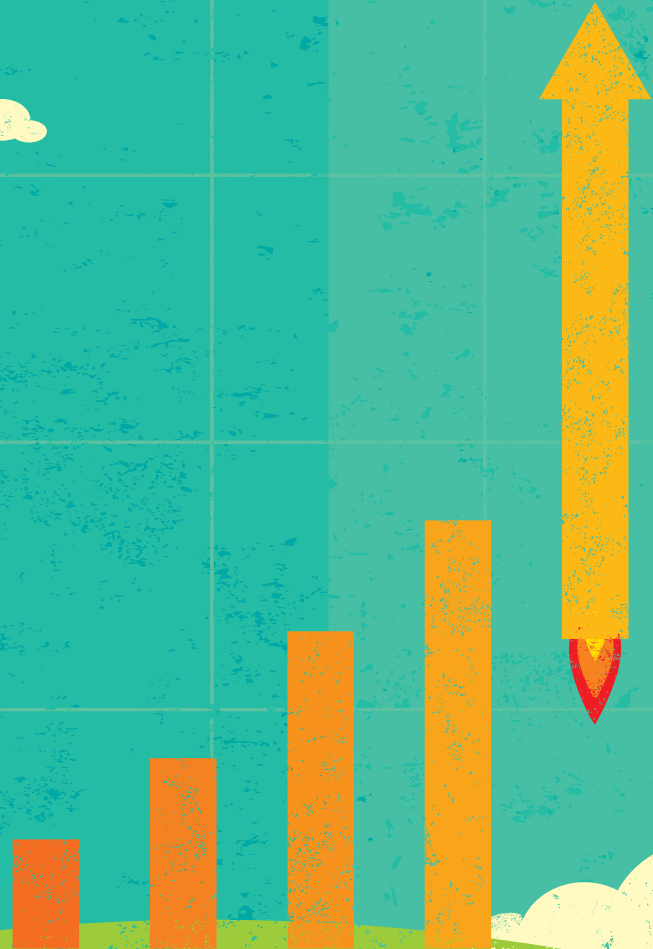




The Ten Commandments of Startup Profit

Ed McLaughlin & Wyn Lydecker



From the beginning, I organized my business, USI, around 10 core profit principles. I call these principles The Ten Commandments of Startup Profit. By factoring profit into every business decision, USI generated a 20 percent operating profit margin, while growing our revenues at a 40 percent compounded annual rate.

You can use this concentrated list of profit principles to benchmark your business and its potential for generating profit. →

- 1 Build a Business Based on Your Distinctive Competence.**
- 2 Develop and Deliver a Superior Value Proposition.**
- 3 Don't Start Up Until . . .**
 - a. You know how you're going to generate revenue**
 - b. You know how much it will cost to run your business**
 - c. You know how you're going to make a profit**
 - d. You have preorders to validate your business model and liftoff plans**
 - e. You have lined up the funding you need to reach breakeven**
 - f. You understand the impact of startup funding on cost and control**
- 4 Take Charge of the Money and Control It.**
- 5 Create a Profit-Based Reward Structure.**
- 6 Recognize and Hire "Lightning in a Bottle."**
- 7 Create Profit Centers to Scale Your Business.**
- 8 Augment Profits with Proprietary Applications.**
- 9 Build a Financial War Chest for Strategic Advantage.**
- 10 Behave Ethically and Profits Will Follow.**

Understanding these profit principles and applying them to your business can increase the probability of your long-term success and improve your returns along the way.

PROFIT PRINCIPLE #1:

Build a Business Based on Your Distinctive Competence

Distinctive competence is a combination of knowledge, experience, reputation, and achievement. If you can identify a need for a product or service in an industry where you have distinctive competence, you can substantially increase your probability of startup success. You can minimize the risks by utilizing your understanding of existing business models, customer relationships, market needs, gaps in product design, fulfillment challenges, pricing sensitivity, and competition.

Think through the following questions to identify your distinctive competence and its application to your business idea.

- Do you have a unique skill, special knowledge, experience, or talent?
- Does your skill or knowledge have value in the marketplace?
- Can you use your competence to create something unique, disruptive, or innovative?
- Can you use your distinctive competence to secure preorders?
- What additional competencies do you need to succeed?
- How can you fill the competency void?

After wrestling with these questions, and reflecting on my past success, I realized my distinctive competence was my intimate knowledge of the value drivers behind real estate outsourcing. Given my early success with outsourcing, I was certain that the commercial potential to bring this model to market was phenomenal. Every corporation or institution with 100 or more locations was a candidate for outsourcing. The value proposition for the customer was undeniable, and the profit potential for my new business was huge.

Your distinctive competence should be the source of your new business idea. It is the one thing that will set you apart from your competitors. Selecting and building a business around your distinctive competence is the first step toward profitability.

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PROFIT PRINCIPLE #2:

Develop and Deliver a Superior Value Proposition

A superior value proposition captures the essence of your product's unique benefits and how it solves a vexing customer problem, meets a critical need, or relieves severe pain better than anything else in the marketplace. The most efficient path to profit is a value proposition that clearly delineates what your customer will get and how they will get it. Through experience, I have learned that a value proposition with a crystal-clear quantification of benefits is easiest to sell and the most compelling to buy.

Consider the answers to these questions in formulating your value proposition.

- What is your product, and who is your customer?
- How does your product alleviate your customer's pain?
- What is the value of pain relief, or how will your customer benefit?
- Is your customer motivated to buy your product repeatedly to prevent pain?
- Does your product serve a large and growing market?
- Do you have a sustainable competitive advantage—a unique solution to pain?

A good way to test the strength of your value proposition is to reflect on your rationale for starting your business in the first place.

- When you decided to start your business, you developed a vision for delivering unique and differentiated value to your customers. What is the vision for your business?
- You planned to create value so substantial that your customers would be motivated to seek you out to buy your product over and over again. What unique value do you bring to your customers?
- Your product would serve a large and growing market, offering your customers unique benefits not available from competitors. What is your competitive advantage?
- Your product would be priced in proportion to the value created for your customer and produce substantial profits for your stakeholders. How does your customer measure value? How will you price your product? What is your price/value ratio?

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USI's value proposition revolutionized the way corporations managed and controlled their real estate. Corporations were suffering from high overhead costs, which were dragging down their bottom lines. USI's solution resolved their pain by reducing real estate costs across the enterprise, saving them millions of dollars. We structured our outsourcing contracts as multiyear exclusives. By alleviating a major source of pain, USI enjoyed a 95 percent contract renewal rate while maintaining a 20 percent net profit margin.

PROFIT PRINCIPLE #3:

Don't Start Up Until ...

It is only natural that you struggle with the desire to start up while knowing that you do not have all the answers. At the same time, you realize that you will never start up if you attempt to answer every question. Recognizing this challenge, I developed a short list of questions entitled, Don't Start Up Until . . .

These questions center around your business model, but it only requires the back of an envelope for you to figure out how you are going to make money; how much it is going to cost to run your business; and how soon you will reach breakeven and generate a profit.

Your ability to secure preorders will not only validate your business model, but will have a direct impact on your funding requirements, which will influence ownership and control.

Remember, you only need rough estimates to validate your business model, but you will need firm preorders to launch. Tackling the following six business model imperatives will give you confidence that you are ready to start up.

1. Don't start up until you know how you're going to generate revenue (simple estimates will suffice).

- a. How many customers are there?
- b. How much product will each customer buy?
- c. How will you price your product (share of value, cost-plus, market pricing)?
- d. Calculate revenue by estimating monthly sales (customers \times units \times price).
- e. Calculate revenue per quarter and revenue per year.

2. Don't start up until you understand how much it will cost to run your business (do your homework on expenses).

- a. How much will it cost to produce your product (manufacturing & distribution)?
- b. Who will be on your management team, and how much will it cost to compensate them (equity and/or salary)?
- c. How many employees will you need to start up, and what will it cost to compensate them (salary & medical)?
- d. Where will you work, and how much will it cost (rent & utilities per month/year, furniture costs, supplies, etc.)?
- e. How will you communicate with your customers and how much will it cost (computers, printers, mobile phones, Internet access, hosting, cloud services, etc.)?
- f. How will you brand the business (logo, website, blog, social media, business cards, letterhead, signage, etc.)?
- g. How much will it cost to sell your product (marketing, travel, entertainment, proposal generation, ongoing pursuit costs, etc.)?
- h. How much will it cost for risk management and compliance (legal, accounting, & insurance)?

3. Don't start up until you know how you're going to make a profit (back of the envelope).

- a. Revenues minus costs equals profit or (loss).

4. Don't start up until you have preorders to validate your business model and liftoff plans.

5. Don't start up until you have lined up the funding you need to reach breakeven (typically 18 months of operating capital).

- a. Estimate how long it will take you to reach breakeven.
- b. Determine your startup and operating capital needs.
- c. Generate a list of funding sources and alternatives.
- d. Secure the necessary funding with a cushion for unanticipated challenges (sensitive to imperative #6 below).

6. Don't start up until you have a crystal-clear understanding of the impact of your choice of startup funding on cost and control.

- a. Self-funding or bootstrapping will maximize control and avoid outside partners and interest payments.
- b. Selling equity will avoid interest payments but reduce control by introducing outside partners.
- c. Raising debt financing will let you maintain control by avoiding outside partners but will require interest payments.

I completed the financial modeling portion of this exercise in my kitchen with my two founding partners. We hashed things out with a flip chart and markers until we were comfortable that we had a financial model that would work. It took about two months to figure things out and be confident that we were on the right track. I completed the preorder portion of this exercise by meeting in the field with my first two customers: Patterson Dental and IDS Financial Services (now known as Ameriprise). Once we had these orders in hand, along with our financial model, we were able to make the decision to bootstrap and launch.

PROFIT PRINCIPLE #4:

Take Charge of the Money and Control It

Your decision to build a profitable business is directly proportional to your ability to take charge of the money. Taking control of your money is a commitment to take responsibility for all of the following financial disciplines:

- Developing a realistic budget and operating the business within it
- Understanding how the timing of revenues and expenses affects cash flow
- Keeping a stranglehold on salaries and operating expenses
- Retaining your earnings for reinvestment as a first priority

Develop the discipline to generate and review simple financial reports and budgets on a daily basis until you achieve breakeven. Thereafter, continue with this financial discipline on a weekly basis until you achieve consistent profitability and hire a qualified financial officer that you can trust. Besides sleeping better at night, you will gain a clear understanding of the rhythm and flow of your revenues and expenses and their impact on your operating budget.

During USI's first three years of operation, I knew where every dollar of revenue came from and where every dollar was spent. I reviewed simple financial reports every single night and made judgments about budgets every day. We started out with a one-write checkbook system, quickly shifted to Excel to generate budgets and financial reports, and later migrated to QuickBooks as our primary financial management system. Throughout the life of USI, I always stayed very close to the money, and I was very cautious about extending trust when it came to the money. As a result, I was never surprised and slept peacefully most nights.

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PROFIT PRINCIPLE #5:

Create a Profit-Based Reward Structure

A profit-based reward structure compensates your management team for achievement of financial goals and your sales force for developing profitable new business. Rewarding performance with a percentage of profits is a surefire way to turn your management team and your sales force into P&L managers. Think about it. If your management team and your sales force can only increase their personal income when the business is generating a profit, then the business is almost guaranteed to make a profit.

At USI, we compensated our management team and our sales force with a moderate base salary to cover living expenses. At the same time, USI offered unlimited upside potential based on the generation of genuine profits. This type of reward structure aligned the financial interests of the producer with the financial interests of the business. Of course, we established profitability guidelines to ensure we achieved the desired financial results.

This incentive system required the management team and the sales force to become intimate with the financial model behind the business. Said another way, if your upside is tied to the generation of profit, you have to understand how much profit is generated by each dollar

of revenue after costs. At USI, we pushed the responsibility for profit and loss management all the way down the organization.

As much as possible, we maximized the contribution and accountability of every professional by connecting them to an income-producing role. This operating model minimized USI's overhead by keeping a lid on non-income-producing staff.

PROFIT PRINCIPLE #6:

Recognize and Hire “Lightning in a Bottle”

As you are scaling your business, you will be faced with the challenge to stretch beyond your comfort zone and reach to hire special talent. While I believe in developing and promoting internal management, sometimes you need to make the big external hiring decision to enable the business to realize its full potential.

As the business leader, you need to step up and make these transformational personnel decisions. It's not always comfortable or convenient, but sometimes you really can catch lightning in a bottle. This kind of talent only comes along once in a while. When it does, it can unlock business value and catalyze strategic growth. Even though this type of hiring decision may involve an

aggressive compensation package, including a share of equity and control, it can be well worth the price to achieve your strategic vision.

Recognizing strategic leadership and acting decisively to bring it on board can revolutionize your business model, transform your organizational structure, and engineer the strategy to scale the business. It certainly did for me. I had the opportunity to make four critical hiring decisions that changed the trajectory of USI:

- 1.** Rick Bertasi became President and Chief Operating Officer. Rick reengineered USI's business model, upgraded the organizational structure, implemented our annual business planning process, developed our customer-facing technology, and catalyzed our growth plans.
- 2.** Nick Westley became USI's West Region President & Chief Strategy Officer. Nick opened up the western half of the US market, laid the foundation for our geographic profit centers, sculpted and quantified USI's value proposition, and developed our strategic growth plan.
- 3.** Michael Casolo became USI's President of Design & Construction. Michael conceived the Space and Projects business, laid the foundation for our Line-of-Business profit centers, developed the Design & Construction business model, and hired a geographically distributed staff of architects and project managers.

4. Kip Chaffee became USI's Chief Financial Officer. Kip redesigned USI's internal operating model, re-engineered our financial & accounting system, developed USI's technology development team, and played a crucial role in facilitating our sale to Johnson Controls.

I was very fortunate. I captured lightning in a bottle four times. These talented leaders played a vital role in USI's growth and the ultimate value realized when we sold the business. Recognizing the opportunity to reach and hire strategic leadership will enable you to scale your business and realize its full potential.

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PROFIT PRINCIPLE #7:

Create Profit Centers to Scale Your Business

Determining how you will scale your business will be one of your biggest challenges. After assessing numerous growth strategies, we came to realize that expansion based on the profit motive could be the key to our continued success. If we established geographic and line-of-business profit centers, we could drive growth by distributing profit and loss responsibility across the organization.

As a result, we embarked on a strategy to develop and deploy profit centers throughout USI. Each new P&L manager had the responsibility to generate new revenue, control expenses, and enhance profit performance. We scaled the business by creating four different kinds of profit centers:

- Regional P&Ls to expand geographic coverage
- Line-of-business P&Ls to build product lines
- Account-based P&Ls to grow existing customer relationships
- New business P&Ls to create new customer relationships

There are five steps to consider in formulating your plan to scale around profit centers.

1. Think through your current and potential customers' product and service requirements.
2. Assess your product and service fulfillment plans.
3. Formulate your new business development and sales plans.
4. Determine your geographic and line-of-business coverage plans.
5. Recruit, hire, and train qualified P&L managers for each profit center.

Based on our customers' requirements, USI created a combination of regional profit centers and line-of-business profit centers. Our regional profit centers enabled us to stay close to our customers, expand geographic coverage, and distribute financial responsibility. Our line-of-business profit centers focused managers on product-line performance, improved service delivery, and enhanced new product development. We also created account-based P&Ls for every account and new business P&Ls within each regional P&L.

Although complex, this profit-oriented growth model helped us achieve our financial objectives as we scaled the business.

PROFIT PRINCIPLE #8:

Augment Profits with Proprietary Applications

Application software tools can generate new revenues and form the basis for a stand-alone profit center. Besides streamlining work processes and improving service delivery, software applications can enable your customers to manage workflows, eliminate process steps, and gain access to critical information. Proprietary applications can be so powerful that they can form a mutually dependent relationship between you and your customer.

Here are some of the questions you should consider when devising your strategy for developing proprietary application software:

- What information do your customers need to make better decisions?
- What tools do your customers need to better manage their work?
- How can you help your customers eliminate process steps and reduce operating costs?
- Are there software applications available in the market that solve these problems?
- If the applications are not available, can you develop proprietary applications to solve these problems?

- How can you utilize homegrown applications to tighten the link with your customers?
- Will your software applications create a sustainable competitive advantage?
- Can these applications create new revenue lines?
- Can these new revenue lines be used to form a stand-alone profit center?

As USI customers expanded around the world, they needed a reliable real estate management system to keep track of critical dates, projects, workflows, and costs. Initially, we devised a plan to develop a low-cost proprietary software application. However, since the dot-com boom was in full swing, we decided to take a step back to look at available market alternatives—there were over 300 new real estate applications coming online. We engaged a major consulting firm to cull the list and study “buy, build, or partner” scenarios. To our dismay, the consultant’s final recommendation was a very costly custom-built solution.

Recognizing the limits of our customers’ budgets, we came back full circle to developing a low-cost, proprietary software application that would serve 80 percent of the need at 20 percent of the cost. Our goal was to meet most of our customers’ needs at a budget they all could afford. We called our application Sequentra. It was named after our customers’ primary need to “sequentially track” project work and expenses around the globe. Based on Sequentra’s

revenue potential, we organized the application as a stand-alone profit center. Sequentra integrated all of our service lines into a single reporting dashboard for all of our customers.

Sequentra tightened the link with our customer base and created a barrier to entry for our competitors. It grew to become one of the dominant corporate real estate software solutions in the industry.

PROFIT PRINCIPLE #9:

Build a Financial War Chest for Strategic Advantage

Once your business starts to generate consistent profits, you should retain your earnings to strengthen your balance sheet for strategic advantage. Naturally, there will be temptations to spend by increasing salaries, changing travel and expense limits, enhancing benefits, hiring unnecessary staff, or upgrading offices. If you can increase revenues while holding the line on expenses, you can begin to build a financial war chest.

At USI, we chose to stockpile our earnings. At first, we were just concerned about staying in business and having funds available for a rainy day. Then, as we continued to build our war chest, we gained confidence that we could make expansion decisions without the need for a

bank or outside funding. It was interesting to discover that the less we needed the banks, the more they wanted to lend us their money. The same was true with private equity firms; they loved our growth trajectory, income statement, and balance sheet. They couldn't believe that we had no debt and that we had accumulated retained earnings of almost 20 percent of annual sales. As a result, the leverage shifted in favor of USI in all of our financial negotiations.

We built a balance sheet so formidable that we were able to offer \$1 million advances on projected savings to win multiyear corporate outsourcing contracts. This offer became a strategic weapon so powerful that it increased our close rate to over 50 percent.

Like most sacrifices, employing financial disciplines early and building a financial war chest can shift the balance of power and pay substantial dividends in the future. Imagine what you can achieve if you have such significant cash reserves that you are not reliant on third-party sources to grow your business.

“ If you can increase revenues while holding the line on expenses, you can begin to build a financial war chest.

A Few Words about Spending

Of course, we did increase spending as the business grew, but we were always spending much less than the amount of money we were making. Since we paid our producers (executives, management, sales, account leaders, and delivery professionals) a moderate base salary with an unlimited upside based on profits, we were not under pressure to increase salaries. We maintained very strict travel and entertainment standards throughout the life of the business. For example, we capped airfares and used flight miles if the trip cost exceeded the cap. For the most part, we shared hotel rooms and lived within a moderate per diem for food.

In regard to benefits, we provided medical coverage from the beginning. Beyond that, I had made an early decision not to add other benefits until I knew I would never have to take them away. USI's benefits program grew to include dental, vision, sick days, personal days, maternity leave, extended vacation, short-term disability, long-term disability, term life insurance, 50 percent match on 401(k), etc. We never reduced or eliminated a benefit, so we never had to deal with morale issues around the loss of benefits.

Over time, we upgraded our offices and expanded staff carefully. Since every producer was paid on profit, expense bloating was never an issue. Finally, we never implemented a company car-, boat-, or aircraft-leasing program. I knew that we had done something right when Johnson Controls remarked that USI had the cleanest set of financials of any acquisition that they had ever made. Their sentiments were reflected in the purchase price.

PROFIT PRINCIPLE #10:

Behave Ethically and Profits Will Follow

From the outset, I was committed to building a culture of trust and integrity. I had learned the importance of business ethics from some of the finest corporations in the world, including IBM and Hewlett-Packard. These companies enjoyed tremendous profit and growth while going out of their way to teach, manage, and deliver principled behavior. It seemed very clear to me that you could do the right thing, feel very good about it, and make plenty of money. Profits did not come at the expense of ethical behavior. Quite the contrary—profits resulted from ethical behavior.

I have had the opportunity to work for some terrific managers who set the bar on ethical standards. Likewise, I have been burned by bosses who exercised poor judgment and acted with a lack of integrity. Some of these painful experiences left scars that will never go away. When starting USI, I made a pact with myself that I would build a business where integrity was nurtured and mismanagement would not be tolerated. I felt so strongly about the importance of ethical behavior and mutual accountability that every employment offer included the following language:

This employment offer is based on your commitment to USI's Standard Business Practices and Operating Philosophy including the following:

- Making commitments and keeping them
- Providing total quality and integrity in everything you do
- Being a team player
- Holding yourself accountable to the USI team
- Holding the USI team accountable to you

By documenting our commitment to a culture of integrity, we strengthened all our internal and external relationships.

Beyond offer letters, we made it clear to all employees that we understood that every now and then a mistake would inevitably happen. We wanted to create an environment where employees were not afraid to acknowledge mistakes. We knew that apologizing for a mistake right away would enhance trust, whereas attempting to cover up mistakes would only damage relationships. Our motto was to acknowledge mistakes early and, when appropriate, make reparations.

Using this simple, straightforward approach of acknowledging mistakes saved us millions in legal fees and built powerful and profitable long-term customer relationships.

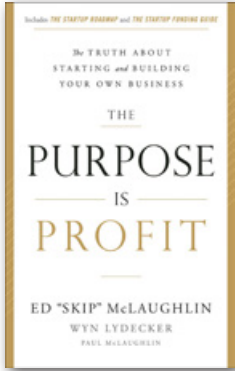
Ethical behavior influenced every aspect of our business. We believed in fulfilling every promise in every contract and paying every employee and vendor in full and on time. We wanted everyone to know how much we valued and appreciated their relationships. We knew ethical behavior engendered loyalty and trust.

Summary

Implementing the 10 profit principles had a dramatic effect on USI's growth and profitability. In 2001, USI was acknowledged as one of the fastest growing companies and included in the Inc. 500. That same year, I was honored as Entrepreneur of the Year by Ernst & Young in the outsourcing category.

All the pieces were in place for continued growth and achievement. 🏆

Info



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ABOUT THE AUTHOR | **Ed McLaughlin** is the founder of four businesses and is currently running Blue Sunsets LLC, a real estate and angel investment firm. He bootstrapped his first business, United Systems Integrators (USI) Corporation, a corporate real estate outsourcing firm, and grew it into an Inc. 500 company. In 2001, Ed earned Entrepreneur of the Year honors from Ernst & Young. In 2005, he sold USI to Johnson Controls, a Fortune 100 company, and at that point, became CEO of JCI's Global Workplace Business for the Americas.

Wyn Lydecker is the founder of Upstart Business Planning, where she works with entrepreneurs to develop plans that answer the questions investors ask most often.

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