Preview of Chapter 10 Excerpted From

THE PURPOSE IS PROFIT

Secrets of a Successful Entrepreneur
From Start-Up to Exit

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Growth Stage: Chapter 10

The Ten Commandments of Startup Profit

In the late 90s the dot-com boom was in full swing. It seemed that everyone was jumping on the Internet bandwagon to ride the electronic highway to untold fortune and fame. Everyday new businesses were being formed and funded with only a name, a concept, and the promise of future revenues. There were literally thousands of new dot-com businesses being introduced to the market on a wing and a prayer.

Some of these businesses went public in an investor feeding frenzy that drove stock prices to exponential multiples of revenue. Many of these businesses had never even made a profit. It seemed that everyone was required to bet on the come. Employee compensation was based on stock options and ultra-low salaries in exchange for the promise to work 24 hours a day, 7 days a week.

Although somewhat envious of the paper wealth created, I just felt certain that it was going to come apart at the seams. How could a concept business with minimal revenue, very few contracts, disproportional budgets, undisciplined spending, and no profits in the offing survive? It seemed like a house of cards just waiting for the wind to pick up.
Mind you, it’s not that I don’t like tech startups. I do. It’s just that there were literally hundreds of new dot-com businesses being formed, without much differentiation, in the narrowest of vertical markets. Each of these new businesses was in hot pursuit of customers, striving to take the high ground and become the industry standard without enough capital to stay afloat. Of course, there were exceptions. Nowadays, investors are more selective about the product, the team, and the real opportunity to capture users and become a dominant player in its market.

USI was not a sexy dot-com being pursued by investment bankers to make a public offering, even though our numbers were robust. We were generating a 20% operating profit, growing at a 40% average annual rate, and funding expansion from free cash flow. The dichotomy was remarkable. Tried-and-true businesses that made consistent profits were passed over for unproven dot-com models with no track record. It made no sense to me.

The operating model during the dot-com boom was the antithesis of USI’s structured approach to making money. The eventual dot-com collapse validated the benefits of operating disciplines and financial controls on the production of genuine profits. It crystalized my belief that the purpose of every business is profit.

From the beginning, USI was organized around 10 core profit principles. I call these profit principles The Ten Commandments of Startup Profit. We factored profit into every business decision that we made. The 10 profit principles listed below get at the nub of how
USI made consistent profits and how they can help you build an enduring business that produces sustainable profits as well.

**The Ten Commandments of Startup Profit**

In many respects these principles are discussed to differing levels and degrees throughout the book: *The Purpose Is Profit*. This concentrated list of profit principles can be used to benchmark your business model 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…**
   - You know how you’re going to generate revenue
   - You know how much it will cost to run your business
   - You know how you’re going to make a profit
   - You have pre-orders to validate your business model
   - You have lined up the funding you need to reach breakeven
   - You understand the impact of 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 Technology**
9. **Build a Financial War Chest for Strategic Advantage**
10. **Behave Ethically, and Profits Will Follow**
Understanding each one of these profit principles and applying them to your business can increase the probability of your long-term success and improve your profitability 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, unserved needs, gaps in product design, fulfillment challenges, pricing sensitivity, and competition. (This is explained in greater detail in Chapter 2.)

Think through these 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 disruptive or innovative?
- Can you monetize your distinctive competence?
- Can you use your distinctive competence to secure pre-orders?
- What additional competencies do you need to succeed?
• How can you fill the competency void?

After wrestling through 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.

**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. (This is discussed in greater detail...
detail in *The Startup Roadmap* in the Appendix.)

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 do you measure value? How do you price your product? What is your price/value ratio?

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

Profit Principle #3: Don’t Start Up Until...

It is only natural that you struggle with the desire to start up knowing 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 have developed a short list of questions entitled, Don’t Start Up Until...

These questions center around your business model but only require ‘the back of an envelope” 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 generate a profit and reach breakeven.
Your ability to secure pre-orders will not only validate your business model, but 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 pre-orders to launch. Answering the following six questions 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)
   - How many customers are there?
   - How much product will each customer buy?
   - How will you price your product (share of value, cost-plus, market pricing)?
   - Calculate revenue by estimating monthly sales (customers x units x price)
   - 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)
   - How much will it cost to produce your product (manufacturing & distribution)?
   - Who will be on your management team, and how much will it cost to compensate them (equity and/or salary)?
   - How many employees will you need to start up, and what will it cost to compensate them (salary & medical)?
   - Where will you work and how much will it cost (rent per month/year, furniture costs, utilities, & supplies)?
• How will you communicate with your customers and how much will it cost (computers, printers, mobile phones, internet access, website, & hosting)?
• How will you brand the business (business cards, brochures, letterhead, & signage)?
• How much will it cost to sell your product (marketing, travel, & entertainment)?
• 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)
   • Revenue minus Cost to Run Your Business equals Profit or (Loss)

4. Don’t start up until you have pre-orders 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)
   • Estimate how long it will take you to reach breakeven
   • Determine your startup and operating capital needs
   • Generate a list of funding sources and alternatives

6. Don’t start up until you have a crystal-clear understanding of the impact of your choice of startup funding on your costs and control.
   • Self-funding or bootstrapping will maximize control and avoid outside partners and interest payments
• Selling equity will avoid interest payments but reduce control by introducing outside partners
• 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 to get 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 pre-order 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, combined 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:

• Develop a realistic budget and operate the business within it
• Understand how the timing of revenues and expenses affects cash flow
• Keep a stranglehold on salaries and operating expenses
• Retain 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 ongoing 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 make-shift financial reports every single night and made judgments about budgets every day. We started out with the 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.

Profit Principle #5: Create a Profit-Based Reward Structure

A profit-based reward structure compensates your management team for achievement of business goals and your business development team for achievement of sales goals. Rewarding performance with a percentage of profits is a sure-fire 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 interest of the individual with the financial interest of the business. Of course, we established profitability guidelines to ensure we achieved the desired financial outcome.

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 was tied to the generation of profit, you had to understand the cost of every revenue dollar to ensure that a portion of revenue flowed to the bottom line. 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. You can save money in the short term by developing internal management, but 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. Talent like this only comes along every so often. But 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, change 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 destiny of USI:

1. Our President & COO re-engineered 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. Our West Region President & Chief Strategy Officer laid the foundation for our geographic profit centers, opened more than 12 new operating locations, and developed our strategic growth plan.
3. Our President of Design & Construction conceived the Space and Projects business, laid the foundation for our Line-of-Business profit centers, and hired a geographically distributed staff of architects and project managers.

4. Our Chief Financial Officer redesigned USI’s internal operating model, directed our financial & accounting system, developed USI’s technology team, and played a crucial role in facilitating our sale to Johnson Controls.

I was very fortunate. I had captured lightning in a bottle four times. These talented leaders played a vital role in USI’s growth trajectory 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.

**Profit Principle #7: Create Profit Centers to Scale Your Business**

Determining how you will scale your business will be your biggest challenge. Building your business around profit centers can be a powerful solution. Here is the way we organized and operated at USI. We scaled the business by creating:

- Geographic (GEO) P&Ls to expand regional coverage
- Line-of-business (LOB) P&Ls to build product lines
- Account-based P&Ls to grow existing customer relationships
- Business development P&Ls to create new customer relationships
It all starts with a clear understanding of your customers’ needs and how they procure and utilize your products.

- How do your customers buy (centrally, regionally, or globally)?
- What products do your customers need (existing products and new products)?
- Where do your customers use your products (existing or new markets)?
- When do your customers need your products (frequency)?
- How much product do your customers need (volume)?

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

1. You need to think through your customers’ product and service needs
2. You need to assess your product and service fulfillment plans
3. You need to formulate your new business development and sales plans
4. You need to determine your GEO and LOB coverage plans
5. You need to hire qualified talent to manage a GEO or LOB profit center

Based on our customers’ needs, 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 business development P&Ls within each regional P&L.

Although complex, this profit-oriented growth model helped us achieve our financial objectives, while keeping a lid on expenses, as we scaled the business.

Profit Principle #8: Augment Profits with Proprietary Technology

Your proprietary technology (applications) should be so powerful that they form a mutually dependent relationship between you and your customer. Besides streamlining work processes and improving service delivery, these applications should enable your customers to manage workflows and access critical information not otherwise available. These software tools should generate new revenues and form the basis of a stand-alone profit center.

Here are some of the questions you should consider when devising your strategy for developing software (SaaS) applications:

- What information do your customers need to make better decisions?
- What tools do your customers need to better manage their work?
- How can you eliminate process steps and reduce operating costs?
• What type of software applications can you develop to solve these problems?
• How can you utilize these applications to tighten the link with your customers?
• How can your applications create a sustainable competitive advantage?
• How can these applications create new revenue lines?
• How can these new revenue lines be used to form a stand-alone profit center?

As USI customers began to globalize their business models, they needed a reliable information management and control system to keep track of critical dates, projects, workflows, and costs. Initially, we devised a plan to develop a low-cost proprietary software solution. Given that the dot-com boom was in full swing, we decided to take a step back to look at all the market alternatives – there were over 300 new real estate applications coming online. In order to separate the wheat from the chaff, we engaged a major consulting firm to cull the list to study “buy, build, or partner” scenarios. The consultant’s final recommendation was a very costly custom-built solution.

Recognizing the limits of our customers’ budgets, we were skeptical and came full circle back to developing a low-cost, proprietary software application. Our goal was to meet most of the people’s needs most of the time at a budget everyone could afford. We called our application Sequentra, named after our customers’ primary need to “sequentially track” project work and expenses.
around the globe. Based on Sequentra’s strategic contribution and revenue potential, we organized the service (SaaS) as a stand-alone profit center. Sequentra integrated all of our service lines into a single reporting dashboard for all of our customers.

Sequentra grew to become one of the dominant corporate real estate software solutions in the industry. It became one of USI’s strategic weapons tightening the link with our customer base and creating a barrier to entry for our competitors.

Profit Principle #9: Build a Financial War Chest for Strategic Advantage

Once your business starts to generate consistent profits, you can easily take your eye off the ball. Rather than retain earnings to build a financial war chest, you can choose to spend beyond your means. There are unlimited temptations to spend: increasing salaries, changing travel & expense limits, enhancing benefits, hiring unnecessary staff, upgrading offices, or getting really aggressive and implementing a company car program or buying a boat for yourself by putting the expense on the company as entertainment. This kind of uncontrolled spending can be the death knell for many promising young businesses.

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 financial war chest, it gave us confidence that we could make expansion decisions without the need for a bank or outside funding. It was interesting
the less we needed the banks, the more they wanted to lend us 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% of annual sales. As a result, the leverage shifted in favor of USI in all of our financial negotiations.

We built a financial war chest so powerful that we were able to offer a $1,000,000 advance on projected savings to win multi-year outsourcing contracts with major corporations, as discussed in detail in Chapter 9. This offer became a strategic weapon so powerful that it increased our close rate to almost 50%.

Like most sacrifices, employing financial disciplines early and sticking with them can shift the balance of power and pay substantial dividends to you and your business in the future. Imagine what you can achieve if you have such significant cash reserves that you are not reliant on 3rd party sources to grow your business.

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.
Regarding travel, we capped airfares at $600 and used flight miles if the trip cost more than $600. For the most part, we shared hotel rooms and never stayed at a place that cost more than $150 per night with a $35 per diem for food.

    In regards to benefits, we provided medical benefits from the beginning, but I had made the decision early not to increase other forms of benefits until we knew we would never have to take them away. Our benefits program grew to include dental, vision, sick days, personal days, extended vacation, short-term disability, long-term disability, term life insurance, 50% match on 401K, etc. And we never reduced or eliminated a benefit, so we never dealt with employee morale issues.

    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 conducted their due diligence. They 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 build 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 ethical 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 that set the bar on ethical standards. Likewise, I have been burned by bosses that exercised poor judgment, blatant mismanagement, and a lack of integrity. Some of these painful experiences left scar tissue that I will never forget. 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:

- 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; and
- 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 necessary, make reparation. 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 the relationship. We knew ethical behavior engendered loyalty and trust.

**Summary: The Ten Commandments of Startup Profit**

Having the discipline to apply these profit principles will increase your probability of building a business of enduring value and long-term profitability.

1. **Build a Business Based on Your Distinctive Competence**
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   - You know how you’re going to generate revenue
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