Profits as the Basis of Strategy

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1 A Mandatory Agenda Point

It is a mandatory element of the monitoring function of governance to review the profitability. Not only the profitability of the whole enterprise but also of its individual business segments. This review is essential both when the overall profitability is excellent as well as when it is insufficient. Without knowing the root causes of good profitability the board would not know which key conditions need to be met in order to continue the high profitability. Thus, in good as well as in bad times, profits are of the essence. Let us review what the key issues are in such a monitoring process.

2 A Key Maxime: Profit by Avoiding Losses

The first rule for making profit is to avoid losses. This may sound simple, but it is not. To meet this requirement, one has to know where the company makes losses. Normally the financial data report an average: The sales of all orders in a certain product category and the sum of profits. To identify the loss-causing leaks the board should ask the management to break up the average into discernible subsegments. We recommend splitting up the total of sales into four even quarters with the respective amount of profit and loss for each quarter. Of course, the profit is “after all cost.” This is called “full costs accounting,” “fully charged costing,” or equivalent. Marginal costing with variable cost only is irrelevant for strategic considerations.
Having this breakdown one can answer two questions: First, which segment is highly profitable? This is the fundamental profit source for our business. It reflects a certain strength this business has. There is no high profitability without quality and good prices. Maintaining and developing this strength is essential for sustainability. Maintaining strengths is more important than eliminating weaknesses.

The second question which is answered: Which segment generates losses, which are an indicator of weakness? Too much of a weakness can destroy good strength. Therefore, it is essential that the weakness resulting from losses is limited to an acceptable volume. Look at the portion of loss generating sales: If these are double-digit losses on sales, cost-cutting will not help. Either one can increase prices significantly or one has to eliminate the product segment—or the customer segment. It is always worthwhile to try a price increase before eliminating a business. Often the price increase can be implemented and the issue is solved.

After having decided on the route of action regarding the losses, we need to return again to the segment of the high-profit business. Perhaps the profit is too high and it is better to level the price to a reasonable profitability before the competitors penetrate our profitable niche and customers are frustrated. Keep in mind the possibility of giving our long-term customers a fair deal—they deserve it.

3 Profits Are Results, Find Out the Causes

Nobody can influence profits directly. Profits are the results of actions directed at the root causes of profitability. Thus, one has to work on the levers for costs, volume, and prices in order to get the effect on the profits. Take this into your reporting system. It is more important to report on the development of the important cause-factors than on the result (profitability). Key Performance Measures are items such as: material quote, sales per capita, and similar.

4 Profits Through Good Prices

There is no good profitability without good pricing. And there is no good pricing without good quality and customer service. When you can offer good quality, you are almost forced to ask for a slightly higher price than your weaker competitor. How should your customer otherwise know that you offer good quality?

An acceptable price level is under constant pressure to fall. Therefore, monitoring the price quality is a key information requirement. The ways and means are specific for the various lines of industries. Rough approximation is better than not monitoring at all. A “quick and dirty,” but fairly reliable test of how the price quality is developing over time is the ratio of sales to material cost.
5 Profits Through Continuous Productivity Improvement

Personnel costs have been and will continue rising substantially and are not negligible anymore. Sustainable profits can only be assured by constant productivity increases. In the industries with assembled and engineered products—and these industries cover a broad range of items, from automobiles to sneakers—from two-thirds up to three quarters of a cost reduction potential stems from a more efficient design of the product which then allows a more efficient manufacturing and assembling process including higher levels of mechanization or automation. Thus, as soon as a new generation of products is successfully launched one has to start the next project of designing an even better and more efficient product.

6 Assessing the Viable Range of Profitability

Profits fluctuate during the economic cycle. In our ripe economies, we estimate that in a “normal” recession (not the COVID-19 case) the profits as a percentage of sales are reduced to one-third of the average across the cycle. This is the consequence of reduced or stagnating volume and increased price pressure. In the upswing and boom-periods, the profits should—of course—be above average, typically one-third better than average. Considering this, one realizes that good profitability is the best hedging insurance against drops in sales volume.

In cases where profits are significantly higher than they used to be, say twice the average, then most likely this is a very limited span of extraordinary profits. They might be the consequence of an exceptional demand for our products, a favorable reduction of the material prices due to fluctuations of raw material prices—such as oil—or movements of the currency exchange rates. Be careful then and do not base your plans on the continuation of extraordinary influences.

7 Assessing the Required Level of Profitability

The most important function of profits is to finance the productivity improvements (mechanization, automation) and/or the growth of the business. In family businesses, the share of profits distributed to the owners is always the smaller part of profits. The rate of profitability, therefore, sets the ceiling for the sustainable growth rate of the business. This is also true the other way around. All companies in high growth industries have to make substantial profits in order to maintain their position in the industry. In the long term, the equity of a company has to increase at the same rate as the sales and assets grow. The exact ratios depend on many factors (assets intensity, taxes, financing structure). Roughly speaking, one needs close to double-digit profit/sales ratio to finance a double-digit growth ratio.
8 Deploy Extraordinary Profits

Whenever a company enjoys extraordinary profits which are one-time windfall benefits, one should not plow back the funds into the “ordinary” business. These profits are best applied to cover extraordinary purposes: a major infrastructure investment, which does not have a direct financial return, a “savings account” for the retirement phase of the owner, for example.

In conclusion: One needs a strategy not only on how to generate profits but also wisdom and a strategy on what to do with the profits in order to keep the business healthy and the family happy.

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