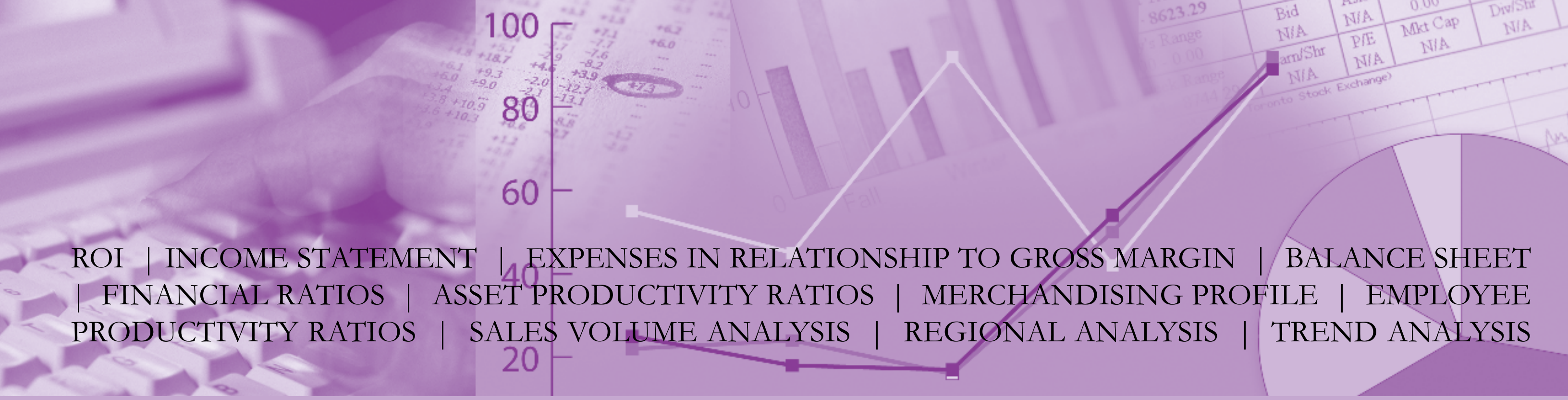

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Profit Improvement Report

"Never Again! Until Next Time of Course: Thoughts on Recession-Proofing the Business"

Sponsored By the Door and Hardware Institute
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Profit Improvement Report

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Never Again! Until Next Time of Course: Thoughts on Recession-Proofing the Business

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In the current economic environment, firms are placing much more emphasis on financial integrity than ever before. However, the vast majority of potential actions are ones that should have been taken before a recession hits. It proves almost impossible to strengthen balance sheets, for example, when sales and profits are sliding.

In addition, some of the actions taken to strengthen the firm are proving to be counter-productive. For example, enhancing the firm's cash position frequently, comes at the expense of profitability.

This report will examine the issue of financial integrity. That means the ability to survive an economic downturn with a minimum of pain. The report will also suggest that the lessons of this recession should not be forgotten amidst the euphoria of the eventual recovery. The report is organized into two key sections:

- **Things To Do in the Future**—This section will provide a checklist of key ratios to monitor that will ensure the firm faces the most minimal financial turbulence possible under any economic conditions.
- **Things Not To Do Now**—This will provide a cautionary road map to actions that should be avoided at present.

Things To Do in the Future

There are a lot of ratios that firms should review to make sure they are prepared for economic challenges in the future. The four most important of these are reviewed in **Exhibit 1**. These include 1) Debt to Equity, 2) Defensive Interval, 3) Cash to Current Liabilities and 4) the Break-even Point. These ratios were chosen because they are best suited to help the firm maintain a strong banking relationship, offset sales declines and position the firm for growth when economic conditions improve.

Exhibit 1
Suggested Financial Integrity Ratios

Ratio	Conservative Guideline	Typical DHI Results	Financial Gap
Debt to Equity (times)	1.0	1.0	0.0
Defensive Interval (Days)	15.0	10.6	-4.4
Cash to Current Liabilities (%)	20.0	5.6	-14.4
Break Even Point (% of Current Sales)	80.0	87.8	-7.8

The first column of numbers in Exhibit 1 presents suggestions for an appropriate result for each ratio. It should be noted that these guidelines are conservative. These are the results that will keep firms out of financial trouble except under the direst economic conditions. The second column of numbers presents results for the typical DHI member based upon the latest PROFIT Report. Column three is simply the difference between the first two columns and represents any potential gaps that must be closed.

Debt to Equity—This is the classic banker's measurement of a firm's financial philosophy. The lower the figure, the more conservative the firm. It is calculated by dividing total liabilities (all obligations of any kind, including accounts payable, notes payable and the like) by total equity (net worth). The historical banker's goal for debt to equity is 1.0.

In good economic times firms tend to increase their debt to equity ratio in an effort to grow the business as fast as possible using outside financing. In bad economic times firms tend to die in reverse debt to equity order. In the future firms would be well advised to maintain a 1.0 level and avoid the widely discussed "excessive exuberance." This will most likely involve reinvesting a sizeable portion of future profits back in to the business.

Defensive Interval—This is a classic "little used and little understood" ratio. It is calculated by dividing total operating expenses (excluding depreciation) by 365 to determine the cash expenses that must be met each day. This figure is then divided into cash to determine how many days the firm can operate if sales and collections fall all the way to zero.

Clearly, this ratio measures a worst-case scenario. However, it provides some very strategic insights into the firm's ability to withstand a sudden jolt in terms of sales and collections. Ideally, this ratio should be at least 15 days. The two alternatives to improve this result are to increase cash balances or to lower operating expenses, particularly payroll.

Cash to Current Liabilities—This is the most stringent test of the ability of the firm to meet its short-term obligations with existing cash balances. It is calculated by dividing cash by total current liabilities (largely accounts payable and short-term notes payable).

This ratio examines how well the firm is able to continue to pay suppliers and other creditors (as opposed to operating expenses) without an additional infusion of cash. To be truly conservative with cash, this ratio should be around 20.0%. Again, there are two improvement paths—increase cash or lower short-term debt. One of the real mistakes that many firms made in the period of steady growth was to finance sales growth through short-term financing.

Break-even Point—This is the level to which sales can drop before profit falls to zero. Since every DHI member has a different level of sales, this measure is presented as a percentage of current annual sales. Ideally, the break-even point should be no more than 80.0% of current sales. That is, the firm should be able to experience a 20.0% sales decline before profits are eliminated.

Lowering the break-even point requires two parallel efforts. The first is to enhance the gross margin percentage so that the firm gets paid for what it does. The second is to gain tighter control over operating expenses.

Things Not To Do Now

Sadly, the list of things not to do is very similar to the list of things that most firms are currently doing. Of these, two are the most strategic.

Don't Lower the Investment in Inventory and Accounts Receivable—Cash may be king, but converting inventory and accounts receivable to cash is not just a bad move, it is often a disastrous one. Lowering inventory almost always involves a "stop buying" edict. The firm immediately runs out of good inventory. Accounts receivable is often subject to a similar line of thinking. Lowering either of these will drive sales down even further.

Don't Sell Out the Future—The break-even point needs to be lowered. However, anything that is associated with sales generation should be cut only if the situation is desperate. Too many firms reduce their marketing expenditures only to find that when the market begins to turn up, they have lost all of their visibility to potential customers. Cuts may be unavoidable, but they should be made only to the degree that is absolutely necessary for survival.

Moving Forward

The good news is that the recession will end; possibly even faster than most economists think. The bad news is that old habits die hard. Firms will forget about financial integrity in a bid for sales growth. When the next downturn comes too many firms will inevitably repeat the mistakes of this recession.

It is a cycle that only enriches profitability/financial consultants, such as the author of this report. It is a cycle that must be broken.

About the Author:
Dr. Albert D. Bates is founder and president of Profit Planning Group, a distribution research firm headquartered in Boulder, Colorado.

A Managerial Sidebar:
Calculating the Break-even Point

Break-even analysis is one of the most useful measurements that firms have in their financial tool kit. However, very few firms actually utilize the break-even point in their financial planning, largely because of uncertainty as to how it is calculated.

The following example should assist in the calculation. All of the figures presented are for a typical DHI member currently generating $10,000,000 in sales. As can be seen, the formula requires knowing only three things:

- **Gross Margin %—**Gross margin dollars as a percent of sales volume.
- **Fixed Expenses**—Fixed expenses for the year, expressed in dollars.
- **Variable Expenses %—**Variable expenses expressed as a percent of sales volume.

If the firm is unsure about the relative mix of fixed and variable expenses, a useful approximation is that about 80.0% of total expenses are fixed and everything else is variable. The formula is not overly with regard to assumptions about fixed and variable expenses. As long as the breakout is reasonable, the formula will provide an accurate answer.

As can be seen, the typical DHI member, with current sales of $10,000,000, has a break-even point of 2,150,000. This is equal to 87.8% of current sales, which means the firm can experience a sales decline of 12.2% before profits are eliminated.

$$\frac{\text{Fixed Expenses--\$}}{\text{Gross Margin \%} \ - \ \text{Variable Expense \%}}$$

$$=$$

$$\frac{\$2{,}150{,}000}{30.0\% \ - \ 5.5\%}$$

$$=$$

$$\frac{\$2{,}150{,}000}{24.5\%}$$

$$=$$

$$\$8{,}775{,}510$$

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As the direction of the Foundation has changed, now so has its name. The DHI Education Foundation is now the "Foundation for the Advancement of Life Safety and Security." This name change reflects the work that the Foundation has undertaken on behalf of our industry. The name reflects an area of growth opportunity—security. There is much to be done to provide enhanced security within the buildings we touch.

Along with providing security, we also have an opportunity to play a very important leadership role in life safety - through the fire-door inspection process. If we can achieve increased financial support, the Foundation can begin to implement a program that will raise the awareness level of this important new code change. The fire-door inspection concept is a huge opportunity for the architectural openings community - an opportunity to provide valuable insight into the safety and security of each and every fire-rated door.

The Foundation's core purpose is to raise funds to provide education and research for the advancement of the architectural openings industry and the safety and security of the built environment.

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