Project Business Management[1]

Freebie Projects And The Project Business Management Office (PBMO)

Oliver Lehmann

"Profitability is the sovereign criterion of the enterprise."
Peter F. Drucker

Summary

Project business management is high risk for all parties involved. For organizations performing projects for paying customers, a very central area of uncertainty is profitability from one or more projects. A second one is liquidity, and on top of that, the customer must be satisfied. Assigning persons as *Project Business Managers* can help meet these goals for individual projects. For a portfolio of projects, a *Project Business Management Office (PBMO)* can be beneficial to ensure portfolio-wide profitability.

Freebie Projects

Case Story: A Customer Betraying High Hopes

Silk Moth Inc.[2] is a JAM. The company performs a continuous portfolio of customer projects and is *Just About Managing*, meaning that it makes enough profit to survive the day but has no monetary resources to manage unexpected problems and crises and to grow into new capabilities and markets.

As a small publicly listed manufacturer of automotive components with roughly 1,000 employees, Silk Moth's name stands for quality and for timeliness in delivering its products to its customers, mostly automotive manufacturers. The name also stands for effective integration of product development and production design for small components roughly up to the size of a tin can. In its development work for its customers, it follows the standard process of the industry, which predevelops innovative products to a market maturity of

[1] *This is the 5th in a series of articles by Oliver Lehmann, author of the book "Situational Project Management: The Dynamics of Success and Failure" (ISBN 9781498722612), published by Auerbach / Taylor & Francis in 2016. See full author profile at the end of this article.*

[2] *Name changed by the author*

roughly 50% to 80%, then offers the product on the market and finishes development when a customer and with the customer a business case has been found[3].

Automotive industry is generally a high-pressure environment, and while some suppliers of automotive components and services are highly profitable there, the majority are JAMs. Profitability is a leadership task, and while most companies in automotive industry are well managed, they are also under-led.

In the specific case, the product was a new type of pump for break fluids and coolants, designed to be located around an axle. The pump uses the rotation of the axle to propel the liquids, when the car is driving and switch on an electric motor when the car and with it the axle stands still, to ensure uninterrupted and steady flow and pressure of the fluid. During a presentation on an exhibition, a customer was indeed found for the item, who was in the process to develop a new electric car, Botfly Corp., and an agreement was soon made that the final development, based on the predeveloped immature product, would be finished for the item, production design started for it, and that it would become a part of the future car model.

Such a development project is often a *Freebie project*. It is done by the contractor for the customer free of charge, but after its end, revenues created from the product or service that the project has created will pay back the investment for the contractor. Figure 1 describes the lifespan of a freebie project with those of internal projects and customer projects that are regularly paid by the customer during the course of the project.

Silk Moth was normally a very careful company, that would not take too many risks for a new and uncertain customer business in development. The high hopes associated with the first application of the new product and the expectations of the Botfly car to sell in high numbers and to give the company a first-class reference customer for future business development however blinded their attention to business risks. They also considered the customer strongly dependent on them and thought, this will protect the return from the investments ahead. Being driven by devoted engineers, Silk Moth never understood, how Botfly's processes actually brought about their decisions.

[3] *The development process is called Produkt-Entwicklungsprozess (PEP) and has been highly standardized in automotive industry to combine creativity in development with consistent technical and business practices* (Moehrle, Isenmann & Phaal, 2013)

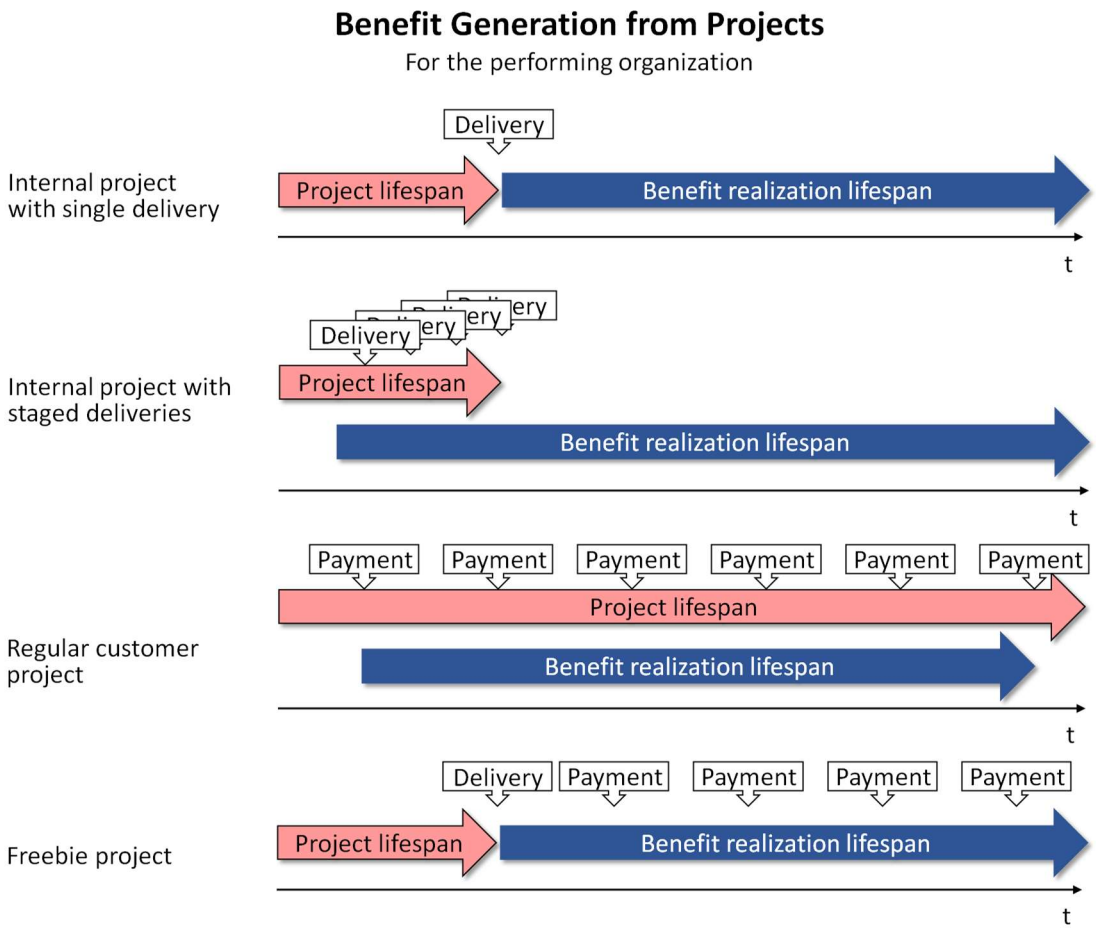

Figure 1: The benefit generation lifespans (lifecycles) of internal projects, regularly paid customer projects and freebie projects.[4]

Botfly's management rejected performing the project based on a written contract. Contract development is a lengthy process that consumes a lot of management attention, and the company's top management repeatedly said: "It takes a woman nine months to have a baby, why does it take us years to develop a car?" It is unclear, to what degree Silk Moth's management was aware of the risks it accepted by agreeing to a solely verbal agreement. When the relationship between a customer and a contractor goes well, forfeiting a written contract can be a great decision, saving a lot of time and energy that would be otherwise needed for negotiations and documentation of the outcomes of these negotiations.

Unfortunately, project business relationships are rarely free from challenges and conflicts, and then, having no written and enforceable agreement as a reference to settle disputes or in a worst case seek remedy at court can be a disaster for at least one of the parties,

[4] *Freebie projects may also have staged deliveries and then follow the second model. Compare my PM Network paper per February this year* (Lehmann, 2017a)

sometimes for both. Another aspect further increasing these risks was that the two companies were in different countries with very different legal systems.

The project was agreed between the parties, and Silk Moth had dedicated a large number of resources into this promising future business. The project was done in tight cooperation with the customer, which included massive transfer of know how from Silk Moth to the customer on product details, but also on production design specifics. Designing mass production is often the critical moment not only in automotive, when it turns out that the product developed is difficult to make within the technical constraints of mass production with its specific technologies, and this transfer has often delayed market entries of new products. Silk Moth was very successful in avoiding such mistakes, and their customer Botfly could profit from this knowledge. One should note, at this point in time, all the work was done free of charge, as no product delivery had been made so far that could be billed by Silk Moth.

One legal requirement that the contractor needed to meet during this time was an ad-hoc notice to the capital market to comply with the rules of the local investor protection laws. The disclosure was written in a language that avoided naming the new customer, but from the descriptions given, it was easy to see for a reader, who that company was. Silk Moth was obliged to publish the notice, but it could also be seen that the company was very proud of the new business and hoped to use it to lure further new business.

Some weeks later, Botfly also published a notice to investors and press, confirming that the company was the unnamed customer of Silk Moth and informing the market that the contact was ended and Silk Moth would nevermore be their supplier. Explanations given for the decision were failure to meet specifications, lack of timeliness and "plot spoiling" of Silk Moth by not adhering with non-disclosure agreements. Silk Moth was informed of the cancellation of the business relationship just two days before the Botfly gave public notice through the press, so they were not given much time to try and rescue the business. It was just sufficient time to allow them to be the first to inform the markets.

Botfly had got the know-how on both the product and the production processes and Silk Moth had invested time, energy and resources with the final result that they had given away their most innovative intellectual property for free, which included the design of a product and its production secrets that probably has a great future.

The project began with high hopes and ended in a commercial failure.

Freebie Projects

Freebie projects come with risks. They also known as "razor-and-blade" projects, as a reference to the classical business model of razor manufacturers, who gave away the razor handle cheaply or even for free and then made profit with blades that were inexpensively to make but could be sold at high prices. As the blades needed to be replaced frequently, the business model promised the company a steady and profitable income stream. Other industries copied the business model; one may remember instant cameras that sold at a low

price but needed expensive special films and batteries. Manufacturers of inkjet and laser printers use the same model.

The author knows two industries, where the model is used in project management. One is automotive, as shown in the case story above, the other one is the service business of synchronized logistics providers.

For customers with the need of high volume transport logistics tightly harmonized with internal material flow processes to ensure Just-in-Time availability of items, logistics companies do projects tasked to connect the customers' internal logistics systems with their own land, sea, and air transportation assets. This is to a major degree a matter of software development, often combined with optimizations on the side of the customer, who finally gets a highly integrated solution that makes the company more efficient and helps it respond to varying production demands. The price for the customer is a high dependency of the logistics provider. Changing to another one becomes difficult, often impossible. Freebie projects can be a powerful tool to sell operational products and services that will then bring the profit over time that pays back the investment in the project.

They also bear risks for the contractor. The contractor's financial success from the project relies on the realization of the customer's business phantasies and on the invulnerability of the business dependency. The business that the customer intends may not be successful at all. Or it may take longer for the customer to implement stated business goals, for example when the launch of the new product or service gets delayed, or when it is not accepted by the market as expected. If the launch of the customer's product or service is successful, there is another risk of a seething feeling of dependency from the contractor; the customer may wish to strip that off. Depending on the flexibility, that the contractor left to the customer, technically as much as contractually, the customer may be successful in doing that. The result will be that the amortization of the contractor's investment in the customer will not take place at all. This situation is similar to a customer of a subsidized inkjet printer, who decides to use low-cost third-party ink instead of paying back the manufacturer's subsidies by buying expensive ink. The contractor must find ropes to bind the customer to the business, but if the tighter these ropes are bound, the stronger the customer's desire will be to evade the dependency. The contractor will need to bring lasting benefits to the customer that exceed the disadvantages without driving the own business into a loss.

Another critical factor of risk is the contractor's ability to actually deliver the goods and services after the project. If the contractor cannot do that, there is no opportunity to send invoices to the customer. To make things worse, the damage for the customer will probably be much higher than in a normal buyer-seller relationship, given the increased dependency from the contractor. In such a case, the originally profitable business will not only fail to generate income, but damage claims can also turn it into a massive liability. As a contractor, one must have a lot of confidence into the own ability to bind the customer that tightly by doing a Freebie project. Or one needs to have effective contingency plans prepared for cases that one is not able to deliver.

Freebie projects are an example for business consequences of projects, particularly customer projects, for whose management project managers have not been educated. They – hopefully – understand how to breakdown large chunks of work and deliverables into smaller and better manageable work items, how to schedule, or run sprints, and how to communicate with team members, managers and with customers, the latter in customer projects. They have rarely been trained in developing and applying business acumen and commercial situational awareness, and the degree of strategic risk management exceeds the level in which they feel comfortable.

Managing the Business of Project Management

In another article of this series on Project Business Management[5], the author described how a portfolio of projects can turn from a forecast profit into a loss with some few numbers changing.

To go more into detail, the mechanics of these calculations are detailed in the following figures.

Figure 2[6] shows the forecasts at the beginning of the business year 2016. The portfolio of six projects was expected to provide a sound total margin of $150 Mio. by the end of the year, which would be 29.1% of the turnover generated. After deducting overhead costs that cannot be assigned to the individual projects but are associated with the organization's ability to do the projects, a profit remains of $52 Mio. or 10.1%.

	Payments from customers	Cost for contractor	Margin for contractor	
Project 1	12,500,000	8,150,000	4,350,000	
Project 2	153,000,000	119,000,000	34,000,000	
Project 3	9,800,000	8,200,000	1,600,000	
Project 4	231,000,000	165,000,000	66,000,000	
Project 5	16,000,000	10,900,000	5,100,000	
Project 6	93,000,000	54,000,000	39,000,000	
Total	515,300,000	365,250,000	150,050,000	
		General & administration	98,000,000	
		Profit from projects	**52,050,000**	**10.1%**

Figure 2: A portfolio of projects forecast at the beginning of a business year to be successful.

At the end of June, the company reviews the projects and finds that two of them have actual and forecast future cost overruns of $20 Mio each by the end of the year. This variance reduces the expected profit from the portfolio to 2.5%, a quarter of the original expectation.

[5] (Lehmann, 2017b)

[6] *Taken from a real situation, but data changed.*

The company is turning to a JAM – *Just About Managing*, which means, it has no monetary reserves to cover its risks, project management is high-risk business, and also not to finance future developments. Another problem that often comes with being a JAM is liquidity. Customers expect the contractor to outlay money and work for their projects, that will be paid back later, often much later. Even profitable corporations can run into problems when the liquidity is suffering, but for a JAM, this kind of business risk becomes even more pressing; they do not have the financial substance to shell out these sums.

Figure 3 shows the business situation of the firm by the end of June, six months later, as a set of forecasts to the end of the year.

	Payments from customers	Cost for contractor	Margin for contractor	
Project 1	12,500,000	8,150,000	4,350,000	
Project 2	153,000,000	*139,000,000*	14,000,000	
Project 3	9,800,000	8,200,000	1,600,000	
Project 4	231,000,000	165,000,000	66,000,000	
Project 5	16,000,000	10,900,000	5,100,000	
Project 6	93,000,000	*73,000,000*	20,000,000	
Total	515,300,000	404,250,000	111,050,000	
		General & administration	98,000,000	
		Profit from projects	**13,050,000**	**2.5%**

Figure 3: After ½ year, the portfolio of projects is estimated to will have lost 75% of its profits due to cost increases by the end of the year.

Most companies respond to such a situation by cutting costs, commonly euphemized as "Cost engineering". While effective in some situations, cost engineering can often have the opposite effect and further damage the profit, as Figure 4 is showing.

	Payments from customers	Cost for contractor	Margin for contractor	
Project 1	12,500,000	8,150,000	4,350,000	
Project 2	153,000,000	139,000,000	14,000,000	
Project 3	9,800,000	8,200,000	1,600,000	
Project 4	*214,000,000*	165,000,000	49,000,000	
Project 5	*13,300,000*	10,900,000	2,400,000	
Project 6	*58,000,000*	73,000,000	-15,000,000	
Total	460,600,000	404,250,000	56,350,000	
		General & administration	98,000,000	
		Profit from projects	**-41,650,000**	**-9.0%**

Figure 4: By the end of the year, cost engineering has damaged the profit further by reducing or delaying the payments from the customers, reducing the portfolio-wide income from projects for the organization and make the business a financial loss.

Several effects can make limit the benefit from cost engineering and even turn it into a loss:

- **The options of cost engineering are limited:**
  Limitations can lie in the contract with the customer, in laws and regulations that must be adhered with, or in general business practices and state-of-the-art methods, whose adherence is mandatory or at least strongly expected.

- **Cost engineering can slow down a project:**
  Using less costly resources often affects the speed of a project. This can delay payments expected in this business year into the next one.

- **Unhappy customers:**
  Customers may be disappointed by the shoddier products and services that are supplied; they may reject acceptance of these items and delay or reject payments.

- **Rework:**
  The inferior quality is likely to cause rework, which creates additional costs and delays, further increasing the disadvantages described above.

In the already mentioned article on benefit engineering[7], it was recommended to take a different approach in such a situation and focus on additional benefits for the customer, that are attractive enough to allow the re-discussion of price, but also deadlines, scope and other areas of problems. Modern business situations on customer-side favor such *Benefit Engineering*, but project managers are rarely trained to identify and exploit such opportunities.

Project managers are not educated for *Project Business Management*. The widely used standard *A Guide to the Project Management Body of Knowledge (PMBOK Guide)* for example has a full chapter on the role of the project manager[8], but matters of profitability of customer projects are not described in it. Together with customer satisfaction, bringing money home and ensuring profitability is the priority task in a customer project, and roughly 50% of project managers are tasked with that[9], but in literature, this is rarely found as part of a project manager's professionalism.

One option is to either develop a project manager to become a *Project Business Manager*, or to assign a separate person with such a role, overlooking the customer project from the first contact over business development and project management to the final handover and beyond[10]. This person exists in small companies that live on project business, it is commonly the general manager or a sales person, who does not only develop the business but also uses the position at the beginning of the project, which allows a full overview of the entire project

[7] (Lehmann, 2017b)

[8] (PMI, 2017, pp. 51-68)

[9] (Lehmann, 2017c)

[10] *Ibid.*

lifespan to ensure that the customer is served well, but also that the project brings enough money home to allow the company to survive and grow.

In larger organizations that live on project management, such a person is often inexistent, and cost engineering is often applied without regard of the projects done for customers, and also for just these customers.

The Project Business Management Office

A *Project Business Manager* can help avoid or resolve problems in a single project, as seen in the initial case story, but may not be in a situation to overlook and manage an entire project portfolio. Cost accountants[11] can have an overview of a project portfolio, but their focus is generally more on calculating costs and income, not in discussing how to increase benefits in order to make the customer happy and create additional income for the contractor.

Many organizations that perform portfolios of projects and programs have *Project Management Offices* (PMOs) to unify approaches, terminology and methodology in organizations used to perform the projects in the portfolio in a continuum between supportive and directing PMOs.[12]

In companies that earn their income from doing projects for paying customers, these PMOs are in a perfect situation to also ensure the profitability of the projects:

- **Central monitoring position:**
  PMOs can see earlier than other units when the portfolio is turning to becoming unprofitable or even a loss-bringer. In the second example in this article, one should criticize that it took the organization 6 months to identify the emerging profitability crisis, and that it then not responded when the cost engineering decisions did not bring the expected success.

- **Understanding of project management:**
  A PMO is commonly staffed with employees who understand project management. The staff may not have had the knowledge when they got recruited for the position, but the daily work with project managers is a strong teacher for them.

- **Strategic links to management:**
  PMOs are commonly expected to ensure that the projects help implement the strategic visions and approaches of management. For a company dealing with customer projects, the strategic aspect of the project may be of lower importance compared with questions of profitability than in internal projects, but it is still there.

[11] *In a more German interpretation often referred to as "Project controllers", "controlling" interpreted rather in the meaning of "monitoring" than actually managing.*

[12] (PMI, 2017, p. 48)

A PMO that deals with the matters of Project Business Management in the organization could then be further developed to become a *Project Business Management Office*, a *PBMO*. Its relevance would go far beyond administering Organizational Process Assets, which include templates, forms, checklists, software etc., that are used portfolio-wide in a more or less standardized fashion.

Figure 5 describes, how the PBMO differs from the PMO, that would further find its place in portfolios with internal projects. The PMO would also look at the external interfaces with the customers of the projects and ensure profitability and customer satisfaction.

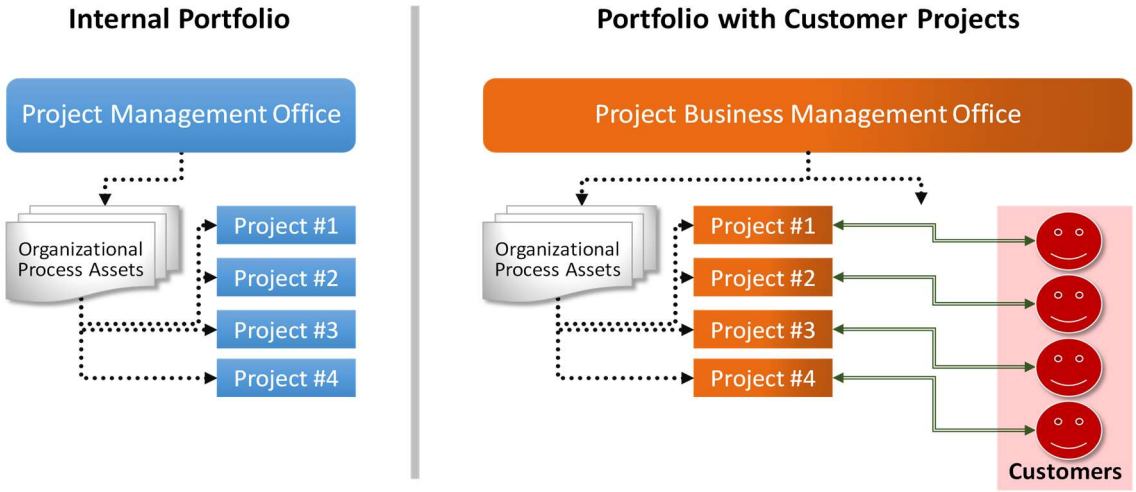

Figure 5: The PMO provides organizational process assets, such as standardized templates, forms, software, etc. to internal projects to unify approaches and terminology. A PBMO in addition supports the profitability of the projects and ensures a happy customer.

A benefit of the approach would lie in the validation of the organizational process assets against the project business, which may lead to reduction or disposal of those process assets, that are not in support of the project business objectives, and an increased emphasis on those assets that are. It would in addition ensure that enough business acumen and commercial awareness is applied in all projects, and that actual practices support the business objectives as much as the process assets. Its staff members may then also offer themselves as ombudspersons for the project managers to ensure that the business interests of their projects, each of them a profit center on its own, are considered when the organization makes decisions that affect project success and profitability.

Such a PBMO would have the task to make sure that not only the projects, but the entire portfolio meets the two central goals of customer business: Making customers happy and bringing money home with projects.

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