AlixPartners

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TOP NINE MYTHS OF REVENUE AND GROWTH

Myth two: beware of false profits

In the **Top Nine Myths of Revenue & Growth,** a nine-part series, AlixPartners spotlights the changing calculus of top-line revenue strategies and suggests ways companies can overcome commonly held revenue and growth myths as they pursue—and achieve—profitable growth.

FOR COMPANIES SEEKING TOP-LINE REVENUE GROWTH, THE RULES OF THE GAME HAVE CHANGED.

Across industries, market dynamics are evolving at an ever-increasing pace as companies derive data-driven insights and apply digital strategies to move quickly and decisively in order to adapt and grow.

WITH THOSE NEW RULES COME NEW STRATEGIES.

Now more than ever, speed to results and rapid execution in sales, marketing, pricing, and profitability are becoming fundamental to remaining competitive. Many commonly held assumptions have been rendered obsolete, yet many companies still fall prey to the myths as they struggle to respond to the competition.

AVOIDING THE MYTHS AND ACHIEVING TANGIBLE GROWTH.

With the changing rules of the game, how can investors and managers overcome myths and maintain or enhance profitable growth? More important, how can they execute while staying strategically nimble enough to remain responsive to the market and not only survive but also thrive?

MYTH TWO: BEWARE OF FALSE PROFITS

THE HIGH PRICE OF HIDDEN COSTS

False prophets, we're told, can all too easily lead even the best growth-oriented executives astray. So too can false profits. At a surprising number of companies, management cannot measure true profit by any relevant metrics—such as geography, product, business line, or customer—because the true cost of revenue is being obscured by convoluted and incomplete financial reporting. The reported, but often inaccurate, numbers lead management to believe they are creating and managing profitable growth when in fact the company may be losing money on all or nearly all new business.

It is not uncommon for 30% of a company's revenue to be unprofitable. That destructive blind spot doesn't develop overnight. It's a typical artifact of the way companies grow. The company adds new business and revenue gradually over time—but without fully accounting for the real costs that accompany each new piece of business. To understand how that can happen, imagine a manufacturer's business unit with $100 million in annual revenue and an estimated 10% net margin. The company's star salesperson lands a new customer worth $10 million in annual orders—to the delight of members of senior management, who can report 10% annual growth to shareholders and expect a proportionate bump in their personal compensations. The problem is, the salesperson landed the business by offering the new customer a 10% discount—which sounds reasonable until you realize that the salesperson is not just giving a 10% price break but also, potentially, giving away 100% or more of the expected net profit from the deal.

It gets worse. When booking the sale, the finance function proceeds on the assumption that the order doesn't bring with it any incremental costs, direct or indirect, and thus the finance function doesn't factor in the cost of new revenue when setting future prices and estimating margins. This is a fundamental error, and its effects compound over time—as long as management continues to convince itself that no new costs accompany incremental revenue increases. Moreover, investors could be inadvertently misreading the effect of revenue growth on the company's financial health.

MISSING INFORMATION LEADS TO LOWER PROFITS AND VALUELESS COMPLEXITY

The fact is, every piece of new business will eventually incur new costs, which will have to be recovered through pricing. Which in turn raises the question: how should any new costs be attributed once they're finally acknowledged? Should they be spread like peanut butter over the entire cost base, without regard to levels of plant capacity, infrastructure, and other overhead needed to support each transaction? That's typically the course management takes: (1) shifting the reporting and management of select, corporate-type costs out of the business units; (2) reporting only controllable costs; and (3) stranding the remaining costs in catchall rest-of-world or corporate accounts, which then become invisible to those who actually set price and margin. As a result, companies might fail to consider as much as 20 to 30% of total costs when making pricing and investment decisions.

Compounding that problem is the fact that many salespeople are coin operated. They're motivated by volume targets and revenue-driven commissions, which give them powerful incentive to offer aggressive discounting based on perverse margins calculated with underallocated costs. That kind of incomplete costing and marginal pricing creates the illusion of [false] profits. Earnings get diluted as the business chases volume on erroneous margin estimates in a futile attempt to spread what are perceived to be fixed costs.

Coupled with the gradual attrition of fully costed legacy business over time, the company can find itself in a death spiral, in which estimated profits from the new business never materialize.

Another consequence of faulty linkage of cost to revenue is that in pursuit of volume and commissions, salespeople will agitate for small but costly variations in existing products; they'll beat the bushes for small accounts in out-of-the-way high cost to serve locations; and they'll relentlessly add unprofitable or marginally profitable customers to meet volume targets. The result: the company piles on substantial valueless complexity.

HOW ONE COMPANY FIXED ITS FALSE-PROFITS PROBLEM

One of our clients recently found itself in just such a plight. A key business unit, which provided hardware and consumables for the consumer and small-business markets, was hemorrhaging cash. At the core of the business unit's problems was a severe shortage of trustworthy information about specific channels', products', and customers' profit contributions. Unable to identify the true cost to serve its markets, the company simply could not accurately determine where it was making or losing money. With key functions, including finance and marketing, operating in the dark, promotional spending generated little return, and profit forecasts were unreliable, resulting in erosion of investor confidence.

AlixPartners performed a customer and product profitability analysis that enabled the company to pinpoint the activities, products, and markets that were draining cash, and management responded with aggressive channel management and pricing actions that generated a $200-million annual increase in the business unit's contribution to overall corporate net profits. More broadly, the company developed a realistic picture of the unit's growth potential and cost to serve, thereby enabling it to sustain its return to profitability.

THE LASTING BENEFITS OF CUSTOMER AND PRODUCT PROFITABILITY ANALYSIS

That company's experience points out how critical it is that management understand—in detail—its full profit picture, not only to reduce levels of complexity and reset unfavorable customer relationships, but also, and more importantly, to regain control of the business. A fully visible and accurately costed profit model is essential to creating such a picture. Armed with the information a profitability analysis provides, management becomes able to determine the true implications of the company's volume and revenue growth, to simplify its business, and to generate rapid and sustainable net profit growth.

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ABOUT US

For nearly forty years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.