The Profit Maximization Paradox

Abstract:
Long term profitability that exceeds industry norms is the essence of shareholder value. Based on studies of the Fortune 500, few companies can boast of long-term growth for five much less ten consecutive years. Management experts have written volumes regarding the traits of successful companies only to see these observations vaporize when these same companies flounder a few years later. Perhaps the issue of long-term profitability is not tied to some unique capability or a more fundamental operating perspective.

As the title suggests, this white paper makes the argument that there is a major flaw in the assumptions companies make in their strategies to maximize profitability. This flaw can be characterized as a paradox in management thought. A paradox is an apparently true statement or group of statements that leads to a contradiction or a situation that defies intuition. In the case of profit maximization, it is broadly assumed that maximizing functional performance will maximize profitability; it is the basis of how we manage, it is intuitive, but in today's competitive landscape, such an assumption leads to inconsistent results and pervasive alignment issues. This is the core of the paradox. This white paper will explain why a functional perspective is almost guaranteed to lead to sub-optimization and will suggest an alternative which will serve as a more effective focus for optimizing performance.

Strategy versus Implementation

Strategy defines the approach that will be used to manage the growth engine of the enterprise. For simplicity, strategy can be segmented into two components: (1) mergers and acquisitions (M&A) and (2) organic growth. Though M&A strategies are often used to bolster the growth equation, it is not central to the arguments that will be made in this white paper because the issues associated with its success are different from those associated with organic growth. Therefore, the focus of this paper will be on organic growth.

Organic growth is driven by selling more to existing customers plus acquiring new customers at a rate that exceeds customer defections and/or returns. Ideally, these sales will reflect higher margins or at a minimum, the sale of lesser margin will lead to an opportunity to cross or up sell higher margin products/services. Despite the simplicity of this understanding of growth, most organizations plan in terms of aggregate revenue, margin, and cost. The aggregate numbers (adjusted for inflation and productivity) are incorporated into an operating plan that is further divided into functional objectives. After several iterations, the resulting plan arithmetically dovetails with aggregate financials; this process typically spans multiple months and an endless number of meetings. The paradox should be obvious; the focus is on internal performance when in fact, it is customer behavior that is going to drive most of what constitutes profitability. The strategy/plan ritual is an artifact of the past when the marketplace was simpler and customer groups more homogeneous. Clearly, these are not the characteristics of today's marketplace and competitive landscape.

When corporate strategies fail, management commentaries often point to the issue of implementation but that conclusion merely clouds an already flawed assumption regarding cause and effect. As referenced earlier, profitability is driven by metrics such as:

- Number of product inquiries
- Number of product trials
- Number of line items purchased
- Frequency of purchase
- Number of customer of defections
- Number of customer returns
- Number of customer leads or recommendations
- Customer profitability
- Customer life time value

Success is predicated on the ability of the organization to profitably manage these metrics (not an exhaustive list). However, functional performance metrics frequently operate tangentially to these metrics and in some cases in conflict with their achievement. Consider some of the following examples:

- The objective of the sales function is to hit a revenue quota while managing costs to meet budget levels. The quality of customers, in terms of industry leadership, profitability, or retention prospects is completely ignored. Discounts or allowances created to hit quota distort value perceptions and may compromise future revenue.
- The marketing function is commonly structured into product management and program management. Product managers compete with each other for resources and sales function mind share; their objective is to meet product specific revenue, margin, and market share objectives. The disconnect, is that the customer is often seeking a solution that is not met by a single product manager's purview. How does this need get met? Meanwhile, program managers are often evaluated on the number of completed programs or broad metrics such as the number of leads generated. This begs the question of the quality of those leads such as how many leads generated incremental business? Likewise, effectiveness of communication is often evaluated on the basis of customer attitudes as opposed to behavior. Promotional activity can encourage forward buying that negatively impacts inventory management and production costs/capacity.
- Customer Service, Help Desk, and Field Service functions are often viewed by management as a *necessary cost*. This orientation drives productivity goals such as utilization, number of calls handled, etc. There is a lack of connection between customer experience and behavior; for example, future purchases and recommendations.
- The quality and financial organizations often focus on managing internal risks and institute policies that alienate customers. For example, processes for accepting new customers, return product policies, inventory level policies, etc.

Each function is oriented toward the achievement of its goal subject to its allocated resources. How can this optimization possibly generate maximum profits in the short or long term?

Creating a Customer Focus

Organizations are recognizing the symptoms of these disconnects. Admonitions to become *customer centric* have driven organizations to implement CRM and adopt new positions such as Chief Marketing Officer (CMO) and Chief Customer Officer (CCO). However, these moves do not address the paradox and have limited staying power; consider the following:

1. Customer Relationship Management (CRM) has existed for over twenty years and the industry cannot articulate a coherent definition.
2. Success with CRM remains south of fifty percent despite hundreds of books and articles that purport to describe best practices.
3. The CRM industry has moved from terminology such as customer centricity to customer experience but these terms are empty without addressing goal setting.
4. CMOs are hired and fired in rapid succession as though they can unilaterally inject an instant performance boost into their respective organization.

No matter how one tries to change the culture, employee behavior is going to revert to their basic performance criteria or they will become frustrated and resign.

An Answer

The answer to the paradox is a basic recognition of its existence and a commitment by senior management to create a new framework for performance. If one examines the success stories of CRM, he will find that true success is almost always accompanied by the vision of a senior executive, with P&L responsibility, who makes it happen. Therefore the first ingredient is recognition and leadership for change.

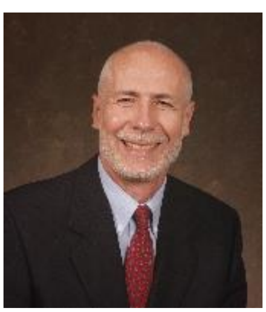
The second ingredient is the creation of customer profitability model and an understanding of what makes customer groups more or less profitable? This leads to more effective segmentation and the identification of the best target prospects for the organization. Customer profitability can be extended to customer life time value which provides insight into customer retention and the use of effective value propositions. If properly managed, these discussions should drive synergy between marketing and sales. The accomplishment of marketing/sales synergy will by itself leverage organizational profitability enormously.

Lastly, the organization must examine current performance metrics in the light of how they impact customer profitability and life time value. Reporting and performance analysis must focus on the correlation of progress in the context of customer behavior and customer profitability. A side benefit will be that the organization will migrate from metrics that are essentially forensic evidence to more forward looking metrics that actually help the organization to plan.

None of these benefits appear without a significant amount of hand wringing and finger pointing. There are always embarrassing revelations regarding misplaced practices and beliefs. Leadership is indispensable, this is not a bottom-up transformation and the blame game has no place in a strategy to move forward.

Summary

It is rather strange that with all of the sophistication in technology, reporting tools, and the complexity of the marketplace, that we still plan, implement, and manage in a manner that was developed 80 years ago. Though individual functions may recognize the disconnect, it will require the commitment and action of C-level management to change this source of operational and competitive dilution.



About The Author

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