--How to Avoid Death by 10,000 Cuts--

How to <u>Protect</u> Dealer Cash Flow
By Walter J. McDonald

A recent industry survey of Dealer Principals ranked Cash Flow as their #1 **issue of concern. Everyone knows that "cash is king." But, how do you build the systems infrastructure to defend and optimize your cash flow?**

The amount of money flowing through a dealership makes cash control critical. How do you avoid "cash leaks" that can cause "Death by 10,000 Cuts"? There are many, many ways your employees can positively and negatively affect cash.

The first giant step is to hold everyone accountable. A well-defined organizational chart with detailed job descriptions for each person in the organization really helps. This holds employees accountable for the tasks essential to build positive cash flow.

There are three important steps to the process:

> **Better *Asset Management* and *Unfreezing Cash* will accelerate cash flow.**
> ***Optimizing Margins* will build more robust and profitable cash flow.**

Here are some practical suggestions in each area you might find helpful.

Asset Management

In my *<u>Master's Program in Dealer Management Workshop</u>* we examine the four big potential cash traps: Obsolete Parts Inventory, Used Equipment Inventory, Receivables and Fraud.

Obsolete Parts Inventory. **If you don't keep your eye on it, your parts inventory can go through the roof, a serious cash trap. It is not unusual to see a dealer with 35-40% of its inventory as "dead stock." Keep dead and slow moving stock (zero turns in 12 months) under 10% of parts inventory value. I encourage you to look strategically at your parts inventory. Are you providing at least 95% off-shelf fill rate on your <u>most important models</u>?**

> **Fill rate is the percent of line items on an invoice or repair order that are filled immediately and completely from your inventory stock. Partial fill of a line item is no fill.**

Your off-shelf parts fill rate for your most important equipment models is your single most critical value-added service in the distribution channel. If you have poor off-shelf parts availability, it is very difficult to provide timely maintenance. This makes customer satisfaction an extremely difficult task and your entire customer base becomes vulnerable to defection to aggressive competitors. In my *<u>Executive Sales Management Workshop</u>* we work on structuring a "competitive crush" strategy that focuses on competitors <u>with weak parts and service support capabilities</u>!

<u>Suggestions</u>: Your management team should identify the 8-10 strategic equipment models you want to support with an extremely high level of service. Review parts consumption history for these models. What is your off-shelf fill rate now for these models? What steps can you take to convert slow-moving or obsolete stock to cash? Then, invest this cash in parts necessary to support your strategic models.

Establish an off-shelf fill rate goal of at least 89.5% for each strategic model. Combine this objective with an overall inventory turn goal of 5 (72 days) and obsolete stock level goal (under 10% in dollars). An astute Parts Manager is able to successfully achieve all three: high fill rate + strong turns + control obsolescence.

Also, track parts turns by line item for main inventories, service vans and consignments. Fully utilize manufacturers' return programs. Monitor performance monthly. Be sure to negotiate protected inventory stocked for new models and return non-selling items.

Purge obsolete inventory. How? First, run a ranking report of obsolete line items by manufacturer by dollar value. Focus your attention on the top 20% which probably includes 80% of your obsolete stock problems. Identify parts by equipment model and offer special deals to customers with those models. Set up a "sale table" at the dealership. Share gross profit with employees who sell obsolete stock over a specific price. Distribute your obsolete inventory list to other in-line dealers. You can also consider donating dead, non-returnable stock to your local vo-tech school. For additional suggestions see my *<u>Strategies, Tactics, Operations for Achieving Dealer Excellence,</u>* pages 124 – 137 and 234-236.

CAUTION: A very alarming problem is many Parts Managers <u>do not</u> understand how to read and utilize their "Stock Status Report." In some dealerships, this essential report is not even generated. Step One is to fix this!

Used Equipment Inventory. **Fortunately there appears to be an upswing in used equipment demand. We predicted for several years that declining wholesale values on used equipment was a sure-fire indicator of an economic downturn. Fortunately, this seems to be behind us for now. However, you may still be suffering from excess used units with market values well under book value.**

<u>Book Value</u> is amount invested in the unit including purchase price, delivery, in-bound charges, reconditioning costs, write downs flooring cost, etc.

<u>Wholesale Value</u> is Fire Sale cash value you can get by tomorrow (within 48 hours) from other dealers in your network.

<u>Retail Value</u> is amount you can obtain at retail in reasonable time: 60 – 90 days.

<u>Market Value</u> is cash amount you can get at Wholesale by tomorrow. Same as Wholesale Value.

Dealers who were carefully monitoring over/under wholesale cash value of inventory could see the rapid drop in values. Their prompt disposition of used equipment helped them avoid this large cash trap. What are your used equipment inventory turns today? Are your turns 90 days or under?

<u>Suggestions</u>: Work toward reducing your used equipment inventory. Each month sell higher margin units with selected low margin units that blend together to reduce the profit impact.

Establish realistic trade values and reconditioning cost estimates by an independent appraiser such as your Service Manager. Build that expertise to avoid overly enthusiastic valuations by your sales department.

Make the disposition decision early in the deal. What are you going to do with this puppy? Sell "as is," put in wholesale, recondition to original factory fresh condition, use for parts? If you don't make the disposition decision until 45 days after purchase, you will never get four turns on your used equipment inventory. Also, be certain to maintain the right "sellable" product mix.

Finally, hold payment of commissions on the new model until the trade is sold.

Receivables. **Have you done the analysis to determine <u>where</u> your past due receivables originate? Are you tracking by revenue center? Are you monitoring percentage collected by revenue center and branch?**

A Southeastern dealer found that more than half of their past due receivables originated in the Service Department. The past due delay was from the time of billing to collection. Conduct a "cause analysis." If Service Department receivables top your list, ask "Why?" Keep investigating the system until you determine the original "cause." It might be poorly written repair orders, sloppy administrative procedures, etc.

Don't forget to put tight controls on warranty recovery. Try to recover 90% of warranty due within 60 days.

A California dealer struggled with its parts and service managers selling something to a customer for cash, but let it go out the door without collecting. Usually these sales are to a well-known customer with a promise to bring in a check right away, but this doesn't always happen, a big cash leak. Now they keep "cash" jobs on the radar screen so they don't become a collection item.

Another important area: manufacturer discounts. Often this pool of funds can get very large. Monitor it with the expectation of clearing it up within 60 days. A little later we will look at other cash flow delays due to "work in process."

<u>Suggestion</u>: Be certain to monitor Days Sales Outstanding by department. Calculate it monthly by department and overall and compare to a rolling 12-month average. The rolling 12-month average takes out fluctuations due to spikes in sales (usually at year end) or large collection periods (usually in the first 2 months of the year).

Fraud Protection. **Work with your outside auditor to make certain proper controls are in place. A local area dealer just took a hit of more than $200,000 from his "trusted" accountant. In less than five months, all three primary cash flows were compromised: payroll, accounts payable and accounts receivable. Forged payroll checks, forged disbursement checks to bogus vendors and a phony receivables bank deposit account have been uncovered so far. His pre-employment references were excellent because he did the same thing with his prior employer. His old company was hopeful that he would make restitution on this new job!**

Unfreezing Cash

Transaction Cash Cycles. **When business systems technology was more primitive, many dealers didn't bill service customers until the end of the month. I believe this practice has almost entirely ended.**

Each department has a transaction cash cycle: the amount of elapsed time from the completion of a transaction until it is converted to cash. The longer this

cycle, the longer your cash is "frozen" and unusable. You could easily have as much as $300,000.00 in frozen capital.

<u>Suggestion</u>

Review all transactions from when they occur to when they become cash. How long does it take to get your money? Challenge each department manager to define transaction cycles and establish specific objectives. For example, in the Service Department, *Work in Process* (WIP) can be a huge cash deep freeze. What is the average elapsed time from job completion by the technician to date of invoicing? I know at least three dealers that are working to reduce WIP to <u>under</u> two days. What is one day of reduced WIP worth to you in unfrozen cash?

Another Service Department hint: resubmit rejected warranty claims immediately. Pay a bonus when warranty receivables are kept under 60 days.

What about new equipment sales? How quickly do you get payment on financed contracts in transit? If a contract isn't funded, it may be due to a simple oversight. And, it may just sit on someone's desk unless the dealer has good controls.

Have you investigated credit card sales for service and parts transactions? How would that impact your cash flow?

Accounting Practices. **Here some additional suggestions.**

- ☑ **Flag past-due payments for all receivables on an exception report.**
- ☑ **Analyze factory receivables as soon as they arrive. Make sure you are following up on rebates and warranty payments promptly.**
- ☑ **Use online banking to reconcile bank's balance with your balance daily.**
- ☑ **Reconcile monthly bank statement within two days of receiving it.**
- ☑ **You should check the following:**
  - **A daily "money due" list.**
  - **A monthly "frozen assets" spreadsheet.**
  - **A monthly spreadsheet showing changes in cash position from previous month.**
  - **Monthly global balance sheet measurements that focus on asset management (current ratio; quick ratio; working capital; line of credit).**

Optimizing Margins

Cost Controls. **By now you surely have reviewed each and every expense line item to ensure you are purchasing at the very best price and paying the least amount of freight. But, what about examining your return on payroll investment by department? How many dollars of gross profit do you get for each one dollar you invest in total personnel cost in equipment sales, parts, service and rentals?**

One of the very best dealers in North America gets $4.60 in Gross Profit for each $1.00 invested in total sales compensation including salary, commissions, expenses, car and telephone. How are you doing in each department? Is gross profit return on employee compensation investment by department something you should monitor? How can it be improved?

<u>Suggestion</u>. Employee compensation is one of your largest expenses. Make certain you are getting the proper return. Ways to increase yield in the sales department include more efficient and effective prospecting techniques.

Parts gross profit dollars can be improved by incremental sales generated by PM's and increasing the average phone order amount.

Service gross profit dollars can be increased by improving labor productivity, reducing re-work, quoting estimates by the job, seeking additional PM "second segment work," and, striving to attain at least 90% of published labor rate each month.

Internal Discounts. **Internal discounts for service labor and parts are often seen in used equipment repairs, rental unit maintenance and new equipment pre-delivery work. However, the most profitable dealers, those in the top profit performance quartile, <u>do not</u> discount parts and service for internal repairs. They charge internal rates at no less than rates charged to their best external customers.**

Internal discounts severely distort profit contributions of parts and service managers. They understate true costs and give a false sense of security. This is especially risky when evaluating financial decisions for rental fleet investments. The worst possible way to reduce rental maintenance cost is to discount. You are far better investigating details of causes of excessive maintenance by unit.

The reality of internal discounts is they diminish the profitability of the entire business. Internal discounts are rarely recovered through better pricing to retail customers. The only result is a deterioration of the entire gross profit margin of the dealership.

<u>Suggestion</u>. Charge internal prices at no less than the very best external customer price for parts and service.

External Discounts. **What is the difference between your published labor rate and your effective labor rate (labor hour $ sales ÷ labor hours billed)? Challenge your service writer to achieve at least 90% of your published labor rate overall on a monthly basis. Move to quotes by the job instead of by the hour. This helps.**

What about customer discounts on rentals? How often do you see slow paying accounts using equipment in a very hostile and abusive environment with untrained operators getting the best discounts? Does this make good business sense? Should you only offer good paying customers the very best discounts?

Pressure to give discounts on new equipment sales is often the result of poor territory deal visibility. If the sales rep has only a few deals working, he is under tremendous pressure to close. So, his “only” tool is a better price. Additionally, poor deal visibility means that when he arrives, the relationship is already being developed by competitors. Your rep doesn’t have time to do the diagnostics, so, again, more price pressure.

Better prospecting as well as improved time and territory management will increase visibility or awareness and significantly reduce the pressure on pricing. Check out the “Sales Management” section of my ***Strategies, Tactics, Operations for Achieving Dealer Excellence***, pages 327-501 for additional practical solutions.

Suggestion. Review each department for discounting practices and policies. Are the discounts really necessary? What is causing the pressure for discounting? Is the approved discount going to achieve the incremental sales you expect?

Summary

Improved Cash Flow and Profitability isn’t just one big strategy. Working on increasing your cash involves literally dozens of carefully structured management actions.

Avoiding death from 10,000 cuts means that you remember to focus on the little, often apparently insignificant issues that together can damage or destroy your prosperity. As one Mid-South dealer told me, he is in the margin business. It’s the little microscopic activities that can make or break him. Improving Dealer Cash Flow and Profitability is a skill that will be useful far into the future.

Please contact me if you would like to discuss any of these issues. *walt@mcdonaldgroupinc.com.*

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