Five factors for manufacturing growth in an uncertain economy
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In today’s uncertain business environment, every dollar matters in the quest for competitive advantage. But focusing on cash doesn’t always mean just cost-cutting — because workforces have already been cut, capital expenditure projects have already been delayed, and market opportunities have already been missed, as leaders wait for a sustained recovery to take hold.

In 2012 and beyond, businesses must focus on growth. Staying ahead of business rivals requires manufacturers to maximize their existing resources while continuing to deliver top-notch products and services. And that means finding cash to fund new talent, investments and opportunities.

Five factors for manufacturing growth in an uncertain economy highlights a number of strategies manufacturers can use to improve their business prospects and heighten their competitiveness, while at the same time boosting their cash flow:

1. **Optimize the supply chain.** Best-in-class manufacturers are relying more heavily on suppliers to enhance their capacity and capabilities. Manufacturers should be assessing and tracking supplier risks and key performance metrics regularly. In many cases, manufacturers are finding that they can cut costs and improve performance by expanding the roles of trusted suppliers.

2. **Build a business intelligence foundation for strategic decision-making.** A culture based on business intelligence leads to better decision-making, increased agility in reacting to market changes, reduced operational risks, and heightened productivity.

3. **Establish an effective strategy for exploring acquisition opportunities.** This requires not just robust due diligence that examines candidates’ financial and operating results and tax and regulatory considerations, but also careful post-transaction integration planning.

4. **Generate cash by leveraging tax opportunities.** Whether by accelerating deductions, restructuring for maximum tax advantage, or generating credit or refund opportunities, manufacturers may be able to free up cash for their businesses if they rethink their tax positions.

5. **Find the capital to grow.** Well-run companies with strong financials can typically secure financing for investment in facilities, equipment and increased production capacity. But manufacturers must also be aware of their borrowing capacity and its constraints. Many will need to be selective at this time and concentrate on the areas of the business where investment is needed most.

By focusing on and leveraging these five factors, manufacturers can maximize their financial and operating successes.

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National Manufacturing Practice Leader
Five factors for manufacturing growth in an uncertain economy
During the recession, many manufacturers’ supply chains suffered cracks and more than a few collapses as critical suppliers failed. The good news is that most manufacturers, given the right information, can assist struggling suppliers and leverage high-performing vendors to improve their own results.

### Knowing suppliers

Manufacturers gain value from their partnerships with key vendors when they take the time to align their needs with vendors’ capabilities. Understanding vendors’ financial and operational health is one aspect of this. So, too, is clearly understanding suppliers’ capabilities and how their processes correspond to the manufacturer’s strategic objectives. For example: Do all links along the supply chain share the same approach and goals concerning quality? Are urgent requests for invoice payment your only clue that a supplier is in desperate need for cash and that something may be going wrong?

“All right suppliers?” and ‘Do we have enough suppliers in strategic locations?’ are likely the first two questions companies should be asking themselves,” says Brian Larsh, manager, Business Advisory Services.

Larsh advocates using a vendor scorecard to track key metrics in the supplier relationship, such as cost, quality, on-time delivery and numerous other factors. This allows the manufacturer to 1) define the key performance metrics, 2) identify when suppliers aren’t meeting established standards and where there is room for improvement, 3) offer feedback to suppliers on how their performance can improve the manufacturer’s processes, and 4) reward vendors that meet and exceed expectations.

Vendor scorecards allow manufacturers to measure what’s important to them, track results against those metrics, leverage that data in future negotiations, and formalize performance metrics as part of contract renewals. For example, manufacturers can specify cost savings targets in their supplier agreements and develop process improvement incentives such as sharing achieved cost savings with their suppliers. Other metrics can involve tracking sustainability measures throughout the supply chain — a sharpening of the focus on sustainability at leading original equipment manufacturers (OEMs). In addition, political and legal restrictions on the use of certain raw materials require documentation of some supplier processes and materials. All supplier monitoring and measurement processes should map to corporate strategy — and should be updated and revised as business issues and strategies change.

“Unfortunately, too often we have seen that organizations either don’t have vendor scorecards or continue to use outdated versions that don’t reflect current business processes or corporate strategy,” Larsh says. In other instances, suppliers are asked to self-report, without the benefit of validation or an independent audit to assure that the information is timely, balanced and factual. “In an ideal situation, the scorecard confirms that the vendor’s processes are appropriate and that key performance metrics are monitored and updated on a timely basis to incorporate vendor process changes.”

Larsh emphasizes that it’s important to review scorecards periodically to identify risks at specific suppliers and across the supply chain as part of a broader enterprise risk management (ERM) program. For example, does a key supplier have a one-of-a-kind process or unique equipment with no viable second source or true competition, making the manufacturer dependent on its products or services? Larsh also suggests that manufacturers calculate the cost or impact of a supply chain interruption by one or more of their major vendors.
Disruptions in automotive supply chains in the months following the 2011 Japan tsunami highlight the importance of developing planned redundancy among vendors. Often this is as simple as making sure that multiple suppliers have access to tooling capabilities. This proactive approach can deliver other benefits, such as encouraging competition among vendors.

“But you should be strategic about how you do this, lest you park millions of dollars in redundant tools all over the world and never get any tangible value out of them,” cautions Larsh. “Ideally the development and placement of redundant tools and processes should take supply chain risk into account — and help you take advantage of nearshoring trends by placing production close to both your raw material suppliers and your customers.”

Expanding supplier roles
Leading manufacturers are finding that by expanding their suppliers’ roles, they’re often able to reduce costs, increase flexibility, and add cost-effective and scalable capacity. Some circumstances lend themselves naturally to heightened supplier involvement:

Required capabilities: Manufacturers frequently realize that some production work is better completed by suppliers — especially during periods of growth. Supplier support might take the form of procurement and staging of components from other suppliers and kitting them for assembly, or even building the subassembly. In other situations, a supplier may be able to produce an item more cost-effectively than the OEM, given its cost structure and access to tooling or intellectual property. Manufacturers with systems in place to monitor and manage supplier relationships can take advantage of these opportunities, helping themselves and their suppliers grow.

New capabilities: New products and changing customer demand can lead to novel production or design requirements that cannot be satisfied by an OEM. Before developing these capabilities in-house — e.g., through employee skills or sourcing relationships — manufacturers should assess whether suppliers can provide them. It’s not unusual to find that suppliers already produce similar goods and have an infrastructure in place to support that production.

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Supporting suppliers

Valued suppliers occasionally need financial support — especially if they play an expanding role in the supply chain. There are many ways to help suppliers stabilize their financial position, but a manufacturer must first understand the supplier’s situation. Not surprisingly, the best place to start is with an examination of the supplier’s financials via an internal audit, which is often conducted by a third party.

If the manufacturer decides to provide assistance after an audit, typical forms of support include the following:

• **Advance payment:** When a supplier is asked to take on new equipment, capacity or engineering to develop components and materials for a customer, it’s not unusual for the customer to offer a deposit (of up to 50 percent) on the initial order to help fund expenses and ensure timely delivery of quality goods.

• **Procurement power:** Many OEMs have access to negotiated or volume-based pricing that smaller suppliers cannot obtain. By purchasing raw materials or components that go into supplier-made goods, the OEM assumes both the material cost and the price-volume risk while freeing up cash for the supplier. Advantages of this arrangement include insight into true raw material prices and supplier value-added costs, better control over the quality and delivery of raw materials, and the possibility of lower overall costs.

• **Contract reassurances:** Even if a supplier isn’t cash-strapped, the size and timing of a project can potentially overextend the supplier’s capacity and resources. “Sometimes a small vendor cannot afford to take on the additional risks,” Larsh observes. “If the contract is written so that the OEM can cancel easily, suppliers will be conservative with the amount of capital and resources they invest. Anything that the buyer can do to provide suppliers with confidence and the peace of mind that their investments will be rewarded will encourage them to be more aggressive.” For instance, the OEM could take on ownership of the most costly materials and tooling in the early stages of a new product launch, and when demand stabilizes and is more predictable, the supplier can buy any remaining OEM inventory and manage all purchases going forward.

Any time a manufacturer chooses to take on risks from a supplier, Larsh advises, the company needs to trust but verify. “There are a lot of things manufacturers can do and accomplish with a strong network of vendors when they are trusted partners. If a vendor has a good tone at the top, then you can have more confidence in the transactions that happen every day,” says Larsh.
Developing a total-cost perspective

Good supply chains consist of select services delivered by a network of stable partners. It is common practice among many manufacturers to nag suppliers about cost, sometimes focusing myopically on price per unit for one specific item or service and then using price quotes to shop for lower-cost vendors. But Larsh believes that these practices don’t typically foster the kind of lowest-total-cost/value-added partnerships that make supply chains strong.

Data indicates that many manufacturers haven’t looked beyond the basics when evaluating their suppliers and supply chains. For example, nearly 40 percent of manufacturers assess their supply chain’s competitive advantage only in terms of cost, quality and delivery performance. Few consider other important factors, such as the efforts of suppliers to work on continuous improvements, or benefits that suppliers offer with respect to product development and strategic planning (see table).¹

### Measuring, evaluating and partnering with suppliers for competitive advantage

<table>
<thead>
<tr>
<th>How close do you stay to your suppliers?</th>
<th>% of manufacturers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Suppliers are regularly measured on cost, quality and delivery performance.</td>
<td>38.6%</td>
</tr>
<tr>
<td>Suppliers are regularly measured on cost, quality and delivery performance, as well as total acquisition cost.</td>
<td>11.0%</td>
</tr>
<tr>
<td>Suppliers are regularly measured on cost, quality and delivery performance, as well as total acquisition cost and “soft” qualities (e.g., trust, flexibility).</td>
<td>30.0%</td>
</tr>
<tr>
<td>Strategic suppliers and customers are active participants in our operations, continuous improvement and product development efforts.</td>
<td>16.6%</td>
</tr>
<tr>
<td>Strategic suppliers and customers are active participants in our operations, continuous improvement and product development efforts, and participate fully in strategic planning and identifying and responding to new markets.</td>
<td>3.8%</td>
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</tbody>
</table>

Source: Next Generation Manufacturing Study, the MPI Group, 2011

¹ Next Generation Manufacturing Study, the MPI Group, 2011
Even when the focus is solely on cost and quality, that focus is generally not on total cost of acquisition, which comprises all of the costs associated with buying goods, services or assets. Aside from unit price, other factors such as these can have a dramatic impact on total cost:

- **Logistics costs:** Low-cost suppliers from overseas can erode margins through transportation expenses, customs duties and tariffs, as well as loss of flexibility due to long lead times.

- **Order quantity:** To reduce the high cost of transportation and boost availability from overseas suppliers, manufacturers often increase order volumes, which can result in excessive inventory carrying costs and obsolete inventories. This can lead to delays in introducing new products until inventory of older versions is depleted.

- **Delivery method and frequency:** Local suppliers that can’t match the unit cost of overseas vendors may be able to cut total costs through just-in-time delivery to production lines — in exact quantities needed on an hourly or shift basis (minimizing OEM material handling, reducing carrying costs and supporting timely demand fluctuations). They may also be able to use recyclable containers, eliminating costs associated with dunnage.

Ways to reduce total cost are typically discovered and developed over time through collaborative relationships between suppliers and manufacturers. When suppliers have access to customer departments such as R&D, production planning and manufacturing, they have the opportunity to add significant value, says Larsh. Yet it is still common for most buying decisions to be made by purchasing departments that are sometimes located far from plant floors and for performance to be measured internally by transactional costs rather than strategic value. When a supplier’s access is limited to the purchasing department, and last purchase price is all that matters, the supplier’s ability to add value is equally limited.

As a result of disconnects such as these, it’s not uncommon for an OEM to contribute to higher unit prices through its own actions or processes. “This ties back to linking measurement, strategy and risk,” Larsh observes. “This is not a one-step process or something that you focus on only in the beginning of vendor selection. Developing and maintaining a robust, advantage-delivering supply chain is a continuous process that needs to be fostered at every level, because it changes every day.”
Five factors for manufacturing growth in an uncertain economy
In today’s uncertain economic environment, it’s more vital than ever that executives have the ability to make strategic, operational and tactical decisions based on accurate and timely information. Nearly all companies generate vast volumes of valuable data throughout their supply chain, yet accessing this information and collating it effectively can be daunting. Mountains of critical data reside in numerous and disparate supply chain systems, many of which are not integrated from a reporting perspective. Furthermore, definitions of net sales, inventory or cost of poor quality (COPQ) differ from one plant, division or subsidiary to another. Consequently, many executives cannot rely on their reports to give them the “one version of the truth” they require or provide the insight necessary for their companies to survive and thrive in a fiercely competitive marketplace. However, some executives have improved their decision-making through the effective implementation of business intelligence (BI) solutions. BI solutions include processes and software applications that consolidate and integrate disparate data into easy-to-use executive dashboards, operational scorecards and detailed reports for all types of business users. When designed and implemented properly, BI solutions offer organizations the ability to make critical decisions and drive action-oriented results based on accurate and timely reporting about their supply chain operations. The most effective BI solutions are designed to align a company’s strategic objectives with appropriate key performance indicators (KPIs) and support detailed reporting on these KPIs. These solutions allow executives to proactively monitor their business, identify trends, detect problems early, and drive action and accountability throughout their organizations.

Implementing enterprise BI solutions can lead to valuable qualitative benefits across the supply chain:

- **Higher overall quality**: When manufacturing performance is consistently measured and reported with enough detail to drive accountability, issues regarding quality can be identified and remedied much earlier.

- **Increased productivity**: With advanced analytics enabled by BI, manufacturers can identify and assess variances (e.g., price, material usage, labor) faster and take stronger actions to optimize productivity.

- **Lower costs**: With more intelligent sourcing reporting and analytics, costs related to production and delivery can be managed more effectively. This efficiency can reduce the need for rework and lead to fewer customer rejects and warranty claims.

“Enterprise BI supports better business decision-making. Yet the ability to leverage BI is very limited at many companies because most manufacturers don’t collect or analyze their data in a disciplined, systematic, enterprise-wide manner,” says John Gutierrez, national Business Intelligence Solution practice leader. “Often various supply chain processes and systems are so disparate that they represent items that should be reported consistently throughout the company — such as part or model numbers or BOM [bill of materials] details — differently on different reports.” These issues can be resolved, he believes, but only if there’s executive support for achieving information consistency, accountability and good governance throughout the organization.
Many manufacturing leaders have begun to invest in BI software solutions. The market for BI, analytics and corporate performance management software grew by 13.4 percent in 2010 to $10.5 billion after experiencing 4.2 percent growth in 2009 during the depths of the recession, according to one Gartner study.²

“How companies implement a BI solution is even more important than the software they select,” asserts Gutierrez. “A well-designed solution should include a foundational initiative that defines the overall BI strategy, governance structure and key technologies to be used. The strategy should ensure alignment between top corporate objectives and their corresponding supply chain KPIs. It should also outline BI standards and provide an implementation roadmap.”

The roadmap helps the BI program team manage delivery expectations, while the governance structure helps the company achieve each project’s business case and deliver results as promised. “Many companies secure organizational buy-in by presenting a high-priority strategic executive dashboard report as an initial deliverable. Realizing a quick win and reporting it in a very visible format such as an executive dashboard can set the stage for rapid user adoption and long-term success,” Gutierrez says.

**Developing one version of the truth**

The most critical business case driver for BI is the concept of building one version of the truth on which the entire organization relies to gauge performance, identify issues and base decisions. Historically, executives and stakeholders often couldn’t rely on enterprise reports because the information they contained varied significantly from one data source to the next. Any response to their inquiries regarding the performance of almost all key metrics — e.g., sales, inventory, gross margin, COPQ — was almost wholly dependent on whom they asked and would differ from other stakeholders’ perspectives. Today, companies must support daily decisions based on reliable operational data in order to maximize their competitive advantage. They must be able to rely confidently on BI reports and know that everyone in the organization is making decisions based on the same information. Also, stakeholders must be able to draw on this information to meet their own unique business requirements — using the access method, frequency and format best suited to them.

For example, a senior executive may want a dashboard or scorecard whose data is unambiguous and tells the story quickly. Notes Gutierrez: “If he sees something he thinks is an issue, he will direct others to take specific actions or conduct further analysis. An analyst will drill deeper and review data in much more detail. But they will both be looking at the same data, just examining different presentation views that result from different reporting technologies, and hence relying on one version of the truth.”

Aligning stakeholder requirements with organizational strategy

Effective BI must be based on the unique needs of each business user group: What specific types of data do decision-makers need to have in order to make critical decisions? “This requires understanding what information leaders need on a regular basis to drive action in their organizations,” says Eric Krchnak, Advisory Services senior manager. “If companies don’t design their BI solutions to support their business strategy, they can invest millions of dollars in BI initiatives and only achieve limited business value,” he cautions.

Therefore, it is critical for a company to align its strategic objectives with its BI governance processes before it begins building a BI solution. For example, if the manufacturer’s goal is to reduce external COPQ (ECOPQ) by 30 percent in three years, then the company must design metrics and construct the BI solution to measure quality drivers appropriately. For a decentralized manufacturer with numerous products and multiple plants, this requires standardization of key data elements across the supply chain. In this case, many types of stakeholders may have influence over similar data elements such as the part master record. To build an effective BI solution, a part master data steward or stewards must be empowered to define and maintain all related data standards in order to ensure the most consistent reporting presentation and interpretation throughout the company.

Monitoring progress toward strategic goals with a balanced scorecard approach

Action-oriented balanced scorecards, which are an important element of BI projects, provide concise, at-a-glance information measuring progress toward strategic goals across the enterprise. They highlight financial as well as nonfinancial information critical to measuring results. These scorecards typically measure performance using intuitive, simple formats such as red-yellow-green stoplights. They include predictive alerts, which help executives see what areas need their attention and where to focus key resources. Finally, in order to maximize their value, balanced scorecards must drive corrective action. For example, if performance in a scorecard category falls below acceptable thresholds, the scorecard should outline a remedial action plan to address specific problems.

Scorecards also allow executives to drill down into the data to explore operational variances. Many manufacturers that have not implemented BI solutions may track COPQ as a lump-sum cost of doing business, but these companies cannot give a detailed explanation of where key problems reside and how to remedy them. For example, are warranty cost overruns due to new versus obsolete product lines? Are there issues with product quality or design? Without access to consistent information throughout the supply chain, executives simply cannot make informed decisions about how to reduce COPQ. But a properly designed BI solution allows executives to confidently answer these kinds of questions and initiate action to resolve underlying issues — increasing customer satisfaction and potentially saving millions of dollars in warranty costs.
Achieving BI maturity

As manufacturers mature in their use of BI, a common challenge they face is the ability to act on improved information. (See the Business intelligence maturity model below). “In order to move beyond simply informing executives of results to acting on trends using these analytics and learning from them, you must be able to change how you operate. This is a consistent challenge for companies and does not happen overnight,” says Gutierrez.

He recommends that companies begin with a pilot initiative focused on one key area or strategic objective before propagating BI throughout the organization. “The objective of this type of project is to build organizational buy-in and excitement by getting a quick win, while implementing critical foundational components required for a successful long-term BI program such as an enterprise BI charter and governance process.”

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**Business intelligence maturity model**
Subsequently, BI can be rolled out to the rest of the organization by building on the foundational processes, technologies and implementation roadmap designed during the pilot project. Gradually, a culture of performance measurement will emerge across the company, with senior executives, middle managers and front-line workers all using the same reliable data to drive action and accountability.

Ultimately, a culture built on robust BI helps companies react quickly to market and regulatory changes and, more importantly, remain competitive and foster growth. “A powerful enterprise BI solution helps executives understand what is really happening inside their business and drive the actions and accountabilities needed to achieve high performance,” says Gutierrez.

Ultimately, a culture built on robust BI helps companies react quickly to market and regulatory changes and, more importantly, remain competitive and foster growth.
Five factors for manufacturing growth in an uncertain economy
M&A activity is rebounding from the impact of the global financial crisis. As a result, there is an increasing supply of potential deals for those who are looking to grow through acquisitions.

“There’s renewed activity in the M&A market now, and sellers can get strong prices,” says Steve Brady, national partner-in-charge, Transaction Advisory Services. “But successful M&A requires more upfront diligence to identify risk and exposure than in the recent past.”

Developing an acquisition strategy
Every company should have a defined M&A strategy and process, even if M&A is not expected to be an avenue for growth in the short term; the market changes quickly, and companies cannot be caught off guard when an opportunity or threat arises. Whether a company seeks to expand product lines, access new markets or supply chains, or extend operating capabilities or intellectual property rights, an acquisition strategy should be in place to filter a candidate’s strengths and weaknesses against the manufacturer’s objectives.

The M&A process will depend on a manufacturer’s objectives, previous acquisition experience and available internal resources and should provide a framework for assessing potential deals. The process should also address how to conduct a transaction once a target is identified. Many manufacturers have corporate development officers or a senior executive such as a CFO, chief operating officer or CEO with the experience to fill an M&A leadership role and manage an internal or external team that researches and evaluates companies that align with the manufacturer’s strategy.

Without a clear-cut strategy, the management team can become emotionally invested in a deal, often to the detriment of the business. Whether the deal ultimately closes or not, the weeks and months spent on due diligence, negotiations, drafting purchase agreements, and other aspects of a transaction are all wasted when companies pursue deals that do not support their M&A strategy.

“Manufacturers that are proactive and have a well-thought-out strategy and a disciplined approach to filtering potential acquisition candidates tend to have better outcomes. They not only get deals done, but also operate post-acquisition entities more successfully,” Brady says.
Evaluating M&A candidates

Having a strategy that identifies potential targets based on desirable attributes is only part of a robust due diligence process. Companies must also rigorously evaluate:

- financial trends;
- operating results;
- tax and regulatory issues;
- litigation risk;
- intellectual property;
- IT systems and internal controls; and
- operating capabilities, capacities, systems and methods.

The more access the acquiring company and its advisory team have to a candidate’s key management and operations, the more realistic the assessment of a transaction’s value. Consequently, Brady prefers to conduct most due diligence on-site in order to obtain the best view of an acquisition candidate.

“Compiling an accurate picture of the target’s operating results and working capital needs is the foundation of a deal,” says Brady. “Yet focusing strictly on the numbers won’t illuminate the operating potential of the business after a transaction closes.” Therefore, Brady advises, due diligence should concentrate equally on other key questions:

- How solid is the target’s customer base? Are there satisfaction issues that could lead to diminished revenues?
- Can the target’s high-growth earnings stream be accommodated within our existing cost structure?
- Is current profitability the result of aggressive cost cutting? Can profitability be sustained?
- What are the key issues involved in integrating shop floor and back-office processes?
- What are perceived synergies and investment needs?
- Are performance results due to management talent that may not be retained?
- Are the two corporate cultures compatible?

“All those elements need to be examined. The more they’re understood and tied to the acquirer’s strategy, the more successful the transaction will be. Business performance and financial reports are the foundation, but all of these other elements drive success. As a buyer, you need to be confident that you know exactly how to sustain those success factors going forward,” asserts Brady.
Establishing a post-merger integration plan

Buyer’s remorse is common among manufacturers after an acquisition. “Buyers have a certain trajectory of value that they perceive they’re going to get from the acquisition. They expect great things to happen — including stellar operating performance and financial results,” Brady notes.

But research indicates that a majority of transactions quickly lose value. Indeed, Bloomberg reports that “[the] stocks of 53 companies that made the biggest purchases from 2005 to 2008 lagged behind industry peers two years later.”³

Disciplined M&A preparation that incorporates merger integration planning can help prevent such disappointments. This preparation and planning should include:

- rationalizing manufacturing and office locations;
- coordinating business and technology systems and methods;
- leveraging economies of scale (e.g., procurement, service providers);
- realistically quantifying expected results; and
- embracing the talents of the new management team.

“When considering the expected synergies, it is critical to make sure they’re realistic and driven down to roles/positions and the capabilities of the individuals in those positions. This lays down the path for pragmatic expectations and offers a roadmap for achieving them,” says Brady.

³ Mider, Zachary R. “M&A Losers in $10 Trillion Deal Binge Led by McClatchy, Sprint,” Bloomberg, Aug. 12, 2010
Five factors for manufacturing growth in an uncertain economy
These days, no manufacturer can afford to leave cash locked up. When seeking improvements in tax positions, it’s useful to consider three action items:

1. Take advantage of benefits, such as credits that can be obtained within normal business operations.
2. Time items and accounting methods to accelerate deductions and defer revenue recognition.
3. Restructure operations to take appropriate advantage of tax benefits that improve cash flow.

Creating cash savings
There are multiple opportunities for a manufacturer to reduce tax payments or generate refunds given current business conditions,” notes Kullen Birkeland, Manufacturing Tax practice leader.

“Good targets for tax-saving opportunities are sales taxes, property taxes and other taxes that you pay regardless of whether you have taxable income, as well as refundable credits and incentives, such as research and development (R&D) credits,” says Birkeland.

The federal research tax credit, last extended by the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (2010 Tax Relief Act), officially expired in December 2011 for the 15th time in its 30-year history. The credit is expected to be extended again for 2012 and beyond. It allows manufacturers to offset product and process development work — such as idea creation, product engineering and development of prototypes — provided they can accurately account for and document costs associated with those activities. The credit can also be used for improvements to existing products and processes.

In addition, the federal Work Opportunity Tax Credit (WOTC) is available to businesses that hire individuals from any of nine target groups that have faced barriers to employment. Employers are compensated for their hiring efforts with reductions in their federal income tax liabilities. In addition to these tax opportunities, many states offer research incentives, business-expansion credits, incentives related to enterprise zones and sustainability-related credits.
Accelerating deductions
Companies that generate profit and pay taxes can optimize cash flow through timing differences, i.e., accelerating deductions or deferring revenue. Most manufacturers operate on accrual basis. These companies should consider significant assets and revenue streams, as well as expense streams when looking for areas to optimize cash flow.

Assets
The most significant assets are fixed assets, inventory and receivables. Companies can consider accelerating depreciation on fixed assets, keeping inventory values as low as possible, and recognizing receivables as late as possible. Another approach for recognizing receivables is to link them with revenue recognition — for example, when revenue is tied to multiyear contracts.

Birkeland suggests that companies take advantage of bonus depreciation for purchasing equipment when possible, an incentive expanded by the 2010 Tax Relief Act. Companies can take 50 percent depreciation on qualified assets placed in service from Jan. 1, 2012 to Dec. 31, 2012.

Errors in fixed asset classification are a common issue that can increase tax liabilities. For example, production-related facets of a building are often depreciated on the same 39-year tax recovery period as most real estate, but may qualify for the seven-year depreciation schedule allowed on many production assets.

One specific opportunity for recovering fixed-asset investments was provided in the IRS Temporary Regulations issued on Dec. 23, 2011. Those regulations are generally effective for taxable years beginning on or after Jan. 1, 2012, and provide new rules regarding which assets and repairs could be expensed rather than capitalized. In addition, the regulations now allow the recovery of a structural component of a building, if it is replaced. For example, if a building roof is completely replaced, the adjusted tax basis of the original roof can now be written off as the new roof is capitalized. The prior rules would have required the adjusted basis in the disposed roof to continue to be depreciated over the remaining life of the building. These regulations will likely require that manufacturers submit a change in method of tax accounting to the IRS for 2012.

Inventory
Tax accounting of inventory can be as simple as managing the cost-flow assumptions, with the goal of recognizing the largest expense (the cost of goods sold) as quickly as possible. The primary inventory cost flow methodologies are first in/first out (FIFO) and last in/first out (LIFO). FIFO records oldest-produced inventory as being sold first, while LIFO records most recently produced inventory as sold first. LIFO — usually considered advantageous to manufacturers — can only be used for tax purposes if it is also used for book purposes. Many lawmakers have proposed repealing LIFO for tax purposes, and LIFO will not be allowed for book purposes if the United States moves to International Financial Reporting Standards. But these changes are likely years away if they come.

Item valuation is another inventory consideration that can be significant in a stagnant economy. Opportunities exist to write down items that are valued below cost due to damage, shop wear or change of style. There are restrictions but often companies overlook the tax deduction because they do not deduct an inventory reserve.
Receivables
Some manufacturers aren’t aware of options such as contract terms for dealing with receivables, especially with respect to revenue recognition and deferral of revenue. Unfortunately, this means that many companies fail to structure transactions, including shipments and title transfers, for the most favorable tax treatments.

“Consider a situation where there is an upfront payment for a maintenance contract that extends over a period of years,” explains Birkeland. “Certain tax rules allow for income recognition in the year of receipt to follow book treatment with the balance of the income to be recognized in the following year. It may be possible for a company to structure such agreements to take advantage of these deferral rules and reduce their current tax liability.”

On the other side of the tax-accounting equation are expenses. It’s generally advantageous to recognize expenses as soon as possible. Yet cash-generating opportunities from year-end expenses are often ignored, with manufacturers deferring the expense until the following year, when the invoice is received. Manufacturers may deduct certain expenses that are incurred by the end of the year but not reported. But often companies will treat the expense as a reserve and not deduct it, such as the cost of services rendered late in a year, for which bills are not received until months later.

Other large expenses that can be accelerated include interest payments and deferred payments; payroll; bonus plans; deferred compensation; and qualified plan contributions, such as a 401(k) plan or a profit-sharing plan. “It’s important to go down the balance sheet and look at significant items to determine if they’ve been treated properly,” says Birkeland. “It’s possible to uncover within the balance sheet hundreds of thousands of dollars in these types of opportunities.”

Restructuring for tax advantages
The third step in the tax review process is to examine structural changes that can improve tax positions. One possibility is to locate facilities or offices in tax-favored states. “One state may tax a certain transaction, and another state doesn’t. A sale of property may be treated differently with respect to taxes than the performance of services,” says Birkeland. “Proper categorization of sales and review of significant transactions can create significant savings.”

In some instances, companies can segregate revenue from services such as engineering and distribution from revenues for manufactured products. This creates an opportunity to restructure the supply chain. With the proper economic substance and business purpose, the restructuring could result in the manufacturing activity recognizing revenue in one state, while the distributor-sales company may be taxed on a smaller percentage of the remaining profit in other states.

This type of restructuring involves administrative cost, such as establishing, developing and accounting for the separate entities, so development costs must be weighed against potential benefits. But the tax savings can be significant for some companies.

Developing tax expertise
Manufacturers vary widely in their tax expertise, from companies that manage most tax positions internally to those that hire outside firms to direct most or all tax-accounting and compliance functions. Executives should regularly evaluate the cost of their tax resources, whether internal or external, as well as the business value that each provides for that cost.
Five factors for manufacturing growth in an uncertain economy
Prior to the recession, manufacturers had unprecedented access to capital — access that vanished almost overnight during the 2008 banking crisis. Credit markets have gradually improved, but with lending prospects still challenging, manufacturers must develop rigorous processes to quantify how much financing they need. And they must determine the best options for getting it.

**Understanding current borrowing capacity**

Companies that don’t borrow significant amounts of money, or that only occasionally draw upon their lines of credit, often fail to understand their borrowing capacity, notes Stephen McGee, managing director, Grant Thornton Corporate Finance LLC. “It’s important for them to be aware of their borrowing capacity and be knowledgeable about the challenges and constraints of their lending agreements.”

Lenders typically assess manufacturers’ borrowing capacity on the asset basis and/or the cash flow basis:

- **Asset-based assessments:** These involve an examination of the company’s assets, primarily its receivables and inventory. The lender will calculate a borrowing base using different percentages across different asset classes. For example, the lender may apply 80 percent against the accounts receivable balance and 50 percent against the inventory balance in determining how much the company can borrow. Certain exclusions and restrictions will apply in calculating the borrowing base such as aged receivables, significant concentrations, foreign receivables, aged/obsolete inventory, or work in process.

- **Cash flow-based assessments:** Unlike asset-based facilities, cash flow-based facilities apply a simple multiple of EBITDA (earnings before interest, taxes, depreciation and amortization) in determining how much the company can borrow. When credit was freely available, multiples for cash flow-based facilities stretched as high as 4x to 5x EBITDA, but since the financial crisis, these multiples have fallen, tending to range from 2.5x to 3x EBITDA.

McGee also advises clients to review their lending agreements regularly: “Depending upon when you put your credit agreement in place, you may have more or less aggressive borrowing terms, which would leave you in a position of either advantage or disadvantage compared with what you can get from a different lender now. If you drew up your loan package in 2004 or 2005, it was probably pretty favorable to the borrower. If it was in 2008 or 2009, the odds are that you can do better and would benefit from this exercise.”

In reviewing their borrowing requirements, manufacturers should assess alternative funding options, which might reduce the need for outside financing:

- **Customers:** Companies can be diligent in the terms they offer customers as well as the collection of outstanding receivables. In exceptional situations, it might be possible to have customers fund working capital requirements that support that particular customer.
Five factors for manufacturing growth in an uncertain economy

- **Suppliers:** Companies can also negotiate favorable terms with suppliers, allowing for more time to pay invoices. A word of caution, however: Approaching customers or suppliers to ask for financing, covertly or overtly, can be an extremely sensitive issue. The last thing a manufacturer wants is to create doubts or concerns among customers or suppliers about its own financial stability.

- **Other:** Manufacturers may be able to take advantage of certain state and local government financing vehicles that either offer funding directly to the company — e.g., through tax credits or other programs linked to employment — or provide guarantees to lenders, thereby increasing availability and reducing borrowing costs.

**Analyzing funding needs**

Not all funding needs are created equal. For example, capital required to provide liquidity for shareholders because an owner is planning to retire will be evaluated differently by lenders than capital needed to expand capacity to meet increased demand. Savvy executives must look critically at their business imperatives and options before approaching outside lenders, taking into account what exactly is driving financing needs.

A number of manufacturers are coming out of a period of lower profitability, and they are borrowing more on their existing facilities. Many don’t have much, if any, excess borrowing capacity. But as sales get stronger, those companies will need to increase inventory and production capacity and may have borrowing requirements in excess of their current availability — and this scenario can make for a rude awakening. Manufacturers should pick the spots where capital is most urgently required and then identify the financing needs and options available for those areas.

**Determining appropriate financing options**

Evaluating your financing options can be a straightforward exercise when you are building inventory, buying a piece of equipment, purchasing a building, or funding an acquisition. Since these activities can be documented clearly and accurately, traditional or senior debt lenders (e.g., banks) are usually comfortable with providing these types of financing.

“Financing needs tend to be either asset-based (tangible) or not. As you might expect, asset-based needs can typically be financed with asset-based facilities, while non-asset-based (intangible) needs lend themselves more to cash flow-based arrangements,” says McGee.

Despite improvements in the credit markets, borrowers may still be unlikely to find 100 percent of their required financing from traditional lenders focused on asset or cash flow formulas. Consequently, more manufacturers are looking beyond senior debt lenders to alternative providers that offer junior forms of capital. Such alternate funding sources include providers of second lien or subordinated debt, also known as mezzanine capital.

Inevitably, these alternative sources of financing come at a higher price. While bank financing generally costs in the range of 4 to 6 percent, interest on subordinated debt can reach 12 to 14 percent and, if equity warrants are included in the package, can go as high as 20 percent.

“The situation isn’t so dire,” says McGee. “Even today, most lenders are willing to provide capital that stays in the company and is invested in the business. Use of proceeds is clearly a very important factor in extending a loan or providing capital.”
Taking advantage of the lending climate and building relationships with lenders

Despite challenges, the current lending climate has improved substantially since the recession. “We are moving in the right direction. I don’t think we’re quite at pre-recession levels yet, but we’re closer than we have been over the last few years,” McGee notes. “Interest rates are still very low, so the cost of money remains artificially cheap.”

There’s also plenty of idle cash being held by private equity investors. Hundreds of billions are available for investment, much of it with an expiration date, at which point it will have to be returned to limited partners if it is not used. “The challenge has been in deploying that money. The quality of assets coming to market has been improving slowly; however, private equity firms had a couple of lean years of investment activity during the recession, so they are playing catch-up,” explains McGee.

While well-run companies with solid finances can find lenders, manufacturers shouldn’t be complacent and wait until capital is required before asking for financing. “Having a good relationship is important. Being proactive, staying communicative, and having reliable access to financial and operational information so that you can demonstrate to the lending community that you have your act together — all of these are critical,” McGee asserts.
Five factors for manufacturing growth in an uncertain economy
In times of economic uncertainty, manufacturers must optimize every chance to improve their cash flows and their bottom lines. Manufacturers need to be asking themselves some critical questions:

• Are we measuring and reinforcing our supply chain?
• Are we supporting key decision-making with robust BI?
• Do we have a clearly delineated M&A strategy and process for identifying and capitalizing on opportunities as they emerge?
• Are we getting as much cash out of our tax processes and positions as possible?
• Are we leveraging our financing to address the right strategies, systems and processes?

If manufacturers are not tapping into these areas, they may be missing out on key opportunities to strengthen their businesses and competitive positions. In a challenging marketplace with ever-diminishing margins, these five strategies may just make the difference between a manufacturer’s failure and success.
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