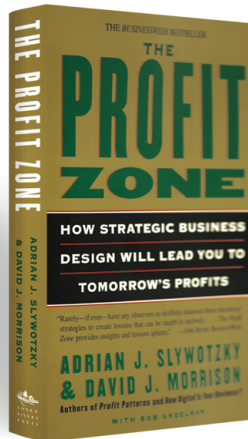




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by Adrian J. Slywotzky
and David J. Morrison

How Strategic Business Design Will Lead You to Tomorrow's Profits

THE PROFIT ZONE

THE SUMMARY IN BRIEF

The No. 1 problem in business today is profitability. Where is the profit zone today? Where will it be tomorrow? The profit zone is the area of your economic neighborhood where you are allowed to earn a profit. To reach and operate in the profit zone is the goal of every company.

The quest for profitability has become more important than ever. The hype of the Internet, the free flow of excess venture capital and the strength of the equity markets have collaborated to create many foolish business models. This increases the need for the discipline of business design reinvention.

We're looking forward to the real possibility of a sustained period of low profit and low growth for all the thousands of businesses that don't understand where tomorrow's profit will come from — and how to reinvent their obsolete business designs accordingly.

By studying the examples of great business reinventors — such as Jack Welch, Charles Schwab, Michael Eisner, Bill Gates and several others — you will be able to create value for your customers and capture value for your business. Each of the reinventors have been extraordinarily successful at using carefully chosen tactics to create exceptional profit growth for his company.

By developing superior insight into customers and adapting a company's business design accordingly, business leaders can get off the treadmill of just doing the same old things faster and better and return to the profit zone. This summary answers the most fundamental question in business: Where will I make a profit tomorrow?

IN THIS SUMMARY, YOU WILL LEARN:

- How to protect your profitability.
- Why market share is dead.
- How to design a customer-centric business that leads to profit.
- About 11 different profitability models that can be used to achieve various profit-centric business designs.
- About the business leaders and companies who have led the way in reinventing their business design and how they succeeded.
- How business design innovation creates the profit zone.

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THE COMPLETE SUMMARY: THE PROFIT ZONE

by Adrian J. Slywotzky and David J. Morrison

Market Share Is Dead

As a manager, you were taught that the pursuit of market share and growth automatically places you on a direct route to business success. However, these formerly direct roads have become mazes riddled with traps, wrong turns and dead ends. Many large companies, after taking the turn toward market share and volume growth, have only hit a profitless wall.

Consider the experience of IBM, DEC, GM, Ford, United Airlines, US Steel, Kodak, Sears and Kmart. All achieved leading market share positions: No. 1 or No. 2 in their industries. Yet all these leaders saw their profitability begin to erode during the 1980s. Their dominant share positions did not protect them. Several of these companies have since implemented radical changes in their business design. Their focus on profit, not just market share, has led to dramatic rebounds in value.

Managing for Volume Growth or Value Growth?

In the old economic order, in the age of market share, volume growth was a guarantor of success. Growth was what we were taught to pursue. It created higher profits for all, including market share laggards, companies with poor business designs and companies that were poorly managed. A rising tide raised all boats.

However, industry growth and a company's value (stock price) growth no longer have a one-to-one correlation. Fast-growing industries such as consumer electronics, telecommunications and software have each produced scores of terminally unprofitable companies. By contrast, Coca-Cola achieved significant value growth in the low-growth beverage industry, as did General Electric in a collection of low-growth manufacturing industries.

No-Profit Zones

No-profit zones are the black holes of the business universe. In a physical black hole, light waves go in but never come back out. In an economic black hole, investment dollars go in, but the profit dollars never come back out. Paradoxically, the devout pursuit of market share may be the single greatest creator of no-profit zones in the economy. ■

Customer-Centric Business Design

Let's begin with what customer-centric thinking isn't. It isn't traditional, conventional market research — mountains of data, hundreds of tables and no actionable insight. Nor is it traditional customer satisfaction research, an important but backward-looking measurement of how yesterday's decision makers rated us on what was important in yesterday's business model.

By contrast, customer-centric thinking needs to look at the customers' problems through the customers' eyes, not through the eyes of a market researcher. The customer-centric thinker spends time talking to customers rather than reading reports and thereby gains an understanding of the customer's perspective.

Customer-centric thinking is difficult for two reasons. First, managers and executives who have been around for a couple of decades were trained in a product-centric world. Second, a company's focus changes over time. During the entrepreneurial phase, the company must focus intensely on the customers or it will fail. As the company grows and succeeds, however, it tends to become focused more and more on itself — its internal budgets, internal resource concerns and internal politics — and therefore has a great deal of difficulty with customer-centric thinking.

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Summary: THE PROFIT ZONE

Customer-Centric Business Design

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Reverse the Value Chain

To begin customer-centric thinking, managers must reverse the traditional value chain. Customer-centric thinking focuses on the customers' needs and priorities and identifies options through which these needs and priorities can best be met.

From there, it is determined what channels can satisfy those needs and priorities, the service and products best suited to flow through those channels, the inputs and raw materials required to create the products and services, and the assets and core competencies essential to the inputs and raw materials. In other words, the traditional value chain must be completely reversed.

Cracking the Code on Customer Priorities and Systems Economics

Customer priorities are the things that are so important that the customer will pay a premium for them or, when they can't get them, will switch suppliers. With an industrial customer, there is rarely one buyer or one source of influence. The structure of a customer's needs, behavior, decision-making process, price sensitivities and preferences is as complex as any molecule. The challenge in strategic customer analysis is to both understand multiple levels within an organization and be able to use various methodologies to put together a mosaic of the real picture.

Even putting the right questions to the right people will not always provide a manager with enough information, because not all of a customer's needs are articulated. One of the most powerful tools for ferreting out those silent, unarticulated and at times unknown priorities is analysis of the customer's systems economics.

A customer's systems economics includes the amount paid for the product or service; the costs to use, store and dispose of it; the time consumed in the purchase transaction and the usage pattern; and the amount of

hassle that has to be tolerated or paid out throughout the entire process.

Really knowing the customer's systems economics enables you to answer this question: "How can we really add value to the customer?" The answer to that question can be ascertained by creating a privileged information flow from a truly market-representative cross section of customers. If you aren't meeting true customer priorities, you run the risk of supplying an irrelevant product to indifferent customers.

Anticipate Changing Priorities

The key question for customer-centric business design is not what a customer's priorities are today — that game is already over — but what a customer's priorities will be tomorrow. The odds of discovering that rise dramatically when three things happen:

1. The information comes from relevant sources at multiple levels of the customer's organization.
2. The questions asked are nonstandard, creative and challenging.
3. There is a balance between understanding the next opportunity and recognizing the financial, political, accounting and organizational barriers that stand in the way of capturing it.

Build the Next Business Design

Equipped with an understanding of what your customer's priorities will be tomorrow, you can begin the process of building your company's next business design. The first question in customer-centric business design will not be about core competency but about customer relevance.

The offering will change from products (which are abundant) to solutions (which are difficult to create). The company's activities will change from "Do everything" or "Do what we do well" to "Do what matters to the customer" and "Do what we are best at." Outsource the rest, or find business partners to provide it with you.

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The Value Chain

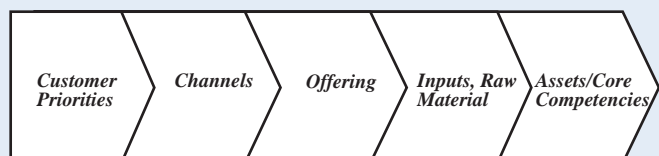
The Traditional Value Chain

Start with Assets, Core Competencies



The Modern Value Chain

Start with the Customer



Customer-Centric Business Design

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The key driver will be customer relevance rather than a focus on what a company knows how to do. ■

How Profit Happens

Profitability is an extraordinarily complex phenomenon. How and why profitability occurs varies significantly from one industry or company to another. There are at least 22 models/patterns of profitability that explain how profit happens in various businesses. More will be discovered. And, in certain businesses, the interplay of two or more of these models explains how profit really happens in the business.

Profit-Centric Business Design

In the classic product-centric age, the key question was, “How can I gain market share, increase unit volume and gain scale economies?” In the new age of rapidly shifting market value that commenced in the mid to late 1980s, the questions are different: “Where will I be allowed to make a profit in this industry?” and “How should I design my business model so that it will be profitable?”

Eleven profitability models are described here. Each model has different business patterns and strategies that you can use to move your company into the profit zone.

1. Customer Development/Customer Solutions

Profit: Companies that implement a customer development model invest heavily to understand their customers’ economics and find ways to make them more favorable. They reach the profit zone by first probing how their customers buy and use their products and then finding ways — beyond merely selling the products — to help the customers in the difficult, expensive or time-consuming areas of their process. The method by which customers are developed explains the companies’ profitability.

Successful firms that have applied the discipline of the customer development model include Nordstrom, Intuit and Northwestern Life. Each has achieved significantly higher customer continuity than its competitors and, as a result, higher levels of sustained profitability.

2. Product Pyramid Profit: The variations in customer income and preferences make it possible to build product pyramids. They exist in markets as diverse as watchmaking, automotive sales and credit cards. At the base are low-priced, high-volume products. At the apex are high-priced, low-volume products.

The profit is concentrated at the top of the product pyramid, but the base of each pyramid plays a critical

strategic role in the system. Astute business designers such as Mattel make certain to build a “firewall” brand at the bottom of the pyramid: a strong, low-priced brand that is produced at a profit, however slim. The purpose of this brand is to deter competitor entry, thereby protecting the enormous profit margins at the top of the pyramid.

For example, Mattel produces a low-end Barbie doll so that (1) no uncontested space is left open for competitors and (2) profits from the \$200 special-edition Barbie doll at the top of the product pyramid are protected. When a firewall brand isn’t built, competitors have the opportunity to come in at the bottom and then work their way toward the top, where the profits are.

3. Multicomponent System Profit: In some businesses, there are several components of the production and selling system and each component has radically different profit characteristics. Failure to maximize participation in the highest-profit components depresses the profitability of the entire system. On the other hand, full participation in the less profitable components is required to win the market for the most profitable components.

In carbonated beverages, for example, the components are grocery, fountain and vending. Price realizations are: grocery, 2 cents per ounce; fountain, 4 cents per ounce; and vending, 6 cents per ounce. The profit zone is in fountain and vending, but in order to win in those areas, a company needs a strong brand. Brands are developed and maintained through the mass-market, low-profit grocery segment. One fights to maintain share and brand position in low-margin grocery; one maximizes vending penetration to maximize profitability. Coca-Cola learned and applied this brilliantly.

4. Switchboard Profit: Some markets are characterized by multiple sellers communicating to multiple buyers. High transaction costs are incurred by both. There may be an opportunity to create a high-value intermediary that concentrates these multiple communication pathways through one channel, by creating a “switchboard.” This reduces the costs of both buyers and sellers, in exchange for a fee to the switchboard operator. Examples include Schwab’s OneSource and Autobytel.

5. Time Profit: In business, speed is usually important. Often, a first-mover advantage allows an innovator to generate excess returns before imitators begin to erode margins. The time profit model is designed to take advantage of this phenomenon. In this model, profit derives from uniqueness. Price premiums exist, but only until imitation erases them.

The reality of this pattern is that prices are high and

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Summary: THE PROFIT ZONE

How Profit Happens

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profits are abundant — there is a profit zone — but only for a short period of time. Constant innovation is the only way to remain in the profit zone. As value migrates away from its most recent innovation, a company must introduce the next one, in order to re-enter the profit zone. This profit model is at the core of Intel's success, which is why the entire Intel business design is geared for speed.

6. Blockbuster Profit: Understanding blockbuster profit is essential for pharmaceutical companies, publishers, film studios, music companies and software firms, which have large R&D and launch costs and finite product cycles.

When the cost to develop a new product is fixed (and usually high) and marginal costs of manufacturing after development are low, the best way to maximize profits is to improve the chances that the product will achieve very high volume levels. With these economics, it is better to be the dominant leader in a few products than to support average positions in many products.

7. Profit Multiplier Model: A profit multiplier model reaps gains, continually, from the same product, character, trademark, capability, or service. Profit multiplier models can be powerful engines for businesses that have strong consumer brands. Once the huge investment in creating a brand has been made, the creator may give the brand license across a broad array of products.

The best example of a profit multiplier is Disney. Mickey, Minnie, Hercules et al. appear in movies, videos and books; on clothes, watches and lunch boxes; at theme parks; and in stores. No matter what form they take, these characters are generating returns for Disney.

8. Entrepreneurial Profit: Some determinants of profitability are organizational rather than economic. As organizations succeed and grow, they become more formalized, more bureaucratic, more careful, more remote from customers and slower to act. Diseconomies of scale begin to work, overhead grows and decision making slows. Direct feedback from customers is reduced, filtered and often ignored.

The company is vulnerable to entrepreneurs who are in direct contact with customers or proactively solicit feedback and who remain frugal because they have no cushion of affordability to support unnecessary expenses. These twin forces of direct customer contact and extreme frugality create the potential for enormous profitability. Most large companies, however, do not have a business design that permits them to harness these twin

forces of the entrepreneurial condition.

The most determined application of the entrepreneurial profit model is Thermo Electron, which pre-empts the profit-destroying effects of size by constantly spinning out new companies. It's hard to compete against the entrepreneurial profit model. It's easier to compete against a larger, slower, more insulated player.

9. Specialization Profit: All businesses start off being very good at something. They begin by offering a specialist's expertise. But as they grow, they often move beyond their specialization. They take on more and more activities at which they are mediocre. Revenues grow; profitability declines.

On the other hand, growth through *sequenced* specialization can be extraordinarily profitable. Electronic Data Systems (EDS), for example, grew through sequenced specialization — mastering the intricacies and economics of computer solutions for many vertical segments (health care, insurance, manufacturing, banking), but doing so sequentially, not simultaneously. In each vertical segment, EDS establishes expertise that is unmatched — it becomes a specialist — and it rolls that expertise across the entire segment. Then it moves on to another segment.

10. Installed Base Profit: One of the most powerful profit mechanisms in business is the installed base profit model. The supplier creates an extensive installed base of users, who then buy the supplier's brand of consumables or follow-on products. The installed base profit model can be extremely lucrative — if the follow-on market can be controlled.

This was a key component of Bill Gates' thinking, from his very first business move. Microsoft's strategy was to price low, set the standard, achieve ubiquity and then harvest the profits from upgrade/revision revenue.

11. DeFacto Standard Profit: The installed base becomes a critical element of another high-profit model when it allows the owner to establish a de facto standard. The standard then drives customer and competitive behavior for an entire industry. In this type of business, numerous players, from original equipment manufacturers (OEMs) to applications developers to users, are drawn into the gravitational orbit of the standard holder.

The more players that enter the system, the more valuable the system becomes. As a consequence, the holder of the standard can experience increasing returns as the value of the system grows. Microsoft has been able to convert its installed base position into a de facto standard that is a very powerful economic engine.

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How Profit Happens

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Protecting Your Profitability

While a company is developing a powerful business design to generate profit growth, it must simultaneously search for and develop the strategic control points in its industry. The purpose of a strategic control point is to protect the profit stream against the corrosive effects of competition and customer power. The rapid growth of customer power in the past two decades has forced strategic control to the top of the priority list.

There are many types of strategic control points: brand, patent, copyright, two-year product development lead, 20 percent cost advantage, control of distribution, control of supply, owning customer information flow, a unique organizational culture and value chain control. Each control point is designed to keep a company in the profit zone and to prevent competitors from stealing away that profitability.

Every good business design has at least one strategic control point. The best business designs have two or more. Intel, for example, has a two-year lead, value chain control and a brand. Coca-Cola has a brand, a low-cost logistics system, value chain management and a string of superdominant positions (a market share that is three, four or five times its competitors' share) around the world.

GE has a low-cost position and owns the customer relationship in the many cases where it provides a full package of services and solutions to its customers. Disney owns the customer relationship in family vacations, plus a set of copyrights and a unique organizational culture that competitors have yet to duplicate. Microsoft owns the standard, a string of superdominant positions (in multiple product categories) and a brand. ■

Some of the Reinventors and How They Succeeded

Over the past couple of decades, several business leaders have emerged who have figured out, or intuitively understood, how the rules of the game have changed. Their record of value growth is all the more remarkable when compared to the growth prospects of their industries and the lagging value performance of the market share leaders.

These reinventors think, see and act differently. They start with the customer and work their way back. They are constantly focused on how the profit zone is shifting. A decade ahead of their peers, the reinventors saw the move from the old product-centric, market share world to

the new customer-centric and profit-centric environment.

The old-order companies concentrated on market share and yesterday's profit zone. The new-order companies reinvented their business design every five years to stay relevant to customers and to move into new profit zones. Several hundred billions of dollars of value shifted from companies that had dominated yesterday's profit zone to those that were finding or creating the profit zones of tomorrow.

Jack Welch — GE

GE's business design answers the manufacturer's primary question: "How can I make a profit by making and selling my product?" Most manufacturing companies only create value for customers with their products — they all have product-centric business designs. In this environment, the only way a company can distinguish itself is by establishing itself as a cost or quality leader. And if all players within an industry pursue cost and quality leadership, the industry becomes a no-profit zone.

As CEO of General Electric, Jack Welch reinvented GE's business design three times, each time moving further away from the product-centric manufacturing model. His most recent design is referred to as "Solutions Selling" — a response to the needs and priorities of GE's customers.

A mid-size company bought \$500,000 worth of personal computers from General Electric. What makes this news? Well, for starters, GE doesn't make computers! The firm didn't buy its computers directly from the manufacturer because the manufacturer only sells computers — a commodity product available from dozens of sources.

In contrast, GE sold the company the computers — plus much more. GE saw this company's set of needs and met them. It provided a solution. The profit zone for GE was not found in the product (the computer); it was found in the solution (add-on options, accessories, service contracts and financing).

Jim Donahugh — Madden Communications

Reinvention is not just for the giants of industry, CEOs of large public companies, nor just for senior managers. The principles and techniques of reinventing a company's business design to get it into the industry's profit zone are available to all of us.

Jim Donahugh was hired as a salesman by Madden Graphics, a commercial printing company, in 1975. He exercised persistent customer-centric thinking by asking such questions as "What can I do to add real value to a customer?" and "What would be more valuable than just

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Some of the Reinventors and How They Succeeded

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selling the customer a printing job?” Donahugh followed his instincts all the way to the presidency of his company.

Madden Graphics eventually became Madden Communications. Donahugh changed Madden’s printing company business model to that of a communications management company, which integrates display construction design, manufacturing, assembly and distribution of point-of-sale materials. Madden’s core activity is still printing, but the Madden people don’t really *care* about printing as an end in itself. They care about what it does for their customers.

Nicholas G. Hayek — The Swatch

Sometimes, the reinvention of a company starts with reinventing an entire industry. That was the task that Nicholas Hayek, a Swiss engineer and the entrepreneur behind the Swatch watch, set for himself. His approach was to emotionalize his product, build a product pyramid from low price point to high and build a firewall brand to protect the profits in his product pyramid system.

The Swiss watch industry, leading the world market for decades, was essentially destroyed in the 1970s by new business designs from Timex, Citizen, Seiko and Casio. It became a no-profit zone.

Hayek’s key move in the 1980s was to cross the threshold defining “economy timepiece” and move into an economic neighborhood defined as “accessory,” “style” and “fashion statement.” This was a world of design and fashion, not craftsmanship. He was interpreting the 18- to 30-year-old consumer who was buying Nike athletic shoes, Benetton sweaters and Gap apparel.

In the face of enormous skepticism, Hayek decided to make a plastic watch that could be manufactured inexpensively in Switzerland, with fewer moving parts and less frequent repairs. He combined the words “Swiss watch” to make “Swatch” and introduced a product that challenged all the traditions of the industry.

Hayek made Swatch his firewall brand at the bottom of the product pyramid, which secured the low-end market and made it profitable. Then he protected and expanded his positions in the upper part of the pyramid, taking advantage of the profit zone in mid- and high-level watches, selling for 1 million Swiss francs or more.

Charles Schwab

Charles Schwab revolutionized the financial services industry by asking the right questions. By always looking

Roberto Goizueta — Coca-Cola

As Coca-Cola’s new CEO in the early 1980s, Roberto Goizueta inherited a Coke that was powerless to manage the profitability of its own system. In the beverage industry, the value chain consists of syrup manufacturing, bottling, logistics, distribution, marketing and consumer relations. Moving from syrup maker and advertiser (Coke’s business design in 1980) to value chain manager (Coke’s business design in 1997 and beyond) helped Coca-Cola capture the most profitable zones of the beverage industry.

Goizueta’s most significant business design innovations were managing the value chain and focusing investment on the high-profit zones. He regained control of profit opportunities by redefining who his customers were.

forward and asking how customers’ priorities are shifting, Schwab has remained two steps ahead of the industry.

There was only one kind of player in the investment game of the early 1970s — the full-service broker. A traditional brokerage house commanded high fees because it provided investors with a “bundled package” — advice and counsel along with trading capabilities. There was no option for investors who only wanted access to low-cost trades.

Schwab’s first new business design was the discount brokerage, which allowed an investor, acting on his own ideas and without advice, to execute trades at a lower price.

Then, when independent, fee-based investment advisory services started to grow in popularity in the 1980s, Schwab saw a new set of customer priorities. Investors were going to independent investment advisors, or “financial planners” because they needed and wanted advice unvarnished by the broker commission structure. Recognizing these advisors as potential allies and bridges to new customers, Schwab expanded his business design to treat financial planners as his customers and developed new services for them.

Finally, during the 1990s, Schwab redesigned his business once again. He noticed the soaring popularity of mutual funds among investors and observed that the way they were being bought and sold was inefficient and expensive. It was expensive for the mutual fund companies to market broadly, and it was expensive and time-consuming for a customer to simultaneously deal with several mutual funds. Schwab established a “switchboard” between them, making it less costly for mutual funds to reach customers and less complicated

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Some of the Reinventors and How They Succeeded

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for the customers who could now deal with several mutual funds through one point of contact. This new innovation was called the Schwab OneSource.

Schwab was responding to both profit-centric and customer-centric questions. He redesigned his business to meet investors' needs for less record-keeping hassle and lower transaction costs. At the same time, he made the mutual fund companies into Schwab customers by charging them for access to the Schwab investor base. ■

Other Reinventors

Reinvention can be found in almost any industry and can be bolstered by a variety of business designs.

• **Andrew Grove of Intel used the “Two Steps Ahead” business design.** In an industry that has seen enormous growth and innovation, he managed to stay in the profit zone by managing more of the industry's value chain and by owning the relationship with the end user.

• **Michael Eisner of Disney used the “Profit Multiplier” business design.** He saw that Disney was becoming more and more an intellectual property business. He expanded Disney's audience from children to the entire family. He also expanded Disney's scope from movies, theme parks and licensed consumer products, to television production, TV and radio network broadcasting, cable networks, videocassettes, DVDs, retail stores, theme park hotels, vacation packages, sports teams, Broadway musicals, cruises and much more.

• **George Hatsopoulos of Thermo Electron used the “Spin-Out” or “Entrepreneurial” business design.** Believing that the size of the company hindered its ability to stay one step ahead of the customer — and the need to continually motivate and retain his most talented employees — as the company grew, Hatsopoulos implemented a plan to spin out its core businesses into separate semi-independent companies. Led by key talented employees who were rewarded based on performance, Thermo Electron was able to intensify the company's contact with customers, gain better profit results and more easily attract capital investment. ■

The Profit Zone Handbook

Perhaps the single most striking observation about the reinventors' achievements in business design is how different they are — different from each other and different from their peers. The success logic that drives Coke's

business design is completely different from the logic that drives GE's. Microsoft and Disney are worlds apart.

Reinvention is about the customer and profitability, but ultimately it is about creativity — about designing a business model that is unique.

Perhaps the most important benefit of studying reinventors and how they discover or create profit zones in their industries is grasping how the creative process works in business (how business designs change every five years), what discipline (in customer and profit thinking) it requires and how extraordinary its outcomes can be.

Moving Your Company Into the Profit Zone

The process of moving your company into the profit zone involves addressing a sequence of 12 questions:

1. Who are my customers?
2. How are their priorities changing?
3. Who *should* be my customer?
4. How can I add value to the customer?
5. How can I become the customer's first choice?
6. What is my profit model?
7. What is my current business design?
8. Who are my *real* competitors?
9. What is my toughest competitors' business design?
10. What is my next business design?
11. What is my strategic control point?
12. What is my company worth?

By answering these questions, you will be equipped to beat your competitors to the profit zone.

Each of the reinventors previously mentioned has been extraordinarily successful at using carefully chosen tactics to create exceptional profit growth for his company. These are also tactics that can be used by anyone at any level in any business. By using these techniques, you will be able to create value for your customers and capture value for your business. You will be able to move your company into the profit zone. ■



If you liked *The Profit Zone*, you'll also like:

1. ***Exceeding Customer Expectations* by Kirk Kazanjian.** Kazanjian provides a thorough case study of the success of Enterprise Rent-A-Car and offers an in-depth look into the practices that have boosted the company to the top of its industry.
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