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The Hunt for Profits

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What's a profit map? According to Jonathan Byrnes, it's a shrewd way to conceptualize the relationships among your customers, products, services, and transactions. There are five steps to drawing up a profit map, says Byrnes. In this article, he explains what they are and how they work together.

by Jonathan Byrnes

Part III

The hunt for profits begins in your own backyard. A thoughtful IT vendor executive, commenting on last month's column, noted, "I suppose that if supermarket executives sat down, they would agree that probably 25 percent of the customers that walk in the door cost them money. All the profit comes from the 25 percent with the largest baskets—not necessarily the largest revenue…Well over half of that profit comes from 10 percent or less of the base."

In most companies, 20-30 percent of the business provides most of the profits, while 30-40 percent of the customers, products, and transactions lose money. The key question is how to identify which is which.

In last month's column, I explained how a national trucking company had more than doubled its profitability by utilizing the three key elements of the profit management process: profit mapping, profit levers, and profit management process. This column focuses on the first element of profit management, profit mapping.

Five-step profit map
A profit map is a clustering of customers, products, services, and transactions by profitability, and an analysis of the key profit drivers. This forms the basis for rapidly improving a company's profitability through careful management of the details of the business without the need for major capital expenditures.

Let's look at the profit mapping process, using the example of a distribution company. The process has five steps.

Process accuracy. First, decide to analyze profitability at a "70 percent accuracy" level. Some companies spend a huge amount of time and money setting up an activity-based costing system that is much too detailed. All too often, the measurement becomes the project, and after endless debates, many projects lose momentum before they are translated into actions that hit the bottom line.

The most important results usually will be very clear from rapid, intelligent analysis using best knowledge and rules of thumb. Once a profitability picture emerges, it makes sense to improve the accuracy only where better information will change an important action. In most companies, after the analysis is over, the managers institute only a few high-leverage initiatives.

Profitability database. Second, construct a profitability database. Select a time period, often two to six months, that is representative, and load the full set, or an excerpted set, of transactions (i.e. order lines) onto a computer. Each transaction should carry crucial information including the identity of the customer and product, as well as special services. Next, develop cost functions and use these to net the transaction's gross margin (GM) to a net profit (NP).

In developing cost functions, it is generally best to allocate costs using an easy-to-measure variable. For example, allocating operations costs by transaction or order line usually works well, as each line entails order-taking and picking. Inventory carrying costs can be handled by rules of thumb, such as holding "A" items for two weeks, "B" items for four weeks, and "C" items for eight weeks. Transportation costs can be allocated through simple decision rules based on customer location (region, near to or far from a distribution center). Where a sales call is needed to take an order, that portion of the selling expense can be allocated by orders. Other costs can be similarly allocated with reasonable accuracy.

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It's important to allocate all costs, including general overhead, for two reasons: (1) this enforces the discipline of viewing the whole cost of the business when determining whether to keep or change a major component; and (2) this ties the analysis directly to the company's financial statements, ensuring credibility and accurate projections.

This process will yield a database of transactions, each with revenues, GP, and NP. The database can be analyzed to display account, product, and transaction profitability. It will show you where the big pools of profits and losses are.

The database also can be used to project the impact of changing the account and product mix, as well as changing the cost of key elements of operations and sales. The former shows the effect of focusing the company on high-profit market segments, while the latter shows the effect of altering the business model to change "bad" customers into "good" customers.

Model a customer. In the third step, choose a few customers and products that are reasonably representative, and look carefully at their economics. Try choosing a large and small customer each from a few key market segments, and a fast-moving and slow-moving product from each of a few key product families. Ideally, you will have about six to twelve representative situations to examine closely.

For each customer, look methodically at the profit drivers—revenues, margins, and costs—for different products. Try different business model configurations such as changing the order interval, sales interval, or service interval. Look at the pricing, both price levels and price mechanisms. (For an example of how a national trucking company did this, see my October column.) Altering the product mix and developing substitution programs also can provide valuable levers for profit improvement.

Here, you are looking for profit levers, which I will talk about more systematically in upcoming columns. Once you have found effective profit levers, check several other similar customers to be sure you can generalize your findings.

Modeling the effects of key profit levers on representative customers works well for three reasons: (1) it will be intuitively clear which elements of the business model (e.g. order pattern) can be changed and what the effect will be; (2) you can actually call the customers to see what their reaction to the potential changes would be; and (3) it will be easier to explain the changes using concrete examples when you "sell" the initiative to your colleagues.

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Project to the whole business. Fourth, take another look at the whole business. Divide it into clusters, or market segments, that are similar to the customers and products you've modeled. See where the big pools of profits and losses are now, and what the profit impact would be of making the changes. This will tell you what's most important to do.

With this picture of current profits and profit improvement potential, you can identify the few high-payoff actions that your company can take relatively quickly. First and foremost, act forcefully to secure the high-profit segment of your business. Only then institute a process to improve the profitability of the marginal part of the business. This process probably will include training front-line sales and operations associates in day-to-day coordination to improve profitability to its highest potential.

What about the unprofitable customers? Here's what the CEO of a major service company said about exiting unprofitable business segments or customers:

Before exiting, give them a chance to pay higher prices or modify the profit levers. We did exactly that. We knew our profitability was eroding. Through analysis, we found a business segment where we were losing money. Profit analysis allowed us to determine what changes would be required to generate acceptable returns. The underlying issue was not pricing—it was order pattern, order size, and delivery requirements. Before exiting the segment, we told our customers what we needed in order to continue servicing them. To our pleasure, they agreed to make the changes, and we saw a quantum improvement in profitability in six months!

Finally, phase out the parts of the business that cannot be made profitable. This will be counter-intuitive and some in the company will resist, but keep your eye on the huge upside to refocusing 20-40 percent of your sales force and operations assets away from tending unprofitable business and toward aggressively growing your share of the highest-profit end of the business.

Institutionalize profit mapping. Fifth, reflect on the value produced by profit mapping and decide to institutionalize the process. Repeat the analysis every six months. Once you have set up the analysis, subsequent rounds will go very quickly. The process itself will build teamwork and it will become a new way of looking at the business. In parallel, build profit mapping into the new account qualification process. As your profitability improves, new opportunities will constantly be created. The better you get, the better you can get.

From financial information to action

The service company CEO mentioned above reflected on his experience with profit mapping, "Financial systems often do not have the information that you need. If they did, the problems would have been solved long ago. To be truly effective, you need to create a cross-functional team that understands how the business operates. This will allow the conversion of financial information into management information which, through analysis, will lead to action."

Next time, we'll focus on profit levers; changes in the business model that improve profitability.

By the way, how do you hunt for profits? By looking in your own backyard—again and again and again!

See you next month.

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