

Profitability via Productivity

Canadian manufacturers can compete – even dominate – in the global market. But they will need new skills – and a new concept of manufacturing.

Introduction

Canadian manufacturers are optimistic about revenue and economic growth but unsure about their prospects for improved profitability. Why? Grant Thornton believes this uncertainty reflects concerns about whether Canadian manufacturers are measuring up to world-class standards. Some questions need to be asked: Are Canadian manufacturers improving productivity as quickly as their global competitors? Are Canadian manufacturers flexible enough to adapt to rapidly changing markets? Are Canadian manufacturers innovating with both products and processes? Are Canadian manufacturers getting the most out of their supply and value chains or are they falling behind more nimble competitors?

Some Canadian manufacturers are already doing all of the above, but recent research indicates they're more the exception than the rule.

Canadian manufacturers face both threats and opportunities in global markets that require excellence in all phases of business, from R&D to sales to customer support. Few manufacturers can achieve world-class performance across this entire spectrum of activities, and the savviest will search out supply-chain partners to support their operations. The rest — including a large percentage of Canadian manufacturers — will find the transition from vertically integrated manufacturer to supply-chain manager difficult. Yet this transition is necessary if manufacturers want to improve productivity and maintain profitability.

Profitability via Productivity offers a clear view of Canada's current manufacturing climate as well as strategic insights. The key to consistent profitability is improving the productivity of a manufacturer's core competencies and, where that cannot be done, leveraging the company's supply chain wherever possible to boost productivity. Profitability via Productivity shows how that can be achieved.

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Optimism and reality

Are dramatic improvements in both growth and profitability possible for Canadian manufacturers in today's business climate? Yes, but we see evidence that many manufacturers are mistaking growth for profitability, and volume for productivity. Grant Thornton research on the economic climate and prospects for Canadian manufacturers reveals strong optimism:

- 70% of Canadian manufacturers are optimistic about the economy¹
- 61% of Canadian manufacturers report economic growth over the last three years²
- 74% of Canadian manufacturers expect revenues to rise in 2006 and 62% expect increases in profitability³
- 36% of Canadian manufacturers expect market demand within Canada to improve⁴
- 37% of Canadian manufacturers anticipate demand from outside of Canada to improve⁵

Yet despite this overall optimism, one in five Canadian manufacturers expects demand to weaken. And there are other indicators — such as employment expectations, a bellwether of economic growth — that suggest that manufacturers' bottom lines may not be improving as much as their top lines:

- 42% of Canadian manufacturers experienced employment growth over the past year⁶
- 49% of Canadian manufacturers expect employment levels to grow this year⁷, while
- 49% of Canadian manufacturers report higher production volumes in 2006, yet only 41% will see that growth translate into higher profits⁸

Savvy manufacturers can beat even underperforming markets, but it's important to remember that optimism about growth and revenues (volume) does not necessarily translate into improved profitability. In order to prepare for business growth, manufacturers believe they must reduce operating costs (76% of companies), introduce new/improved processes (72%), and improve labour productivity (69%).⁹ The *Grant Thornton Manufacturing Insights* report similarly underscores these beliefs. For example, Canadian manufacturers, like many other manufacturers around the world, have relied on cost-cutting (93% of companies), improved cash management (83%), and investment in new technology and systems (86%) to prop up profitability.¹⁰ But does this approach, especially the focus on cost-cutting and cash management, really improve profitability?

1 Grant Thornton Manufacturing Insights 2006 (MI 2006); reports on a sample of privately held mid-sized manufacturers.

2 MI 2006.

3 MI 2006.

4 Canadian Manufacturers & Exporters 2006-2007 Management Issues Survey (CME 2006-2007 MIS); Grant Thornton sponsor; reports on a sample of Canadian manufacturers, the majority of which are mid-sized manufacturers.

5 CME 2006-2007 MIS.

6 MI 2006

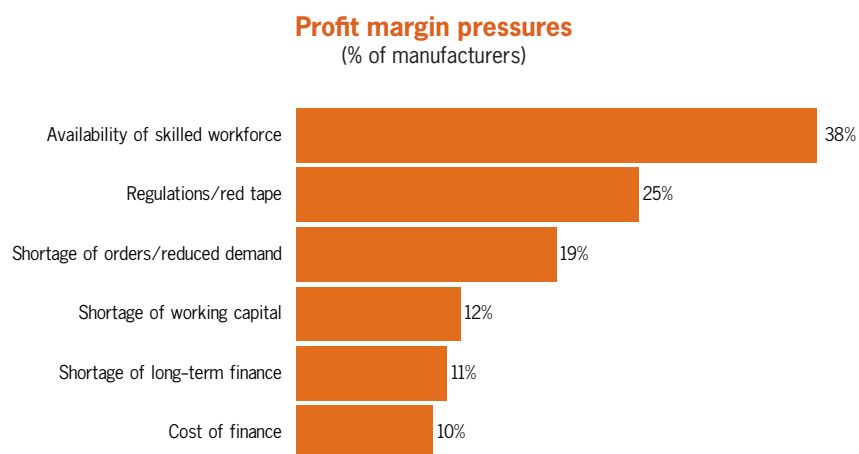
7 MI 2006

8 CME 2006-2007 MIS

9 CME 2006-2007 MIS

10 MI 2006

Companies can whittle away at costs, but if sales don't increase they can find themselves trapped. That's because customers worldwide are pressuring companies to cut prices. Only a slim majority of Canadian manufacturers (52%) expect selling prices to rise in 2006, while 62% expect that pressure to reduce prices will damage profits.¹¹



Source: Grant Thornton Manufacturing Insights 2006

Aggravating these pricing pressures is the fact that after years of cost-reduction focus, there is only so much left to trim at many businesses:

- 58% of Canadian manufacturers surveyed report increased raw material costs
- 57% of Canadian manufacturers report concerns with currency fluctuations
- 53% of Canadian manufacturers report rising fuel prices

Manufacturers also report higher employee-related costs, increased competition and increasing compliance and regulatory expenditures.¹²

The *CME Management Issues Survey* also finds that the vast majority of companies are concerned about worsening conditions for energy costs (80%), shipping costs (78%), and cost of materials (71%).¹³

The problems emerging from the cost side of the equation have been compounded by the appreciation of the Canadian dollar relative to most major currencies and the emergence of new economies creating increased manufacturing capacity. Both of these factors have put pressure on selling prices (as indicated earlier). This means it is becoming more difficult for Canadian manufacturers to compete primarily on a low-cost basis, and increasingly more apparent they must step up and innovate; Canadian companies have traditionally underinvested in R&D relative to the other countries in the G8, and that will have to fundamentally change. They must pursue efforts to differentiate and improve products, processes, and services.

The question is not whether Canadian manufacturers can improve, but rather whether they can improve quickly enough to keep pace with global competitors.

¹¹ MI 2006

¹² MI 2006

¹³ CME 2006-2007 MIS

Can Canadian manufacturers succeed alone?

Canadian manufacturers are bullish about investing in technology and systems. But technology needs to be applied correctly (why automate poor processes or speed up inefficiencies?) and it often requires an increasingly skilled workforce. Yet 38% of Canadian manufacturers report that the availability of skilled labour is a constraint on business growth.¹⁴

Even more troubling is that many Canadian manufacturers seem to be running faster just to stay in place. In our experience, most of these businesses would do well to pause, step back, and ask themselves, “What strategies are we using to guide both our cost-reduction and our investments? Are these strategies based on sound analysis and geared to improving productivity (not just lowering costs)? Are these strategies actually improving profitability?”

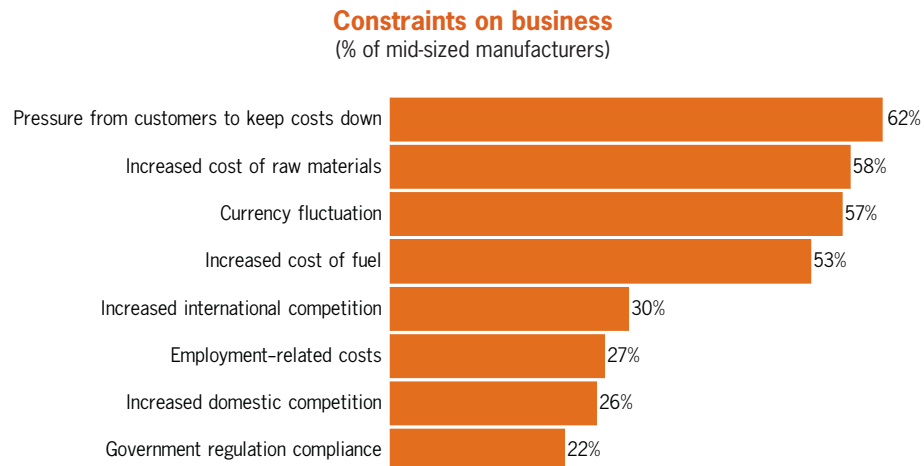
The reality is that while some manufacturers do rigorously assess their operations, many do not. For example, only half of Canadian manufacturers (54%) say they seek to “eliminate non-core services/activities.” Too often owners and executives want to believe (without evidence) that improvement is possible or feel compelled to “protect” employees even in non-core activities. Yet in today’s global manufacturing climate, a business can be a manufacturer without performing every facet of manufacturing — R&D, fabricating, assembly, shipping, etc. — by moving these functions to wherever they can be most efficiently executed.

Indeed success for Canadian manufacturers will increasingly require growth beyond domestic borders. Most Canadian manufacturers are already engaged in some degree of exporting (85%), and about one-third of companies expect stronger export sales.¹⁵ But while there is an awareness of the importance of exports, there is little evidence of cross-border outsourcing:

- 13% of Canadian manufacturers currently outsource some of their operations to other countries
- 37% of Canadian manufacturers currently outsource, and only
- 4% of those who don’t outsource plan to start.¹⁶

¹⁴ MI 2006
¹⁵ CME 2006-2007 MIS
¹⁶ MI 2006

We see countless manufacturers, particularly those that are privately owned, hesitate to consider outsourcing or offshoring, in part because they operate like bootstrapping entrepreneurs rather than strategic CEOs. Consider the constraints cited by Canadian manufacturers for achieving performance improvements: limited resources (39%), cost (35%), lack of qualified personnel (33%), lack of time (31%), and organizational culture (24%).¹⁷ These constraints collectively plead for an approach that combines internal improvements with the ability to make the most of available external competencies. The *Grant Thornton Manufacturing Insights 2006* study echoes many of these findings.



Source: Grant Thornton Manufacturing Insights 2006

Savvy manufacturers optimize their internal organizations and seek outside support from the supply chain to grow as world-class manufacturers, improving productivity, profitability, and their ability to innovate. They typically do this using a four-step method:

- analyzing business operations based on meaningful performance indicators, such as “total cost”
- understanding potential internal capabilities and, where possible, retaining and improving the organization’s strengths
- identifying weak internal activities that cannot deliver profitability, and subsequently seeking external relationships to support these; and
- managing, controlling, and improving all of these activities as a seamless stream of supply-chain activities.

Achieving productivity via internal improvements with external support

Canadian manufacturers often lack the metrics required to assess their organizations, and frequently fail to make these measures visible even when they're available. Today's global environment requires world-class capabilities for all activities in which a company is engaged; gauging those capabilities requires a structured analysis that answers four questions:

- What is the financial performance (profit) of this activity or function?
- What are the total costs associated with this activity and how can they be reduced?
- Can we realistically improve performance of the function — speed, delivery, quality, innovation, productivity, etc. — in a reasonable amount of time? And how do we do it?
- Are there reasons other than performance (tax ramifications, intellectual property, image or brand-building, emerging markets or process advantages, etc.) that require the activity to remain internal?

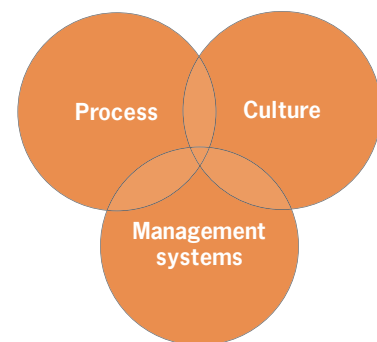
Unless the answers to these questions lead to a definitive conclusion that the work should be kept inside, external options ought to be considered by weighing the potential of the internal activity. Ask the question, “If we worked at this, could we do it better?” This is particularly true as it relates to improving or developing the culture and tools of innovation, which are often found lacking. Upon analysis external options may not be superior to internal operations, and so outsourcing wouldn't be worth the effort. Analysis must take into account that outsourcing is not an activity to be considered in isolation, but should be incorporated into the complete manufacturing strategy. Prior to embarking on an outsourcing strategy, Canadian manufacturers need to act on the following:

- **Improve internally:** Manufacturers keeping business activities in-house must commit to continuous improvement of those functions. Strategic direction, organizational effort, and financial investment should be targeted to improve behaviour, processes and management systems, and thus improve productivity:

- Culture/behaviour: Ensure that organizations work with a sense of urgency and purpose. Individuals must have realistic targets and they must feel accountable to these targets. When targets are not attained there must be thoughtful fact-based analysis as to why. After the why is determined there needs to be solid action to eliminate the causes.

- Processes: A culture that continuously reviews its current processes and actively searches for ways to improve will be required to effectively compete. Process improvements can come from a variety of methods, but for sure an organization will always need to be driving to improve their organization's productivity through improved processes.

Capitalizing on growth



Source: Grant Thornton Productivity Improvement

- Management systems and tools: The information that is required to make decisions must be constantly challenged and upgraded to ensure that accurate data is being used at the right level in the organization to support proper decision-making.

When working to improve internally, many manufacturers often overlook substantial government support that is available. Take advantage of federal government programs offered by departments such as the Industrial Research Assistance Program and the Scientific Research & Experimental Development (SR&ED) tax credit system. A *Canadian Manufacturers & Exporters'* recent survey of Canadian manufacturers shows that only 39% of the manufacturers use the SR&ED program and 31% of the companies not using it were not even aware of the program.¹⁸

If, upon analysis, it is apparent an outsourcing strategy makes sense, consider doing the following:

- **Engage outside support:** Functions that are not core, or where it is difficult improved productivity, should be “managed” as part of the supply chain but “owned” by supply-chain partners. Depending on an organization’s unique ownership and financial structure, this can occur simply by outsourcing or offshoring, or it might take the form of consortiums, partnerships, alliances, joint ventures, etc. Outside support from supply-chain partners as well as universities and institutions is especially helpful for companies migrating from a low-cost position to one of innovation, quickly gaining access to research and product development capabilities.
- **Manage the pieces:** Managing business activities that have been distributed across the supply chain is challenging but can also be highly productive and profitable. Every organization has unique strengths, weaknesses, needs and cultural issues. And although certain business functions may no longer be technically “owned” by the business itself, it must still manage the activities as if they are. This will require active oversight, especially regarding handoffs between functions. Manufacturers must take the lead in communications, setting standards by which information is shared.

Even when external options are clearly better, many manufacturers remain reluctant to outsource. They fail to recognize the need to transform themselves from makers of products to managers of a broader supply chain that benefits all stakeholders: customers, employees, and vendors. Canadian manufacturers need to be looking in two directions to improve productivity — internally and externally — and only by doing so will they achieve the profitability possible in their organizations.

Who is Grant Thornton LLP?

Grant Thornton LLP is one of Canada's largest accounting and consulting firms focused on serving entrepreneurial organizations. Our team of dedicated professionals offers a full range of services, including audit, tax, business and financial advice and more. With offices from coast to coast, and access to member firms worldwide, rest assured you'll be receiving a wealth of expertise accumulated on a global scale with the professionals at Grant Thornton LLP.

Leaders in services for the manufacturing and distribution sector

When it comes to serving your sector, many of our practitioners are leaders in their area of practice. With over 60 years of experience in the manufacturing and distribution sector across Canada, business owners have counted on us to provide the advice they seek to compete and grow in their industry sector.

What makes us different?

Grant Thornton has extensive experience in working with clients in manufacturing and distribution. Why? Like our clients, we are entrepreneurial in how we do business. Not only do all our practitioners commit to ongoing sector-specific training, our integrated, team-based approach means your business benefits from the result of Results-Driven Advice™. Our regular interaction with clients is why Grant Thornton has many long-term relationships, and the reason why many business owners turn to us to better position their business for success every day.

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