	248,530	37%	1,583	81,587	43,741	123,202	77.83
H	246,466	37%	1,886	8,263	69,797	168,405	89.29
I	294,883	4%	329	34,567	173,789	86,528	263.00
J	237,768	35%	1,183	23,707	100,598	113,464	95.91
K	179,197	42%	539	24,220	84,275	70,702	131.17
L	187,651	29%	1,809	11,898	87,476	88,277	48.80
M	234,299	26%	508	20,556	52,330	161,414	317.74
N	192,254	35%	1,759	643	65,607	126,004	71.63
All Others	3,049,128		25,429	389,496	794,599	1,865,032	73.34
Totals	\$ 12,201,694	21%	84,367	\$ 1,324,631	\$ 4,402,006	\$ 6,475,056	\$ 76.75

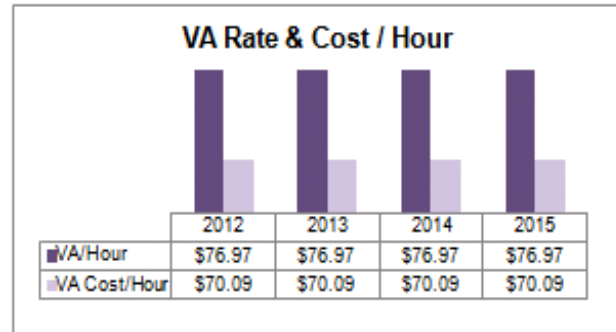
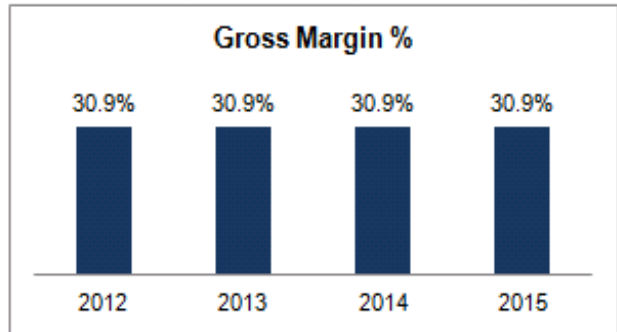
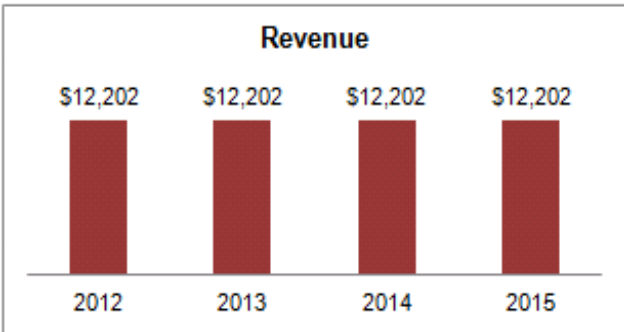
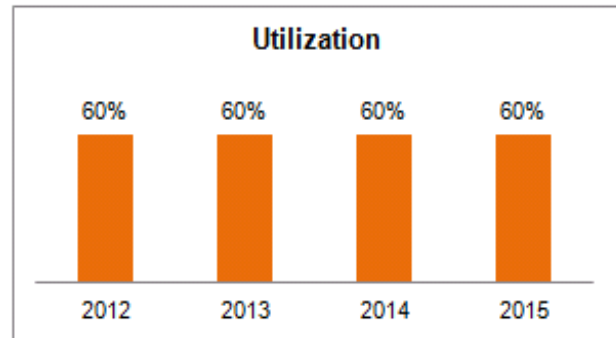
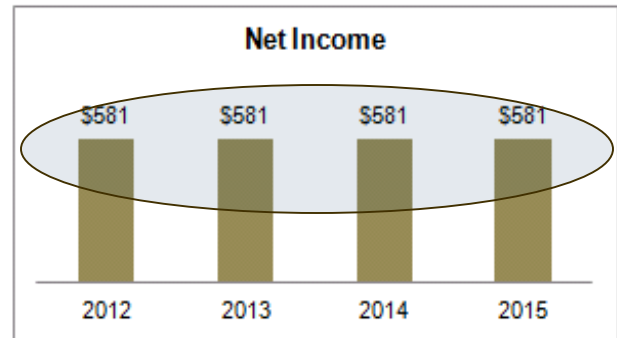
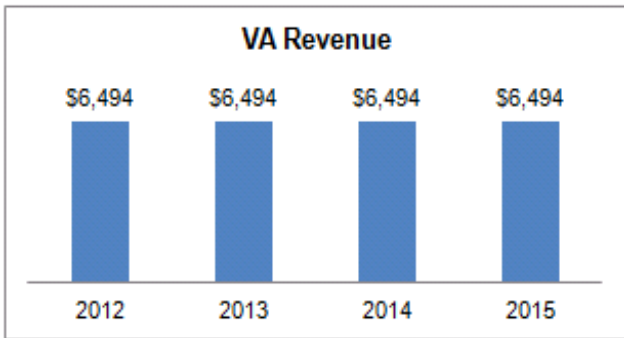
Value-Added Analysis – Same Company

Current-Year Facts

# of Hours	84,367
Total Capacity	140,612
Revenue / Hour	\$145
Material / Hour	\$68
Subcontract Exp / Hour	\$0
Labor / Hour	\$24
Value-Add / Hour	\$76.97

Future-State Scenario

Sales Assumptions:		Variable Cost Assumptions:		Infrastructure Cost Assumptions:	
Add'l Hours /Year	0	Add'l Labor costs/Hour	\$0	Add'l Salaries & Wages (,000)	\$0
Pricing approach	Value-Add	Add'l Subcontract costs/Hour	\$0	Capital Investment (,000)	\$0
VA Rate on Add'l Hours	\$76.97	Other add'l costs/Hour	\$0	Depreciation Life (Years)	0
Annual or One-Time?	Annual			Add'l Hours of capacity	0
				Incurred in which year?	2013



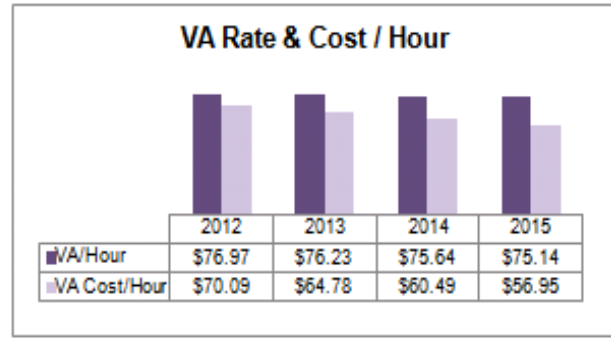
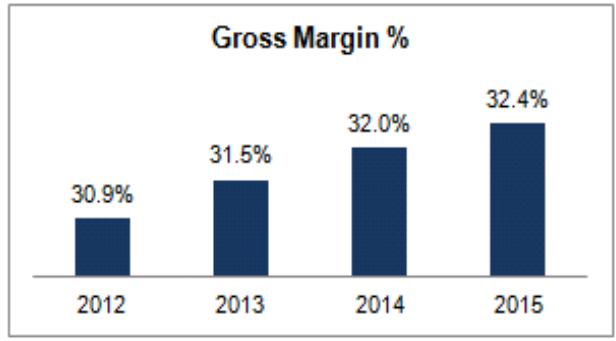
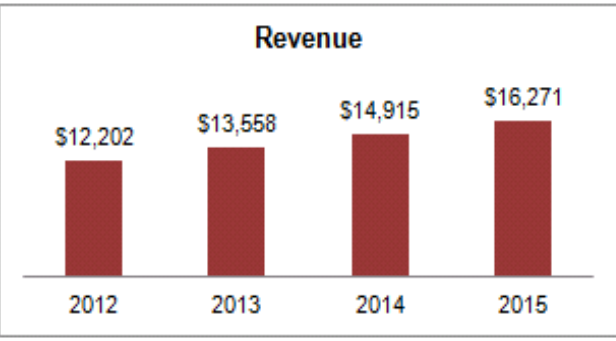
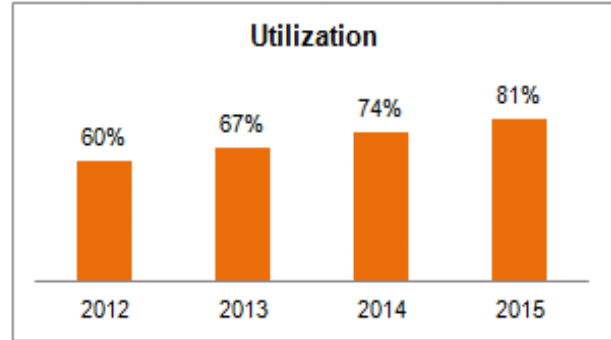
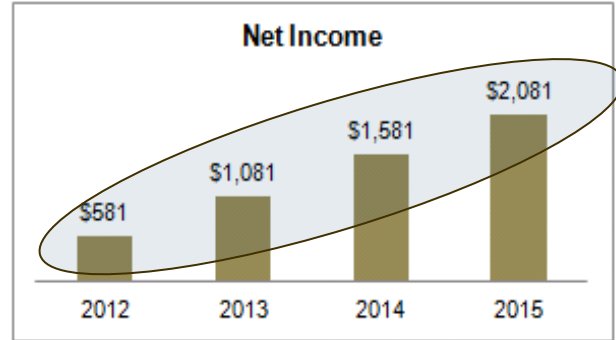
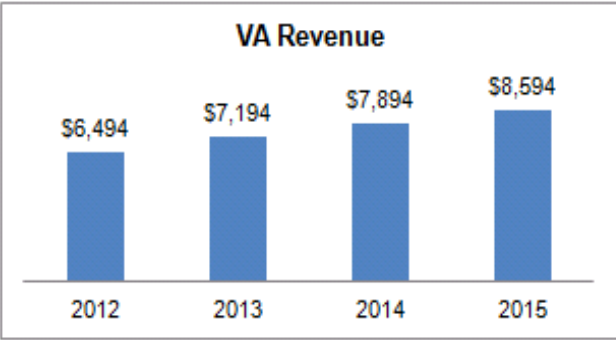
Same Company – at Full Capacity

Current-Year Facts	
# of Hours	84,367
Total Capacity	140,612
Revenue / Hour	\$145
Material / Hour	\$68
Subcontract Exp / Hour	\$0
Labor / Hour	\$24
Value-Add / Hour	\$76.97

Future-State Scenario	
Sales Assumptions:	
Add'l Hours /Year	10,000
Pricing approach	Value-Add
VA Rate on Add'l Hours	\$70.00
Annual or One-Time?	Annual

Variable Cost Assumptions:	
Add'l Labor costs/Hour	\$20
Add'l Subcontract costs/Hour	\$0
Other add'l costs/Hour	\$0

Infrastructure Cost Assumptions:	
Add'l Salaries & Wages (,000)	\$0
Capital Investment (,000)	\$0
Depreciation Life (Years)	0
Add'l Hours of capacity	0
Incurred in which year?	2013



Now, it's your turn...

- Bring your team together and share what you learned!
- We want you to go back to your shop and do the following (using the example case study provided)
 - ***Understand your cost structure***
 - ◇ Value-added revenue vs. all other costs
 - ***Understand your capacity***
 - ◇ Hours applied vs. actual hours
 - ***Understand your pricing***
 - ◇ Divide value-added revenue by the actual hours
 - ***Drill down***
 - ◇ Look at the information by product line or customer
- Act on what you learn!

Final Thoughts...

- Your business is much more complex than a lemonade stand, but your profitability model is not
- The three keys to improving profitability
 - Understand your **cost structure**
 - Understand your **capacity**
 - Understand your **pricing**
- Improving profitability is a team sport – ***sales, operations and finance*** work together to win!



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