



The Bottom Line: Who's Managing Profitability?

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The most important issue facing most managers in this difficult economy is making more money from an existing business without costly new initiatives. Here's how to do it. by Jonathan Byrnes



Jonathan Byrnes

The most important issue facing most 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.

Let's look at the case of a lab supply distributor:

Thirty-three 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.

Thirty-five percent of all transaction (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.

Forty percent of the product lines clustered by vendor were unprofitable, and an additional 38 percent were marginal, including several major vendor lines.

Telesales achieved much better gross margins (41 percent) than other channels (36 percent for field sales territory accounts, 30 percent for large accounts), even controlling for other factors. But I was surprised to see that there was a wide range of employment of telesales—ranging from a low penetration rate of 3 percent in the lowest region to a high of 32 percent in the highest region.

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

— Jonathan Byrnes

Against all expectations, fast-moving stocked products had much higher gross margins (36 percent) than slower-moving ones (34 percent) and both surpassed non-stock special and custom orders (29 percent).

The picture that emerged: The overall profit improvement opportunity exceeded 30 percent. These potential gains stemmed from management adjustments to the current business mix, and could be rapidly implemented. Capital expenditures were not required. And this tracked with findings in other industries.

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. 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 profitability, but few companies have a process to systematically *manage profits* on a day-to-day basis. (Note: This means

creating real profit increases, not manipulating the appearance of earnings.)

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

I remember sitting in a monthly operating review meeting several years ago. The company's president sat at the head of the table. We were in a windowless conference room with all of the vice presidents and a number of directors. 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!"

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 customer would have been happy to substitute a similar in-stock product had he been asked or had a substitution program been set up.

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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. And these "tweaks" required only careful thought and management—not a lot of capital!

In a very different industry, telecom, the same issues arise. For example, a really sharp planning manager in one of the "Baby Bells" did a great piece of analysis. He looked at customer profitability and found that the high-volume customers, that everyone pursued, were either very profitable or very unprofitable. The difference was that the very unprofitable customers were either early technology adopters or "complainers." Both of these groups of customers used an inordinate amount of customer service support. But the early adopters were needed, and supporting them was considered a good investment; while the complainers were just a sea anchor on profit growth.

The solution

Is the solution to get rid of the complainers? No—make them profitable! The company devised some insightful automated measures to help 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 analysis, the telecom company's prime focus for sales growth was indiscriminately placed on all high-volume customers, a policy that made sense years ago in the era of simple services, but makes no sense today. The Sales VP met her growth quota. And the Customer Service VP met his average cost targets. The opportunity for major profit improvement was very well hidden. As before, these customers were not necessarily "bad" customers. They were *unmanaged customers*.

A few years ago, horizontal process management was all the rage. 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 profit management process—unseen and unmanaged.

At least one company got it right—Dell. Everyone knows about Dell's famous make-to-order system. But far fewer know that at the heart of Dell's success is a process for day-to-day demand management. Although Dell has a very fast assembly cycle, it has a much longer component order cycle that limits what it can build at any particular time. Consequently, Dell developed a system it calls "sell what you have."

"Sell what you have" has two key elements. First, top-level managers from Sales, Marketing, Manufacturing, and Purchasing meet weekly to determine where component overages and underages are likely to develop, and these are adjusted on a daily basis. Second, the order takers' computer screens show what configurations are makeable that day, and they have strong incentives to steer customers toward these—even to the point of giving a customer a more expensive option at a reduced price. This is how Dell balances supply and demand—profit management on a daily basis.

Dell's pricing reflects this real-time demand management. In an interesting study, a researcher called several PC makers daily over a ten-week period to price a particular PC configuration. Most makers' prices were stable with periodic adjustments. Dell's prices varied a lot as the company managed its prices to balance supply and demand.

How can you manage profits effectively in your company? In my next few monthly columns, I'll talk about the three key elements that you have to put in place: profit map, profit levers, and profit management process. Here's a preview of the key questions I'll answer:

Profit map. How can I analyze account, product, and order profitability without spending years building an activity-based costing system? How accurate do I have to be? How can I see where my company is "under water" 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 many can we do at once? 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?

By the way—who's managing profitability? The answer should be—YOU! See you next month.

Jonathan Byrnes is a senior lecturer at MIT and president of Jonathan Byrnes & Co., a focused consulting company. He earned a doctorate from Harvard Business School in 1980 and can be reached at jlbyrnes@mit.edu.

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The Bottom Line: Which Customers Don't Fit?

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*Asking yourself which customers, products, and services don't fit your business model can reveal quickly whether your company is managing profitability effectively, and whether your key managers' actions are aligned, argues **Jonathan Byrnes**. How to start? Get an earful from your managers.*

by Jonathan Byrnes



Jonathan Byrnes

Part II

Try this today. Sit down for thirty minutes with the managers who run your company's major departments (sales, operations, etc.), and ask each one to write down the names of five significant customers who shouldn't be sold to, five products that shouldn't be carried, and five services that shouldn't be provided.

Surprisingly, in many companies, the managers' lists would be so different that an outsider would think they were from different companies.

Why? Because most companies don't manage profitability on a day-to-day basis—coordinating sales and operations to maximize profits to the fullest potential. Consequently, they have a few islands of high profitability, but lots of unprofitable accounts, products, and transactions.

As the president of a healthcare company said, "We see the same thing in our company. I worry about the risk of having so much riding on such a small portion of the business."

The questions of which customers, products, and services don't fit are penetrating diagnostics. They tell you quickly whether your company is managing profitability effectively, and whether your key managers' actions are aligned.

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—Jonathan Byrnes

Startling profit opportunities can be found in their answers. This was the message of last month's column, which gave examples of the 30 percent or more profit increases available.

When you think about it, though, the question of fit really has two parts: *what fits?* and, *fits what?* A company has to get both right to manage profitability effectively, and they are closely related.

A manager answering *what fits* needs to think about customers, products, and transactions in a methodical way. To answer *fits what* the manager must focus on the company's business model (internal business processes and the way the company engages the market), shaping it to maximize the company's profit potential.

These *what fits* and *fits what* questions are answered through a process involving the three key profit management elements I mentioned in last month's column: profit map, profit levers, and profit management process.

The *profit map* shows which accounts, products, and transactions fit the business model (and are profitable). *Profit levers* are elements of a company's business model that can be adjusted to improve profitability, turning "bad" customers into "good" customers. And the *profit management process* is the organizational procedure by which the company aligns its day-to-day business activities with its business model.

A company that got it right

Let's look at how one national trucking company got it right. Three years ago, this company had no good process to manage profitability. Today, it has more than doubled its profit margins. As one key manager put it, "Now our sales reps know exactly what to sell."

Profit map. In the first step, a small group of key sales and operations managers, called the Yield Management team, thought hard about what was driving their costs.

They had an insight—the sales department had been selling individual point-to-point movements, but the real cost driver was the whole route, including backhauls. So a sales rep might charge a price for the primary movement (headhaul) that appeared to make a profit, but the company would lose money if the backhaul price were too low.

They developed a set of cost models for their routes. They also saw that each cost model divided into three components: fixed costs (daily cost of a truck), variable costs (mileage), and special costs (handling, etc.).

Profit levers are elements of a company's business model that can be adjusted to improve profitability.

Next, they put together a database of all of their transactions over a six-month period. They applied the cost models to the transactions to see which customers, services, and routes were profitable and which were not.

—Jonathan Byrnes

They found a few islands of customers that were very profitable—20 percent to 30 percent margins. Shockingly, fully 40 percent of the business was unprofitable. Just like the lab supply company in last month's column.

Profit levers. While the Yield Management team was analyzing profitability, the company pushed hard for a general cost reduction—but this was not nearly enough. To increase profitability, they had to engage several profit management levers.

First, the team moved aggressively to secure the highly profitable customers, ensuring that they received flawless service, including first priority on capacity.

The next lever was pricing—and it wasn't simply a price increase. In the past, when the company had sold a point-to-point movement to a customer, the sales reps had to scramble to sell backhaul movements at low rates (often on the spot market). If the customer cancelled the pick-up, the company had to scramble to find a new headhaul—very reactive and inefficient.

Under the new regime, the team did two things. First, they decided to charge rates with fixed and variable components. The customer who ordered a truck had to pay a fixed daily charge whether it used the truck or not; the customer's mileage charge reflected actual use. Second, they incorporated forecast accuracy in pricing. The customer had to forecast its needs a month in advance, and pay an additional charge if the usage was greater than 110 percent of forecast (causing uncovered backhauls) or less than 94 percent of forecast (causing uncovered headhauls).

This changed the customer/company relationship to shared risks and rewards, and created a strong incentive

for joint planning. Now the trucking company could presell the whole route, receiving a much better price, and could get much better equipment utilization. In return, the company awarded the customer priority on capacity—crucial at peak times of the year—and passed on some of the savings as a price *decrease*.

In a series of meetings, the team sold the concept to the key customers. Most of the best customers saw the need for a stable supplier and the wisdom of focusing on joint cost reduction. To further reduce costs, the company scheduled monthly safety meetings with these customers, and agreed to reduce prices even more if safety targets were met.

Also, the trucking company sought to increase its integration with these key customers, offering services such as spotting, loading, and inventory processing—further reducing customer costs while building differentiation and switching costs.

Most importantly, according to a key team manager, the company "stopped saying yes to everyone." With the new bottom-line focus, the team took hard stances. They walked away from customers who were not willing to participate in joint cost reductions and risk/reward sharing. As it turned out, many of these customers came back and accepted the new pricing terms because the company offered the opportunity for them to reduce costs and lock in capacity.

Profit management process. The profit management process featured three key components. First, the Yield Management team continued periodic reviews of account and service profitability, ensuring that profit management was permanently built into the company.

Second, the company strengthened day-to-day profit management at the account level. Previously, account management was primarily a sales task. Now, a high-level sales team sets the relationship and pricing, and operations personnel manage the day-to-day account relationship. Sales became so productive that the company was able to reduce its sales force by 50 percent over time.

Third, the company used training to drive bottom line awareness down to the grassroots level. The goal was to ensure that the frontline sales and operations people understood the profit drivers, and that they managed the details of the account relationship to achieve its full profit potential.

The training sessions were held in five-member groups. They were very interactive with lots of "what would you do if?" examples and quizzes. In the first wave, the company trained the dispatchers and customer service reps; in the second wave, the support groups, such as billing.

One manager on the Yield Management team described the change. "At first, the customers thought I was the bad guy. Now, it's very rewarding. The hard feelings went away. Before, customer meetings were about price increases; now, they're about cost reductions. We start every meeting with a business review of cost takeouts, and only adjust prices if necessary."

What changed?

What changed here? These managers had the clarity to answer the two key questions *what fits?* and *fits what?* They did this through a three-step process. First, they analyzed which customers and services were profitable and which were not, and *why*. Second, they changed the company's business model to realign the pricing mechanism and customer relationship, focusing on joint cost reductions to benefit both parties. Third, they modified account selection and account management to drive the new efficiencies through every service, in every account, every day.

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In other words, they managed profit on a day-to-day basis, driving profits up to the fullest potential: No big investments, just clarity and great management.

One SVP of sales responded to last month's column: "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."

Next month, we'll look at more examples of companies that manage profitability effectively, and talk about how they use the three key elements—profit map, profit levers, and profit management process—to do it.

By the way, as to the question of which customers don't fit? The answer should be, NONE! Now our sales reps know exactly what to sell!

See you next month.

Part I: The Bottom Line: Who's Managing Profitability?

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The Bottom Line: The Hunt for Profits

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*What's a profit map? According to **Jonathan Byrnes**, it's a shrewd way to conceptualize the relationships among your customers, products, services, and transactions. There are five steps to drawing up a profit map, says Byrnes. In this article, he explains what they are and how they work together.*

by Jonathan Byrnes



Jonathan Byrnes

Part III

The hunt for profits begins in your own backyard. A thoughtful IT vendor executive, commenting on [last month's column](#), noted, "I suppose that if supermarket executives sat down, they would agree that probably 25 percent of the customers that walk in the door cost them money. All the profit comes from the 25 percent with the largest baskets—not necessarily the largest revenue... Well over half of that profit comes from 10 percent or less of the base."

In most companies, 20-30 percent of the business provides most of the profits, while 30-40 percent of the customers, products, and transactions lose money. The key question is how to identify which is which.

In last month's column, I explained how a national trucking company had more than doubled its profitability by utilizing the three key elements of the profit management process: profit mapping, profit levers, and profit management process. This column focuses on the first element of profit management, profit mapping.

Five-step profit map

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 through careful management of the details of the business without the need for major capital expenditures.

Let's look at the profit mapping process, using the example of a distribution company. The process has five steps.

Process accuracy. First, decide to analyze profitability at a "70 percent accuracy" level. Some companies spend a huge amount of time and money setting up an activity-based costing system that is much too detailed. All too often, the measurement becomes the project, and after endless debates, many projects lose momentum before they are translated into actions that hit the bottom line.

The most important results usually will be very clear from rapid, intelligent analysis using best knowledge and rules of thumb. Once a profitability picture emerges, it makes sense to improve the accuracy only where better information will change an important action. In most companies, after the analysis is over, the managers institute only a few high-leverage initiatives.

Profitability database. Second, construct a profitability database. Select a time period, often two to six months, that is representative, and load the full set, or an excerpted set, of transactions (i.e. order lines) onto a computer. Each transaction should carry crucial information including the identity of the customer and

product, as well as special services. Next, develop cost functions and use these to net the transaction's gross margin (GM) to a net profit (NP).

In developing cost functions, it is generally best to allocate costs using an easy-to-measure variable. For example, allocating operations costs by transaction or order line usually works well, as each line entails order-taking and picking. Inventory carrying costs can be handled by rules of thumb, such as holding "A" items for two weeks, "B" items for four weeks, and "C" items for eight weeks. Transportation costs can be allocated through simple decision rules based on customer location (region, near to or far from a distribution center). Where a sales call is needed to take an order, that portion of the selling expense can be allocated by orders. Other costs can be similarly allocated with reasonable accuracy.

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It's important to allocate all costs, including general overhead, for two reasons: (1) this enforces the discipline of viewing the whole cost of the business when determining whether to keep or change a major component; and (2) this ties the analysis directly to the company's financial statements, ensuring credibility and accurate projections.

This process will yield a database of transactions, each with revenues, GP, and NP. The database can be analyzed to display account, product, and transaction profitability. It will show you where the big pools of profits and losses are.

The database also can be used to project the impact of changing the account and product mix, as well as changing the cost of key elements of operations and sales. The former shows the effect of focusing the company on high-profit market segments, while the latter shows the effect of altering the business model to change "bad" customers into "good" customers.

Model a customer. In the third step, choose a few customers and products that are reasonably representative, and look carefully at their economics. Try choosing a large and small customer each from a few key market segments, and a fast-moving and slow-moving product from each of a few key product families. Ideally, you will have about six to twelve representative situations to examine closely.

For each customer, look methodically at the profit drivers—revenues, margins, and costs—for different products. Try different business model configurations such as changing the order interval, sales interval, or service interval. Look at the pricing, both price levels and price mechanisms. (For an example of how a national trucking company did this, see my October column.) Altering the product mix and developing substitution programs also can provide valuable levers for profit improvement.

Here, you are looking for profit levers, which I will talk about more systematically in upcoming columns. Once you have found effective profit levers, check several other similar customers to be sure you can generalize your findings.

Modeling the effects of key profit levers on representative customers works well for three reasons: (1) it will be intuitively clear which elements of the business model (e.g. order pattern) can be changed and what the effect will be; (2) you can actually call the customers to see what their reaction to the potential changes would be; and (3) it will be easier to explain the changes using concrete examples when you "sell" the initiative to your colleagues.

Project to the whole business. Fourth, take another look at the whole business. Divide it into clusters, or market segments, that are

To be truly effective, you need to create a cross-functional team that understands how the business operates.

similar to the customers and products you've modeled. See where the big pools of profits and losses are now, and what the profit impact would be of making the changes. This will tell you what's most important to do.

— Jonathan Byrnes

With this picture of current profits and profit improvement potential, you can identify the few high-payoff actions that your company can take relatively quickly. First and foremost, act forcefully to secure the high-profit segment of your business. Only then institute a process to improve the profitability of the marginal part of the business. This process probably will include training front-line sales and operations associates in day-to-day coordination to improve profitability to its highest potential.

What about the unprofitable customers? Here's what the CEO of a major service company said about exiting unprofitable business segments or customers:

Before exiting, give them a chance to pay higher prices or modify the profit levers. We did exactly that. We knew our profitability was eroding. Through analysis, we found a business segment where we were losing money. Profit analysis allowed us to determine what changes would be required to generate acceptable returns. The underlying issue was not pricing—it was order pattern, order size, and delivery requirements. Before exiting the segment, we told our customers what we needed in order to continue servicing them. To our pleasure, they agreed to make the changes, and we saw a quantum improvement in profitability in six months!

Finally, phase out the parts of the business that cannot be made profitable. This will be counter-intuitive and some in the company will resist, but keep your eye on the huge upside to refocusing 20-40 percent of your sales force and operations assets away from tending unprofitable business and toward aggressively growing your share of the highest-profit end of the business.

Institutionalize profit mapping. Fifth, reflect on the value produced by profit mapping and decide to institutionalize the process. Repeat the analysis every six months. Once you have set up the analysis, subsequent rounds will go very quickly. The process itself will build teamwork and it will become a new way of looking at the business. In parallel, build profit mapping into the new account qualification process. As your profitability improves, new opportunities will constantly be created. The better you get, the better you can get.

From financial information to action

The service company CEO mentioned above reflected on his experience with profit mapping, "Financial systems often do not have the information that you need. If they did, the problems would have been solved long ago. To be truly effective, you need to create a cross-functional team that understands how the business operates. This will allow the conversion of financial information into management information which, through analysis, will lead to action."

Next time, we'll focus on profit levers; changes in the business model that improve profitability.

By the way, how do you hunt for profits? By looking in your own backyard—again and again and again!

See you next month.

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Part II: Which Customers Don't Fit?

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