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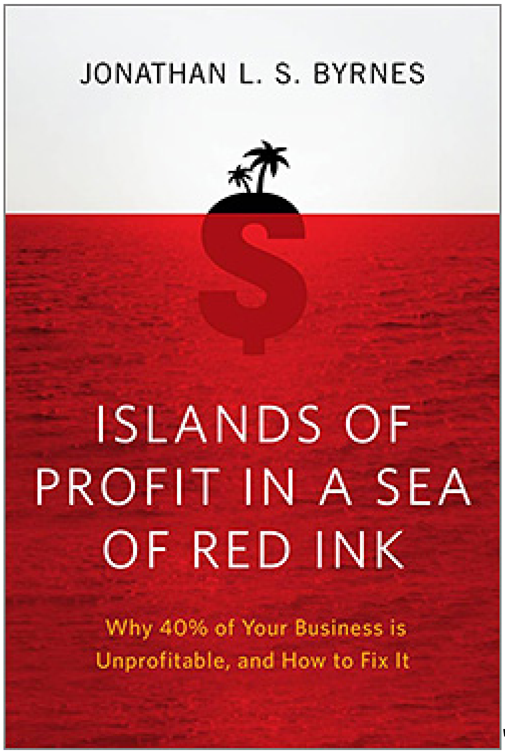
The Profit Cycle: A Tale of One Business's Turnaround

By Jonathan Byrnes



"Watch out for the bump in the road," Grace blurted out.

Mike glanced down at the newly patched pothole, and braked his bicycle to a stop. Grace stopped beside him. Mike turned to her, "You know, I could take that two ways."

Grace smiled. Mike had been her bicycling partner since college. In the distance, the Cambridge Reservoir presented a lovely early morning tableau. The maple trees were just turning blood red and yellow, and there was a slight mist rising from the water. "I thought your company was growing."

Mike paused. "That's the problem. Our revenues are rising, and our profits are falling. I'm working really hard, but it feels like I'm falling further and further behind."

Grace visualized the changes she had managed over the past year as president of her distribution company. She understood Mike's challenge--managing his fast-growing software company.

"I went through this last year, Mike. The good news is that you can grow your revenues and boost profitability at the same time."

"I'd really like to hear about it. I'm pretty good at product development and selling. I thought we'd be profitable if I nailed these. I don't know what else to do."

Grace and Mike cycled over to a bench by the water, and Grace began to tell Mike about how she led her company's profitability turnaround. Here's her story:

Grace's story

It all started about a year and a half ago. Grace was president of a $30 million distribution company that had the problem Mike's company now faced: revenues were rising, and profits were falling. She was puzzled, so she went to a talk at MIT on profitability management.

The speaker outlined a four-step process for managing a profitability turnaround: (1) develop the right information, (2) institute the right priorities, (3) create the right processes, and (4) establish the right compensation.

Grace was surprised. The process seemed very straightforward and logical, but different from the way that she managed day-to-day operations and growth. She was also surprised that so many managers she met at the talk had the same problem--and reaction.

After the talk, Grace kept thinking about the speaker's words at end of the lecture. The first step is to develop the right information, which he called a "profit map," which two managers could create in a month or two using standard desktop tools. "You'll be amazed at what you see."

A few weeks later, Grace reviewed her quarterly results and became concerned. The tough economy had slowed her sales, and profitability was plunging quickly. The next morning, she decided to develop a profit map.

The right information

The process was straightforward. She tapped an experienced marketing manager, who was open-minded and analytically inclined, and a rising senior finance analyst. They created a database of every order line over the past three months. Their objective was to develop an "income statement" for *each order line*.

Each order line already had information on the product, customer, price, and product cost. They developed a few tables to add other important cost elements, like whether the customer was near to or far from the warehouse, whether the product was fast, medium, or slow moving, and whether the customer was served by the web, by telesales, or by a sales rep. There were other cost factors as well.

They were careful to heed the MIT speaker's advice to work at "70% accuracy," and they were amazed at how fast the process went compared to activity-based costing.

Once the database was complete, they used a standard database program to hunt for profits. They were astounded by what they saw. The MIT speaker had said that virtually every company was 30-40% unprofitable by any measure, and 20-30% of the business provided all of the reported profits and subsidized the losses. That's exactly what they saw.

They were surprised that many of their best accounts were only marginally profitable, even though they had good gross margins. They also saw that even large, profitable customers had 20-30% unprofitable products, and that these could be made profitable with some surprisingly simple changes.

When the team showed this information to the company's management committee, they were asked to check some specific customers. They double-checked, and found that they were right the first time.

The right priorities

Grace reconvened her management committee. The VP of Sales started by saying that they couldn't just "fire" the unprofitable customers. Grace thought about the MIT talk, and replied that "firing customers" was not the priority, and was not even on the agenda.

She said that her biggest concern was that the company's survival was riding on 20-30% of their business. Grace was afraid that all of the customers were getting the same service and pricing, when many of the best customers had good forecasts, flawless ordering, and steady order patterns. Her best customers were being overcharged and underserved. The company's biggest danger was the likelihood of a competitor targeting these accounts.

Grace explained the priorities she had heard at the talk. First, secure the best business by investing in great service and other innovations to make the customers more profitable--the MIT speaker noted that this typically raised sales by over 35%, even in highly penetrated accounts. Second, get more good business, chiefly by focusing on growing high-potential underpenetrated accounts. Third, the MIT speaker had described a number of what he called "profit levers" to turn around marginal accounts. Finally, reprice the few remaining unprofitable accounts to compensatory levels.

The right processes

The management committee agreed with Grace's priorities, and started a process to prioritize the company's accounts. By the end of the quarter, they were delighted by the early results. They were also startled that the improvements generated an enormous amount of cash as the company's inventories, sales, and shipping expenses plunged.

At a subsequent management committee meeting, the VP of Marketing asked how they could better coordinate with each other so the company could remain highly profitable.

Grace thought about the MIT talk, and suggested that the management committee institute three core processes to get sales, marketing, and supply chain management on the same page.

The first process was to standardize customer relationships. Grace proposed that sales, marketing, and supply chain define four to six standard relationships, ranging from arm's-length to highly integrated, that would be offered to customers. Each customer relationship would have clear value for both customer and supplier, and an explicit to-do list for each party.

Grace recalled visiting a distribution center in which 40% of the cost came from non-standard requests from small customers, and she felt strongly that developing a standard set of customer relationships would enable the supply chain group to keep costs under control while producing terrific service.

Second, all three departments would coordinate on market mapping, the process of matching customers to the relationships that they should wind up with. Because a customer targeted for a highly integrated relationship had to be willing and able to partner, supply chain managers had a critical role in the customer assessment process.

The third core process was account development and account management. Grace thought about the current process: sales developed an account and brought in the supply chain managers for a courtesy call. The MIT speaker had described a very different process--in accounts targeted for integrated relationships, supply chain managers should meet with their customer counterparts early in the sales process because they would naturally work together to drive down their mutual costs. This process would develop big customer profitability increases that create enormous sales increases. Grace suggested shifting to this process.

The right compensation

The management committee agreed to create the three core processes, and turned to the question of compensation. The VP of Human Resources noted that the hallmark of sales is "work your pay plan." She explained that as long as sales reps were compensated on revenues, there would be a disconnect between sales and company performance. She also observed that sales reps needed to focus on a small number of very understandable measures.

The management committee outlined a new sales compensation program that would reflect their new priorities, including a simple "red-yellow-green" system for communicating the profitability objectives for specific accounts.

Mike's reaction

Grace finished her story by telling Mike that her company's profits had risen by over 30% within a year, even in a difficult economy, and she saw a clear pathway to strong growth with high sustained profitability year after year. "We are posting strong gains in market share with surging profits. I wouldn't have believed it."

Mike asked whether he could use the same process in his software company.

"Before the MIT talk, I would have said, 'No way.' But now, having been through it, I'd say, 'Absolutely.'"

"I'll bet you have the same profitability pattern I heard described at MIT. In fact, the speaker had worked with leading companies in an broad range of industries--distribution, telecom, steel, high tech, financial services, and more--and they all looked the same. The process we went through was completely logical and straightforward. But it was very different from anything we had done before. Even my most skeptical managers came up to me afterwards and asked why we had not done it earlier."

Mike thought for a moment, "I'll give it a try tomorrow. What did you say was the first step?"

"Develop a profit map. We were amazed and you will be too."

"Thanks, Grace. For the first time in a long while, I'm actually looking forward to Monday morning. Let's finish our ride."

Jonathan Byrnes is Senior Lecturer at MIT, and author of Islands of Profit in a Sea of Red Ink *(Portfolio, 2010). He is an acknowledged authority on profit generation and profitability management. He holds a doctorate from Harvard University.*
