# 7 FINANCIAL HABITS OF SUCCESSFUL COMPANIES:

# HOW TO SURVIVE, AND THRIVE, IN TOUGH TIMES

***WHITE PAPER AT A GLANCE***

*Successful companies do things differently to their less successful competitors. One of the areas where they operate differently is in how they manage their finances. Successful companies create wealth for their shareholders by focusing on such things as gathering as much profit from their most profitable customers and products as possible. They recognise that margin is more important than revenues. And that cash is more important than both! When it comes to cost-cutting, they make sure that they cut cost, not value. They are 'cost agile' and they continually question how they do things. Even though times may be hard, successful companies continue to invest – but they invest carefully, and wisely. Finally, these companies make it their business to ensure that everyone in their organisation with the possibility to impact on the bottom line understands the basics of finance. Successful companies do all of these things in good times – and in bad. In that way they can survive in times of difficulty, and thrive in times of plenty.*

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BY VINCENT REYNOLDS

## INTRODUCTION

Businesses exist primarily for a single reason: to create wealth for their owners, the shareholders. They do this by selling goods and services at a price that is greater than the cost of producing those goods and services. This simple reality applies to businesses in all sectors, whether they are a manufacturing company, an energy utility, a professional services firm, or a film studio. There are just two levers a business manager can pull in order to increase profitability: increase revenue or reduce costs. The clever ones are able to pull both levers at once. The really clever ones can do so while at the same time converting profits into cash flows that will sustain the business. The really, really clever ones can do all of this during tough times, times such as those we live in now, with wobbly financial markets and jittery economic forecasts the order of the day. This article looks at seven financial habits that can mean the difference between success and failure for a business operating during tough times.

## HABIT #1: RECOGNISE THAT NOT ALL REVENUES ARE EQUAL

More than a century ago, Alfredo Pareto first popularised the Pareto (or 80/20) Rule, a simple rule-of-thumb assumption that recognises that a disproportionately large number of effects stem from a small number of causes. While Pareto focused on the fact that eighty percent of a nation's wealth appeared to be owned by twenty percent of the nation's inhabitants, I prefer to apply the assumption to business applications such as the fact that very often eighty percent (or some other high percentage) of our revenue (and profits) will stem from twenty percent of our customers. Similarly, often eighty percent of revenues and profits will stem from twenty percent of the products or services in our product/service portfolio. In tough times, it is more important than ever to single out the customers and products that can most critically affect your business. Financially effective companies scrutinise where their most important revenues and profits are coming from and act to protect and grow them. Losing one key customer in a recession can spell death for a business. At the same time, successful companies look at the eighty percent of customers (and products) that make up twenty percent of revenue and make tough decisions about which ones they will de-prioritise or even drop. The adage 'Revenue is Vanity. Profit is Sanity' comes to mind here. Successful companies ask 'how can we focus on the revenue that will generate best profits for our business?'

## HABIT #2: KNOW THE MAGIC OF MARGIN

An early mentor in my career drummed into me that margin was the key to a profitable business. Put simply, gross margin is the difference between the revenue generated by the sale of goods and services and the direct costs (materials, labour, freight, etc.) of generating those revenues. Why is margin so important? Well, it is what is used to pay for everything else that needs to be deducted from revenue in order to leave a profit for shareholders. Therefore it needs to cover overheads (costs – mainly fixed in nature - that cannot be directly traced to units of product or services sold) as well as interest and tax. Since overheads are predominantly fixed in the short term, every extra percentage point in gross margin can boost the bottom line. A company with revenues of €100m and net profit of €10m can, all things being equal, boost its bottom line by ten percent, or €1m, as a result of just a one percent increase in gross margin. That is the magic of margin. Financially effective companies look at how they can increase margin by improving sales mix (back to Pareto, shifting more high-margin products) or by reducing input costs, such as the cost of materials, direct labour, packaging and freight. Another key way to influence margin is to educate everyone in your organisation about how margin and its constituent parts work. In this way, sales personnel, for example, can bring a new level of financial discipline to how they offer discounts to customers. Every percentage point given away in discount is a percentage point taken away from profitability. And every percentage point matters in times of tough economic conditions. It is far better to find ways to create value by differentiating a product or service to create value, rather than trading solely on the basis of price.

## HABIT #3: CUT COST BUT NOT VALUE

The natural tendency in straitened times is to cut cost out of the operation. Sometimes this may be done somewhat arbitrarily. Arbitrary cost-cutting can damage the long-term sustainability of a business. For example, consider a technology company with a €10m R&D budget. Laying off half of those engaged in R&D may take €5m out of the immediate cost base but what are the longer-term implications? Such a move could leave the business with a weakened pipeline of new products and features along with a vulnerability to lost development talent when the economy moves into upswing mode. This could mean that the company is not able to compete. And companies not able to compete either go out of business or are snapped up by predatory competitors better able to exploit opportunities in the market place. Tom Peters famously said that an organisation cannot ‘cut its way to success’. True, in tough times it is very necessary to challenge every item of cost in the income statement but only after considering very carefully the implications for long-term shareholder value. Effective managers realise this and focus not just on taking cost out but on *putting value in* to their business operations.

## HABIT #4: DEVELOP ‘COST AGILITY’ SKILLS

A high level of fixed costs can drag a profit-making company into loss during a downturn in the business environment. Fixed costs are just that – fixed – and cannot easily be taken out of the business without painful reorganisations and restructuring. Those companies that recognise that there is a strong need for ‘cost agility’ – achieving an optimum balance between fixed and variable costs - will have the upper hand when they need to ‘cut their cloth to their measure’ during difficult times. One of the ways to do this is to think about which costs can be outsourced. Outsourcing can have the effect of taking a chunk of fixed costs – for example, an IT department – and putting it outside the organisation in the hands of a vendor that has IT as its core expertise. A service level agreement can be negotiated that links payment to both a fixed monthly charge and a variable charge based on usage or volume of activity per month. In this way, a fixed cost can be switched to a combination of a fixed and variable cost, one that is linked to actual business activity levels. The other key benefit of course is that outsourcing some of its costs allows the outsourcing company to focus more of its energies on bringing value to its customers via its core products and services. This level of focus will be especially important during tough times.

## HABIT #5: INVEST WISELY IN NEW PROJECTS

A natural tendency of companies during a recession is to pull up the drawbridge, protect cash, and not venture forth into the highly dangerous world of new investments. Yet, none other than the Sage of Omaha, Warren Buffet, has said that when the waters are dangerous that is the very time to move in to pick up bargains and value. For a business intent on creating sustainable value for its shareholders, there is never a time when business-worthy investments should not be considered. The key thing is to create a business case process that will allow investment opportunities to be fully evaluated before committing cash and resources to them. Well managed companies evaluate such things as opening a new sales office in the Middle East, acquiring an ailing competitor or investing in a new product or process all in the light of the overall business strategy. Managers at all levels should be able to understand in simple terms the financial consequences of adopting such a proposal. They will have a format for answering such questions as: What will the return on investment be? How long will it take to pay back initial outlay? Does it have a positive net present value? Does the Internal Rate of Return meet our company's cost of capital? There is no need for these topics to be the vocabulary of just the accountants and MBA graduate members of the management team but rather they can easily become part of the vernacular of all decision-makers within the company.

## HABIT #6: QUESTION EVERYTHING

In Ireland, where this writer is based, we have a concept in our educational system called the 'transition year'. The transition year occurs mid-way through the secondary school curriculum, around age fifteen for most students. In transition year, students spend twelve months outside of the conventional education system working on projects, getting work experience in commercial enterprises and participating in other activities that will broaden their experience of the world before they return for their final two years of pre-university schooling. Often, when I am consulting for companies intent on improving their financial performance, I ask management 'What would a bunch of transition year students recommend if they were to come in here for a few months?' Many times I am met with blank stares when I ask this question but I feel that the very naivety of these kids can be a natural counterfoil to the 'we've always done it this way' attitude that can take hold in many companies. Successful companies in a downturn ask themselves 'If we were starting the business today, what would we do differently? How would we simplify how we do business? What should we start doing?' 'What should we stop doing?' And most tellingly of all, 'What single thing could we do differently that would have the greatest positive impact on our financial performance?' Another version of this exercise is to ask management, 'If a predatory competitor were to take us over tomorrow, what would they change? What cost would they take out of the organisation? How would they reshuffle how we do business? What waste would they identify and how would they eliminate it?' It is by continuously challenging the status quo and by continuously questioning what we do that we can protect our business from the fog of complacency and the hubris borne of past successes.

## HABIT #7: MAKE EVERYONE IN THE ORGANISATION A FINANCIAL EXPERT

Although as an accountant it grieves me to say it, in the past finance has often been left in the hands of the 'financial experts' – the accountants. I am not suggesting that those are not always a safe pair of hands (although one would wonder, having regard to the litany of financial scandals aided and abetted by accountants this past ten years!) but surely almost everyone in the organisation is capable of understanding the fundamentals of finance in so far as they apply to the business of the organisation. Finance is a language, not an abstract concept! Ensuring that everyone in the organisation is conversant with the language of finance can only help to create 'joined up thinking' and increase the chances of financial success. This should start with an induction programme for everyone in the company that explains how exactly the company makes its money. Concepts as crucial as profitable revenue growth, optimising gross profit margin, eliminating wasteful overhead and generating cash from every aspect of our business are not topics for the exclusive consideration of the CFO and the senior management team. These concepts should be explained in simple terms and socialised at every level of the business. Nowhere is this more critical than in the case of those professionals and managers whose actions will have the power to commit the company to potentially expensive courses of action – buyers, sales professionals, R&D managers managing multi-million euro projects, HR managers recruiting key talent – since those managers will ultimately decide the profitability (and viability) of the organisation. In-house financial acumen and business acumen training should cover the basics of how the company competes and how it makes money and manages its profits, balance sheet and cash. Every single person within the company should understand how their efforts link to ongoing viability and success.

## CONCLUSION

The seven habits outlined in this paper work. They can help a business not only to survive but to thrive in an economic downturn. They can also help a business to achieve excellent results in times of prosperity. In short, what each of these habits comes down to is common sense. But we all know the problem with common sense – it's not so common! Effective companies in a downturn constantly ask: Which products or services should we be pushing? How are our margins performing? How can we reduce costs without eroding value to our business, and to our customers? How can we create cost agility/flexibility? How can we be sure we are investing in the right things? What would we do if we were starting over in this business? And finally: How can we educate more of our staff in the key skills of financial acumen? By asking questions such as these, companies can help ensure that they create sustainable value for their shareholders. In doing so, they will ensure that the company not only rides out the tough times, but is ready to participate fully in the recovery that inevitably follows a downswing.

### About the Author

*Vincent Reynolds is the founder of Rapport Consulting. His background is in corporate finance, having acted as Finance Director for Tellabs Inc., a NASDAQ quoted telecommunications equipment manufacturer. For the past seven years, Mr Reynolds has acted as a consultant providing financial acumen and management development programmes to global companies such as British Telecom, GlaxoSmithKline, ESB and a host of other clients.*