About the Manufacturing Executive Institute

The Manufacturing Executive Institute (MEI) is a training and publishing organization dedicated to bringing relevant knowledge to individuals who are interested in making dramatic performance improvements in their manufacturing and distribution companies. To learn more about the Manufacturing Executive Institute, go to: **www.mfgexecutive.com**

How MEI Delivers Knowledge

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These include several regularly scheduled and focused training series, and custom designed and scheduled training programs delivered either at MEI's training center or at a client company's site. To learn more about MEI's live training programs, go to: **MEI Live Training**.

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"Don't blame the marketing department. The buck stops with the chief executive."

... John D. Rockefeller

What *Really* Drives Shareholder Value?

By Alan G. Dunn, President of GDI Consulting & Training Company

In simplest economic terms, *(the terms we most prefer)* shareholder value can be measured by looking at the performance of the stock and the dividends over some reasonable time period. A company is returning a reasonable value to owners if the return meets or exceeds the alternatives. If it does not, then it is a sub-standard return.

Profitability and ROE increase when an organization's leaders obsessively and continually seek answers to the following four critical questions:

1. How can our company increase unit sales price?
2. How can our company increase unit sales volume?
3. How can our company reduce direct operating expenses?
4. How can our company better utilize fixed resources?

While these questions seem to be void of direct comment relating to markets and customers, they are not ignoring them. These questions will ultimately measure the success of any strategy that focuses on markets and customers. It will be very difficult to enter discussions about profitability or market share without discussing pricing or sales price. Such discussions around customers and markets will happen naturally.

These four issues have a significant amount of intellectual overlap. Change one and you could impact the others. Understand each of them individually and how they collectively impact one another, and you may be on the road to some serious cost reductions!

Now, a little more drill-down on these four important issues:

1. Increasing Your Unit Sales Price

Executives must stop believing that price is the key driver of demand for their products and services. Even in commodity products, customers look for value. Study after study have shown that while the product or service being provided may be a commodity, the go-to-market process (strategy) rarely is a commodity.

For example, gasoline is clearly a commodity by any definition. And yet, there

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are some gasoline stations that perform substantially better than others selling this commodity. There is a consumer gas station in Anaheim, California that generates over $35 million in annual gasoline sales. There is also a gasoline station in Tumalo, Oregon that sells just a little under $5 million in annual gasoline sales. Both sell at exactly the same price. Then why such a difference in volume? How can it be that this commodity, which is sold at roughly the same price everywhere, has such a broad range in station sales volume? Though many may "over-intellectualize" the answer to this question, the answer is actually very simple. Sales of the gasoline commodity are higher at the Anaheim station because it is a better location that has far more automobiles passing by it's pumps in a given day than the Tumalo station does. The commodity sells more volume because the "design" of the "service" is superior in Anaheim than in Tumalo. The reason the Tumalo station sells less gasoline is that the owners either designed it or allowed it to be designed that way. Philosophically speaking, they chose to *restrict* their volume… irrespective of price.

Improving sales volume in Tumalo will therefore require a total rethinking of the product, the price, the distribution channel and the buyers' desires. Increasing price in a commodity market means that the fabric of the product and all that makes, sells and distributes the product, must be assailed.

In 1973, breweries in the United States were blazing along, generating 9% to 11.5% pretax profits. Shareholders were pleased with performance but did not know of the impending disaster. You see, sales were beginning to flatten and pricing was becoming more competitive, especially as national brewers built mega-breweries to capture economies of packaging and hub-distribution scale. The product… beer… was clearly a commodity and was rapidly moving into "pork belly" status. All the major breweries were therefore at "parity" with one another. No one was doing anything that would set their company apart from the pack. Finally, Miller brewing invented "light" beer and changed the rules of competition… and gained substantial share value improvement through a new product that they could sell at a premium price.

2. Increasing Your Unit Sales Volume

Sometimes companies have to "break some china" in order to increase sales volume. They have to look at new markets for old products, old markets for new products, new distribution channels and new "go-to-market" strategies. Irrespective of the way sales volume is increased, it all ends up as a larger numerator which financially results in lower incremental fixed costs and potentially higher margins.

Increasing sales volume is all about growing the company. After decades of downsizing, right sizing and otherwise shrinking the asset base of companies, executives are now keenly interested in unique and even risky ways to grow the company's top lines. Executives have learned what my entrepreneurial father taught me at an early age:

"Cost reduction is an obligation in bad weather and Sales growth is an obligation in good weather. Cost MANAGEMENT is an obligation in ALL weather."

Companies that focus exclusively, or disproportionately, on cost reduction are not doing their stockholders any favors. Shareholder value has never sustained a growth pattern in a cost-reduction-focused enterprise… never! Share value enhancement requires as much innovation on the sales side as the operations side of the company. This is not to say that cost management should be ignored, only that the enterprises leaders should worry about growth as much as they worry about cost containment. Let me provide an illustration to explain this point better.

In 1989, 17% of the domestic airlines were either in legal or technical bankruptcy. Every time another airline filed for legal bankruptcy protection, they immediately were relieved from their monumental debt service which is so prevalent in the capital intensive airline industry. After this relief, their cash flows immediately improved, allowing them to reduce fares and draw in new customers. Effectively, each airline was incrementally pricing with the absence of debt service. This in turn drove down prices throughout the airline industry which further exacerbated the industry's price and volume problems.

clearing house for manufacturing and distribution industry professionals to post their resumes and position desires, and for employers to post their employment needs. To learn more how to post a job or resume on MEI's Career Clearing House, go to: **MEI Career Clearing House.**

Contact MEI

With a state-of-the-art training facility located in Corona, California; *(the geographic center of Southern California's manufacturing and distribution communities),* MEI is uniquely positioned to provide hands-on and electronically delivered training programs to all manufacturers and distributors. To learn more about the Manufacturing Executive Institute, its mission and additional programs, go to **www.mfgexecutive.com** or call (951) 736-2114.

In the end, each airline grew its volume but did not solve the over-capacity situation in the industry. What at least one bankrupt airline should have done, was used their debt service relief to fund the introduction of new and innovative services that customers would be willing to pay extra for. Increasing volume without increasing cash flows gains the airline NO competitive advantage. Investing in a NEW competitive advantage is always a better strategy when an entire industry is fighting for survival.

3. Reducing Your Direct Operating Expenses

Reducing direct operating expenses is the fastest way to increase ROE. This is because when direct operating expenses are reduced, savings go right to the bottom line. In addition to these, the savings manifest as increased liquidity… which is very easy to spend. This is because cash is the rawest of inventory and has many alternate uses. When cash is converted to raw material, its alternate uses diminish. When it converts to finished goods, you have virtually no alternative other than to sell the product in its final form. Thus, risk increases as liquidity decreases and as direct expenses increase. The logic may not be rocket science, but it certainly is irrefutable!
Direct operating expenses are normally limited to:

- Material
- Scrap
- Consumable supplies
- Variable energy costs

Most other costs are either fixed or approaching fixed… including people (aka; direct labor) costs!

A good test of direct expenses is in their variability. Virtually all expenses that are variable, (that is, those expenses that vary proportionally to output), impact profits in an immediate way. For example, if material cost is $6, allocated fixed cost are $4 and total cost are $10, you can expect an immediate increase in cash-based profitability when you find an innovative way to reduce the material content from $6 to $5. *"Immediate"* is a key word because it suggests that cost reduction can have immediate results and short term promise. This is a fact that has never been lost on turn-around professionals who are often hired to fix broken companies.

4. Better Utilizing Your Fixed Resources

Business process re-engineering largely concerns itself with finding ways to better utilize the fixed assets of the business. And while traditional thinking suggests that *"fixed"* includes property, plant and equipment resources, we all know that people need to be added to this list. People are clearly a semi-fixed asset and therefore need to be managed as a semi-fixed asset.

If your company's investment in people does not represent the most significant fixed cost in your product, then it certainly represents the most volatile. The only way to reduce people costs are to:

1. Reduce work content and the sheer number of people on the payroll.
2. Increase the utilization of the people with true value adding work content, thereby reducing the need to hire additional people. This new work content should come as a result of sales growth… not bureaucracy growth!

Fixed-cost reductions always translate to lower incremental fixed costs, so long as the *"muscle"* of the organization is not reduced. Transformational cost reduction clearly focuses on how to use people, machines, facilities and know-how more efficiently and more effectively.

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