THE PROACTION GROUP LLC

Identifying Operational Opportunities to Reduce Fixed Costs During Due Diligence

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The M&A Chicago Expert Author Series®

A $110 million revenue client was busting at the seams, operating two plants and they didn't have room for planned acquisition growth. They hired a well-known engineering firm to design a new, third plant that would prepare them to handle organic growth and to expand their product platform through an acquisition. When the price tag for the investment reached $40 million, our client decided to take another look at how they operate the plants and to evaluate less capital intensive options. Our client allowed us to review their facilities, capacity and foot print. We found significant opportunities to increase throughput, free up space and to move, or eliminate, monuments that limited the use of space.

In fact, combined, these improvements did free up enough space to allow our client to consolidate both current plants into an existing plant, and provided the room needed to acquire the new business and fold the volume into the existing facility.

In this article we will share with you the signs we look for that indicate a company may be able to consolidate facilities, reduce space requirements, or otherwise reduce fixed costs.

We can have a long semantic debate about the line between fixed and variable costs. Largely speaking, we are looking at costs that do not change, in the short term, based on customer demand. Examples might include the costs of facilities, base labor (not including temporaries or overtime), equipment, long term leases, IT systems, and general & administrative costs. The benefits of improving fixed costs are fairly simple, but can shift a company's ability to serve a market, weather tough times and provide a return to shareholders. We often find our clients can:

These are the seven buckets:

1. **Throughput.** Can we increase the output of a plant, office, service location, or other facility?
2. **Variable Costs.** Can we reduce the costs directly tied to our volume and revenues?
3. **Fixed Costs.** Can we reduce the costs that do not change in the short term, based on customer demand?
4. **Order to Cash Cycle.** Can we shrink the time between investment on our part and collection from our customers?
5. **Asset Utilization.** Can we increase inventory turns, the use of plant equipment, or the use of facilities?
6. **Pricing.** Can we collect more revenue for the services we are providing?
7. **Risk.** How can we reduce risks related to running our business?

When we look at fixed costs, we are often looking for ways to help a company:

- Reduce labor costs (beyond overtime and temporary labor)
- Consolidate Facilities / reduce floor space required
- Access / leverage low cost country resources
- Adjust their cost infrastructure to make it commensurate with the company's position in the market
- Developing effective strategies for managing the total cost of risk (TCOR)

This article will focus on the signs that can indicate that a company has a fixed cost structure that does not effectively reflect their business volumes and model. The following indicators show the items we look for in our initial due diligence site visits. If any of the following are true, your company very likely has the ability to make meaningful improvements in fixed costs, investments in property, plant and equipment, total cost of risk and EBITDA.

Indicator	What it can mean
The company has more locations than strictly needed to serve current customers	Companies often have more facilities, or space, than they need to serve their customers. Warehouses can come with an acquisition. Customers can require a facility be maintained to support their operations. A company manager might be comfortable operating on a large investment in inventory (you can't sell from an empty cart!!). Build multiple such scenarios over time and you will have a foot print no one would design from scratch. A quick and dirty sketch of the current distribution network will show any duplicate locations and will provide the motivation for additional investigation.
The company does not utilize make vs. buy decisions	Often, there is a substantial benefit to make something you buy, or to buy something you make. In some cases, you have the scale to justify expanding your fixed cost base, and at other times your suppliers offer a cost structure that beats your own. If the company does document make vs. buy decisions, there may very well be an opportunity.
Signs exist (see article 2) that indicate the opportunity to increase throughput	We have seen productivity increases lead to the opportunity to remove a line or retire older equipment. An increase in throughput, or capacity, can be used to satisfy increased demand. It can also be used, if demand is flat, to reduce the space needed to fill current order volume. If you see work in process inventory, high scrap levels, rework, downtime, inconsistent line speeds, and / or growing excess and obsolete inventory levels, opportunities exist to increase output.
Overproduction	As discussed in an earlier article, "Overproduction" is the most heinous of the 7 types of waste. When this waste is addressed, sometimes the result is excess equipment or inactive lines. The opportunity that exists here is equipment to incorporate additional flexibility into the operation by utilizing this it into dedicated lines and move the people as the schedule demands. Additionally, if flexibility or increased demand isn't emanate, sale of these assets can generate cash.
No recent 5S red tag event	In a "5S red tag" event, a company goes through every operation and every square foot of space within a facility and tags any item that is not currently needed to fill orders. Any such item is then collected and quarantined for a period of time. If the item is not needed, then is it dealt with appropriately. Effective red tag events often find materials, tools and equipment that people are used to seeing and have not questioned. If the company has not recently moved or held such an event, there will be a surprising amount of space that can be freed up .

Indicator	What it can mean
No recent work balancing calculation	Work balancing is a lean manufacturing concept. Balancing work on a manufacturing line, or any operation with repetitive tasks, leads to assigning work to each person or machine such that each operation is completed in the same or balanced cycle time. Work balancing reduces work in process and ensures that everyone is working at the same pace. In fact at the pace set by customer demand (also known as Takt time). In completing this process we often find significant improvements in output and productivity. If this calculation has not been completed and documented, there is reason to dig deeper!
The company operates more than one IT system	When a company operates "more than one IT system", it generally indicates cumbersome, wasteful, inefficient and customer unfriendly processes. Legacy systems can be effective for the company that does the acquiring, but the acquired companies have their own IT systems and integration can be costly, yet very often required to leverage the potential of the 'new company' platform.

Here are some recent historical examples of fixed cost improvements that sprouted from observing indicators like those described above.

- After a quick review of the distribution network and an evaluation of the use of warehouse space, one client eliminated 250,000 square feet consolidated 2 facilities
- An international seafood distribution company reduced their distribution network costs by 15% (over $4 million) without consolidating any facilities!
- A heavy duty machining company implemented a series of lean improvements that increased EBITDA from 33% to 36%, and, in the process, was able to acquire a new company and absorb the volume into plants which, prior to the improvements, were considered overcapacity.
- A consumer products company was looking to build a new plant after landing two new accounts and doubling their volume! After identifying and implementing the potential to improve throughput in their existing plant, the company was able to satisfy all demand in the current facility with existing staff and equipment (within 2 months!!).
- This automotive, tier 2 supplier, needed to ramp up production to handle contingency volumes that would come if another plant went on strike. They had to increase throughput by 200% in existing space within 3 months. A combination of improved production scheduling (which eliminated over production), work balancing to takt time and a 5S red tag event delivered the needed improvement!

There are hundreds of examples like these. Look for these indicators. When you find them, it is time to investigate and take action!

In our next article we will look at indicators that the order to cash cycle can be improved. What signs indicate that we can we shrink the time between investment on our part and collection from our customers?

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If you have any questions or requests, please feel free to contact me at
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