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# The Big Three: Microsoft, SAP- And Kronos?

Long-term success is wickedly devilish to achieve. According to my research, of all public product software companies in the world, only three have records of 15 or more years of continuous growth and profitability: i.e. every year their sales increased and every year they were profitable. Microsoft, our industry's 100-ton gorilla, has the longest record at 22 years, while SAP and Kronos share the next record at 15 years each.

We expect Microsoft to have such a record. And we might suspect that SAP would also. But Kronos? Who is Kronos and what did Kronos' leadership do to join such a distinguished and exclusive club?

Executive Strategy

*Insight From Brian Turchin*

Business Development Excellence

**Kronos**

## Kronos

In 1977, Mark Ain, an MIT graduate, started Kronos, named after the Greek god of time. What was his idea? Build a better mousetrap: automate the front-end process of collecting time and attendance information. Although the back-end payroll process had been automated already-software was used to calculate and print salary checks-the front end remained manual. Hourly workers still used time cards that they punched with a time clock. These cards were collected and the information manually tabulated.

With help from some friends at MIT, Ain built an automated time clock; i.e. he added a microprocessor chip to a mechanical device so that software on the chip would collect the time and attendance information.

The benefit in savings was, and remains, immediate and real. The automated time clock provides a tangible ROI by cutting administrative work and eliminating costly payroll errors. As early as 1985, Modern Office Technology reported: "The new system [for Better-Bilt Aluminum] has resulted in an annual savings of 1040 hours in manual preparation. Savings from possible human errors in payroll calculation are far more dramatic…an over-payment of only 1/2 percent of our yearly payroll would pay for the system in less than a year."

## Find An Underserved Market And Fill Its Needs

By focusing on automating the collection of time and attendance information, Ain was following a classic formula to success: Find an underserved market, one where you can provide value, and fill its needs better than anyone.

In this case, it was a latent market that only emerged with automation. Ain saw this and chose to build a $100 million company, even though the old-timers in the mechanical time clock business thought he was nuts. After all they said, if you combined the revenues of all players in this market, you probably wouldn't even reach $60 million.

Over time, Kronos grew much larger than $100 million, and ended up controlling the automated time and attendance market with a 50% share or more. It set the standard.

And even though Kronos is in a much smaller market, it is interesting to compare its market share with some of its brethren. In an interesting side note, Paul Hamerman, Research Director, Forrester Research, reported: "Kronos' dominant market position…represents a share that is considerably higher than the market leaders in customer relationship management (CRM) (Siebel, 28 percent) and enterprise resource planning(ERP) (SAP, 31 percent)."

## Be A Prudent Risk-Taker

As the dominant player in its market, Kronos developed some natural competitive advantages. For example, when someone considers buying a product in its category, Kronos is first on the list. A competitive advantage that lessens the cost of sales and marketing quite considerably. But this doesn't explain why Kronos has such a consistent sustained record of success. Where boldness may drive rapid growth-and perhaps rapid failure-Kronos took the more conservative route.

Executive Vice President and CFO Paul Lacy illustrates the point with a story. "As a golfer, sometimes you find yourself in the woods with two different shots. One shot is a clear, safe shot to the fairway, which sets you up perfectly for your next shot to the green. The other is a high risk, high reward shot, say a shot between two trees that are only a foot apart. Hit it right and you are on the green near the pin. Hit it wrong and you are deeper into the woods." Kronos, he said, " takes the fairway shot, not the shot to the green."

This conservative bent was re-enforced when Mark Ain discussed his view on acquisitions. He acquires smaller companies that already fit within the existing strategies, adding more customers and cash to the bottom line. He stressed that Kronos does not engage in strategic acquisitions that have the potential to put Kronos' business at risk.

Moving on, I learned about several other strategies from interviews with Mark Ain, and Paul Lacy who I mentioned before and from Aron Ain, Executive Vice President and Chief Operating Officer. Four are focused on growth and two are essential to running a profitable business.

## Growth Strategies

**1. Employee Retention Breeds Strong Domain Knowledge; And Strong Domain Knowledge Grows Revenue**

According to Aron Ain, a fundamental in Kronos' strategy is its focus on the customer: understanding their business, their lingo, and their problems. So far, this sounds like many other businesses. But Ain stressed something more unusual. He emphasized how important it was for Kronos to retain employees for long-periods of time. Why? Here is how he explained it.

-- First it is vital to treat employees right, so they stay longer.

-- When they stay longer, employees develop a deeper and more intimate knowledge of customers. (What is usually referred to as domain knowledge)

-- And because employees truly understand a customer, they can provide world-class products and customer service.

-- When customers know they are cared for by knowledgeable personnel who help them solve their problems, they become loyal customers.

-- Loyal customers buy more.

The impact of this general strategy shows up in a variety of ways.

-- The average turnover in a typical Customer Service department is notoriously high, with an average tenure of 18 to 24 months. Yet, at Kronos, during the last 12 months they had an exceedingly low attrition rate of 4%.

-- It is a standard practice to outsource manufacturing overseas. And increasingly, it is a standard practice to outsource customer service overseas to countries like India. But Kronos takes quite a contrary view. Both functions remain in the U. S. Why? Mark said in the U. S. these areas are staffed with employees while overseas they are not. And employees care more.

-- And customers stay. In the mid-80s Home Depot bought Kronos' products for what was then its small number of stores. Since then it has moved on to its third generation of Kronos software, going from DOS to Unix and from Unix to the Web. And now every employee in every one of its more than 1,500+ Home Depot stores use Kronos' software.

-- Kronos obtains a very high 70 percent of its revenue from its current customers.

So make an employee smile and your cash register will go ka-ching, ka-ching.

**2. Convert Stagnant Distributorships Into High Performing Branch Offices**

Like many young companies in the early years, Kronos found distributors an inexpensive way to reach a broader marketplace. Distributors eliminated the need for building a large sales organization or the need for significant selling expenses.

As Kronos succeeded and grew larger, its distributors succeeded and grew as well; which is a win-win, except that distributor success eventually translated into comfort. Distributors had upscale houses, several cars, money for colleges and vacations. And with this comfort, came a reluctance to take risks. What was the impact? Growth in the distributor channel slowed down.

To deal with this obstacle, Kronos developed a different win-win strategy. Often times, the distributors welcomed an opportunity to cash out, so to speak. They may, for example, have had most of the material things they wanted but now would be provided an excellent retirement fund.

Fine for the distributor, but how did this work for Kronos?

In its usual studied fashion Kronos developed an efficient by-the-book process, improved over time, to take over a distributor and turn it into a high performing branch office that doubled or even tripled revenue. Here are a few elements of this process:

-- Kronos created a financial model to evaluate a distributor acquisition.

-- The rule: only buy if the acquisition would turn cash-positive and add to earnings by the 3rd quarter after being acquired

-- Where there may be an issue, Kronos ensures original owners on-going support after the sale. They make the distributorship's sale price contingent on the acquisition meeting specific financial targets over several years.

-- Reserve the right to decide what people to hire.

-- Assign a Kronos executive to run the new "branch," to help establish the Kronos culture and management methods.

-- Install a financial performance management system to set in place and measure several key metrics.

-- Treat the newly acquired employees as welcomed members of the Kronos family. On day one, make sure each employee has a new PC; make sure the office has all the new forms; and change all the signs to reflect the new name of the business.

-- Treat the acquired customers to tender loving care, while aggressively marketing your products and services

Channel partners can be great friends to software companies offering a low-cost way to broaden your entry into a market. But they also pose potential growth problems. When complacency stalls a channel partner's growth, be prepared with an acquisition plan that works for you and for them.

**3. Design Your Products to Serve Multiple Markets**

In Kronos' 3rd year, it faced an early crisis. Mark Ain said, "We should have gone out of business during the 1982 recession. We had a very expensive time-and-attendance product that was geared toward the manufacturing segment. When the bottom fell out of the manufacturing market, we redesigned and refocused our product on nursing homes, where business was still going strong."

By modifying Kronos' product to fit another industry, Ain weathered his first economic storm. But as adversity often does, the experience taught Ain a valuable lesson: build a product you can sell to different industries in order to protect yourself against an economic decline in one.

**4. Build A Parameterized Software Product**

As you enter several industries there is another substantial impact as well. Your product complexity goes up. Union regulations in the nursing industry are different from those in the manufacturing industry. To handle this, software designers have a choice. Customize the code to suit each customer in each industry. Or capture the industry and customer differences in a parameter driven table.

Even though it requires much more upfront design, Kronos adopted the parameterized table approach; one, by the way, that SAP also adopted. Why? It drives down implementation cost, and significantly reduces implementation time. Lower cost and speedier implementation become another competitive advantage.

And as Lacy mentioned, a number of Kronos' competitors chose the customize path. The problem, he said, is that as the number of customers grew so did the problem of how to upgrade all of these different software implementations. Since each customer had some special customized code developed just for them, to make an underlying change in the software product led to a prohibitive cost structure, putting some competitors out of business.

**5. Decide To Be Profitable**

Nineteen eighty seven was an inflection point for Kronos. Up to then, it focused on growth, while also keeping a close eye on expenses. But this changed. Mark Ain knew if he wanted to bring the company public he would need a string of profitable quarters. And he realized the time was right for the company; it was large enough, in terms of scale, and was operating well.

At a Board meeting, he, his board, and his executive team make a conscious decision to now run Kronos as a profitable business. But as we know, saying you will run a profitable business is very different from doing it. To execute on this new strategy, Kronos did two things. First, Ain hired Paul Lacy who had a reputation as a strong and experienced CFO. And second it meant, as former President, Pat Decker (now retired) said, that the executive team had to learn to say "no" and mean it. No we can't do all ten initiatives. Since we have limited resources, we must prioritize and decide on only two.

Again, sounds easy, but this posed a challenge for Ain. He has a restless mind always on the prowl for new problems to conquer. He likes to explore new ideas. In this, he is like many founders. And in a founder this is a terrific trait when starting a company, because you need to explore your product and market space. But it becomes a counter productive trait in a more mature organization.

But Ain understood that even though it went counter to his instincts, the future success of his company depended on his ability to adjust. And adjust he did. At the end of 1988 with Kronos' new focus and with their new CFO in place, it eked out a small 2 percent net profit, and then continued on its amazing streak of 14 more consecutive years of profitability.

**6. Institutionalize A Focus On Profitability**

But profitability is not just about the CEO and his executive team. A push for profitability requires discipline across all parts of the company, and as such needs to be ingrained into the culture of the company. How do you do that? Here is one approach that Kronos uses.

Traditionally sales commission is based on a percentage of revenue. Sell $1 million of software licenses and services, and if you have say a 5 percent sales commission, you earn $50,000. The problem is that this only emphasizes the revenue side of the equation. It doesn't make sales personnel focus on cost at all.

Kronos solved this problem by tying sales commission to a combination of revenue and cost with a two-tier structure based on a modified P&L statement: one tier for sales executives, those in charge of a region, and another tier for sales representatives.

Kronos pays a sales executive a management bonus based on sales revenue minus the cost of goods sold and minus expenses. So on $40 million in revenue, with $8 million in cost of goods sold and with an expense of $20 million, a sales executives' bonus is based on the net income of $12 million. Whereas Kronos pays a sales representative a commission based on sales revenue minus the cost of goods sold only. With sales of $2 million and with a cost of goods sold at $400,000, the sales representative is paid on the gross income of $1.6 million.

What's the value? Michael Bosworth, author of *Solution Selling: Creating Buyers In Difficult Selling Market*, and co-founder of CustomerCentricSelling, said he "is absolutely in favor of this approach," because "it takes sales personnel and makes them stakeholders in the company. It has them operating as businessmen, not just as someone focused on revenue without any thought of expense."

## Summary

Success is a complex business. It is not formulaic. If it were, we would all be rich and living in Tahiti. But there are lessons we can learn from others who have been successful; lessons that once put into a broader context can provide a framework, a guide, for our own success.

In this third column in our series, I focused on several of Kronos' success strategies and learned the following:

1. Opportunity lurks in underserved markets where underserved may mean opportunity that others don't see yet.
2. A more measured approach can provide more consistent success.
3. Domain knowledge, that special and unique understanding of your customer, can be a key to keeping our customers and growing the revenue you receive from them.
4. Expect complacency from some successful channel partners, and be prepared to make them an offer they won't want to refuse, while at the same time protecting yourself with a well-thought through acquisition process.
5. Protect your business against an economic downturn by diversifying your sales into different industries.
6. Design for software product with the intent to make the least amount of custom code changes for each customer.
7. Make a conscious decision to run a profitable business-if you haven't already
8. Choose strategies to institutionalize a focus on profitability like Kronos did with its combining of sales revenue to cost in determining a sales executives commission.

In our next column, I will examine Manhattan Associates, a provider of supply-chain execution software.

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