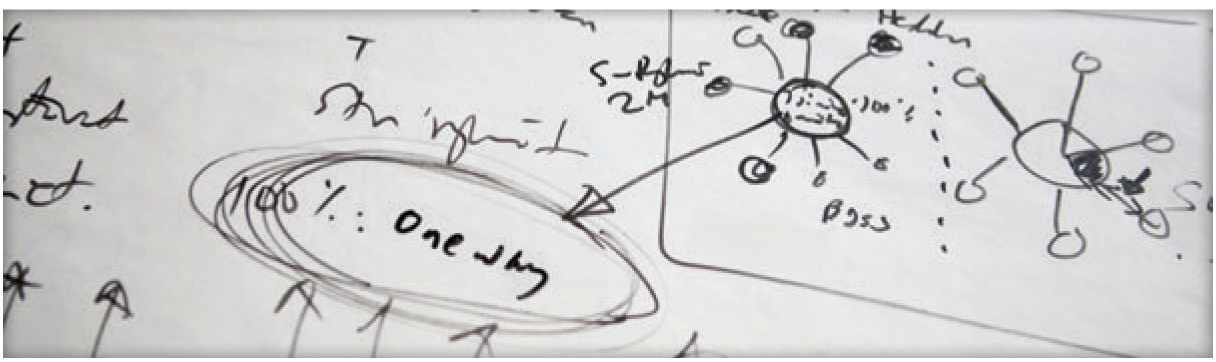
Managing with Precision: The Power of Profit Based Segmentation

NAG White Paper April 2015



By Jonathan Byrnes and Kalle Heikkinen

April 2015

NAG

STRATEGY & TRANSACTIONS

MANAGING WITH PRECISION: THE POWER OF PROFIT BASED SEGMENTATION

What's Keeping You from a 30% Profit Increase this Year? Profit-based segmentation, is the answer.

Think about these questions:

- Who are your most profitable customers?
- Which are your most profitable products/services and vendors?
- In a changing market, where should you look for growth?
- When competitors attack, how/where should you defend?
- When customers and vendors push you, how should you respond?
- How should you prioritize your opportunities/resources for next year?

Now, ask yourself the following question: If you selected five of your customers at random, and in each customer you chose five products at random, could you tell the all-in profitability of each of these twenty-five data points?

If not, you have an enormous opportunity for profitable growth in the next few months – or, put another way, you have an enormous risk that your competitors may pick off your best business.

Today, many of Finland's best companies are under attack. The annual global survey conducted by Harvard Business School Professor Boris Groysberg and NAG shows that Finnish companies are feeling a steadily increasing pressure from substitute products and services, and also strongly increasing price competition[1]. Some companies are being attacked by strong offshore competitors encroaching on their traditional markets, a good example being retail. Others are being challenged by competitive pressures globally, and by market shifts to Asia and other fast-growing areas. In this marketplace, identifying, understanding, and accelerating your prime sources of profitability, the 20% of your business that often produces 150% or more of your profits, is the key differentiator between success and failure.

1 Groysberg B, Heikkinen K. More evidence for Finnish "Success-Driven Complacency" syndrome. Finnish and Global Executives' Assessments of Their Firms in 2013. (2014). http://www.naggroup.fi/docs/NAGTT08012014.pdf

NEW NEEDS, NEW CAPABILITIES

Business wasn't always this way. The world has changed, and management success requires new capabilities.

In the past, the key to success was to simply dominate a market. For years, the biggest and best competitor won because it could outgrow its competitors. Nearly every industry had huge economies of scale in every function, from production to marketing to distribution. That meant that the biggest company had the lowest cost, creating a powerful virtuous cycle. Pricing was reasonably uniform, and the cost to serve customers was largely uniform as well. In this world, all a manager had to do to succeed was to maximize revenues and keep costs under control.

All this has completely changed in the past thirty years: companies have instituted much more flexible pricing, along with much more varied levels of support and supply chain integration, for different customers. Ask yourself this: Do you price products the same for all customers? Is your cost to serve the same for all customers, even for similar products? In virtually all companies, the answer is a resounding no.

This means that all managers face a new, business-critical need. In the past, managers could maximize profits simply by boosting revenues and minimizing costs independently of each other. Today, this is a recipe for disaster. Today, managers need to match revenue and cost for every transaction (invoice line) in order to see, and act on, the actual profitability pattern within their companies.

Traditional control systems simply do not have the capability to do this. In fact, we have demonstrated many times that revenues and gross margins are not correlated with net profits, especially in the best-run companies. Yet sales compensation is traditionally based on just these obsolete metrics.

Today, effective managers require a completely new type of analytical process, both to understand actual granular profitability, and to frame and manage effective profitable growth initiatives. We have moved far past the time when sweeping revenue-generation programs and broad cost-cutting initiatives were the key to management effectiveness.

The good news is that such a system exists, and managers that employ it regularly see profit increases of 30% or more, often within a year or less.

SURPRISINGLY LARGE PROFIT INCREASES

NAG, with offices in Helsinki and Boston, has teamed with Boston-based *Profit Isle*™ to offer just such a powerful transaction based, profit analytics system, along with an effective, prioritized process to manage profitable growth. This capability produces surprisingly large profit increases in industries ranging from retail to manufacturing to distribution to financial services.

Profit Isle was founded by MIT's Jonathan Byrnes, and incorporates big-data technology to transform companies' profitability. Most big data initiatives today operate on information external to a company, like customers or social media; Profit Isle's custom-designed system is unique because it focuses on analyzing and accelerating the profitability of a company's own internal book of business. Dr. Byrnes describes this process in his award-winning book, *Islands of Profit in a Sea of Red Ink*, which was an Inc Magazine book of the year.

The key to Profit Isle's powerful, proprietary profit analytics is a process that essentially creates a full P&L, including all overheads, on every transaction (invoice line) in a large, complex company. In this process, overheads are not simply blanket-allocated in a top-down manner across the company; rather, each element of operating cost and overhead is carefully assigned to each transaction based on the nature of the product, the customer, and any special circumstances (rush orders, special services, etc.). The big data analytical runs are often comprised of 50 million records or more. Over a thirty-year period, Profit Isle has analyzed and improved over $100 billion of annual client revenues.

No other company in the world has this capability and track record.

MANAGING PROFITABLE GROWTH

Once a manager has full information on a company's profitability, how can he or she translate it into prioritized, practical action-initiatives to accelerate profits?

The first step is to organize the information into actionable profit-based segmentation using *Profit Maps*™. A Profit Map is simply a clustering of customers, products, vendors, stores, sales reps, or other dimensions of a company into four quadrants: high profits and revenues *Islands of Profit*™; low profits and high revenues *Coral Reefs*™; high profits and low revenues *Palm Trees*™; and low profits and revenues *Minnows*™. Each of these quadrants has completely different characteristics, different profit levers, different strategic and tactical needs, different pace of change, and different payoff.

For example, in most traditional marketing projects, the objective is to identify the high-revenue customers, profile them, and develop initiatives to get more of them. It is counter-intuitive but true that this often actually lowers profits.

Here's an actual example. We recently worked with a major retailer. About thirty percent of the customers had relatively high revenues. But of these high-revenue customers, about 1/3 had high profits, while the other 2/3 had marginal or negative profits (a common pattern). We surveyed each group separately, and found that while each group was itself quite homogeneous, the high-profit high-revenue group was completely different from the low-profit high-revenue group. Once we saw this, we designed a precision-targeted marketing and social media campaign aimed directly at the Islands of Profit customers – we knew who they were, what products they liked, and when/how they bought.

However, if we had simply surveyed all the high-revenue customers, without the profit-based segmentation, we would have wound up targeting the low-profit high-revenue segment that dominated that population. The end result would have been lower profits and a lost opportunity to more than double the best business.

This is the power of profit-based segmentation.

Similarly, think about the cost to serve. In virtually all operations projects the obvious objective is to reduce costs. The seemingly obvious first step: find the costs that are out of line, higher than the rest, and lower them. However, think about this: in our experience, in almost every company the actual all-in cost to serve the most profitable customers is somewhat higher than the cost to serve the low-profit customers. But the additional cost is a great investment that more than pays for itself, plus provides a huge return. If the company focuses on cutting these costs, it will in all likelihood kill its most profitable business.

Importantly, think about the converse: if your competitor doesn't understand profit-based segmentation and you do, you can pick off your competitor's best business – and the competitor will simply see profits plunge, and not have a clue why it happened.

Again, observe the power of profit-based segmentation.

PRECISION MANAGEMENT: NEW COMPETITIVE ADVANTAGE FOR FINNISH COMPANIES

Armed with the understanding that profit-based segmentation provides, a management team can develop focused, prioritized profit improvement initiatives and metrics that will rapidly and effectively accelerate profitable growth.

The really powerful aspect of this process is that it transforms business leadership from a relatively qualitative process to a very precise, quantitative one that can be validated and managed effectively, and subjected to constant improvement. This is a perfect fit with the skill-sets of Finnish business leaders who, in a global comparison, are very analytical, and focused on leading with facts.

Finland is known for its insightful and disciplined business leaders, who have built great companies over generations. Profit-based segmentation provides a viable pathway to accelerate the profitable growth of these great companies for generations to come.

Jonathan L. Byrnes is Senior Lecturer at MIT, and the Founder of Profit Isle.

Kalle Heikkinen is Managing Partner of NAG, Based in Boston.

NAG

STRATEGY & TRANSACTIONS

www.naggroup.fi