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Profit Builder

March 2009

Have we hit the bottom?

There are a number of pundits out there who are saying the current rally on global share markets represents the "bottom" of the investment cycle and things should start to get better from here on in. In some respects, we can see their logic – there has been a sustained rally (particularly in late March) on global markets (22%+ in the US) which has flowed on to the Australian bourse.

Maybe, BUT....

There are however a number of considerations in assessing "where we are" on the cycle. Firstly, housing starts and housing prices are, generally, far below where they were 18 months previously. This is especially concerning in Australia where we have an existing net shortage of housing and not enough starts to meet our natural demand increase (let alone further increases associated with immigration/relocation etc). This is going to place increased pressure on the rental vacancies and should see rents continue to rise in the short to medium term.

From a capital growth aspect however, the position is a little more confusing. With the decline in house values over recent times, peoples' equity in their major asset has taken a hit (often a big hit). This may well be the result of the credit binge Australia has been on for the past eight or so years – people drawing down on the equity in their homes to purchase "discretionary" items like TV's, new cars etc. Putting depreciating assets on to a 25 year home loan makes no sense. The drop in value on the home therefore means, in many cases, what equity there was in the home has now disappeared.

Couple all this with the increasing unemployment rate in Australia (and globally) and you can see that we have set ourselves on the path to a "world of pain". There are a number of distressed sellers in the market who need to quit their holdings to get their debt to manageable levels (or get it gone if they've lost their job) – this means market prices are being kept low due to increased supply of property on to the market. Not a bad time to buy, but it would appear from recent data that investors are being very cautious at present. Sure, there is a fair bit of activity associated with the First Home Buyers Grant, but this ceases in July.

In most situations like this, investors will sit back and wait for some clarity in the markets before deciding to jump. They will also have a bit of a "bad times hangover" where they have seen what bad things can happen and not want to go down that path again.

We are putting a somewhat contrary argument to this.

Governments are very concerned about the likelihood of recession/depression and possible deflation. As a response, they are borrowing to stimulate the economy. Whether the stimuli they are using will work is open to interpretation; however they are trying all the tricks in the book to stave off economic contraction. Some countries are resorting to

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printing more cash.

Working through this scenario, the fear of recession/depression has had them fiddle with the "levers" to stave this off. In circumstances like this, it can often be that things will turn around but the stimulus components continue well beyond the time when things have started to improve. The impact of this is that the governments actually create the reverse impact they were hoping for – inflation.

In inflationary times, the best person to be is a creditor! Consider this scenario – you've bought a house for \$200,000 with a loan of \$150,000. Inflation takes off and the house value increases by 20%. The house is now worth \$240,000 but your debt is still worth \$150,000. There will be people saying that this is what happened a few years ago but we disagree. The increase in house prices was funded by a debt binge and was in an environment of very low inflation. Therefore, house prices were outstripping inflation by a massive rate. In the example we provide above, things are different as inflationary pressures will cause prices to increase pretty much forever. If you can remember the 1970's, you may recall how a lot of people actually created a significant portion of their wealth in those years. It is fairly likely that the above scenario will play out over the coming 24 months – it presents an opportunity for you to review your strategy in the short term to possibly take advantage of the times which have been created.

Therefore, our thoughts on the matter are that it may be a good time to consider investing in growth assets now – the market is subdued, credit is very cheap, demand for quality assets will only increase over time and, based on the above, inflationary pressures should take care of a fair portion of the leverage on the asset over the next couple of years.

And then there's the government bailout...

There has also been fairly detailed discussion in the media over recent times regarding the nationalisation of a lot of the world's banks. The governments have stepped in and bought large holdings in the banks to keep them afloat. Many are concerned that the debt associated with this will pass to future generations. Our view is that the governments will (generally) look to dispose of their interests in the banks once things get "back to rights" and they should yield significant funds from re-floating them on to the world stock markets. This should, in large part, deal with the debt they have taken on to support the banks.

Our only comment here regarding the Australian situation is that the government has borrowed to fund shorter term stimulus packages which have a fairly brief stimulatory impact. The debt is not in exchange for anything other than some gifts to a large portion of the population. In repaying the debt, Australia won't have the capacity to float off the good feelings it has created in the electorate at the moment. It would appear that our children will be bearing the burden.

Workplace Relations

The government has introduced the legislation and it has been amended on its way through the parliament. There are some changes to the law as they have drafted it, but we recommend all employers familiarise themselves with the new provisions and be aware of the impact on this new legislation on their businesses from 1 July 2009.

It has been argued that the introduction of this legislation is having an increased impact on unemployment as businesses is downsizing while they can. This may be the case, however, we do recommend that you come to terms with the new obligations for employers.

The Budget

Wayne Swan will be delivering his second budget in May. Unlike Keating's "bringing home the bacon" budget, this is more likely to be the "let's kill the pig" budget. We can expect a significant change in government policy and issues including the discounts for Capital gains tax, taxation of pensioners and a number of the "middle class welfare" taxation benefits. We will not know exactly what form these steps will take. It will be a case of "watch this space".

Given the discussion of late re paid maternity leave, the debt owed by federal Labor to the unions and the general economic environment, we believe there will be some significant pain in the budget. Some form of tax increase is fairly likely for higher income earners – if you can bring income forward this year or defer expenses to next year, it may well prove to be a wise strategy.

Interest Rates

As discussed in our last update, we believe it is getting toward the time when you need to consider the possibility of locking in some of your interest rates. The banks are predicting further interest rate falls in the coming months (these have been deferred due to the RBA decision last month) – it will be interesting to see what the result of the RBA Board meeting is on seventh of this month.

If you would like to discuss your interest rate strategy with us, please call and we will arrange a time to sit down and have a chat with you about it.

Small Business and General Business Tax Break

You all may be aware by now that the Federal Government has decided to enhance the allowance and 'rebadge' it as the "Small Business and General Business Tax Break".

In summary, the enhanced tax break now provides for:

- If the asset is acquired from 13 December 2008 to 30 June 2009 and installed by 30 June 2010, the taxpayer will be eligible for a **bonus deduction in the 2009 year equal to 30% of the cost of the asset**; and
- If the asset is acquired from 1 July 2009 to 31 December 2009 and installed by 31 December 2010, the taxpayer will be eligible for a **bonus deduction in the 2010 year equal to 10% of the cost of the asset**.

A further 'enhancement' is that the \$10,000 asset threshold has been replaced with a **\$1,000 asset threshold for small businesses** with a turnover of \$2 million or less.

The type of eligible assets has not changed, that is assets which should qualify will include expenditure on new assets such as plant and equipment and motor vehicles. However the bonus deduction for expenditure on a new motor vehicle is likely to be capped at the luxury car limit which is presently \$57,180.

The types of ineligible assets which will not qualify has also not changed, that is expenditure on second hand assets, land, trading stock and intangible assets and rights such as intellectual property and software.

Please do not hesitate to contact us if you would like to discuss the new rules in further detail.

How to turn a recession into a time of great opportunity

It has been talked about a recession being a time of great opportunity for business. So we thought it might be useful to share some ideas on why this is so and what you can do to take advantage of the situation.

In good times every man and his dog can run a successful business and many will even be in great shape. But good times hide from view the real weaknesses that exist in so many businesses and they also hide from view underlying strengths. When the going gets tough both the strengths and weaknesses are revealed.

A recession is a time when the business landscape is cleansed. It's a time in the economic cycle that presents you with an opportunity to lay the groundwork to build your bottom line by addressing the things you should have been doing right irrespective of economic conditions. For already well run business it is a time for them to drive home their advantage by focusing even harder on the things that have made them successful. What follows are some thoughts on how to do that.

Your pricing strategy. Typically people think nothing comes to rest on the bottom line unless it first appears on the top line. That line of thinking leads to the mistaken belief that revenue is the major profit driver and a price reduction enables you to hold or even grow market share and thereby maintain profitability. It isn't that simple.

If you're servicing a market where price elasticity is high or at least rising because of the recession (i.e. customers become more price sensitive in tough times) then some price reduction might make sense but if you try this and don't see an increase in sales (both in terms of revenue and units shipped) then market demand may not be as elastic as you think so don't continue with it. Furthermore, in tough times customers tend to have smaller order sizes which means

your cost of supplying the order is relatively higher (this would be obvious if you used activity based costing) with the result that if you discount your price, your margin shrinks even more.

It's fair to say that typically customers do become more price sensitive during a recession but not as much as many business people think. However, rather than drop your price it is far smarter to explore ways to introduce a lower priced alternative to your main service or product with some "value" removed. In other words maintain your margin on your main lines and introduce a lower priced alternative to service your price sensitive customers. In other words, give your customers two opportunities to say 'yes' instead of either 'yes' or 'no'.

One suggestion is do not consider a discounting strategy unless you can introduce an additional lower priced alternative or you have a cost advantage over your competitors and you have available capacity and the demand for the product or service you offer is sensitive to price.

Because price cutting is so transparent it is by far and away the easiest initiative for competitors to copy so the minute you do it you not only lose margin on all your sales but you'll probably lose some of your physical volume as well. At the end of the day, the game of business is about the bottom line, not the top line.

The team at Matthew Tol & Associates can help you to see the impact that a price reduction has on the need for additional sales to maintain gross profit. For example, if your GP% is 30% a price reduction of 10% (a common discount used) will require a 50% increase in sales to maintain your gross profit (it's even higher than this if your GP% is less than 30%). Quite frankly, it would be amazing to achieve a 50% increase in sales from a 10% price reduction during an economic boom but you'd have to be living with the fairies to believe that would be possible in a recession.

Matthew Tol & Associates have the tools to demonstrate that as long as you hold your price (and therefore your margin) your competitors could take 33% of your business before your gross profit declines—this is most unlikely to happen but to the extent you do lose some business you just might find it's from customers who are not profitable for you in any event—this is discussed below.

This is not to say pricing is irrelevant. Pricing is a critically important issue in any economic environment and there are some pricing and related product bundling strategies that should be especially considered in a recession.

So if price is not the answer, what is?

Identify your very best customers and your most profitable products and/or services then focus all your attention on both of those elements of your business. If you do a thorough analysis of your customer base you will inevitably find that between 10–30% are unprofitable for you, a great starting point for this is to do a Pareto Analysis that will tell you what percentage of your customers contribute 80% of your revenue and a separate analysis of the percentage that contributes 80% of your gross profit. Get rid of the low profit contributors or allow your competitors, who are implementing a price reduction strategy, "win" them. You'll benefit in two ways: first, your immediate profitability will improve because you are generating quality revenue by ridding yourself of unprofitable business and secondly, you'll ultimately gain market share when your competitors go out of business as a consequence of them trying to service your bad customers on their lower margins.

Strengthen your balance sheet. Many businesses get away with murder in good times. They have way too much debt that is incorrectly balanced (e.g. too heavily weighted to short term), their shareholder distributions (drawings) are too high and their receivables and inventory are poorly managed. This is a time to clean all of these things up. Dispose of unused or under-utilized assets (and under-performing non-core businesses) and if those assets are required for some aspect of your operations, out-source that service. Even if this ends up costing you a little more, the benefit you will get is some debt retirement (assuming the proceeds for the sale of the assets is used for that purpose) and secondly, a reduction in your break-even point (assuming the increase in variable cost does not out-weigh the effect of the reduction in fixed costs) which give you more capacity to deal with sales volume fluctuations.

Improve the quality of your financial reporting and financial management processes. In boom conditions people don't worry too much about the quality of either their financial reporting system or their financial management. As long as there's money in the bank to pay the bills everything's OK. Unfortunately when these bad habits spill over into difficult economic times we you have a recipe for disaster.

You should have a full set of financial that are accurate and available within 3–7 days of the end of each month. This is where Principa's DashBoard comes into it own. A monthly review meeting with Matthew Tol & Associates, with the DashBoard at the center of discussion and supplemented with your GamePlan analysis, can make a dramatic difference by helping you keep focused on the things that need to get done in your key result areas. In addition, a weekly flash report should be available by COB Friday that shows your sales, receivables, payables, cash, sales pipeline,

orders on hand, your primary activity metric (e.g. transaction count) and average transaction value. The KPIs will depend on the business but this is an indicative list. Ask the team at Matthew Tol & Associates about Principa's Dashboard and GamePlan systems.

Focus on your core business and supporting operational processes. Successful businesses have a laser-like focus on their core business. This is what makes them very good at it. In difficult times it often happens that people look for non-core activities to boost revenue which distracts them from their main business, confuses their customers and starves their principal activities of resources. My advice: stick to your knitting and concentrate on improving the productivity of your existing processes.

Don't cut back on discretionary expenses without good reason. In tough times it's normal to think we should cut expenses because with a gross margin of say 30% then for each \$1 reduction in costs we do not need \$3.33 in revenue. This is something that can't be ignored because these numbers speak for themselves. But simply cutting any expense simply because it's possible does not make sense even though that may appear to be counter intuitive.

A discretionary expense is one over which management has discretion in the sense of that it can be cut, increased or eliminated. Expenses that fall into this category would include R&D, team training, marketing, customer service initiatives, some team salaries and discretionary bonuses and so on. In contrast, non-discretionary expenses are those expenses in respect of which the business is either contractually obligated or are absolutely necessary to "keep the doors open."

For the most part, discretionary expenses are associated with activities and initiatives that grow the business or to put that another way, they ensure the business will be vibrant tomorrow. In contrast, non-discretionary expenses are the ones that are associated with what the business must do to meet today's operational needs. Lazy (or ill-informed) business managers tend to look first at discretionary expenses when they launch a cost cutting exercise which is precisely why a business that is going to come out of a recession stronger than its competitors always employs a different strategy. There are always some discretionary expenses that should be cut or eliminated (even in good times) e.g. business/first air travel for short trips, long lunches and \$100+ wine, chauffeured limos ... need I go on?

You should not cut any expenses that directly impact the strength of the relationship you have with your profitable customers. Nor should you cut the investment you're making in developing and delivering your most profitable products and services. You will find that as a result of reducing your unprofitable products and purging your unprofitable customers you will have opportunity to reduce some of your non-discretionary expenses.

The key here is to undertake a customer and product line profitability analysis in conjunction with an ROI review of your expense line items and seek out better suppliers who will offer better service at lower prices (remember, your suppliers are also in a recession). This of course is a strategy that should be in place irrespective of the state of the economic environment but good times breed lazy managers.

Work with your suppliers to find ways that you can help them lower their cost of servicing you. Intuitively, one way to achieve cost reduction would be to put pressure on your suppliers to lower their prices &/or offer better payment terms. That might be possible and should be pursued but it also makes sense to work with your suppliers to find ways to help them achieve cost savings that can be passed on to you as lower prices. Having a good relationship with your suppliers is critical to your continued success when the economy improves and the quality of the relationship you enjoy during tough times will influence that. The last thing you want coming out of a recession is an inability to meet demand because your suppliers are no longer in business or they give preference to your competitors who were kinder to them in the hard times.

Keep your team in the loop. Your team is the key to your success. In a recession people always worry about their job and the last thing you want is your best people jumping ship and joining a more successful business, so that you're left with under-performers. Your people need to know what your strategy is and they need to feel confident that their job is not on the line. If they feel secure but at the same time realize that everyone has to pull his/her weight you'll find they'll step up to the challenge and you'll not only be able to grow your bottom line, you'll build a stronger team that will remain loyal to you for many years to come. You'll also position yourself nicely to bring on board people who have been retrenched by your competitors so you might want to pick the gems out of that to strengthen your team by letting go people who don't want to roll up their sleeves and get behind you.

About Our Consulting Services

We are not your 'average' consulting firm. Far from it.

We are members of the Principa Alliance, an international network of business consultants and our goal is to help you build a stronger, more profitable business and enjoy a higher quality of life as a result.



When you work with us to improve your business you're gaining access to a global knowledgebase and a wealth of consulting experience that is so much more powerful than any one firm could offer.

By combining our knowledge of your business, the personal relationship we share with our clients and the consulting tools, support and networking power of the Principa Alliance, we can help you achieve more with your business than you imagined possible.

In short, we can, and will, do so much more for you than just 'keep the score.'

Contact us today to discuss how we can help you implement any of the topics described in this newsletter, and help you build a business that delivers on its promise.

Staff Profile: Peter Jacks



Nickname/s: Jacksy, Crackers

Most important person/people in your life:

My wife Ann, son Aiden and daughter Ellie

What was your childhood ambition: To be a fighter pilot

Your favorite movie: Gladiator.

Your favorite album: The best of Sting & The Police

Your favorite Book: Da Vinci Code

Your favorite meal and drink: Steak with Red wine Sauce and a glass of red.

Your favorite holiday destination: Rome, Italy

Pet Hates: Making lots of noise when chewing food.

Football Team: Richmond

If you could invite three people over for dinner, dead or alive, who would they be:

Michael Jordan, Warren Buffet, Leigh Matthews

Specialty in the kitchen: Not much – probably marinated chicken fillets on potato mash sprinkled with choice vegetables covered with a marinade sauce

What do you want to be remembered for: Being devoted to family.



Our Competitive Advantage

"Chartered Accountants who specialise in business solutions"

Strategic Business Growth Service.

We see it as a partnership that we work together with business owners to strategically grow their business.

Value Pricing:

Our focus is to deliver on value. We listen, to determine your objectives, tailor a plan and work in 'partnership' to achieve the objectives. An agreed Fixed Fee provides certainty and value for money.



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