Profitability FAQ

A year ago, my new book, *Islands of Profit in a Sea of Red Ink*, was published. Since then, it was named a best book of 2010 by *Inc*, and many companies have purchased copies for their top management team. Here are fifteen key questions – with brief answers – that managers have asked me.

Why is 40% of most businesses unprofitable?

All of our management information and processes were developed in a prior business era. Our accounting categories are too broad to see which accounts and products are profitable and which aren't – so people simply assume that more revenues equals more profits. Some revenues are very profitable, and a surprising portion produce big losses. In virtually all companies, no one is responsible for monitoring and managing the interaction of revenues and costs at the grass-roots level to maximize profits.

How do top managers react to this?

They strongly agree. In years of writing about this in Harvard Business School's *Working Knowledge* e-newsletter and website, no one has disagreed. When I speak to top managers about this at MIT and in my consulting clients, no one disagrees. The problem is that they don't know what to do about it, and they are rightly concerned that just "firing bad customers" (wrong thing to do) will hurt their stock price.

How can this be fixed?

Four building blocks: (1) the right information – granular (specific products in specific customers) not aggregated; (2) the right priorities – first, secure and grow the profitable business, then improve the marginal business, then reprice the money-losers; (3) the right processes – mostly coordinating sales, marketing, and operations to get things right; and (4) the right compensation, especially for sales – matching compensation to real profitability, not just revenues.

Why is your advice particularly important in our current economy?

Today is prime time for rapid improvements. Customers are desperate for new ways to get better, and they're very receptive to trying new ways of doing things. Most competitors are frozen in the headlights trying to cut costs indiscriminately. The key is to focus on growing the 20-30% of your company that can give you high sustained profitability, and then get more high-potential business that fits. You'll rarely have this great an opportunity to lock in the best business – just stop wasting good resources on business that will never generate profits.

Why are so many companies today meeting their sales targets but still losing money?

Because budgets are developed and performance is judged relative to history not potential. If a company is 30-40% unprofitable, and its budget aims for a 10% improvement, the company will still have a huge amount of embedded unprofitability. Everyone looks at the improvement and

celebrates. But 10% better than last year, and just as good as the competition is simply not good enough.

What are the most common mistakes businesses are making that prevent them from being consistently as profitable as possible?

Three big mistakes: (1) assuming that more revenues means more profits; (2) failing to focus attention and resources on securing and growing the business that produces high sustained profitability – this makes a company vulnerable to focused competitors and reduces reported profits; and (3) failing to put anyone in charge of maximizing account and product profitability at the grassroots level (in contrast with putting lots of people in charge of managing budgets).

What is "the age of precision markets" that we have entered?

In the prior "age of mass markets," companies sought the economies of scale of mass production, coupled with mass distribution using arm's length customer relationships. In that era, more revenues really did mean lower costs and more profits. In today's "age of precision markets," companies form different relationships with different sets of customers, each with different costs and profits. Yet, virtually all of our management information and processes were developed in the prior era, when all revenues really were equally desirable. This is the underlying reason why almost every company has so much embedded unprofitability and why so many managers fail to see and build their sustainably profitable core of business.

How should the role of the CFO change to adapt to today's new economic conditions?

In these difficult and uncertain economic times, companies need broad-gauge, strategic CFOs. An effective CFO must be able to chart a course to sustainable profitability and growth, and orchestrate the company's functional managers to accomplish this objective. This process goes far beyond managing operating efficiencies, cash flows, and budgets. It involves three essential elements: (1) profit mapping - moving beyond our traditional, overly broad, aggregated accounting measures to construct a granular transaction-based picture of account and product profitability; (2) sustainability – identifying the 30-40% of the company that is unprofitable, and more importantly, the 20-30% that is capable of strong sustainable profitability and growth, even in tough times; and (3) driving performance – identifying and prioritizing the key initiatives that will cement and grow the sustainably profitable portion of the business.

Should your advice be adapted differently when we're in a recession vs. when we start recovering?

The management to-do list is the same, but the distractions are different. In a recession, there is an overwhelming instinct to cut costs across the board and to hoard cash. This is exactly the wrong thing to do. Instead managers should step on the gas – identify and grow the sustainably profitable portion of their business by focusing their resources and investments on these customer relationships. When times improve and all ships rise on the incoming tide, the instinct is to cling to all revenue increases – no matter what the profit impact. Rather, managers should shift their resources to the business that produces high sustainable profits and growth.

How can a company's sales force become more profit focused?

Four key elements: (1) know the score – both account potential and profitability; (2) know the priorities – secure the best (most profitable) accounts, then get more of the best business, then

turn around the marginal business, and lastly reprice the remaining losing business; (3) know the company's best practice – observe the president's club winners' best practices, codify them, and teach them to the others (especially the critical task of ramping up high-potential underpenetrated accounts); and (4) know how to link sales compensation to profitability, not just to revenues and gross margins. Note that these are top management's responsibility – how can a sales rep maximize profitability if the company's top managers don't know how to do it?

How can you make your customers more profitable?

If your *operations* managers can't tell you what they would do to maximize a key customer's profitability, they need to spend much more time in their customers – walking in their customers' shoes. (Note that I said operations managers, not sales reps.) They need to work directly with their customer counterparts to develop three things: (1) great rapport, relationships, and trust; (2) a joint end-to-end understanding of the activities and costs of the intercompany supply chain – and an agreement on how to lower costs and increase asset productivity for both companies; and (3) an understanding of the political situation and attitudes of the members of the customer's buying center. These three things will drive huge sales and profit increases, even in highly penetrated customers. Unfortunately, most managers incorrectly assume that operations managers should only meet with customers after a mature sales relationship is established.

How should supply chain management be adapted to be more profitable?

Supply chain managers should have a critical role but are in danger of being bypassed. Traditionally supply chain managers focused primarily on internal cost reduction, an artifact of the age of mass markets. Today, they have to shift focus to supply chain productivity, which involves four critical tasks: (1) understanding and maximizing the earnings of their assets, not just minimizing costs; (2) spending a large portion of their time with their counterparts in key customers (those capable of providing high sustained profitability and growth) in order to figure out how to drive sales by making the customers more profitable; (3) working with the sales and marketing team to develop a standard set of customer relationships (arm's length to highly integrated), so they can fulfill each in a streamlined and economical way; and (4) teaming with sales and marketing to match customers to relationships.

How should marketing be adapted to be more profitable?

At budget time in many companies, the marketing group gets concerned about quantifying its value-added. Yet marketing is at the center of two critical profitability variables – customer relationships and product development. Customer relationships are the key to securing and growing profitable revenues. Marketing should lead the way in developing a standard set of relationships (from arm's length to highly integrated), matching customers to relationships, and establishing relationship migration paths to deepen key account integration. The key to effective product development is to meet the needs of the customers in the core of sustainably profitable business, rather than designing products for the average customer. By excelling in these two critical areas, marketing managers can make a huge lasting contribution to profitability.

Does profitability require a different sort of leadership?

Yes, everyone has to manage at the right level. Vice presidents should spend most of their time positioning the company for the next 3-5 years – since that's the time it takes to develop major new initiatives. Directors (department heads) should spend *half their time* coordinating with each other to manage the company's profitability, and the other half directing the managers who

report to them. Managers should run the day-to-day company. Instead, in many companies, everyone focuses primarily on the company's day-to-day performance.

What are the first steps anyone can start taking tomorrow to make their business more consistently profitable in today's economy?

A small team of managers can analyze the profitability of a multi-billion dollar company at a very granular level in several weeks using standard desktop tools. This is the first step. With this view, the management team can develop a highly targeted set of initiatives to secure and grow the best business, and to turn around the marginal business. Within a year, the company will experience a dramatic, sustainable increase in profitability.