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# FASTFACTS

A quarterly insiders update from ALTFELD INC.

## The Sub Prime Mortgage Disaster:

*How did it happen and how will it affect you?*

You would think that after the Enron era, greed and avarice in business would have been too shamed to rear its ugly head this soon. But unabashedly, that was not the case. In this case, Stanley O'Neal, CEO of Merrill Lynch lost his job (although he did walk away with about a \$164MM severance package) and about \$8 Billion on his sub-prime gamble. Charles Prince out did that number by losing around \$10 Billion. Worse is the fact that Citi's shares have dropped 35% since the end of June, while Merrill's stock dropped 36%. There are another dozen large investment companies that include Bank of America, J.P. Morgan Chase and Credit Suisse, who combined, have also lost tens of Billions in market share. It didn't stop there either. Several mortgage companies also realized huge losses and while others have already folded.

Oh, by the way, there's more bad news coming. Wall Street banks are apparently holding tens of billions in risky securities on their books. The other fun thought is that no one seems to have an actual number. Merrill Lynch for example, predicted a \$4-5 billion loss in the third quarter of '07. Surprise! They miscalculated and the real number turned out to be \$7.9 billion. Missed it by THAT much!!

Just how big could the losses be? How about \$50 to \$100 billion? I don't know about you, but I can't even comprehend one billion, much less 100 billion. I do know that common sense says it is going to take 2-3 years for all of this to wash out.

So, besides greed and avarice, just how did the brain trust of Merrill and Citi fall into such a large pile of subprime swill? It all begins with an investment vehicle called CDO, or Collateralized Debt Obligation in which neither Merrill nor Citi get involved.

*There is nothing more short term than a 60-year old CEO holding a fistful of stock options.*

Here's how the greed took over. In a typical scenario, a collateral manager goes to Merrill, for example and says it wants financing for a CDO that holds, let's say for argument sake, one billion worth of bonds backed by subprime mortgages. If it looks like a worthwhile deal, Merrill would make the one billion available to the collateral manager and take a 1.5 - 2% fee, or \$15 - \$20 million. Then the collateral manager goes

out and buys bonds backed by pools of asset-backed securities (ABS) subprime mortgages that are issued by wall street firms, including Merrill. (Notice how everything is suppose to be backed up by secure investments and thereby keeping the risk low?)

To quote Fortune magazine's November issue, "Using complex mathematical models that predict default and payoff rates, among other things, the bankers create several tranches of securities with different interest rates and levels of risk."

The number one bond in this type of scenario is a super senior bond which usually earns a AAA rating and has first dibs on the cash coming into the CDO. These of course also pay the lowest rates because they are the safest bet. The bonds with more risk attached pay a higher interest rate. The old high risk, high reward game.

Merrill's sales force would then be unleashed to sell these bonds to pension funds, hedge funds, etc. Again, according to the Fortune magazine article, "The appeal of the CDO bonds is simple: They pay better rates than corporate issues with identical credit ratings. And in the low rate environment of the past seven years, yield-hungry hedge funds were eager to buy any paper that offered extra returns."

Here's where the dice got rolled. We've already established high risk/high reward. So, why gamble on one of these risky, lowest rated mortgage backed bonds built on loans to borrowers with suspect credit ratings, even though the interest rate pays a hefty 9-11%? Because historically, the default rate on mortgages has been very low. And getting wrapped up in their own greed, figured out that the trend would continue ad infinitum. (If you want to read a tremendous book on why this type of thinking never works, read the Labyrinth of Reason by ) Which is exactly the card counting scheme that companies like Merrill gambled on. The brilliant O'Neal of Merrill Lynch and Prince of Citi saw an opportunity to go from merely a manufacturer of CDOs and collecting their modest fees to becoming a large investor in their own CDO and double ending the deal. They went from a practice of non-speculative trading to rolling the dice. Merrill, for example went from a handful of CDOs worth \$3.4 billion in 2003 to a large player with \$44 billion in CDOs in 2006 backed by some very questionable mortgages.

Then the bottom fell out. The media could not talk enough about how bad the real estate market was getting hit.

Foreclosures were up, prices were falling in several major markets and a lot of people were taking it in the shorts. We had no idea of what was really going on or how it all happened in the first place. We also had no idea what it meant when the yields on the subprime paper fell and the yields on the CDO bonds sunk, too. What we come to find is that it meant no one was buying the AAA rated bonds, which for Merrill Lynch, was a shot to the solar plexus. Merrill was in trouble and knew it. So what did they do? They decided that if no one else would buy the AAA rated bonds, they would and put even more debt on their own books!! Again, according to the November Fortune magazine article, "By the end of June, Merrill held \$41 billion in subprime CDO and subprime mortgage bonds. Since the average deal is between \$1 billion and \$1.5 billion, and the AAA debt is around 80% of each deal, Merrill must have been buying nearly all the top-rated debt from dozens of CDOs." In other words, they were buying bonds that their own customers didn't want. A calculated risk that cost them dearly. Bear Stearns hedge fund collapsed in June. Merrill came out in October with a prediction of a \$4.5 billion loss on subprime. Turned out to be a conservative estimate. The real number was \$7.9 billion. Their exposure to subprime paper was greater than their entire shareholders' equity. They borrowed short-term money to buy long-term assets and lost. They never hedged their bets and put it all on the Pass Line.

How could a AAA rated bond experience a Milken-type junk bond dive? Simple. They forget that impermanence is a fact of life. They forgot that the default rate on mortgages could change, which it obviously did, and could ruin their cash flow, which it obviously did as well and they could not make their own payments. The best and the brightest risk managers in the world were consumed by their own greed and nearly brought everything down with them in the process.

Now comes the write offs followed by lay offs. Unfortunately, it is the little people who are going to pay the consequences. The geniuses who masterminded the debacle are walking away with hundreds of millions for their fine work.

### *How Long?*

Best guess by all the experts is 2-5 years.

### *Is the worst yet to come?*

Possibly. The banking industry is now stagnant. Real estate overall is having problems. Which means that real estate construction is having problems. Which means goods and materials that pertain to real estate are not moving like they used to. Which means that since no market works in a vacuum, eventually whatever markets and industries you serve will become

affected. Which means we are looking at a slowing economy accompanied by a weakening dollar.

### *Why is that?*

We've been running a huge trade deficit for a long time now. Between the subprime insanity and an apparent on-coming economic downturn, investors are baling out of U.S. assets and are putting their money into investments requiring different currencies. Add to that the Fed's dropping interest rates and the dollar looks even less attractive, especially when compared to the Euro. Smart investors move their reserves from weak currencies into strong ones and they're pulling away from the dollar. Why? Primarily because we have never gotten our arms around the trade deficit. Why? Because we've become addicted to China. What is scarier yet, is the fact that it is China who has over \$1 Trillion in U.S. reserves and has already announced it is in the throes of moving them, which will only further weaken the dollar and damage an already volatile market.

### **The Fat Lady Hasn't Even Begun Warming Up Yet.**

You know that piece of plastic in your wallet called a credit card? Don't look now, but it's in trouble, too. The \$900 billion subprime catastrophe has put a tremendous strain on the banking industry. Simultaneously, there is another \$915 billion in U.S. credit card debt floating around out there and the strain of the two combined could become unbearable. Credit card delinquencies are now on the rise. People are beginning to put more debt on their cards and are taking cash advances against them.

According to the November 12 issue of Fortune magazine, "... like CDOs and other asset backed securities, credit card debt is sliced, diced and sold off again as packages of securities. Rising delinquencies would hurt not only the banks involved but the securities backed by credit card receivables. Those securities would decline in value as consumers defaulted, leading to bank losses as well as portfolio losses in the hedge funds, institutions and pensions that own the securities. If the damage is widespread enough, it could wreak havoc on the economy much as the subprime has done."

What's worse is that credit card debt is unsecured debt and a loss there is total loss. Currently, missed payments are at a historical low, but we've already discovered that doesn't mean much.

What I find amusing in this credit card situation is the fact that we are being pushed further and further into a cashless society. Checks and cash are out. Credit Cards and Pay Pal are in. Even our currency isn't safe anymore as counterfeiters continue to use the latest technology to create the perfect C-Note and other denominations.

One of the more interesting ideas I've heard about is the replacement of cash machines with instant, automatic payment machines and wireless handheld devices that will process and pay money to all recipients.

*Where is all of this taking us and when will we know when it's over?*

Beats the hell out of me. If you have any suggestions or ideas of your own, contact me at [jaltfeld@altfeldinc.com](mailto:jaltfeld@altfeldinc.com) and I'll post your comments on our web site. Δ

## How Can Your Company Make the World a Better Place?

Sound farfetched? It shouldn't. There is a new (old) idea being more than just kicked around lately called Sustainability. I say old because it is one that I, and many others like me have been preaching for a very long time. It is only recently however, that I discovered it had a name. Sustainability is all about leaving the world a better place than it was when you started your company. It is all about your company not doing harm to the world, your employees, your suppliers, your customers, yourself, your management team, your investors, and your community. It is about purpose beyond profit. It really comes down to not being afraid to ask the right questions and having the guts to act upon your answers.

Start by asking: *What difference do we want to make in the world as a company? What goals would be worth taking personal risks for? What do I want to tell my kids I do every day besides working hard and making money?*

**Worry less about building a great business climate and more about building a great people climate.**

As a company, what are you doing to provide your employees the chance to explore the limits of their own capabilities? Think about the conventions of behavior, interaction, expression, and dress that predominate in your company's culture. Do you reward eccentricity or do you stifle it? Are people respected for the value they add, or for the titles and credentials they hold? Does the hiring process put a premium on people who have had unique life experiences or zero in on those that fit the mold? Does passion score highly in making job appointments or does experience always get the nod?

Or, in the words of Albert Einstein, "Not everything that can be counted counts and not everything that counts can be counted."

If you'd like to read an interesting book on the topic, read Squeeze. It is not quite up to par with The Goal by Goldratt, but it does make for an interesting and enlightening read. Δ

## Is This the Era of the Self-Managed Employee?

Prior to even considering this concept, it is imperative to understand and appreciate the viewpoints of others without reference to your own feelings or self-interests. It is critical that you and everyone on your team are willing to be fair-minded and listen to arguments you do not necessarily agree with. It is about treating every viewpoint relevant to a situation in an unbiased, unprejudiced way. You and your team must be willing to change your views when faced with better reasoning.

Over the past ten-plus decades, the practice of management has been to use its thinking to manipulate the thinking of others, to not tell all, and in many instances, to hide from the truth. And, because we are management, we sometimes become intellectually arrogant in our thinking. We claim to know more than we actually do because we feel we would lose face in not knowing.

*The biggest problem facing most companies is that too much power has been vested in too few people.*

Take a look at your own organization and give yourself a gut check on how much power actually is concentrated at the top. How many of your senior executives have the power to hold your company hostage when it comes to new ideas and change. To get a better picture, take a look at your organizational chart. Where is the power and who has it? Plus, be honest with yourself. Doesn't just looking at it provide a tremendous self-comforting illusion of control? Next, consider taking that org chart from a hierarchal pyramid to something closer to a spider web where communication is wide open. Where no one can run interference on any one and all ideas and suggestions have an open path.

The thought here is that the mighty oak tree doesn't just shed one measly acorn on the ground. It tosses off thousands of them and litters the ground with them. Nature is smart enough to know that it never knows which one of those acorns will land in the right spot to become another mighty oak tree.

The same holds true for ideas, thoughts, suggestions, creativity and innovation in your own company.

Or, as the late Peter Drucker said, "Companies have a low sperm count when it comes to generating ideas."

It all boils down to the fact that the more you consolidate power in the hands of a few senior leaders, the less resilient your system will be.

Now, with an open mind, begin thinking about the concept of

a self-managed employee. The first problem you will encounter with this concept is that most managers and companies have it in their head that you cannot manage without managers. In a hierarchy, the person at the top has to truly believe in their heart of hearts that their thinking is superior to all others because they are at the top. It makes sense that upper management thinks "If I am superior to you in authority and power, I must therefore conclude that I am superior to you in my thinking." Now, what if the person at the top who thinks this way has to admit they thought wrong and that they made a mistake? They obviously lose credibility. Therefore, they can't afford to admit they made a mistake.

Simply stated, it all comes down to the premise of, "We need managers because we have employees." Yet, in manufacturing, you don't control quality you produce quality. As a result, we expect each machinist to take responsibility for his own quality assurance. We are looking to eliminate the need for a QC department. My point being that if we can eliminate the need for a QC department, why can't we eliminate the need for Management and make each worker responsible for managing themselves.

Besides the fact that your management team will balk at this idea, accomplishing such a feat would require your letting each employee know that they can and are allowed to self manage. Then provide them with the tools, knowledge and resources to do it.

Simply stated on the other side of the perspective, if all employees were self-managing, you no longer need as many managers, supervisors and leads.

When you get right down to it, employees need managers for the same reason young teen-agers need parents. They are incapable of self-regulation. They lack the knowledge, wisdom and experience to consistently make wise choices. They also lack good judgment. But your employees are NOT short of knowledge, wisdom and experience. They do, however lack information and context since they are so often disconnected from customers, associates, end products, owners and the big financial picture.

The reality is that, it is only natural that as human beings, we want to be in control. Most of us hope the future will unfold according to our plans. Unfortunately, the only thing you can bank on is that the future is going to be surprising. Whether those surprises turn out to be good or bad for your company will depend largely on the extent to which it proactively invests in exploring alternatives to the status quo. As a result, too much of what gets done in most companies is in response to some already pressing issue. We almost always find ourselves

working in the business instead of working on it.

As difficult as this may be to swallow, you are going to have to accept that, like the oak tree, it is OK to be wrong most of the time if you are really right some of the time. If you want to ensure the survival of your company, you need to make sure the natural selection, not the Senior Management selection, determines which ideas go forward and which do not.

The greater the diversity in the decision making process the better off you are going to be. Much like The Sixteen Laws of Success and the Master Mind Concept, none of us is as smart as all of us together, especially when the group is comprised of people with diverse backgrounds.

As change accelerates, diversity becomes more and more critical to your strategic survival.

Your goal as your company's Chief Strategy Officer is to make sure that it must forever be on the way to becoming something more than it is right now. It must possess a mission compelling enough to overcome all the baggage of the past and spur individual renewal.

**Consider this:** People are not afraid of change as much as everyone seems to think they are. People get married, divorced, have babies, change jobs, move, grow old, learn new skills and change careers. It is not so much change that bothers them but the promise of change. Change brings hope. But all too often, the more things change, the more they remain the same or get worse. As a result, people do become cynical. When you get right down to it, people change for what they care about. There are NO adaptable companies. There are only adaptable people. Δ

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**Problems & Challenges facing most companies:**

**Problem:** The farther down employees sit in the organization, or the more conventional their views, the harder it is for them to get a hearing. This often contributes to denial at the top.

**Challenge:** How do you create an organization where everyone's voice gets heard and ideas compete solely on their merits? How do you build a democracy of ideas?

**Problem:** Most companies exploit no more than a fraction of their employees imagination, due in part to a sort of creative apartheid.

**Challenge:** How do you turn ordinary employees into extraordinary innovators? How do you amplify human imagination?

**Problem:** Allocational rigidities frequently impair a company's capacity to fund the future. This puts a brake on the work of strategic renewal.

**Challenge:** How do you accelerate the redeployment of capital and talent? How do you dynamically reallocate resources?

**Problem:** Positional biases and inattention to competing view points often lead to poor decision making at the top.

**Challenge:** How do you ensure that decisions fully reflect the collective knowledge of the organization? How do you aggregate collective wisdom?

**Problem:** Executive knowledge and capability often depreciate faster than management power and influence, often with unfortunate consequences.

**Challenge:** How do you keep top management's out of date beliefs from impeding strategic renewal? How do you minimize the drag of old mental models? How do you keep your generals from fighting their last wars over and over again?

**Problem:** Too much management and too little freedom sap the initiative of employees and leave little time or energy for innovation.

**Challenge:** How do you turn an army of conscripts into a company of volunteers? How do you give everyone the chance to opt in?

As Harvard Professor and author Gary Hamel asks, "Why are the views of senior executives so often granted a higher coefficient of credibility than the convictions of mid and lower level employees? Is it solely because of their wisdom, foresight and imagination? Or because they put in the time, have the position, have the power and fought hard to get where they are now?"

Perhaps we need to become more like the Internet and less like companies. The Internet has decisively destroyed the power of the elites to determine what gets published and who gets heard. The Web was founded on the principle of openness, management was founded on the power of control.

For most managers, the thinking is that what good is it to be in control if you can't script the conversation? What does it mean to be in charge if your views have to compete with everyone else's views? What does it mean to be the boss if anyone can publicly disparage your ideas, your ideas or even your IQ?

Executives are most comfortable when communicating TO the frontlines or fielding questions FROM the front lines. What worries them is the prospect of the frontline employees grabbing the microphone and communicating, en masse, with other employees. One to one communication is OK. But many to many it's the start of an insurrection.

Instead of facing skeptics one at a time, or in controlled circumstances, what if you had to confront a mob of disgruntled employees? What if your company encouraged, rather than discouraged, your employees to write critical in-house blogs and to read and respond to them. You bet, dirty laundry will be aired. Yes some things will leak to the outside. But think about the gains that will be made by allowing your employees to speak out on key issues.

*We are the first generation in history that can honestly say that we are limited only by our own imagination.*

Nearly 2 million video clips are being uploaded to YouTube each month and more than 100 million clips are being viewed every day by visitors to the site. In the past 60 days, more than 1.6million people have wandered through the 65,000 acres of Second Life, a virtual world built almost entirely by its residents.

Make No Mistake about it. Your company has employees who are bloggers, mixers, hackers, mashers, tuners and pod casters. So, what has your company done to help all these ingenious people become fully empowered business innovators? Do associates have access to a comprehensive suite of business innovation tools? Do they have access to a global database of customer insights and competitor intelligence? Can they download detailed financial statistics? Is there an internal WEB site that helps individuals to gather feedback on their creative ideas? Trust me, your employees are exercising their creativity some where, it just may not be at work.

Take a look at the critical decisions made in your company. What percentage of the organization's collective wisdom was brought to bear in making the decision?

How many individuals were given the opportunity to weigh in and participate? Whatever your answer, my response is probably, not enough.

Why is the executive management team so reluctant to exploit the power of collective wisdom? Perhaps because they feel they are being paid the big bucks to make those decisions. But what if the culture was different. What if they were instead being paid the big bucks to get everyone else's heads and hearts in the game?

Having consulted for Santa Anita racetrack, I can assure you that there is more wisdom lodged in the average sports bet than there is the typical corporate investment decision. Bookmakers and tote boards are constantly adjusting their odds over time as additional bets are placed and more information comes to play.

Suppose you had a major direction changing decision to make and you allowed your employees to buy and sell stocks based upon their beliefs regarding the success or failure of the outcome of the project. And, as more information became available, they could either buy more, sell more or hold.

The challenge is to create an organization in which authority is a fluid commodity, flowing smoothly toward leaders who add value and away from those who don't.

For those companies thinking lean and becoming more efficient, it may appear that employees who are working on things that they care about may be giving less attention to the things that their superiors care about. But this type of thinking can literally kill your company in the long run. The challenge is to get both employees and their superiors thinking and caring about the same things.

If your company is going to thrive in the new century, it must build a management system that allows more and more of your employees be informed, involved and inspired. To allow more and more of them to devote an ever-increasing proportion of their time to projects of their own choosing. (Sounds scary at first, but it shouldn't be when you really begin to think about it.) The result: An ever-growing sense of commitment and passion.

Ask Yourself: What new management challenge, if mastered, would give your company a unique performance advantage? How can you grow great leaders within your own company? How can you build a boundary-less organization?

How many people in your company feel personally responsible for helping the company? How many people in your company feel personally responsible for helping the company build a bona fide Management Advantage?

Number 1. Most are probably focused on the today. Most are too busy working in the business to spend enough time working on the business. Most are focused solely on compliance and efficiency issues.

Number 2. Most don't feel any sense of personal responsibility.

The most important thing you can do to help your company reinvent its management processes is to give ordinary employees and lower level managers the opportunity to challenge, question and offer alternatives to change those processes. To create a forum in which anyone across the company is free to suggest alternatives to the management status quo.

Ask yourself: What management practice or behavior does most to drive really great people out of our company? OR, which of our management practices does the most to destroy employee initiative?

Ask Your Employees: What will be the new and distinguishing characteristics of our management systems five years from now? How will the way in which we manage give us a competitive advantage?

Should you require assistance in determining, implementing and executing your company's current and future strategies, need an interim Chief Strategy Officer, or would just like to elevate the level of your current management team, contact Jim Altfeld at [jaltfeld@altfeldinc.com](mailto:jaltfeld@altfeldinc.com) or call 1-800-397-0010. Δ

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## **Sales may not be the whole company, but the whole company better be Sales!**

What have you done to get all the departments in your company to understand what their role, responsibility and contribution is to the customer and the sale and how they are interdependently linked to all the other departments?

For that matter, what are you doing to grade your own company's performance record? Your kids and grand kids have to come home with report cards, how about your company? Would your customers give you an A for knocking their socks off or a B for exceeding their expectations? Or would they give you a C for merely giving them what they'd already expected. Or a D for when you failed to support the promise when it wasn't critical to the customer, but an F when you failed to support the promise at a time when it was critical to them.

How do you know what grade you'd get unless you ask your customers? And when they've handed you the grade, ask them what you can do to raise the grade they gave you!

Remember: The highest grade your product can get is a C. It is what they expected to receive. So, it's NOT the product that is going to differentiate you from everyone else, it's everything beyond the product that will!

To discuss how you can make all of the above happen within your company, contact Jim Altfeld at [jaltfeld@altfeldinc.com](mailto:jaltfeld@altfeldinc.com) or call 1-800-397-0010. You can also hire Jim as an Interim Sales Manager, teach your sales team Sales and Territory Management or create and implement a rep/distributor organization for you.

## Lean Purchasing and What It Can Mean to You and Your Company

As a national average, 60% of the cost to manufacture is attributable to purchased materials. If the purchasing function controls over 60% of the costs in a product, then resources and talent must be focused on this function if the business is to stay healthy.

What should be emphasized is the establishment of business relationships and arrangements with suppliers as a primary task and satisfaction as a primary measurement. Emphasis on placing purchase orders and on expediting delivery should be minimized.

- Can today's suppliers grow with us and supply the technologies and capacity required for our future needs?
- What strategic alliances with suppliers will be required in the future?
- What roles will price and quality play in the product sourcing decisions of the future?

Purchasing establishes and maintains the supplier base, seeing to it that adequate capacity and quality are available and that the level of service and price are optimal. To accomplish that requires purchasing to develop your suppliers. You need suppliers who are dependent upon your company's success and are willing to work closely with you.

### Lean and Inventory Management

The only good reason for maintaining inventory is that conditions exist that make it less costly to have it than not to have it. If a supplier doesn't deliver on time, extra inventory compensates for the problem and allows operations to continue. It also makes us an enabler and sends a wrong signal to the supplier.

Inventory is a RESULT and very expensive. Inventory simply hides problems. Drain the inventory and expose the problems. Now you can deal with them.

### Problems covered by inventory:

- Unpredictable customer demand
- Inaccurate forecasts
- Low process yields, scrap, rework
- Incoming materials rejects
- Unreliable supplier deliveries
- Equipment availability
- Missed production schedules
- Field failures, customer returns

*Fact: The longer the lead-time the greater the need for more inventory and the greater the costs.*

*Fact: The longer inventory sits, the harder it is to move.*

*Fact: The cost of carrying inventory has been looked upon by accounting as strictly a dollar item based upon what you paid for it. The TRUTH is, you are looking at roughly 75% of year of the purchase price, or 1.5% per week.*

We keep trying to solve problems with increased inventory. And price increases are only an enabler for the habit. The only way to reduce inventory is reduce the lead-time. The only way to reduce the lead-time is to reduce your process cycle time. The way to do that is to reduce your set up time.

### The Problem with Inventory:

- When the market or technology changes, all you have is worthless inventory.
- It is expensive to hold on to
- It requires support resources of people, systems, equipment and transactions
- It is difficult to work around
- Eventually it becomes not worth what you paid for it
- It can be a coping mechanism that hides the real problems

### The Cost of Carrying Inventory

Recognized Costs	Approximate % per Year
Interest rate of money	5 – 10%
Taxes	2 – 5%
Insurance	2 – 3%
Space (occupancy + utilities)	5%
Obsolescence reserve	<u>7 – 20%</u>
<b>Total</b>	<b>20 – 30%</b>

**Unrecognized Costs**

Personnel	10 – 15%
Capital equipment	5 – 10%
Computation Costs (hardware + transactions)	3%
Secondary quality costs (reinspection)	5 – 10%
Rework, handling damage, additional costs	<u>5 – 10%</u>
<b>Total:</b>	<b>50 – 75%</b>

*References: The Supply Management Handbook, 7th ed., McGraw Hill, The Institute of Supply Management; and Profitable Purchasing, Leading Manufacturing Excellence, John Wiley & Sons.*

The hidden cost of inventory is massive.

Factors included in determining Inventory Carrying Costs:

- Cost of money
- Obsolescence or Scrap
- Space
- Taxes
- Insurance
- Personnel
- Handling
- Storage
- Overhead Allocations
- Equipment
- Lost Opportunity
- Inflation
- Rework
- Service Costs
- Currency Devaluation
- Packaging Materials

We need to move from Supplier Managed Inventories to Supplier Managed Deliveries

- Identify the demand
- Produce and deliver to that demand
- Deliver to point of use
- Monitor and adjust to usage

Let our suppliers become Bread or Milk Men restocking as they see fit.

**LOOK AT THE PRODUCTS YOU PURCHASE  
NOT BY PRICE BUT BY PRIORITY.**

You have A, B, and C Items. An A item is one that is extremely critical and will shut you down. Price does not matter. It's the criticality of the item.

Sell what you are producing at the time you produce it. Get rid of inventory by eliminating lead times.

If it cost 1.5% per week to hold something, the very same number applies to the manufacturer, the distributor and the customer.

It all comes down to the supplier's lead time versus when you need it, versus the price of inventory.

The point is that the item may appear to be less expensive than the competition, but their lead-time can really cost you.

In working with a supplier, why not have them ship to you out of inventory for the first 4 months. Afterward, they have to ship directly off their manufacturing line.

**Elements of Lean Purchasing**

- Collapsed cycle times
- Speed replaces inventories
- Direct links to top suppliers
- Appropriate quality for the particular application is a given
- Direct user/provider interface
- The deeper the supply chain, the better

**Elements of a Good Supplier**

- Has minimized cycle times
- Quality is appropriate – Cpk 2-4 (process capability)
- Owns logistics – transport & POU deliveries
- Assists in the design of components/products
- Knows your business/customers
- Knows why they are profitable
- Is a technology leader in their field
- Prices based on a superior process
- Personnel turnover <5% per year

**Example:**

Let's say you have a product that takes 12 minutes to produce, but it has an 8-week lead time. To determine the Velocity ratio you would do the following:

$$60 \text{ (minutes)} \times 8 \text{ (hours)} \times 5 \text{ (days)} \times 8 \text{ (weeks)} = 19,200 \text{ minutes} \div 12 \text{ minutes} = 1:1600$$

The question becomes, if it takes 12 minutes to produce a part, why is there an 8 week lead time?

Just as we took a look at our OMC, our suppliers need to do the same. They have to get their Process Cycle Time reduced. To do that means reducing WIP while increasing output. Furthermore, by making everything happen faster, you also improve cash flow. Because the faster it all happens, the faster

you get paid.

### Exercise:

The Gazorp Manufacturing Company is a 15 year old, publicly traded company. It manufactures smoke and carbon monoxide detectors for homes, offices, institutions, and public buildings. It sells to retail outlets, electrical distributors, and construction contractors. Gordon has no sales staff. They sell solely through independent sales agents.

Last year sales: \$176MM

Last year costs:

Direct Labor	\$11MM
Material	\$80MM
Overhead	\$40MM
Sales & Commissions	\$20MM
Taxes	\$14MM
<b>Net Profit</b>	<b>\$11MM</b>

The year's beginning inventory was \$23MM and the ending inventory was \$19MM. The quoted lead time for new production is eight weeks. Actual process cycle time is 6 hours (the plant works five days per week with one eight hour shift per day). The company is ISO 9000-2004 compliant. Their cost of all quality activities is \$8MM of the \$40MM overhead and \$6MM of the Sales and Commissions.

- What is their manufacturing velocity?
- What are the inventory turns at year end?
- What is their PONC (as a percent of sales)?
- What is their PAT percentage?

*(Answers on page 11)*

### We need to stop doing business on the terms of our suppliers:

- Their lead times
- Their costs
- Their quality
- Their policies
- You cannot afford it
- You are dealing with hundreds of different commercial terms
- You are the customer

### It is time we made some demands and issue orders with our terms:

- Affordable prices at any volume
- Required lead times (Mr. Supplier, I can no longer afford the lead times you've given me.)
- Process capability (Does it match our needs? What do we say about quality on our purchase order. How good does the product being delivered by the supplier need to be?

How often does it have to look like the print? And what happens if it doesn't?

- Technical assistance
- Service, returns, response times (How long can we afford to give them to rectify a situation? Minutes, hours, days? What is our policy? Do we state right on our purchase order that if the product is bad, you have exactly 24 hours to deal with it, replace it, or we dump it and don't pay you for it?)
- Packaging, standard counts (Why are we doing things the supplier should already be doing for us? What do we consider a standard container and a standard count?)
- Transportation/delivery terms (When is delivery actually completed?)
- Payment terms

Perhaps it's time to challenge your own purchasing department by asking them:

- Do we know the level of quality we require in specific terms? How good does it have to be? How good is good?
- Are our blueprints and spec a reflection of our true needs?
- Do we know what a process in control looks like? Can we fairly evaluate a supplier's process?
- Is there a correlation between the supplier's quality system and ours?
- Are we willing and able to assist the supplier?
- Is the certification looked upon as the beginning of the quality process or the end?
- Do we have the sustaining power to make quality a life long process?
- What are the quality targets WE have set for the products we buy and sell? Cpk 1? Cpk2? Or, Mil Std. 105?
- What is our supplier's plan to improve the quality of his product line and reduce his lead times to meet our needs?
- What is the supplier's cost of non-conformance? Remember that it can be as much as 25% of the cost to produce.
- What is their manufacturing cycle time and ratio? What's their plan to improve upon it? Remember: The right product delivered at the wrong time is a wrong product.
- When will the supplier eliminate the need for our incoming inspection of his product?
- When will we have the confidence to do that?
- When will we begin introducing more errors by inspecting than by accepting the goods without inspection?
- When can we begin reducing the unnecessary inspection overhead?
- When will we begin using inspection only to correlate data?

We must demand from each of our suppliers that they inform us whenever they:

- Change their manufacturing processes or equipment
- Change ownership or make significant management changes
- Change their raw material suppliers
- Change their technology

Things to consider:

- Lead time should only be incurred on an initial order
- Repeat orders should utilize
- Requirements Contracts for Direct Material
- Systems Contracts for MRO
- Minimum orders are the suppliers' set up time problem
- Lead time is a choice the supplier makes

The time has come for us to be thinking in terms of Contribution to Profit instead of Controlling Costs.

#### If Purchasing Wants to Become Lean:

- Buy from lean suppliers
- Key suppliers must have lead times no greater than your needs
- Each week of lead time costs you 1.5% per week of the price
- Suppliers cannot hide behind inventory
- Suppliers' quality system must match your product needs
- Purchasing must buy affordable cost
- Contribution to profit- not PPV (Purchase Price Variance), cost reduction

#### Recommendation:

Invite the OWNERS of your top 20 suppliers, or the highest official person you can, to your company for lunch. Explain to them what your company is all about and where your company is going. Explain to them what we need from them to help us get from where we are now to where it is we need to be. Educate them on Lean if they aren't already. Ask them to declare who wants to come with us right then, there and now.

Explain to them that you are seeking a business partner. That you want a business strategy not an individual package with each supplier. Then hold a one day seminar at the suppliers site talking to their employees about LEAN.

*A key role of purchasing is to build roads of communication between your company and your suppliers. In doing so, you must:*

- Define Quality. What is it?
- Listen to suppliers' issues
- Resolve historic issues – engineering, personnel, broken promises, singed fingers, etc.
- Establish lines of communications – people systems
- Agree on quality definitions

*Consider this:*

#### If 99% Quality Were Good Enough

The following examples are based upon figures from the University of Michigan and the US Bureau of the Census and the standard being that 99% quality were good enough:

- The wrong baby would be given to new parents 33 times a year
- 19.2 million pieces of mail would be delivered to the wrong address each week
- Electricity would be off 14 minutes every day
- 117 miles of highway in Michigan would be impassable
- More than half a million US airline passengers would lose their luggage annually
- Nearly 200,000 inedible chickens would be sold each year.

As consumers, we do not tolerate such terrible quality; yet, we ask our customers to accept it every day.

Should the concept of Lean Purchasing interest you, contact SME to attend the next Lean Purchasing Course in nearest you. Or, if you would like the concept of Lean Manufacturing explained and introduced to your employees, contact Jim Altfeld at [jaltfeld@altfeldinc.com](mailto:jaltfeld@altfeldinc.com) or call 1-800-397-0010 for his introduction to Lean. Δ

#### Answers to the Gazorp Manufacturing Exercise:

What is their manufacturing velocity:

$$60 \times 8 \times 5 \times 6 = 19,200 \div 6 \text{ hours (360 minutes)} = 53.3$$

(Amount of time the plant works per week) 60 minutes x 8 hours x 5 days x 6 weeks lead time ÷ time to produce = Velocity

What are the inventory turns at year end:  $131 \div 19 = 6.9$

$$IT = \text{Annual Cost of Sales} \div \text{Dollar Value of Inventory} \\ (\text{Direct Labor} + \text{Material} + \text{Overhead}) \div \text{Ending Inventory} \\ \text{Annual Cost of Sales} = \text{Standard Cost} \times \text{Total Forecast or Total Units Sold} \div \text{Total Invested Inventory}$$

What is their PONC (as a percent of sales):  $176 \div (6 + 8) = 8\%$   
Sales ÷ Quality Activity Costs = PONC

What is their PAT percentage:  $176 \div 11 = 6.25\%$   
Sales ÷ Net Profit = PAT

Overall, you have a choice. You can either seize control of your own destiny and take charge of your company's future, or leave it to the business gods to decide that for you. For a free consultation to discuss your business, where it is you would

like to see it go and what it would take for it to get there, contact Jim Altfeld at [jaltfeld@altfeldinc.com](mailto:jaltfeld@altfeldinc.com) or call 1-800-397-0010. Δ

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## Meetings

One of the biggest problems confronting all companies, large and small, are meetings. When to have them, why to have them and who needs to attend. The latest push is to have a huddle. Huddles are short (no more than 20 minutes), succinct, quick, concise, to the point meetings that can be utilized to cover a number of items. They can be used to share specific information that was not getting shared before such as new projects, new customers, who is working on what and who needs to be involved in what. Huddles can also be used for everyone to explain to everyone else, what it is they will be working on that particular day, week or month. They can even state those things that are imperative to get done versus those things that are not. It's the old urgent and important versus urgent but not important or, important but not urgent. This way everyone can stay focused on what is critical versus getting involved in distractions. One aspect I personally enjoy about these huddles is that the participants are invited or asked to attend. If they snooze, they lose. There is no running down the hall to find Bob. Bob is either there or he isn't. One other thing with a huddle is that not everyone needs to be there in person. You can always set up a conference call or a video conference, especially when you have key people out of state or out of the country.

Besides the quick and dirty huddles, companies also need to have real meetings that go longer than 15 to 20 minutes. To get a copy of how to conduct an effective and efficient staff meeting, contact Jim Altfeld at [jaltfeld@altfeldinc.com](mailto:jaltfeld@altfeldinc.com) and we'll be happy to mail or email one out to you. Δ

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## Time for a Short Commercial Break:

### *Why Would I Use Strategic Planning?*

Use Strategic Planning/Thinking to take an introspective, honest look at your company. To determine what business you are really in and whether it is the right business to be in. To identify where you want to take the company and what you will have to do to get it there. To identify who you are as a company.

What are the company's true values and what is its culture. Strategic thinking is a means for the leadership of the company to extract itself from the subjective state of crisis management

and take a step back to objectively assess where the company is now and where it needs to be. It allows the company's "brain trust" to take a time out. To breath long enough to create a desired future state, identify ways to make it happen (a strategic plan), determine who will make them happen by when, and anticipate the consequences (good or bad) of your decisions through "what if" scenarios.

### *What Do Most Companies Get Out of It?*

Strategic thinking permits the top management of the company to look at the enterprise as a whole and the inter-relationships of the parts. As a result of strategic planning, a company realizes the futility of independent, vertical departments with each fighting to protect its own fiefdom. Rather, it becomes an eye opener for department heads to realize how much more effective they can be and how much more can be accomplished through horizontal interdependence. That by working interdependently with each department instead of independently of one another, they really can achieve the common goals that were established in the overall strategic plan. It is a coordination of the inter-related parts of the organization making the whole greater than the sum of its parts. By then implementing atop-down/bottom-up alignment of objectives, the entire company can understand what you are trying to accomplish, resulting in their involvement and buy-in. The result of which is usually a more productive workforce, increased operating efficiencies, greater retention of your more profitable customers, and a consistent revenue stream.

### *What are some more hard core results I can expect to achieve with it?*

Unity, Focus, Direction and Understanding. Everyone pulling on the same rope in the same direction. A company with involved, informed and inspired employees who understand how they contribute to the goals of the company. What is expected of them, how they will fit into the company's culture and how far they can or cannot go in their actions and the decisions they make. Lower employee turn-over, happier, more loyal customers and stockholders, and a continuous stream of revenue.

### *What Kind of Commitment Are We Looking At?*

No company can rely on taking care of today to ensure a bright tomorrow. It's a sure ticket to extinction. Considering the longest most companies survive is 40 years, one gets a real appreciation for those 100+ year old companies that are still around today. Companies such as General Electric which has reinvented itself and changed its culture time and time again as a result of continuous improvement and strategic planning.

The length of commitment is up to you. Should your overall plan be “build to flip” then that is your plan. Should you decide you are in it for the long haul and expect to be around for awhile, then your commitment needs to be longer. The caveat is that once you have done strategic planning, your commitment is not so much to the plan, as it is to the planning process. Plans fail and things change to cause them to fail, or force them to be changed. The planning process never fails. Abandoning it however, will have its consequences. The key to success for any company is to inform, involve and inspire its people which is what strategic planning and alignment of objectives is all about. With the genie out of the bottle, it is near impossible to get it back in.

The discipline of strategic planning forces a company to anticipate and solve its near term future problems today. It causes you to focus and start thinking about your long range tomorrow's. The future will always be an invisible place until you start thinking about it. If your company is in it for the short term and wants to sell out while profits are high and sales are good, that is the best time to do that. As an owner or CEO, it's always your job to maintain your company at peak performance and position it for sale, no matter if your selling it or not. The problem is staying at the top.

For example, of all the Fortune 500 companies listed in 1980, 46%, or 230 are gone. The point being that no company can rely on taking care of today to ensure a bright tomorrow. It's a sure ticket to extinction. The best time to ask for a loan is when you don't need the money. The best time to try something new, to take risks, to move in a different direction is in good times, not bad, and certainly not when you are desperate.

### *Why Altfeld, Inc.?*

First of all, Altfeld, Inc. specializes in \$2 to \$100 Million dollar business to business companies. Our expertise lies in working with manufacturers, distributors and service providers. We are not the right choice for business to consumer or business to commerce companies and those companies with revenues much larger than \$100 million. As to why us versus somebody else, there are four things that make us distinct. The first is our guarantee. Should the client's chief representative not find our strategic planning event stimulating, thought provoking, productive, and/or informative at any time after two hours, one day, or a day and a half into the two-day session, we will promptly refund their entire deposit plus pay them an additional \$300.00 for their time.

The second is that we don't just do the strategic planning and leave the client on its own to fend for themselves. We really like to go deeper than that. We want to get involved and work with all three segments of the company to ensure the implementation of the planning process and the overall success of the plan. For example, should some of the smaller companies not yet have a full time marketing manager, we offer to fulfill that role for them on an outsourced basis until they grow to the point of needing a full time person. Should they need help with their marketing and/or sales planning, we can assist them there, too. We also provide public relations and advertising services.

Our third leg up is that Jim Altfeld is one of the few strategic planning consultants with actual marketing, industrial sales and advertising experience working for small, medium, large and extra large companies. And the fourth is that he grew up in a small, boot strap, family owned manufacturing company that has helped him to empathize and commiserate with most of the owners he's met and gets to work with.



*Jim Altfeld and Miss Terrible at Santa Anita Park*

For a free initial consultation meeting or to merely discuss ideas, concerns or challenges, contact Jim Altfeld at 1-800-397-0010 or [jaltfeld@altfeldinc.com](mailto:jaltfeld@altfeldinc.com). Δ

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