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Pruning Matters: It's as important to a Healthy Business as to a Rare Wine Vintage

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Wine lovers will appreciate that building a successful business is similar to making a rare wine – both are highly dependent on the environment and climate, both require proper pruning to get a good yield, and finally, both need to be tended carefully and monitored at every stage to produce the best results.

In this article, we will focus on pruning – a concept that most grape harvesters grasp rather quickly, but often gets a bad rap when it comes to businesses. A grape harvester will tell you that vines bear fruit only on one-year-old stems. The act of pruning removes the non-fruit bearing stems to maximize yield of the high quality grapes and to allow adequate vegetative growth for the following season. He will also tell you that without pruning, the result is an out-of-control vine made up of shoots and stems but no grapes. Sound like any companies you know?

The Bigger Picture

Let us first look at the big picture - the ultimate goal of any business is to generate profits (and of course to be socially responsible). To do that every business follows some business model consisting of viable products, processes, markets, geography, and so forth. As the technological and business environments change, however, old business models lose their value. Businesses find themselves seeking ways to find new sources of growth and profitability, forcing continuous evolution or facing the risk of losing their competitive advantage. To evolve, companies may choose one or more of these three options:

1. **Pruning:** Cutting away non-core businesses, assets, SKUs, etc. or re-engineering inefficient processes to focus on the core business
2. **Organic Growth:** Changing the business model and developing capabilities in-house
3. **Merger & Acquisition:** Acquiring capabilities and transforming the business model by purchasing other businesses that already have that capability

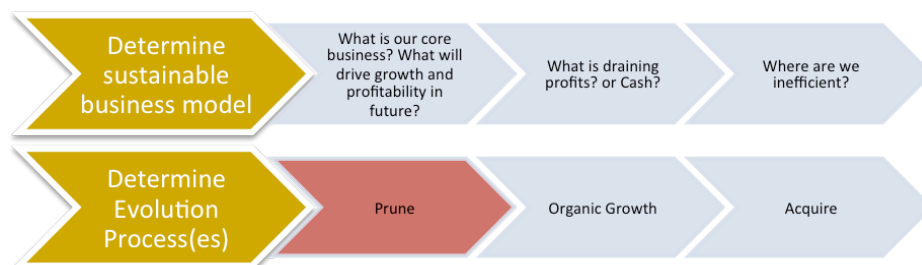


Fig1: Art and Science of Business Evolution

Most companies end up following “Organic Growth” and/or “Merger and Acquisition” paths of evolution and avoid Pruning altogether. Often the result is the out-of-control vine - an amalgamation of past strategies, processes, products, geographic locations, customers or product lines (“Business Model”) that have lost their value. If not pruned, these strategies, products, etc. still consume resources. They reduce profitability. They demand management time and attention, all at the cost of concentrating on the healthy parts of the business and the future growth-drivers. Pruning is essential for the evolution and long-term health of a company.

A prime example of pruning done right is that of Au Bon Pain and Panera. In the 1980s, Ron Shaich bought the troubled “Au Bon Pain” stores and merged them with his company, Cookie Jar, to form Au Bon Pain Co., Inc. In 1993, Au Bon Pain purchased St. Louis Bread Company, a chain of 20 bakery cafes located in the St. Louis area. To broaden its geographical appeal, the name of St. Louis Bread Company was changed to Panera Bread. Although it was his last acquisition and the smallest part of the company, Ron quickly grasped the potential of the Panera concept. He also realized that management’s complete focus would be required to harness Panera’s full potential. In 1999, Ron convinced his board to sell the entire business except Panera. Today Panera is a \$1.6 billion revenue company operating 1,750 stores in 40 states with over \$3 billion valuation. Not a bad lesson in pruning and focus.

Determining the New Business Model and Determining What to Prune

Before a business can start pruning, it first needs to determine the end goal – the core business, the star-product (a product that will be the growth and profitability driver in future), and where profitability can be improved. Anything that is not the core business or star product and is a profitability impediment is subject to pruning. Identifying these requires several different layers of analyses - each one of those analyses can be a topic of a separate article. At a high level, though, we use a methodology that focuses on three key questions:

1. **What is our business / where is the market going?** Understanding the company’s competitive advantage and how that measures up against the direction of the market creates a foundation for the assessment process. The question is simple but the answers are not always obvious, but inform any pruning exercise in determining what needs to be protected, developed or even acquired for the business to thrive.
2. **Where are we bleeding?** If a company’s profitability is lower than its peers’ or is consuming more cash than its peers, the management needs to perform a top-down analysis to identify sources of lower profitability and cash drain. This analysis reveals the business lines, geographic locations, facilities and SKUs, etc. that need to be exited or optimized.

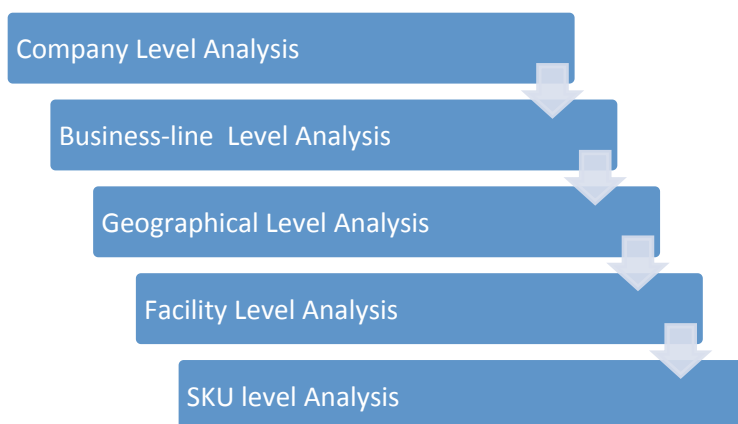


Fig 2: Levels of Profitability Analysis

3. **Where are we inefficient?** Many savvy companies measure efficiency as well as profitability on a regular basis, such as order fulfillment times, service call times, etc. By looking at trends of efficiency metrics and comparing these metrics with industry standards, and speaking with people involved in such processes, management can identify the processes that are not efficient or are irrelevant. The processes thus identified need to be re-vamped or re-engineered.

How to Prune

Once it has been identified what to prune, the next step is the actual act of pruning. Our recommended approach involves following steps:

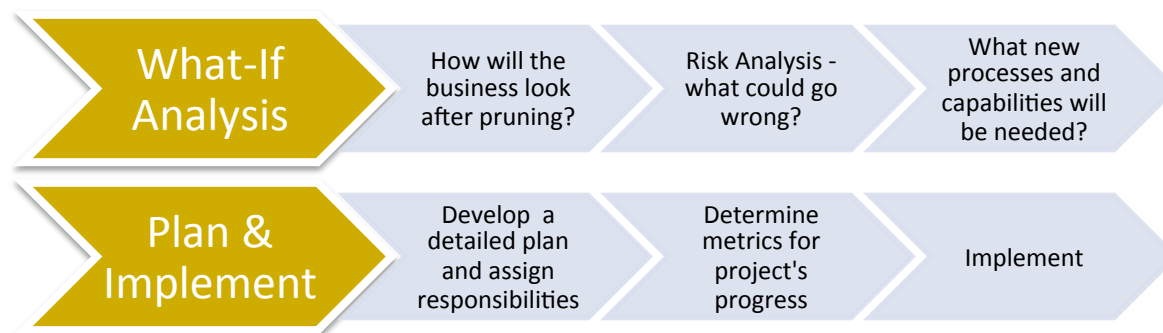


Fig 3: How to Prune?

Two aspects are often overlooked in pruning/operational restructuring:

1. **Inter-relatedness:** Management should thoroughly understand the inter-relatedness of businesses and processes during the planning phase of operational restructuring. When certain functions/processes/products are discontinued, they impact the other parts of the business – some costs may go up because of lack of volume, certain processes become un-necessary and certain processes require re-training. Thus, while planning for an operational restructuring, management should analyze each process and function that is impacted and plan accordingly.
2. **Risk Assessment and Management:** Often companies undergoing operational restructuring do not adequately identify the risks associated with such decisions. Pinpointing each of the risks (even risks with remote probabilities) and their significance helps define the contingency plans if things do not go as expected—which they won't!

We bring two prime examples from AEG's repertoire of operational restructuring and profitability improvement engagements, ranging from shutting down a business segment to optimizing the SKU line-up, to highlight where the pruning process can be most effective:

Packaging Company: A flexible packaging company was struggling and less profitable than its peers. The company manufactured and produced two types of packaging: paper-based and film-based, both for the snack market. AEG led a profitability analysis on individual product lines, clearly identifying costs, assets and work force directly attributable to each product line to determine the real source of margin drain (the "Where are we bleeding?" analysis). The analysis revealed that the film products were substantially less profitable than the paper products. Market analysis (or "What is our business?" analysis) revealed that the company did not have a competitive advantage or pricing power in film products.

While the obvious conclusion was to exit the film segment, the path to exit was far from obvious. The “What-If Analysis” revealed that one-third of revenue came from the film products, while more than 30% of customers purchased both paper and film products, often under a single contract.

Under AEG’s guidance, the company prepared a careful project plan. The plan included clear communication with the customers and a realistic timeline and identification of alternative suppliers to assist in the transition to new vendors without disruption. The process took a full year and very active management at the highest level of the firm. The result was that the company lost one-third of its revenue, but increased its EBITDA by \$4 million. With freed-up resources, the company downsized staff, revamped its sales team and is now fully focused on the paper segment where it has a number of competitive advantages.

Frozen Food Manufacturer: When AEG first started working with this company, it was performing poorly with a negative EBITDA. The company manufactured about 600 active SKUs across two business lines, produced in two factories for approximately 160 customers. AEG performed a “Where are we bleeding?” analysis at the product-line, facility, and SKU levels to pinpoint the source of the profitability issues. Three things became clear – (i) one of the facilities had a far higher cost-structure due to its location, (ii) the higher-margin and growing product line (call it the star product) was being manufactured in a higher cost facility reducing its profitability potential, and (iii) almost 15% of the SKUs were not covering their costs. AEG recommended that the new sustainable business model entails single-facility production, increasing prices on existing products, and discontinuing unprofitable customers and SKUs.

AEG’s next step was to put together a cross-functional team that could plan, implement and monitor key elements of the performance improvement plan: closing the inefficient manufacturing facility, consolidating production into one plant, discontinuing unprofitable SKUs and executing on product price increases where appropriate. Since the star product was being manufactured at the facility to be shut down, AEG developed a plan to make sure that there was no disruption in customer product flow. To do that, we put in incentives for customers to pre-order, built excess inventory to avoid shortages, and prioritized orders for the most important customers. AEG also helped prepare a communication package for customers to get a buy-in for a price increase, while at the same time building an internal accountability system to make certain price increases were not compromised through other discounts.

As a result of these steps, within six months the company’s TTM EBITDA improved by \$2 million. In addition, when commodity prices increased sharply, the company had enough margin-cushion to absorb costs internally while determining where it could pass through such costs to customers.

Both of these examples illustrate that past decisions of businesses – a business line or a geographical location – once core to the businesses, had become a consistent drain on the company’s resources and performance. Due to the inter-related nature and complexity of the businesses, management was not clear what the real source of decline in profitability was. The Pruning process brought a step-change in profitability in a relatively short period while freeing up each company’s resources and management to focus on growing the business. Clear identification of the problem areas while at the same time protecting the growth-drivers was key to success.

Pruning – A Managed Process of Evolution

Returning to our grapevine analogy, the best time to prune a grapevine is about a month before spring, just when the vines are starting to grow after a long winter. Curiously enough, the best time to prune a business is also when things are stagnant, which is a great description of our current economic environment: the economy is still listless, unable to determine a direction; some economists expect spring to be right around the corner. Most businesses have gone through some sort of financial restructuring so they have time and liquidity in the short-term to affect an operational restructuring. Essentially, businesses are in a holding pattern and this, wine makers at AEG say, is the best time to make necessary changes so that the healthy parts of your business are ready for a good yield when the economic spring arrives.

It is quite natural that consumer needs and tastes change, technology evolves and business decisions of yester-years lose their relevance, often becoming a drain on profitability and distracting management. Just as pruning is essential to increase yield of high-quality grapes and promote growth in future years, operational restructuring is essential for businesses to constantly evolve and adapt to changing environment. To be effective, however, Pruning cannot be done in isolation. It starts by correctly identifying the business model for the future and determining the best way to attain it. Alas, if only identifying the sustainable business model was as easy as identifying the fruit-bearing stem of a vine...