Sales Growth is Great
Until It Isn't

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The economy appears to be slowly, but steadily digging its way out of the recession. Experience from past recessions strongly suggests that profits will rise as sales increase. That will happen almost automatically, even if firms do nothing to change their business model.

That same experience, though, suggests that the increase in profit will not be as robust as it could be with planning. In short, for too many firms allow a portion of potential profit to go to waste.

This report examines the sales growth versus profit growth dilemma from two different perspectives.

- **The Small Changes Challenge—**An exploration of the two key factors underlying the lag in profitability.
- **Managing the Sales to Profit Relationship—**An identification of specific actions that firms must take to optimize profit growth from sales growth.

The Small Changes Challenge

The profitability challenges identified after past recessions were pressures on the gross margin percentage and accelerating payroll costs. To be clear, distributors did not suffer any major problems in these areas. However, even the small changes experienced had a large cumulative effect on profit.

Exhibit 1 demonstrates the impact of sales growth on profit for a representative distributor. As can be seen in the first column, the firm generates $20.0 million in sales, operates on a gross margin of 25.0% of sales and produces a bottom line profit of 2.5% of sales or $500,000.

Three different scenarios are presented in the exhibit. They all represent sales growth of 10.0%. The differences in the scenarios are related to what happens to gross margin and payroll expense as a result of the sales growth.

The Business as Usual scenario assumes that sales, gross margin and payroll expenses all increase at the same 10.0% rate. The only leveraging of the sales growth is that non-payroll expenses (labeled *All Other Expenses*) increase in aggregate only with inflation. In the exhibit that is a 2.0% increase in each

scenario. The result is that dollar profit increases by 26.0%. The firm then declares victory.

The second scenario, Unplanned Performance, reflects the profit challenges that face distributors after every recession. These changes are subtle, but insidious. How they arise will be discussed in the next section.

In this scenario gross margin dollars increase by only 9.0% while sales increase by 10.0%. Second, payroll expenses increase by 11.0% during the same period. With these minor variations, profit only increases to $545,000. That is still a 9.0% increase, but a large part of the sales increase has been wasted.

In simplest terms, even small, seemingly insignificant changes in gross margin and payroll expense are not all that insignificant. The sad reality is these are the sort of minor changes that arise during recovery.

The final scenario, Planned Performance, reverses the profit challenges. It demonstrates the effect of an 11.0% increase in gross margin and only a 9.0% increase in payroll. The profit impact, however, is not simply a mirror image of the Unplanned Performance results. The impact is dramatic, with profit rising to $715,000, an increase of 43.0%%.

In short, sales growth is nice. However, the factors underlying the sales growth are decidedly more important than the sales growth itself. The potential deterioration in gross margin and payroll expense performance must be averted. If that can be achieved, distributors are in position for the strongest possible profit results.

Managing the Sales to Profit Relationship

The profit challenges facing distributors today are nothing more than a repetition of the challenges that have followed every period of economic sluggishness and recovery. The euphoria of sales growth causes managers to forget most of the painful lessons learned in the previous recession and recovery periods.

As demonstrated in Exhibit 1, those lessons are centered on gross margin and payroll expense. While both of these factors are important, gross margin is the real profit driver.

Gross Margin—Experience from prior periods of strong recovery suggests that gross margin walks out the door when strong sales growth walks in. This is simply human nature. The sales focus diminishes the margin focus. Getting the margin focus back requires communication and analysis.

The communication issue requires reinforcing the important of price integrity throughout the firm, but especially to the sales team. Without constant reminders regarding pricing, gross margin slippage occurs almost automatically.

The analysis component involves finding hidden opportunities to improve gross margin. In both good times and bad, firms continue to underprice their slowest selling items and special-order merchandise. The improvement potential is more substantial than most firms believe.

Payroll Control—The keys to payroll control also are twofold. The first is euphoria. The second is infrastructure bias.

The euphoria problem arises because there is an understandable tendency to want to help employees "catch up" on payroll increases that may have been deferred during the down economy. It is essential to ensure the increase in payroll *follows* rather than leads the increase in sales volume.

The infrastructure bias comes into play because now that sales are up nicely, the firm would like to generate even more growth. The thought process is that if the firm increased its infrastructure, then sales growth would be not just nice, but spectacular. The timing of such increases, in terms of additional sales staff, must be related directly to real sales potential.

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 payroll 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 Planned Versus Unplanned Performance
For a Representative Distributor

Financial Profile--$	Current Results	------10.0% Sales Increase------ Business As Usual	Unplanned Performance	Planned Performance
Net Sales	$20,000,000	$22,000,000	$22,000,000	$22,000,000
Cost of Goods Sold	15,000,000	16,500,000	15,750,000	16,450,000
Gross Margin	5,000,000	5,500,000	5,450,000	5,550,000
Payroll and Fringe Benefits	3,500,000	3,850,000	3,885,000	3,815,000
All Other Expenses	1,000,000	1,020,000	1,020,000	1,020,000
Total Expenses	4,500,000	4,870,000	4,905,000	4,835,000
Profit Before Taxes	$500,000	$630,000	$545,000	$715,000
Financial Profile--% of Sales				
Net Sales	100.0	100.0	100.0	100.0
Cost of Goods Sold	75.0	75.0	71.6	74.8
Gross Margin	25.0	25.0	24.8	25.2
Payroll and Fringe Benefits	17.5	17.5	17.7	17.3
All Other Expenses	5.0	4.6	4.6	4.6
Total Expenses	22.5	22.1	22.3	22.0
Profit Before Taxes	2.5	2.9	2.5	3.3