



## Who's Managing Profitability?

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*The most important issue facing most managers in this difficult economy is making more money from an existing business without costly new initiatives. Here's how to do it.*

by Jonathan Byrnes

The most important issue facing most managers in this difficult economy is making more money from the existing business without costly new initiatives. In my research and work with companies ranging from distribution to telecom, I have been fascinated to find that at least 30 percent of each company's business by any measure (accounts, products, transactions) is unprofitable, but that this is offset by a few islands of high profitability. This sounds amazing, but it's true.

Let's look at the case of a lab supply distributor:

Thirty-three percent of the company's accounts were unprofitable, ranging from a low of 29 percent in one region to a high of 42 percent in another.

Thirty-five percent of all transaction (order) lines were unprofitable. Again, this varied by region, from a low of 23 percent in one region to a high of 50 percent in another.

Forty percent of the product lines clustered by vendor were unprofitable, and an additional 38 percent were marginal, including several major vendor lines.

Telesales achieved much better gross margins (41 percent) than other channels (36 percent for field sales territory accounts, 30 percent for large accounts), even controlling for other factors. But I was surprised to see that there was a wide range of employment of telesales—ranging from a low penetration rate of 3 percent in the lowest region to a high of 32 percent in the highest region.

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Against all expectations, fast-moving stocked products had much higher gross margins (36 percent) than slower-moving ones (34 percent) and both surpassed non-stock special and custom orders (29 percent).

The picture that emerged: The overall profit improvement opportunity exceeded 30 percent. These potential gains stemmed from management adjustments to the current business mix, and could be rapidly implemented. Capital expenditures were not required. And this tracked with findings in other industries.

Believe it or not, this company had been viewed as a solid performer in its industry—on budget and just as good as its competitors. This is the core of the problem. On budget and just as good as the competition is simply not good enough.

### Who manages profits?

Why does this happen so often? In most companies, everyone pays attention to profitability, but few companies have a process to systematically *manage profits* on a day-to-day basis. (Note: This means creating real profit increases, not manipulating the appearance of earnings.)

The executive team has a profit plan, each department head (Sales, Marketing, Operations) owns an important element of the plan, and progress to plan is watched closely. Yet even if each manager meets objectives, the company still is a lot less profitable than it should be. The reason? In most companies, no one is responsible for managing the interaction of these elements to increase profitability to its full potential.

I remember sitting in a monthly operating review meeting several years ago. The company's president sat at the head of the table. We were in a windowless conference room with all of the vice presidents and a number

of directors. The President's eyes fixed on each VP in turn, and each responded, "I made my numbers this month." At the end, he looked at them and said, "That's great—I'm the only one in the room who didn't make his numbers!"

What happened? Let's look at a few specific situations that happened during that month. The VP of sales grew the top line and met his quota. But the additional sales came from new customers who ordered frequently in small amounts. The gross margins on these orders did not cover the distribution cost. Other customers ordered products that were out-of-stock locally, and had to be shipped in from other regions—even though the customer would have been happy to substitute a similar in-stock product had he been asked or had a substitution program been set up.

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Two things are important in these situations. First, both the Sales VP and Operations VP were right on budget—the Sales VP really did grow revenues, and the Operations VP made her numbers because her budget was based on an average cost that assumed that these inefficiencies were simply part of the system. Remember that even though they made their numbers, they lost the opportunity to grow profits! Second, these accounts and orders could have been made much more profitable through some very simple "tweaks," which would have benefited the customers as well as the company. And these "tweaks" required only careful

thought and management—not a lot of capital!

In a very different industry, telecom, the same issues arise. For example, a really sharp planning manager in one of the "Baby Bells" did a great piece of analysis. He looked at customer profitability and found that the high-volume customers, that everyone pursued, were either very profitable or very unprofitable. The difference was that the very unprofitable customers were either early technology adopters or "complainers." Both of these groups of customers used an inordinate amount of customer service support. But the early adopters were needed, and supporting them was considered a good investment; while the complainers were just a sea anchor on profit growth.

#### **The solution**

Is the solution to get rid of the complainers? No—make them profitable! The company devised some insightful automated measures to help the complainers—many of whom had a legitimate need for instructional assistance—changing many of these from "bad" to "good" customers.

Yet, in the absence of this analysis, the telecom company's prime focus for sales growth was indiscriminately placed on all high-volume customers, a policy that made sense years ago in the era of simple services, but makes no sense today. The Sales VP met her growth quota. And the Customer Service VP met his average cost targets. The opportunity for major profit improvement was very well hidden. As before, these customers were not necessarily "bad" customers. They were *unmanaged customers*.

A few years ago, horizontal process management was all the rage. I remember looking at a lot of very busy slides showing the product-supply process, the order process, the product-development process, the cash cycle process, and on and on.

What was always missing was the profit management process—unseen and unmanaged.

At least one company got it right—Dell. Everyone knows about Dell's famous make-to-order system. But far fewer know that at the heart of Dell's success is a process for day-to-day demand management. Although Dell has a very fast assembly cycle, it has a much longer component order cycle that limits what it can build at any particular time. Consequently, Dell developed a system it calls "sell what you have."

"Sell what you have" has two key elements. First, top-level managers from Sales, Marketing, Manufacturing, and Purchasing meet weekly to determine where component overages and underages are likely to develop, and these are adjusted on a daily basis. Second, the order takers' computer screens show what configurations are makeable that day, and they have strong incentives to steer customers toward these—even to the point of giving a customer a more expensive option at a reduced price. This is how Dell balances supply and demand—profit management on a daily basis.

Dell's pricing reflects this real-time demand management. In an interesting study, a researcher called several PC makers daily over a ten-week period to price a particular PC configuration. Most makers' prices were stable with periodic adjustments. Dell's prices varied a lot as the company managed its prices to balance supply and demand.

How can you manage profits effectively in your company? In my next few monthly columns, I'll talk about the three key elements that you have to put in place: profit map, profit levers, and profit management process. Here's a preview of the key questions I'll answer:

**Profit map.** How can I analyze account, product, and order profitability without spending years building an activity-based costing system? How accurate do I have to be? How can I see where my company is "under water" and where the islands of high profitability are?

**Profit levers.** What are the key profit levers in managing accounts, products, and operations? How can I change "bad" accounts into "good" accounts?

**Profit management process.** How can I prioritize our profit improvement opportunities? Which initiatives have the fastest payoff? How many can we do at once? How can I get my colleagues to work with me to improve profits when they are already making their numbers? Who should take the lead?

By the way—who's managing profitability? The answer should be—YOU!

See you next month. 

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