

The Spring Industry's High-Profit Performers: How Do They Do That?

The SMI Annual Market Report answers this question and outlines the steps you can take to improve your own company's profits

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The past four years have been challenging for spring manufacturers, to say the least. According to the 2005 SMI Annual Market Report, the typical spring manufacturer earned a Return On Assets (ROA) of only 6.1%. One of every four spring manufacturers, however, earned an impressive 20.7% ROA. How do they do that?

First, let's define Return On Assets. ROA is profit (before taxes) expressed as a percentage of total assets or total investment. So a 6.1% ROA means that for every \$1 invested, the typical company earned 6.1 cents in profit. It's better than a money-market account, but not nearly enough to justify the risk that businesses are taking in today's economy.

Return on Assets (ROA) is the best overall measure of a company's economic likelihood to survive. Companies that cannot produce an adequate ROA are unlikely to stay alive in the future.

In sharp contrast to the typical spring manufacturer's performance, the high-profit springmakers produced an ROA of 20.7%. That is, every dollar of asset investment resulted in a return of 20.7 cents in profit. For spring manufacturers with \$6,303,532 in sales, the difference was a profit of just \$214,320 for the typical company vs. \$687,085 for the high-profit company. That was three times more profit for the high-profit manufacturer (see Exhibit 1, right). Furthermore, if one of every four spring companies can earn nearly \$700,000 in profit, as shown in the Market Report, it should be a goal that is attainable by the other three companies.

In planning improvements in profitability, Return on Assets can be broken down into two key components: profit margin and asset turnover. Each of these components has its own implications.

Profit Margin = Profit Before Taxes ÷ Net Sales × 100

In the most basic terms, Profit Margin is the bottom line on the income

statement. The typical spring manufacturer earned a 3.4% Profit Margin, or 3.4 cents in profit before taxes for every \$1 in revenue. By comparison, the high-profit manufacturer earned a bottom line of 10.9%. The more successful companies differentiate their performance primarily in this key component.

Most of the effort in improving profitability should be geared toward factors such as the Gross Margin percentage on sales and the level of selling, general and administrative (SG&A) expenses on those same sales.

Asset Turnover = Net Sales ÷ Total Assets

Asset Turnover indicates the asset investment required to support the current level of sales, as measured by Net Sales divided by Total Assets. For the typical spring manufacturer, the Asset Turnover ratio was 1.8 times. This means the company generated \$1.80 in sales for each \$1.00 invested in assets. For the high-profit company, the ratio

Exhibit 1
A Comparison Of Financial Results

	Typical	High Profit
Net Sales	\$6,303,532	\$6,303,532
Profit Before Taxes	\$214,320	\$687,085
Total Assets	\$3,501,962	\$3,317,648
Return On Assets	6.1%	20.7%
Profit Margin	3.4%	10.9%
Asset Turnover	1.8	1.9

Exhibit 2
A Comparison Of Income Statement Results

	Typical	High Profit
Net Sales	\$6,303,532 100.0%	\$6,303,532 100.0%
Cost Of Goods Sold	<u>4,601,578</u> <u>73.0</u>	<u>3,990,136</u> <u>63.3</u>
Gross Margin	1,701,954 27.0	2,313,396 36.7
S, G & A Expenses	<u>1,443,509</u> <u>22.9</u>	<u>1,588,490</u> <u>25.2</u>
Operating Profit	258,445 4.1	724,906 11.5
Interest Expense/Other Income	<u>-44,125</u> <u>-0.7</u>	<u>-37,821</u> <u>-0.6</u>
Profit Before Taxes	\$214,320 3.4%	\$687,085 10.9%

was 1.9, so they produced an additional 10 cents in sales per dollar of investment. That is, the successful companies created nearly 6% more revenue per dollar of asset investment.

So far, we know that the successful companies in the spring industry earned higher Return On Assets by:

1. Earning a significantly higher bottom-line Profit Margin.
2. Producing slightly higher Asset Turnover.

Now let's dig deeper into "How do they do that?"

Factors For Success

In improving both profit margin and asset turnover, and ultimately return on assets, it is necessary to identify the factors that really drive profitability.

One of the prevailing myths about high-profit businesses is that they do everything better than the typical company, and not just better; they do it a lot better. The reality is just the opposite: The high-profit company inevitably does only some things better than the typical company. Moreover, they do them only a little better. The challenge is in identifying what they do better and why these factors are so important in generating higher profits.

Exhibit 3, above, reviews the factors for success. Even with this small number of factors, no company is perfect. Instead, the most successful springmakers tend to fit these factors into a model that creates improved results for their company. The challenge is in knowing how to build the model for your company.

Gross Margin Management

Gross Margin (or manufacturing profit) has a huge impact on bottom-line profitability. Gross Margin is, of course, Sales minus Cost Of Goods Sold. Improving Gross Margin immediately takes pressure off the sales department and administrative areas of the business. For the typical spring manufacturer, Gross Margin was 27% of sales in 2004. That is, every dollar of sales volume produced 27 cents of margin to cover S, G & A expenses and earn a profit. At the same time, the high-profit company had a gross margin of 36.7%.

"Gross Margin management," in its simplest terms, means, "buy low, sell high." The connotation for buy low, of course, is reducing the Cost Of Goods Sold (COGS). Exhibit 4, page 51, gives further details on COGS. Notice that the high-profit manufacturers managed to reduce their COGS by 9.7 percentage points, primarily due to lower material costs or less subcontracting cost.

Selling, General and Administrative Expenses

In analyzing SG&A expenses, companies typically utilize expenses as a percent of sales. For springmakers, SG&A

Exhibit 3 Factors For Success

	Typical	High Profit
Income Statement Factors		
Gross Margin	27.0%	36.7%
S, G & A Expenses	22.9%	25.2%
Interest Expense	0.8%	0.4%
Balance Sheet Factors		
Average Collection Period	49.9 Days	40.2 Days
Inventory Turnover	6.7 Times	8.9 Times
Sales to Fixed Assets	4.5 Times	5.7 Times

expenses represented 22.9% of sales for the typical company and 25.2% for the high-profit one. Yes, the high-profit companies actually reported higher SG&A expenses (see Exhibit 2, page 49). This may be one of the tradeoffs that the successful company makes to achieve their lucrative bottom line: Better sales and customer support enabled the more profitable companies to command a higher gross margin.

Interest Expense

One final note on improving Profit Margin: Interest expense for the typical spring manufacturer was 0.8%. The high-profit company paid only 0.4% of their sales revenue in interest. Interest expense, naturally, is the result of too much debt from too much asset investment. This leads us to our next issue, which is improving Asset Turnover by controlling the investment base.

Controlling the Investment Base

For manufacturing companies, accounts receivable, inventory and particularly fixed assets are the major investment categories. As seen in Exhibit 5, page 52, for spring manufacturers these three categories account for approximately 90% of total assets. As a result, the level of asset productivity achieved is highly dependent upon controlling these investments.

Accounts Receivable productivity is measured by the average collection period. The average collection period for the typical spring manufacturer was 49.9 days. In comparison, the high-profit company had an accounts receivable investment of 40.2 days. Improvements in the collection period have a modest profit impact (primarily interest expense) but significant cash flow implications.

The inventory investment, of course, is measured using inventory turnover. The typical company had an inventory turnover of 6.7 times, which means it held the inventory 54 days. The high-profit company also had an inventory turnover of 8.9 times. As with accounts receivable, the major impact of shortening the inventory holding period, through lean manufacturing methods, is on cash flow.

Exhibit 4
Cost of Goods Sold (COGS) Detail

	<u>Typical</u>	<u>High Profit</u>
Direct Materials	25.1%	22.5%
Subcontracting & Purchased Components	5.7	2.5
Direct Labor	17.0	16.5
Indirect Labor	10.2	9.4
Plant Depreciation	3.7	2.9
Other Manufacturing Expenses	<u>11.3</u>	<u>9.5</u>
Total Cost Of Goods Sold	73.0%	63.3%

Fixed asset utilization can be evaluated in a number of ways. The most direct method is to examine the sales-to-fixed-assets ratio. The typical spring manufacturer had a ratio of 4.5-to-1. This means the company was able to generate \$4.50 in sales from each dollar invested in plant and equipment. In comparison, the high-profit company had an outstanding sales-to-fixed-assets ratio of 5.7-to-1. That is, the same \$1.00 of investment supported sales of \$5.70.

Improving Results

These continue to be challenging financial times for most manufacturers. At times like these, financial benchmarks are especially important. The SMI Annual Market Report provides those benchmarks for spring manufacturers.

The Spring Manufacturers Institute can supply the benchmarks you need with the Annual Market Report. This free and unique service provides individualized consulting advice for participating springmakers. It is designed around specific guidelines for improving financial results. It not only presents a profile for the typical company in the industry, but it also outlines the results obtained by the most successful ones. It helps identify a path for improving your bottom line. (Individual company data is confidential, of course. Submitted directly to Mackay Research Group; your information is shared neither with other companies nor SMI.)

Every spring manufacturer that participates in the Annual Market Report receives an individual company report that compares their company's results to those of similar spring manufacturers. Such comparable benchmarks

Exhibit 5
A Comparison Of Balance Sheet Results

	<u>Typical</u>		<u>High Profit</u>	
Accounts Receivable	\$980,549	28.0%	\$902,400	27.2%
Inventory	707,396	20.2	557,365	16.8
Fixed Assets	1,390,279	39.7	1,283,930	38.7
All Other Assets	<u>423,737</u>	<u>12.1</u>	<u>573,953</u>	<u>17.3</u>
Total Assets	\$3,501,962	100.0%	\$3,317,648	100.0%

include not only the typical spring manufacturer's performance but also those spring manufacturers of the same size, from manufacturers under \$3 million to manufacturers over \$20 million. The report, called the Financial Performance Report (FPR), also indicates how your company compares to the industry's most profitable manufacturers.

The FPR provides data for more than 100 different measures, ranging from sales

per employee through inventory turnover to gross margin as a percentage of sales. The report also includes all key financial ratios, as well as a complete percentage income statement and balance sheet.

In addition, each of the key measures is accompanied by a management discussion explaining why it's important to the company. In short, the FPR provides a detailed analysis of where your company stands financially. However, it goes one step further than just reporting history. It also indicates how the company should go about improving performance. It lays out a complete game plan indicating the profit results that you can expect if the changes are made. This combination of features makes the FPR an exceptionally valuable management tool.

Summary

At present there is a significant gap between the typical and the high-profit spring manufacturer with regard to bottom-line profit. If the typical company is to move toward high-profit, it must identify exactly how the successful company produces superior results. In doing so, it must re-examine the cost to manufacturer products (especially direct materials), SG&A expenses and interest expense, as well as its major asset investments. Then the company must set specific benchmarks for each measure. The SMI Annual Market Report can provide you with the best, most relevant benchmarks to aid in the planning process. Without such planning, high-profit performance will always remain an elusive target.

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