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Managing Profitability: One Year Later

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A look back and a look forward on how managers can better turn unprofitable operations into a bottom-line plus.

by Jonathan Byrnes

The most important issue facing 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.

A year ago, I opened my debut *HBS Working Knowledge* column with these words. The column was widely reprinted by a number of organizations, industry associations, and companies all over the world. Dozens of managers told me they agreed.

Today, on the first anniversary of "The Bottom Line" columns, the message still rings true. However, now the question on the table is, have you managed your company's profitability this past year? But first, let's review the past year's columns.

Managing profitability

The first column, "Who's Managing Profitability?" observes that in most companies, everyone pays attention to profitability, but few companies have a process to systematically manage profitability on a day-to-day basis.

The column relates an anecdote about the president of a company. "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.'"

In most companies, the executive team has a profit plan, each department head owns an important element of the plan, and progress to plan 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.

The column identifies three key elements of a profitability management system: profit map, profit levers, and profit management process. The following eleven columns explain and amplify these elements, providing an integrated view of how managers can improve their companies' profitability.

Customer fit

The key elements of profitability management were illustrated here. The column's title, "Which Customers Don't Fit," refers to the fact that in most companies top managers would not agree on a list of the top five customers, products, and services that *shouldn't* be pursued. This occurs because they have different tacit assumptions about the business, and this underlying conflict causes the profitability problems I describe in my first column.

The column outlines a detailed case study of profitability management reported by a reader, in which his major national trucking company more than doubled its profitability in a surprisingly short period of time. The company's executives had the clarity of thought to identify the customers that fit the company's business model, and to adjust the business model to fit the most attractive set of customers. Most importantly, they built an effective management process to drive new profits.

Profit map

Two subsequent columns explain the principles of profit mapping. 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.

"The Hunt for Profits" details a five-step profit mapping process. The column also identifies the critical prioritization in profitability improvement: (1) secure your best customers, (2) obtain more of the best customers, (3) improve the profitability of your marginal customers, and (4) divest your unprofitable customers.

"The Problem With Planning" further develops profit mapping by introducing integrated profitability planning, a powerful management tool. This process is based on a technique for gauging the latent profitability, or unrealized profit potential, of both a company's existing business and its potentially obtainable business. The column illustrates this process with specific examples showing how to identify your highest payoff situations, and how to align and focus your resources to maximize your company's profitability.

Profit levers

Profit levers are techniques for managing accounts, products, and operations that significantly improve profitability. The first and foremost priority in profitability management is to secure your best customers. "Profit from Customer Operating Partnerships" describes one of the most effective ways to accomplish this.

Customer operating partnerships are customer-vendor arrangements featuring tightly-linked extended supply chains that offer tremendous gains, including (1) 20 percent to 35 percent share increases even in the highest penetrated, most profitable accounts; (2) a shift to a strategic positioning as a highly service-differentiated supplier, even for companies who are stuck as commodity providers subject to constant price wars; (3) a direct sales relationship with value-oriented top customer executives, rather than price-oriented purchasing managers; and (4) a highly defensible competitive position with switching costs.

Today, most leading companies are reducing their supplier bases by 50 percent or more. The most desirable customers are seeking more intensive operating partnerships with fewer, more capable suppliers. This is creating an historic opportunity for rapid market share gains.

The column describes in detail the process of creating and selling effective customer operating partnerships. It illustrates the process with a comprehensive case study of the hospital supply company that pioneered vendor-managed inventory.

"Out-of-the-Box Customer Service" continues the theme of developing tight links with the best customers. Today, the definition of customer service is shifting fundamentally from quality-oriented goals, like keeping promises and meeting expectations, to innovation-oriented goals, like anticipating customer needs and creating new sources of profitability for the customer. The column offers concrete examples of companies that have grown market share dramatically while reducing costs by creating new forms of customer service. It explains the process of creating out-of-the-box customer service innovations.

Importantly, a well-packaged critical mass of customer services can shift a company from a commodity-like positioning to a highly differentiated positioning.

"Who Will Profit from Auto-ID" describes the tremendous impact that this new supply chain technology will have on the profitability of retailers, distributors, and the manufacturers that supply them. Wal-Mart has already mandated that their top 100 suppliers must be compliant with this technology by the end of 2004. Auto-ID will have a great impact on many other industries as well. This technology creates new sources of value, but entails great costs and risks. Those who move aggressively and early with this technology will secure large market share increases in their best customers; those who wait and see will be left far behind, struggling with both market share and profitability problems. The column offers a six-step process to guide managers in developing a plan.

Turn "bad" customers into "good" customers

Once a company secures its best business, and commences a search for more of this business, it is important to find effective ways to increase the profitability of the remaining marginal business. "The Dilemma of Customer Service" addresses this issue.

Customer service is one of the most important levers of profitability, but one of the least understood. Most managers can improve customer service and lower costs at the same time, but this requires that they reexamine some important assumptions about how customer service is defined, measured, and managed. Customer service is a prime area for profitability improvement through insightful management.

The key to profitability improvement is service differentiation—setting appropriate service intervals (e.g., order

cycle time, delivery time) for different sets of customers and products. Given an appropriate set of service intervals, a manager can provide customers with near-perfect service at a reasonable cost. The column offers a three-step process for creating effective service differentiation.

"Profit From Managing Your Product Flow" shows how intercompany (customer-vendor) cooperation can stabilize erratic replenishment patterns and increase profitability, especially with major accounts. The column explains how to develop an effective product flow management program, and illustrates it with a detailed case study. The column also identifies why several competitors failed in trying to achieve the same objective.

"Profit-Focused Selling" parallels the theme of service differentiation, but applies it to the selling process. These both are profit levers because they lower service cost or selling expense, relative to the gross margin of an order. The column describes the case example of a general manager that had increased his company's net profits by over 50 percent by matching his selling resource to account potential. The general manager drove the sales force to accomplish his objectives by developing a new sales compensation system and complementing it with an extensive customer education program.

"Supply Chain Management in a Wal-Mart World" addresses one of the most pressing issues in supply chain management today. Increasingly, top managers have learned how to integrate their supply chains with major customers like Wal-Mart. What most companies have not sorted through, however, is what to do with all of their other customers.

Drawing from the paradigm of service differentiation, introduced in "The Dilemma of Customer Service," the column shows how to create a service differentiation matrix for the retail industry. The matrix has four cells: strategic accounts, integrated accounts, emerging accounts, and stable accounts. Each account cluster requires a very different set of account relationships and supply chain structures. The column describes the appropriate relationships and supply chain structures for each cluster of accounts.

The sea changes that retailers and their suppliers are now experiencing are starting to play out in industry after industry. The evolving retail supply chain, which I analyze in this August column and in "Who Will Profit From Auto-ID?" provides a model for top managers in these other industries as they face the seemingly impossible dilemma of providing excellent service with limited resources in the presence of escalating customer demands.

Profit management process

The case of Dell, "Dell Manages Profitability, Not Inventory," provides a stunning example of an effective profit management process. A profit management process is a set of steps a manager can take to develop and implement a systematic program for profit improvement. Over a four-year period, Dell's revenues grew from $2 billion to $16 billion, a 50 percent annual growth rate. Earnings per share increased by over 62 percent per year. Dell's stock price increased by over 17,000 percent in a little over eight years, and Dell's return on invested capital was 217 percent in the peak year.

Dell achieved these amazing results through a tight, comprehensive profitability management program that involved: (1) account selection, (2) demand management ("sell what you have"), (3) product lifecycle management, (4) supplier management, (5) forecasting, and (6) liquidity management. The column describes in detail how Dell manages these factors to maximize its profitability, and how Dell developed its innovative system. It also explains how Dell structured its internal management processes and created a set of management meetings to manage its profitability so effectively on a day-to-day basis.

The case of Dell demonstrates that effective profitability management requires clarity of vision and a commitment to great management of the day-to-day details of the business. However, profitability management does not require capital; it generates cash.

This year profitability—next year even more

Over the past year, I have heard from many managers who have successfully improved their companies' profitability by employing the processes described in these columns. Other managers are facing the opportunity with concerns. Several of these concerns stand out: (1) too much complexity to see a pathway, (2) too many moving parts to manage, (3) too much risk of failure, (4) too hard to get people to change, and (5) too much going on elsewhere to get to it.

When we talk through these concerns, however, we usually come to the same conclusion: The obstacles can

be realistically overcome, but it appears to be much easier to spend money on new initiatives than to get people to change. This is a common concern, but unfounded. Being a change agent is not as hard as it looks. The columns describe how a number of effective managers have taken the straightforward, stepwise pathway to improved results that profitability management offers.

In many industries today, especially those in which customers are aggressively consolidating their supplier bases, profitability management is a matter of survival. In this coming year, I will address the implementation issues, including how to develop and install a profit management process, while I continue to explain effective new profit mapping techniques and profit levers.

By the way, who managed profitability? If the answer is *you*, be assured that next year's results will be even better!

See you next month.

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