Managing at the margin: How manufacturers can improve profitability

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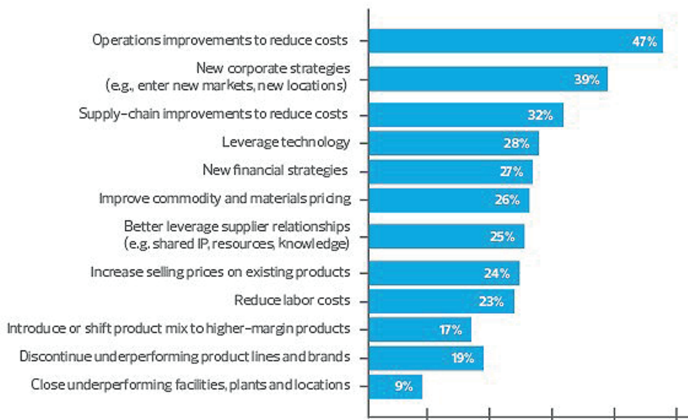
Growth among U.S. middle market companies has outpaced national averages across the board since 2011—in a number of organizations (87 percent increase), employment (103 percent increase) and revenues (100 percent increase). Manufacturing is already the largest middle market sector (18 percent of organizations), with some sectors enjoying dramatic growth—middle market manufacturers of industrial, commercial and computer equipment increased revenues a whopping 163 percent between 2011 and 2016.[1]

Yet rising revenues do not always generate corresponding profit increases, leading many manufacturing executives to refocus their attention on margin management. Among U.S. middle market manufacturers, the top methodology used to boost profits is to deploy operations improvements to reduce costs (Figure 1). But some profit-motivated initiatives are expensive, and may not be strategic for all. Individual manufacturers should prioritize initiatives to increase margins, mitigate risk and support long-term growth—specific to their companies.

1. Top plans by U.S. manufacturers to increase profitability in next 12 months (% of manufacturers)



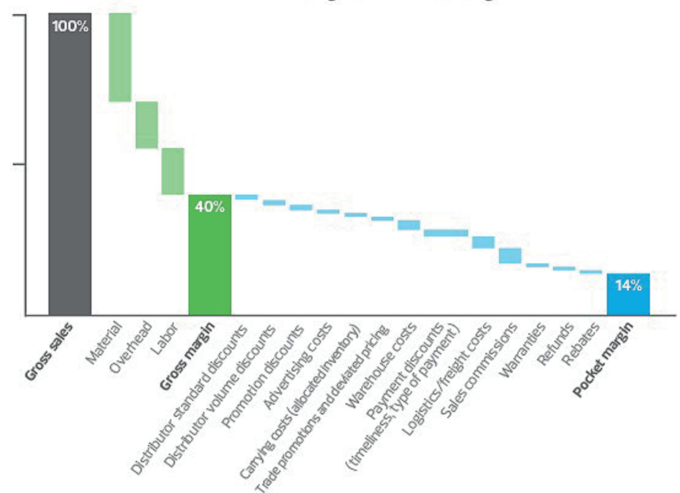
Margin analytics improves decision-making

Manufacturing executives often think they know how well their company is managing margins, but often fail to rigorously quantify internal and external factors that affect profitability. They rarely look beyond the gross margin view of their operations, failing to account for sales costs (e.g., commissions, trade promotions, discounts, freight and the like) that contribute to lower net sales—and lower margins. Without this deeper analysis, it's impossible to identify the profitability of specific channels, geographies, markets, customers and products. Even worse, leaders may invest time and effort into improvement activities that deliver little or no value—addressing symptoms instead of curing a profit illness.

Leaders are increasingly turning to margin analytics to understand true profitability and to prioritize within their organizations:

- *Customer margins*: All customers are not created equal, especially when it comes to margins. Some analysts estimate that the top 20 percent of customers (by profitability) generate more than 120 percent of an organization's profits—while the bottom 20 percent account for more than 100 percent of company losses.[1] Manufacturing executives must do everything possible to understand individual customers' margins, and how to improve or end customer relationships as appropriate.
- *Channel margins*: Manufacturers can sell across a wide range of sales channels today, from conventional wholesalers, distributors and retailers to direct sales via the company or third-party websites. Effective margin management requires a thorough analysis of the cost structures for each channel, and their respective profit potentials. For example, launching a direct-to-customer sales initiative could jeopardize relationships with wholesalers and distributors as well as development of new capabilities currently managed by third parties (such as returns and warranty claims). Because service and inventory levels may differ among channels, executives must evaluate each channel and potentially other dimensions, separately. This allows for effective demand management of a stock-keeping unit (SKU) across multiple channels.
- *Product margins*: Many middle market manufacturers fail to track margins by SKU, which leaves executives at these firms in the dark regarding which high-margin products to invest in—and which low- or no-margin products to discontinue. This lack of data not only damages profitability today, but limits growth tomorrow as capital and resources are directed at the wrong opportunities. Better understanding of variable and fixed costs at the product level helps managers make more informed decisions. Additionally, understanding buyer behaviors regarding strategic low-margin SKUs through deeper understanding of customer analysis is critical. An especially important example is SKU analysis related to the impact of landed costs on exports, given that U.S. manufacturers sell, on average, 29 percent of their goods outside of the country.[2]

2. Gross Margin to Pocket Margin



- *Hidden costs*: As a product moves to market, an assortment of hidden costs can eat away at margins (Figure 2). While these costs always have an impact on the bottom line, they are rarely linked to specific customers, channels and products, making them difficult to minimize or control.
- *Function performance*: A single product moves through many processes, departments and functions before it becomes salable—and potentially profitable. Any one of these functions—sales, research and development, procurement, supplier management, receiving, production and assembly, shipping, logistics—can prevent a product from getting to market, driving up costs through failure or poor performance. For example, a disorganized shipping department can delay deliveries, resulting in late-delivery penalties; an understaffed research and development department may miss prototype testing dates, affecting product launches; and an inefficient production line can damage profitability due to excessive rework, bloated inventories and unplanned maintenance.

1 Middle Market Power Index: A Detailed Look at Top Industries, (Sept. 6, 2016) American Express and Dun & Bradstreet; middle market firms identified as $10 million to $1 billion.

2 RSM Monitor, 2016.

Knowing what drives margins can improve margins

Leading middle market manufacturers include margin improvement plans as part of an overall strategy deployment process that asks: "Where is the organization today, and where do we want to be three to five years from now?" Too often the first margin improvement strategy is simply to increase prices. But a sophisticated margin improvement plan will also recognize that some products may require lower prices, whether for new sales channels or to differentiate them as "economy" versions of competitor offerings.

Most manufacturers are also improving margins by improving operational efficiency in offices, plants and supply chains via methods such as lean and six sigma. It's important to note that high-performing processes require highly skilled individuals; indeed, many middle market companies plateau because they outgrow their internal talent. Executives must make sure that employee recruitment and development practices keep pace with new growth in capabilities and sales, or risk losing profits.

Operations improvements should also enhance agility and flexibility so an organization can rapidly respond to new competitors, changing economic conditions and emerging opportunities. For example, a printer facing declining revenues and margins from printed material may find new life by adding fulfilment services. Similarly, machinery manufacturers are expanding their profit potential via maintenance services. These fundamental changes in business models also require new talent—and new technologies.

Paradoxically, sometimes the best way to increase margins is by subtraction. Executives need nuanced margin analyses that permit them to discontinue underperforming product lines or exit unprofitable markets, or to amend or cancel contracts with low-margin customers—freeing resources for higher-margin growth.

Margin analytics can deliver these insights, helping middle market executives:

- Prioritize their best opportunities
- Identify areas of greatest risk
- Establish goals and timing for results
- Align the organization to achieve objectives
- Deploy resources and capital to make improvements

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