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## The New Leader's Guide to Diagnosing the Business

by Mark Gottfredson, Steve Schaubert, and  
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From 1999 to 2006, the average tenure of departing chief executive officers in the United States declined from about 10 years to slightly more than eight. Although some CEOs stay a long time, a lot of them find that their stint in the corner office is remarkably brief. In 2006, for instance, about 40% of CEOs who left their jobs had lasted an average of just 1.8 years, according to the outplacement firm Challenger, Gray & Christmas. Tenure for the lower half of this group was only eight months. Some of these short-timers were simply a poor fit and left of their own accord, but many others were ushered out the door because they appeared unable to improve the business's performance. Nobody these days gets much time to show what he or she can do.

So within a few months at most, incoming CEOs and general managers must identify ways to boost profitability, increase market share, overtake competitors—whatever the key tasks may be. But they can't map out specific objectives and initiatives until they know where they are starting from. Every organiza-

tion, after all, has its distinctive strengths and weaknesses and faces a unique combination of threats and opportunities. Accurately assessing all these is the only way to determine what goals are reasonable and where a management team should focus its performance-improvement efforts.

Embarking on this kind of diagnosis, however, can be daunting because there are countless possible points of entry. Your company's operations may span the globe and involve many thousands of employees and customers. Should you start by talking to those employees and customers or by examining your processes? Should you focus on the effectiveness of your procurement or analyze your product lines? Managers often begin with whatever they know best—customer segments, for example, or the supply chain. But that approach is not likely to produce either the thoroughness or the accuracy that the management team and the business situation require.

What's needed instead is a systematic diagnostic template that can be tailored as neces-

sary to an individual business's situation. Such a template has to meet at least three criteria: It must reflect an understanding of the fundamentals of business performance—the basic constraints under which any company must operate. The template must be both comprehensive and focused—covering all the critical bases of the business, but only those bases, without requiring any waste of time or resources on less important matters. And it should lend itself to easy communication and action.

This article presents a template that we think meets these criteria. It is built on four widely accepted principles that define any successful performance-improvement program. First, costs and prices almost always decline; second, your competitive position determines your options; third, customers and profit pools don't stand still; and fourth, simplicity gets results. Along with each principle, we offer question sets and analytic tools to help you determine your position and future actions.

We developed and refined this template over our combined 50-plus years of working with clients, nearly all of whom have needed to perform an accurate diagnosis quickly. We have recently used it both with large corporations and with private equity firms evaluating the potential of their portfolio companies. We tested it through a series of research studies and interviews that we conducted in preparation for writing the book from which this article is adapted. Our experience and research convinced us that the template is a powerful tool. Its four principles cover the critical bases of virtually every business, providing managers with the minimum information required for a comprehensive diagnosis. Of course each manager will have to decide which elements of the template to emphasize (or de-emphasize) based on his or her business situation.

A word of caution: As the article makes clear, you will need to gather a lot of data quickly, ideally within the first three or four months of your tenure. Ask your senior leaders to head up teams that take on as many questions relevant to their areas of responsibility as they can handle. Ask for short, focused presentations to facilitate discussions about the main threats and opportunities. That should enable you and your teams to

make quick, accurate decisions about the few areas on which to concentrate your efforts.

This process not only will show you where you are starting from (your point of departure, so to speak) but also will help you map out your performance objectives (or desired point of arrival) along with three to five critical change initiatives that will take you where you want to go. Indeed, many companies have used the template to create a set of charts showing exactly where and how the business can improve. Incoming leaders find that reaching a diagnosis within their first three to four months helps them lay a foundation for breakthrough performance—and avoid the pitfalls that other new leaders encounter all too frequently.

### Analyze Costs and Prices

The first principle in our template is that costs and prices almost always decline. This may seem counterintuitive: Inflation often clouds the view, and special circumstances can sometimes drive costs and prices upward. But it is a well-established fact that inflation-adjusted costs—and therefore inflation-adjusted prices—decline over time in nearly every competitive industry. The analytic tool that best charts this principle is the *experience curve*, a graph showing the decline in a company's or an industry's costs or prices as a function of accumulated experience. For example, you might find that for every doubling of total units produced in your company, your per-unit cost in constant dollars drops by 20%. (In this case your experience curve is said to have a "slope" of 80%.) Because the same principle holds true for your competitors—and thus for your entire industry—the curve allows you to estimate where costs or prices are likely to be in the future. By comparing your company's cost curve with your industry's price curve, you can determine whether your costs are declining at the rate necessary for your company to remain competitive.

**Construct cost and price experience curves.** The first diagnostic questions to ask regarding this principle are "What is the slope of price change in our industry right now for the products or services we offer?" and "How does our cost curve compare with the industry's price curve and with our competitors' cost curves?" (See the exhibit "Understanding Experience Curves.")

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The relationship between prices and costs in any given business area will determine some of your top priorities. If industry prices are going down while your costs are going up or holding steady, for instance, cost improvement is likely to be your single most urgent challenge. Your costs need to be decreasing over the long term regardless of what prices are doing. An upward movement in prices is frequently only temporary.

Understanding your overall cost trends, of course, is just a preliminary step. You then need to examine every segment of costs to determine where the central challenges and opportunities lie. Dig into the cost areas that are most important for your organization: manufacturing, supply chain, service operations, overhead—whatever they may be. Identify the key cost components and the trends in each one. Look specifically for instances of failure to manage to the experience curve, such as rising unit costs for labor or rising procurement costs. This kind of detailed analysis will identify opportunities for improvement at the most granular level and will provide the basis for a plan of action.

One CEO we spoke with reflected on what he called his biggest mistake in his first few

months on the job. One of his company's business units was the leader in an industrial market. It had been raising prices, so it was quite profitable, and the new CEO decided to leave it alone for the time being. Then new, low-cost competitors from Asia entered the market and found that this unit had established both a price umbrella and a cost umbrella. The competitors soon undermined the unit's pricing power. The situation required urgent action to reduce costs by at least 15%, an initiative that is well under way. The lesson that CEO drew from the experience was stark: Be sure to diagnose *every* business position carefully, particularly in units that seem to be doing well.

**Determine costs relative to competitors'.** After comparing your overall costs with industry prices and your competitors' costs, you need to take a more detailed look at your cost position in your industry. How do you compare with your key competitors in each cost area? Which company is most efficient and effective in priority areas? Where can you improve most relative to others? An analysis of cost position quantifies cost differences between your business and your competitors'; it also shows which cost elements and specific

## Questions That Will Lead You to Breakthrough Performance

### 1. First Principle

**Costs and prices almost always decline.**

- How does your cost slope compare with your competitors'?
- What is the slope of price change in your industry right now, and how does your cost curve compare?
- What are your costs compared with competitors'?
- Who is most efficient and effective in priority areas?
- Where can you improve most, relative to others?
- Which of your products or services are making money (or not) and why?

### 2. Second Principle

**Your competitive position determines your options.**

- How do you and your competitors compare in terms of returns on assets and relative market share?

- How are the leaders making money, and what is their approach?
- What is the full potential of your business position?
- How big is your market?
- Which parts are growing fastest?
- Where are you gaining or losing share?
- What capabilities are creating a competitive advantage for you?
- Which ones need to be strengthened or acquired?

### 3. Third Principle

**Customers and profit pools don't stand still.**

- Which are the biggest, fastest-growing, and most profitable customer segments?
- How well do you meet customer needs relative to competitors and substitutes?
- What proportion of customers are you retaining?
- How does your Net Promoter Score track against competitors'?

- How much of the profit pool do you have today?
- How is the pool likely to change in the future?
- What are the opportunities and threats?

### 4. Fourth Principle

**Simplicity gets results.**

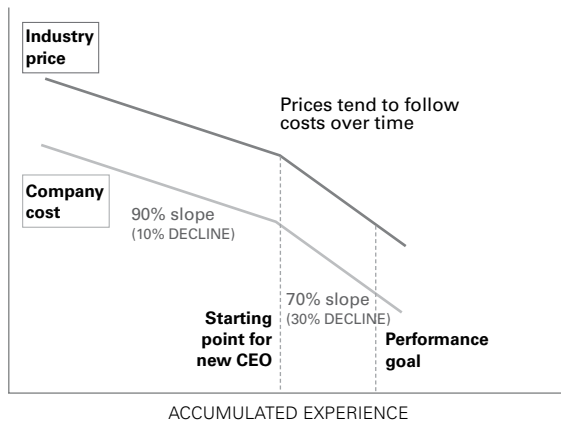
- How complex are your product or service offerings, and what is that degree of complexity costing you?
- Where is your innovation fulcrum?
- What are the few critical ways your products stand out in customers' minds?
- How complex is your decision making and organization relative to competitors'?
- What is the impact of this complexity?
- Where does complexity reside in your processes?
- What is that costing you?

## Understanding Experience Curves

Experience curves show how much industry prices and your costs have fallen each time the industry's cumulative experience (total units produced or services delivered) has doubled. They also allow you to predict how much inflation-adjusted prices and costs are likely to decline in the future.

The "slope" is the percentage of original price or cost remaining after each doubling of experience: A 70% slope, for example, means that prices have dropped by 30%.

Mapping your industry's price curve against your own cost curve can help pinpoint cost-reduction objectives. If you can reduce your costs faster than the previous CEO or general manager did, as in the graph below, you may be able to drive industry prices down faster as well, thereby putting pressure on your competitors' margins.



Source: Bain

This chart shows the rate of price declines for every doubling of accumulated experience for a sample of both manufacturing and service industries. (The time periods here reflect a wide variety of studies conducted at different times.)

| Industry                     | Dates     | Price slope | Price decline |
|------------------------------|-----------|-------------|---------------|
| <b>Microprocessors</b>       | 1980–2005 | 60%         | 40%           |
| <b>LCDs</b>                  | 1997–2003 | 60%         | 40%           |
| <b>Brokerages</b>            | 1990–2003 | 64%         | 36%           |
| <b>Wireless services</b>     | 1991–1995 | 66%         | 34%           |
| <b>Butter</b>                | 1970–2005 | 68%         | 32%           |
| <b>VCRs</b>                  | 1993–2004 | 71%         | 29%           |
| <b>Airlines</b>              | 1988–2003 | 75%         | 25%           |
| <b>Crushed stone</b>         | 1940–2004 | 75%         | 25%           |
| <b>Mobile phone services</b> | 1994–2000 | 76%         | 24%           |
| <b>Personal computers</b>    | 1988–2004 | 77%         | 23%           |
| <b>DVD players/recorders</b> | 1997–2005 | 78%         | 22%           |
| <b>Cable set-top boxes</b>   | 1998–2003 | 80%         | 20%           |
| <b>Cars*</b>                 | 1968–2004 | 81%         | 19%           |
| <b>Milk bottles</b>          | 1990–2004 | 81%         | 19%           |
| <b>Plastics</b>              | 1987–2004 | 81%         | 19%           |
| <b>Color TVs</b>             | 1955–2005 | 83%         | 17%           |
| <b>DVDs</b>                  | 1997–2002 | 85%         | 15%           |

\* Adjusted for changes in features and regulatory requirements

*You can construct a hypothetical competitor representing the best of the best and then use it as a benchmark for improvement, striving to leapfrog your competitors.*

practices are different. Drill down until you understand where and how you differ, and why. That, in turn, will help you figure out where you can close cost gaps and gain or regain competitive advantage. It will also help you formulate detailed plans to do so.

Not long after he took on the top job, David Weidman, CEO of the \$6.7 billion chemical company Celanese, headquartered in Dallas, asked his management team to conduct such a competitive assessment. "They came back and said, 'Holy cow, our average EBITDA to sales is seven or eight percentage points lower than the competition's,'" he told us. "And this was not in one business—this was across every organization." Weidman asked the team to identify specific areas where the company could improve relative to the competition. He wanted to find out, for instance, what one key competitor was doing in maintenance, because that company's maintenance spending was far better than Celanese's.

Understanding your cost position as well as your experience curve enables you to set proper targets. You will know, for example, that your lower-cost competitors are on their own experience curves and will have improved their own positions by the time you reach their current cost levels.

This kind of analysis presents a unique opportunity. Rather than simply comparing yourself with your top competitor, figure out which firm (including yours) is the best in each area. Maybe one is world-class in supply-chain logistics practices, another in a particular manufacturing step, and so on. You can then construct a hypothetical competitor representing the best of the best, or what we call best demonstrated practices. That hypothetical company will have lower costs and better performance than any real-world company; you can use it as a benchmark for improvement, striving to leapfrog your competitors instead of just trying to catch up.

**Assess the profitability of your product lines.** Your next job is to determine which of your products or services are making money (or not), and why. The goal is to calculate the true margins of your products or services. First, you need to figure out direct costs for each product based on actual activities performed, rather than using standard costing. Then you must accurately allocate indirect

costs—logistics, selling expenses, general and administrative expenses—to each product line and customer segment. Activity-based costing will give you a more accurate picture than you or your predecessor may have had in the past. The analysis should reveal the key cost and revenue drivers you need to address: areas where the cost of goods sold, for instance, is out of line, or where your revenue performance is below benchmark levels.

When Warren Knowlton, until recently the CEO of the venerable British company Morgan Crucible, agreed to take the top job there, he learned that Morgan had hundreds of products, ranging from crucibles and advanced piezoceramics to body armor and state-of-the-art superconductor magnetic systems. He needed to determine which were making money and which were dragging the company down, so he drew up a list of critical questions for the heads of his business units. For example, he asked them to delineate their expectations for operating profit during the coming year and to explain expected changes from the preceding year. Then he asked for details. One question was "What percentage of your revenues represents sales to customers you would consider to have significant leverage over you?" Another was "How much of your revenue do you believe represents price-sensitive, commodity-type products?" Other questions focused on the cost side, including matters such as purchasing procedures and performance compared with that of rivals. The answers gave Knowlton a jump-start on his analysis of product-line profitability. He subsequently made major shifts in product lines to de-emphasize commodity products and unprofitable customers. Along with significant cost reductions, these moves enabled him to engineer a remarkable performance breakthrough, increasing the company's share price 10-fold in just three and a half years.

### **Evaluate Your Competitive Position**

The second principle in our template is that your competitive position determines your options. Depending on your industry, there can be different drivers of profit leadership, including customer loyalty and "premiumness" of the product. But in most industries, one of the strongest predictors of a company's performance is its relative market share (RMS).

RMS is easy to calculate. If your company is a market leader, simply divide your share by the share held by your closest competitor (30% divided by 20%, say, equals an RMS of 1.5). If you're a follower, divide your share by that of the market leader (20% divided by 30% equals 0.67 RMS). Now plot the companies in your industry according to their RMS and their returns on assets (ROA). (See the exhibit "A Map of the Marketplace.")

You are likely to find that for many firms, higher RMS corresponds to higher ROA, and vice versa. This reflects the fact that market leaders typically outperform market followers on ROA; they have greater accumulated experience, leading to lower costs and superior customer insights, which in turn lead to higher profits. They thus have a greater ability to outinvest the competition in innovation, customer service, branding, and product support.

**Compare your returns and market share with those of your rivals.** The ROA/RMS chart is an extraordinarily useful diagnostic tool because it helps you narrow down your options for performance improvement. There are five generic positions on the ROA/RMS chart:

in-band leaders, in-band followers, distant or below-band followers, below-band leaders, and overperformers. Each has its own imperatives. Typically, for instance, in-band leaders find that they can raise the bar for competitors by investing in still-greater market share and in product or service improvements. In-band followers usually need to work hard just to keep up; only occasionally can they jump into a leadership role through heavy investment in innovation, the way Sony Computer Entertainment's PlayStation leapfrogged Nintendo in the video game industry in the 1990s. Overperformers, which earn returns well beyond what their relative market share would suggest, typically need to maintain high levels of investment in whatever has enabled them to escape the pull of the band (assuming they aren't simply capitalizing on a temporary price umbrella). That might be a trusted or prestigious brand, an innovative or patented technology, exceptionally loyal customers, or some other asset. Below-band companies, of course, have probably not been managing their costs down the experience curve, which would be a primary reason for their underperformance.

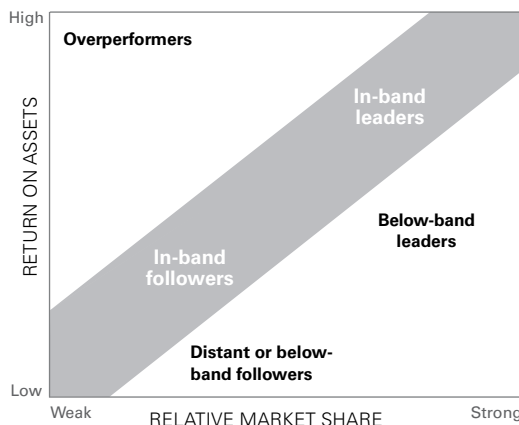
Whatever your company's position, the band helps you understand its full potential by showing both opportunities and constraints. An in-band follower, for example, can't expect to earn the returns of a leader unless it moves up the band or escapes into the overperformer category through one of the strategies mentioned.

Band analysis can be used for two other diagnostic tasks: anticipating competitors' improvement strategies and assessing businesses in a multiunit organization.

Mapping your company against competitors is the first step toward seeing how each firm is making money or where it is failing to do so. It allows you to spot potential threats to and opportunities for your business, and to assess the strategic options available to others. For example, when we and our colleagues began compiling a band chart for credit card companies, we could find no relationship between market share and returns—a highly unusual situation. So we asked what was driving the returns of the most successful players. The analysis showed us that in this business, customer loyalty was the single most important factor in determining profitability.

## A Map of the Marketplace

One method of assessing your position in the marketplace is to plot the company's relative market share against its return on assets, and to do the same for your competitors. Companies in a well-defined industry typically line up in a fairly narrow band, reflecting the fact that market leaders usually outperform market followers on ROA. But a handful of companies ("overperformers") earn above-band returns while having a midrange or low market share, and others languish below the band with low ROA—often because they have not managed their costs down the experience curve.



If every company were equally skilled at retaining customers, then market share *would* be the principal driver—but that wasn't the case. Because of the high cost of customer acquisition and the tendency of customers to increase their credit card use over time, sophisticated techniques for retaining customers could overcome advantages of pure scale and allow successful companies to become more profitable than their competitors. That would increase their RMS as well. Companies that had not developed such techniques were operating at a serious disadvantage.

Band analysis can also help the leader of a multiunit organization determine whether each business is achieving close to its full-potential performance. This objective was at the heart of Knowlton's decision-making process regarding Morgan Crucible's many businesses. Placing Morgan's business units on a band chart that compared their economic performance with their region-weighted relative market share, Knowlton could see at a glance that some units, such as the company's industrial rail and traction division, were in the band: They were performing as expected. Others, such as thermal ceramics, were below the band and needed to be moved upward, typically through aggressive cost control and measures designed to grow revenue. Still others were laggards in the lower left of the band and were candidates for divestiture.

**Measure your market size and trends.** How big is your market, exactly? Which parts are growing fastest? Where are you gaining or losing share? A simple way to map your market's size and dynamics is to draw a rectangle and then divide it into vertical segments representing your most important submarkets or products. The width of the segments should be set in proportion to the share of revenues they account for in the market. Next, divide each of these vertical segments into boxes representing the share held by each principal competitor. Create one chart for three to five years ago and one for the present. The two charts will show you the sectors and the competitors experiencing market growth. Depending on your situation, of course, you may need to customize the basic chart. A company selling telecommunications equipment in Asia might first map the Asian telecom market by country and by sector (wireline, wireless, and so on) and then break it down

into competitors' market shares. Again, comparing two or more points in time will show you where, and how fast, the market is growing. Faster-growing markets attract more competitive interest, so you will need an aggressive plan to win your share.

Other tools may be useful as well. A so-called S-curve chart, for instance, which plots industry growth against time, can show the inflection points where growth accelerates and then tapers off.

**Assess your firm's capabilities.** Your company's chances to achieve its full potential—to improve its position on the band chart—depend significantly on its capabilities. Which critical capabilities are giving you a competitive advantage? Which do you lack? Which need to be strengthened or acquired? The global technology and engineering company Emerson, for example, knows how to manage its costs so aggressively that it can acquire other businesses and then add substantial amounts of value. Companies can also succeed if they can develop capabilities they don't currently have. The iPod didn't really take off until Apple developed the capabilities to manage and sell digitized music through its iTunes store.

Every company, of course, must make decisions about which capabilities it wants to develop or maintain in house and which it wants to obtain from suppliers. The context for these decisions has changed dramatically in recent years. In many industries the primary basis of competition has shifted from ownership of assets (stores, factories, and so on) to ownership of intangibles (expertise in supply chain or brand management, for example). At the same time, a handful of vanguard companies have transformed what used to be purely internal corporate functions into entirely new industries. Thus FedEx and UPS offer world-class logistics-management services, while Wipro and IBM offer numerous business and IT services.

The result of all this is that companies can no longer afford to make sourcing decisions on a piecemeal basis—nor can they be satisfied with a “good enough” approach to selecting and working with suppliers. Today, you must assess every capability that you need in order to create or develop a product or service. You should analyze every step of your value chain, from design and engineering to

product or service delivery. You should compare yourself not only with competitors in your industry at every step of the chain but also with whatever companies are the best in the world at performing each particular step. Are you the best? Or do you have some capability that creates a sustainable competitive advantage in a given step? If the answer to both questions is no, you should ask whether you can improve or acquire the relevant capability, or whether you might be better off sourcing that part of your value chain to the best supplier.

### Understand Your Industry's Profit Pool

The third principle in our template is that customers and profit pools don't stand still. Markets undergo massive changes all the time, mostly because customers' desires and needs evolve. Companies repeatedly discover that the landscape they operate in has altered significantly and that the plans and strategies that worked so well yesterday no longer work today. They find that the *profit pool* from

which they were drawing their earnings has dried up or attracted new competitors, and that deep new pools of profit have appeared elsewhere. (For more on profit pools, see Orit Gadiesh and James L. Gilbert, "Profit Pools: A Fresh Look at Strategy," HBR May–June 1998.) For these reasons, you'll need to examine the profit pools you currently draw on and those that might hold potential for the future.

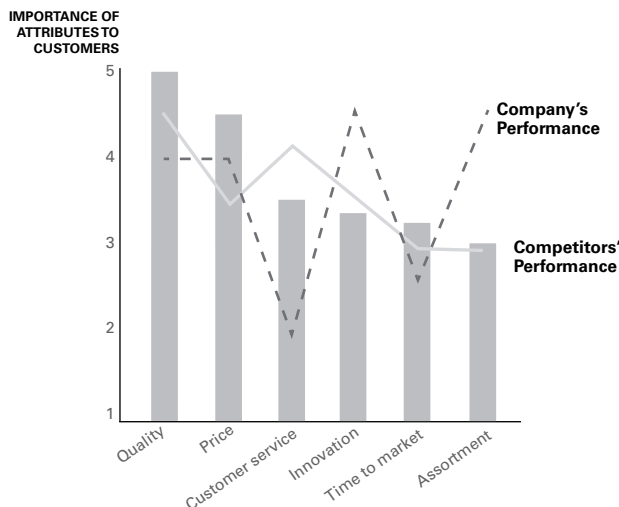
**Study customer needs and behavior by segment.** Correctly segmenting customers and developing proprietary insights into their purchasing behavior is one of the most powerful methods of building loyalty, increasing growth, gaining market share, and thus expanding your share of the profit pool. Which are the biggest, fastest-growing, and most profitable segments? How well do you meet customers' needs, compared with competitors and substitutes? As you raise these questions, you will want more-specific answers, such as how customers are segmented. On the basis of needs? Behavior? Occasion of use? Demographics? What are each segment's characteristics and spending habits? What share of wallet is each one currently giving you, and is there reason to think that you can increase that share?

You can use many tools to delve deeply into customer needs and behavior. These range from cluster analysis to sophisticated ethnographic research. It's often worthwhile to look at customers through many different lenses because you may spot something that customers themselves aren't even aware of. While we don't have space to discuss all such tools in this article, we'll mention a simple one that has been remarkably effective even in highly sophisticated industries. We call it a SNAP (segment needs and performance) chart. It can help you assess how well you are meeting the needs of the segments you are targeting.

To develop a SNAP chart, start by defining the attributes of the products or services you offer that may be important to the customer segments you want to target. Then conduct research to determine how important each of these actually is to these customers. A bank, for instance, might study everything from its hours of business to its loan rates to the quality of the advice it offers and the ease of access to its ATMs. Finally, assess where you stand on each scale and where your competitors stand.

## Segment Needs and Performance

This SNAP (segment needs and performance) chart displays data for a fitness machine company we're calling FitEquipCo. The company exceeds customers' requirements on innovation and assortment, the attributes that rank fourth and sixth, respectively, in importance to customers. It is thus incurring costs that may not earn a return in the marketplace. Meanwhile, it is slightly underperforming competitors on quality, which is first in importance, and significantly underperforming on customer service, which is third. FitEquipCo needs to take action to close those gaps.



This process will show how you measure up to the competition in the eyes of your key customer segments. You can use the SNAP chart to identify which gaps are most important to close (if you're behind) or widen (if you're ahead). You can also see where you might be overshooting the mark. (See the exhibit "Segment Needs and Performance.")

**Track customer retention and loyalty.** What proportion of customers are you retaining? Loyalty can be a critical factor in the economics of a business, particularly when the cost of acquiring a customer is high, switching costs are relatively low, or both. Accordingly, you need to know your retention rates for each segment. Doing so not only will help you determine the profitability of the segment but also will help you make plans to boost retention rates where necessary.

A good indicator of loyalty and probable retention is the Net Promoter Score (NPS), developed by our colleague Fred Reichheld. This measures customers' responses to the question "How likely is it that you would recommend this company (or product or service) to a friend or colleague?" Respondents answer on a zero-to-10 scale, where a 10 means "Extremely likely" and a zero means "Not at all likely." Those who give you a nine or a 10 are your *promoters*. Research shows they spend more with you, are likely to increase their spending in the future, and sing your praises to their friends and colleagues. Those who give you a seven or an eight are *passives*, and those who rank you zero to six are *detractors*. Promoters are an engine of growth, but detractors often cost your company more than they are worth, and they bad-mouth you to anybody who will listen.

Your Net Promoter Score is simply the percentage of promoters minus the percentage of detractors. Measured relative to competitors, NPS has been shown to correlate with growth rates and with other measures of customer satisfaction. Properly implemented, NPS creates a closed learning loop among customers, the front line, and management, and thus can be used as a basis for managerial decisions, just as financial reports are. American Express and many other companies use NPS-like metrics throughout their organizations to give them quick, regular reads on customers' attitudes and potential behavior.

Segmentation and retention efforts are at the opposite ends of a six-step chain of activity that enables a company to earn more profits per customer than its competitors and then to outinvest the competitors to generate faster growth. The first steps are (1) identifying the most attractive target segments and (2) designing the best value propositions to meet their needs. The next ones are (3) acquiring more customers in the target segment and (4) delivering a superior customer experience. That enables the company (5) to grow its share of wallet and (6) to increase loyalty and retention, with more promoters and fewer detractors.

**Anticipate profit-pool shifts.** CEOs and general managers naturally need to assess how much of their industry's profit pools their firms own today. But they must also gauge how profit pools are likely to change in the future and what opportunities or threats these shifts may create. One useful tool is a profit-pool map, which shows the channels, products, or sequential value-chain activities in the market and indicates the total profits available from them. You can then locate your business and its competitors on the map, showing how much each company takes from each part of the profit pool. It's wise to do this for all customer segments and all sets of products.

A company we'll call FitEquipCo mapped the growth (historical and projected) of its industry. Then it gathered extensive data about customers' intent to purchase or repurchase and developed profit-pool projections by product (treadmills, elliptical machines, and so on), by sales channel (mass merchants, specialty stores, and so on), and by price point (entry-level, value, and premium). The map showed, for instance, that FitEquipCo needed to build up its distribution through sports specialty stores, which delivered higher margins. Through such measures, the company projected, it could increase earnings by \$86 million over a three-year period, more than doubling operating profits. (See "A Map of the Profit Pool.")

As with the market map, it's wise to compare at least two points in time so that you can see how the pool is evolving. Often a significant threat to the profit pool comes from companies that don't yet compete in your industry or are still too small to be noticed. Yet these competitors can turn an

industry upside down. Think, for example, of the effects minimill companies such as Nucor had on the U.S. steel industry.

### Simplify, Simplify

The fourth principle in our template is that simplicity gets results. A couple of years ago, researchers from Bain & Company surveyed executives in 960 companies around the world, asking them about complexity in their organizations. Nearly 70% of the respondents told us that complexity was raising their companies' costs and hindering growth. Another team of researchers studied the impact of complexity on the growth rates of 110 compa-

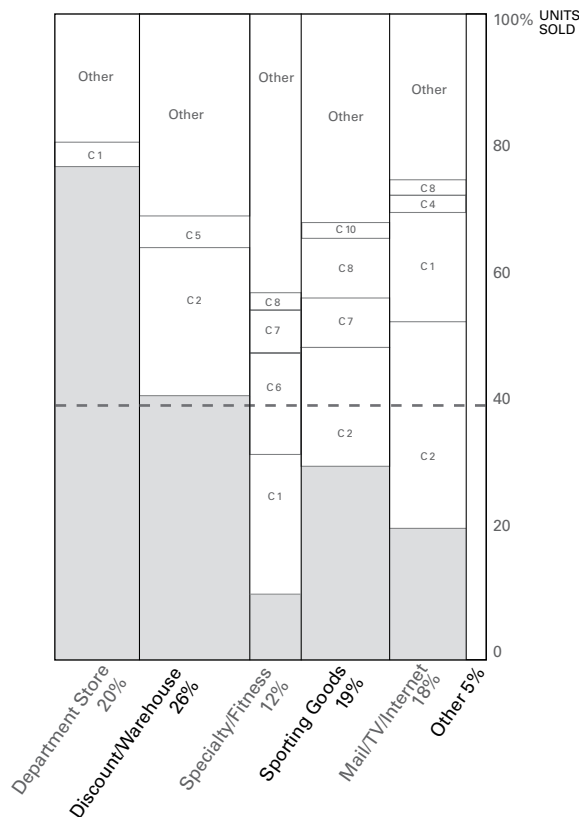
nies in 17 different industries. The researchers found that the least complex companies grew 30% to 50% faster than companies with average levels of complexity, and 80% to 100% faster than the most complex companies. In one particularly dramatic example, a telecommunications company that offered consumers only about one-fifth the number of options offered by a competitor was growing almost 10 times as fast.

**Gauge the complexity of your products or services.** To diagnose your company's level of complexity, begin by asking how complex your product or service offerings are and what that degree of complexity may be costing you.

## A Map of the Profit Pool

A profit-pool map for FitEquipCo revealed some telling market developments. Although the company was shipping almost 40% of all units in the marketplace, it had only about 20% of the profits. The column widths reflect the proportion of units sold (left) and operating profits earned (right) in each channel.

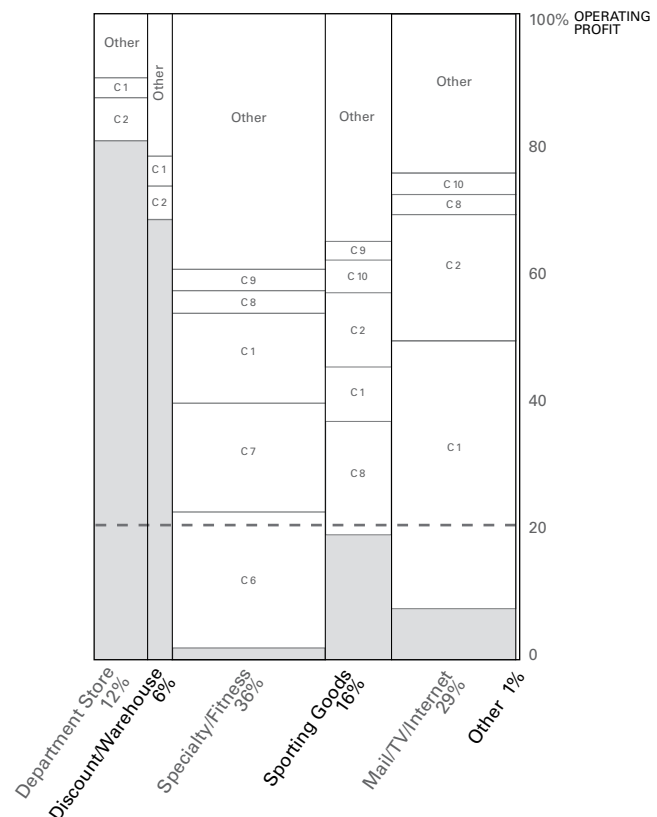
**FitEquipCo has about a 40% share of units sold...**



Total units sold: 10M (disguised)  
Total operating profit: \$200M (disguised)

FitEquipCo  
Competitor = C

**...but only about a 20% share of profits**



*When sizing up your company's decision making, turn to suppliers, distributors, and customers for feedback.*

Benchmark your line of products or services against the competition's; try to identify your "innovation fulcrum," the point at which the variety of products or services you offer maximizes your sales and profits. It will be helpful to construct what we call a Model T chart, showing the costs when you add features to the basic product or service. It's valuable to do this exercise not only with your own company's data but also with your competitors'. (For more on complexity and the Model T chart, see Mark Gottfredson and Keith Aspinall, "Innovation Versus Complexity: What Is Too Much of a Good Thing?" HBR November 2005.) Ask yourself which of your competitors has the advantage as variety and complexity in the industry increase—and why. You can apply what you learned from your customer segmentation research to this assessment. If you know what customers want now and what they are likely to want in the future, you can better judge what level of variety is appropriate for your marketplace.

The complexity test is a necessary counterbalance to tools such as customer segmentation. The temptation, after all, is to divide your customer base into finer and finer subcategories and tailor your offerings to each segment, all in the name of giving customers exactly what they want. That was one way Charles Schwab, the financial-services firm, got itself into a difficult situation in the early 2000s. Schwab added a plethora of new offerings and divisions, including a firm specializing in institutional investments and an East Coast wealth-management company. In 2004, founder Charles Schwab returned to the firm as CEO and promptly took steps to reduce the complexity. He sold off most of the recent acquisitions, reduced the number of service offerings, and streamlined internal roles and processes. These and other moves allowed him to take out some \$600 million in costs, reduce commissions, gain market share, and increase the firm's operating income by 3%.

**Assess the complexity of your organization.** Decision-making procedures and organizations grow complex over time as well. You need to know how your company stacks up against competitors on these dimensions and what the effects of undue complexity may be. Our colleagues Paul Rogers and Marcia Blenko have developed what they call a

RAPID analysis, which allows managers to assess decision-making bottlenecks, assign clear decision roles to individuals in the organization, and hold them accountable. (RAPID is a loose acronym for the different roles people can take on: *recommend*; *agree*; *give input*; *decide*; and *perform*, or implement the decision.) Another useful tool is a spans-and-layers analysis, which shows the number of levels in an organization from the CEO to the frontline worker, and the number of people reporting up to each level. Spans that are too narrow—meaning too few people report to individual bosses—are likely to lead to excess overhead costs, slow decision making, and unnecessary managerial oversight.

When sizing up your company's decision making, turn to suppliers, distributors, and customers for feedback. They are often good judges of how quickly and effectively you can make a decision compared with others in the industry. Employees will be quick to tell you whether they feel supported and empowered by the organization's management structure or whether it just gets in their way.

**Determine where you can simplify processes.** Where does complexity reside in your processes? What is that costing you? St. George Bank, like others in Australia, experienced a slowdown in residential lending at one point and so was developing a growth strategy for commercial banking. But the complexity of the bank's commercial credit processes was a major constraint on growth. All loan applications, large or small, were treated in a similar way. A sizable number of applications had to be sent up the ladder to a central credit group. Then-CEO Gail Kelly and her management team determined that this level of complexity was not inevitable—for example, they could create a fast-track system for applications from existing customers that fell within certain risk boundaries. That alone led to a 30% reduction in time spent by the lending officers. The bank also increased the amounts that a local lending officer could approve, resulting in a reduction of 50% or more in deals sent to the central credit group.

How can you identify such opportunities for process improvement? As at St. George Bank, process complexity can show up in any number of areas: on the production floor, in distribution networks, in interactions with customers, in back-office procedures.

*Figure out where complexity is unavoidable—and where, by contrast, you can put processes in place to reduce it.*

The key is to figure out where complexity is unavoidable—and where, by contrast, you can put practices in place to reduce complexity while still delivering the products and services that customers want. Process mapping is a good way to get started. In a process map, diagrams show the interactions among different steps in a process and the people or departments responsible for the steps. This enables the management team to visualize and understand the whole process, spot problems and opportunities for improvement, and address them through root-cause analysis. You want to map activities, inputs, and outputs associated with each step, and the wait times between steps.

Successful streamlining of the processes produces several mutually reinforcing benefits. It increases efficiency, allowing a company to reduce head count and its costs. Streamlining also cuts down on errors and rework. It reduces cycle time, enabling the company to deliver the product or service to the customer significantly faster and enhancing customer loyalty. More-loyal customers are likely to order more, generating growth and increasing the possibilities for still greater economies in production or service delivery.

Many companies try to simplify their processes without simplifying any other aspect of the organization. This is a mistake. Process simplification tends to be undermined by unnecessary complexity in the company's product lines, organization, and decision-making procedures. So gather the data to address complexity on all three fronts and then determine the most fruitful points of attack.

• • •

A diagnostic template such as the one we've described here is powerful not because it contains any single new insight but because it covers the ground a management team needs to cover. By answering the questions we've provided, you can pull together a comprehen-

sive set of data enabling you to understand the gap between your current performance and your full potential. You can then set specific goals and launch initiatives that will drive the company to achieve that potential during your tenure and develop the performance profile that you are shooting for. A company that has worked through such a diagnostic template might aim for objectives such as these:

- Reduce costs by \$200 million to move relative cost position from 110% of best competitor to 90%.
- Increase relative market share from 0.9 to 1.2; move share of high-profit segment A from 40% to 60%, with a retention increase of six percentage points.
- Increase share of profit pool from 40% of \$2 billion to 70% of \$2.8 billion by expanding into a downstream service business in the most profitable product segments.
- Cut SKUs from 100,000 to 2,000; reduce organizational layers in SG&A from five to three; outsource 20% of all G&A costs.

Objectives like these can translate into marching orders for an entire organization. Because they stem from a comprehensive diagnosis, everyone can understand them and see why they are important. Both managers and employees are more likely to buy in and put their shoulders to the wheel.

Diagnosis, of course, is only one part of a performance-improvement program. You still must decide on where you want the company to go, along with the three to five critical initiatives that will get you there. But a thorough, accurate diagnosis is what makes the rest possible. It's an indispensable first step toward breakthrough performance.

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