Hermann Simon

True Profit!

No Company Ever Went Broke Turning a Profit

Springer

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Preface

Profit is the cost of survival. If a company does not earn profits, it will go under sooner or later. This happens to thousands of companies every year.

A company must file for insolvency when it cannot pay its current liabilities. Illiquidity is the proximate cause, but it is not the reason for insolvency. The real reason is continued losses, which means that the resources a company puts in exceed the value it produces. That is unsustainable for private companies in the long run.

Starting a business is not too difficult. The bigger challenge is to run it profitably over time. Nine out of ten start-ups go bankrupt within the first 3 years. Why does this happen? The visible reason is a lack of liquidity. Ultimately, however, they go under because they have no profit prospects. Founders should therefore remember that turning a profit is a necessity, not a nice-to-have.

Profit is the opposite of waste. It is and will remain the sole criterion for the sustainable success and viability of a company. It is a company's bedrock pillar of support.

With those views in mind, one would expect to find a lot written about profit. But as a glance at amazon.com indicates, there is no book explicitly on the subject of profit. This book is the first one devoted exclusively to the topic. It illuminates the many dazzling facets of profit: its terminology, pursuit, ethics, causes, and drivers.

The contents of this book derive equally from my experiences as an academic researcher and as a practitioner. Perhaps one can fully explore the

complexities of profit only if one knows profit firsthand from its theoretical and its real-world sides. The book's numerous case studies and quotes from around the world reveal that profit has a deeply emotional side, and not only an economic one. Sometimes, an entrepreneur's fate ends tragically because he or she has relegated or neglected the profit motive.

I take a clear stand and leave no doubt about my conviction that entrepreneurs should be resolutely profit-oriented. Making a profit is not only the best long-term goal for a company but also a business leader's ethical responsibility.

With this book, I would like to put profit at the heart of what entrepreneurs, managers, and ambitious founders strive to accomplish. No company ever went broke from turning a profit.

In the summer of 2021
Bonn, Germany

Prof. Dr. Dr. h.c. mult. Hermann SimonFounder and Honorary Chairman, Simon-Kucher & Partners

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Profit: What is It?

"I'm for profit maximization!"

If you want to infuriate large portions of society and turn people against you, uttering that sentence is a very effective way to do it.

Few phrases are more explosively controversial than "profit maximization." Some people even go berserk when they hear the word "profit." During a large demonstration against the German industrial giant Bayer AG at its annual shareholders meeting on April 26, 2019, I became involved in a discussion with the protesters. When I mentioned that a company needs to earn profits in order to survive, I was aggressively taunted and berated.

This kind of aggressive reaction seems to be universal. The maximization of profit—or perhaps worse, the maximization of "shareholder value"—is considered by many observers to be the root of all economic evils. Of course, most rank-and-file employees oppose profit maximization. But beyond that, it doesn't matter whether the listeners are teachers, doctors, lawyers, or civil servants, not to mention the critics among political scientists, sociologists, or philosophers. There isn't even general consensus in favor of the "profit" concept among businesspeople.

But in its essence, profit maximization is simply the antithesis of waste. One could also equate profit maximization with "waste minimization." Critics claim that the maximization of profit and shareholder value is responsible for the exploitation of resources and workers, for disparities in income and assets, for the offshoring of jobs to low-wage countries, for the relocation of corporate headquarters to tax havens, and many other abuses.

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These criticisms stand in stark contrast to the theoretical groundwork of microeconomics. If a company doesn't strive to achieve the highest possible profit, it faces the risk that its competition will wipe it out. To co-opt the mantra from the scientific community, the ultimate law of business is "profit or perish."

Profit is the reward for undertaking business risks. Profit is what is left over after a company meets all of its contractual obligations to its employees, suppliers, banks, other creditors, and the various national, state, and local governments that levy taxes. Profit is thus a residual that belongs exclusively to the company's owners. As soon as the company has met all of its obligations to outside parties, no one else can make any additional claims.

This simple and incontrovertible definition of profit is by no means generally accepted. During his tenure as French president, Nicolas Sarkozy "declared that it is unfair that shareholders and owners get to keep all of a firm's profit, and that it would be more fair for company profits to be divided into three equal parts: one for the shareholders, one for employees, and one for re-investment into the company."[1] In Sarkozy's view, it is unacceptable that the owners of a company claim all of the profits for themselves. But isn't that tantamount to saying that it is unacceptable for employees to keep their net wages for themselves and allow no other parties to lay claim to their money? Nonetheless, populist statements such as Sarkozy's enjoy broad public appeal.

So What is Profit Anyway?

The simplest and easiest-to-understand definition is the one above: profit is the residual amount left over after a company has met all its financial obligations. But the reality is unfortunately more complicated.

There is a variety of definitions for profit, and it is not an exaggeration to say that some of these definitions are confusing or even misleading. When we talk about profit, we should know *exactly* what we are talking about. Otherwise it is easy to be deceived. For that reason, I cannot let the reader off the hook by glossing over the prevailing definitions of profit that are in common use. At first glance, the upcoming parts of this chapter may come across as a bunch of boring accounting and financial jargon. But the clarifications and distinctions we make in this chapter should be indispensable to you when we

[1] https://www.wsj.com/articles/SB10001424052748703922804576301090149677206.

get to the hopefully more exciting chapters on what profit truly represents, not what it is mathematically.

Profit is defined as follows:

$$\text{profit} = \text{revenue} - \text{costs} \tag{1.1}$$

Revenue comprises sales or operating revenue, defined as the product of price and unit volume:

$$\text{revenue} = \text{price} \times \text{unit volume} \tag{1.2}$$

Revenue also includes financial components such as interest income, income from securities, and extraordinary income from asset sales, tax refunds, or other similar financial holdings.

Profit depends on three drivers, namely, price, sales volume, and costs. Costs break down into fixed costs and variable costs. If a country imposes a sales or value-added tax (VAT), revenue is usually expressed without those taxes included. But some practices deviate from this standard.

In addition to the operating revenue and operating costs, financial aspects such as the ones mentioned above (interest income, proceeds from asset sales, etc.) can flow into the profit calculation.

Revenue occupies the first line in standard financial reporting, which is why it is commonly referred to as the "top line." Profit after taxes—the true profit in line with our definition above—typically is the last line of the report, or the "bottom line."

Is Profit Actually a Cost?

An insightful perspective is to interpret profit as a cost. "Profit is the cost of survival," Peter Drucker once said.[2] According to his view, profit comprises three types of costs:

- costs of capital
- costs of business/entrepreneurial risk
- costs of securing future jobs and pensions.

[2] See Peter Drucker [1].

In this sense, profit should not be understood as a residual that hopefully has a plus-sign at the end of the business year. Instead, profit should be factored in upfront, like cost, in order to secure the company's survival.

The wide range of nouns and adjectives to identify profit adds confusion rather than transparency. First, we see results, earnings, gains, surplus, profit, income, yield, and margin. Then we compound the problem with the inclusion of modifiers such as operating, from continuing operations, preliminary, nominal, real, inflation-adjusted, extraordinary, plus distinctions across different organizational levels (corporate, group, business unit) and time periods (quarterly, annual). There is also "book" profit, based on the operating revenue and costs that are covered explicitly in the company's books. Finally, we have profit concepts such as normal profit and economic profit, with the latter taking the opportunity cost of capital into account.

Do you see now why we need clarity and focus when it comes to profit?

In press reports and meetings, it is often not precisely clear what kind of profit is being discussed. In the finance community, certain profit measures have established themselves, but they have nothing in common with the definition of true profit, namely, the residual amount of money after a company meets its obligations. One is inclined to think that this jargon arises from intentional obfuscation tactics so that the general public—and in some cases even insiders—struggles to understand the different concepts and terms and to distinguish among them. This jargon is at least partially responsible for the widespread confusion and misperceptions about the profit situation of individual companies or industries.

The goal of this book is not to engage in a comprehensive examination of profit calculations in all their complexity. That is what specialized accounting literature is for. My goal with these sections is to provide the reader with brief explanations of the most common profit terms and concepts. But I leave you with one recommendation: in any discussion when the word "profit" comes up, you should ask, for the purpose of clarity, what that term includes and excludes.

Clearing Up the Alphabet Soup of Profit

In addition to the terms mentioned above, reports often come filled with an alphabet soup of acronyms, such as EAT (earnings after taxes), EBT (earnings before taxes), EBIT (earnings before interest and taxes), and EBITDA (earnings before interest, taxes, depreciation, and amortization). Let's look into these in some detail.

- Earnings after Taxes (EAT): This is often referred to as net profit or net income. It is ultimately the most relevant profit term, because it is the amount the shareholders retain. When we refer to net profit or net income throughout the book, we mean EAT.
- Earnings before Taxes (EBT): As the name implies, the income taxes have not yet been subtracted from this profit number. Thus, it does not represent the true profit in the sense of what the firm's owners can retain for themselves.
- Earnings before Interest and Taxes (EBIT): This key profit figure is often referred to as operating profit, but it is not used consistently. If the company's debt, and thus its interest payments, is high, then the EBIT amount will look much more impressive than EAT, or net profit. That is one reason EBIT is a very popular metric in corporate financial reports.
- Earnings before Interest, Taxes, Depreciation, and Amortization (EBITDA): In contrast to EBIT, this amount is higher because it includes the depreciation and amortization of plant and machinery and intangible assets. This term is likewise often referred to as operating profit. Sometimes the number will be adjusted to reflect extraordinary expenditures and income. In that case, one uses the term "adjusted EBITDA". EBITDA has next to nothing to do with EAT, as we defined it above. Nonetheless, the valuation of an individual firm is often expressed as a multiple of EBIT or EBITDA. For EBITDA, depreciation and amortization not only encompass physical assets, but also write-downs of the company's value after an acquisition, a term known as goodwill. These sums are often quite large.

Figure 1.1. shows the relationship between the different levels of "profit."

These explanations underscore once again how important it is to pay close attention to what profit term or concept someone is using. Otherwise, one can be easily fooled or misled.

The amount of imagination expended to enhance or inflate profit numbers seems limitless. One business journalist sent me this comment: "I regularly attend annual shareholder meetings. The managers toss around all kinds of key numbers and indicators, apparently in an effort to mask their mistakes. One such number is EBITDAR (R stands for restructuring.) Sometimes it sounds as if these numbers were made up just for an earnings conference. In the New Economy, CFOs have played up the 'burn rate'[3] of their companies

[3]The term "burn rate" or "cash burn rate" is most often used in connection with start-ups. The cash burn rate indicates the rate at which the financial resources of a company decline.

EAT (Earnings after Taxes)
+ Taxes
- Tax refunds
= **EBT (Earnings before Taxes)**
+ Interest expenses
- Interest income
= **EBIT (Earnings before Interest and Taxes)**
+ Depreciation and amortization of assets
- Asset impairments
- Asset write-ups
= **EBITDA (Earnings before Interest, Taxes, Depreciation, and Amortization)**
+ Non-operating income
- Non-operating expenses
= **Adjusted EBITDA**

Fig. 1.1 Interconnections between the different levels of profit

as a success factor. This confused me, and started to make me think that profit is more of a 'nice to have' instead of a 'must have.'".[4]

The aftermath of the New Economy bubble of the early 2000's did not diminish the creativity at all. I recently heard about a new variant called EBITDAL. The L stands for leases, meaning that the firm has apparently added the cost of its leases to its "profit" number. It seems there is no limit to the number of letters one can add to these definitions.

Then again, why should one worry, when "losses are 'sexy' again," according to one magazine. More than 80% of all companies that have recently launched an initial public offering (IPO) in the US have never turned a profit.[5] The ride-sharing company Uber launched its IPO on May 10, 2019. But in 2018, Uber posted a loss of $3.8 billion, according to figures at the time. At the same time, Uber declared a "core platform contribution profit" of $940 million.

In the same year, WeWork, a provider of shared office space, recorded a loss of $1.9 billion on revenue of $1.8 billion. So the firm came up with a new metric called "community adjusted EBITDA," which excluded items such as marketing expenditures. Then there is Groupon, the global e-commerce platform for discounted goods and services. It announced an "adjusted consolidated segment operating income" of $61 million, although

[4] Personal mail from Finn Mayer-Kuckuk on December 12, 2011.

[5] See https://www.wiwo.de/finanzen/boerse/stelter-strategische-verluste-sind-wieder-sexy/24253188.html.

the company's loss totaled $420 million. The creative new metric did not include the acquisition costs for new customers. Groupon considered those costs to be an investment in its future.[6]

Under the ironic title "Profit before Costs," a journalist elaborated on this modern tendency to put an upbeat face on what is, in reality, a miserable profit situation. "In some years, the true profit is miniscule or fully unsatisfactory. That's when the companies get very imaginative. They will add taxes and interest to their net profit, or the depreciation. And when that is still not a number worthy of presenting, they will add in 'special items' or one-time expenses. A company revises the profit number upwards for so long, using whatever items it wants, until it reaches a number that looks good relative to the competition. But that number no longer says anything about the company's true profitability."[7]

The journalist added: "Many companies consider EBITDA to be relevant. But to me, this number says absolutely nothing. If a company can't even earn its depreciation, it is destroying capital and very likely heading toward its demise."[8]

Expressing Profit as Returns

One preferred way to express profits is in the form of returns, which enable better comparisons across companies, business sectors, and industries. A return is a ratio with the profit level—no matter how it is defined—as the numerator and the reference or comparison basis as the denominator. Any of the profit metrics mentioned above could be used to determine returns. The ratios are usually expressed as percentages.

The most commonly used returns are the following:

$$\text{return on sales (ROS)} = \text{profit/revenue} \tag{1.3}$$

This ratio indicates what percentage of revenue is left over as profit. If one uses net income or EAT in (1.3), the resulting percentage is the net return on sales. In the same spirit, we will refer to this number as "net profit margin."

One can also measure profit (income) relative to capital invested. This ratio uses the total amount of capital invested (=assets) and the profit (regardless

[6]Regarding these examples, see Rolf Winkler [2].

[7]Georg Giersberg [3].

[8]Personal e-mail from January 6, 2013.

of which definition) in order to calculate the return on total capital invested:

$$\text{return on assets} = \text{profit/assets} \tag{1.4}$$

Commonly used in practice is the variant of Eq. (1.4) that includes interest. The rationale is that the yield on total capital is comprised of profit and interest. Using this method, we get the equation:

$$\text{return on assets} = \left(\text{profit} + \text{interest}\right)/\text{assets} \tag{1.5}$$

Because interest is deductible as an expense, the following variant is also used:

$$\text{return on assets} = \left(\text{profit} + \text{interest}\left(1 - s\right)\right)/\text{assets} \tag{1.6}$$

The s represents the corporate tax rate.

Other variants for these kinds of equations include return on investment (ROI), return on capital employed (ROCE), and return on net assets (RONA). For ROCE and RONA, the calculation uses total capital, or total assets adjusted for accounts payable and accounts receivable.

The return on equity (ROE) expresses profit as a percentage of equity:

$$\text{return on equity} = \text{profit/equity} \tag{1.7}$$

Equity is defined as total assets less liabilities (usually debt). As with the other equations, this one can have different variants of profit in the numerator.

The following relationship exists between the various types of returns:

$$\text{return on sales} = \text{return on assets/capital turnover} \tag{1.8}$$

Capital turnover is defined as revenue divided by total assets, and indicates how often the capital is turned over in one year. The capital turnover varies considerably across industries. Figure 1.2 shows how strong these differences in capital turnover are for large companies in different industries and countries.

If capital turnover is less than 1, it means that the return on sales is greater than the return on assets. If we solve Eq. (1.8) for return on assets, we get:

$$\text{return on assets} = \text{return on sales} \times \text{capital turnover} \tag{1.9}$$

Company	Country	Revenue in $bn	Assets in $bn	Capital Turnover
Walmart	USA	524	236	2.22
Volkswagen	Germany	283	548	0.52
Amazon	USA	281	225	1.25
Exxon Mobil	USA	265	363	0.73
Apple	USA	260	339	0.77
Samsung Electronics	South Korea	198	305	0.65
AT&T	USA	181	552	0.33
Hon Hai	Taiwan	173	111	1.56
Alphabet	USA	162	276	0.59
JPMorgan Chase	USA	142	2687	0.05
Bank of China	China	135	3269	0.04
Allianz	Germany	130	1135	0.11
Lukoil	Russia	115	96	1.20
Hitachi	Japan	81	92	0.88
Vodafone Group	UK	50	185	0.27
Sanofi	France	42	127	0.33

Fig. 1.2 Revenue, assets, and capital turnover for companies in various industries and countries (2019 fiscal year, Source: Fortune, August 2020)

This equation shows that the return on assets rises proportionally with return on sales and capital turnover.

For the interrelationship between return on equity and return on assets, the debt-to-assets ratio plays an essential role. This ratio is defined as debt divided by total assets.

$$\text{return on equity} = \text{return on assets}/(1 - \text{debt/total assets}) \qquad (1.10)$$

We'll use a numerical example to illustrate this. Total assets are $100 and $50 of that is borrowed, leaving a debt-to-assets ratio of 0.5. Profit before interest is $10 (we will ignore taxes for now) and the interest rate on the debt is 5%. That means that the $50 of debt cost $2.50 in interest.

The profit after interest is therefore $7.50. Using Eq. (1.4), we get a return on assets of 7.5%. According to Eq. (1.7), the return on equity is 15%. If we use Eq. (1.5) for the return on assets, with the interest included in the numerator, we get a return on assets of ($7.50 + $2.50)/$100 = 0.10 or 10%. If we use Eq. (1.6) and assume a corporate tax rate of 30%, we get a return on assets of ($7.50 + $2.50 × 0.7)/100 = 0.0925, or 9.25%.

Now, what happens when we increase the amount of debt from $50 to $60, which reduces equity to $40? Revenue and profit before interest remain

unchanged. In this case, the amount of interest due is $3, so that profit after interest is $7 and the return on assets declines to 7%. Equation (1.10) leads to a return on equity of 7/0.4 = 17.5%. This demonstrates the so-called leverage effect. If the interest rate is lower than the return on assets, a higher level of debt will increase the return on equity. A higher level of debt, however, also increases the firm's risk. And when the interest rate is higher than the internal rate of return, the leverage effect becomes negative, i.e. higher debt decreases return on equity.

Indicators such as return on sales, return on total assets, and return on equity have advantages compared to the reporting of absolute profits. They allow comparisons across business units, companies, industries, and even across countries, although each measures different aspects of profit achievement. We will get back to these in later chapters.

To illustrate all of these financial indicators together, we use the example of a midsized manufacturer of consumer goods. Figure 1.3 shows the key figures for their previous fiscal year. This company has total assets of $134 million and revenue of $91 million. Capital turnover is therefore 0.67 times per year. The company's net return on sales is 10.3%. The net return on assets is 7.0%. The ratio of debt to assets is 58.2%, which means the return on equity is 16.8% according to Eq. (1.10). Overall, this company has a solid profit and financial picture.

Key figures	$m	in percent
Assets	134	100
Equity	56	41.8
Debt	78	58.2
Capital turnover		67.9
Revenue	91	100
Depreciation	5.9	6.5
Interest	1,5	1.6
Tax	3.8	4.2
Earnings before interest, taxes, depreciation, amortization (EBITDA)	20.6	22.6
Earnings before interest and tax (EBIT)	14.7	16.2
Earnings before tax (EBT)	13.2	14.5
Earnings after tax (EAT)	9.4	10.3
Return on assets based on EBIT		11.0
Return on assets based on EAT		7.0
Return on equity		16.8

Fig. 1.3 Profit indicators for a midsized consumer goods company

Nominal versus Real Profit

Thus far we have only considered the nominal, accounting-based profit. That means that the profit figures—no matter which ones we choose—are expressed in current currency units. If one adjusts the nominal profit for inflation, one gets the so-called real profit. In periods of relatively low inflation, like what we have experienced since 1994, the difference between nominal and real profit is small. During that 25-year period to 2019, the annual inflation rate in the United States exceeded 3% only five times, and was under 2% in 12 years. That is much different from the 1970s. The annual inflation rate was above 6% in eight years between 1971 and 1982. Europe has experienced similar inflation rates during the same periods.

Let's assume that a company has revenue of $100 million and an after-tax profit of $10 million. The company's machinery, which cost $50 million to purchase, is depreciated over five years and then replaced all at once. The annual depreciation was thus $10 million. The business remains steady over the five-year period, i.e. the nominal revenue and profit remained unchanged from year to year at $100 million and $10 million respectively. What is the effect of an annual inflation rate of 5%, which means that the machinery becomes 5% more expensive every year? Replacing the machinery after five years would not cost $50 million, but rather $63.8 million. This difference of $13.8 million is a "phantom profit."

One can also express this in another way. The profit declines every year by 5% in real terms. In the fifth year, the company earns a real profit of only $7.8 million on a nominal profit of $10 million. The company would have had to increase its tax-reducing level of depreciation by a total of $13.8 million to offset the effects of inflation and maintain the same level of purchasing power in real terms. But the tax basis for depreciation is solely the original purchase costs, and the total amount of depreciation cannot exceed them.

Taxes are levied against nominal profit. The phantom profits are therefore subject to taxation, even though they do not contribute to an increase in real value. Regarding additional effects of inflation, such as the question of passing on higher input costs in the form of higher prices, we refer the reader to specialized literature.[9] In times of high inflation, companies should strive to protect their real profit and not get blinded by the allure of phantom profits.

[9]See Hermann Simon and Martin Fassnacht [4].