Expanding the Profit Frontier

Aesop’s fabled fox, who sought ripening grapes too high to reach, remains famous not only because of his inappropriate but all too familiar conclusion—“I am sure they are sour”—but also because the dilemma is so familiar in everyday life. What do you do after you have harvested the low-hanging fruit?
FOR BUSINESSES SEEKING TO IMPROVE

profits, the low-hanging fruit is obvious. Fixes, such as reducing manufacturing costs, improving marketing effectiveness, or optimizing a supply chain are typically among the first to be implemented. Thus, a company that has already made such improvements faces a challenge. Does it, like the fox, conclude that anything else is out of reach and therefore not worthwhile? In such challenging economic times, a company can’t afford to draw such conclusions. Does it then run for a ladder and raise it to a spot where, at first glance, more fruit appears to be within reach? Because of past improvement activities that seemed promising but failed to produce bottom-line results, many companies are wisely hesitant to do so. So is there a way to take a more holistic approach—to use the ladder to learn more about the tree, use scaffolding to align efforts to achieve productive results, and even prune the tree’s branches to improve the likelihood of a long-term sustainable harvest?

Yes, there is a way. We call our approach Expanding the Profit Frontier. We’ve used it to help companies improve overall earnings 300 to 500 basis points before interest and taxes. For example, one company saw a 1 to 2 percent revenue lift when it aligned its pricing and discount strategies with a cost-to-serve model for each customer segment. Another company, initially planning to implement a single fixed-cost reduction strategy, instead combined this one initiative with another designed to streamline the product portfolio, and achieved six times the benefits with this more holistic approach.

Success for these companies was achieved using proven tools to address all of their profit frontiers (cost reductions, price increases, portfolio adjustments and other actions)—and doing so simultaneously as part of a continual business process to ensure maximum profitability both today and in the future.

Where Are You Making Money?

Long-term profitability always comes down to having a clear understanding of where and how your company makes money. Unfortunately, for many of today’s highly respected market leaders in a variety of industries, complexity makes that question surprisingly difficult to answer. Senior executives seeking to maximize profitability generally face what might appear to be simple challenges but in reality can be quite complex decisions and issues to overcome:

- **Products.** They don’t agree on which products are making them money. Their merchandise plans don’t have a long-term focus. And they can never agree to kill a product.
- **Customers.** They don’t agree on which customers are making money. They find customer demands increasingly expensive to meet. And they tend to offer all of their customers the same level of service.
- **Pricing.** Their pricing doesn’t keep up with their cost structure. Some don’t realize they are pricing below cost; many find raising prices to be a struggle despite the fact that suppliers are raising prices.
- **Costs.** They have limited visibility into the true total cost of their products, and it takes too long to experience the impact of cost improvements.

Issues like these do not have simple answers. But that doesn’t mean the answers—if you can find them—will be worthless. Rather, it means that in finding the answers, you need to attack profit opportunities systematically along the entire value chain and throughout the product life cycle.
Three components—the basis for *Expanding the Profit Frontier*—can provide structure and rigor for the attack:

1. **Match a product’s strategy to its life cycle.**
   Cut through the fog of uncertainty about where you make money today and plan to make money in the future.

2. **Capture meaningful business intelligence.**
   With true visibility into profits, at the level of the transaction and stock-keeping unit (SKU), you can generate insights granular enough to prompt specific, value-building actions.

3. **Make a difference that lasts.** By implementing a governance model to accelerate improvements, with performance metrics to track real results, you can ensure that profit improvements are not one-time-only events.

By combining these elements into a single framework, there are multiple paths and levers available along the entire value chain to push out profit frontiers for specific products and customers. The following discusses each in more detail.

### Match a Product’s Strategy to Its Life Cycle

Every product or service has a life cycle: introduction, growth, maturity and decline. Most companies are aware of product life-cycle management (PLM), and many use it to design marketing management strategies. This thinking is too narrow in two respects: PLM is commonly considered merely a marketing concept, but its value expands significantly when it is applied to *all* functions. And although

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**FIGURE 1**

Align strategic decisions across all phases of a product’s life cycle

<table>
<thead>
<tr>
<th>Strategic dimensions</th>
<th>Introduction</th>
<th>Growth</th>
<th>Maturity</th>
<th>Decline</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Raw materials</strong></td>
<td>Maintain small volume of raw materials for emerging portfolio</td>
<td>Explore new formulations as SKUs and raw materials multiply</td>
<td>Rationalize SKUs and associated raw materials</td>
<td>Standardize on large volume SKUs; consolidate to bulk raw materials</td>
</tr>
<tr>
<td><strong>Conversion</strong></td>
<td>Dedicate small volume production lines as appropriate</td>
<td>Combine sales orders if possible to minimize costs</td>
<td>Establish MOQs* and lead time rules to enable large batch production</td>
<td>Evaluate MTS or MTO* schedules; Explore tolling options</td>
</tr>
<tr>
<td><strong>Logistics</strong></td>
<td>Combine orders to reduce ship-to-customer costs</td>
<td>Identify possible opportunities to shift modes</td>
<td>Establish MOQs and lead time rules to facilitate mode shifting</td>
<td>Establish price premiums for high-cost routes</td>
</tr>
<tr>
<td><strong>SG&amp;A</strong>*</td>
<td>Ensure full-time employee (FTE) support to guarantee product acceptance</td>
<td>Allocate FTE support to more profitable customers</td>
<td>Rationalize FTE support; reallocate to early phase</td>
<td>Minimize FTE support; implement price premiums for FTE service</td>
</tr>
<tr>
<td><strong>Pricing</strong></td>
<td>Define pricing strategy for growth phase</td>
<td>Determine price to penetrate market</td>
<td>Determine price to maintain margin and market share</td>
<td>Determine price to avoid negative profits</td>
</tr>
</tbody>
</table>

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*SG&A is sales, general and administrative; MOQ is minimum order quantity; MTS/MTO is made-to-stock or made-to-order

Source: A.T. Kearney analysis
PLM is traditionally used to justify investments during the introduction phase, it may have greater profit-maximizing value in later stages, where the profit opportunities are. Thus, strategic misalignments in these stages often shrink the frontiers of available profits, squandering the effort spent on product development.

Successful companies align their products’ strategic decisions throughout all life-cycle phases across the key dimensions: raw materials, conversion, logistics, SG&A expenses and pricing (see figure 1 on page 17). For example, although the growth phase is typically characterized by excessive SKU proliferation as companies try to gain share and meet evolving customer requirements, when a product reaches the maturity phase, it’s time to rationalize SKUs to lower raw material costs and gain other efficiencies of scale.

The key to unlocking the value of PLM is to operationalize life-cycle analysis across the value chain. In other words, life-cycle curves must be integrated into the traditional value-chain analyses that lead to specific operational decisions. The first step is to analyze time-series sales data to show where a product family is in its life cycle (see figure 2). The product family’s position on the life-cycle curve then suggests certain spending and profitability patterns—and departures from those patterns represent areas of concern. For example, in figure 3, products B, C and D are all in the maturity phase, where an effective life-cycle strategy would suggest decreasing the number of SKUs. Yet products C and D have increasing SKU proliferation— that is likely contributing to their decreasing profitability. Addressing this inconsistency and then capturing cost reductions through such tactics as enlarging batch runs, collapsing production lines, and adjusting labor levels will expand the profit frontier by improving profitability for the remaining core-product offerings. Compared to a broad,
single-dimension initiative, this approach identifies both the small-but-meaningful profit frontier and the specific, targeted actions that can increase profitability.

With such operationalized tools, product analyses are performed without tying all products to uniform (perhaps unrealistic) profitability goals. For example, product E in figure 3 also has decreasing profitability, but because it’s in the decline phase of its life cycle, addressing its decline should be a lower priority than for products C or D. Product E can be priced to avoid negative profits while minimizing SG&A support; meanwhile, company resources can be better diverted to product A, which is in its introduction phase.

A key to the success of this strategy is the analysis that goes into figure 2, identifying the location of each product family along the life-cycle curve. The shape of a PLM curve, however, rarely matches the ideal. Although it isn’t easy, the analysis is important. We have found that people in different company functions often disagree about the shape of the curve, a product’s location on the curve, or both—and those disagreements cause strategic misalignments.

Cross-functional review sessions can draw out these disagreements and may lead to the evaluation and debate required to resolve them. In the debate, we have found that modeling the life cycle for end-use markets where the product is employed provides valuable understanding of the shape and duration of life-cycle phases. For example, we worked with one manufacturer whose sales data suggested that a family of products was in the process of maturity and decline. But before acting, management wanted more confidence that the life-cycle

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**FIGURE 3**

Illustrative

When a product family strategy is inconsistent with its life-cycle stage, profitability suffers

<table>
<thead>
<tr>
<th>Product family</th>
<th>Estimated life-cycle stage</th>
<th>SKU proliferation</th>
<th>Profitability</th>
<th>Consistency with life-cycle positioning</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td></td>
<td>↑ ↑</td>
<td>↑ ↑</td>
<td>Yes</td>
</tr>
<tr>
<td>B</td>
<td></td>
<td>↓ ↓</td>
<td>→ →</td>
<td>Yes</td>
</tr>
<tr>
<td>C</td>
<td></td>
<td>↓ ↑</td>
<td>→ ↑</td>
<td>No</td>
</tr>
<tr>
<td>D</td>
<td></td>
<td>↓ ↑</td>
<td>→ ↑</td>
<td>No</td>
</tr>
<tr>
<td>E</td>
<td></td>
<td>↓ ↓</td>
<td>↓ ↓</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Source: A.T. Kearney analysis
analysis reflected the market as a whole. So we analyzed total unit sales volume data from the entire end-use market in which the product was employed—which confirmed the life-cycle positioning and gave management confidence in its life-cycle analysis.

Again, however, note that the key to this company’s success was to make the life-cycle analysis operational along the entire value chain, not just in the marketing mix. In this case, the company made adjustments to each of the management functions listed vertically in figure 1 on page 17. For example, it sought lower-cost substitutes for the product’s raw materials; it consolidated manufacturing runs at a single, lower-cost plant; and it transitioned deliveries to lower-cost modes. The company’s results averaged a 2 to 5 percent increase in profitability across the portfolio where the analysis was applied.

Capture Meaningful Business Intelligence

Effective business intelligence relies on visibility and “actionability.” You need to be able to see information (the right information), and that information needs to lead to insights you can act on. It’s not enough to know whether a customer or product is profitable—you need to know why. Getting to the multiple dimensions of why requires business intelligence at the level of individual transactions and a methodology to translate that visibility into insight.

Roadblocks to Business Intelligence

Business intelligence and business analytics are hot topics these days, and many companies have invested in systems and software to provide enterprise-wide analytics capabilities. Some companies have used these investments to achieve a deeper understanding of market dynamics, improve their ability to predict changes in customer behavior, and obtain better insights into the value added by various activities along the value chain. Other companies have struggled, often blaming poor data and systems, and sometimes that blame is justified. Our experience suggests that organizational factors are equally significant hurdles to building effective analytics capabilities. These hurdles include:

Lack of vision and objectives. As with any transformation, the first step is to establish a clear vision. However, many companies embark on an IT-led initiative, rather than one that first sets strategic objectives to achieve business intelligence.

Limited cooperation across silos. Silos happen. Whether through acquisitions, or autonomous business units aggressively pursuing their markets, corporations end up with distinct, poorly aligned units of information and expertise. How do people (and subsequently the IT systems they design and use) reach across those silos to gain the insights they need?

Unaudited data and processes. Does your company have data stewards and process owners? Are processes audited properly? If not, process variants can cause data incoherence and your business intelligence becomes a case of garbage in, garbage out.

Focus on precision over accuracy. Although meaningful analytical models need high-quality data, they don’t need perfect data. Companies are like sailors in the middle of the ocean, far from any destination: It’s better to start sailing today using a crude compass than to wait until next year when a new, perfect GPS solution may become available.

We believe that business intelligence is best seen as an initiative, rather than a system. It cannot be achieved by any one new piece of software, or any single change to an organizational chart. Rather, business intelligence needs to be part of a structured approach to maximizing profits by fully understanding the transaction-level details that make up those profits.
The second component of our framework builds usable business intelligence through a “profitability cube” (see figure 4). The cube is a multidimensional tool that calculates profitability at the transaction, SKU and customer levels by linking sales order data directly with multiple sources of cost data, such as raw-material purchases, manufacturing and logistics, sales, marketing, technology, and research and development (R&D).

At this point you may be saying, we already have an enterprise resource planning (ERP) system. (Indeed, some of you may be saying, and I’m not going down that road again….) Despite the expense, in many large organizations today, ERP systems don’t always generate meaningful business intelligence. They simply aren’t implemented to collect end-to-end transaction-level historical information. Instead, they’re set up to serve the needs of specific functions, such as finance, sales, logistics or manufacturing. Rarely is one instance designed to serve the entire value chain seamlessly, and almost never across all geographies. Yet without this transaction-level visibility into data across the value chain, you can’t get a crisp, far-reaching, comprehensive view of where you are making money.

It’s not simply a matter of blaming the technology, because ERP systems do what people tell them to do. ERP vendors will tell you that their products have capabilities to link orders from procurement through sales—and they will often also tell you that these capabilities are rarely implemented or even requested by their clients (see sidebar: Roadblocks to Business Intelligence). Although some companies have sought to overcome the drawbacks of multiple transactional systems by constructing global data warehouses to capture cross-functional data, even these warehouses rarely provide visibility at the transaction level.

**FIGURE 4**

The profitability cube calculates where your company is making money

**Cube inputs**
- Cost allocation methodology for variable costs using:
  - Purchase order invoices
  - Bill of materials/production
  - Distribution
  - Sales and pricing

**Cube outputs**
- Dynamic profit and loss (P&L) reporting
- Scenario planning and optimization
- Profit maximization
- Complexity management

*Source: A.T. Kearney analysis*
The process of aggregating information into the warehouse sacrifices its granularity, which is what you need to take action. Even companies that have worked hard to gain thorough data transparency have found that transparency alone is not sufficient to drive change, because of the difficulty of allocating fixed costs and shared costs down to the level of individual products, customers, and transactions. Finally, ERP systems track actual or historical data and therefore perspectives on profits already achieved. The profit cube allows you to project profit levels that could occur if different management or economic decisions are made.

So the hurdle to understanding true profitability is gaining this transaction-level visibility and defensible cost allocations that can lead to meaningful insights. With the profitability cube, you can open discussions about activity-based analyses to address cost allocations, and you have access to the multidimensional analytics to help achieve widespread buy-in while minimizing painful internal battles. The cube is like the scaffolding that helps you see and access the various parts of the vine, using whatever tools you find most effective. For example, a multinational company used the cube to account for its costs in a consistent manner. Because business units and geographic regions were using different cost methodologies, key cost elements were often excluded or inaccurately accounted for. With the profitability cube, the company was able to gather correct cost information and thus make consistent decisions across its global markets.

The next level of business intelligence combines the multidimensional profitability cube with a mathematical capability to enable data-driven scenario planning. You can examine “what if” scenarios to determine earnings sensitivity to future market conditions. These predictive analytics allow exploration of the furthest “profit frontiers” of a business—the unexplored (and potentially dangerous) terrain that offers opportunities for vast wealth.

You become empowered to ask questions such as: Which profit levers—increased SKU volumes, lower raw-material costs, new pricing strategies—would give the best results (and in which timeframes)? If we eliminated 40 percent of our SKUs for a business unit, what would happen to certain customers, products, strategic facilities, and other markets? And which practical actions will be needed to realize the desired scenario?

**Make a Difference that Lasts**

A company can improve its profitability without this last element of our framework, but its benefits will be short-lived. Lasting benefits come from the right governance structure that cuts across all functions to establish a common mission toward profitability. The biggest challenge is establishing ownership of an effort that really doesn’t belong to any one single function. Several companies have addressed this challenge by setting up a “profitability council” that reports directly to—or is even chaired by—the CEO. One key to the success of a profitability council is finding the right performance metrics that link back to profitability. (As is well known, benefits wither or evaporate when the actions that contribute to them are not measured.)

For example, we worked with a company that blamed its low profits on problems arising from its one-size-fits-all customer service model. It was trying to provide rapid delivery of an exhaustive product line with very low cost structures. But its most important customers were frequently disappointed. By developing a multidimensional solution to address products, customers, manufacturing, purchasing, and design, performance was dramatically...
Three Questions for Your Company

In conclusion, we’d like to suggest that every company’s future sustained profitability depends in part on answers to the following questions:

Is improving profitability a project, or a business process? Projects are great for harvesting low-hanging fruit. But profitability management is both holistic and ongoing. Thus, to address the complex challenges between you and the higher-hanging fruit, you need to commit to an ongoing process. Like the fox seeking the grapes, you must ignore the temptation to invent self-serving justifications, and instead get together with your colleagues on a comprehensive plan of attack that builds stable scaffolding from which to harvest.

Do you have usable information? Analytics drive good decision making, but good analytics have two prerequisites. First, does everyone in your company agree on the data? And second, does your data exist on a level granular enough to provide visibility on performance at the SKU, customer and transaction levels? This visibility is required to achieve understanding of where to invest in profitability improvements.

Are your functions aligned? And the follow-up questions: Do your different departments think about your business in the same way? Have you fine-tuned your product and customer portfolios to maximize margins and strategic value? Do you measure performance using metrics that ensure long-term sustainability of your results?

As a writer of fables, Aesop was in the business of memorializing the way things are. But “sour grapes” doesn’t represent the way things have to be. Through continual learning and planning, with tools such as Expanding the Profit Frontier, companies today can strive to outsmart Aesop’s fox and reap the fruits he left behind.
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