Profit Pitfalls

When I talk to managers about profit generation, I'm often asked about profit pitfalls – logic traps that lead to major profitability drains. Here are three big offenders:

- *Contribution* – Why shouldn't we take business that contributes to overhead, even if it doesn't cover full cost?
- *Product line* – Why shouldn't we carry products that lose money if they are part of a product line that makes money overall?
- *Traffic drivers* – Why shouldn't we carry money-losing products if they attract customers who then buy very lucrative products so we make money overall?

Each of these questions seems to have a perfectly logical answer that leads to the suggestion that it is OK to carry money-losing business. Maybe, the Sea of Red Ink is not so bad after all.

But think about each question carefully.

Contribution

The question of contribution is one I hear in almost every talk and meeting. After all, the question goes, if our warehouses and trucks are not full, isn't it better to take some business that helps cover the cost, than to leave them partly empty? Sounds sensible.

There are two big problems with this logic.

First, if a company takes business that doesn't pay full freight, it also needs a strict "sunset" mechanism to throw out that business (or reprice it) when full-freight business becomes available. In fact, companies almost never do this.

Instead they keep the marginal business because it provides "volume." When new business moves them beyond capacity, they simply build more capacity. The logic always is that the marginal business provides a contribution. Over time they wind up with a warehouse full of mixed business – some paying its way, some not. This is the source of the Sea of Red Ink.

The second problem is much more insidious. If there is full-freight business available that has not been sold, the company is implicitly letting the sales reps "off the hook" by allowing them to fill their quota with marginal business. The false logic of taking business that covers variable cost but doesn't pay for full cost removes the pressure on sales reps to do what they need to do: continue to sell until they bring in lucrative business.

The net effect: Islands of Profit in a Sea of Red Ink. And no one knows where it came from.

Product line

The second profit pitfall also seems to have an unassailable logic. Since customers want a supplier with a full product line, it seems obvious that a company has to have some losing products in order to make money on the product line overall.

This seems completely logical. But think about it carefully.

If this logic is true, than the company is essentially making an investment. It is investing in carrying money-losing products in order to generate *incremental* sales in other products that not only are profitable, but importantly, also cover the losses on the portion of the product line that is underwater.

I can understand this thought process – but it only makes sense if the company calculates the return on this investment, and shows that it is a good investment. How many companies do this?

The counter argument is that it is impossible to do this calculation. However, with a profit map, showing the net profitability of every product in every account – and every account's buying pattern – you can quickly make this determination. (I explain how to build a profit map in my book, *Islands of Profit in a Sea of Red Ink*.)

Here is a companion reason why product line logic is a profit pitfall. It assumes that you have to be a full-line supplier. In fact, a quick look around business over the past decade or two shows that many very successful companies like Wal-Mart do very well by positioning themselves selectively in key product categories, and competing on price. It goes without saying that the rock-bottom low prices are generated by streamlining the supply chain and eliminating the extraneous products.

Instead, all too many companies simply assume that they have to provide rapid service for a full product line at prices that are competitive with narrow-line competitors.

There is a way to do this, however. If you keep your steadily-consumed, fast-moving products in local distribution centers, and your other products in consolidated national or regional facilities, you can lower your cost to serve on the slower-moving products so you can carry a full line and make money on all or most of it.

Of course, your customers will have to agree to a slight delay. But here's the leverage point. You can keep enough local stock of slow moving products for the customers who really are buying a full product line – if you have a profit map that enables you to identify them. For the customers that are cherry-picking you, they either can wait a little, or pay an expediting fee, or broaden their purchases to move into your favored customer category.

This is the power of profit mapping in action.

Traffic drivers

The third profit pitfall, traffic drivers, is very common. Here's the apparent logic.

Your product strategy centers on attracting customers with a "loss leader" – a product or category that is priced low in order to develop further high-margin sales.

Think about consumer electronics. The new DVDs and CDs hit the shelves on a certain day, and the consumer interest plus attractive pricing generates a lot of business. The retailer may be losing money on this category, but the logic is that the company will make it up in other high-margin purchases.

Almost every supplier has business that looks like this.

When you think carefully about this product strategy, it is similar to the product line logic analyzed in the prior section.

Essentially, the company is making an investment in pricing a traffic driver below full cost in order to generate high-margin sales elsewhere. But how many companies actually track this in order to determine the real return on investment? In practice, very few.

As in the case of the product line profitability, a profit map will quickly show which customers, *over time*, produce a threshold return on investment on the traffic drivers they consume. Armed with this knowledge, the company can build a smart set of incentives and linkages to move customers to the desired buyer behavior.

Where a customer is simply cherry-picking the traffic driver, the company can develop appropriate measures to minimize the losses.

Profit logic

What these three common profit pitfalls have in common is that each seems so logical.

After all, why shouldn't you take business that helps pay for the overhead? Why shouldn't you carry some losing products in order to make money on the whole line? Why shouldn't you offer some loss leaders, or traffic drivers, to draw in customers who will buy high-margin products?

The truth is that each of these profit pitfalls has a reasonable-sounding logic. The really big issue, however, is determining *where* the logic produces sound results.

The problem is that in most companies, the policy that follows from the logic is applied indiscriminately, rather than targeted specifically at customers and situations where it makes sense – and not where it doesn't fit.

The power of profit mapping is that it allows you to draw a line in the sand, and make this precise distinction.

In this way, profit mapping enables you to build your Islands of Profit, while at the same time draining your Sea of Red Ink.