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Accelerating profitability for medium-size industrial companies

As companies transition from medium-size to established organizations, they often lack the DNA and organizational muscle to rapidly improve their bottom-line performance. An accelerated transformation can help.

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Many medium-size industrial companies are familiar with the early, and exciting, stages of growth.[1] A single-minded focus on scaling up is fueled by a seemingly constant flow of investor money, while a solid customer base and good revenues bolster confidence in the organization's direction. In short, the future looks promising.

As medium-size companies transition out of this high-growth phase, however, market expectations become focused on not only growth but also profitability. This shift, combined with investor pressure to generate returns, forces these companies to match growth with operational excellence to achieve profitability. Yet too often, companies continue to focus on building a strong R&D culture and invest heavily in developers, engineers, and product managers (and the products and platforms they develop) while giving short shrift to the operational capabilities needed to thrive in the longer term. As operating expenditures and working capital increase, these companies may find that they lack the cash necessary to make and sell enough products to hit financial benchmarks.

Since profitability is critical to sustaining long-term growth, industrial companies should consider undertaking an accelerated performance transformation (APT). While this concept is not new, it is generally associated with large, more mature companies and multiyear timelines. However, an accelerated approach can allow medium-size companies to reduce operating costs and build the necessary processes and structures to enable the transition from a high-growth company to an enterprise that is built to last.

Four common challenges

For many industrial companies, the concept of operational excellence may have been an afterthought during growth. And it's no wonder, when the high-growth phase is focused on proving a concept or product while attracting more investors. (See sidebar "Indications that medium-size industrial companies need to focus on operational excellence.")

Once these companies realize they must focus on reliably generating revenues, they face the following four common challenges:

Unwieldy management structures and processes. A lack of attention to organizational structure can create inefficiencies and hinder growth. Leadership may micromanage day-to-day tasks but not focus on setting big-picture cost reduction and profitability objectives or addressing issues, such as poor cash management, that could handicap the company down the line. Companies experiencing rapid growth often go on hiring sprees to fill roles that are highly valued but serve only immediate or short-term needs. Thus layers of management can be created to oversee support functions, which slows down decision making.

Exorbitant operational expenses. Executives often attempt to convey their success and potential to investors by trying to emulate the amenities of more mature industry leaders. Medium-size companies can make spending decisions without defining objectives or tracking impact. Common expenditures include memberships to industry associations, attendance at large trade shows, and software licenses.

Heavy investments in R&D and product development. A single-minded focus on R&D and product development can result in product features that don't add value and don't address market or customer needs. Industrial companies can get caught in the cycle of building to outpace competitors without asking if products fit within the current business strategy, thus ending up with overengineered products. In addition, the lack of a proper business plan that includes risk assessments and contingency plans in case of failures and delays can increase product development cycles and costs while also reducing margins.

A lack of agility to respond to changing market conditions. Being first to market has its benefits, but as more companies produce similar products competition can increase and erode margins. This

Indications that medium-size industrial companies need to focus on operational excellence

Striking a healthy balance between revenue growth and operational costs is critical to the long-term profitability of medium-size companies. It can be easy to place too much emphasis on growth and scaling to the detriment of both operational expenditures and the bottom line. Following are several telltale signs that a company's operational performance is a drag on growth:

- Slowing revenue growth
- Increasing competition in core markets
- Erosion in margin
- Lack of focus on costs
- Missing clarity on what is truly needed to run the business

story is familiar to those who have tracked the trajectories of recent innovations such as 3-D printing, drones, or virtual reality; in each case, one company's breakthrough innovation was quickly copied by fast followers. Without the organizational muscle in place to respond quickly to reduce costs and address the competition promptly, the advantage of being first in the market vanishes.

An accelerated approach to turning around company performance

To address these issues, medium-size companies should consider undertaking an accelerated approach that focuses on optimizing operations and enhancing competitiveness. APT can generate a sustainable operational improvement, often within 12 to 18 months. The first half of the transformation requires sufficient resources alongside strong support from owners and the CEO to overcome the hurdles to transformation.

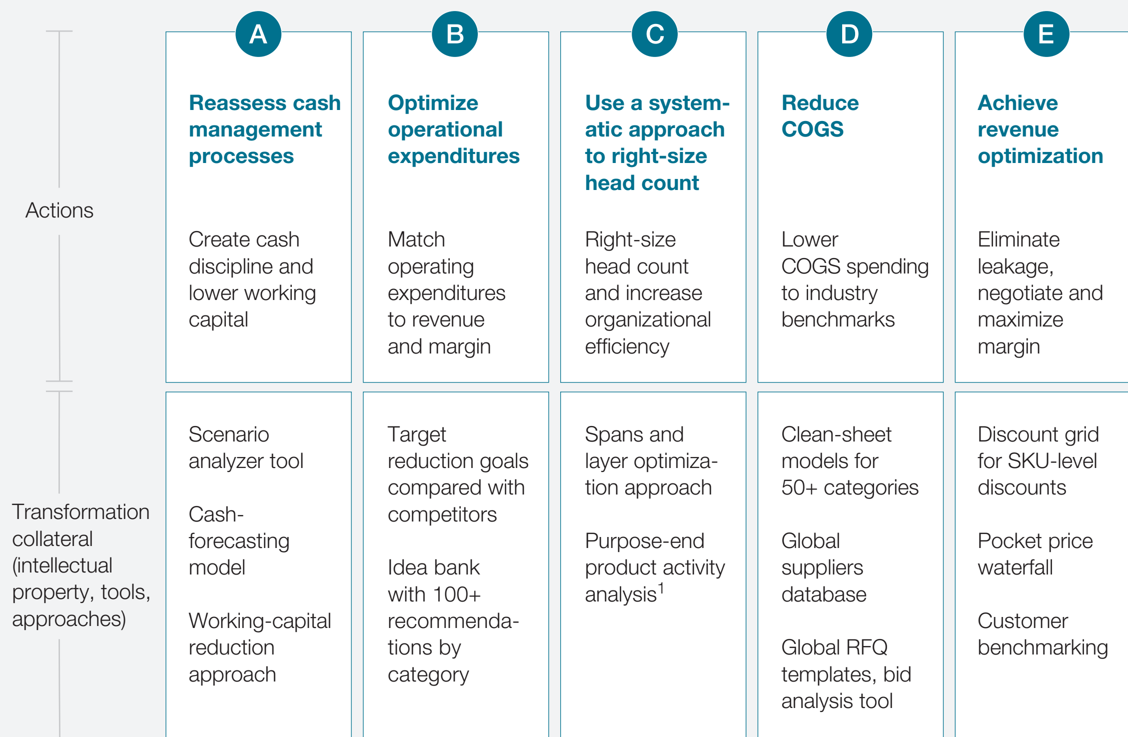
Initial results suggest that industrial companies could reduce operating expenses by more than one-third and boost gross margins by 6 percent in the first year alone. The APT approach requires attention to five areas—cash management, reduction of operational expenses, head count right-sizing, cost of goods sold (COGS), and revenue optimization—supported by a set of standardized tools (Exhibit 1). In most cases, cash management and optimization of operational expenditure unfold in tandem because they generate the most immediate impact on a company's bottom line and provide it with the financial stability to grow. (See sidebar "The accelerated transformation difference.")

Reassess cash management processes

To get on solid financial ground, companies must conduct an analysis of their current cash flow with weekly reviews of all planned outflows and expected inflows. This approach helps to identify activities that could be cut or scaled back and ensures that sales and collections work hand in hand to avoid write-offs and increase cash positions. Templates and processes for forecasting and tracking can be implemented quickly to help avoid a common habit of focusing on cash only at the end of the quarter, by which point it may be too late to address shortfalls.

In addition, companies can lower working capital by identifying areas where products are slow to sell,

Exhibit 1 **Five action areas can help a company make a significant impact on its operational performance.**



[1] This analysis looks at the end products that a business function needs to deliver, defines the amount of tasks that need to be committed to get there, and compares those tasks with the activities currently performed.

removing products that sit in inventory, and closely managing all raw material. Terms with suppliers and customers must be included in this review, as must accounts receivable and accounts payable processes to ensure that collections happen quickly and no invoices are paid early.

Optimize operational expenditures

During this phase, companies should set target reduction goals for each of their business areas based on what is actually needed to run the company and compare current spending against that of competitors. In this way, companies can identify spending imbalances such as overspending in facilities, licensing, and software. Further, these enterprises should harness employee insights for cost-cutting by using an idea-generation program that rewards workers for their contributions.

Use a systematic approach to right-size head count

Medium-size companies must look critically at the number of personnel in each function. To do this, they can create a map of each department complete with head count and attributed costs. Companies can then use this function map to identify duplicated work and opportunities for organizational efficiency. Further, this process provides transparency for non-value-

The accelerated transformation difference

Unlike many other operational transformation approaches, the APT framework requires employee input at each phase. This level of engagement makes it easier to get teams on board, and the collective desire to achieve excellence becomes part of a mind-set that makes the transformation permanent.

In practice, engagement is fostered through transparency, communication, and actions during each phase. For example, stakeholders might meet on a weekly basis to track progress against benchmarks (communicated beforehand) and then follow up with clear next steps and expected timelines (Exhibit 1). With a rapid cadence and an emphasis on accountability, companies are able to accelerate changes in their operations.

APT employs a structured T-C-A model.

	What?	How?
Transparency	What is the baseline? ($/head count, $/category) What is the target? Gap to target? What are the current initiatives to close the gap? Where are they in implementation? What is the 3W (who, what, when) plan?	Control tower • Sets granular baseline • Sets targets • Tracks weekly implementation progress by category • Ensures 3W plans are in place
Communication	What is the program? Why? Who is leading it? What is the plan? Progress to plan? (weekly) Where are roadblocks? (weekly) What is the reconciliation of plan progress to date?	Weekly control tower meetings CEO sends regular newsletters
Actions	What actions are being taken? What is being done differently? Why are actions being taken? Who is responsible for taking actions and setting time line?	Teams work with category owners to make the changes

added costs on the balance sheet as well as understaffed functions. Benchmarking staffing levels can help to identify areas where reductions are possible.

Reduce cost of goods sold

To lower COGS, companies must gain transparency into their current spending profile and build the sourcing skills necessary to negotiate savings with vendors. Obtaining this level of transparency requires companies to understand their bills of materials (BOMs), the common components of BOMs, and the vendors that supply them.

First, companies should use clean sheets—a detailed, bottom-up, "should-cost" model—to look at each component used to build their products. The clean

sheets are used to assess what the cost targets for those components should be and which negotiations should be prioritized to obtain the largest cost savings (Exhibit 2).

Next, a sourcing approach must be created for each of the components. This approach may involve issuing requests for quotations (RFQs), holding e-auctions, having direct negotiations with existing vendors, or doing spot buying. Cost savings achieved through sourcing are tracked in the BOM files, which allow companies to forecast COGS and gross margins.

Achieve revenue optimization

Medium-size companies must take a critical look at what their current pricing policies are and ensure the discounts allocated match customer profiles in a consistent way, as exceptions quickly accelerate price erosion. A pocket price waterfall is a powerful tool companies should have in their arsenal to identify customer accounts that leak revenue through, for example, unjustified distributor support with marketing activities or discounts for quarter-end purchases (Exhibit 3). By renegotiating account discounts, medium-size companies can uncover 10 percent or more in gross margin improvements in some customer segments.

How one electronics manufacturer used APT to get on solid footing

Executives of one electronics manufacturer, eager to achieve growth, faced pricing pressures and stiff competition that effectively choked off its revenues and margins. However, it lacked sufficient organizational capabilities to improve operational performance. Seeking to address the problem quickly, executives decided to execute the APT approach across all five action areas. The results: a 35 percent decrease in operating expenses and an increase in gross margins of 1,500 basis points when comparing quarterly performance pre- and post-transformation (Exhibit 4).

Before APT, the manufacturer was close to tripping covenants in loan agreements. But by using a granular approach to evaluating cash flow sources, the business reduced its inventory and renegotiated payment terms with customers and vendors. The manufacturer also consolidated payment runs and installed invoice accumulation periods, which led to more predictable interactions with vendors as well as an increase in the days of payments outstanding.

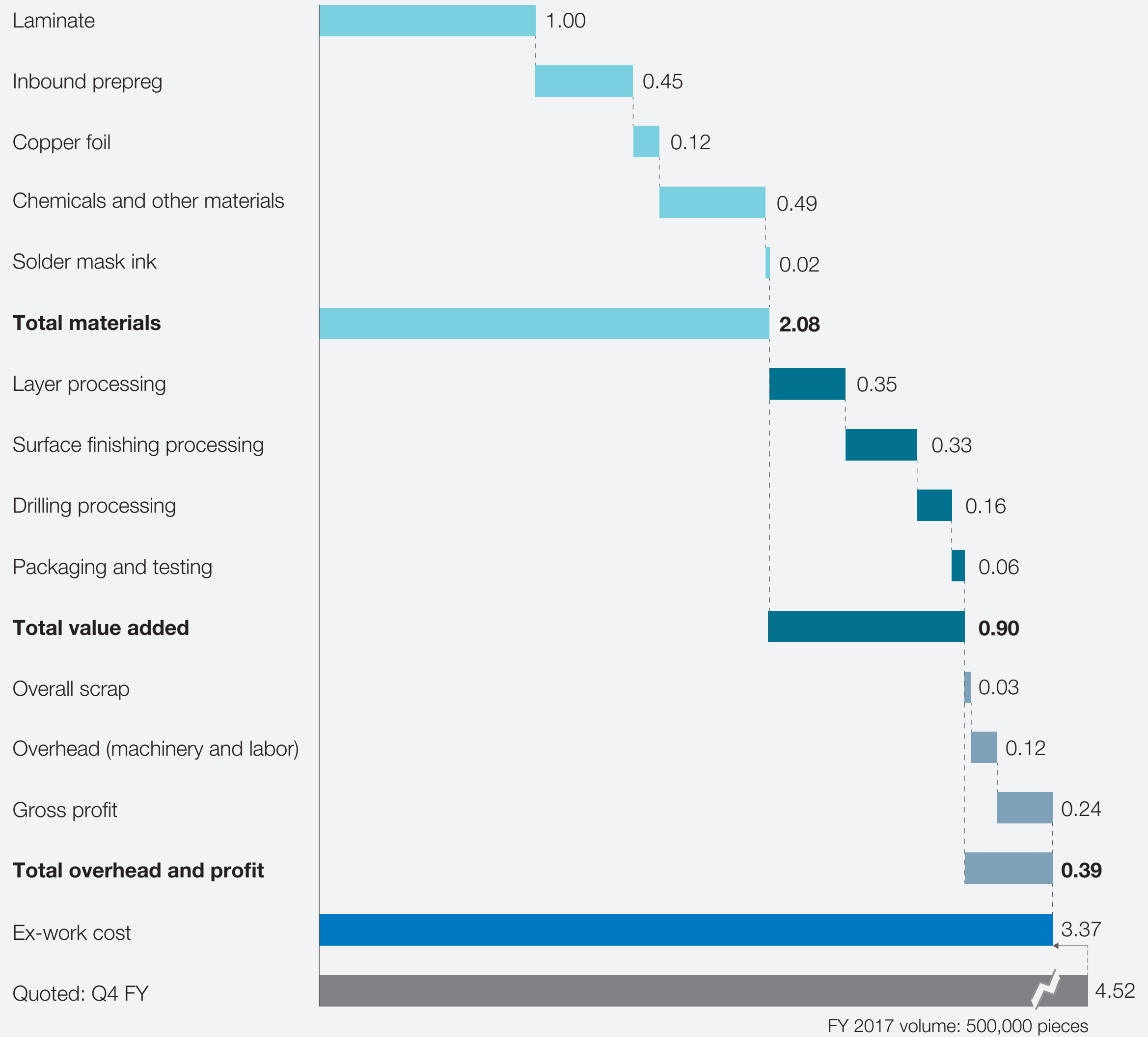
Executives engaged employees during the transformation process by using an idea box. More than 100 employee suggestions were submitted by the 400-person workforce, around 25 of which were implemented. Examples include a redesigned engineering document management process, which reduced 80 percent of the licenses for the documentation software from read-write to read-only. Collective efforts to reduce non-labor spending resulted in savings of more than $10 million in operational expenses per quarter, or a decrease of 30 percent.

Next, the manufacturer completed an analysis of its own management spans and layers across business units, which revealed duplicated processes within the software quality assurance function.[2] To quickly streamline the organizational structure, the manufacturer set benchmarks for each department and, after optimizing the head count, made sure essential functions were still covered adequately.

To achieve transparency across sourcing costs, the manufacturer developed more than 20 clean sheets and RFQs, which helped to reduce COGS spending by about 30 percent. Further, the electronics manufacturer's thorough use of clean-sheet models allowed it to pursue multiple RFQ rounds, giving them per-part targets and thereby closing the gap between the best quotation received and the should-cost from the clean sheets.

Last, the manufacturer implemented pocket price waterfalls for all negotiations with its distribution

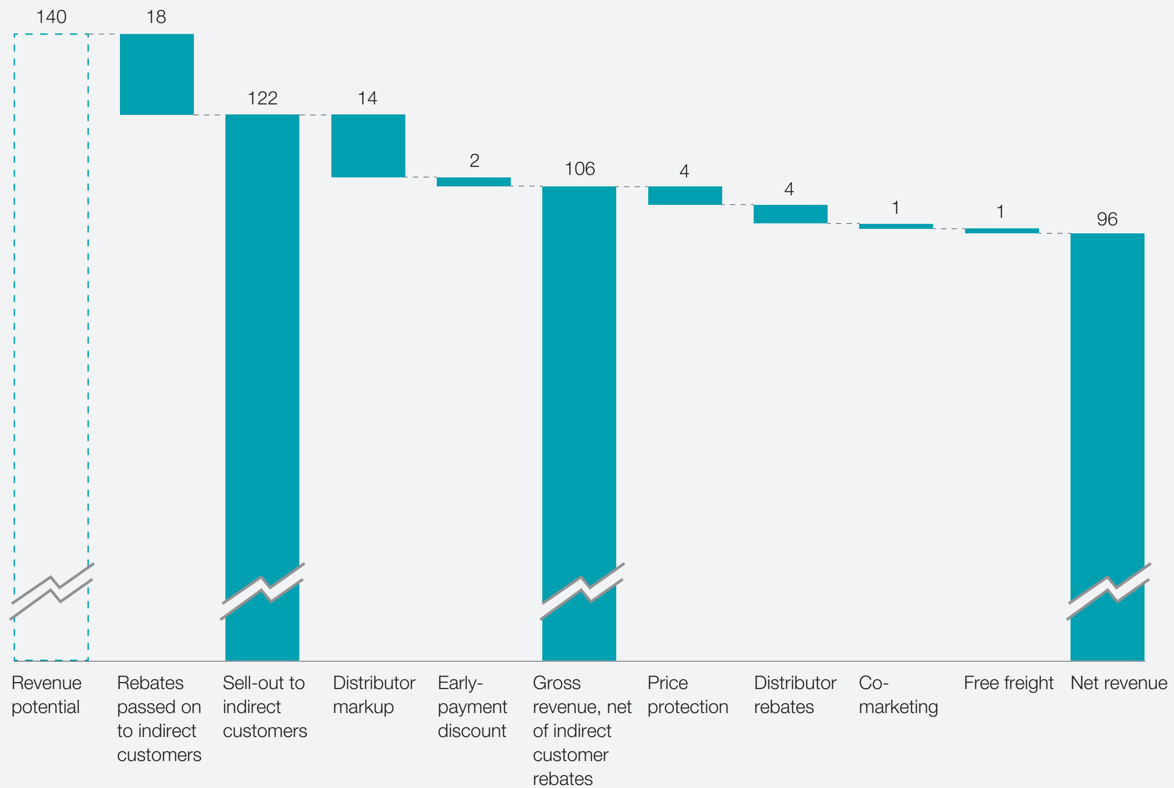
Exhibit 2 **A clean-sheet case example for a four-layer printed circuit board.**



Source: McKinsey Design-to-value (DTV) lab

Exhibit 3

A distributor pocket price waterfall model can show current customer discounts.



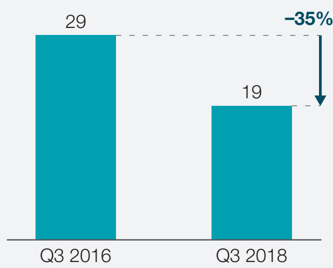
Note: Actual values are disguised. Full potential was calculated from surveying and estimating the actual sales prices that the distributors have with their customers.

partners and direct customers, assessing each element in the waterfall against the benefits it generated. Any unjustified components were removed, which effectively increased prices for some segments by as much as 10 percent and eliminated discounts of more than $5 million per quarter without affecting sales volumes.

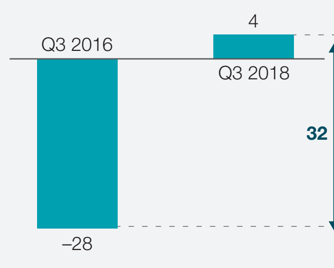
When medium-size industrial companies transitioning from a high-growth enterprise to a mature company get off track, they don't have the luxury of time with investors; change must happen quickly. These companies must prove that they understand how to not only innovate and build products but also lay the foundation required for long-term operational excellence. By using an APT approach, rapid-growth companies in this segment can focus on areas that provide the most impact, allowing them to solidify their place in the market. ■

Exhibit 4 **An electronics manufacturer saw an improvement in operations in just 18 months.**

Operating expense, non-GAAP, $ million

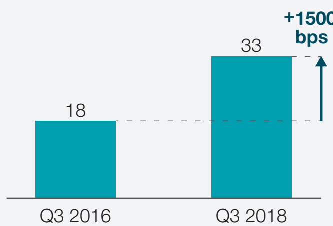


Earnings per share, non-GAAP, cents

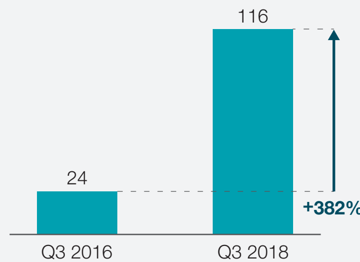


Share price dips 70% in 2016 . . .
% change, 100%: Jan 1, 2016

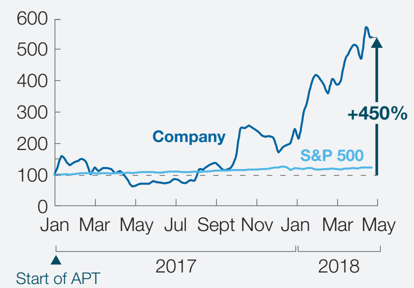
Gross margin, non-GAAP, %



Cash, $ million



. . . but grows 4.5x as transformation impact manifests
% change, 100%: Jan 1, 2017



Note: The APT transformation took place from Q4 2016 to Q3 2017. This exhibit includes the company's performance one quarter before and one quarter after the transformation to show its complete evolution.

[1] Medium-size companies are defined in this article as companies with annual revenues of $200 million to $2 billion.

[2] Spans refers to the number of direct reports under a manager, and layers refers to all the levels of reporting within an organization.

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