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MANAGEMENT BRIEFING

Link Operational Improvements to Financial Results

Make the connection between continuous improvement initiatives and financial returns by understanding the links and levers to shareholder value and capturing the benefits of performance gains.

Executive Summary

Depending upon who you talk to, somewhere between 5 and 50 percent of business improvement initiatives actually deliver the targeted benefits. One of the characteristics of companies that are successful is a tight alignment between improvement activities and business objectives, including financial ones. This TBM management briefing explores the connections between business improvement projects and financial returns, and some of the steps that management must take to capture the financial gains.

Make the connection between continuous improvement initiatives and financial returns by understanding the links to shareholder value and capturing the benefits of performance gains.

Operational improvement initiatives often lead to dramatic improvements in throughput, inventory levels, quality, productivity and overall efficiency. Such efforts can make the workplace look better and make employees feel like they're working more efficiently. But despite double-digit gains in productivity and other operational metrics, many companies have a difficult time realizing the benefits from their work on their financial statements.

Today, the top priorities of manufacturing executives are revenue growth, improving cash flow and containing costs, according to a recent study of business improvement activities by IndustryWeek magazine.[i] If such results aren't achieved and documented, it will only be a matter of time before an operational excellence program loses both momentum and management support.

This TBM Consulting Group management briefing explains how key performance indicators (KPIs) should align current and planned improvement projects with business priorities and directly contribute financial benefits.

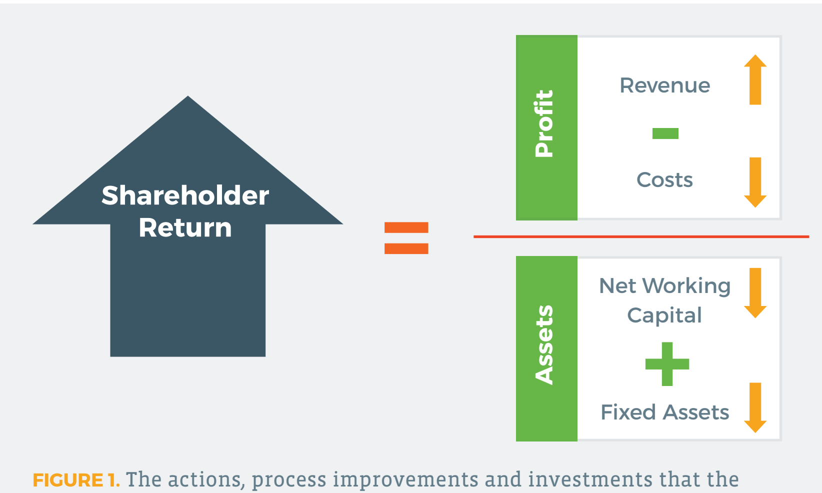


FIGURE 1. The actions, process improvements and investments that the executive team decides to pursue should maximize return on assets by improving both the numerator and the denominator of this equation.

Translating Lean and Six Sigma Gains Into Shareholder Value

At a fundamental level operational improvement programs build shareholder value by increasing profit and reducing the assets required to generate it. Shareholder value can be expressed as a simple equation of profit over assets, or return on assets (ROA). Profits consist of revenues minus costs; and assets consist of net working capital plus fixed assets (see Fig. 1). This may be obvious to most business executives, but it's important for the management team to clearly define and review these factors to make sure improvement activities are aligned with financial performance goals.

Building deeper financial literacy within the organization is one of the primary priorities—often overlooked—that companies must address when committing to a long-term business improvement program. Many supervisors and department heads, and even business managers, tend to focus on hitting and protecting their own budgets.

Most have only a superficial grasp of P&L and cashflow statements, and don't really understand the effects their actions can have on the company's overall financial performance beyond revenues and costs.

A typical initiative in a manufacturing plant that leverages lean manufacturing and Six Sigma principles and tools—which TBM combines as LeanSigma®—can generate double-digit improvements in profits by decreasing costs and improving labor productivity. Many projects also yield doubledigit improvements in asset utilization by reducing inventories, floor space, working capital and, by extension, future investment requirements.[ii] Such gains can really add up if a company continually improves both the numerator (profits) and the denominator (assets) of the equation (see Fig. 2).

For example, starting with a 1:1 ratio for ROA (profits:assets), a typical event or project might reduce material and labor costs sufficiently to improve operating margins by 20 percent. It could also reduce asset requirements such as machine usage, manufacturing footprint or inventory by 20 percent (1.2 ÷ 0.8). The net gain is a 50 percent increase in shareholder value (from 1 to 1.5). That's leverage. Unfortunately, process improvement initiatives don't usually translate so readily into financial returns.

"You hear the question all of the time. 'We see the immediate benefits from our lean projects and events. We understand the power of the process. Why don't we see it on the P&L statement?'" Says Bill Schwartz, operating director in the industrial sector at TPG Growth, part of private investment firm TPG Capital.

"The CFO, who isn't participating directly, might even put it more bluntly, 'On that kaizen event you say you improved productivity in that work cell by 50 percent. But next week's payroll will be the same as this week. Where's the return?'" Schwartz adds.

How WIKA Leveraged Operational Excellence for Efficiency and Growth

No matter how long a company has been working at it, managers who target and work on specific factors of the ROA equation can link a company's business strategy and vision to its performance improvement efforts, thereby maximizing shareholder returns. The lean journey for WIKA Alexander Wiegand SE began in 2001 when sales plateaued at around €300 million. Headquartered in Klingenberg, Germany, the privately held firm employs more than 6,500 people and ships more than 40 million pressure and temperature measurement instruments every year.

Management's primary objective in the beginning was to shorten order lead times, then running anywhere from four to six weeks, and improve on-time delivery performance, which had long hovered between 60-70 percent.

Improving quality and productivity were other key priorities. During this period some of the company's product lines were becoming commoditized by new

competitors offering similar products at 30 to 50 percent lower prices. Rather than start a race to the bottom by trying to compete on lowest prices, WIKA's leaders decided to leverage operational excellence and lean manufacturing to become a highly responsive, high volume supplier of made-to-order instruments.

To move away from batch production methods and warehouses stuffed with inventory, WIKA leveraged kaizen workshops—more than 1,000 to date—to set up work cells, reduce changeover times, implement one-piece flow and slash work-in-process inventory. It took about 18 months for the changes to reach critical mass and begin to show up in the company's overall operational and financial performance, reports Klaus Gross, COO of WIKA Instrument Corp. in the United States.

Financial returns from their efforts over the past ten years include both sales growth and market share growth, healthy margins and operating cost advantages, higher productivity, less scrap and lower working capital requirements. Gross estimates that productivity gains in the United States alone made it possible for the business to grow significantly without adding the labor equivalent of 200 employees, which factors out to cost savings of $7 million per year. It doesn't take very long for results like that to really add up.

By 2008, WIKA's global revenues had grown to €515 million. Then the global economic recession hit, triggering a double-digit sales decline. Lean management practices enabled the company to respond quickly without being caught holding too much inventory. Discipline and transparency enabled WIKA to maintain profitability during the downturn, and bounce back to record-setting growth in 2010.

"Since 2002, we have improved our EBIT margin every year by about 1 percent," WIKA CEO Alexander Wiegand reported in an article in Chief Executive magazine.[iii] "That's the bottom line. It's not all coming from lean of course, but more than half of that improvement is the result of our lean activity.

[i] "Breakthrough Objectives and Continuous Improvement: Closing the Gap," a collaborative study by IndustryWeek and TBM Consulting Group, February 2012.

[ii] For examples see IndustryWeek magazine's Best Plants winners (going back to 1990), and Shingo Prize winners (going back to 1988).

iii "Lean Manufacturing's Next Life," Chief Executive, March/April 2010.

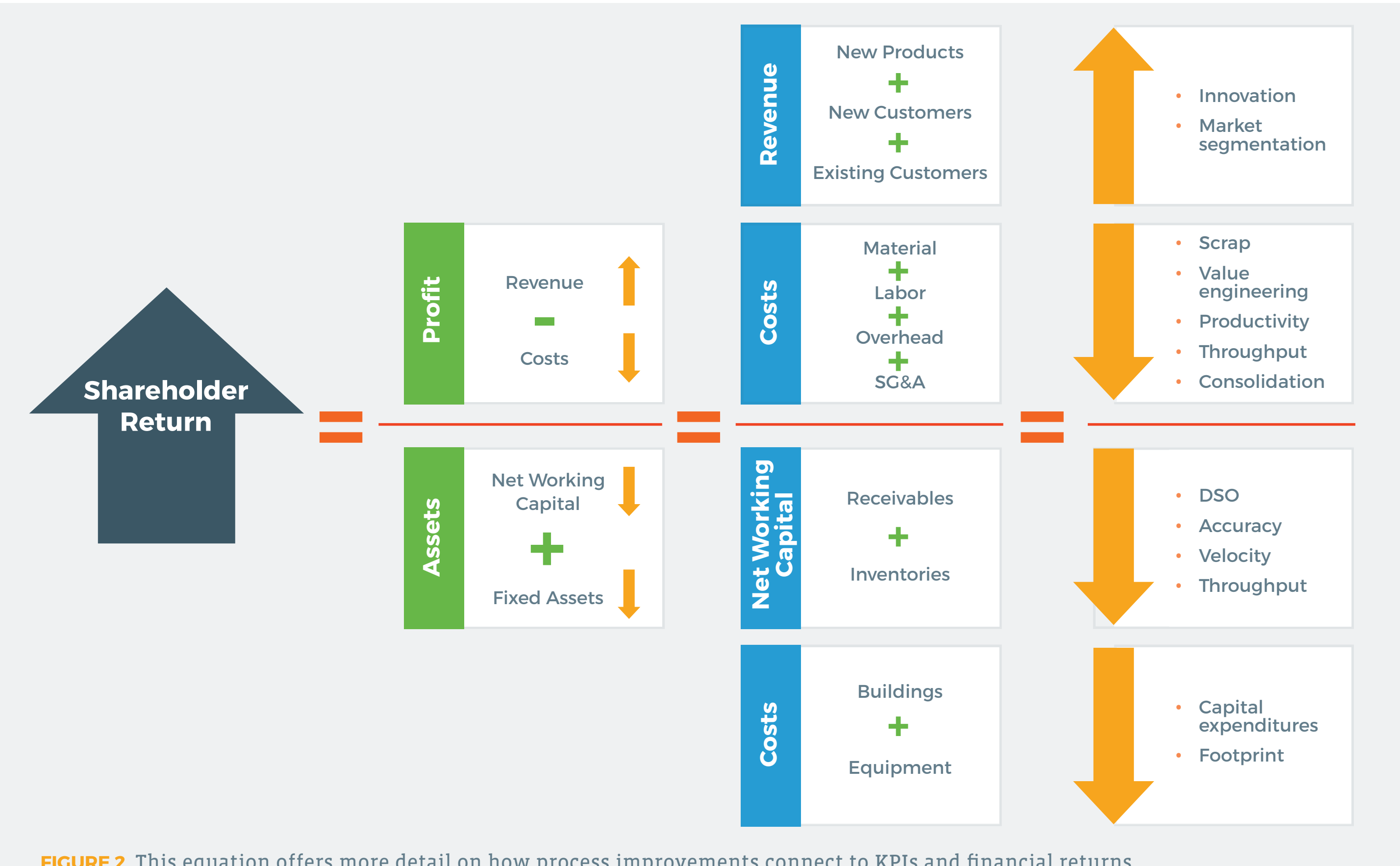
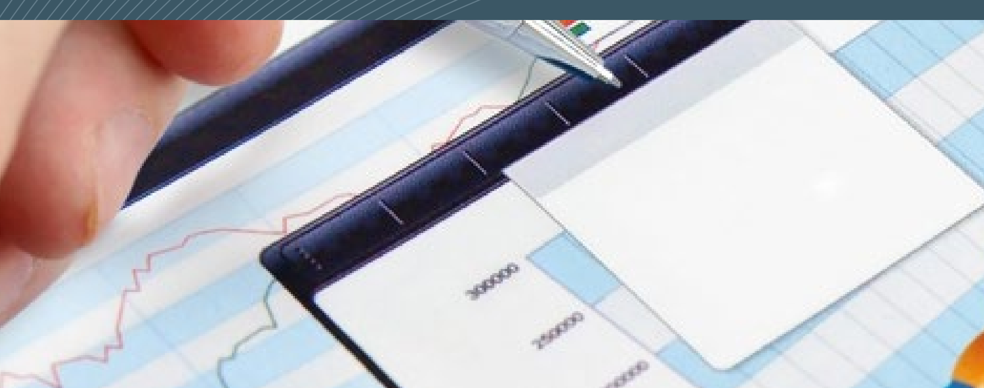


FIGURE 2. This equation offers more detail on how process improvements connect to KPIs and financial returns.



Capturing the Gains

Translating operational improvement activities into financial gains requires specific management actions:

1. The first step is making the process improvements by applying LeanSigma tools and methodologies to eliminate waste, improve productivity, reduce inventory and improve flow.
2. The second step is to physically free up the resources. This could be floor space, labor hours, machine time, material utilization or plant capacity.
3. The third step is the specific action that management takes to capture the gains. For example, if a kaizen project frees up floor space on the factory floor, management action starts by roping it off and not allowing it to be backfilled with miscellaneous material and equipment. But it hasn't been converted to dollars yet. Monetizing such gains happens when the company is able to close an outside warehouse, or use the floor space for additional production and sales without having to invest in new buildings.

To sustain any initiative that leverages employee knowledge and ingenuity, process improvements cannot contribute directly to job cuts. But total labor hours can usually be reduced by eliminating overtime or temporary help, or through attrition.

Despite the visual improvement in operating efficiency, most finance organizations will not allow operations to assign a dollar value to space freed up in a building. But freeing up labor and floor space creates an opportunity to bring in more work—from new product offerings or work that is currently outsourced—and do it with existing employees, thereby eliminating any need for layoffs and improving return on assets.

Acknowledgement

KEITH YEATER

An expert in business transformation, Keith has a proven track record for leading positive change in organizations. Keith works with senior executives at client companies helping them to accelerate value creation and ensure that their Continuous Improvement initiatives are clearly aligned to strategic initiatives and key performance measures.

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507 Airport Blvd, Ste. 105
Morrisville, NC 27560
O 919.471.5535
TF 800.438.5535

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