UNDERSTANDING THE PLUMBING OF YOUR BUSINESS

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Where we are

Oh, the challenges of changing a business...

- Products
- Services
- Pricing
- Marketing campaigns
- Source Selection
- Customer Service
- Locations
- Business Processes
- Customer Touch Points
- Financing Decisions

A Miracle Occurs Here

- Customer Satisfaction
- Revenue
- Operating Expenses
- Gross Margin
- Inventory Turns
- Return on Equity
- Cost of Capital
- Return on Capital
Underneath, reality is worse

Our customers and investors control our destiny, we just (try to) influence them.
Where we’d like to be

At the very least, we’d like to know what we can change to affect outcomes
A deeper look...
Our purpose is to provide the secret sauce
What bugs executives?

Troubleshooting seems to be the primary role for business architects
Is my business healthy?
As always, the correct answer is “It depends…”

Who is asking?
• Determines the points of view from which to frame the answer

What is “my business”?
• Defines the boundaries of the problem and sets the scope for analysis

What does “healthy” mean?
• This is basic – if you can’t define health in an objective, measureable way, you can never know if the business is healthy
If not, what can we do about it?

Where are the problems?
• Look for root causes

What changes are required?
• What is the minimum necessary change required to fix the problem?
• You have to know what levers can be pulled to change the outcomes that need changing
• Otherwise, how do you know what to do?
If so, what is likely to change that?
“The only constant is change.”

What are our competitors doing?

What are our customers doing?

What new technologies or practices are coming that could prove disruptive?

What is our competitive landscape?
Competitive Landscape

Related questions

- If we continue down our current path, will our business remain healthy if we double our business volume?
- What if it cuts in half?
- How will our cost structure likely change? How will it need to change?
- What processes or capabilities need to be significantly rescaled?
What will happen if...
Always good to know, always hard to figure out

- We offer a new product or service?
- We raise or lower prices, or offer bigger discounts?
- We open a new location?
Where do we want to go?
A one-picture summary of business transformation
Business architecture 101
What do we need to know?

Various models and their components
We use several models
We’ll connect them later

- Inputs
- Outcomes
- Customer experience journey map
- Business model canvas
- Operating model
- DuPont chart
The inputs
What we can change directly

- Customer experience journey
- Products and services
- Pricing
- Marketing campaigns and promotions
- Locations
- Source selection
- Financing decisions
- Strategic focus
- Execution
The outcomes
What we wish we could change directly

- Customer satisfaction
- Revenue
- Gross margin
- Inventory turns
- Operating expenses
- Cost of capital
- Return on equity (ROE)
- Return on capital (ROC)
Customer Journey Map

Journey maps document your current and desired customer experiences.

Source: Strativity via Forrester Research

Journey maps show all channels used by customers. They should also indicate customer segments using personas or something similar.
Business Model Canvas

Source: Business Model Alchemist via Wikipedia
## Strategic Focus

**Competitive Necessities**

<table>
<thead>
<tr>
<th>Business Focus</th>
<th>Low Cost</th>
<th>Quality</th>
<th>Speed</th>
<th>Service</th>
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</thead>
<tbody>
<tr>
<td>Product/Service</td>
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<td>Customer</td>
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<td>Technology</td>
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<td>Production Capacity</td>
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Focus on one of these, anchored by one of these

The Operating Model

Business Capabilities

Business Processes

Business Services

Customers

Suppliers
Elements of the operating model

Business capabilities
- Represents something the business does to create value, regardless of organization or implementation

Business processes
- Implement business capabilities in channel- or location-specific ways

Business services
- Package business capabilities and presents them to internal and external participants
Types of operating models

Why is an operating model important?

The operating model combines and connects three of the five primary models in business architecture.

The operating model determines the cost structure and provides answers to several of the inputs in the business model canvas.

The Ross/Weill/Robertson model (aka CISR) describes several flavors of operating models based on the dimensions of process integration and standardization.

They also describe how the type of operating model affects the high level technology architecture.
The DuPont chart

Developed by DuPont in the 50s and is based on these financial ratio identities:

<table>
<thead>
<tr>
<th>Profit Margin</th>
<th>Asset Turnover</th>
<th>Return on Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income ------------</td>
<td>Sales X Total Assets</td>
<td>Net Income ------------</td>
</tr>
<tr>
<td>Sales X Total Assets</td>
<td>=</td>
<td>Total Assets</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Return on Assets</th>
<th>Financial Leverage</th>
<th>Return on Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income ------------</td>
<td>Total Assets X Common Equity</td>
<td>Net Income ------------</td>
</tr>
<tr>
<td>Total Assets</td>
<td>=</td>
<td>Common Equity</td>
</tr>
</tbody>
</table>
The DuPont Chart

The chart is used from right to left using the operations as indicated
How do we connect the dots?

Connecting the models together to get the big picture
First, some words of caution
And a disclaimer or two

The plumbing is unique to your business – you have to build the connections yourself

Building the connections requires decisions about what to measure and how to measure it

Understanding the connections may also require some statistical modeling to determine what actually matters

Keep the model to yourself, it’s very valuable
Where do we start?
It’s all about the measures...

- The key is the structural performance ratios used to monitor the operating model

- The ratios you use should reflect the business model flavor and the type of operating model

- Chains of these ratios should lead from operating performance to business outcomes

- Ratios can focus on inputs or outcomes
What do you measure?

- **Focus on process execution** – they implement capabilities and deliver services.

- **Consider the strategic focus** – if speed is more important than cost, make sure you measure speed and don’t obsess over cost.

- **Remember the goal** – you want to understand how changes in input actually affect outcomes in your business.

- **Be complete** – create links between all of the inputs you can change and the outcomes that matter.
What are structural performance ratios?

They provide insight into the health and performance of business processes, organizations, and other structures

They are based on observable and manageable characteristics of the structure

They focus on inputs (efficiency) or outcomes (productivity)

They are technology and organizationally agnostic

Productivity-based ratios

Focus is on outcomes

Productivity = output / unit input

- Revenue / $ operating expense
- Revenue / employee hour
- Revenue / $ marketing expense
- Revenue / square foot (brick and mortar)
- Revenue / order (online)
- Orders / visitor (online conversion ratio)
- Story points / sprint
- Inventory turns
- Asset turns
**Efficiency-based ratios**  
*Focus is on inputs*

\[ \text{Efficiency} = \frac{\text{input}}{\text{unit output}} \]

- Cost / story point (or feature or whatever)
- Employee hours / $ revenue
- Cost / execution of process
- Defects / execution of process
- Cost / order (online)
- Cost to fulfill / order or item
Some statistical modeling is required
Some inputs don’t tie directly to processes, depend on customer response, and affect multiple outcomes

**Products and services**
- Revenue
- Cost of goods sold and gross margin
- Operating expenses
- Inventory turns

**Pricing**
- Revenue
- Gross margin
- Inventory turns
But, some things are just hard to measure

Example: Conversion ratio for a physical store

Start with what you know

- Number of visitors per day
- Number of transactions per day
- Number of transactions per tender instance per day

Note what you don’t know that might be useful

- Number of people per group
- The real number of cash transactions per person per day

Put it together

- Transactions per day / (transactions per tender instance) = tender instances per day
- Conversion ratio = tender instances per day / visitors per day
OK, so now what?

Just knowing the conversion ratio doesn’t help
• You can’t change it directly
• But it can be influenced

What can affect the conversion ratio?
• Increase the probability that a random customer will buy something
• Increase the proportion of visitors that came to buy something

If the conversion ratio doesn’t change, you can increase sales by increasing the number of visitors
The multiple roles of uncertainty

Uncertainty plays two main roles
• Customers might not respond to changes in inputs
• The enterprise might not execute the changes well

Uncertainty shows up in a couple of ways
• Variability in the process control chart
• Drifting or step changes in the mean for a process

Uncertainty also shows up in the statistical models that link input changes to changes in outcomes
Questions?

Thank you!