

Chapter One

PROFIT IS KING, BUT CASH RULES

First came the phone call. “Mike?” said Charlene. “Is Phil with you?” There was an edge to her voice, a hint of panic. “Haven’t seen him,” I answered. “Is anything wrong?”

“I hope not. He phoned saying he would drop by your place in the evening, but I haven’t heard from him since.” It was already past 11 p.m. by my watch, reason enough to be worried — but not quite that worried. I tried to get her to talk some more, but she just asked me to ring if Philip came around. I put the phone down, puzzled. Philip Jenkinson is a close friend. We go all the way back to senior high, and we’d had a drink only a few weeks ago. He was the successful one. He’d made it big in the world. He’d made it rich. I knew he had been under a lot of work pressure lately, but beyond the usual signs of executive stress, he seemed perfectly fine. I worried he may have had an accident.

The front doorbell rang. A disgruntled cab driver was trying to steer a drunken Philip, who was swaying and blabbering. “This your friend?” grunted the cabby. We lugged Phil inside and dropped him on the couch. He was not only deeply under the influence, but shivering badly, and soaked from the driving rain. I paid the driver, added a tip, and watched him retreat into the filthy night. Philip was already snoring. Feeling like a snitch, I phoned Charlene, remained vague on the details, and told her not to worry, I’d drive her husband back to her in the morning. I could hear the kids bickering in the background and was surprised that they were still up at this time, unusual on a weekday, but after all, it was none of my business.

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I pulled the drenched coat off Philip, battled with his boots, and left him to sleep it off spread-eagled on the sofa. He looked strangely childish, mumbling in his drunken stupor, an echo of the gangling teenager he'd been in our youth, and, not for the first time, I wondered why on earth he'd retained the nerd-like haircut-and-glasses look of his teens. He even had pens sticking out of his shirt pocket! He was a big man, tall, blond, with strong features marred somewhat by pockmarks. A good face, though, and a good man, I reminded myself, irritated. Not particularly subtle or refined, he'd been a good friend over the years — terribly sharp in his own one-dimensional way. Slightly on the boring side, he rarely drank, never smoked, and, aside from a weakness for flashy cars and a compulsion to work, had no particular vices to speak of. What, I wondered, had got him into this dreadful state?

The morning broke bright, cheerful, and noticeably warmer than the past few days. It had been raining continuously for the past week, and I hoped that spring was finally here to stay. I love northern California, but do I hate this late-season rain! I kicked Phil awake and shoved a pot of black coffee, a half-pint of beer, and a raw egg in his face, a fail-proof hangover recipe from our wilder days. He guzzled the beer, drank the coffee, balked at the egg, and finally sat up, slumped on the sofa. I sat down, carefully sipping from my own mug.

“Want to talk about it?”

A shake of the head. Painful, obviously.

“Family trouble?”

He looked up, blearily surprised.

“Nope. Work trouble.”

I blinked. Work trouble? How could that be? Philip was a success story. He'd gone to Berkeley, gotten a Ph.D. in physics and ended up developing some high-tech gizmo, which he then patented. On the back of that he and a partner had successfully started a small manufacturing operation on the West Coast. I was studying for my doctorate in the United Kingdom at the time and didn't know much about it, until the mysterious currents of modern life brought us both

to the same town. Two years ago, Phil and his partner bought an established company, with the aim of integrating the new technology into the existing product line. When I got a job with a good college, Sarah (ex-girlfriend) and I stayed with Phil and Charlene before finding a place of our own in the area. He pulled in more money in a month than I did in a year with my measly university salary, and his constant talk about IPOs and share prices would have bored me to bits if I hadn't been slightly, ah, jealous.

Work trouble? What kind of work trouble can get you dead drunk and crashed out on a friend's couch?

"Bad?"

"Worse." He held a second cup of coffee, his eyes red and vague, the lines of his face showing stark in the morning light. He ran a hand over his face. "I can't cope anymore. I don't know where to start. It's just too much!"

"Tell me."

"You wouldn't understand," he shrugged, and then continued all the same. "If we don't do something real fast, we will be bankrupt in a few months. Everything we own is mortgaged. The banks won't give us another dime. And we've tried everything we can think of. There's just no way."

As I understood it, Phil and his partner Matthew had gambled that they could buy an ailing company in their industry for a bargain price, turn it around with their new technology, and basically make a killing. With what they could raise of their own money and a lot of bank debt, they closed the deal, and, after an initial burst of enthusiasm, the two seemed to settle in to the sober realities of running a company. But I had never realized things had been this hard. I guess everyone was suffering in this latest economic downturn — entrepreneurs more than the rest, barring laid-off workers.

"Too much," he whispered again, with true desperation. An academic myself, I found it difficult to grasp both the scope of his problems and why it should be so tragic, but I was well aware that for

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some people, business was more important than family, life, and the universe wrapped together. I knew. My father was one of those people, and I'd grown up with these sorts of issues, or rather, in spite of them.

"I've looked at the figures from every angle. If we don't find a way to get some cash in real quick, we're about to lose all we have. All of it!"

"Come on, it's only money!"

"I knew you wouldn't understand," he said with a sulk. "See, the banks are calling our loans, we've mortgaged everything we own, and at the moment, we can barely pay the interest on the money we borrowed. If they don't extend the credit line, we can't pay wages, we can't pay suppliers, and that's that. We fold!"

"Oh, hell," he moaned. "I've got to get home. Oh boy!" He put his face in his hands, raking his hair with his fingers. The only thing that went through my mind was that I'd better think of something before driving him back in that state to Charlene.

"Well, there's one thing we can do, although I'm going to regret this," I ventured. He looked at me, not quite listening. "We could go and talk to Dad."

My father was the only person I knew who might be able to help Phil, but, as we drove down to the bay, I was having second thoughts. My Dad was retired now, and spent most of his time fiddling with his boat at the Bay Yacht Club. In his heyday he'd been a successful executive in the automotive supplier industry. He'd joined the navy right out of high school, and used the G.I. bill to get a degree in industrial engineering when he got out. Then, oddly enough, he found a job in Britain working for British Leyland. This was around the time of the merger between Austin Morris and Leyland — back in the days, that is, when the United Kingdom still had a domestically owned auto industry. This is where he met my Mom, and my brother and I grew up in the Midlands, until Dad got a big job back in the United States with a Detroit-based automotive supplier.

The move was horrendous. All of a sudden, I lost all my friends and found myself in a company of strangers. I didn't speak like them, I didn't dress like them. Brother, I didn't even like them — and they hated me back (to be fair, I think it was even worse for my younger brother). At the time, the cool kids equally shunned Phil for his nerdish and complete interest in science, not to mention his hand-me-down clothes. Somehow we got to be friends, two ugly ducklings in a pond, and stayed friends even while I went back to Britain to go to university and eventually to complete my Ph.D. in psychology.

My father had had an unusual career, distinguished by the fact that he'd caught on to the Japanese industrial offensive early on. While most of his colleagues ignored or belittled these new manufacturing techniques, he'd become obsessed. In my teenage years, all he seemed to talk about were barbaric-sounding words such as kanban and kaizen. He went as far as learning the language (approximately), and made a number of trips to Japan, in particular to visit Toyota. Not surprisingly, this had not made him very popular with many of his colleagues, particularly since he insisted on lecturing them on the shortcomings of Western managers. The British resented his American bluntness, and the Americans just ignored him. Some considered him a crank, others a downright pain. As a result, he had moved through a number of companies, turning operations around and then losing the inevitable political battles. Ultimately he would be forced to leave, joining yet another company for yet another fight.

In the end, he became vice president of operations for a large automotive supplier. All went well for a while, until his boss retired, and my father realized he wouldn't be considered for the top job because the board was looking for a younger man. Disgruntled, he retired in a huff, and still tells anyone willing to listen that since he left the company has gone down the tubes (true, but whether there is a cause-and-effect link, I can't say). Eventually my parents decided to settle down near my brother and me in sunny northern California, and found a house in the hills within easy driving distance of where I now live.

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Dad had been a workaholic all his life, and I thought he'd go on working as a consultant. Once again he surprised us. As soon as he retired he walked away from industry without looking back. Being a man of passions, he now poured all his energies into his first love: boats. He'd always had an old tub moored or docked somewhere, but with all the moving around my Dad hadn't had much time to devote to his sailing. On top of which, I think he was deeply disappointed that neither my brother nor I shared his enthusiasm for getting wet and cold and sick just for kicks. He'd bought a lovely wooden 40-foot ketch and spent most of his time tinkering with it, talking endlessly to anyone who'd listen about his navy days. In no time he became something-or-other at the Bay Yacht Club and seemed to spend more time there than at home, to the unspoken relief of my mother, who enjoyed having the house, and the day, to herself.

As we drove, I explained all this to Phil, who was listening distractedly. He'd just been on the phone to his dearly beloved, and the earful he got was not mixing well with last night's drinks, adding to the sour look on his face. In the end, I think he just felt too ill to argue, and wasn't quite up to going home.

"Don't step over there, the varnish is not dry yet!" growled Dad as I was about to step aboard. "Hi, Dad," I answered wryly, after nodding to the florid, red-faced man who lounged in the cockpit with a mug in his hand. My father, his back to us, was working careful strokes on the roof of the cabin. His friend wore a navy blue shirt and pressed chinos, very much the postcard yachtsman. He gilded the lily by wearing a ridiculous sailor's cap at a rakish angle, giving him a vaguely piratical air. He was soaking up the morning sun and smiling contentedly, in total contrast to my father, who was on hands and knees in his working clothes, a torn gray sweatshirt and stained jeans, sporting his usual scowl.

"Hop on, hop on, don't mind him. You know what he's like!" said Long John Silver with an expansive gesture toward Dad. We

clambered on board gingerly, and I sat down on the deck while Philip looked around bewildered, trying to find some place on the ship that could accommodate his bulk.

“Harry, this one here is my son. Boys, meet Harry,” Dad said, flashing us an evil-tempered look as he carefully dipped his paintbrush into the pot.

“Harry,” nodded Philip politely, “Mr. Woods.” Dad turned around and stared at him, his two pale eyes and beak of a nose (family trait, I’m afraid) giving him the hawkish look which made every one feel an instinctive urge to straighten up and salute. I’d managed to shake the intimidation off over the years, and laughed quietly when I saw Philip squirm uncomfortably.

“Hi there, Philip,” said Dad. “These rascals used to steal my whiskey and think I didn’t notice,” he said to Harry, turning back to his work. I never knew that he did. Philip laughed out loud, remembering our foraging in my Dad’s office, and the years fell from his face, finally making him look more his age.

“You’re Bobby’s kid,” said Harry, squinting at me. “I’ll be damned. I could tell. Same nose,” he added with a smirk, draining his mug.

“Well, what brings you boys out here?” asked my father, his back resolutely turned on us again, carefully applying the varnish on the ancient, venerable wood of the boat’s cabin.

“It’s like this, Dad. Phil has problems with his business, and I thought you could talk it over with him and maybe help him out.”

“Well, why don’t you let Philip tell me his troubles then?”

I sat back, held my breath, and let Phil haltingly begin his story. “Do you remember, Mr. Woods, the last time we talked, I told you I had developed a patent for a new technology in the high-voltage business, which applied, among other things, to industrial circuit breakers? Well, I found a partner, and we set up a small factory. It did quite well, and two years ago we bought up one of our competitors, which was filing for Chapter 11 bankruptcy.”

“What was wrong with it?” interrupted Harry.

“Too expensive,” Phil answered with a shrug. “Antiquated technology, inefficient operations, plenty of deadwood in management. At the time we were getting more orders than we could handle and we needed the extra capacity. There was a lot that could be used in the old plant, which had some highly qualified workers. We thought we could turn the business around.”

“So you started streamlining,” pursued Harry, fishing a metal flask out of his pants pocket and looking uncertainly at his empty cup. “But it wasn’t as easy as you thought and ...”

“Let the man finish!” exclaimed Dad. I wondered who this Harry character was. He was obviously enjoying himself. Though his sailing costume and his gut made him look a bit like Falstaff, the keenness of his eyes signaled a deeper wisdom. With a loud sigh he heaved himself up and clambered into the cabin to pour another cup. “Coffee, anyone?”

“Not for me, thanks,” continued Phil. “Yes, we did okay at first. My partner Matt has a law background, so he managed to negotiate the departure of the management team, which really helped with costs. We made do with the remaining people, but eventually we ran into a number of difficulties.

“Matt had secured a bank loan for a big portion off the purchase price, which made it possible for us to buy it, but left us with regular payments to fulfill the loan. As we had guessed, the company had orders, but they weren’t being fulfilled. So, we got the veterans together and asked them what was going on. They told us that management had invested so little in the shop floor over the years that machines were often down, and productivity suffered from a lack of simple tools and many other glitches. They were right, and for a year we worked very hard at cleaning up operations, while setting up our new technology. We also worked with consultants to improve production flows on the shop floor.”

He took a breath, which turned into a sigh. “And it worked,” he said, “for a while, but then ...” he shook his head, still at a loss.

“Cash problems?” asked Harry, spiking his coffee refill from a silver hip flask.

“Yeah. We just seem to be running out of money all the time. And the bankers have just told us they won’t extend our credit. We’re having huge problems paying the interest on our loans, we’re so late in paying some of our suppliers that they’ve put us on COD, and naturally we’re having trouble finding the money to pay wages.” As he talked, he leaned forward, his hands absently pulling his hair.

“What’s wrong with your outfit?” pursued Harry. “Products aren’t profitable?”

“It isn’t so much that. The products are profitable — when we are able to produce them consistently and on time. But materials are expensive and we never seem to be able to make things as effectively as we could. It’s really frustrating. We could do a lot more business, but that would mean investing in additional capacity, and new materials, which, of course, would require more cash.

“We figure that we would be making a healthy profit on the products if we just had simple standard costs: no extra costs for overtime, or extra materials, or the million unexpected fees that crop up everywhere. If we weren’t constantly incurring these penalties, then we figure that we’d be consistently profitable.”

“What are you doing about overhead?” Harry asked.

“We’ve cut all that we could. I don’t see what else we can do to reduce our fixed costs.”

“And what about working capital?”

“We’ve done all we could on that front. When we took over, we focused on receivables, and made customers pay on time. Now we’re the ones who are delaying payment to vendors, and they are threatening to cut us off.”

“Which leaves inventory,” said Dad, turning around and settling in the cockpit, cleaning his brush with a rag.

“Inventory is high,” agreed Phil. “We tried to get it under control, but then we couldn’t make deliveries. At first we weren’t too worried when we bought the company, because they had very reasonable average inventories ...”

This made my father guffaw, but he didn't say more.

"Then we found out that the average didn't actually mean much. We discovered they held far too much stock of some parts, and were out of others. Since different parts go into different end items, they had constant production stoppages from missing parts, which they then compensated for by working on other orders, thus creating in-process inventories. We've been fairly successful in reducing the missing parts problem, but the trouble is that in doing so we found it very hard to reduce the existing inventory of overstocked parts. They usually were long lead time parts, mostly from low-cost countries, and we had to increase the inventories of the parts missing the most. In the end, our inventory kept increasing, and we didn't know how to get it down without damaging delivery."

"Which contributes to your cash-flow problem," concluded Harry, nodding wisely. "Increased orders also drove up the cash outlay needed to build the product, which compounded the inventory problem, along with having to pay for the wages and equipment, and, eventually, the pile of cash you started with just melted away."

Phil said nothing, and just sat there looking miserable.

"Happens all the time," said Harry. "I used to be in purchasing. I've seen more than one supplier go through this, and then go bust. The industrial game is not very complex, but it's tough. Basically it's about economies of scale. The more you repeat a sale, the less it costs you. Double your volume and your cost goes down by about 10%, which is why everyone is always trying to get bigger. The theory is that as long as you can leverage the capital to grow, you're okay."

I looked to Dad for confirmation, but he'd gone back to his work, struggling to get a second can of varnish opened. The whole scene was a bit surreal. We were getting an economics lecture on the deck of his beautiful yacht, on this glorious, balmy morning. It dawned on me for the first time that Dad might have good reason to spend so much of

his time down here. The air was clean and fresh from the night's rain, the water peaceful. Phil, though, was listening intently, chin in hand, oblivious to the scenery. I saw that he had removed a notebook from his jacket (since he was a kid he always carried a notebook with him) and was jotting down notes.

"But there's a catch," Harry continued. "Several catches actually. First, economies of scale only work if you're always selling the same product. Diversity is costly, and doubling your diversity usually brings on a cost hike of the same 10% or more. Trouble is, most customers of industrial goods want customization. So although you're dealing with the same core product or technology, you're not actually selling the same product, and the economies of scale don't materialize. Your costs grow with volume." He let the point sink in and shook the remains of his mug over the rail.

"Second, the larger you grow, the more coordination is needed, which means more overhead, and so the cost-per-sale economies of scale have to be balanced against an increase of management costs. This is why only 20% of mergers and acquisitions are financially successful. You might double your volume by taking on a similar firm and the market that goes with it, but if you can't lose one of the management structures altogether, you've not gained much. You had a good go at it, from what you're saying, but beyond the obvious, getting rid of administrative costs is a lot harder than it seems. By and large, businesses need their systems just to operate, even if these systems are inefficient," he said, taking a swig from his flask. "Right?"

Phil nodded glumly.

"And then comes the clincher. The more you sell, the more you have to finance the cost of the goods you sell, if, as you say, the material content of your product is high. To add insult to injury, supposing that you've worked your way successfully through all that, you soon find out that the only way to guarantee delivery is to keep a very high inventory in order to cover vendor and customer variation."

"Yeah, you've got it," agreed Phil, pulling his glasses back on the

bridge of his nose. “We thought taking over this company would let us leverage our technological edge. And we’ve handled the coordination cost well enough, mind you. We’ve reduced overhead quite drastically, after initially putting a lot of money into improving shop-floor equipment and operations, which had been totally neglected. We’ve also worked hard at reducing lost production because of missing parts. We’ve had some results from these actions, in terms of getting products out to customers, but it’s not nearly enough and our cash situation is catastrophic, all the more so since we had already leveraged our first company quite badly to get enough cash for this deal.”

“Since you seem to know all about it,” I asked Harry hopefully, “isn’t there anything Phil can do to get out of this mess?”

He looked at me doubtfully.

“Hard to say,” he answered with a frown. “Generally speaking, there are three ways to turn around an industrial firm quickly when you’re facing a cash crunch.

“First, you have to drop any nonprofitable activity and stop throwing good money after bad. You need to invest all the cash you can muster up in the profitable stuff, or that with the greatest potential in the market.

“Second, squeeze suppliers. Used to be my job; and,

“Third, improve shop-floor operations. Now, I don’t know much about that — your Dad’s the expert in that regard.”

He shook his head. “Unfortunately, I don’t see what they can do. Not on the financial front anyhow. Why do you think so many new businesses fail each year? They go through this cycle and collapse,” said Harry, fiddling with his flask. “I’ve seen enough of it to know why it happens, and how, but it doesn’t mean I know how to fix it. Your problem is on the operations side. Bob might have some ideas about that,” he added thoughtfully, tossing the ball my father’s way.

“Not likely!” protested Dad.

“Why not?”

Dad fixed his steely-eyed eagle stare on me for a long, uncomfortable silence. Finally he opened his arms in a helpless gesture. “There are so many reasons, I wouldn’t know where to start.”

“Like what?” I pushed. Silence.

“Well, I’d have to go to his factory, for starters,” he answered irritably. “And I swore I’d never set foot in another plant as long as I live.”

“What am I going to do?” Philip gasped, and, to our dismay, we realized he was hunched up over himself, on the verge of sobbing. Overhead, a seagull gave its high-pitched cry.