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WHO'S MANAGING PROFITABILITY?

THE MOST IMPORTANT issue facing most managers is how to make more money from their existing business without starting costly new initiatives.

In my research and work with companies in a wide range of industries, I have found that 30 to 40 percent of each company's business—by any measure (accounts, products, transactions)—is *unprofitable*.

This sounds amazing, but it's true. In each case, a few islands of high profitability offset the damage done by all that red ink.

I first identified this phenomenon several years ago, when I advised the CEO of a large, successful lab supply distributor. Instead of simply developing a big new initiative to increase the company's profitability, we decided to look systematically at where—and *why*—it was profitable. Which customers, which products, and which situations were responsible for their profits?

We knew that every company could be improved, but we were floored by what we found. The company's biggest opportunities for profit improvement were already in hand. The key to success was not to find new things to do, but instead to systematically increase the profitability of what it was already doing.

Here's what we found:

- **Accounts.** 33 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.
- **Order lines.** 35 percent of all 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.
- **Vendors.** 40 percent of the product lines clustered by vendor were unprofitable, and an additional 38 percent were marginal, including several major vendor lines.
- **Sales channels.** Telesales achieved much better gross margins (41 percent) than other channels (36 percent for field sales accounts, 30 percent for large accounts), even controlling for other factors. But surprisingly, there was a wide range of regional employment of telesales—ranging from 3 percent to as high as 32 percent.
- **Products.** Against all expectations, fast-moving stocked products had higher gross margins (36 percent) than slower-moving ones (34 percent), and both surpassed nonstock special and custom orders (29 percent). These differences had a large, magnified impact on the company's *net profits*.

The picture that emerged: the overall profit improvement opportunity exceeded 30 percent. These potential gains stemmed from simple changes to the current business mix that could be rapidly implemented. No capital expenditures were required. And this tracked with my later findings in more than a dozen other industries ranging from steel to retail to telecom.

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. In fact, 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 profits, but few companies have a process to systematically *manage profitability* on a day-to-day basis. (By the way, this means creating real profit increases, not manipulating the numbers to create the appearance of earnings.)

The executive team has a profit plan, each department head owns an important element of that plan, and progress is watched closely. Yet even if each manager meets objectives, the company is still 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.

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I remember sitting in on a monthly operating review meeting several years ago. The company's president sat at the head of the broad mahogany table, fixed his eyes on each VP in turn, and each responded, "I made my numbers this month." At the end, he sighed 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 customers would have been happy to substitute a similar in-stock product had the question been asked or had a substitution program been in place.

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. These tweaks required only careful thought and management—not a lot of capital.

In a very different industry, telecom, the same profitability issues arise. For example, a really sharp planning manager at one of the "Baby Bells" did a great piece of analysis. He looked at customer profitability and found that the high-volume customers, the ones everyone pursued, were either very profitable or very unprofitable.

He looked carefully at the very unprofitable customers, and found that they fell into one of two categories: they were either early technology adopters or "complainers." Both of these groups of customers used an inordinate amount of customer service support. Everyone agreed that the early adopters were critical to the company's market development, and the company considered supporting them a good investment. The complainers, however, were just a sea anchor on profit growth.

The solution

Instead of simply eliminating the complainers, the planning manager saw a better way: he decided to make them profitable. The company devised some simple instructional brochures with frequently asked questions, and access to automated help lines, to aid 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 straightforward analysis, the telecom company had indiscriminately placed its emphasis for sales growth on all high-volume customers. This policy made sense years ago in the earlier mass market era of simple services, when there were large economies of scale and little need for customer support. But it makes no sense today. In this situation, the telecom company's sales VP met her growth quota, and the customer service VP met his average cost targets. But the opportunity for major profit improvement remained very well hidden. As before, these customers were not necessarily "bad" customers. They were *unmanaged customers*—just like the customers of the lab supply company.

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A few years ago, horizontal process management was all the rage. This is a very useful way to coordinate business processes (making products, selling products, collecting revenues) that cross multiple functional department boundaries. 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 profitability management process—unseen and unmanaged.

Managing profitability

How can you manage profitability effectively in your company? In the chapters that follow, I'll explain and illustrate the three key elements: profit mapping, profit levers, and a profit management process. Here are some of the key questions we will answer:

Profit mapping. How can I analyze account, product, and order profitability without spending years building an activity-based costing system (a very complicated process of assigning all of a company's costs to its business activities)? How accurate do I have to be? How can I see where my company is "underwater" 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 can I get my colleagues to work with me to improve profits when they are already making their numbers? Who should take the lead?

With these three building blocks in place, you will be able to maximize your company's profitability and achieve its full potential.

Central elements

The three key elements of profitability management described above are central to the theme of this book, reversing embedded unprofitability. They are woven throughout the whole book and illustrated in every section.

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THINGS TO THINK ABOUT

1. Nearly every company is 30 to 40 percent unprofitable by any measure.

2. In almost every company, 20 to 30 percent of the business is highly profitable, and a large proportion of this profitability is going to cross-subsidize the unprofitable part of the business. The rest of the company is marginal.

3. Most current business metrics and control systems (budgets, etc.) do not even show the problem, or the opportunity for improvement.

4. Most of the unprofitable and marginal business can be turned around using the three key elements of profitability management: profit mapping, profit levers, and a profitability management process. Think about what it would do for your company—and your career prospects—if you took the lead in turning this around in your business.

What's Next

The next chapters of this section give you a broad overview of why the problem of embedded unprofitability arose at this point in time, and what you can do about it. They also tell you how several successful companies have made stunning improvements in their profitability using the principles explained in this book.