Return of the Big Two

By Dr. Albert D. Bates
Principal, Distribution Performance Project

One of the central tenets with distribution is that small improvements in key areas can create large improvements in profitability. In point of fact the differences between the very top firms and the more typical firms is a matter of doing just a little better on a few critical factors.

The difficulty in driving the "philosophy of small changes" throughout the business is that there are lots of different areas where such changes are possible. In short, everything is important.

In reality, though, there are only two factors that management needs to address from a financial perspective. These issues are gross margin management and expense leveraging. They must be the central focus of any profit-improvement program.

The need for control over these two fundamental profit drivers will be examined from two different perspectives:

- **Improvement Goals and Their Profit Impact**—Most firms are not fully aware of the extent to which very modest changes in performance will result in huge improvements in profitability. This section will examine just how large the opportunity is.
- **The Implementation Challenge**—Even though the improvement needs are modest, it is still an improvement. There must be some specific programs in place to help achieve the desired result.

Improvement Goals and Their Profit Impact

The link between small changes and large improvement is outlined in **Exhibit 1**.
The first column in the exhibit presents results for a representative distributor. As can be seen in the exhibit, this typical firm generates sales of $20.0 million, operates on a gross margin of 25.0% of sales and produces a pre-tax profit of 2.5% of sales or $500,000.

The final three columns of numbers in the exhibit demonstrate the profit impact of focusing on gross margin management and expense leveraging, both individually and in combination. In all cases a small 1.0% improvement is used.

In all three columns a sales growth factor of 5.0% is assumed. The 5.0% figure represents the modest performance achieved in many mature industries during periods

of normal economic activity. The point is that rapid growth is not required for profit improvement.

Gross Margin—The column labeled *Gross Margin* shows the impact of 1.0% more margin dollars on whatever level of sales volume is generated. This is not the same as increasing the gross margin percentage by one percentage point. Instead, the new gross margin figure is the new sales volume (which has increased by 5.0%) times the existing gross margin of 25.0%, then adding an additional 1.0% more in margin dollars.

Expenses—The *Sales to Expense Delta* column lays out the basic concept of expense leveraging which is to manage the expenses so that they grow at a slower rate than sales. In the exhibit, both payroll and other expenses have grown by 4.0% which is 1.0% slower than sales growth.

The impact of these changes is dramatic. Profit before taxes increases from $500,000 to $577,500 with the gross margin improvement and to an almost identical $570,000 with expense leveraging. In short, a concerted effort to make small changes in either of the big two can provide a significant improvement in overall profitability.

When the two factors are managed in concert in the last column, labeled *Both Actions*, profit increases by a remarkable 24.5%, reaching $622,500. The result suggests that any profit-improvement program must center on both margin and expenses leveraging.

The specific figures used in the exhibit, such as 1.0% more gross margin, are not necessarily recommended as goals. Every firm has its own unique set of economics which will require company-specific goals.

If performance on margin and expense leveraging can be improved, it should be sufficient for profit improvement. Conversely, if improvements in these areas are not possible, profit enhancement will be extremely difficult.

It is important to note that inventory and accounts receivable are conspicuous by their absence in the analysis. This does not mean that these are not important elements of the business. However, it does suggest that improvements in inventory and accounts receivable control have little effect on profit improvement.

The Implementation Challenge

Plans are wonderful. They're a roadmap that helps firms see how to get where they need to go. A detailed, easy to understand plan is particularly valuable as it readily translates into understandable terms for employees. Understandable plans are more likely to be achieved.

However, even the best plan does not ensure success. From an implementation perspective, firms need to do two specific things. First, they need to educate employees

on the reason for these changes. Second, they need to translate the overall goals into action items for all employees.

Financial education of employees is essential, but frequently ignored. For example, most employees believe that if gross margin and expenses are improved by 1.0%, profit will only increase by 1.0% also, not the actual 24.5%

The second implementation challenge is that the overall goals—in terms of both margin and expense planning—must be translated into a plan for each individual in the firm. In essence, every employee needs to know specifically what to do and how it contributes to realizing the overall company goals and objectives.

For example, if sales must be increased by 5.0% to realize the expense leveraging, then that needs to be translated into the number of additional order lines that the sales force has to produce each week, or the increase in the service level that must be achieved, or the number of potential new accounts that must be contacted. Only when employees have precise marching orders and an appreciation of their overall impact can the company move towards the improved performance goals.

Moving Forward

If distributors are going to reach higher levels of profitability, it is essential that they develop improvement plans in two areas—gross margin and expense leveraging. In addition, they must ensure that every employee understands how individual actions will help make the improvements a reality.

About the Author:
Dr. Albert D. Bates is Principal of the Distribution Performance Project and a Senior Advisor to Benchmarking Analytics. His latest book, ***Breaking Down the Profit Barriers in Distribution***, is available online at Amazon and Barnes & Noble. It covers concepts that every decision maker should understand.

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Exhibit 1
The Impact From Changes in Key Profit Drivers
For a Representative Distributor

		1% Improvement in Key Areas		
Financial Profile--$	**Current Results**	**Gross Margin**	**Sales to Expense Delta**	**Both Actions**
Net Sales	$20,000,000	$21,000,000	$21,000,000	$21,000,000
Cost of Goods Sold	15,000,000	15,697,500	15,750,000	15,697,500
Gross Margin	5,000,000	5,302,500	5,250,000	5,302,500
Payroll and Fringe Benefits	3,500,000	3,675,000	3,640,000	3,640,000
All Other Expenses	1,000,000	1,050,000	1,040,000	1,040,000
Total Expenses	4,500,000	4,725,000	4,680,000	4,680,000
Profit Before Taxes	$500,000	$577,500	$570,000	$622,500
Financial Profile--% of Sales				
Net Sales	100.0	100.0	100.0	100.0
Cost of Goods Sold	75.0	74.8	75.0	74.8
Gross Margin	25.0	25.3	25.0	25.3
Payroll and Fringe Benefits	17.5	17.5	17.3	17.3
All Other Expenses	5.0	5.0	5.0	5.0
Total Expenses	22.5	22.5	22.3	22.3
Profit Before Taxes	2.5	2.8	2.7	3.0