Volume 4

the osborne report

Transforming your business for success

Having a strong financial plan at the outset is the single most important element of any successful business transformation, says Osborne Principal Dana Carroll.

Carroll, who works out of Osborne's Vancouver office, knows intimately the challenges and pressures that surface as part of every restructuring or transformation of a company. He has owned several businesses over the years.

"Most small business operators are people with high aspirations, but they rarely have the capital to do what they want to the degree they want," he says. "It leads them to 'shoestring' the operation and they often don't sufficiently anticipate the operational issues that will arise."

As a result, Carroll says, these businesses are generally under-capitalized, without sufficient letters of credit, investor funds or lines of credit with the banks, so they lack the liquidity needed to get through the first three or four years.

Those first three or four years are critical, especially for retail operations. "It is pretty much a given that a firm will lose money during that time," says Carroll. "You are going to have to build your market, which costs money. You may have lots of receivables or you may have high operational overhead, and your cash flow therefore will be a problem."

He says a business plan must address this and a strong financial plan allows you to get buy-in from the banks and investors to fund a company during this critical stage. After all, cash flow is a key factor in business success or failure. Carroll himself says he has always strived to be as debt free as possible in his businesses.

"If I need cash I'll go to a lender such as GE Capital and arrange to lease back my equipment, which often frees up a significant amount of money each month," he says. "Depending on the kind of business you have, most equipment is a depreciating asset so you might as well lease it. This allows you to avoid going back to the banks or to investors and means you don't have large chunks of capital tied up in equipment."

If the end goal is to get the business on a strong and successful footing so it can be sold, Carroll says, it's not just about making it profitable but how you build equity in the company so it's something people will be interested in buying.

"Goodwill in terms of loyal customers and having good, solid long term contracts in place is vital," he says, "but customer loyalty can be fleeting when ownership changes. Often it is the individual who built a company that is the recipient of customers' loyalty, so if that person leaves, nine times out of 10, the goodwill walks out the door with him."

Building equity in the business is positioning it so if you were to step away, your customers wouldn't really miss you. This is possible if employees have been empowered to actively participate in managing and running the business.

"If the business revolves entirely around me, then if I walk out the door it all goes with me," says Carroll. "My goal is to get it to the point where I am almost irrelevant to its success or failure."

From the CEO, Ed Lavin

Transformation is an ongoing process in any healthy business: Finding a comfortable niche where you can coast for a few years has become almost impossible in the ultra-competitive environment of a global economy and e-commerce.

But while change is inevitable, it should be a planned, focused and disciplined change, not change just for the sake of change. This issue of The Osborne Report looks at transformation and provides some guidelines around why, when and how.

Osborne Principals are an excellent source of skills and knowledge that companies can tap into as they work at building their business. Principals such as Dana Carroll are typical of the diverse skills available through The Osborne Group. All have been successful in operating businesses. They bring a clear-eyed, focused discipline to the change process that helps small and mid-sized business owners and managers determine a course of action.

My own extensive experience in a number of business environments led to the adoption of SAVE, a process which follows four steps: Survey, Analyze, Verify and Execute. This process is supported by Ed Hsing, one of our contributors. It is amazing how many people approach change without taking fundamental steps such as surveying the market, determining customer needs and surveying industry trends,

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Deepen offerings to current customers

One manner of transforming a business is to deepen the offering to current clients, as well as to assess and perhaps change the way you carry out certain parts of the business, even if there is no pressing need.

In fact, Ed Hsing, a former business owner and currently Director, Demand Response for Rodan Energy, just smiles when asked why a business would change anything if everything was going well.

"When a company reaches a point of stability, that should be a trigger point," he says. "A company owner or team of senior executives is naïve to think that if they've got it good it's going to stay that way. That's especially true in this climate of changing technology and globalization."

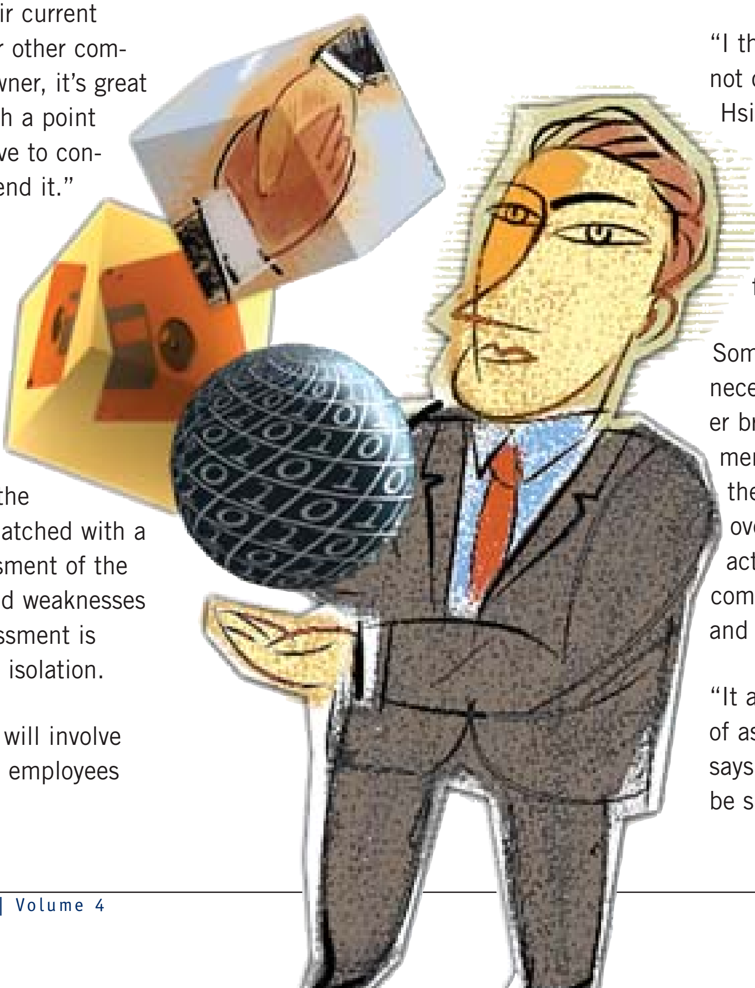
Hsing says business owners who've worked out a niche that appears stable should plan for someone to come along and assault it because their current market is fertile ground for other competitors. "As a business owner, it's great if you've been able to reach a point of equilibrium, but you have to constantly be prepared to defend it."

Hsing believes assessing, planning and then executing the plan are essential steps in any transformation for any reason. The assessment of the competitive environment and the industry the company is in has to be matched with a tough, clear-headed assessment of the organization's strengths and weaknesses and such a sweeping assessment is almost impossible to do in isolation.

"A worthwhile assessment will involve shareholders, partners and employees and will extend outside the company to external partners, vendors and customers. Once you've gathered the data, you can change, amend or expand the company's goals and objectives, then move on to assessing whether you have the financial resources and skills to meet the objectives you now have. Planning, says Hsing, falls out of the assessment. Knowing the objectives and the challenges allows a company to identify gaps and then to put forward a plan that overcomes the gaps and allows you to meet the objectives.

"Execution is everything and it's the area where failure is most likely to occur," says Hsing. "Companies often minimize the challenges they face and they underestimate or overestimate their own abilities. And that's primarily because they failed to assess and plan accurately."

> "When a company reaches a point of stability, that should be a trigger point"



Hsing says when a company is going through a transformative phase, it should start with customers. "How can we deepen our relationship? What else do they need? How can we improve our service?"

He says in most cases, it's better to go deeper rather than broader. "You can broaden your offerings but, if you do, there's always the danger of taking your eye off the ball and creating problems in your existing customer base."

A common change many businesses consider is geographic expansion, but Hsing says it's better to look at how the company delivers its products or services and determine how it can be done more efficiently. Looking at ways to become more efficient, effective and profitable starts with looking at the possibility of increasing revenues and reducing expenditures.

"I think more people need to consider not doing everything in-house," says Hsing. "Increasingly, parts are being outsourced and increasingly services are being outsourced. Do you need a full-time HR manager? Do you need a full-time CFO? Do you need full-time, in-house legal counsel?"

Some of these things may or may not be necessary, but companies should consider bringing in interim executive management, outsourcing other components of the supply chain or just reducing the overhead in the company. All of these actions will transform and strengthen a company to prepare it for both product and geographic expansion.

"It all starts with the initial three steps of assessment, planning and execution," says Hsing. "Get these right and you'll be successful."

Be sure to incorporate best practices

A key factor to any business successfully transforming itself is incorporating best practices into its current operations.

Rebecca Reuber, Associate Professor of Strategic Management at the Rotman School of Business at the University of Toronto, says in an ideal world and in an ideal company, all employees understand the company's strategy and objectives, what their contribution is to the company and how that contribution is critical in helping the company meet its objectives.

"The three characteristics of successful business practices are strategic alignment, operational alignment and behavioral integration," says Reuber.

Strategic alignment, she says, is a linkage between the goals of the company and the goals of individual employees. "It really means everyone is on the same page. People in the company are aware of where you're going and why you are going there as opposed to somewhere else."

Getting buy-in to the company's strategy is essential if employees are to understand how they are making a difference and the importance of their contribution in the overall scheme of things. If business fails to meet its strategic objectives, it is often because their operations and goals are not successfully linked and understood by employees.

Underpinning the first two is behavioural integration, says Reuber. "It's difficult because each of the managers is going off to operate within their own sphere of expertise, and it's hard to find time for them to spend with each other. But business studies have found that growth, whether it be in new markets, and particularly in foreign markets, or in product diversification, is quite complex and really requires that all top managers be aware of the opportunities and difficulties faced by the other top managers."

Reuber says it is essential to find mechanisms to bring information up through the organization and pass it around.

"Firms who do this well tend to do better than those that don't do it. They are good at soliciting information from employees and passing it around the company so that different people see it," she says.

Reuber adds that if the company has sales reps, they are probably gathering a ton of information from customers and the company needs to be able to tap into that and to pass that information around as well. "This could be a gold mine of ideas for product enhancement, extra service offerings or new product lines, among other possibilities."

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to name three important factors. Analysis needs to follow any survey or the facts gleaned through the survey process go to waste. And failure to execute is more common than many would suspect!

Dana Carroll has successfully followed his own advice in the various companies he has owned, including a retail wine store and a retail meat market in British Columbia. Dana understands those who want to build a company as a long-term legacy for their family but he loves the challenge of creating a successful business and then selling it and moving on to new challenges. He likes helping other individuals and sharing his knowledge and experience and does so as an Osborne Principal.

Rebecca Reuber is an Associate Professor of Strategic Management at the Rotman School of Business at the University of Toronto. She says employees must understand the company's strategy and objectives. And with their critical contribution, that's what builds a successful business.

Business owners and executives must continuously think about how to increase shareholder value, explains Howard E. Johnson, President, Veracap Corporate Finance Limited. While there is no secret formula for doing it, it is important they understand the factors that drive shareholder value, as it may influence their decision making.

All of these business leaders share an important trait with Osborne Principals: They have walked in your shoes and they bring experience and hard-won knowledge and insight to every Osborne client.

The Keys to Shareholder Value

By Howard E. Johnson,
MBA, FCMA, CA, CBV, CPA, CFA, ASA
President, Veracap Corporate Finance Limited

Business owners and executives continuously think about how to increase shareholder value. While there is no secret formula for doing it, it is important they understand the factors that drive shareholder value, as it may influence their decision making.

From an economic perspective, shareholder value ultimately is a function of three underlying, interrelated variables: cash flow, rates of return and debt utilization.

As a simplistic example, assume Company X generates annual maintainable cash flow of $3 million, has $10 million of debt outstanding, and that a rate of return of 12 per cent is considered appropriate. The shareholder value of Company X would be calculated as follows:

Annual maintainable cash flow	$3 million
Divided by Rate of Return	12%
Equals 'Enterprise Value'	$25 million
Deduct interest bearing debt	$10 million
Equals shareholder value	$15 million

It follows that, to increase shareholder value, business owners and executives must do one or more of the following: increase cash flow; decrease the required rate of return; or utilize debt more effectively.

Cash flow, rather than accounting earnings, is a key element to shareholder value. However, it is important to understand what is meant by cash flow. Too often the focus is on measures such as EBITDA (earnings before interest, taxes, depreciation and amortization). But this only tells half the story. The true measure of cash flow is discretionary cash flow, the cash that can be withdrawn from a company without impairing its operations or growth prospects. Discretionary cash flow takes into account all of the cash requirements of a business, including income taxes, capital expenditures, and working capital to support growth.

By implementing better inventory management practices, a company can generate immediate discretionary cash flow through a reduction in inventory levels. In addition, as the company grows, the incremental amounts it must invest in inventories should also be reduced, thereby further increasing shareholder value.

The 12 per cent rate of return used in the above example represents an after-tax rate of return applied to discretionary cash flow. While rates of return are subjective, they are influenced by the market's perception of a company's risk exposure and growth prospects.

One of the keys to managing risk and growth potential lies in understanding a company's customer base. Managers need to know who their customers are, why they are buying from the company, their decision process and decision criteria. Shareholder value is created where a company develops a diversified base of repeat customers, as this serves to improve revenue stability and reduce risk.

Interest bearing debts such as bank operating loans, term loans and capital lease obligations are deducted from the enterprise value of a company to derive shareholder value. However, this does not mean that debt financing should be avoided as a means to increase shareholder value. Rather, shareholder value is created where the incremental benefits from borrowing outweigh the cost of capital. Debt financing can be attractive because interest payments are tax-deductible.

In addition, many business owners have most of their economic worth tied up in their company. By substituting equity for a modest amount of debt, shareholder value can be increased because the return on the remaining equity will be higher. This strategy also allows business owners to diversify their holdings and protect themselves against a severe downturn in their business.

In the end, shareholder value is a function of a company's discretionary cash flow, required rates of return and debt utilization. By understanding the dynamics of these variables, business owners and executives will be in a better position to make decisions that impact shareholder value in a positive way.

Welcome new Principals

We're always expanding our team of seasoned executives to accommodate our clients' requests. On behalf of the entire team at The Osborne Group, we extend a special welcome to our newest Principals.

Montreal

Peter Casey	Executive Advisor
Yvan Fortin	Executive Management
Michel Suys	Corporate Development

Toronto

Kathy Fairbarns	Executive Management
Greg Paupst	Executive Management
Robert Plummer	Operations
Don Weaver	Executive Management

Edmonton

Dave Rohachuk	Operations

Vancouver

Kelly Armstrong	Executive Management
Dana Carroll	Executive Management
John Cowan	Operations
Andy Hearne	Financial Management
Darlene Hyde	Operations
Marian Lewandowski	Executive Management
Bill Macdonald-Kerr	Operations
Harry White	Operations

Calgary

Jim Courtney	Business Development: Marketing and Sales

The Osborne Group is a national organization, focused on interim management and consulting services. Over the past fourteen years we have successfully helped clients in every sector and industry, providing executives to fill management gaps on critical projects, during periods of change, or when high growth demands immediate expertise.

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