The following is a highlighted summary of the book, **The Three Rules: How Exceptional Companies Think** by Michael E. Raynor and Mumtaz Ahmed. *The statements below are key points of the book as determined by James Altfeld and have been made available at no charge to the user.*

The Three Rules:

How Exceptional Companies Think

By

Michael E. Raynor and Mumtaz Ahmed.

Whenever we buy something there are two dimensions to the value received: Price and Non-Price. Price is a function of how much we pay for something, with the less we pay, the more price value we get. Non-price value is a function of all the other dimensions of value that are not price:

- Durability
- Functionality
- Quality
- Convenience
- Prestige
- Convenience
- Ease of use
- Style
- Brand
- Etc.

How much of each of Price and Non-Price value a company provides relative to its competition defines it POSITION in competitive space; that is, how a company creates value for its customers.

A company's profitability formula describes how it captures value, not just creates value, for itself compared with others.

We measure profitability using return on assets (ROA), which is defined as income divided by book value of assets. ROA is the product of return on Sales (ROS), or income divided by sales, and total asset turnover (TAS), or sales divided by assets. Consequently, there are only three ways, either individually or in combination that a company can improve its ROA; increase revenue, decrease cost or decrease assets.

Our research shows that exceptional companies are systematically more likely to drive their ROA advantage through higher relative revenue than by lower relative cost or lower relative assets. Going down one more level, a revenue advantage can be driven by higher unit price or higher unit volume, and exceptional companies tend to rely more on price. The rule then is REVENUE BEFORE COST.

Of the eight Miracle Workers we found, with revenue driven exceptional performance, six relied heavily on higher prices, while two relied on volume, either in large part or entirely.

What we found is that it doesn't matter what type of personality the CEO has, all that mattered consistently was whether or not leadership was focused on building a non-price position and a revenue-driven profitability formula.

Expansionary markets: Better before cheaper and revenue before cost.
Recessionary economy: Better before cheaper and revenue before cost.
Technological disruption: Better before cheaper and revenue before cost.
Plague of Locusts: Better before cheaper and revenue before cost.

When you find yourself having to allocate scarce resources – usually people, time or money – among competing priorities, think about which initiatives contribute most to enhancing the non-price elements of your position, or to earning relatively higher prices or greater volume, and give those a nod.

For example, if your operational effectiveness program is mostly about cutting cost while your innovation efforts are mostly about separating you from the pack, go with innovation. But it could just as easily be the other way around; if pushing the envelope on operations is about delivering levels of customer service your competition can only dream of doing while innovation seems geared to doing the same for less, then your operations folks deserve the incremental care and feeding.

No Company Can SHRINK Its Way to Greatness!!

How or where you position the company determines how fast you can go; execution determines how fast you actually go. If your company is a roller coaster, ask yourself, are you rushing toward the ground, or is the ground rushing toward you? All performance is relative, so you must adapt in ways that preserve your ability to store potential energy and release kinetic energy. Your company's position within an industry is key. Just because an industry is consolidating does not mean you are to get into the acquisition game. Just because your industry is in a downturn does not mean you begin slashing and cutting. Doing these things amount to your standing still. The trick is to be different and think independently of the industry.

Doing only what makes sense amounts to your running standing still. To get anywhere, you need to run twice as fast. It is the dynamic, not the static company that wins.

Creating value for the customer is a necessary condition, but it is not sufficient. Exceptional companies must not only create value, but also capture it in the form of profits. Increasing profits can be done in a number of ways.

If you look to Revenue Before Cost thinking, this could also include your buying better, more expensive raw materials, or hiring more expensive skilled/knowledge labor. If you are a non-price value company, this is important.

The key to superior profitability is not how well a company manages any one variable of its Return on Assets, but how it manages the interdependencies among them in light of often avoidable trade-offs.

Exceptional companies utilize revenue before cost. In other words, when the decision to increase profitability needs to be made between increasing revenue or decreasing cost, they always choose increasing revenue, even if means incurring higher costs.

If your advantage Is driven by:	Then you most likely Have higher:	And not lower:
GROSS MARGIN	PRICE	COST
ASSET TURNOVER	VOLUME	ASSETS

A non-price position is associated with exceptional performance; a revenue-driven profitability formula is also associated with exceptional performance; and a non-price position and a revenue-driven profitability formula typically go together. To beat the odds, you want to focus on creating values using Better Before Cheaper, and on capturing value with Revenue Before Cost.

Mergers and Acquisitions are critical to many initiatives that can be essential to a company's success and even its survival, from gaining access to new technologies to international expansion to competitive preemption to creating strategic options. The question should NOT be, Does M&A help? It should be, Given my circumstances, and given the details of this deal, is this particular acquisition the best mechanism for achieving my goals as I understand them now, and how can I employ it most effectively?

(Pharmaceutical Industry changed in 1962 with the Thalidomide Tragedy. The Kefauver-Harris Amendments significantly expanded the FDA authority establishing new standards of evidence for safety, proof of efficacy, the demonstration of good manufacturing practices, and a pre-market testing requirement. In addition, the Drug Efficacy Study, launched in 1966, subjected 3,443 drugs already on the market to the new safety and efficacy requirements, which resulted in the removal of 30% of all drugs reviewed and a dramatic revision in the therapeutic claims of many other medications.

Too often Bad Things Come from Good Intentions: As a result of the K-H Amendments, development time for new compounds increased by 240% between 1960 and 1970 while development costs increased sevenfold. These increased costs drove many smaller operations from the industry, resulting in a dramatic concentration of revenue among much larger, better-capitalized companies. Many companies began looking for less-regulated industries where they might exploit their scientific capabilities. Popular choices were cosmetics, ag chemicals, animal health products and medical devices.

In the early 1990s, there was increasing pressure on health care costs in the US and several drug companies moved to vertically integrate into pharmaceutical benefits management (PBM) by acquiring high volume distributors of prescription drugs. Merck moved first, buying the Medco in 1993, the largest player at the time. In 1994, SmithKline Beecham bought Diversified Pharmaceutical Services, Pfizer went with Value Health, Inc. and Eli Lilly bought PCH Health Systems.

The PBM business has much lower margins and much higher asset turnover. Merck hung on to Medco until 2003, despite regulatory changes that undermined the strategic rationale for having bought it. From 1993 to 2003, Medco climbed from 3% to 58% of Merck's total revenue.

In Conclusion:

Pilots have an expression – Take offs are optional; landings are mandatory. The same can be said for corporations. No matter how high you soar, eventually you will come down. You may not be able to predict when, but it will happen. Which is why being prepared for that moment is so important. It can happened due to internal failings; inertia born of complacency; or hubris causing a lack of focus; or a major change in markets. It can also be a competitor; changes in customer preference; regulatory or legislative constraints. The trick is to stay up for as long as you can. Revenue Before Costs and Better Before Cheap.