

## PROFITABILITY FRAMEWORK

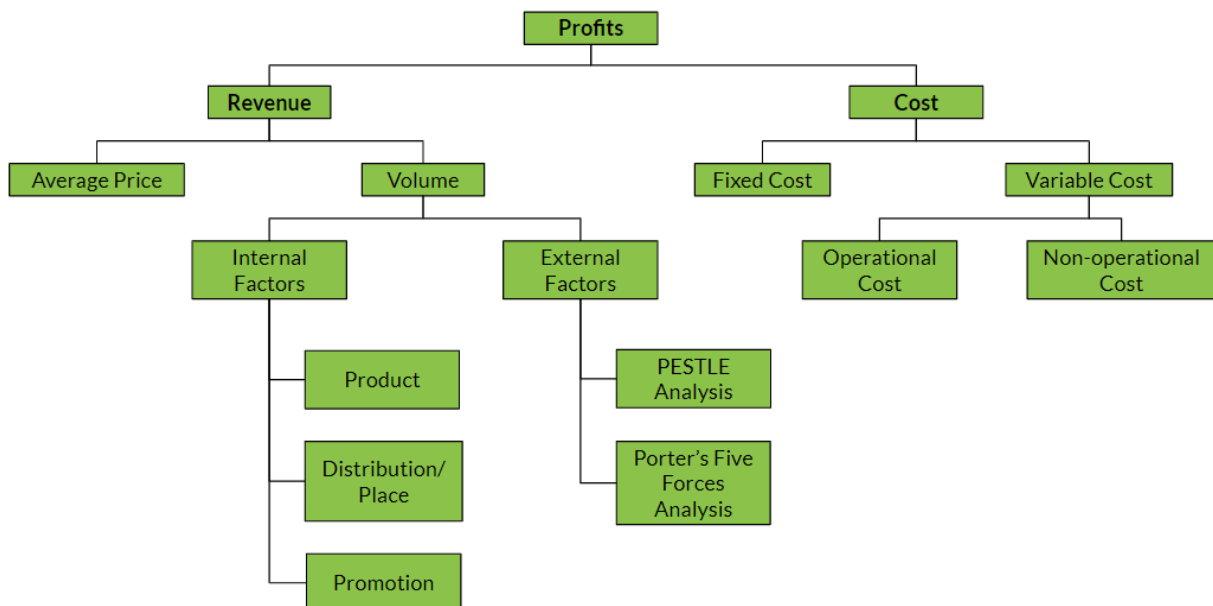
Profitability cases are the ones that deal with decreasing profits of a firm. Declining profits can be due to multiple reasons and in order to identify the reason for declining profits, a comprehensive framework is used. The framework analyzes various factors which could potentially be the reason for this.

$$\text{Profits} = \text{Revenue} - \text{Cost}$$

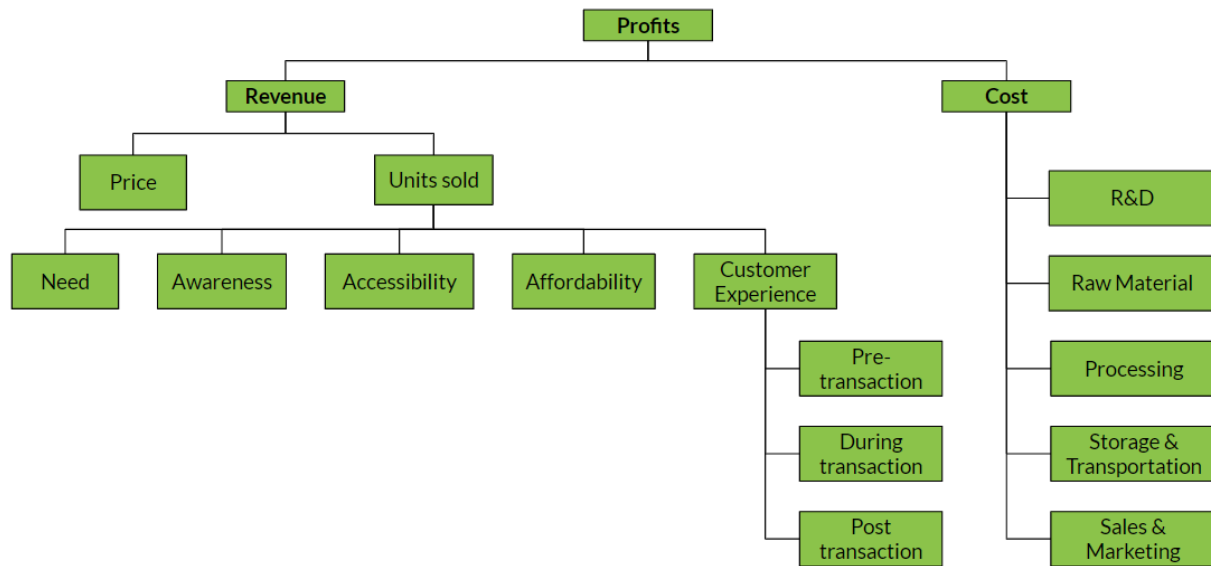
$$= (\text{Price} * \text{Quantity/Units sold}) - \text{Cost}$$

With the given equation of profits, it is understandable that decreasing profits could either be due to decreasing revenues or increasing costs.

We will move ahead by breaking down each component part by part to ensure we don't miss on any significant component. This is the approach which one needs to take even in case interviews.



OR



Once the problem statement is told, reiterate the problem in a comprehensive manner as to know if the understanding of the problem by you is appropriate. If there would be any discrepancy, the interviewer would let you know then and there itself.

### Preliminary Questions

Start with some questions in order to know about the profits.

- Get a primitive understanding of a company: what product/services they offer?
- What geography does it cater to?
- Understand whether this is a company specific problem or industry wide phenomenon
- Since when have the profits been declining?
- What is the percentage (%) of the decline?
- Are the profits declining from some particular areas?
- Are profits declining due to a fall in revenue or an increase in costs?



## REVENUE BREAK-UP

### (i) The Price Component:

The price component is the most visible component in this type of case because any change in the price will directly affect the profitability. However, if the interviewer mentions that there has been no change in the price component, we can move on to the next component.

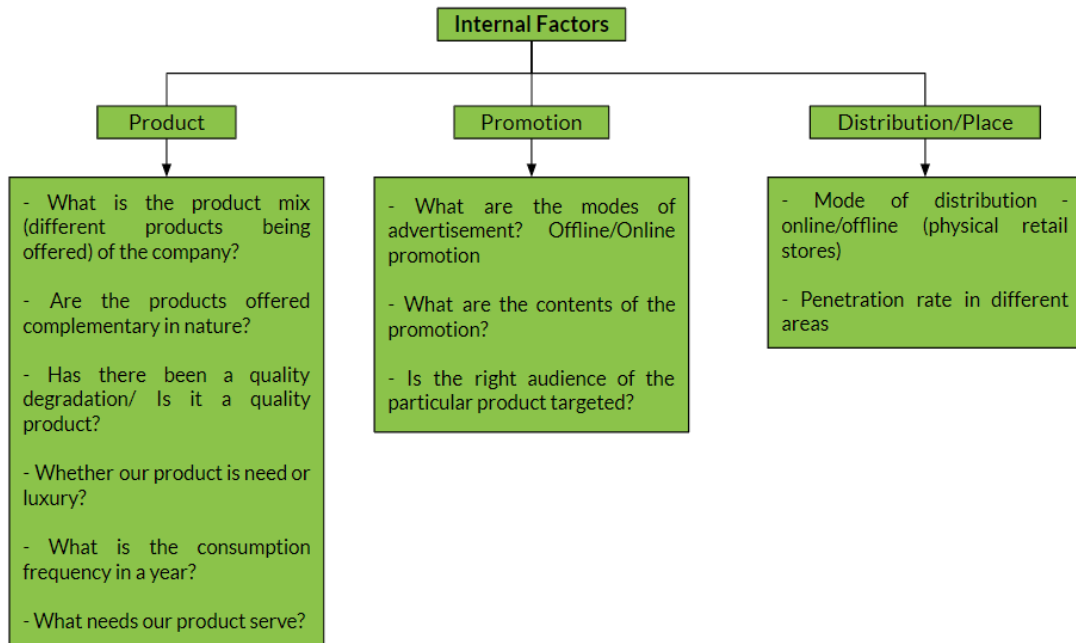
*Note:-* Asking questions related to price will be of greater significance if there has been no mention about decreasing profitability in some particular area. If the overall profitability has been reducing then we can take a step ahead & ask if Price Discrimination is being followed and if any changes have been made in that area.

### (ii) The Quantity Component:

Declining quantity could be due to internal or external factors. Internal factors revolve around the area directly affecting our product. These factors are significant as they are responsible for driving sales of our given product.

Internal Factors (The 4Ps Framework):

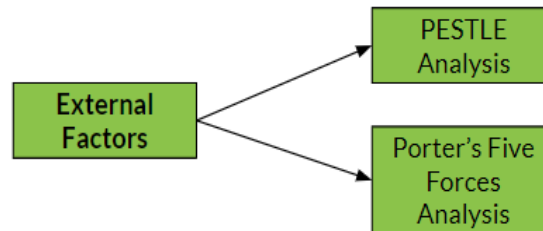
- In which category does the product lie? Is it a necessity or luxury?
- Are the customers even aware of the product? What kind of promotion techniques do you use?
- What is the mode of selling the product?



### External factors:

They are the ones that are beyond the control of the business and impact them indirectly. It becomes significant to identify these factors so that measures can be taken accordingly to mitigate the adverse effects.

To measure and assess external factors, two tools we can use are PESTLE Analysis and Porter's Five Force Analysis.



(a) Porter's Five Forces:

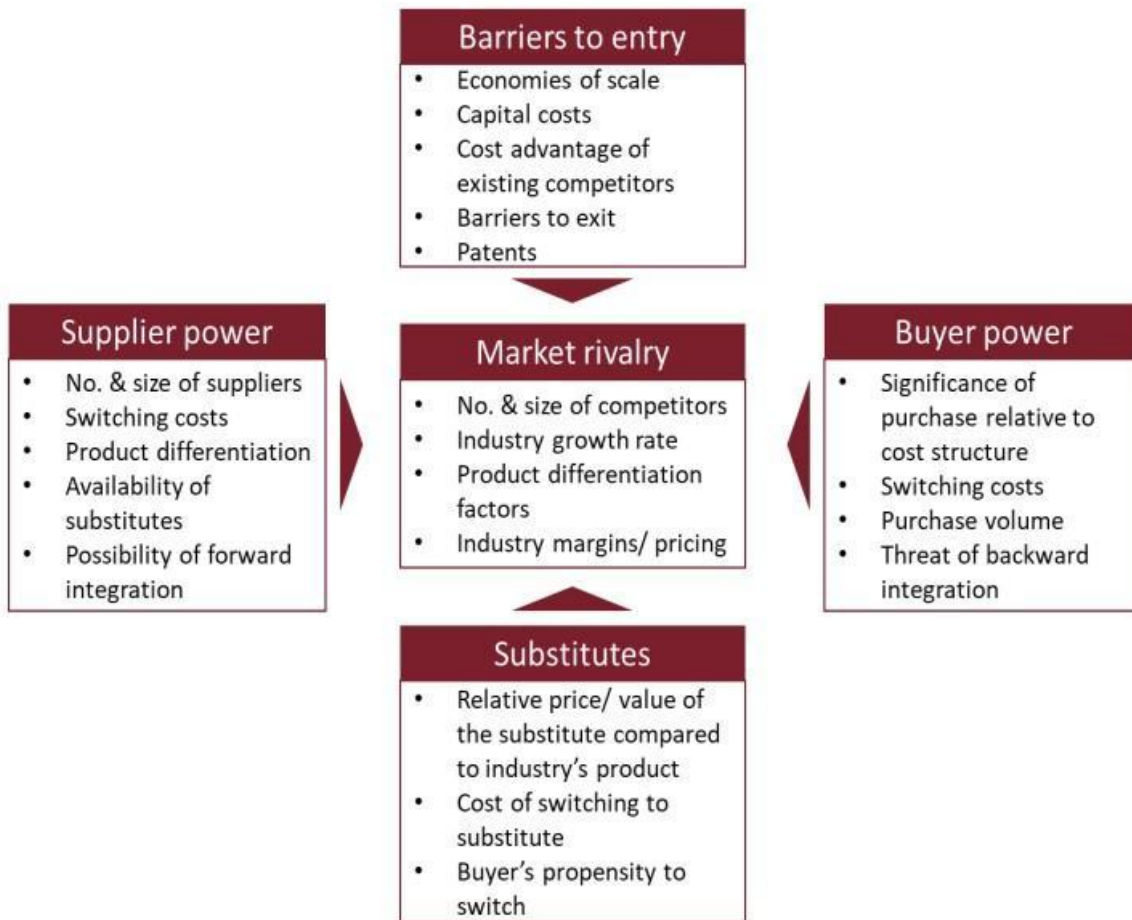
It is a model that identifies and analyzes five competitive forces that shape every industry and helps determine an industry's weaknesses and strengths. Five Forces analysis is frequently used to identify an industry's structure to determine corporate strategy. Porter's model can be applied to any segment of the economy to understand the level of competition within the industry and enhance a company's long-term profitability.

Porter's five forces are:

1. Competition in the industry (Market Rivalry)
2. Potential of new entrants into the industry (Barriers to entry)
3. Power of suppliers
4. Power of customers
5. Threat of substitute products

The figure below further dissects these five forces.

## Porter's 5 forces- Microeconomic analysis



Source: IIM Lucknow Casebook

### (b) PESTLE Analysis

This is a mnemonic which in its expanded form denotes P for Political, E for Economic, S for Social, T for Technological, L for Legal, and E for Environmental. It gives a bird's eye view of the whole environment from many different angles that one wants to check and keep a track of while contemplating a certain idea/plan.

It gives an overview of the macroeconomic conditions and answers questions such as:-

- What is the political situation of the country and how can it affect the industry?
- What are the prevalent economic factors?
- How much importance does culture have in the market and what are its determinants?
- What technological innovations are likely to pop up and affect the market structure?
- Are there any current legislations that regulate the industry or can there be any change in the legislations for the industry?
- What are the environmental concerns for the industry?

<b>Political</b>	<ul style="list-style-type: none"> <li>• Forms of Govt.               <ul style="list-style-type: none"> <li>• Stability of Govt.</li> <li>• Stability/ Continuity of Law</li> </ul> </li> <li>• Outlook towards industry</li> <li>• Current political scenario</li> </ul>	<b>Technology</b>	<ul style="list-style-type: none"> <li>• Core Technology               <ul style="list-style-type: none"> <li>• Technology Availability</li> <li>• Manpower</li> </ul> </li> <li>• Enabling Technology               <ul style="list-style-type: none"> <li>• Internet</li> <li>• Smartphone</li> </ul> </li> </ul>
<b>Economic</b>	<ul style="list-style-type: none"> <li>• Is economy growing?</li> <li>• Sectoral growth</li> <li>• GDP per capita (especially of our target customers)</li> <li>• Credit availability</li> <li>• Investment Environment</li> <li>• Expenditure/ Discretionary Spending</li> </ul>	<b>Legal &amp; Regulatory</b>	<ul style="list-style-type: none"> <li>• National               <ul style="list-style-type: none"> <li>• Entry barriers</li> <li>• One time permit</li> <li>• Compliance requirements</li> <li>• Taxes &amp; Duties</li> <li>• Police &amp; Judiciary</li> </ul> </li> <li>• State/ Federal – Within state and Inter – state</li> <li>• International               <ul style="list-style-type: none"> <li>• Trade Agreements</li> <li>• Trade Barriers</li> <li>• Import restrictions</li> </ul> </li> </ul>
<b>Socio-Cultural</b>	<ul style="list-style-type: none"> <li>• Societal/ group level               <ul style="list-style-type: none"> <li>• Religion</li> <li>• Caste/ Ethnicity</li> <li>• Gender</li> </ul> </li> <li>• Individual level (Habits)               <ul style="list-style-type: none"> <li>• Existing Product Usage</li> <li>• Demographic Patterns – Gender, Income, Region based, Rural/ Urban</li> </ul> </li> </ul>	<b>Infrastructure</b>	<ul style="list-style-type: none"> <li>• Product/ Service specific infrastructure (ex-availability of stadiums if launching a sports event)</li> <li>• Enabling Infrastructure               <ul style="list-style-type: none"> <li>• Transport Connectivity</li> <li>• Land &amp; Buildings</li> <li>• Utilities – Water, Electricity</li> <li>• Waste Disposal</li> </ul> </li> </ul>
<b>Environment</b>	<ul style="list-style-type: none"> <li>• Environmental Regulations</li> </ul>		

Source: IIM Lucknow Casebook

*Note:* It's not necessary to ask questions that will cover all the points mentioned in the above table. The interviewee should select only the key areas and question upon them as per the product segment. This is advisable because due to the paucity of the time it won't be possible to cover each and every area.



When the interviewer clearly states that revenues are NOT declining, we focus on the cost component. It is also possible that the costs might be increasing which is reducing the profit margin.

OR

In order to analyze the change in the number of units sold for the product of a company, one can alternatively look at the following aspects linked to the product (which may cause a decline in sales):

(a) Need

A need motivates a customer to make a purchase. This need is an opportunity to give value to customers in exchange for monetary or loyalty value. Consumers will not buy products that they perceive as having no value/need.

(b) Awareness

Awareness basically addresses both existing and potential customers of a product or service. It focuses on things like; informing customers and/or potential customers about the benefits and features of a product, persuading potential customers to make the purchase, and maintaining a trustable relation with the existing customers.

(c) Accessibility

Accessibility means the level of ease with which a product or service is accessible for the customers. Accessibility here basically addresses customer convenience and customer accessibility.

(d) Affordability

Every product comes with a price, and so affordability is referred to as whether the customers in the target market are economically able and psychologically willing to pay the price of the products.

(e) Customer Experience

A remarkable customer experience is critical to the sustained growth of any business. A positive customer experience promotes loyalty, helps you retain customers, and encourages brand advocacy. Today, customers have the power, not the sellers.





## COST BREAK-UP

Just like revenue, costs can also be broken down into two major heads.

$$\text{Cost} = \text{Fixed Cost} + \text{Variable Cost}$$

Interviewee should begin with asking if there has been an increase in the fixed cost component.

### (i) Fixed Costs:

It refers to the cost which the business needs to incur irrespective of units produced or services sold. This cost is incurred by business on a recurring basis, thereby any change in its cost component can increase the costs of the business manifold.

Fixed costs include :-

- Rent
- Interest Payments
- Loan Repayments
- Utilities bills
- Insurance premium

In case fixed costs have increased (and that too of a major component like rent), further questions can be asked like:-

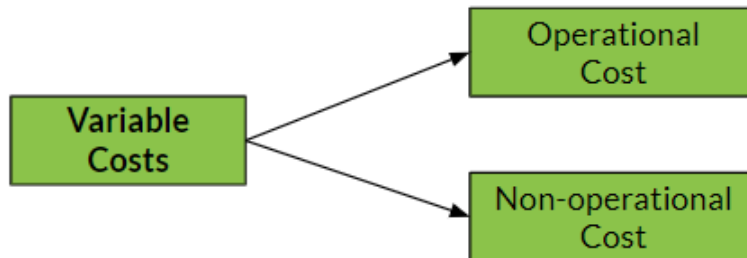
If there is any scope of reducing the rent, either by going through a different broker or say, shifting your stores.

If there is no scope of reduction in fixed cost, interviewee should move on to Variable Cost component.

### (i) Variable Costs:

It refers to the cost which depends on the production in the business.

For example: If the firm decides to double its number of units produced, then labour cost will also vary accordingly.



Operational costs: They refer to costs which are directly related to the production of goods & service. It has a broader coverage as compared to non-operating. Due to this reason we can classify it into a number of sub categories and look at each of them individually.

(Refer to the diagram below for break up of components).

Non operational costs: They are the ones which impact the profitability indirectly. For example: There could be an increase in depreciation owing to change of accounting methods or addition of new machinery to the factory. Increase in bad-debts can also reduce the margins.

Some basic questions that can be asked by the interviewee in accordance with cost segregated into different categories are shown in the flowchart below:

