Lakelet Advisory Group LLC
Focusing on Business Results
NEWSLETTER
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Administrative Capacity

The Challenge for Successful Mid-Size Companies

The development of a Company, like the development of a person, necessitates the ability to grow the capacity to 'administer' their affairs. Capacity is defined as the "the ability to do something: a mental, emotional, or physical ability." This article considers the extent to which Administrative Capacity impacts the performance / success of lower / middle market companies.

Success in lower / middle market companies has a proven barrier that will limit the opportunity of achieving the "Next Level." At a set point the infrastructure, staff, systems, and most importantly, management cannot optimize the marginal revenue generated.

Generally, after achieving a set revenue threshold, the challenges are often attributable not to the product or services of the Company, but to the Administrative Capacity Points ("ACP"). These ACP are as real as the physical capacity thresholds. The key difference, between the ACP and the physical capacity threshold point(s), is that the ACP is not easily recognizable or measurable.

On a macro level, administrative capacity is the company's ability to deliver maximum profits at minimum cost when administrative resources are fully utilized. A critical ACP is the ability to manage the growth of the company, providing effective direction for the transition from what was and what needs to be – a perpetual process. At some critical point, the projected marginal cash from each transaction is no longer being generated. And, in many cases, this is associated with the ACP. This happens to every single business entity. Why?

Symptoms of ACP:

- Taking longer than expected to get things completed;
- Margins are inconsistent – the Company prefers to believe it is a result of the market, vendors, quality, seasonality, product mix, ad infinitum;
- Management stagnation - same Senior Management in place for + 5 years;
- Same product offering and top five customers for more than 2 years;
- Morale is suffering;
- No formal HR team;
- Company is spinning its wheels;
- The day is absorbed on tactical firefighting not strategic opportunities;
- No formal advisory board or Board of Directors; and
- The management is in a comfort zone.

Obviously, there is no set revenue or ratios that yield the ACP. On average, the ACP thresholds for manufacturing companies are as stated in the following table:

	Revenue $$$ (Million)
Level I	Up to $5M
Level II	$5M to $13M
Level III	Above $13M

In a "Normal Expected Return" situation, the amount of marginal transactional costs is proportionally absorbed by revenue, efficiencies, optimal financing, and processes. In other words, a second transaction is cheaper on average than the first transaction. You have economies of scale, learning process, efficiencies, processes in place and knowledge of the results. ACP precipitates inordinate resource requirements – the administrative equivalent of using a drill press as a lathe.

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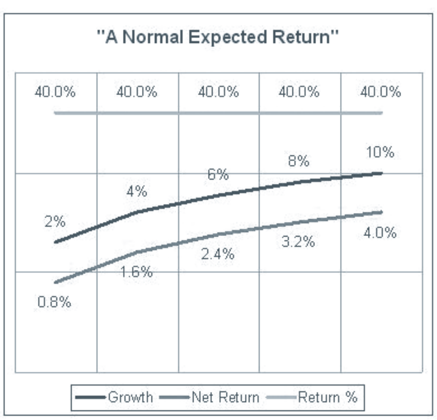
Different Skill Sets at ACP

The following table illustrates the different requirements for companies at various ACP barriers / levels.

	Level 1	Level II	Level III
Management	Founder Specific Product Skills Start-Up	Founder / Acquirer General Business Skills Managers with 5 – 10 years experience	Professional CEO Business experts Executives with +15 years experience Advisory Committee / Board of Directors
Accounting	Bookkeeper Very weak to non-existent Control	Controller / Accounting Manager Basic Controls	CFO Need for internal Controls
Systems	PC Specialist Basic Requirement	PC Manager Used in Production IT viewed as a cost	CIO Strategic Resource IT is a very strategic part of the Company
HR	Part-Time Admin	Full Time Equivalent	Full-Time HR Team
Operations	CEO Addresses Plant Manager	Operations Manager	COO
Financing	Simple Bank Loan	More Complicated	External Requirements
Sales	CEO is Sales Leader Sales Structure Informal No Sales Plan / Marketing Budget	VP of Sales	Sales Team Sales Leader with tangible goals per month
Marketing	Informal Approach	Part Time Marketing	Full Time Resource Formal Marketing Plan reviewed by Quarter Formal Marketing Budget

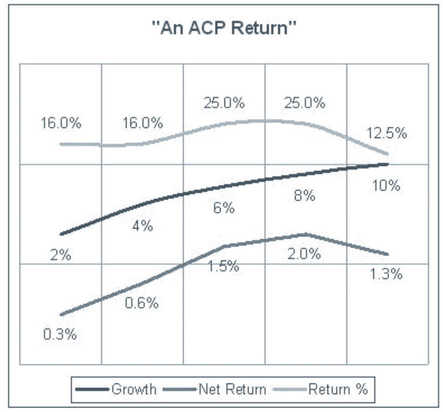
An Illustration of the Returns at ACP



For illustrative purposes, let us assume that for each 10% increase in revenue or 10% reduction in costs, we expect to have a net return of 4%. This scenario is reflected in the following graph.

At the ACP point(s), the organization can no longer absorb the number of transactions, or the complexity associated with the growth of the company. The fixed costs are no longer fixed – in a short term.

The following chart illustrates a typical scenario.



Unfortunately, the negative ramifications of the ACP are usually not apparent. This is especially true when a small to mid-sided company is in a high growth mode. The Company hits this transparent barrier like a brick wall – yet they can't decipher the problem. Despite expanding revenue or reducing cost, the Company's bottom line does not proportionately reflect these improvements.

And yet, the Company is often convinced that with more transactions (revenue) the situation will improve. Whereas, in this scenario, more transactions (revenue) will jeopardize the overall gross margins / performance of the Company.

Identifying the ACP problems

- Number #1 problem is that senior management resists the change; they are simply too close to the problem. The need for cultural and process change is met with distain. After all, the present management created and institutionalized the present set of processes and teams. And in management's defense - it is their processes and abilities that have allowed the Company to achieve this prior success - so why change?;
- Although growth is anticipated and expected – the additional support is not strategic or proactive;
- Outside financing capitalist, banks, new partners, and creative equity / debt structures is needed to support the next level of business (greater than ACP). In some cases, different ownership with different objectives

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is essential for the strategic, long-term success of the company. And, the bank and investors definitely have a different goal than the current owner of this business;

- Change in corporate culture. Just because a culture or set of processes are GREAT for an $8,000,000 company, this culture and / or processes more than likely will not work efficiently for a $24,000,000 entity. Nor will they get the company to the 24-million-dollar level; and
- Most small businesses try to use the same team that was able to accommodate a handful of transactions to operate the Company at the next level - the skills are different. You reach a point where professional executives are required, not just to grow the company, but to ensure it is successful in its current life cycle.

Working Capital "Catch -22"

Challenged Entities Require More Working Capital than Non-Challenged Entities

Having sufficient working capital is a key to all successful businesses. As demonstrated below – the irony is that challenged entities require more working capital than their non-challenged counterparts.

Working Capital requirements play a disproportionate role for two diverse ends of the business spectrum – those that are growing significantly and those that are experiencing a downturn in business. For the purposes of this illustration, allow me to focus on the challenged entities.

In general, we can see that the working capital requirement increases as Inventory and amounts owing by customers (Accounts Receivable) increase, and reduces as the amounts owed to suppliers (Accounts Payable) increases. This is summed up in the formula:

Net Working Capital Requirement = Inventory + Accounts Receivable – Accounts Payable

To compare "apples to apples", we need to convert each of the aforementioned working capital components to a standard measurement – that standardized measurement being a percentage of revenue.

As the business deteriorates, its Revenues decrease, which in turn decreases Accounts Receivable and generally impacts Inventory on hand.

At any given point a business needs to be able to estimate its working capital requirements. As the revenue figure is normally at hand or the first to be forecast, the simplest way to do this is to calculate the working capital requirement as a percentage of revenue. The working capital requirement is a function of Accounts Receivable, Inventory and Accounts Payable. Allow me to illustrate this working capital requirement. For simplicity purposes, let us assume that revenue is $18,500,000, Gross Profit Margin is 40%, with the Number of Days Inventory Held being 45 days, Accounts Receivable Terms are 45 Days, and an average Days of Credit for Accounts Payable being 30 Days.

Cash Analysis		
Revenue	$ 18,250,000	
Gross Margin %	40%	
Number of Days Inventory Held	45	
Accounts Receivable		
Credit Terms for Customers (in days)	45	
Average Accounts Receivable = Days Credit x Daily Revenue	$ 2,250,000	
Accounts Receivable % = Average Accounts Receivable / Revenue		12.3%
On average, at any one time, the working capital requirement resulting from offering credit to customers will be 12.3%		
Inventory		
Costs of Goods Sold = Revenue x (1 - Gross Margin %)	$ 10,950,000	
Average Inventory Held	$ 1,350,000	
Inventory % = Days Inventory x Daily Revenue x (1 - Gross Margin %)		7.4%
Accounts Payable		
Days of Credit	30	
Average Accounts Payable = Days Credit x Daily Revenue x (1- Gross Margin %	$ 900,000	
Accounts Payable % = Average Accounts Payable / Revenue		4.9%
Net Working Capital Requirement		
Accounts Receivable % + Inventory % - Accounts Payable %		**14.8%**

In this scenario, the working capital requirements is 14.8% of the Revenue. Or $2,700,000 required working capital. Although this figure will change over time, providing the business is relatively stable, it gives a good indicator of what the potential working capital requirement is for the business.

Let us modify the aforementioned scenario by having the Revenue decrease 20%, Gross Profit Margin decrease 8% (as a result of lost in economies of scale and lack of capacity optimization), and this company suffers from decrease in Inventory Turns (assume Inventory Held is an Average of 60 Days).

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By failing to prepare, you are preparing to fail. - Benjamin Franklin

The secret of getting ahead is getting started. - Mark Twain

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Revenue Decreases 20% - GPM Decreases 8% - Change in Inventory		
Revenue	$ 14,600,000	
Gross Margin %	32%	
Number of Days Inventory Held	60	
Accounts Receivable		
Credit Terms for Customers (in days)	45	
Average Accounts Receivable = Days Credit x Daily Revenue	$ 1,800,000	
Accounts Receivable % = Average Accounts Receivable / Revenue		12.3%
On average, at any one time, the working capital requirement resulting from offering credit to customers will be 12.3%		
Inventory		
Costs of Goods Sold = Revenue x (1 - Gross Margin %)	$ 9,928,000	
Average Inventory Held	$ 1,632,000	
Inventory % = Days Inventory x Daily Revenue x (1 - Gross Margin %)		11.2%
Accounts Payable		
Days of Credit	15	
Average Accounts Payable = Days Credit x Daily Revenue x (1- Gross Margin %	$ 408,000	
Accounts Payable % = Average Accounts Payable / Revenue		2.8%
Net Working Capital Requirement		
Accounts Receivable % + Inventory % - Accounts Payable %		**20.7%**
Difference		**-5.9%**

As a result of the decrease in business based upon these assumptions, the net working capital required has increase to 20.7% of revenue, or a relative increase in net working capital of 5.9% between the two scenarios. This 5.9% relative change equates to an increase in required cash of $324,000 for the second scenario despite the decrease in volume. To make this net situation worse the company would have the same debt service and fixed costs to address with significantly less cash.

With "Cash is King" mantra – understanding and optimizing your required cash flow is as important, if not more, than understanding the Profit and Loss Statement.

What's Happening With Lakelet This Quarter?

- Lakelet Advisory Group is pleased to announce the addition of Leigh Caldwell as Consultant to the firm. Ms. Caldwell brings significant experience in fraud investigations, audit, regulatory compliance, and anti-money laundering. She will lead the firm in investigating and identifying financial weaknesses for clients and creating strategic solutions to solve those clients' problems.
- Lakelet has been accepted into the prestigious Association of Management Consulting Firms. The Association of Management Consulting Firms (AMCF) is the premier international association of firms engaged in the practice of management consulting. Founded in 1929 as AMCE, the Association of Management Consulting Engineers, AMCF today remains in the forefront of promoting excellence and integrity in the profession.

  Michael Koeppel, Managing Director of Lakelet states "this association with the AMCF will allow us to better serve our clients with additional proven solutions and the ability to be more than a regional firm."

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