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GALE BUSINESS INSIGHTS: ESSENTIALS

Financial planning for asset management

Plant Engineering

The world around us is changing and we have entered into a new age of competitiveness. Businesses that need capital investment to sustain growth are forced to dramatically reduce the cost of operating in order to improve their image, while those with capital are routinely investing inappropriately and thus skewing their financial image.

Competing organizations, even if internally focused, are measured on management's ability to maximize profits through effective utilization of their fixed assets. Said more simply, how effectively is the plant utilizing its assets to generate revenue? This type of financial comparator is known as Return on Net Assets (RONA). In many organizations, RONA is the indicator that supports the decision-making process to determine which locations will receive capital investment from the corporation, or additional market share as a result of their demonstrated efficiency.

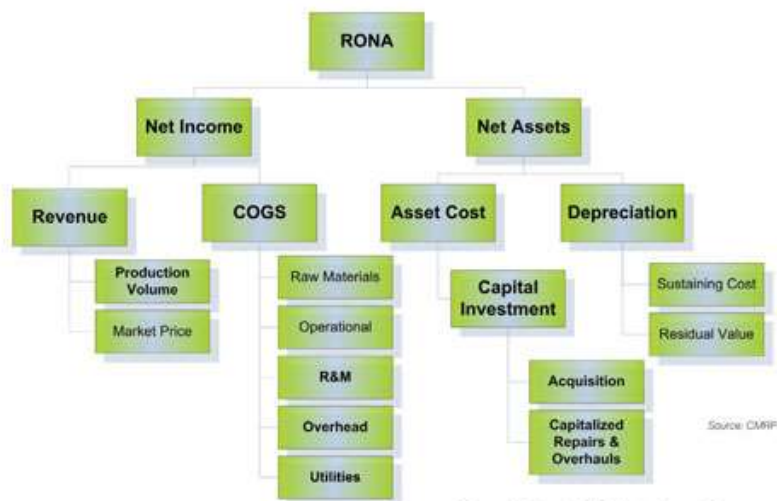


Figure 1: Return On Net Assets model

RONA is a very dynamic metric and works like a pendulum swinging from a fixed point based on fluctuations in net income or net assets. The idea is to create a balance by increasing revenue to offset the cost of consuming fixed assets, or reducing costs to improve margins per unit produced while reducing your net asset value through depreciations. This brings us to the point of this article. When developing your improvement strategy, it is important to begin with a clear understanding of the Financial Plan for Asset Management. Here are a few questions to get you started:

- * At what point will improvements to operating practices and business processes impact my ability to maintain costs at a favorable level?
- * At what point do my current costs overcome my ability to depreciate assets effectively?
- * At what point is it no longer economical to maintain existing plant assets, therefore causing me to invest capital?
- * How much additional production volume is required to offset the impact of capital investment, assuming that the cost of maintaining these assets will remain constant or certainly not increase above current cost ratios?

* At what point does market value impede my ability to offset costs and eliminate the possibility of capital investment as a viable solution?

Two fundamentally bad financial models are those that focus narrowly on "cost cutting to prosperity" or "buying your way to success." Neither of these strategies will sustain long-term growth benefits for your company. Cost cutting refers to the popular opinion that it is financially justified to slash fixed overhead expenses such as wages, compensation, and benefits. Let's face it; we need qualified and competent people to sustain the growth of our business, and cutting headcount for the sake of minimizing short-term expenses will only drive greater downturns in operational performance. I look at it this way: If we don't focus on removing the volume of work, be that operational workloads or maintenance workloads, then how can we expect to reduce the labor that has been mediocre at completing the workload within the current business system?



Cost cutting also refers to the rapid reduction of "reserve" inventories--work-in-process inventories or maintenance supplies that are required within the existing business systems due to the lack of process control and instability. These reserve inventories are in place today because our current asset management practices require them. Without these inventories, the operating process would suffer from extended downtime periods or, at minimum, frequent interruptions in flow or service. If financially we can justify removing the reserve inventories, then financially we can justify improving how we manage assets so we don't need the reserves.

Buying your way to success is an equally ineffective strategy for long-term growth and performance improvement. Although capital investments can improve existing technologies, which in turn improves your ability to maintain a reliable plant short-term, it also increases your net asset base and makes your RONA weaker if revenue remains constant, or worse, Cost of Goods Sold (COGS) increases. Ideally, the invested capital should increase the capacity of the plant to further offset the current COGS. What about the cost to maintain the new or upgraded assets? It has been my unfortunate experience to have witnessed the best-laid plans for capital improvement go unrecognized as a result of unforeseen costs to operate and maintain the new or refurbished assets after commissioning. In some extreme cases, the plant was worse off financially after a significant capital expansion due to the fact that engineering and plant management failed to consider the sustaining costs associated with the new assets relative to the marginal increase in capacity.



Defining the financial strategy

There are two main strategies you and your organizational leaders must consider before embarking on your asset management journey. The first is the Asset Strategy.

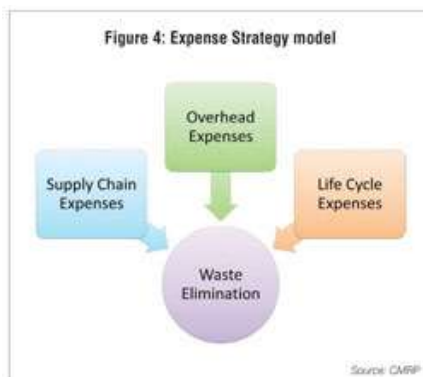
The Asset Strategy is a balancing act between short-term and long-term financial objectives. The task of reducing capital requirements is contingent on your organization's ability to minimize working capital by increasing inventory turns and systematically eliminating reserves based on varying product demand and material availability. The short-term goal of the Asset Strategy is to compress the overall cash conversion cycle, and in effect turn inventory into revenue faster.

On the other hand, the long-term view of the Asset Strategy should consider how your organization will effectively reduce fixed capital by eliminating redundant equipment trains, innovating equipment configurations in order to improve your organization's ability to meet several product specifications with fewer fixed equipment requirements, or consolidating non-physical assets, such as information management systems.

The second strategy that must be considered is the Expense Strategy. This is a given.

Why do we focus our precious resources on improvement projects? We do it because we need to reduce costs. In this view, our focus is on the long-term financial performance picture only, as a short-term focus on expenses can easily turn into a cost-cutting exercise. Do not concern yourself with those expenses outside of your control, like the price of raw materials. Instead, focus your attention on how frequently you order and ship raw materials, or how much energy you consume storing these materials. My point is this: Turn your attention, relative to cost reduction, on those aspects of your business that are within your control and will have a positive, long-term effect. If supply chain expenses are not within your control, then focus your attention on extending the performance life of your fixed assets and lowering your lifecycle expenses. If you feel lifecycle costs are already optimum, then focus the asset management improvement strategy on energy reduction to gain control of overhead expenses.

Lifecycle costing



Expenses are the most commonly misunderstood strategy, as most of our business upbringing has focused on labor and inventory cost reductions as an adequate means of controlling the short-term financial performance. Cost cutting, as stated earlier, is inadequate when a long-term solution is required. Focusing on the various stages of the asset lifecycle

to identify opportunities to reduce expenses is the preferred strategy of world-class organizations. Each asset within your business accrues expenses from initial acquisition to final decommissioning. Lifecycle costing enables your organization to refine internal practices and processes that manage plant assets as sales and capital requirements fluctuate. For example, let's assume your stakeholders need to expand production capacity in order to gain additional sales volume. You will inevitably realize that your fixed capital requirements will increase as well. Your strategy must then look towards offsetting the increase in capital by decreasing other expenses, lifecycle expenses. However, as your organization adds equipment to an already burdensome footprint, the cost of operating and maintaining equipment becomes overwhelming in relation to RONA. Throughout the expansion project, you must quantify expenses long-term to decide if the short-term gain in capacity will generate enough cash to withstand a realistic downturn in demand. Through lifecycle cost analysis, your organization can first determine the rate of return on your initial capital investment, then quantify the time period required to sustain sales growth in order to compensate for the increase in expenses over time. If the rate of return on the sustaining costs is insufficient, practices that govern lifecycle expenses like utilities and maintenance must be refined.

To conclude, financial planning is not just for accountants and savvy investors; it is an integral part of the asset management system. Be careful of embarking on an improvement journey that is solely based on a return on investment. Instead, develop your asset and expense strategies to guide improvements made throughout the enterprise to ensure a stronger financial image after implementation.

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