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Identifying Operational Opportunities to Increase Asset Utilization During Due Diligence

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A few years ago we conducted a diagnostic review for a large commodity manufacturing and distribution client. They had a fleet of hundreds of rail cars and contracts with many rail roads. Most of our time was spent reviewing and benchmarking the rail contracts and rates. As we asked questions about their processes, metrics and reports, we found that they tracked the utilization rate of their rail car fleet. The report showed a 100% utilization rate. Naturally, this seemed too good to be true. So we talked to the manager and asked how the utilization rate was calculated. We were anticipating that they tracked loaded ton miles vs. a standard, or something similar. Instead, we found that they tracked whether each rail car was used in a month. They had 213 rail cars, and they had 213 loads in the month, so their utilization was 100%. This discovery led to a process review and, eventually, process improvements that allowed the company to reduce their fleet by 70%. This reduction did not diminish customer service levels. The excess rail cars were the result of a loose process and a lack of thoughtful oversight. The new improved process allowed the company to stop incurring non-value adding expenses.

This is the eighth and final article in our series on Identifying Opportunities to Improve Operations, and it focuses on identifying opportunities to improve asset utilization. We have divided the opportunities to increase the market capitalization of a company into seven value lever buckets. For each area we describe the signs we look for that indicate the company can improve their financial performance, position in the market and their enterprise value. In other words, we are highlighting points you want to know BEFORE you buy the company; things that expose opportunities to increase EBITDA, capacity and asset utilization.

The Seven Value Levers include:

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. Pricing. Can we collect more revenue for the services we are providing?
6. Risk. How can we reduce risks related to running our business?
7. **Asset Utilization. Can we increase inventory turns, the use of plant equipment, or the use of facilities?**

A company leverages its assets to create and fulfill customer demand. In this section, we are looking for indications that the company can increase EBITDA, decrease working capital and increase return on capital through:

- Consolidating facilities
- Increasing turns on inventory
- Realizing more revenue and throughput from existing assets and equipment
- Reducing days of sales outstanding in Accounts Receivable

- Tapping the latent capabilities of the existing IT system
- Rationalizing private fleets and other fixed costs vs. outsourcing / variable cost alternatives

This is a powerful topic. Often, risks are not readily visible above the surface to the naked eye. We need to look for the following indicators that could show a company is susceptible to the risks listed above.

Indicator	What it can mean
No documented make vs. buy analysis	Often, there is a substantial added 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 not document make vs. buy decisions, there may very well be an opportunity.
No documented distribution network design analysis	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!!). Compound 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.
Does the company turn inventory among the top performers in their industry?	We cannot collect revenues from a customer we have not invoiced. Similarly, every day an item sits in inventory, it is not being invoiced to a customer. Since "good" inventory turn levels vary by industry, comparing the company to competitors provides a good benchmark.
The company controls the release of inbound raw materials.	In the article on Variable costs we explored sourcing approaches that indicate opportunities to reduce variable costs. In addition to managing variable costs, value added sourcing agreements can provide for inventory programs, consignment inventory, smaller minimum order quantities, block scheduling, demand forecast and production schedule sharing and other terms that can reduce inventory. Not only do we may reduce the amount of inventory we have to carry, but we can shift some of the inventory to our suppliers' financials.
The company conducts a physical inventory. Part One.	Banks tend to require that physical inventories be taken when the company demonstrates that their perpetual inventory is not, or may not be accurate. If they have solid inventory controls in place and conduct cycle counts, then the bank will rely on the perpetual inventory. If the bank is not comfortable, then we look closely at how well the record inventory transactions, how well they use their system and how they physically control the materials. The short story is, if the company does not know what they have in inventory, they will inevitably hold more than they need. When this happens, the extra working capital required is the least of the company's problems; it is the tip of the iceberg. See the section on IT below for a painful example of a major issue that results in the bank requiring a physical inventory.
The company conducts a physical inventory. Part Two.	ERP and MRP systems, at one level, are very simple. If you have an accurate bill of materials (BOMs), accurate routings, and an accurate perpetual inventory, a competent system will provide good triggers to help you run your business. This is a proven path. MRP systems only work if your BOMs are accurate and if your perpetual inventory is accurate. If either is wrong the system will suggest purchases and inventory moves that are WRONG. This will lead to increases in inventory and space requirements. This will lead to lower order fulfillment rates. In the words of Dr. Vinkman, this would be bad. It is a gift that keeps giving. You increase your inventory investment and you lose sales.
Joe needs a walkie talkie.	We visited a warehouse and asked the front desk clerk, Joe, what he needed to do his job better. How could we help? He thought for a minute and brightened and asked for a walke talkie. How would that help? Joe explained that when a customer comes in and asks for a specific part, he looks it up on the computer and sees if it is in stock. Then he walks back into the warehouse to see if it is actually there. If he had a walkie talkie, then he could have someone else check so he wouldn't have to leave the customer at the counter. We have found that poor inventory transaction processes lead to inaccurate inventories and to underutilized IT systems.
They have a private fleet	Manufacturing and distribution companies cannot compete with the cost structure of transportation companies. Dedicated freight companies have the scale to buy assets more effectively, to recruit and train drivers and to maintain the vehicles. If the company has a private fleet, dive in deep to find out why. It is often a relief valve to make up for poor processes in other areas of the company, or is a relic kept around to "serve the customer".

Indicator	What it can mean
They do not measure asset / equipment utilization	If it isn't measured, it is not done well consistently. Period.
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 .
Are days of sales outstanding (DSO) in accounts receivable better than industry norms? Is DSO at or below target for the company?	After a sale is made and the customer is invoiced, the company has decided to rely on the customer's ability and habit to pay as negotiated on a timely basis. If the company does not track DSO, if they are above their target levels, or if they take longer to collect than other companies in their industry, then there is an opportunity to improve.

A consumer products client manufactured and distributed their own branded products. They built a tremendous brand and a loyal customer base. They also realized that their plant sat idle for part of the year due to seasonality. We helped them complete a make vs. buy analysis comparing contract manufacturers and 3rd party distribution to their internal cost structure. The analysis and eventual results showed that the company's EBITDA would go up 40%, and their return on capital would grow by more than 4 fold by making this move. Today they are a brand management company focused on sales and marketing. The manufacturing and distribution are left to the dedicated experts. While this example requires that a company defines who they are to evaluate the relevance of such an approach, many other make vs. buy decisions allow us to move a cost, step or process to the party best able to manage or complete the step. Look for these signs and do the math. You will help management focus on core competencies, grow the company, and earn a better return on your capital.

If you have any questions or requests, please feel free to contact me at tvm@proactiongroup.com.

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