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# Don't be a Busy Fool: Make Sure that Growth is Profitable

A venture capitalist recently spoke to me about his concern for 'how not to become a Busy Fool' and commented, "Sadly, many of our Investments fall into the trap of becoming exactly that by pursuing growth without paying sufficient attention to profit or cash."

This white paper looks at why this happens, and how to ensure that growth is profitable.

## BE SURE TO GROW THE RIGHT PART OF THE BUSINESS

Most businesses are mixtures of different types of product or service. By luck or judgment they have arrived at a mix which produces an acceptable average profitability, but often know less than they need to about how the average is made up. Some of the things they do are exceptionally profitable, and cover for other things which could even be losing money.

This is not too bad when the business is in a steady state, but if it starts to make serious efforts to grow, the latent problem emerges. What happens if you decide to grow the least profitable part? You could be investing money in order to lose money!

The answer is to understand the relative profitability of different parts of your business, analysed in a way which makes sense. The right way to slice the business might not be obvious. Take the example of a pharmaceutical marketing consultancy with which we worked. It could analyse its profitability by geography, customer size or the stage of the launch process that the client's product was at. All of these were of some use, but the really crucial thing was the type of work being done. Work with a high scientific content was highly profitable, while the more marketing-oriented work was much less so. Expanding in the area of marketing work would have grown revenues, but pulled down profitability.

Understanding the relative profitability of the different parts of the business is hard work. You need to get down to a low level, probably by individual product or customer, and look for patterns. You can't assume that your existing product or customer groups are right for the purpose. A grouping such as "customers in the oil industry" could be an amalgam of many different customers doing different things with very different profitabilities.

## KNOW WHEN YOU ARE MOVING OUT OF YOUR CORE AREA

This is quite insidious. Slowly, without realising it, you move further and further away from the skills and knowledge that have made you successful. You could ask "how could anyone be so stupid?" but because it happens gradually it is easy to miss what is happening.

As an example, a magazine publisher had been very successful with highly specialist titles in areas such as radio controlled models. It had moved into more popular crafts such as patchwork, with some success. It then decided to launch a general crafts magazine for children. What it missed was that it had now moved into a different world altogether. Its experience and success was in the specialist magazine world of niche products, limited competition, loyal and clearly defined readerships. It was now in the brutal world of mass market magazine publishing with its requirement for huge promotional budg-



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ets, television advertising and large subsidies to retailers. They did not have either the resources or skills in that area and the product was an expensive failure.

The answer here is to be very honest about yourself and what you are good at. Also be realistic about resources. Look at competitors. Who are they? Are they other companies like yourself, or are they different? How much are they spending on promotion, or on research and development? Assume that you, being new to the field, will have to spend much more than that.

## DON'T GET DISTRACTED

It is very easy to underestimate the work involved in generating growth, and this can be fatal. Consider what happened when the Morrison's supermarket chain acquired its competitor Safeway. It looked like a transforming deal, but six months later Morrison's had to admit that its finance function had completely broken down, it had no idea what its financial position was, and the Finance Director had resigned.

They had grossly underestimated the work involved in integrating the two finance functions, and moved ahead too rapidly with a redundancy programme intended to generate cost savings.

This is not just a risk in the finance department – it can happen in sales, marketing, logistics, anywhere.

Here again, you need to be highly realistic. However unpalatable the idea may be, if you are aiming for growth, profits probably need to fall before they can rise. (It's called investment). If you are making an acquisition and merging functions to save money by taking out duplicated costs, you do not move smoothly from two functions costing £1m pa each to one merged function costing £1.5m. You move from two functions costing £1m each to a complicated and risky situation costing £3m a year, and then to one merged function costing £1.5m.

As well as underestimating resources, underestimating the amount of management time available is often a good way to lose focus. There is a common unspoken assumption that senior managers are capable of taking on unlimited amounts of work. Attractive as this belief may be, it is not correct. Senior managers have their limits like anyone else, and are probably quite close to them already. If you want to start pursuing growth, and your senior management team is not obviously short of things to do, you need to add people at or near the top. Ignore this, and the results could be catastrophic.

## BEWARE OF DIMINISHING RETURNS

If moving into new areas or making acquisitions looks risky, what about increasing penetration of existing markets? This can be much safer, provided you take account of the effect of diminishing returns. Consider this: you grow revenues by 10%, profit in absolute terms by 5% and the operating profit margin reduces by less than 0.5%. At first sight, this doesn't seem too bad. When you analyse what it really means, though, it is horrible; the business you are adding is half as profitable as your existing portfolio, which probably means less than a quarter as profitable as the good bits of your existing portfolio (that existing portfolio, remember, was made up of good, bad and indifferent). You are well into the area of diminishing returns. Keep going and you are on the road to ruin.

Two things will ensure you avoid this pitfall: Firstly, look carefully at the effects on the margin: how much additional marketing, for example, are you spending to make the additional sales, and how does this ratio compare with the original marketing to sales ratio?

Secondly, be sure you know enough about the relative profitability of the portfolio

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before you start going for growth. If there is one customer group, product type or market channel which is much more profitable than the average, then it is a pretty safe bet that you can grow this further before running into diminishing returns.

## YOU CAN'T GET THE STAFF. . .

Some types of people are very hard to find and attract, particularly sales staff and people who understand the "black art" of the technical side of your business. Recruitment of these types of people is slow, runs to an unpredictable timetable, and is risky. Failure to get the right people can be fatal to growth.

Your plans need to make allowances for delays and failures in recruitment, but ask whether you do need to be quite so subject to the vagaries of the recruitment market:

- Do you rely too much on individuals rather than systems and teams? This can happen with sales people. Are you expecting your sales people to do it all themselves, functioning without strong marketing support, product training, or sales support?
- If your business involves black arts, does it need to? Is information held in key people's heads when it could be systematised and written down, and so available to others? Are you up to date on the latest methodologies?For example, many in the software business would say that writing software is no longer a black art but a predictable, repeatable industrial process. Have you fully exploited these opportunities?

This recruitment risk can be mitigated, but not eliminated. Allow for finding the right people, and making them productive, to take longer and cost more than you would like, and plan accordingly.

## VALUE SIMPLICITY

Always ask: as we increase in size, are we increasing complexity faster than profitability?. I remember a publishing group which was under pressure to grow but didn't have the money to make acquisitions or the time to start businesses. In a time of rapid change and consolidation in its industry it passed up opportunities for acquisitions which fitted neatly into its existing businesses (too expensive) and bought into a range of fringe activities which had little in common with its original business, and about which it knew little. Cynics said the only reason it could afford these deals was because nobody else wanted them. The end result was unwieldy, unprofitable and after three painful years was broken up.

In a nutshell: simplicity is good. Large simple businesses are better than small simple businesses, but small simple businesses are better than small complicated businesses. If you are an investor, there something very important to watch out for here: managers often like complex businesses because they are more interesting and they get paid more for managing them, even if all they are doing is solving the problems of unnecessary complexity. Make sure that as far as possible incentives are aligned; is your management chasing growth in pursuit of higher profits, or of higher salary and status?

So what can you do? Two points sum it up:

Be very realistic about:

- Your capabilities
- Your place in the market
- Your motivations in seeking growth in the first place

Know as much as you can about the business, where it makes its money and where it does not.

***If you would like to make sure that your growth plans generate the profits they should, we can help. Contact Alastair Dryburgh for a preliminary discussion.***

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