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Drucker on Management: The Five Deadly Business Sins

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Abstract:

-- The first and easily the most common sin is the worship of high profit margins and of "premium pricing." The prime example of what this leads to is the near-collapse of Xerox in the 1970s. Having invented the copier -- and few products in industrial history have had greater success faster -- Xerox soon began to add feature after feature to the machine, each priced to yield the maximum profit margin and each driving up the machine's price. Xerox profits soared and so did the stock price. But the vast majority of consumers who need only a simple machine became increasingly ready to buy from a competitor. And when Japan's Canon brought out such a machine it immediately took over the U.S. market -- Xerox barely survived.

GM's troubles -- and those of the entire U.S. automobile industry -- are, in large measure, also the result of the fixation on profit margin. By 1970, the Volkswagen Beetle had taken almost 10% of the American market, showing there was U.S. demand for a small and fuel-efficient car. A few years later, after the first "oil crisis," that market had become very large and was growing fast. Yet the U.S. auto makers were quite content for many years to leave it to the Japanese, as small-car profit margins appeared to be so much lower than those for big cars.

The lesson: The worship of premium pricing always creates a market for the competitor. And high profit margins do not equal maximum profits. Total profit is profit margin multiplied by turnover. Maximum profit is thus obtained by the profit margin that yields the largest total profit flow, and that is usually the profit margin that produces optimum market standing.

Full Text:

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The past few years have seen the downfall of one once-dominant business after another: General Motors, Sears and IBM, to name just a few. But in every case the main cause has been at least one of the five deadly business sins-avoidable mistakes that will harm the mightiest business.

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This soon turned out to be a delusion -- it usually is. GM, Chrysler and Ford increasingly had to subsidize their big-car buyers with discounts, rebates, cash bonuses. In the end, the Big Three probably gave away more in subsidies than it would have cost them to develop a competitive (and profitable) small car.

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-- Closely related to this first sin is the second one: mispricing a new product by charging "what the market will bear." This, too, creates risk-free opportunity for the competition. It is the wrong policy even if the product has patent protection. Given enough incentive, a potential competitor will find a way around the strongest patent.

The Japanese have the world's fax-machine market today because the Americans who invented the machine, developed it and first produced it charged what the market would bear -- the highest price they could get. The Japanese, however, priced the machine in the U.S. two or three years down the learning curve -- a good 40% lower. They had the market virtually overnight; only one small U.S. fax-machine manufacturer, which makes a specialty product in tiny quantities, survives.

By contrast, DuPont has remained the world's largest producer of synthetic fibers because, in the mid-1940s, it offered its new and patented nylon on the world market for the price at which it would have to be sold five years hence to maintain itself against competition. This was some two-fifths lower than the price DuPont could then have gotten from the manufacturers of women's hosiery and underwear.

DuPont's move delayed competition by five or six years. But it also immediately created a market for nylon that nobody at the company had even thought about (for example, in automobile tires), and this market soon became both bigger and more profitable than the women's wear market could ever have been. This strategy thus produced a much larger total profit for DuPont than charging what the traffic would bear could have done. And DuPont kept the markets when the competitors did appear, after five or six years.

-- The third deadly sin is cost-driven pricing. The only thing that works is price-driven costing. Most American and practically all European companies arrive at their prices by adding up costs and then putting a profit margin on top. And then, as soon as they have introduced the product, they have to start cutting the price, have to redesign the product at enormous expense, have to take losses -- and, often, have to drop a perfectly good product because it is priced incorrectly. Their argument? "We have to recover our costs and make a profit."

This is true but irrelevant: Customers do not see it as their job to ensure manufacturers a profit. The only sound way to price is to start out with what the market is willing to pay -- and thus, it must be assumed, what the competition will charge and design to that price specification.

Cost-driven pricing is the reason there is no American consumer-electronics industry anymore. It had the technology and the products. But it operated on cost-led pricing -- and the Japanese practiced priceled costing. Cost-led pricing also nearly destroyed the U.S. machine-tool industry and gave the Japanese, who again used price-led costing, their leadership in the world market. The U.S. industry's recent (and still quite modest) comeback is the result of the U.S. industry's finally having switched to price-led costing.

If Toyota and Nissan succeed in pushing the German luxury auto makers out of the U.S. market, it will be the result of their using price-led costing. To be sure, to start out with price and then whittle down costs is more work initially. But in the end it is much less work than to start out wrong and then spend loss-making years bringing costs into line -- let alone far cheaper than losing a market.

-- The fourth of the deadly business sins is slaughtering tomorrow's opportunity on the altar of yesterday. It is what derailed IBM. IBM's downfall was paradoxically caused by unique success: IBM's catching up, almost overnight, when Apple brought out the first PC in the mid-1970s. This feat actually contradicts everything everybody now says about the company's "stodginess" and its "bureaucracy." But then when IBM had gained leadership in the new PC market, it subordinated this new and growing business to the old cash cow, the mainframe computer.

Top management practically forbade the PC people to sell to potential mainframe customers. This did not help the mainframe business -- it never does. But it stunted the PC business. All it did was create sales for the IBM "clones" and thereby guarantee that IBM would not reap the fruits of its achievement.

This is actually the second time that IBM has committed this sin. Forty years ago, when IBM first had a computer, top management decreed that it must not be offered where it might interfere with the possible sale of punch cards, then the company's cash cow. Then, the company was saved by the Justice Department's bringing an antitrust suit against IBM's domination of the punch-card market, which forced management to abandon the cards -- and saved the fledgling computer. The second time providence did not come to IBM's rescue, however.

-- The last of the deadly sins is feeding problems and starving opportunities. For many years I have been asking new clients to tell me who their best-performing people are. And then I ask: "What are they assigned to?" Almost without exception, the performers are assigned to problems -- to the old business that is sinking faster than had been forecast; to the old product that is being outflanked by a competitor's new offering; to the old technology -- e.g., analog switches, when the market has already switched to digital. Then I ask: "And who takes care of the opportunities?" Almost invariably, the opportunities are left to fend for themselves.

All one can get by "problem-solving" is damage-containment. Only opportunities produce results and growth. And opportunities are actually every bit as difficult and demanding as problems are. First draw up a list of the opportunities facing the business and make sure that each is adequately staffed (and adequately supported). Only then should you draw up a list of the problems and worry about staffing them.

I suspect that Sears has been doing the opposite -- starving the opportunities and feeding the problems -- in its retail business these past few years. This is also, I suspect, what is being done by the major European companies that have steadily been losing ground on the world market (e.g., Siemens in Germany). The right thing to do has been demonstrated by GE, with its policy to get rid of all businesses -- even profitable ones -- that do not offer long-range growth and the opportunity for the company to be number one or number two world-wide. And then GE places its best-performing people in the opportunity businesses, and pushes and pushes.

Everything I have been saying in this article has been known for generations. Everything has been amply proved by decades of experience. There is thus no excuse for managements to indulge in the five deadly sins. They are temptations that must be resisted.

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