INTRODUCTION

ISLANDS OF PROFIT in a sea of red ink. The fundamental premise of this book is an astonishing proposition: nearly 40 percent of every company is unprofitable by any measure, and 20 to 30 percent is so profitable that it is providing all the reported earnings and cross-subsidizing the losses. The rest of the company is only marginal.

I first discovered this about twenty years ago in work that I did with one of the premier companies in the laboratory supply industry. Since that time, I found the same pattern in my research and consulting with leading companies in industries as diverse as hospital supplies, telecommunications, and steel. And these were not laggards; they were among the highest-performing firms in business.

In these projects, I created a systematic process for analyzing a company's profitability, and I developed a number of "profit levers" for turning unprofitable business into good business, and good business into great business.

Two puzzling questions

This work raised a couple of very puzzling questions: Why is this occurring now in so many companies across all industries? Why is it difficult for managers to get their arms around this huge opportunity, and to act on it?

When I explored these two issues with a number of insightful managers, it became clear that the answer is rooted in a major, historical transition that business is going through today: a change from the prior Age of Mass Markets to a new era in business, the Age of Precision Markets (more on this later). The underlying problem is that most of the management processes and control information in business were developed in the prior era, and are no longer appropriate.

This is the cause of the high level of embedded unprofitability in industry after industry. It means that effective managers today not only have to understand how to profit from this huge new opportunity, they also have to recognize the sources of resistance, and be adept at managing constructive, paradigmatic change.

HBS *Working Knowledge*

A few years ago, Sean Silverthorne, the editor of Harvard Business School's *Working Knowledge* e-newsletter, suggested that I write a monthly column on this subject. Over the course of four years, I wrote a series of columns that covered these topics.

I remember when I wrote my first column, "Who's Managing Profitability," which forms the basis for the first chapter of this book. *Working Knowledge* has a readership of tens of thousands of managers all over the world, and the premise of the column was that in most companies, *no one* is managing profitability effectively. I held my breath when the column went out over the Internet on a Monday morning, wondering what the reaction would be.

The reaction was immediate and decisive. My in-box was flooded with dozens of e-mails from managers agreeing with my conclusions.

I wrote nearly fifty columns on profitability management. In each one I explained how to systematically improve a core business process in a practical, hands-on way. I wrote the columns to be high-impact guidelines for action, designed to be read quickly on the Internet—lots of meat without much fat, most with a very precise to-do list at the end.

Most of my columns were widely reprinted in other publications. Many are used in university courses and training programs. Each of these columns was read by and vetted against the experience of thousands of managers. To this day, no one has disagreed with my conclusions and recommendations.

■ ■ ■

Overview of this book

A number of managers have asked me to develop my *Working Knowledge* columns and some of my other writings into a book. The book that you have in hand is the result of these requests.

I've kept the action-oriented format, and I've organized the chapters into four topics:

- Thinking for Profit
- Selling for Profit
- Operating for Profit
- Leading for Profit

This book is about how to make more money from an existing business without costly new initiatives. Its chapters tell you how to systematically improve your business, land the best customers, build your managers' capabilities, and secure your future through thoughtful, effective management. These improvements will not cost you money; in fact, almost all of them will generate profits and cash from the start.

This is a handbook for all the managers in your company, whether you're a global conglomerate or a local shop with five employees. Regardless of the size of your business, it will guide you in moving your business up to its full potential.

At the end of each chapter, I've included a section called "Things to Think About," which highlights the chapter's critical points and suggests how to put them into action. In my courses at MIT, I conclude each class session this way to help my students consolidate their understanding and relate it to their careers. Many have said that this is one of the most valuable parts of my teaching. Several have told me that they keep a typed version of these comments close at hand for reference.

This book follows a logical sequence that enables you to understand the new opportunities, identify the most productive courses of action, and lead the creation of a high-performing management team. I designed the format to help you thumb through to, or return to, the topics that interest you, and easily share these ideas with your colleagues and associates. You should follow your interests, but reading the whole book in order will give you the complete picture you need to manage effectively in today's new era of business.

New era in business

Why are these huge opportunities present in so many companies today? The answer lies in the sea change that's taking place in business, which I explain in chapter 3, "The Age of Precision Markets."

Today, business is going through a transition from one era to another, from an era of mass markets to an era I call the Age of Precision Markets. In the old era, companies distributed their products as widely as possible using arm's-length customer relationships. Their goal was mass production and mass distribution. In the mass-market era, broad management measures like aggregate revenues and costs were adequate for maximizing profitability. Almost all the management systems and processes in companies today are implicitly geared to meet this legacy objective.

In the new era, however, companies increasingly form different relationships with different sets of customers. These relationships range from arm's length to highly integrated, and include almost everything in between. Today, leading companies are reducing the ranks of their suppliers by 40 to 60 percent or more, creating enormous new opportunities for their most capable suppliers to dramatically increase profits and market share.

The successful business today creates huge competitive advantage and high sustained profitability by developing innovative customer relationships and new types of customer value, and by aligning its internal processes. However, this is a two-edged sword: if customers are matched with the right relationships, and the new value is compelling, sales and profits can increase . . . but if these matches are not done well, profitability plunges.

In this new world, the broad metrics and management approaches of the past no longer enable managers to maximize their companies' profitability. This is the underlying reason for the problematic profitability patterns I've seen so often. It creates an enormous new set of opportunities for the manager who wants to take up the challenge to manage in a new way.

The chapters in this book chronicle this transition and tell you how to create the successful business of the future—what to do, how to do it, what difficulties you'll probably encounter, and how to overcome them. My objective, the reason I wrote this book, is to give you the road map, perspective, and tools that you need to be a highly effective manager in this new era of business.

Your own best practices

Think about this. Imagine that someone took a comprehensive video of everything that went on in your company over the course of a year, and then edited it carefully to pull out your own best practices. When you view the edited film, I'm certain you'd see the best company in the world.

The problem, however, lies on the cutting-room floor: all the rest of your company's activities that don't live up to your own best practice. When you look at your company's actual performance—net profits, market share, customer relations, operations efficiency—you're looking at a blend of your own best practices and everything else that doesn't meet this standard.

How important is this? It creates the profitability pattern that is the core of this book: islands of profit in a sea of red ink.

When my first *Working Knowledge* column appeared on the Internet, several thoughtful managers sent me notes sharing their experiences.

One CEO wrote to say that he saw this pattern in his company. His biggest concern was how vulnerable he would be if a competitor focused on picking off his most profitable customers.

A senior vice president of sales wrote, "I guess I have two ways to get a 30 percent profit increase: boost my sales by 40 percent, adding a lot of new low-margin business, or focus on managing the day-to-day details of the business. It's a pretty easy choice."

These executives' reactions sum up what this book is about. There is an enormous amount of money to be made by improving the business you already have in hand. For some managers, it's easier to spend money on glossy new initiatives than to systematically improve the business. But when your business is tuned up to its full potential, you can drive it like a Ferrari. It's hugely fun and immensely satisfying to manage. It's also very rewarding.

Who should read this book

This book is designed to be a handbook of profitability management, one that a top manager in either a large or small company can give to every manager in his or her organization. However, in my experience corresponding with readers, particular sets of managers are especially interested in certain material. Here's a quick guide.

TOP MANAGERS (CEOs, vice presidents, and general managers). These managers need to read the book from cover to cover in order to develop effective profitability management programs and guide their subordinate managers. Most top managers have been particularly interested in the material in sections 1 and 4. In particular, chapters 1, 2, 3, 4, 9, 10, 16, 17, 19, 25, 26, 31, 32, 33, and 36 have generated a lot of top management e-mails. Chapters 31 and 32 are especially critical for this group.

CFOs. This whole book is extremely relevant for a CFO. If a CFO wants to read selectively, I suggest starting with chapter 9, then continuing with chapters 1, 2, 3, 6, 7, 8, 10, 12, 14, 19, 20, 21, 24, 25, 27, 32, and 34.

Department heads (director-level managers). These managers are the heart of all successful profitability management programs. They need to understand the overall concepts, and must coordinate with their counterpart department heads. For all these individuals, sections 1 and 4 are critical. In addition, they should do a “deep dive” in their respective areas of responsibility, and also develop a general understanding of their counterparts’ respective areas of management. Above all, department heads must develop a very clear understanding and practical appreciation for chapters 28, 31, and 32, which explain change management and organizational effectiveness.

Front-line managers. A front-line manager should focus on developing and managing the profit levers in his or her area of responsibility. Sections 2 and 3 provide deep knowledge in this area. Beyond this, the overall understanding of profitability management that section 1 provides, and the broad overview of leadership that section 4 provides (especially chapter 36), will give a front-line manager an important leg up on career advancement.

Small business owners/managers and entrepreneurs. The name of the game for these managers is to go as far as possible with as few resources as possible. These individuals should focus strongly on section 1, especially chapters 2, 5, 6, 9, and 10. In addition, the chapters in sections 2 and 3 offer a number of concrete ways to maximize asset productivity and cash flow. Chapters 11, 12, 13, 15, 16, 18, 19, 21, 22, and 23 are especially relevant. In section 4, chapters 27, 29, 30, and 35 are very important to this group.

Major profitability and market share increases

All the chapters in this book are based on work that I’ve done directly with great companies and creative managers over a period of more than twenty years. In most of these consulting projects, I have worked directly with the top-level executives of leading companies to create new strategic initiatives and new ways of doing business that have transformed their companies and industries. I have been very fortunate that I've been given the scope to "challenge everything" and look for innovative ways to make things better. This book is the direct result of these experiences.

In addition to my corporate work, I'm a teacher. I have taught graduate students and executives at MIT for nearly twenty years. Thousands of my former students are putting these ideas into practice every day, and letting me know about their successes.

I hope that this material helps you transform your company, and I look forward to hearing about your experiences.

The most important issue facing most managers is how to make more money from their existing business without starting costly new initiatives. Here's how to do it.

1

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.

On budget and just as good as the competition is simply not good enough.

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.

In most companies, no one is responsible for managing the interaction of these elements to increase profitability to its full potential.

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.

■ ■ ■

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.