Analytics That Work

Tools for Creating Value and Focusing Performance

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Bruce R. Limpert

CPS Management Services

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Who We Are:

Providing practices, tools and management services with a focus on financial sustainability, capital performance and value creation.

"Custom" Tools to Support Our Services:

CPS Tool-kit™ - A proprietary web accessible business solution that links assessments, action plans and the key metrics to support CPS's value-based performance approach

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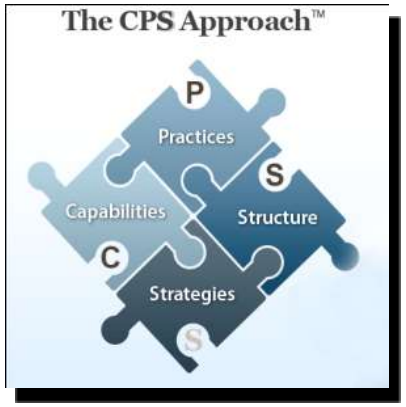
“Value-based” Management

Our Approach:



- A management system built on resource “stewardship” and capital performance
- Aligning vision with strategies, capabilities, and practices for better execution
- Focusing business processes and metrics on creating long-term economic value
- Generating the resources for ongoing financial success

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Capital Performance –*Today's Capital Gap*

Capital Use--Increased risks relative to cost and returns

ROI did not meet real cost relative to capital cushion/profit volatility

Capital Capabilities--Ability to generate new as well as replacement capital

Size, Scalability

Working capital constraints-under funded opportunities

Capital Access--Will be performance driven

Capital Deployment/Performance vs. Profitability Cycle Management

New Conversations–Measuring What Matters

Sustainability, Command, Control & Reporting

Tackling the capital gap - beyond an incremental approach

Strategically align-match structure with business characteristics

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The Drivers of Operating Profitability

A study of the factors affecting operating profitability found that the key factors were:

- The firm's competitive position in terms of market share
- The relative quality of its products and services
- The firm's cost and asset structure

Hawawini & Viallet

Know Your Market, Serve Your Market and Know Your Capabilities

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Value Drivers

Integrated Financial Metrics

P & L- Margin Performance / Trends
Operating Efficiency

Asset Utilization/ Turnover
Management Effectiveness

Invested Capital Management
Capital Utilization

Operating Cash Flow
Earnings Quality, Cash Efficiency

Target Minimum Op Margin
Performance Predictability & Monitoring

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Jim Collins

"How the Mighty Fall"

From-Stage 3: Denial of Risk and Peril:

What indicators should you most closely watch?

"For businesses, our analysis suggests that any deterioration in gross profit margins, current ratio, or debt-to-equity ratios indicates an impending storm"

… yet we found little evidence of significant concern and certainly not the paranoia they should have had about these trends."

Other indicators-

Customer loyalty, stakeholder engagement and watching for any decline in the proportion of the right people in key seats

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Measuring Financial Performance

"Returns Family" - Indicators of Profitability

Return on Sales	ROS	Sales Focus
Return on Assets	ROA	Operations Focus
Return on Equity	ROE	Corporate Focus

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Capital Performance
Why ROE

Owners' return on its capital - measures resources generated to sustain and grow as well as profitability to shareholders

Aligns and focuses assessments, strategy, plans and actions (decisions and execution)

Benchmark for monitoring the drivers of value creation

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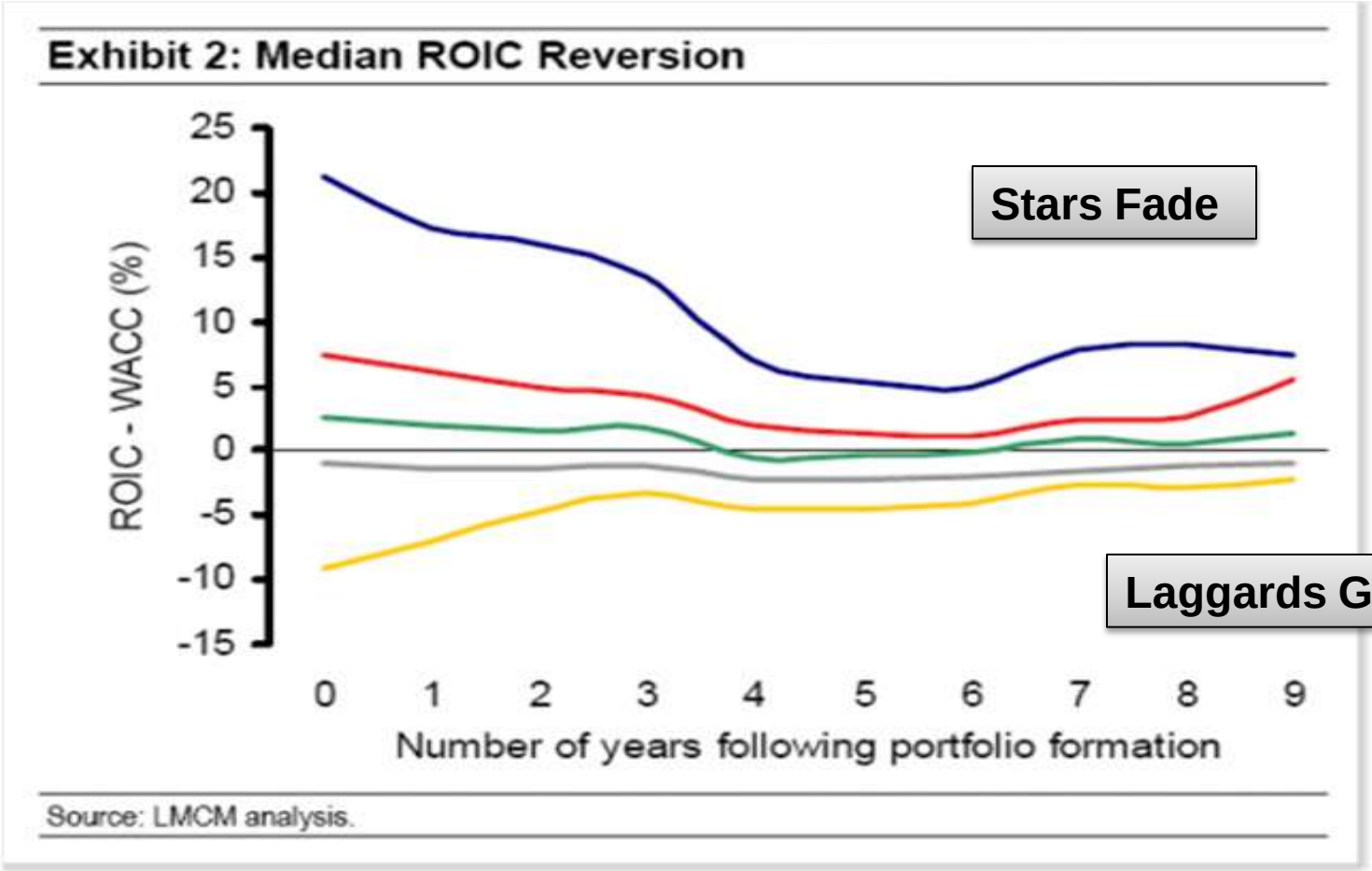
Managing for Capital Returns

Reversion, Persistence & Performance



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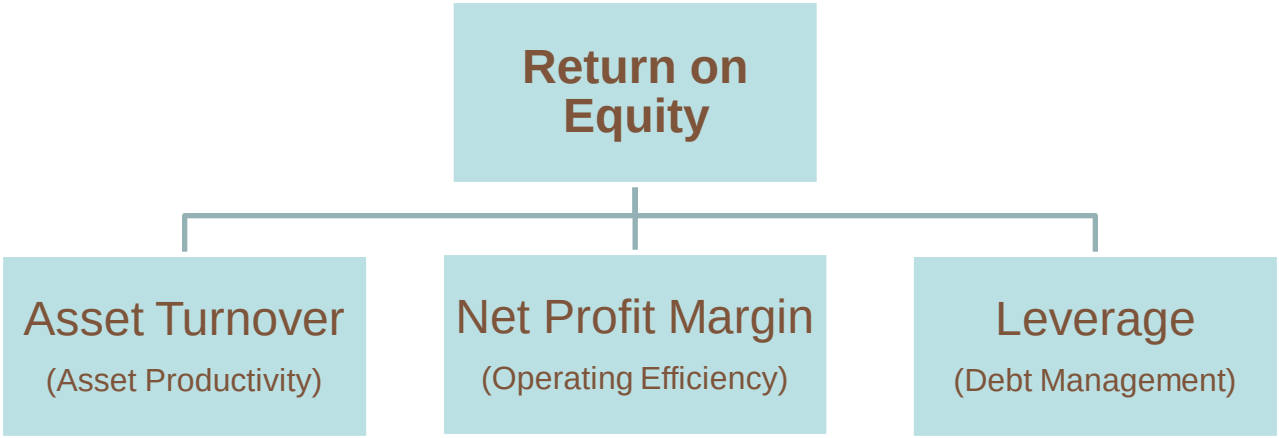
M. Mauboussin -"Mauboussin on Strategy" 12/2007

Measuring Financial Performance

Return on Equity Components



DuPont Method - When ROE is used in its components it becomes a **system** to delve from the **whole to the parts**, showing an integrated perspective in an operationally relevant way

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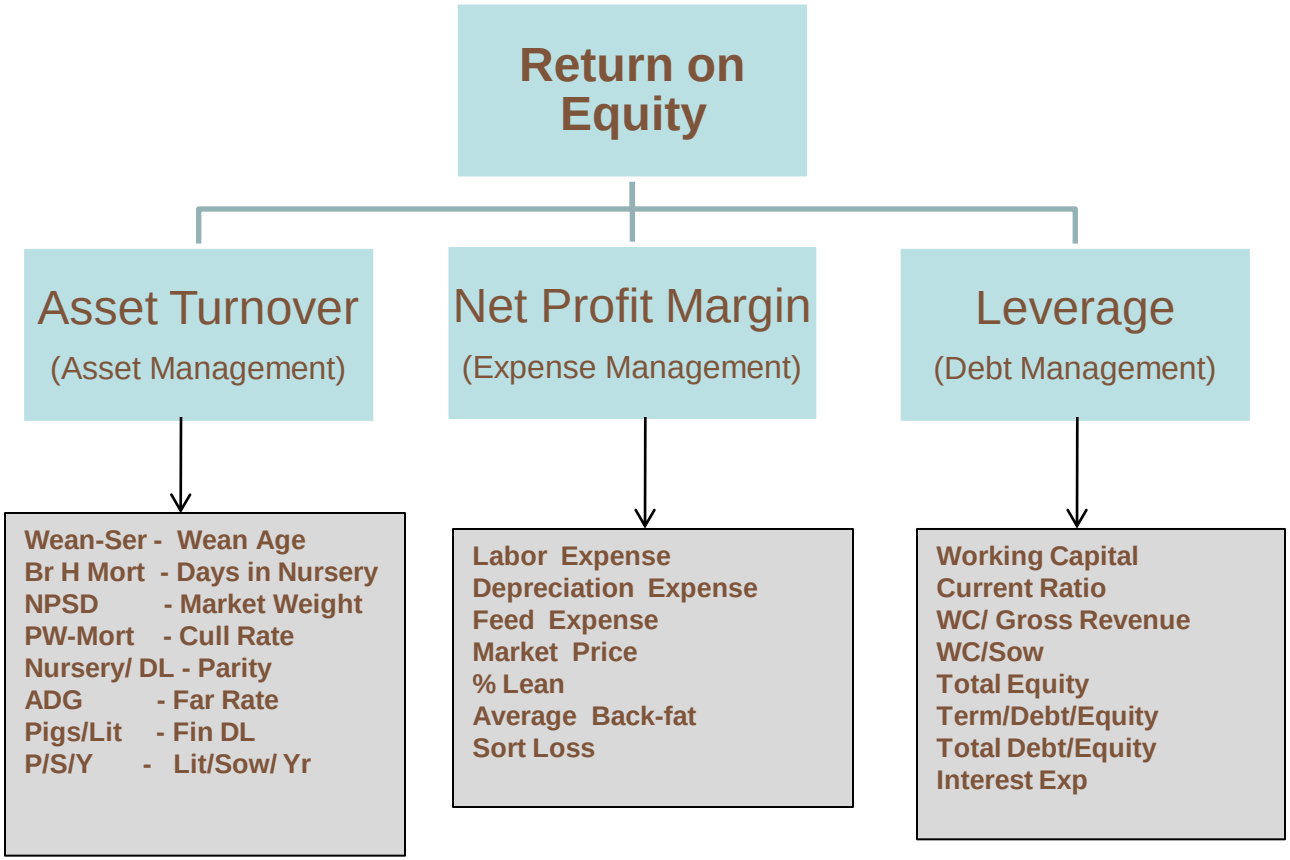
Focusing Financial Performance

ROE– Management Tool Linking FI's to KPI's



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DuPont Family Metrics

Financial Performance Assessments

ROE		Profitability		Asset Utilization				Leverage
Business Process	**Revenue Growth**	**Cost of Goods Sold**	**S, G & A**	**Sales A/R**	**Inventory Cycle**	**Purchases A/P**	**P, P & E Fixed Assets**	**IP & Other Strategic Assets**	**Capital Employed**
Sales & Marketing	✓		✓	✓	✓				
R & D / Development	✓	✓	✓					✓	
Customer Services	☐ ✓		✓	✓					
Order Management	✓			✓					
Purchasing / Sourcing		✓			✓	✓			
Production / Processing		✓			✓		✓		
Warehouse / Distribution		✓			✓		✓		
Transportation		✓			✓		✓		
Financial Management			✓	✓		✓	✓	✓	✓
Human Resources			✓						
Information Systems			✓					✓	
Supply Chain - Logistics					✓		✓		
Strategic & Risk Planning	✓	✓	✓	✓	✓	✓	✓	✓	✓

The ROE Structure of Profitability: Breaking Out the Drivers

ROE is the product of five "Drivers" (ratios)

- Operating profit margin
- Capital turnover

Captures the impact of the firm's investing and operating decisions

- Financial cost ratio
- Financial structure ratio
- Tax effect ratio

Reflects the impact of the financial policy on the firm's overall profitability. Their product is called the financial leverage multiplier.

ROE Components	
Operating Margin	(EBIT/Sales)
Capital Turnover	(Sales/ Invested Capital)
Financial Cost Ratio	(EBT/EBIT)
Financial Structure Ratio	(Invested Capital/Owners' Equity)
Tax Effect Ratio	(EAT/EBT)
ROE	

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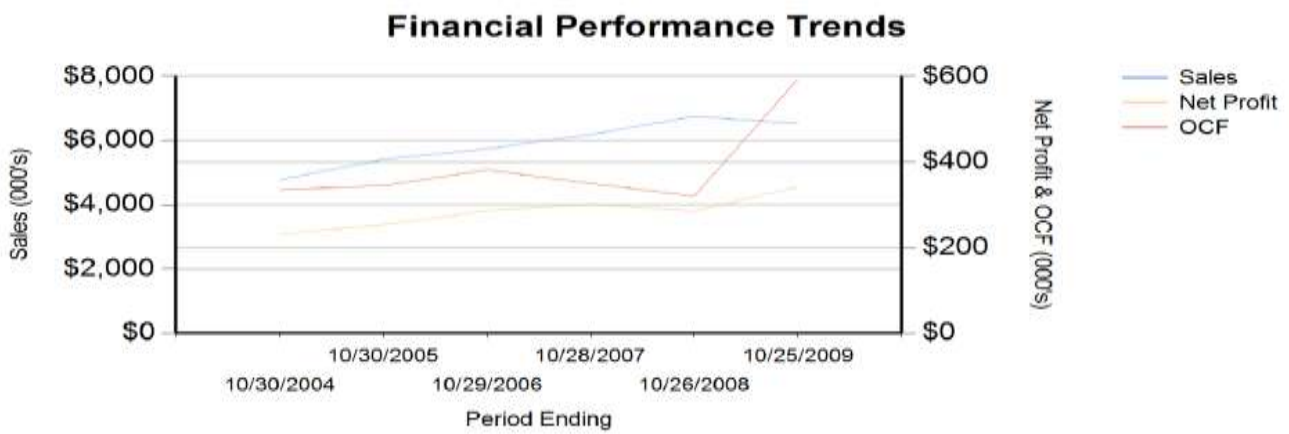
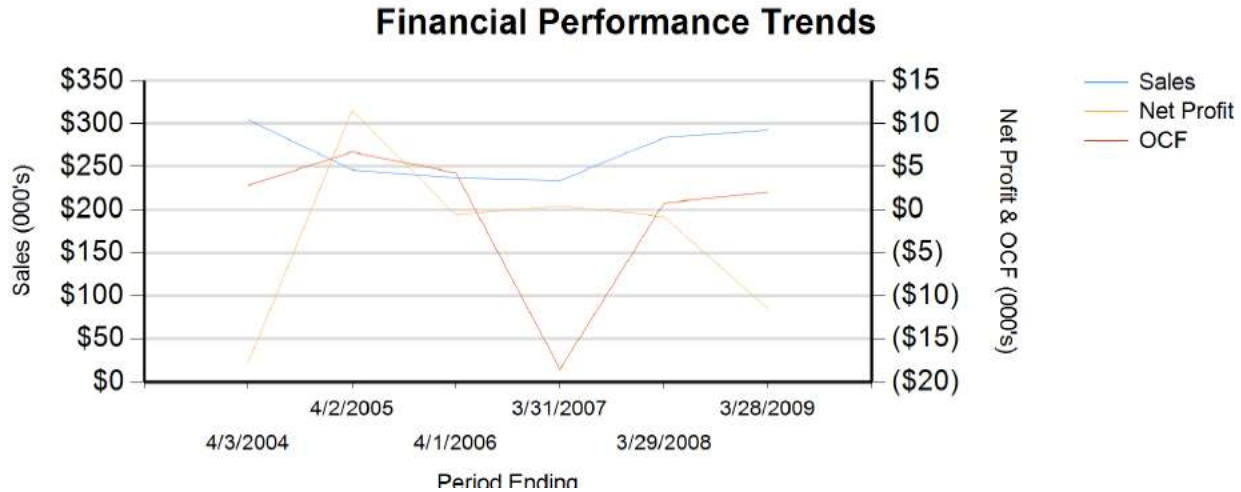
Sales, Net Profit & OCF Trends



Co. 1



Co. 2

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Standardized Capital Cost

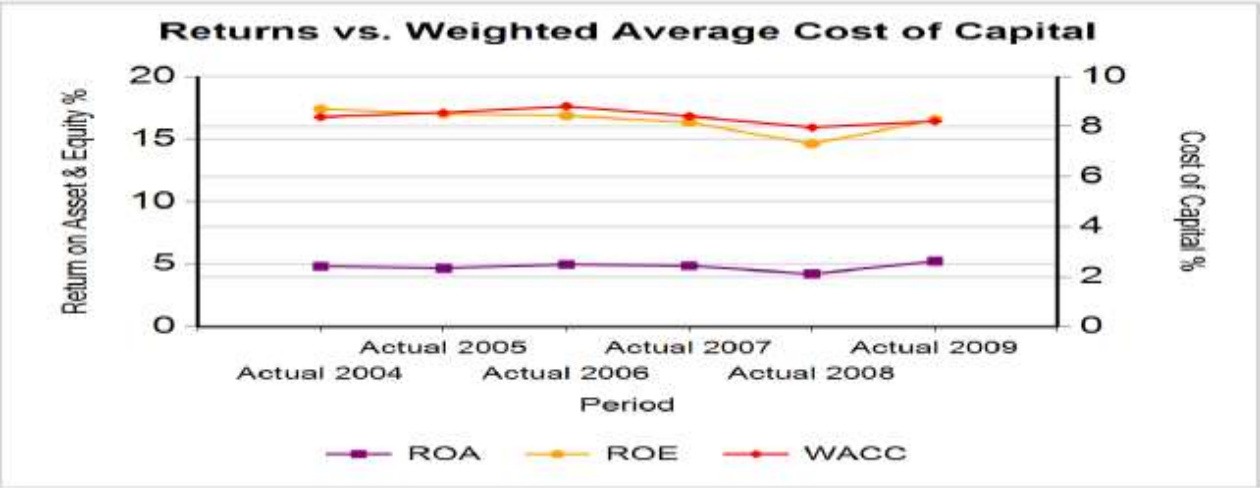
Co.1

Capital Cost							
	Short-Term Debt	3.00%	4.50%	5.50%	5.00%	6.00%	2.50%
	Long-Term Debt	6.50%	6.50%	6.50%	6.50%	6.50%	4.20%
	Owner's Equity	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%
	Average Capital Cost (WACC)	8.19%	8.39%	8.57%	8.82%	8.43%	7.97%

Co. 2

Capital Cost							
	Short-Term Debt	4.50%	5.50%	5.00%	6.00%	2.50%	2.50%
	Long-Term Debt	6.50%	6.50%	6.50%	6.50%	4.20%	4.20%
	Owner's Equity	10.50%	10.50%	10.50%	10.50%	10.50%	10.50%
	Average Capital Cost (WACC)	6.88%	7.94%	8.01%	7.65%	7.84%	6.58%

Returns & Standard Capital Cost Trends



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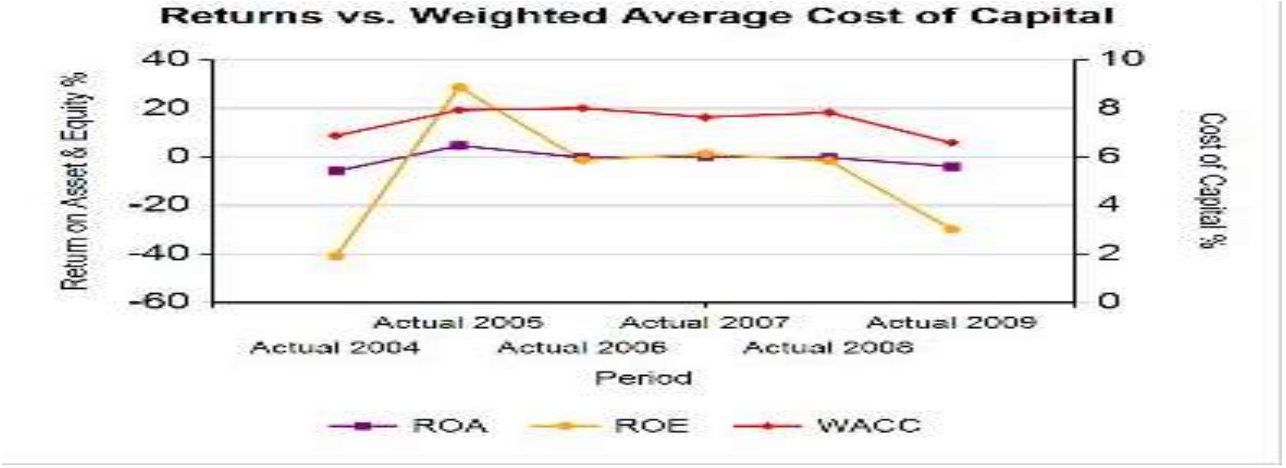

Co. 2

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Shattuck Hammond
Minimum Operating Margin

Premise:

- To maintain value, assets must at least earn their cost of capital
- You must know and actively use full cost of capital
- Challenge for privately held companies

- SH MOM is a DuPont - ROE variation
- Using SH MOM, the required operating profit margin to finance the company's revenue growth plan can be determined – ***"Targeted"***
- SH MOM can be used as a business planning testing tool and to guide and track progress

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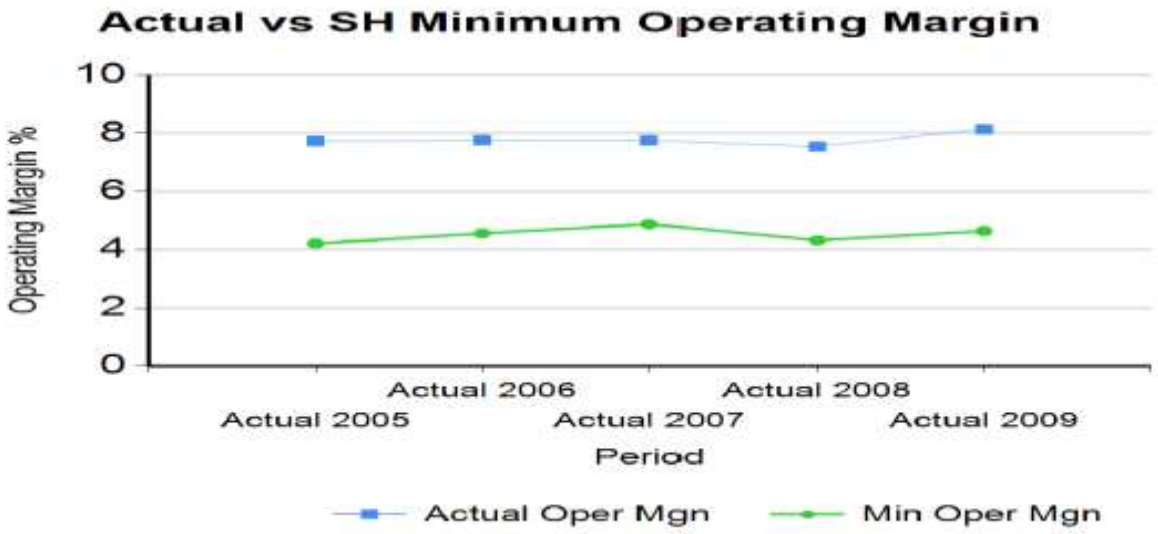
Target Operating Margin Trends



Co. 1

Co. 2

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Case Studies

Case 1 - Growth Strategy & Leveraging Capital
Case 2 - Vertically Integrated Production System
Case 3 - Unmasking Financial Performance

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Case 1: Growth Strategy – Leveraging Capital

Situation:

Expanding a "non-core" division that utilizes core business capacity while justifying the required working capital investment

Solution:

Utilized both comparative costs, returns and target operating margins to justify investment and working capital commitment

Result:

While accepting a lower per unit profit a significantly higher return was achieved compared with the fully–owned and higher required capital investment option

Reduced capital resource requirements 43%, freed capital to grow "core" business and achieved an acceptable return for capacity use

Take Away:

Balancing ROA and profitability for investment justification, capacity utilization and to see value contribution

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CASE 1: Growth Strategy – Leveraging Capital

ANALYTICS OVERVIEW:

	Fully-Owned vs. Contracted	Difference
ROA (10-Year Returns)	**17.71%**	**- 9.56%**
Net Profit Per Unit Sold	**+ $0.0051**	**+13.2%**
Profit & Loss Range	**$0.1985**	**$0.1963**

Note: Comparative profitability and capital returns developed from standardized industry groups to eliminate company bias

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Case 2: Vertically Integrated Production System

Situation:

Determining the optimum investment alternative for integrating swine production into a vertical pork system

Solution:

A dual cost and return approach was developed as part of a scenario analysis to assess the strategic investment options

Scenarios considered- fully owned, partially owned and outsourced

Result:

A partially owned, vertically coordinated system was designed and implemented, its production cost with an acceptable cost variance was more than offset by a greater return and significantly reduced capital requirements

Take Always:

Capital stewardship and supply chain competitiveness -- balancing costs with returns

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CASE 2: Vertically Integrated Production System

ANALYTICS OVERVIEW:

Strategic Investment Options:	**Fully-Owned**	**Partially Owned**	**Outsourced**
Per Unit Production Capacity			
% Financed	**69%**	**73%**	**80%**
Production Cost Index	**1.0000**	**1.0113X**	**1.0255X**
Op Profit Margin Index	**1.41**	**1.16**	**1.00**
ROA	**13%**	**17%**	**20%**
Asset Turnover	**.73**	**1.17**	**1.59**

Note: Analysis utilized industry performance assumptions for comparative purposes

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Case 3: Unmasking Financial Performance

Situation:

Management did not see or understand that the actual results, while profitable, were not generating resources to sustain the company

Solution:

Capital performance trending reveled that margins and cash flows were contracting because returns did not cover the cost of capital for the capital supplied by owners

Result:

Generated a different "team" understanding for the actual financial results achieved compared to traditional operating metrics

Provided a more objective and systematic approach to planning and measurement

Take Always:

Balancing ROA and profitability for investment justification and capacity utilization

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CASE 3: Unmasking Financial Performance

ANALYTICS OVERVIEW:

(000 ‘s)	1	2	3	4	5	6
Gross Profit Trend Index	1.00	1.12	1.25	.99	.99	.97
OCF-%/Sales	14.6%	13.1%	16.1%	.0%	9.0%	9.3%
SHP-Min Op Margin ***(Target)***	--	10%	14%	16%	12%	11%
Actual Margin	15%	13%	16%	2%	9%	9%
ROA	6.1%	5.2%	6.4%	-4.8%	7.5%	.2%
Capital Cost	4.2%	4.5%	6.1%	6.4%	6.2%	7%
Difference	1.9%	.7%	.3%	-11.2%	.3%	-6.8%

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New Conversations–Measuring What Matters

Key Management Questions

- What do my numbers show? What do you measure?
- How are your metrics used? Strategically or tactically?
- Do they lead or guide effective decision making?
- Do they help drive planning/actions that create value?
- *Do you leave meetings with the confidence that your team is in command of the business?*
- *Do you have the right financial processes in place and are you using the right tools and metrics for on-going profitability?*

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