

Manufacturing insights

Special report

The diversification decision July 2008

Many Canadian manufacturers today face uncertain and complex business futures. Economic conditions and currency appreciation suggest a broader approach to business may be necessary—new customers, new products, and/or sales into new markets and geographies. Yet diversifying an organization and its product and service offerings can be formidable, and demands rigorous analysis of the opportunity and its rewards and risks.

The diversification decision begins by gaining a better understanding of what you do well and how you compete in markets, clearly segmenting product lines to reveal what is working and where. Where does your company currently capture its highest margins? But also where might it grow profits (i.e., maybe products aren't selling today but will to different customers, markets or geographies). In doing so you thoughtfully narrow the focus of diversification opportunities based on corporate capabilities (current and

potential) and fuel ideas as to how to proceed (or not).

Ways to diversify

Diversification presents tremendous opportunities for profitable growth, and quick analysis often appears favourable (i.e., higher sales). For example, if a customer requests new products or wants your company to follow it overseas, an immediate vision of new revenue streams ensues. But even under such circumstances it's prudent to explore deeper. Only by assessing how various types of diversification, alone or in combination, will impact your business—operationally, organizationally and systemically—can you begin to make strategic decisions that steer toward long-term, sustainable growth.

New customers

One of the least radical ways to diversify is to simply sell what you currently make to new customers in your existing markets and geographies. While simple, this still

means finding those new customers and then fulfilling more orders:

- **Operations**—Make sure you are a good manufacturer—continuous improvement that leads to productivity gains—before you start throwing assets and investments at diversification. Increased sales volume will require operations capacity, both physical assets and human capital (sales and production). If it doesn't exist or can't be gained through ongoing process improvements, you'll need to secure capacity through expansion or outsourcing. Stretching either sales or operations too thin can lead to diminished sales from existing clients (who retract from the lack of sales attention) and/or products and delivery dates that fail to meet previous standards (as overburdened production can't keep up). And, most basic, can you serve new customers without upsetting existing customers in your market?

- **Organization**—Financially well-structured manufacturers should be able to fiscally manage the impact of increasing sales, as the additional cash flow should be able to support higher volumes of purchased materials. But a mismanaged float can cause a cash crunch, especially if one large customer comes into play, and increased sales also erroneously transform into disproportional increased inventories as manufacturers brace for a wave of new orders or are challenged by more complex production schedules and resource plans.

New markets

Entering into new markets with the same or altered product lines (e.g., a commercial product repositioned for consumer markets) can exponentially increase the customer base:

- **Operations**—New markets pose capacity issues, the need for personnel that are able to navigate new distribution channels (e.g., sales staff with market expertise), and the engineering acumen to take existing products and adapt/translate them to different markets. The latter is no small feat, as product modifications are often accompanied by changes to packaging, distribution and service delivery.
- **Organization**—New markets require new expertise that must be grown or secured via partnerships, alliances or acquisitions. As with any M&A activity, substantial due diligence is necessary to ensure viability beyond merely access to a market. In addition, many manufacturers fail to consider how seemingly simple market changes can impact existing business models. For example, will internet sales upset existing distributors and can you manage the additional costs of warehousing and logistics?

New geographies

The appreciation of the Canadian dollar relative to the US dollar and the deterioration of the US economy has presented manufacturers with the impetus to seek opportunities to expand their geographical customer bases, looking to Europe, Asia and elsewhere:

- **Operations**—Movement of goods into new countries poses operational challenges: build operations facilities, ship products long distances, and/or find partners/outsourcers who can capably carry out your work. You also are likely to encounter unique regulatory bodies and standards that can severely impact the ability to sell your products or, at least, pose engineering challenges as you adapt products for the country. For example, the European Union's Waste Electrical and Electronic Equipment Directive (WEEE Directive) puts the responsibility for disposal of waste electrical and electronic equipment on the manufacturer; similar electronic waste regulations are emerging in Canadian provinces.
- **Organization**—Analytics are required to fully grasp international transfer pricing issues, potential exposure to foreign taxation, and costs and regulatory requirements posed by customs duties and tariffs. Entry into some countries may expose your intellectual properties to local firms operating amid weak copyright and trademark laws. Can you turn sales and profits fast enough before others replicate your goods? Will the window for payback stay open long enough to eventually grow international business and bases of operation?

New products

In many industries, such as communications and electronics, the need to continuously innovate is a must. And even in traditional industries, more frequent innovation and

customization of products is desired by customers. But the ability to truly innovate—not just product iterations—is the most difficult diversification skillset to obtain.

- **Operations**—There are two major operations challenges associated with new products: Have you developed a product that addresses a clear market need? And can you profitably manufacture and distribute that new product? Many companies are launched with a single product or product line, which occasionally sustains a manufacturer for life. But as manufacturers grow, most eventually grow or acquire the acumen to develop new products. Do you have the people, processes and management systems to generate great product ideas? The production challenge is less constraining as innovative product ideas can be supported by outsourcing. If the new product sustains itself in the market, you can always bring those capabilities back in house.
- **Organization**—Even with the financial aids provided by government for innovation—e.g., Scientific Research & Experimental Development (SR&ED) tax incentives—there is substantial risk in launching new products. While sound methodologies exist to incrementally develop and test product concepts, a new product launch can drain an organization of capital that could have been spent on more proven paths. The organizational challenge in innovating is not so much what the process delivers, but the speed at which your company can innovate and turn ideas into marketable products/services. First to market presents a huge advantage, but one that is fleeting. Have you developed the organizational structure—streamlined R&D capabilities, nimble market entry and corrections—to launch products repeatedly?

In addition to the unique operational and organization conditions impacting each form of diversification, systemic business issues of tax consequences and financing are ever present.

Most Canadian banks are aggressively raising the costs of capital. Other options do exist, such as venture capital and government-sponsored equity funds, but you will give up some degree of control and/or face premium pricing.

Upfront and efficient assessment of tax consequences is integral to effective diversification. Don't let weak internal accounting slow or derail a diversification initiative.

The reverse option—contraction

No two manufacturers are the same, even when it appears that all assets, markets and operations expertise match up. Too often the diversification decision comes down to leadership's appetite for diversification. We frequently see manufacturers ignore sound analysis and stand pat because of fear. Complacency can be a crutch that slows growth and forces a slow, unintended contraction.

Yet there are good reasons for businesses to contract:

- **Focus**—In tough economic times, “sticking to your knitting” can keep companies afloat until markets rebound. The quicker such contraction decisions are enacted, the more likely a turnaround is possible.
- **Simplify**—Overexuberant diversification eventually calls for an analysis of product portfolios and markets. Have product lines become too broad and SKUs too many?
- **End**—In privately held companies, succession paths for owners can end. Here, as with any contraction, protecting the assets of owners as well as employees and other stakeholders must be a priority.

Diversification, accepting the status quo, and contraction are all sound business decisions for manufacturers—provided you've done the analysis and know, with reasonable certainty, the likelihood of success prior to execution. And you'll need to have the systems in place to measure and monitor the progress of your diversification decisions. If outcomes don't materialize as planned, you can fix it or pull back.



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Diversification—Grant Thornton solutions

	Operations best practices	Organization best practices	Systemic best practices
New customers	<ul style="list-style-type: none"> Identify potential conflict with existing customers and ensure resources in place to manage existing clients while pursuing new clients 	<ul style="list-style-type: none"> Develop profitable-customer profile as guidance for sales efforts Equip sales staff with resources/tools to develop new-customer relationships 	<ul style="list-style-type: none"> Regularly evaluate tax consequences of potential actions/inaction Evaluate the availability of capital and understand the potential sources of capital (e.g., traditional financing, equity, venture, angel and government assistance); conduct in conjunction with cash-flow analysis Verify appropriate planning is undertaken to ensure adequate cash flow; establish clarity around amounts required, when it will be needed and when it will be available Strengthen your banking relationship by treating your bank as a partner not a service provider; keep them informed Establish management systems to monitor growth and results in a timely fashion against pre-established goals/expectation
New markets	<ul style="list-style-type: none"> Analyze existing processes in context of new market requirements/adaptations Identify necessary product adaptations Acquire (hire or outsource) expertise to navigate new distribution channels Assess distribution channel conflicts with existing markets (e.g., bypassing distributors) and preempt issues 		
New geographies	<ul style="list-style-type: none"> Evaluate all product-build options (build-and-ship, outsource, new overseas facilities) short- and long-term Identify unique product characteristics (e.g., labelling, insurance, packing) required per region/country Understand logistical challenges of getting product to the right place at the right time 	<ul style="list-style-type: none"> Recognize that rules governing IP, trademarks and patents are generally territorial and complex (i.e., although you may have protection in Canada, it likely does not extend to other jurisdictions) 	
New products	<ul style="list-style-type: none"> Build capabilities to repeatedly incubate ideas and swiftly bring new products to market Align product ideas with long-term strategy Collaborate/communicate with customers for new product or product enhancement ideas Regularly assess industry conditions and impact on potential and existing products 	<ul style="list-style-type: none"> Utilize sound project management methodologies Create a culture supportive of innovation—e.g., don't punish failure Establish “gate-posts” at which key decisions like commercial viability and technical feasibility are revisited and confirmed Create effective teams by encouraging cross-functional participation and diversity of experience 	

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