

Know and Grow

In order for a company to develop a profitable growth strategy, it should have a detailed understanding of its profitability, competitive position and customer environment. However, due to the fact that many small to medium-sized businesses operate lean organizations, finance and sales/marketing departments are typically bare-bones functions.

Finance's role is generally geared toward taking care of accounts receivable and payables, managing cash flow and reporting a consolidated profit and loss statements. It is rare to find these departments with the resources to focus on cost accounting to develop accurate P&L statements at the product line level.

The sales/marketing function is typically weighted to sales and is focused on booking new business. The marketing function, if it exists, is usually focused on promotional activities such as tradeshow, advertising and creation of collateral materials. Most marketing departments do not have the resources to understand their customers' product roadmap, the competitive threats of substitutive technologies, new market opportunities and the optimal sales channels through which to market their products.

As a result, to the extent that these companies perform strategic planning, their knowledge base for developing these plans is often inaccurate, outdated or both. In general, these companies tend to recycle the myths of conventional wisdom that are resident within their companies.

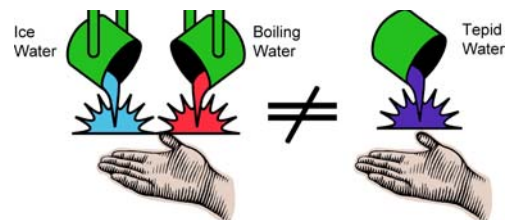
However, in order for a company to maximize its investment in people, technology and capital, it must develop strategies that are synchronized with current and accurate information about its profitability, competitive and customer environment.

Understanding Profitability

If a company is going to set out to grow its business, it is important that it grows its profitable product lines and develops turnaround or exit strategies for underperforming ones. To understand if a product line is profitable, you must understand the direct costs that are associated with the product line and eliminate as many "allocated" expenses as possible. Most companies use a flat manufacturing overhead rate and apply it to direct labor hours. Years ago, when direct labor was the dominant cost and overhead was minor, this made sense. Today, with the high degree of automation and support functions such as quality and information technology, overhead can be three to four times the cost of direct labor. Therefore, direct labor is more than likely to be the wrong variable to use to allocate overhead.

In addition, not every product line uses the same overhead assets, and therefore overhead rate. For example, one product line may use an inexpensive semi-automated machine, whereas another uses an expensive fully automated machine. To allocate the depreciation, supplies and other costs of both machines in the same overhead pool would over-allocate the semi-automated product line with depreciation while under-allocating the fully automated product line.

AVERAGES are DECEIVING - While the combination of ice water and boiling water results in tepid water, most people would agree that they would rather not have ice water poured on a hand followed by boiling water.



To the extent possible, companies must identify the costs that are unique or dedicated to a product line and apply these costs directly to the product line. This includes not only traditional manufacturing overhead charges such as depreciation and supplies, but also engineering and sales, if these costs are dedicated to a product line. Other shared expenses should be allocated based on appropriate metrics. For example, facilities charges such as rent and utilities might be allocated based on facility space used, while the cost of incoming quality inspection might be allocated based on the value of materials purchased.

When going through this exercise, management is often surprised to find that product line profitability is far different from what they had originally thought.

When armed with this knowledge, management can begin to make educated decisions with respect to pricing strategies, new product development plans and product line dispositions in order to optimize the business's profitability and growth.

Understanding Customers

Most of the conversations that companies have with their customers involve the customer's purchasing department. These discussions are usually about pricing, quantity and timing of new or existing orders. Unfortunately, information related to the future direction of the customer company rarely resides in the purchasing department.

In order to find out where the customer is heading, it is important to talk with their marketing and engineering personnel. Marketing people can provide a sense of the size of their market, their growth rate, their competitive situation and anticipated changes in their product offerings. This information is useful for developing the size and growth rate of your product to this market as well as for identifying other potential customers, that is, your customers' competitors.

Engineers are an excellent resource to understand any changes in the technical implementation of their new products, which may either provide new applications for your technology or make it obsolete. They are also an excellent resource to help define new products concepts.

Understand Competitors

Your competitors can be an excellent source of information about the business. While competitors are not willing participants, by analyzing their public actions, you can learn valuable insights. See what tradeshow they attend. If they attend tradeshow for markets that you don't compete in, attend the tradeshow, see what products they are exhibiting and what potential customers are present. Look at your competitors' sales channels. Do they sell through a channel (such as a distribution channel) different from yours? Do they use independent sales representatives that might want to represent you instead? Do they mention customers on their Web site? Are you aware of these customers and the markets in which they compete?

In summary, companies that are resource constrained tend to rely on the myths of conventional wisdom to guide their future. They rarely have the luxury of a professional staff to take a fresh look at their business, identifying market trends, new channels, competitive threats and other factors challenging their business. However, armed with current and accurate information about their operating environment, a company can successfully develop profitable growth strategies.

About the Author:

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