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# The Profit Perspective

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*How a fresh look at your firm's profit structure can reveal which assets are profitable, which ones aren't, and what you can do to enhance your firm's overall profitability.*

**First  
Hawthorn  
Group**

**Management Consultants**

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**“While issues of market share and sales growth should remain near the top of management’s agenda, a firm’s understanding of its profit structure can unlock powerful insights.”**

**“The profitability analysis becomes the basis for business initiatives to refocus revenue volume towards the firm’s profitable business assets and to find the best way to manage the break-even and unprofitable business assets.”**

### Introduction

Our experience suggests few firms invest the time and resources needed to understand where profit is and is not produced in their businesses. As a result, they concede what could otherwise be an important source of competitive advantage. Many managers, following conventional wisdom, use revenue as the primary measure of performance. They may only consider profit at the company or business unit level and stop short of gaining a perspective of where profit originates in their businesses. While issues of market share and sales growth should remain near the top of management’s agenda, a firm’s understanding of its profit structure can unlock powerful insights. These insights can generate new strategies to maximize the performance of businesses and inform future plans for growth.

We have developed a management tool called *the profit perspective* that any size organization can use to analyze its profit structure and to optimize its position to generate profit. Driven by a transaction-level profitability analysis, the profit perspective traces profit back to the business assets that created or destroyed it. We find the most useful insights tend to surface when the profit is disaggregated across the firm’s products or services, distribution channels, and customers. The profitability analysis becomes the basis for business initiatives to refocus revenue volume towards the firm’s profitable business assets and to find the best way to manage the break-even and unprofitable business assets. A very useful follow-up activity is conducting a profitability analysis at the industry level. This analysis reveals how profit is distributed between industry players and other areas of the industry value chain.

While the profit perspective concept is relatively straightforward, assessing the profit structure of a firm’s business and its industry requires substantial analytical rigor. Nonetheless, we believe these insights are of critical importance. Competitive pressures to get the most from a firm’s profit structure will likely leave firms that do not understand the profit structure of their businesses and industries at a significant competitive disadvantage.

Whether start-ups or large enterprises, firms of any size can use the profit perspective approach to optimize their profit structure and enhance their ability to create value for their owners. For example:

- Insurance provider MetLife has used the profit perspective approach to drive product, pricing, marketing, and even distribution strategies.<sup>1</sup>
- Telecommunications provider AT&T has used this approach to enhance its customer relationship strategy.<sup>1</sup>
- Communications headset manufacturer Plantronics is using this tool to manage its business through an anticipated economic down cycle in 2009.<sup>1</sup>

### A Closer Look at Profit and Profit Structure

Profit is what ends up in a firm’s pocket after it has paid all other business expenses. Yet due to the increasingly complex conditions that can be attached to a single business transaction, profit can be calculated in many ways. *Gross profit* is perhaps the easiest profit calculation to produce; however, it rarely provides a reliable basis for decision making since it does not account for any overhead or capital costs. We find the most useful types of profit measures of interest in strategic measurement are *operating profit*, *accounting profit*, *cash*

<sup>1</sup> As described in analyst events and earnings conference call transcripts.

**“If a firm’s profit is disaggregated across its products, distribution channels, or customers, does the analysis show profit is equally distributed across all of those assets? Our experience suggests this answer is almost always no.”**

*flow* and *economic profit* (Exhibit 1).

Just as an auto mechanic looks under the hood of a car to diagnose the inner workings of a vehicle, managers can use an understanding of their profit structures to diagnose the inner workings of their businesses. When management reviews its annual or quarterly income statement, does it pay enough attention to *looking under the hood* to learn where its profit came from and use that knowledge to better manage the business?

If a firm’s profit is disaggregated across its products, distribution channels, or customers, does the analysis show profit is equally distributed across all of those assets? Our experience suggests this answer is almost always no. In fact, many firms would see these assets follow the 80-20 Rule. The 80-20 Rule, which is also referred to as the Pareto Principle, predicts 20 percent of a population studied will account for 80 percent of the effects observed. In other words, it’s common for firms to see 80 percent of profits come from

only 20 percent of products, distribution channels, or customers. The firm’s remaining assets are either break-even or have a negative return, consuming more cash in expenses than they produce in sales. By itself, this doesn’t signal poor management practices or inefficient business operations, but it does build a compelling business case for developing targeted initiatives to exploit a firm’s most profitable assets and for assessing the best course of action for its break-even and unprofitable assets (Exhibit 2).

### Managing Profitable Assets

Managers can exploit their most profitable assets by appropriately funneling revenue volume through these products, distribution channels, and customers, thus more effectively harnessing their profit contributions. For example, many retailers have discovered they can realize additional profit contribution from revenue funneled through their Web sites since their online distribution channels enjoy a higher profit margin

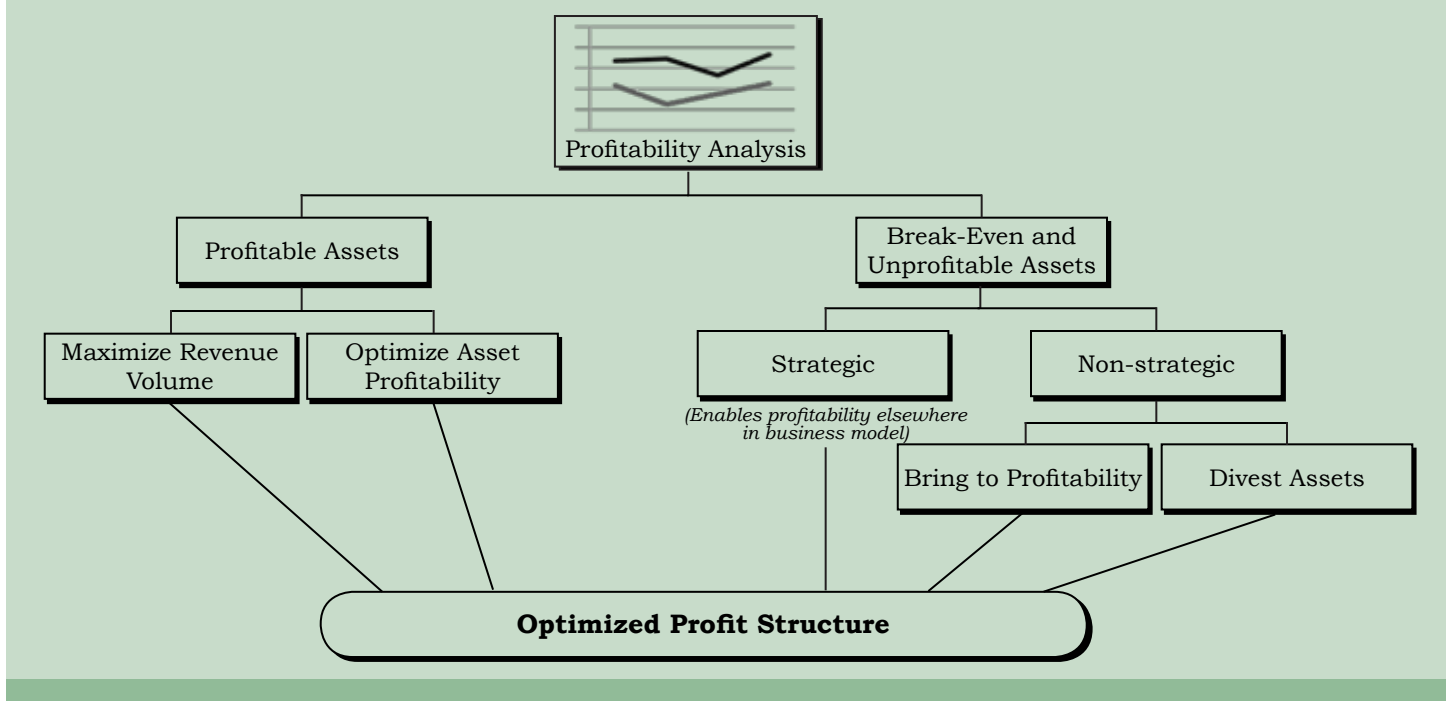
## EXHIBIT 1: STRATEGIC MEASURES OF PROFIT

Profit Type	Other Names	Applications
<b>Operating Profit</b>	<ul style="list-style-type: none"> <li>Earnings Before Interest, Taxes, Depreciation, Amortization (EBITDA/EBIT)</li> </ul>	<ul style="list-style-type: none"> <li>Assessing profitability of core business operations</li> </ul>
<b>Accounting Profit</b>	<ul style="list-style-type: none"> <li>Earnings</li> <li>Net Profit</li> <li>“Bottom Line”</li> </ul>	<ul style="list-style-type: none"> <li>Assessing profitability after operating expenses, interest, taxes, and depreciation</li> </ul>
<b>Cash Flow</b>	<ul style="list-style-type: none"> <li>Free Cash Flow</li> <li>Net Cash Flow</li> </ul>	<ul style="list-style-type: none"> <li>Assessing net cash generated after operating, financing, and investing activities</li> <li>Business valuation</li> </ul>
<b>Economic Profit</b>	<ul style="list-style-type: none"> <li>Economic Value Add (EVA)<sup>2</sup></li> </ul>	<ul style="list-style-type: none"> <li>Assessing profitability after operating expenses and capital costs</li> </ul>

<sup>1</sup> As there are no universally accepted definitions of these profit measures, the exact items included in the calculation may vary from firm to firm

<sup>2</sup> Economic Value Add (EVA) is a registered trademark of Stern Stewart & Co.

### EXHIBIT 2: THE PROFIT PERSPECTIVE USES A PROFITABILITY ANALYSIS OF THE FIRM'S BUSINESS TO DRIVE OPTIMIZATION OF ITS PROFIT STRUCTURE



than their core storefront distribution channels. As a result, they may offer customers a discount to complete transactions using their Web sites. Managers should put initiatives in place to expand their customer base within their most profitable customer segments, match customer needs with their most profitable products, and make profitable distribution channels more attractive to their customer base.

Additionally, managers should consider whether these assets have reached their full profitability potential. Managers should not be afraid to ask if prices are being set consistently and proportional to the value they create for the customer. They should give further thought to special promotions, incentives, and discounts introduced to stimulate new business: if these measures have reached the end of their usefulness, they can be retired to prevent erosion of profit margins. In some cases, they must extend the scope of analysis to other areas of

the business. For example, firms can apply the profit perspective to their supplier base to identify opportunities to increase profitability. In doing so, they may discover opportunities to procure raw materials and overhead items at a lower cost through strategic levers such as supplier consolidation or revised demand specifications.

### Managing Break-Even and Unprofitable Assets

Additionally, managers need to assess available options for best dealing with their break-even and unprofitable assets. These assets can be thought of as either strategic or non-strategic. Some of a firm's unprofitable assets may actually funnel future revenue volume through their most profitable assets. For example, Hewlett-Packard, Canon, Lexmark, and other ink-jet printer manufacturers typically make little or no profit from the sale of ink-jet printers but make up for it by the sales from high profit margin, re-

***“In this example, the printers, while typically unprofitable, act as a strategic asset because they play an essential role in enabling the firm’s profitability elsewhere in the business model.”***

***“Considering the profit potential in new products or services, previously unused distribution channels, and untapped customer markets can guide managers to growth initiatives that can enhance future business profits.”***

curing purchases such as replacement ink cartridges. Though consumers are likely to comparison-shop before buying a printer, when purchasing replacement ink cartridges for that printer, they orient themselves toward convenience rather than cost. In this example, the printers, while typically unprofitable, act as a strategic asset because they play an essential role in enabling the firm’s profitability elsewhere in the business model.

Likewise, one of a firm’s most profitable customers may rely on the firm for a product of critical importance to its business. While the product in question may be unprofitable to the firm, it retains a customer who likely purchases other, more profitable items. Although these strategic assets do not directly contribute to profit, firms should continue to leverage them to funnel future revenue volume through more profitable assets. Finding a majority of break-even or unprofitable assets is common in start-ups and other new businesses. These new ventures require an incubation period to gain control of their profit structures. Any issues of unprofitability at these new ventures will likely correct themselves if a viable business model materializes.

Managers will often find assets that produce a gross profit lose any remaining profit in their requirement of overhead resources, such as marketing, post-sales support, and quality control, among others. In other instances, managers may find off-invoice items attached as conditions to the pricing in the business transaction compromise an asset’s profit margin. These off-invoice items can include rebates, freight charges, and annual volume discounts.

Once the firm determines that break-even or unprofitable assets play no di-

rect role in enabling profit generation elsewhere in the business and there’s no clear path to bring the assets to profitability, it has to make tough decisions. It could mean retiring a product or service, eliminating a distribution channel, pulling out of a customer market, or even ending a customer relationship. Managers might hesitate to accept such drastic measures, but it is in the best interest of the business to do so. In our experience, firms can divest these assets with limited impact on their businesses and reputations.

### **Profit Perspective-Driven Strategies for Growth**

Maximizing profit generation in a firm’s existing business operations is just one way firms can apply the profit perspective to their business strategies. Managers can also employ the profit perspective to find attractive growth opportunities outside their current businesses. Investigating the profit generated in competing, substitute, and complementary businesses can reveal areas of profit that live elsewhere in the industry value chain. Considering the profit potential in new products or services, previously unused distribution channels, and untapped customer markets can guide managers to growth initiatives that can enhance future business profits.

For example, in 2004, Hewlett-Packard responded to increasing concerns of commoditization and decreasing profit margins of its core computer manufacturing business by expanding into information technology integration services through its Technology Solutions Group (TSG) business segment. Since the services enjoyed a higher profit margin than the computer manufacturing business, Hewlett-Packard tapped into a new source to enhance the growth of

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its business profits.

Prioritizing growth opportunities is critical to a business’s long-term sustainability. Ultimately, a firm’s control over its profit structure and plans for its future profit structure can determine its competitive position. Competitors outperforming a firm in market share can pose a threat, but the competitors outperforming them in profit share pose an even greater threat. Therefore, firms must periodically reassess their dynamic profit structures. They will discover the profit margins of their most profitable assets today will erode over time as they mature in their asset lifecycles. Profit contributions will migrate to new products and services, new distribution channels, and new customers.

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Our consultants’ past experiences partnering with organizations developing and executing their profit perspective-driven strategies have produced impressive results. One client project delivered up to \$70 million in one-year revenue enhancement by funneling its revenue

volume through its most profitable customer segments. Another client project delivered up to \$5 million in one-year profit contribution by divesting many of its non-strategic, break-even, and unprofitable products.

It’s common to see discussion of profitability even produce an emotional reaction from firm members, particularly when big decisions must be made about what the firm’s future customer, distribution channel, and product portfolios will look like. We find firms are most successful in capturing value from profit perspective-driven initiatives when they step back from any emotional connections and anchor their decisions to the facts and best long-term interests of their businesses.

Managers should also recognize these initiatives as opportunities to develop the leadership potential of future management talent. The firm’s future leaders can gain valuable experience leading a team integrating the profit perspective approach into an area of the business such as products, distribution channels, or customers.

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### About the Author

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### About First Hawthorn Group

**First Hawthorn Group** is a management consulting firm that assists top management with issues of business strategy, operations, and organization. We help them improve the value of their business and enhance the leadership capacity of their organization.

Collectively, we have completed strategic reviews of more than **\$27 billion** of client business operations over our careers. First Hawthorn Group consulting professionals have helped management executives, from Fortune 500 corporations to family-owned operations, conceive and implement solutions to some of their most significant business challenges. From turnarounds to new growth strategies, we exist to help management achieve breakthrough business performance.

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