BusinessPlus+ Newsletter

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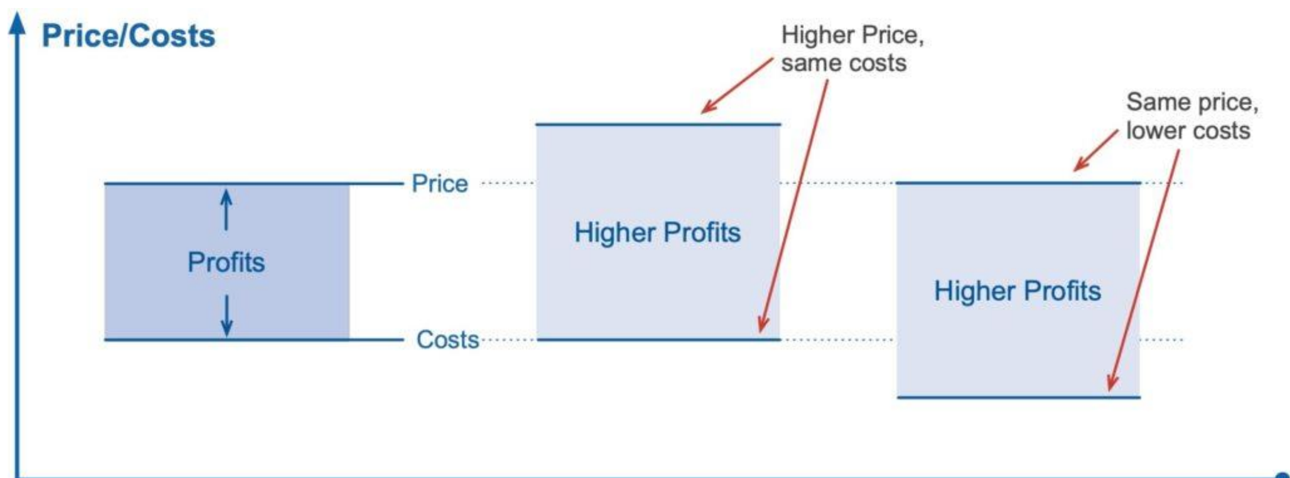
Profit versus Profitability

The Profit Equation
The profit equation only has three variables: price, volume and costs.

Price x Volume = Revenues; and
Revenues - Costs = Profits (Losses)

That means that to increase profits all you need to do is to increase sales (either by increasing prices or driving more demand), reduce costs (or get higher productivity relative to your current fixed costs), or achieve some combination of the two. The diagram below clearly illustrates these inter-relationships.



How Price and Costs Affect Profitability

That seems like a very simplistic definition, but the underlying implications of these relationships go well beyond that formula since profits, as we will see, connect to everything a company does.

For example, revenues, through sales, connect a company's products and services with its customers, its distribution channels and its sales force, while costs on the other hand interface a company's offering with its operations and supply chain.

The way you create wealth for a company is by maintaining a healthy balance between revenues and costs over time.

In general, the wealth-creation cycle happens in three steps. First, you sell products and services that create ***Value*** for customers. Second, you retain a piece of that value in the form of ***Profits***, and third, you transform those profits into ***Cash***, which is the ultimate goal of ***Strategy***.

With this cycle in mind, you could define profitability then as a measure of the *wealth* that a company gets to keep for itself from the creation of value for customers. That wealth, however, must later be converted into cash, which is the final prize. It is hard cash not profits, that you can use to pay bills, grow the company and pay earnings to shareholders, **therefore cash, not profit, is the ultimate goal of strategy**.

The role of strategy, therefore, is in providing a plan that helps a company retain as much value as possible in the form of "cash", provided that such a plan is sustainable over the long term through sustainable (and growing) profitability.

The profitability that a company can achieve in any given market will be restricted or "constrained" in some way by the influence of different factors that work inside and outside the organisation, including:

Business Choices about Product Design: Decisions about the features and benefits that your products and services offer, and how well those align with the identified needs of your target customers. Since you are only able to capture a fraction of the value created, the more value your products create for customers the more you can target to keep for yourself.

Structural Factors in Our Core Markets: The relative power of the players in the markets where your products and services are sold defines to some extent how the value that you create must be *shared* with those other players. If you are a powerful incumbent, you get to keep a bigger share of the value you create; if not, better positioned players will command a bigger piece of the action.

Structural Factors in Adjacent Markets: Similarly, the nature of adjacent markets or industries where your competitors, customers, vendors, substitute products and complementary offers operate influences their power to claim a bigger share of your product's core market. Vendors that are powerful in their industry for example, can make you pay more for their products, getting a bigger bite of your profits.

Official Regulations: Regulators, in the form of government, lawmakers and others, can limit the profitability of an industry through laws, taxation and incentives. Mature industries will naturally have the most established regulation frameworks, but in emerging one's regulation will be weak or even lacking, presenting an opportunity for savvy executives to be part of how that regulation is shaped.

Non-Market Factors and Trends: Factors outside the market itself such as prevailing industry standards (or lack thereof), state of technological development, labour and unions, predominant working style and cultural norms may influence how value, and in turn profit, is created. Similarly, observable trends and industry evolution might also affect the space of potential profits in the foreseeable future.

Each of these factors can affect your ability to claim a bigger share of the value you create for your customers, and your strategy is in a way your response to your understanding of those factors, which means you should really understand them very well before you can come up with a winning strategy.

It is your job as a business leader to understand how these factors are having an influence on your company's performance. You may have the best strategy and still get poor results if your market sucks, in the same way that you could get great results with a poor strategy in a thriving market.

But at any given time, you should be able to say what is driving unusual performance of the market. Is it because of a market trend; Competitors behaving more or less aggressively; Regulators tightening or loosening things up; OR is it because the market is growing too fast or too slow?

Common Misconceptions about Profits and Profitability

Before we move on, it is important that we clarify a few misconceptions about critical concepts when it comes to strategy and profits.

Market Share and Sales DO NOT Guarantee Profits: Increasing sales and market share doesn't automatically mean higher profits. Any company could increase sales significantly by pricing products and services below cost (losing money of course).

Sales and market share only provide an indication of revenues, but revenues alone don't make profits, as they don't consider the costs associated with those sales.

Being Bigger Doesn't Guarantee Profits: Another misconception is that being bigger than everybody else, because of the economies of scale you create, is how you beat competitors. In reality, scale alone cannot ensure higher profits. ***Economies of scale do exist and are very important, but they dissipate fairly quickly in many industries, and once that happens, they no longer provide a competitive edge.***

Beating Competitors Doesn't Guarantee Profits: Kicking rivals out of business will not ensure higher profits unless you beat ALL your competitors out of the market.

Being unique and achieving superior returns should be your goal, but beating rivals is not a strategy.

Innovation Doesn't Guarantee Profits: Innovation is expensive, difficult and can't ensure your products will be overnight hits. In fact, most innovation attempts fail by big numbers.

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