

# Perspectives

## COMMERCIAL SERVICES

### IN SEARCH OF IDEAL METRICS—LEVERAGING PORTFOLIO OPTIMIZATION TO INCREASE PROFITABILITY

*Birgitta Oltersdorf, a senior manager with BearingPoint's Supply Chain solutions segment and Michael Rothschild, chief executive officer of the software company Maxager, discuss how asset-intensive manufacturing companies can leverage the concept of portfolio optimization to improve profits with an increased focus on identifying the most critical key performance indicators.*

The success of your company is measured by the growth of profits over time. The faster profits rise, the more attractive the company is to shareholders. But in today's highly competitive business environment, what's the best way for a company—particularly an asset-intensive company with high fixed costs—to increase profits? The answer may be to optimize the product portfolio based on the rate, or velocity, at which products are generating cash per production minute.

Today, one-dimensional contribution margin analysis is the foundation for setting price and a standard measure of profitability. Most financial experts,

however, will tell you that product margin is not a complete profit measure since it does not properly account for the production efficiency of one product versus the other. A more accurate measure of product profitability also accounts for how fast a product generates contribution margin and profit for the business. In financial circles, the ideal metric for manufacturers with a large fixed asset base is return on assets (ROA), or the amount of profit per cost of assets in a given period of time. Few companies have access to this critical information except at an aggregate level. If ROA could be controlled at the order or product level, companies would be in a better position to know exactly which products, and what product mix, are going to deliver the greatest financial return for shareholders.

We believe ROA, or velocity-based portfolio optimization, is the key for asset-intensive manufacturing companies to achieve a holistic view and break through the jungle of sales and production reporting metrics. Controlling the amount of cash or profit per

minute will help your company to identify the products you need to focus on—and how to price them—to increase profit.

#### **IMPROVING YOUR "VALUE FROM ASSETS AND OPERATIONS" BY ACCELERATING PROFIT MARGINS**

No one disputes the old saying "You can't manage what you can't measure." But do you really know which key performance indicators are the right ones to measure in order to manage your business properly? If you ask different managers for their definition of profit, some will talk about gross margin, others will mention profit after tax, earnings per quarter, earnings per share, return on assets or return on equity. Still others will refer to abbreviations like ROS, EBITDA, ROCE, ROI, RONA and EVA. Each one is a measure of profit, but which one is the most important?

As any investment analyst will attest, the ultimate measure of profitability is return on equity (ROE). ROE is the ratio of the current year's profit divided by shareholders' equity (accumulated

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past profits), or profit/equity. The higher this ratio, the faster shareholder equity will grow as each year's profit is added to the stockpile of shareholder wealth.

Unfortunately, the ROE ratio is too abstract and removed from daily business operations to be of any practical use in managing profitability. To gain real control over profitability, the profit/equity ratio needs to be broken down into component parts that are useful in daily operations. The clearest explanation of what drives profit/equity is the famous DuPont Formula:

$$\frac{\text{Assets}}{\text{Equity}} \times \frac{\text{Profit}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Assets}} = \frac{\text{Profit}}{\text{Equity}}$$

The arithmetic is unforgiving. Unless you manage all three ratios, you simply cannot control your ROE or destiny of your business.

By far, the most simple to control is the assets/equity ratio. If your company has no debt, all of your assets are paid for by shareholder equity and your assets/equity ratio equals one. But if your assets are financed by equity and debt, the more debt you

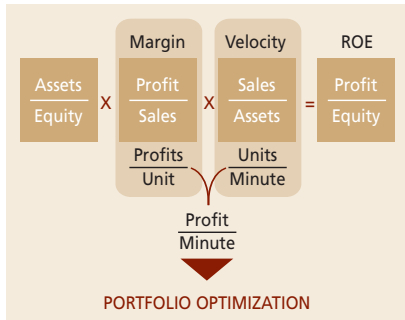
carry, the more assets you can acquire with the same equity. This financial leverage works wonders in boom times. But as everyone knows, a high assets/equity ratio can lead to disaster when times get tough.

From a competitive standpoint, the assets/equity ratio is not that interesting. To outperform the competition, you need to win by maximizing the other two ratios. Of these, profit/sales, or the profit margin, gets enormous attention in every company. To calculate the profit generated by each unit shipped or dollar of revenue sold, organizations expend huge resources attempting to calculate accurately the full cost of each product type made. Management teams pound away at cost studies, standard setting, activity-based costing and margin analysis in a relentless effort to make their detailed profit/sales figures perfect.

No such claim can be made for the equally crucial sales/assets ratio. For manufacturers, it is hard to factor detailed sales/assets measurements into vital operating decisions like pricing and scheduling. Do you know exactly how many minutes it takes to

process € 1,000 worth of product A through your most asset-intensive production step, be it a mill, reactor, assembly line, stamping press or extrusion line? What about product B? If you make a profit margin of € 50 per € 1,000 of sales for product A and only € 25 on product B, is A twice as profitable? What if A takes three times as long to flow through that key production step? If B produces cash faster than A for each minute of capacity, by exactly how much would you be willing to trim the price of B to succeed against competition?

In the real world where complexity rules, what if you make 200 different products on four different lines in runs of various sizes for 20 different customers, all paying different prices? Do you really know how to commit your capacity optimally, or what your best price should be on a given day to a particular customer for a specific product quantity? Until you deploy an easy-to-use system that factors time (sales/assets) as well as margin (profit/sales) into your daily operating decisions, you simply cannot gain effective control over your bottom line.



In the long term, companies need to move in the direction where they have a competitive advantage. Users of this concept will welcome this action because their supply chain will become more profitable while delivering products faster, better and cheaper.

This concept is especially relevant for manufacturers in industries such as metals, specialty chemicals, plastics and semiconductors, where a variety of products are produced on capital-intensive assets. In order to fully exploit the advantages, software tools like Maxager can support a company-wide ROA alignment and lead to increased profitability. At BearingPoint, we're helping companies to prepare their organizations, implement the concept, prepare the necessary data, install the tool, draw conclusions and

figure out which direction to take—focusing on ROA alignment.

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To price products more profitably, manufacturers need to be able to combine margin and velocity data to determine the amount of incremental cash generated per minute as a product moves through the production line. This way, manufacturers have the information required to compute ROA at the product level and understand how to adjust product prices to increase cash and shareholder return.



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