A Wall Street View of Lean Transformation

Presented by the Lean Enterprise Institute
Today’s Speaker

Cliff Ransom

Cliff Ransom is the President of Ransom Research, Inc., an independent equity investment research firm that acts as an outsourced resource for a limited number of major investment management organizations. The hallmark of the work of the firm is his focus on “going to the gemba”, where he meets corporate managers and insists upon plant tours. In the last five years, he has become increasingly interested in the migration of “lean” off the traditional factory floor, into back office, service, financial, sales and marketing, and new product development realms.

A few of Cliff’s many accomplishments in the lean community:

• The first financial services executive made a Life Member of the Shingo Prize Academy; also elected to the Academy’s Board.
• The only investment professional made a “Champion” of AME
• Chairman of the Advisory Board of Lean Horizons Consulting LLC.
• Frequent Lean program speaker, including the LEI, Shingo Prize, AME, the Lean Accounting Summit, Parker Hannifin, Regal-Beloit, Terex, among others.
Genchi Genbutsu

The essence of what I do for institutional clients is simple: go and see, at the point where the real work is done.
I am a Zealot

This Lean Stuff Just Works!

Today will be all about proving my thesis to you
My Basic Thesis

• Adoption of a lean culture will improve financial performance.
• Improved financial performance will enhance valuations.
Culture

How people think, behave, act, and respond to problems and rewards on a daily basis.
Lean is the Toyota Way

• Differentiate between “tools” and “thoughtware.”
• It’s not about tools; it’s about culture.
Remember just two tenets...

Respect for the individual

and

Constant elimination of waste
…Or is it five tenets?

1. Voice of the customer
2. Empowered people
3. Flow and pull
4. Value stream focus
5. Pursuit of perfection
What lean really does:

Foster

and

Finance Growth
To begin: Let’s not kid ourselves

There’s good news and bad news for managements and investors...

Wall Street may be clueless, but it can still reward you.
Lean has to be led from “The Top”

• Lean often starts in the middle, or even close to the bottom.
• But I have never seen it succeed without the boss as Champion.
• I’ve also never seen it succeed without deep Board involvement.
• The question is always: “How do I make my bosses GET IT?”
Why lean? The creation of true business value

It’s all about *Business Valuation*

- Every company, public or private, has to be concerned with creating value.
- Every organization, whether for-profit or not-for-profit, needs to minimize waste.
There are lots of ways to get to heaven

*Lean concepts: Many do not get it; there is advantage for those who do!*

- 85% are clueless
- Another 10% know the jargon
- Only 5% practice the art skillfully

- Toyota Production System
- Danaher Business System
- Six Sigma (done many places, but few do it as well as GE)
- Lean Six Sigma (not that it kept Maytag independent!)
- 80/20 process at Illinois Tool Works
Why lean?
“Because it works!”

My two archetypes:
Toyota
and
Danaher
Taking a long-term view of Toyota’s share price
Understanding relative performance

TOYOTA MOTOR ADR vs GENERAL MOTORS vs FORD MOTOR
(Jan 1991 to Dec 2007)
It’s easy to love Danaher
The dilemma of benchmarking
Benchmark only against world-class!
Investor Mindset: “We should like everything about lean”

- Inventory reduction, particularly WIP
- Physical room to grow
- Avoidance of capital expenditures
- Productivity acceleration
- Cycle time acceleration
- Quality enhancement
- Bolstered competitive position
- CASH, CASH, CASH
Getting started with lean: The real reasons to change? Well, maybe….

Lean’s “usual” start

- Kaizen-in-a-box
- Reduce WIP
- Reduce footprint
- Reduce cycle time
The crux of it all!

The “real” reasons for change

1. Customer intimacy
2. Capital avoidance
3. Enhanced valuation
4. Sustaining the culture
Think “GROWTH!”

At the end of the day, lean is about sustaining growth of the enterprise, in revenues, in earnings, and in cash flow.

It really is that simple.
Again, my dirty little secret…

**Satisfying yourself or Wall Street?**

- Again, virtually no one on Wall Street “gets it” when it comes to lean
- They just don’t have visibility into the metrics of lean:
  - Reduced floor space
  - Reduced WIP
  - Elimination of finished goods inventory
  - Decreased cycle times
  - Enhanced quality
  - Correspondence with takt time
  - Improved customer satisfaction.
How to get a premium valuation!

The three mantras of Wall Street

- Consistency
- Sustainability, and most importantly,
- PREDICTABILITY
Enabling the lean life cycle: A Warning for executives

*Lean is fragile and can fail*

- Lean is NOT robust; it is fragile
- It needs constant feeding & watering & reinforcing & scrutiny
- There is no automatic pilot for lean
- It fails more often than it succeeds

- One-piece flow runs counter to generations of managers who thought only about overhead absorption
- Lean is hard; it requires great consistency and it takes time
- Empowering employees can be scary, for both bosses and employees
- Traditional GAAP accounting can retard lean, particularly in the early stages of implementation
My best guess is why companies fail at lean

- Comfort with the status quo; Change is threatening
- Fear of failure
- The tyranny of the “end of the quarter”
- Over emphasis on “tools”
- Loss of face/status/seniority
- No definable catalyst: a crisis, champion or leader
- And last, but far from least, STUPIDITY
- I’ll stop…even though I have four more slides!
### Danaher as earnings exemplar

**DANAHER**
(DHR)  86.5

**Earnings Per Share - % change**

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**Yr.**

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**Yr. to Yr.**

|       | 21%  | 19%  | 22%  | 20%  | 19%  | 3%   |

**Next Expected EPS Date: Jan 21**

**Mean Estimates: First Call**

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**Yr.**

|       | 1.64 | 2.30 | 2.75 | 3.24 | 3.84 | 4.37 | 4.98 |

**Yr. to Yr.**

|       | 40%  | 20%  | 18%  | 19%  | 14%  | 14%  |

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**Yr. to Yr.**

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**Mean Estimates: First Call**

F (Quarterly numbers may not add to annuals)
Free cash flow to net income ratio: the Golden Rule

- 2001-2005 Range and Median %

Companies Included:
- 3M
- Honeywell
- Agilent
- ITW
- Cooper
- Parker Hannifin
- Dover
- SPX
- Eaton
- Thermo Electron
- Emerson Electric
- Tyco
- GE (no GECS)

A Wall Street View of Lean Transformation

Lean Enterprise Institute
But it’s more than earnings and cash flow

“It’s the multiple, stupid.”
Danaher is also a king of industrial valuation

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P/E Range
S&P 500 P/E 16.3

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P/E Based on Estimated EPS: 23 20

P/E Range Relative To S&P 500

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Rel P/E Based on Estimated EPS: 1.4 1.3
It’s not just about the multiple

“It’s about being early, stupid.”
## ITT Industries: Confidence building about earnings

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<th>ITT (ITT)</th>
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### Earnings Per Share - % change
Latest Qtr (Sep 07) ........up 23 %

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Mean Estimates: First Call
ITT valuation: Turning heads

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P/E Range
S&P 500: P/E 16.3

P/E Based on Estimated EPS: 18 16

P/E Range
Relative To S&P 500

REL P/E Based on Estimated EPS: 1.1 1.1
The end result for ITT
Parker Hannifin: Another recent adopter
Parker Hannifin:
Don’t get jealous… yet.
Parker Hannifin: Re-valuation comes slowly!

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P/E Range
S&P 500 P/E 16.3

P/E Range
Relative To S&P 500

A Wall Street View of Lean Transformation  Lean Enterprise Institute
Belden: Nothing to brag about for half a decade
Belden: Another Danaher alumnus takes the helm
IDEX: Yet another Danaher alumnus
Circor: A company early in lean adoption?
“Transactional” Lean

Here’s the sad part about today’s Webinar:

- Not enough time to explore this realm
- Huge opportunities, albeit hard to identify
- FAR more *muda* than on the factory floor!
Is The Glass Half Empty Or Half Full?

Leading market positions
Innovation
Solid foundation
Improving working capital
Healthy cash flow
Commitment from the top

Your Answer Matters:
Are you prepared for the journey?
Ransom Lean Adoption Model, Part One

- Organic revenue growth between 6% and 8%
- Total revenue growth at between 10% and 12%
- Annual margin expansion
- Income growth rate between 12% to 15%
- Cash conversion greater than 100% of net income
- An aftermarket or service capability is a real plus
- You probably need to operate globally
Ransom Lean Adoption Model, Part Two

- Demonstrate an ability to utilize cash effectively
- Investigate, price, finance, and integrate the right acquisitions
- Make acquisitions a seamless, repeatable, and predictable process
- Payment of dividends (no special dividends); do stock buybacks to at least offset option dilution
United Technologies: Putting it all together
My final comments: Ask the right questions; Guarantee the result

The Right Questions
- Does management know what it doesn’t know?
- If they do know, are they committed to change?
- If they are committed, do they have the tools?
- Is compensation tied to execution?

The Right Result
- Consistent, sustainable and predictable results
- Improved earnings and cash flow
- Higher business valuations
- We all make money using lean as our vehicle
I Am Easy To Find!

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Cliff@RansomResearch.com
Keynote Speaker: Jim Womack

Plenary Speakers from:
Boeing, Barry-Wehmiller, Wells Fargo

Plus informative Learning Sessions!