THE PROACTION GROUP LLC

Identifying Operational Opportunities to Reduce Variable Costs During Due Diligence

By Timothy Van Mieghem
Partner
The ProAction Group

The M&A Chicago Expert Author Series®

After the first day of working at the chocolate factory, I thoroughly enjoyed my drive home. Working with and around chocolate, your clothes take on that sweet aroma, and the ride home was like smelling chocolate chip cookies baking in the kitchen. Only later did I learn that the milk and butter in chocolate spoil after a couple of days. The rides home became much less pleasant, and my jacket needed a good weekly cleaning.

Our client made and packed chocolate bars for national brands. They had a major autumn promotion that required them to approach their maximum output every day. Once the equipment was up and running, the chocolate flowed and a dozen packers placed the bars into the cases. We observed the 12 packers and saw that each made the process their own. We also noted that one of the 12 packed more than anyone else. Naturally, we standardized the process based on the best practice.

By the end of this project, we reduced the cost of making chocolate from 8 cents per pound to 2.5 cents per pound – a dramatic 68-percent reduction. Knowing where to look for opportunities to reduce variable cost can drive such significant results. Not only did this improvement reduce labor costs, it also increased throughput and cycle times.

This is the third article in our eight-part Expert Author Series entitled Identifying Operational Opportunities During Due Diligence. Another, perhaps more pithy title, would be Things You Want to Know BEFORE Buying the Company. We began with an overview identifying the seven areas we focus on to evaluate a company's ability to make their stated plan, and we quantify their ability to go beyond those plans. In each article, we highlight the features we look for in companies that indicate opportunities do in fact exist.

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?

This article focuses on variable cost reductions. Variable costs (those costs that flex up and down in proportion to volume) are made up of the dozens or thousands of tasks that the company performs every day. Small variations in these tasks are multiplied, geometrically. If a company has the opportunity to reduce variable costs, the impact can be dramatic.

The following indicators show the items we look for in our initial due diligence site visits. They represent the smoke that lets you know there is a fire. If any of the following are true, your company has the ability to make meaningful improvements in variable costs and EBITDA. Period.

Indicator	What it can mean
The company does not maintain a closed-loop metric system. The company does not post visible metrics.	If you can't measure something, it doesn't exist. This may seem to be a strong statement, but it is hard to overestimate the impact of measuring performance, conducting root-cause analysis, and implementing corrective action. Companies that do this show continuous improvements. Companies that don't will go backwards. No one stays stagnant – you either get better or you get worse. We often see a 10- to 15-percent improvement in performance when we start effectively measuring it.
No defined sourcing strategy.	For many manufacturing and distribution companies, the cost of purchased goods and services is 60 to 80 percent of the cost of goods sold. Yet, much of this spend is set up and managed by relatively low-level clerks and untrained buyers. If a company does not have documented sourcing strategies, it is an indicator that there is significant opportunity to better utilize their leverage with suppliers.
Sourced materials have not been competitively bid in the last three to five years.	Perhaps counter intuitively, we have found evergreen (ongoing) contracts to indicate that the company does not test the market and leverage their volume and position to their full advantage. Some companies do put specific and narrow needs out to bid. Either of these signals potential to improve the cost of goods purchased and related items.
The company does not measure supplier performance.	In a tightly run plant, suppliers have to deliver exactly what is needed when it is needed. No room for inspections, late deliveries, inaccurate picks, or defects. Companies that do not maintain a closed-loop system on supplier performance cannot maintain a high level of performance.
Sourcing agreements are not documented or are limited to pricing terms (excluding issues such as order management, inventory management, hedging, allocation, future pricing, etc.)	Regardless of who you are and how big your company is, your suppliers' resources dwarf your own. Effectively negotiating with your suppliers sets up your ability to leverage their resources to your benefit. If the company limits their negotiation to pricing terms, they are missing out on significant value. If the agreements are not documented, it is another sign that sourcing needs further investigation.
Inbound freight costs are buried in product costs.	A common answer to "Who pays freight on incoming shipments" is, "Oh, well, freight is free." We often find that suppliers build profit into freight charges. Unbundling freight costs can lead to significant improvements.
Schedule attainment is not measured.	One of the first questions we ask a plant manager during a tour is, "How are things going?" If they respond, "Great, all the machines are running" or "Our efficiencies are well over 100 percent", then we know they are likely scheduling the plant based on a "push" methodology. There is a good likelihood that they are building schedules to minimize changeovers and downtime. Measuring schedule attainment is most common among higher-performing companies that run the plant to fill customer orders or on some type of pull system.
Invoice accuracy / denials / chargebacks are not measured or tracked.	Credit memos, chargebacks, denied claims, and inaccurate invoices all show potential buckets of improvement. If the company does not actively track and measure these items, it is unlikely that they are well managed.

Indicator	What it can mean
E&O reserve is insufficient to cover actual levels.	Excess and Obsolete inventory is a target-rich area. Any of the following situations can indicate that the company can reduce the amount of E&O inventory it creates through ongoing operations: • The company does not measure or track E&O. • The company does not perform root-cause analysis and corrective action processes on E&O. • An aging of the inventory shows balances in excess of one year that exceed reserves.
Forecast is not measured or is low quality.	Often, companies that do not have the discipline to forecast well put unnecessary burdens on operations. These burdens lead to E&O inventory, overtime, downtime, expediting costs, and chaos. If forecast accuracy is low or not measured, the company is likely not managing this area effectively.
Service levels are low.	There are rare instances that require a company to provide poor service and quality levels to their customers. If a company does not have an industry-leading perfect order level, has longer lead times than competitors, or has high scrap/warranty costs, then there is likely a significant opportunity to improve operations and EBITDA.
Service levels are buoyed by high inventory levels.	One easy method to lift service levels is to increase inventory. This approach, however, leads to many costs and problems. If a company has competitive service levels, but holds more inventory than others in their industry, there is opportunity.
Significant work in process (WIP) and overproduction.	Work in process may not be evil, but it is close. When we tour any factory or office, we look for WIP in front of machines, in warehouses or in inboxes in the office. Any of these can indicate unbalanced lines and processes. Putting lines and processes into balance leads to cost, service level, inventory, and lead-time improvements.
The company has not conducted a value engineering exercise.	We know that lean manufacturing and process re-engineering can work to dramatically improve cycle times and lead times, and lower the costs to process paperwork, products, and services. The same mindset can be applied to the product design itself. Design for manufacturing, value engineering, or similar methodologies can dramatically improve the landed cost for an item.
Variation	If anything is worse than WIP, variation might be the thing. If a company does not measure variation in scrap, quality, cycle times, warranty costs, or key specification measures, the opportunity could be significant. When variation is reduced, costs go down.
Plant observations of the "7 Wastes" • **Defects** • **Overproduction** • **Inventory** • **Transportation** • **Waiting** • **Motion** • **Extra Processing**	These items represent the most fundamental items to observe during the plant tour and to have management communicate their views on the measurement and management of these wastes. Individually, these items can be identified and quantified for focused improvement efforts. Collectively, they represent the cornerstone of any operational excellence initiative to enhance profits, service, and morale.

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

- The cost to produce a pound of chocolate decreased over 68 percent.
- A $40M international freight budget was reduced to $30M through competitive bidding and the development of strategic alliances.
- A $4.5M cost reduction in the cost of importing frozen seafood (over 15 percent) through effective use of third-party warehouses and international freight.
- Reduced the cost of purchased goods and materials by 11 percent for a $400M manufacturer

- Reduced the creation of excess and obsolete inventory by over 80 percent (over $1M per year)

There are hundreds of examples like these. Look for these indicators. When you find them, it is time to investigate. In our next article we will look at indicators that fixed costs can be improved. Can the company reduce labor beyond temporary labor and overtime, consolidate facilities, reduce floor space requirements, leverage low-cost country resources, improve IT and system costs/value.

THE PROACTION℠ GROUP LLC

The Competition is Fierce. Change the Rules.™

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