

Structural Inefficiencies Can Cripple Your Borrower

By Gerald M. Sherman

A better understanding of structural inefficiencies can lead to both more booked business and fewer problem loans.

During their careers, most lenders analyze countless borrowers across a broad range of industries. To make the task manageable, fundamental credit analysis techniques have evolved. Financial statements are spread, a borrower or prospect's trends are identified, their ratios are compared to industry norms, and the lenders and analysts involved talk about strengths and weaknesses. While generally effective, this approach has a subtle but significant weakness. Specifically many, perhaps most, lenders believe that *knowing* what a company's financial statements should look like is virtually the same as knowing how to correct the problem. While this might sound naïve, it's not really that difficult to understand. Relatively few lenders have spent substantial time working for an operating company. Accordingly, it's reasonable to expect that many don't have the experience or training to go easily beyond the numbers and assess effectively the impediments a company may have to overcome to improve its long-term profitability.

This article, focusing on the issue of "structural inefficiencies," is the first in a series that will focus on various operating challenges where a lender has to go beyond the numbers to develop a solid understanding of a borrower or prospect. For the purpose of this article, structural inefficiencies exist when a company's internal operations leave it incapable of performing close to or at industry norms. For a number of reasons, every lender needs to be keenly aware of this area. First, structural inefficiencies can leave a borrower or prospect literally incapable of delivering the financial performance it needs. Second, even for an experienced lender, structural inefficiencies can be difficult to identify. Third, an enhanced ability to assess if a company is taking the steps needed to

address structural inefficiencies or, conversely, if it's not, will serve every lender well.

Several case studies will illustrate various aspects of this issue, and suggestions will be offered about where and how to go beyond the numbers to assess the likelihood that a borrower or prospect is hampered by significant structural inefficiencies.

Case 1: Import/Distribution Nightmare

This 25-year-old importer and distributor of decorative home accessories had been stagnant for a number of years with sales declining from about \$42 million to \$38 million annually over a five-year period. To maintain modest profitability, the owner/CEO had cut his salary 55 percent over a three-year period.

The owner/CEO was an old-school, strongly authoritarian, hands-on manager. He placed his desk in the middle of the operations and customer service area and stayed on top of every aspect of the business. He was very late to adopt any form of computerization and, tellingly, average sales per worker were only about 75 percent of industry norm. Further, selling, general and administrative (SG&A) expense was about 42.5 percent of sales versus the industry norm of 39 percent. Fortunately, the balance sheet continued to be relatively strong and the company borrowed on a conservative basis.

A financial review of the company suggested that even with flat sales, the company could regain ad-

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equate profitability by bringing manufacturing and SG&A expense in line with the industry. As problems go, this would appear relatively easy to correct.

Beyond the Numbers

A key challenge for the company was the detail-intensive nature of the business, as many orders included 200 distinct SKUs (“stock-keeping units”) or more. Further, for most orders, some of the SKUs would be in stock and others would typically have to be special ordered. To make it even more complicated, some of the special-order SKUs would require finishing by an outside contractor after receipt from the Far East. On an overall basis, it took an extraordinary amount of coordination and attention to detail to fill an order.

The key element of the company’s structural inefficiency was an inadequate systems infrastructure.

Information for each order in process was maintained on paper in a central filing area known as the “tubs.” Further, the company didn’t maintain a complete, perpetual inventory system. In fact, the inventory was maintained on four *different* systems that weren’t integrated. To

coordinate the entire process, the company needed a team of 12 customer service representatives. To assemble a complete and accurate order, each rep would have to get up and walk to the tubs on numerous occasions. He or she would also have to place numerous phone calls or e-mails to check the status of SKUs in transit. Finally, because numerous people used the central file while each order was in process, an extraordinary amount of time was spent searching for the file on an order when it wasn’t in the tubs.

To get costs to within industry standards, three major changes would be required. First, the overall work flow needed to be reengineered. Second, an entirely new systems infrastructure for storing information electronically had to be developed. Third, the majority of supervisory, customer service and warehouse personnel would have to be retrained, or replaced, in order to work effectively in an upgraded environment.

While it would be readily apparent to a reasonably experienced and knowledgeable lender that the company did not use state-of-the-art practices, the extent of the problem would be very difficult to identify without a clear reason to look further.

Case 2: Growing Sales + Insufficient Infrastructure = Increasing Losses

This \$140 million manufacturer of capital equipment was a leader in its field, the third largest in the United States. It experienced its first significant loss in 2004, \$2 million, and continued to lose money in 2005. Management blamed the loss on rapidly increasing steel costs that the company could not, contractually, pass on to customers. A review of the company’s financials suggested that the gross margin was at

least five percent (of sales) below its primary competitors and that SG&A was at least three percent (of sales) higher. A one-and-a-half to two percent (of sales) improvement in both gross margin and SG&A would bring the company back to modest profitability. Given

that raw material price protection was being built into new contracts, a gross margin improvement in this range would appear attainable. Beyond that, it would appear reasonable to believe that a serious cost-reduction effort would be able to do the job.

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Beyond the Numbers

This labor-intensive company’s manufacturing practices were outdated and out of control. Having started in business as an equipment reseller, management was not at all sophisticated on the manufacturing floor. The company’s weaknesses, when compared to an efficient equipment builder, were staggering. The company had no labor standards against which to measure labor efficiency; used unreliable data to develop contract quotes; did not track actual labor time accurately; did not accumulate cost data on a real-time basis; provided

no incentives to workers for strong productivity; and did not hold workers accountable for either weak production or substandard quality.

Making the situation immeasurably worse, the company's systems infrastructure could not support the information needs of an efficient manufacturer. Accordingly, to address the manufacturing cost issue comprehensively, the company had to begin by developing a systems infrastructure that could support data requirements. This alone would take the better part of a year and more than \$400,000. Further, once the system was onstream, it would likely take months to get the workers trained to use it effectively.

The company's materials management systems were also totally insufficient. It was difficult to determine where needed raw materials were located or even if they were in stock. In addition, purchasing practices were also substandard, in significant part because purchasing agents often had to place orders on a last-minute, small-quantity basis. This made it impossible for the company to negotiate appropriate, let alone advantageous, pricing.

Management compensated for the systems infrastructure inadequacies and substandard materials management, in part, by throwing people at the problem. As a result, payroll costs in both manufacturing and SG&A were substantially above average, and there was no short-term way to reduce them. For example, between 10 and 15 parts runners were used daily to shuttle materials between the company's 14 separate production buildings spread out over a sprawling rural site. In short, the company was truly incapable of materially improving its cost structure in the near term. Realistically, the best it could do would be to save where it could and commit to the improvements necessary to support efficient operations.

Overcoming Structural Inefficiencies

In these two cases, company ownership had only a limited appreciation of the challenges it was facing

and was effectively doing nothing to address them. With an appreciation of this, a lender could correctly assume that financial performance wouldn't improve appreciably in the foreseeable future. At the same time, many companies do recognize the structural issues they have and work effectively to address them. Just as it is important for a lender to recognize when little is being done, it is important to recognize when a company is undertaking an effective improvement program. Sometimes, a company's fate can rest with the assessment of its lender.

Case 3: Comprehensive Change Saves a Defense Contractor

This defense contractor had won a major contract to manufacture the new generation of load-carrying packs used by U.S. infantry soldiers. After the first year of production, the company's gross margin was

three percent of sales, 20 percentage points lower than what had been estimated in the company's contract costing. Given that the company prided itself on being a highly efficient manufacturer in its five plants, it appeared that it had made a huge pricing

mistake. With severely depleted capital and the expectation of continued losses due to this contract, the company's future was in severe doubt. Furthermore, the bank was highly skeptical about the likelihood of a turnaround and reluctant to extend the company's line of credit.

Beyond the Numbers

Due to contractual commitments, pricing could not be altered. Accordingly, the company's only hope was to find ways to manufacture more efficiently. To accomplish this, over the protests of the CEO/head of manufacturing, the company's board authorized the retention of a leading consultant who was highly experienced in this area of manufacturing. With his help, the bank was convinced to wait until he completed an assessment of the situation.

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Within two weeks, he had identified efficiencies that would enable the company to fulfill the balance of the contract profitably. Given this information, and again with the consultant's help, the company convinced the bank that it was prudent to continue its financial relationship and extend the company's line of credit.

To gain needed efficiencies, four critical initiatives were undertaken:

- **Redesign of work flow and reengineering of assembly processes.** The company used a traditional assembly-line work flow structure. The consultant recommended adoption of a "modular manufacturing" design where groups of work teams take responsibility for various sections of the product. The consultant also was able to reengineer many aspects of the actual production process. For example, an assembly step that previously took 90 seconds could sometimes be reduced to 45 seconds or less.
- **Redesign of incentive compensation systems.** A critical aspect of modular manufacturing is the payment of incentives to *the team, not the individuals*, for meeting or exceeding production goals. This strategy relies heavily on peer pressure and assistance to motivate and support less productive team members.
- **Establishment of new labor standards.** The head of manufacturing, who also happened to be the company CEO, was very concerned about maintaining his labor force of factory workers. As a result, he had established artificially low labor standards, which allowed the workers to easily qualify for incentive payments on top of their base hourly wage. This strategy guaranteed that labor costs would exceed budget. The consultant conducted time studies and established appropriate labor standards. By then helping workers to meet or exceed the new standards, the company could keep labor costs within appropriate parameters.
- **Enhanced training.** To perform effectively within this new manufacturing environment, substantial training was required at both the factory floor and supervisory levels. The supervisors were a particular challenge because they generally considered the new labor standards to be too demanding. First, they had to be trained to understand them. Once that was accomplished,

the supervisors were trained in the new assembly techniques as well as in how to supervise in the reengineered environment. The factory workers then had to learn the new methods for completing tasks and reorient themselves to a team approach.

Within 12 months, gross margin was increased to 23 percent (of sales), precisely what the company's contract costing originally estimated. As a result, the company regained both profitability and the renewed confidence of its bank. It's important to note that the CEO/head of manufacturing was terminated during the early stages of the reengineering project. He was firmly rooted in antiquated manufacturing practices, did not recognize that new strategies were available and would not embrace them. It's also important to note that the steps taken to complete this reengineering effort required virtually no investment in capital equipment. The issue wasn't an outdated physical plant. Rather, the issue was an outdated approach to how it was used. The reengineering project did require a substantial investment in consulting and engineering as well as management time. But the total investment for this 600-person company was less than \$450,000.

Four years after starting the program, the company's annual sales had grown from \$39 million to \$90 million. More important, pretax profit had grown to \$14 million—more than 15 percent of sales!

Beyond the Numbers: What to Look for

The problem of structural inefficiency is more common than many may think, and the first indicator is a history of chronic underperformance. Therefore, it's critical to develop an understanding of why a company hasn't been able to sustain adequate profitability. This presents a challenge because many borrowers simply don't realize they're being hampered by fundamental structural inefficiencies. Beyond this, many borrowers are reticent to discuss these problems, even if they are aware of them. When confronted with the prospect of structural issues at a borrower or prospect, a scan of competitors is often an effective place to start. If, for example, several competitors have significantly more modern facilities, the problem may be clear. In

addition, a review of industry or trade association publications may also provide important information about trends or new technologies the company is or is not embracing.

Ownership and senior management is the other key area to consider when assessing whether or not a company is structurally inefficient. Some companies may not have the resources to invest for the future but, more typically, management lacks the foresight. Given that most owners and senior managers think they have foresight, it's more important to consider their actions than their words. An objective review of a company's key decisions (or nondecisions) about facilities, capital equipment, systems infrastructure and human resources should provide a very good indication of where a company really stands. It can be difficult to get owners and senior management to be forthcoming about these decisions, but consistent probing can usually help a lender develop basic information. Sometimes, the best strategy is to pose questions that appear to be benign but can get at an important issue. For example, a casual question during a facilities tour about the age of a machine or the adoption of a systems upgrade might yield important information.

On many occasions, a lender or prospective lender for a company struggling with these issues will be presented with the company's proposed program for improvement. While it can be a daunting task to assess such a program, there are two aspects to consider initially. First, there needs to be total commitment from the very top of the organization. In a significant number of situations, management may say it is committed but either is not or does not fully understand what that commitment will require. The best way to determine the strength of management's commitment is to learn about success with prior major corporate initiatives. Generally, history will repeat itself, both positively and negatively. Sec-

ond, the company has to be able to present a very detailed and realistic plan for tackling its issues. As with many business challenges, significant changes in efficiencies will generally take longer and cost more than one might expect. A management team with highly optimistic expectations just might not have the capability to deliver.

It's also important to note that systems inefficiencies are not limited to manufacturers and distributors. As a practical matter, they can be found in any type of company. Service companies, technology companies, nonprofits, *etc.*—no area is immune by definition.

What Underlying Issues Are Driving a Borrower's Ratios and Trends?

Confronted by a company with significant structural inefficiencies, a knowledgeable lender will most likely conclude that improved performance can only happen when those inefficiencies are addressed. Conversely, by thoughtfully reviewing a company's plan for improvements, a lender may be able to gain confidence that a borrower or prospect will be able to do better in the future. To assess this issue clearly, every lender will be well served to look beyond traditional ratio and trend analysis and try to understand the underlying issues that are driving those ratios and trends. In some cases, more discipline and a clearer focus on cost control might be the answer. In most, however, the solution just might not be that easy. It takes hard work and experience for a lender to go beyond the numbers effectively. Nonetheless, the payoff can be substantial in terms of both more booked business and fewer problem loans.

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