

CHRONIC PROFITABILITY

How to Make Money All the Time



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Chronic Profitability

How to Make Money All the Time

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“Chronic Profitability” shows you how to build a company that makes money all the time no matter what, all because of one simple shift in focus.

Give this book to anyone you know who runs a business and wants to make more profit!

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The Authors

JAMES SKINNER is the founder of two global financial groups that manage billions of dollars of assets. He is also recognized as one of the world's foremost business thinkers and appears regularly on Japanese television.

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Chronically Profitable

The word *chronic* usually makes you think of sickness, so it catches your attention. How many of you want to be chronically profitable, meaning that you make a profit every time, no matter what?

A chronic disease is a disease that does not go away no matter what you do. I want all of your companies and all of your businesses to be so profitable that you can't get the profit to go away no matter what you do. Would that be good, would that be great, and would that be extraordinary? Say yes!

You want your company to be so profitable that it makes money all the time no matter what!

This is called how to make money all the time—every single month of your business life, no matter what. We want to make you so profitable, that if you say “I don't want to be profitable this month,” we would say, “So sorry. There is nothing we can do about it. You are going to be profitable anyway.” Do you like that?

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Fixed Costs and Variable Costs

I was the first non-Asian to ever be certified as a management consultant in Japan. We spent a lot of time studying traditional management theory. In traditional management theory you talk a lot about costs. How many of you have ever heard about costs? That is the money that you spend doing your business.

When we study costs, we talk about fixed costs and variable costs.

A fixed cost is a cost that you incur whether you conduct any business or not.

A fixed cost is something you have to pay whether you conduct any business or not.

If you have rented an office, that is a fixed cost.

It does not matter from the property owner's perspective whether you do any business or not; they are going to charge you rent.

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If you hire an employee and they are on a salary, then their salary is a fixed cost. If you sell anything or not, you still have to pay it.

We have many things that are fixed costs.

We also have variable costs. A variable cost is a cost that is only incurred when we actually do business.

A variable cost is something you only have to pay when you conduct business or make a sale.

For example, if I make a shirt for a customer, then the material cost is a variable cost. It is only incurred if we are actually making shirts. For each shirt that we make we incur a new variable cost. If we have outsourced the tailoring to somebody else, then the tailoring costs are a variable cost. It is incurred only when we make a sale.

The Break-Even Point

Every business has two kinds of costs: F (fixed costs) and V (variable costs).

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In traditional management theory, when we want to find out how healthy a company is we calculate what is called the break-even point. We are going to call that the BEP.

The break-even point tells you what level of sales you need to achieve to break even (not lose any money).

We are going to give you a bit of a formula here: Don't be too concerned if you don't understand it right away. We will make it very simple for you in a minute.

$$\text{BEP} = F / (1 - V/S)$$

What this means is that the break-even point of any company is equal to the **fixed costs** divided by 1 minus the **variable costs** divided by the **sales**.

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You can look at your financial statements and see what those costs are and what your current level of sales is.

What this actually means is that if you divide the fixed costs by the percentage of profit on each sale, you find out how many sales you have to make in order to be profitable.

Your fixed costs divided by the percentage of profit on each sale equals the break-even point.

Let's do a really simple example.

Say we have a company that has fixed costs of \$50. In other words they have \$50 of costs that they incur whether they do anything or not—rent, fixed salaries, and equipment leases, and so on.

Now let's say that for every dollar the company sells, they have to spend 20 cents. In other words, they pay 20¢ on material, sales commissions, and so forth that are only paid out if the company actually sells something.

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Therefore, their variable cost ratio is 20 percent, or to put it another way, they have a profit ratio of 80% on each sale made.

One hundred percent minus 20 percent gives you 80 percent, so the profit margin on each is 80%.

$$1-20\text{¢}/\$1=0.80$$

To calculate the break-even point, all we have to do is divide \$50 (the amount of fixed costs) by 80% (the profit margin on each sale).

The break-even point for this company is \$62.50

$$\$50/(1-20\text{¢}/1\$)=\$62.50$$

If this company has sales of \$62.50, then they will be profitable and can pay their fixed costs and their variable costs. That is their break-even point.

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Any sales less than that will be a big problem, and any sales after that will make them money; and since the profit ratio is quite high, they are going to do quite nicely if they make more than \$62.50.

So what does all this mean in terms of actually doing your business?

Improving Your Break-Even Point

What this formula tells us is that if you want a very good business, you want the break-even point to be very low. Then you don't have to get that many sales before you start making money.

If you have to have a lot of sales before you start making any money and the economy starts to go down, what happens? You are not making any money anymore.

As management consultants, we love companies that don't have to work very hard to be profitable. Would you like a company that does not have to work very hard to be profitable?

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To achieve that, what you need to do is decrease the fixed costs.

If you can take your fixed costs and turn them into variable costs, your break-even point will go down.

Converting fixed costs into variable costs will improve your break-even point!

If you have no fixed costs, what is your break-even point? Zero! So that makes it very simple. If you do not have any fixed costs, you can't lose any money. If you just sit there and do not do anything, you are not losing any money. Now you know why everybody is doing what? *Outsourcing*.

Outsourcing converts fixed costs to variable costs improving your company's break-even point.

When you outsource rather than pay somebody in-house to do it, which is a fixed cost, it now becomes a variable cost. Therefore, if your sales go down, you are still profitable.

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I studied this as I was becoming a management consultant. It is good to value this formula and know your break-even point. You want to stick the formula on your wall and periodically calculate how many sales your company has to generate to stay profitable.

Can your sales go down before you drop into the red? If our sales drop 1 percent, 5 percent or even 20 percent, are we still profitable? Knowing that your sales could drop 50 percent and you would still be making a profit is good.

Your banker would also like to know your break-even point, as would your shareholders.

Periodically calculate the break-even point for your company.

From Costs to Sales!

However, what I started to realize, as I consulted with many companies and taught them how to do this, was that everybody was talking about costs and nobody was

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talking about sales. I thought, “Hmmm.... that is interesting because as an owner of businesses, I am very concerned about satisfying our customers, making them happy, getting them to buy something from us, and meeting their needs, in other words, SALES!”

That is the reason we are here in the first place. What if we started to study sales at the same level we studied costs?

I came up with a new idea called *fixed sales*. Then I came up with an idea called *variable sales*. I thought, “What if we not only thought of our costs as being variable but also started looking at our sales and divided them into fixed and variable sales?”

**If costs can be both fixed and variable, so can
SALES!**

A fixed sale is a sale that you do not have to put any work into to generate. It comes in like clockwork whether you do anything or not.

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Fixed sales are sales that take place no matter what whether you do anything or not!

Is having automatically generated sales a good thing or a bad thing? It is an extraordinary thing, and you want to make sure that you have sales that happen no matter what.

The variable sales, on the other hand, are the sales that you have to go out and work for.

Every month you have to go out and wear down your shoe leather, and wear out your ear and your mouth getting somebody to buy.

Variable sales are sales that you have to work for each time.

Are variable sales a good thing or a bad thing? They are a good thing! Sales are always a good thing. You do not want to get that confused look and go back to the company and say that you found that variable sales are a

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bad thing so we are stopping all our variable sales now.
Don't do that! All sales are good.

But if you had your choice, would you rather have
fixed sales or variable sales? Fixed sales, of course.

**All sales are good—fixed or variable, but fixed
sales are better!**

Calculating Chronic Profitability

From this simple idea, I developed a formula that
calculates Chronic Profitability.

$$CP=FS*(1-VC/TS)-FC$$

CP=Chronic Profitability

FS=Fixed Sales

VC=Variable Costs

TS=Total Sales

FC=Fixed Costs

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What this means is Chronic Profitability is equal to your fixed sales times your profit margin on each sale minus your fixed costs (FC).

You want to study this and get used to calculating your **fixed sales** and the **profit margin** on those sales, and then subtracting your **fixed costs**. That tells you your level of Chronic Profitability.

What to Actually Do!

Would you like to be chronically profitable? There are only three things that you can do to make it happen.

The formula is nice, but it can get complicated and tied up in your brain; and besides, you only need to know what to actually do.

Would that be useful?

If you do or if you don't get the formula, you're still going to get the result.

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Chronic Profitability is something I like to establish immediately in every company I ever own. I can go on vacation, I know the sales are coming in, the margins are there and it is a done deal.

Here are the three things you can do to be chronically profitable:

Step 1: Decrease Your Fixed Costs

The lower your fixed costs, the higher your Chronic Profitability. Therefore, you want to start thinking about ways to decrease your fixed costs.

Fixed costs going down is a good thing. It lowers your break-even point and improves Chronic Profitability.

The whole trend of the economic world today is that fixed costs are dead.

In our e-book business, we have just two fixed costs: the servers and our web master. Everything else is variable.

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We know that if we can keep fixed costs low, we will always be Chronically Profitable.

Step 2: Increase the Profit Margin on Each Sale

Even if it is a fixed sale, it still has to be a profitable sale. Having fixed sales that you lose money on is not generating Chronic Profitability. It generates chronic losses.

You have the fixed costs you want to go down and the profit margin you want to go up. You have a higher margin on each sale.

This part is not complicated.

Step 3: Increase Your Fixed Sales

You now know what to do. You decrease fixed costs, and you improve profitability. The next part, however, is key. I could be a televangelist on this next part.

We have created what we call the “**suffering ratio.**” The amount you suffer every month at work is equal to

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your variable sales divided by your total sales—in other words, the proportion of sales that you need to make again every month.

$$\text{Suffering} = \text{Variable Sales} / \text{Total Sales}$$

You worked all last month, finally got some sales, and then you have to go out and do it all over again.

That is called suffering.

The opposite of suffering is your “ecstasy ratio.” Now, your ecstasy ratio is equal to your fixed sales divided by your total sales.

$$\text{Ecstasy} = \text{Fixed Sales} / \text{Total Sales}$$

That means that I already did it so I don’t have to show up anymore.

How many of you are starting to like this idea? Is this triggering some thinking in your brain about how you may want to change your business?

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Lots of Ways to Get It Done

Now we are going to go through each of the three things. We are going to give a whole bunch of ideas about ways you can make Chronic Profitability happen in your business. Would that be useful?

What you need to know is how to do it in your business right now, because you are no longer in business school; you are in business reality.

Getting Rid of Fixed Costs

The first thing I want to focus on is fixed costs. What are some ways that you can get rid of your fixed costs? You thought I was going to teach you. Now you actually have to think for yourself.

So how can you get rid of your fixed costs? What can you do?

You can outsource.

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I want you to write down on paper, “Outsource everything, including yourself.” You think I am joking. How do you outsource yourself? You can become a vendor that provides services to your company on a contract basis instead of being an employee.

It is not just other people who can be vendors; you can be a vendor. I believe that in the future, everyone will be an independent vendor. We are moving from a dependent paradigm to an independent and interdependent paradigm.

In the future, every individual will be their own business!

The dependent paradigm is the paradigm of parent and child, which says, “I will take care of you, but you must do what I say.”

This is the traditional paradigm of the employee/employer relationship. Do you know what they call the employee/employer relationship in the law?

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The law of masters and servants. Is that shocking? That is what it is called.

We are moving away from a masters-and-servants paradigm.

The reason is that companies can no longer be the parent, because of global competition.

The fact is technology is advancing so rapidly that entire industries now become irrelevant and can no longer guarantee they can take care of you forever.

Industry says, “You know we can work together while it is profitable to do so, but I don’t know what is going to happen three years from now. I really don’t. We could be in the business of making whips and buggies, and somebody could invent an automobile. We could become completely irrelevant, and in this case I can’t take care of you.

So we now need to be independent. You need to be able to take care of yourself. But we can work together,

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which is called interdependency. We can work together while it is profitable for us to do so. We are moving to a different paradigm.” So we are all outsourced.

You need to be independent, because now we are all outsourced!

Let me put this to you in just a little different way and build on it. This is a powerful phenomenon happening throughout the world. If the company is the parent and the parent is becoming less stable, then the child cannot depend on the parent, so the child must quickly become independent, meaning that they can provide for themselves. The company is required to outsource, and the child must become independent.

Yes, we all must become adults very, very quickly now. We must become economical adults who are able to be responsible and work together in a responsible manner. The social contract has shifted, for better or worse.

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I am merely describing the world as we work and live in it. Personally, I believe that it is a good thing because it causes us human beings to grow instead of forcing other people into dependency. I happen to like the paradigm that says “I have to earn my keep.” I am good with that. But I am not going to make a moral judgment on it overall. I understand that there are many social issues involved.

We all must become economic adults!

Now what other ways can you reduce your fixed costs?

Outsourcing is not the only way.

Think hard.

You can reduce your rent, downgrade your offices. Eeeewww! you might say.

You know, Peter Lynch, one of the greatest stock investors of all time, says that when he goes to visit a

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company and it is in very flash offices, he runs for the door.

Why?

Because they are not going to be chronically *what?* Profitable.

They have got to work really hard just to pay the rent.

You are not in the business of making your landlord wealthy. You are in the business of making you and your shareholders and your employees wealthy.

That is another way to decrease fixed cost. How else can you do it?

Lease instead of buy? Nice try. See, everybody thinks leasing is a V, but it is actually an F. You are tied to that contract, so it is a fixed cost. You can pretend that it is variable, but guess what? It has to be paid every month.

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When I set up my last company in Japan, I would not let the employees purchase or lease a copy machine. I told them that every time they wanted to make a copy, they had to go to 7-Eleven. Now *that* is a variable cost.

Every time that they wanted to make a copy, they had to put a coin in the slot. Guess what? They didn't make very many copies.

Seriously.

That is called driving fixed cost all the way out. Does that make sense? Use equipment that is used only on a when-needed basis: That is variable cost.

How else can you get rid of your fixed costs? You can downsize and get rid of all your fixed costs entirely. Which fixed costs? Salaries. So what is a way you can take a fixed salary cost and turn it into a variable cost? You can pay your people in stock options—which are only going to be valuable if your people make you a bunch of money. Or you can give them a commission or

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a percentage of profits. You can create a larger bonus pool and a lesser salary, but then the bonus pool depends on the profits. So unless you are profitable, you don't have to pay them. Would that increase your Chronic Profitability, yes or no? Yes. You have to have many ways to do it.

Drive fixed costs all the way out!

Improving Your Margin

Now let's look at improving your profit margin.

You have many ways to do this. What are some of the ones you can think of?

Increase the prices. That is a really terrific one. Does it actually work? It does. There are some products that will sell better when the price is raised. It is really interesting. You increase the price and more people want to buy.

You want to find your ideal price point that gives you the maximum margin you can get.

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Here is an example: In 1984 Tony Robbins put together his Personal Power® infomercial with my first client, Bill Guthy. Bill tested the price point at \$89, \$129, and \$179. They sold more at \$179, because that was the perceived value. If you want Personal Power®, that's what you paid; today the product sells millions of copies a year worldwide. It is important that you check the price by what the client thinks the value is.

What else can you do to improve the margins? If you don't know, I am concerned. Aren't these the questions you need to be asking yourself every day?

One way to improve margins is to improve the quality.

Now I want you to understand that improving the quality is very profound, because improving quality does what to costs? It reduces the costs. You need to understand this: *Higher quality costs less!*

Higher quality costs less!

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This is the one single paradigm shift that Deming taught the Japanese that created the entire postwar economical miracle. He went in and said, “I am going to tell you the big secret.” They said, “What is that?” He said, “The big secret is higher quality costs less.” They all fell out of their chairs.

Now, Deming wouldn’t do any seminar that didn’t have 500 CEOs in the room. If the CEO wouldn’t come, he wouldn’t let anybody in the company come. He said that otherwise it was completely pointless for what they were doing, because they needed to change the whole management paradigm.

He said higher quality costs less because, number one, you don’t have to process the claims. Claim processing is devilishly expensive and time consuming. Number two, no rework. Devilishly expensive. Number three, less marketing costs. Because, if it is higher quality, you start to get word of mouth and you start to drive the marketing cost outside the organization instead of inside. Lower selling cost, lower marketing cost, less

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rework. And less waste—because when you start to drive quality into a process, you actually waste fewer materials. It actually drives the cost down.

Not only does it bring the price point up, but you do it while driving the cost down. Does that make sense?

So the formula for success, since we are doing a formula-based discussion here, is very interesting. This is what the very best companies do.

They take the quality and raise it up. And when they raise the quality, what that does that do to the cost? The cost goes down. And when the cost goes down, what happens to the profitability? It goes up. And when the profitability goes up, what does the company do with the profitability?

The first thing they do is invest in higher quality. The second thing they do is give the customer a lower price, out of the increased profitability. And the third thing they do is reward their employees, their

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shareholders, and all the other stakeholders in their business with a larger dividend.

Can anybody say TOYOTA? This is how they do it. They drive the quality up, which drives the cost down, which increases the profit margin, which allows them to give a lower price, even-higher quality, and a bigger shareholders' dividend. Start doing this for a couple of years and nobody will be able to catch up.

$$\begin{aligned} \text{Quality } \uparrow &= \text{Cost } \downarrow = \text{Profit } \uparrow \\ \text{Profit } \uparrow &= \text{Quality } \uparrow + \text{Price } \downarrow + \text{Profit } \uparrow \end{aligned}$$

How else can you improve the margins? You can negotiate better terms of business with your suppliers. I am not only talking about price, although part of it is price.

In the equation value, you have four things: **quality**, **cost**, **delivery**, and **service**, or QSDC. So, getting a better delivery schedule can allow you to drive down your inventory, which will improve your margin and return on capital.

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Also, you can improve your operational efficiency.

I started out as an industrial engineer. One of the first factories I went to was an automotive parts factory. I followed the forklifts around for two days. This factory was having one forklift accident a week. Does that drive any cost into your business? Yes. Not to mention the fact that they drove forklifts all over the factory, which did not add value. It is a nonviable added process.

We laid out the whole factory and got rid of most of the forklifts just by following them around and finding out how things really needed to move through the factory. The factory radically improved its operating efficiency.

Here's another example. Say an employee is doing one process that is taking 20 seconds. The guy next to him is doing a process that takes 40 seconds. What you do is get two people doing the process that takes 40 seconds and you get twice the output by increasing the

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manpower by only a third. There are all sorts of things you can do to increase the operating efficiency.

Another thing you can do is decrease waste of all kinds. Decrease waste in time, materials, and energy. All these things will improve your margin.

Creating Fixed Sales

Now for the big one (a little drum roll please): We have decreased the fixed cost. We have improved the margin, and now we want to increase the fixed sales.

Let's talk about some different ways you can create fixed sales in your organization. Remember that fixed sales lead to Chronic Profitability, when you are making money all the time no matter what.

Without the fixed sales, it doesn't matter what you multiply or subtract at the end; you are not going to have the Chronic Profitability that you desire.

Now we are at the crux of the equation.

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How do you get fixed sales?

Contracts. You can have ongoing purchase order agreements that they are going to purchase \$X amount from you every month, every month that you have a fixed sale. Using our training company as an example, when we built training programs that were integrated into organizations as part of their systems, whenever a manager was promoted, they had to go through our training. This is a fixed sale. We knew they were going to come in every year. When it gets to be promotion time, those guys are going up the ladder and we are getting the order. Is that good or is that good? That is good.

You want to start looking into ongoing purchase agreements or how to get yourself systematized so your products and services are part of the system of your client.

What other kinds of things are fixed sales?
Exclusivity. You have an agreement that they purchase

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exclusively from you, and you know that they have to purchase.

What else?

Word of mouth. Word of mouth is not a fixed sale; nice try. Word of mouth is not a fixed sale because you don't know if it is going to happen or not. It is nice. I like word of mouth. Word of mouth is better than having to do it myself, but it is not fixed. I want something that I can put a number on, and I know what is coming in.

Subscriptions. Yes! Yes! Yes! Subscriptions. Memberships. Do you know that if everybody who has a membership at your sports club actually showed up, your club would be toast? But they get those memberships, and they take money out of the bank account every month. They get \$80, \$100 a month out of the bank account whether you go to the sports club or not, and they don't have to sell you anymore. That stuff just keeps coming. It is a fixed sale.

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What else? How about multilevel marketing? Only certain parts of multilevel marketing become fixed sales. I am going to give you the operative word that can be used in multilevel marketing: “auto-ship.”

“Auto-ship” means that we are going to ship this product to you every single week or every single month, depending on the periodicity of the product. We do not need a new order from you; you have ordered an “auto-ship.” It comes; we charge your credit card. Everybody say “Auto-ship.”

How else can you get a fixed sale? Joint ventures? Partnerships? What kind? I have had a lot of partnerships that did not generate me any fixed revenue. Licensees and franchises. Yes. Everybody say “yes.”

Let me give you the profit margins on franchises. This is what you really need to know. I used to manage a franchise business and for every dollar that we brought in, our fixed cost was six cents. You like the margin?

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So franchising and licensing is an awesome business. Now sometimes you are not going to get that same ratio. If you are not getting that same ratio, you need to hire Roice as a consultant. But you can get your margin to at least 40 percent. You ought to be looking at 40 percent coming in.

In our case we would create a training program and nurture it, mature it, and make it grow in the United States. We created a profitable model and would just wait for the telephone to ring, because people would call up and say, “We would like to represent your product in our country.” We didn’t have sales costs because we didn’t have to go look for licensees. We did have some legal cost involved, which I guess is a variable cost in this case because you do that each time.

So you would have a one-time variable cost. In your company you might have a product that you would ship out, which could also be a variable cost. But what we would do in our case was outsource, so the companies could actually produce the materials in their country. They didn’t have to buy them from us, and they simply

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sent us a royalty check. Then what we would have is an accounting cost and we would have a service cost of the individual on telephone and so forth. You could work on that type of margin.

In one organization, I decided to completely outsource myself from them. I said, “Look, I have such a profitable model, why don’t you just pay me a percentage of that profit?” So I licensed to the company to license for them. Got it? Then I just developed an income stream. I said, “Not only do I want that income for the time that I am working with you, but when I retire I would like to have it five years in the future.” And they bought the deal. Got it? This is a powerful concept. Think licensing. It is what I call the multiplier effect. It is how to multiply your organization and what you are doing.

In *Chicken Soup for the Soul*—we became inundated with people who wanted the licenses because our name is a brand. This is why I said your title is everything in a book or a product or a subject.

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For example, Diamond Pet Foods came to us. I do not make the pet food or anything, but we get 15 percent off the top on \$2 million sales a month this company makes. That is \$300,000. Jack gets half: 7.5 percent. I get 7.5 percent. This is a pure-profit business. I could retire just on that.

We just gave you another \$1 million in value from these ideas!

There are a lot of levels of licensing. Licensing is a young business. The first guy in licensing was Walt Disney. He started licensing the Disney characters and images.

Then there's George Lucas and Steven Spielberg. Lucas said to Spielberg, "We ought to be licensing all that stuff you are doing with E.T." Look what happened. In Spielberg's book he says he made \$800 million on E.T. and \$1.5 billion on licensing.

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Bottom line: You have rentals, interest, annuities, and trail fees on introductions. You have all kinds of fixed sales.

Summary: All You Need to Know

So that is basically all you need to know. You have to lower your **fixed costs**. You have to improve your **margins**. You have to increase your **fixed sales**. And you will be chronically profitable.

With best wishes,

James Skinner, Roice Krueger, Mark Victor Hansen

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