Joining the 40/40 Club

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The statement “gross margin minus expenses equals profit” is an accounting tautology. It is also probably the single most important concept in improving profitability. That is because gross margin and expenses are highly correlated. Firms with high margins tend to have high expenses, while low margin firms have low expenses. The reality is that at all points along the spectrum, from low margin/low expenses to high margin/high expenses, profits are inadequate.

The key to profit improvement is to break the linkage and either produce an enhanced margin without increasing expenses or lower expenses without sacrificing gross margin. This is incredibly easy to talk about, but frustratingly difficult to actually accomplish.

This report will examine the linkage between gross margin and expenses from two perspectives:

- **The Nature of the Margin/Expense Linkage**—An empirical examination of the precise link between gross margin and expenses in distribution.
- **Breaking the Link**—A discussion of the specific margin and expense improvement levels that are required to break the linkage.

The Nature of the Margin/Expense Linkage

Within every line of trade in distribution there are wide variations in the gross margin percentage. The reasons are myriad, including different product assortments, variations in the firm’s service profile and strategic decisions about the role of price in the firm.

At the same time there are equally wide variations in expense percentages. These arise because of differing levels of technology usage, the complexity of operations and, as with margin, the firm’s service profile.

The critical issue in profitability improvement is that the gross margin percentage and the expense percentage are essentially joined at the hip in distribution. This relationship is presented graphically in Exhibit 1.

The exhibit highlights results from a recently-published analysis of distributor profitability by the Profit Planning Group. It is the largest such study ever conducted, encompassing 885 firms from 17 different lines of trade. The size of the study ensures that the results are applicable to distributors in any segment.

Across the horizontal axis the graph reflects the gross margin percentage for firms relative to other firms in the same line of trade. For example, at the 20% point on the axis the firm would have a gross margin percentage that is 20% higher than the typical firm. Assuming an industry-average gross margin of 25.0%, this would mean a gross margin of 30.0% of sales versus the industry norm of 25.0% (25.0% x 1.2 = 30.0%).

At first blush, such large variations may not seem realistic. However, they appear in every sector of distribution. There is always an industry norm, but there is also always a wide range of variation around that norm.

The vertical axis presents information for expense percentages. Again, the variations are from the norm in the industry. Also, once again because of strategic, operating and product mix differences, the range is large.

There are two main points to be gleaned from the exhibit. The first point is that gross margin and expense percentages are inexorably tied together. The trend line from lower left to upper left clearly reflects that.

The second point is that the key to profitability is to either lower expense percentages while maintaining margin or raise margin percentages without impacting expenses. Ideally, firms should do both. The open issue is how much of an improvement is possible.

Breaking the Link

Despite the linkage between gross margin and expenses, some firms are able to break out of the margin/expense straight jacket. Three different improvement scenarios are evaluated here. They all involve producing just slightly better results than other firms in the industry, either on margin, expenses or both. Dramatically better is not required; slightly better is good enough.

- **Good Gross Margin/Adequate Operating Expenses—**This combination includes those in the top 40% of the firms in the industry with regard to gross margin and whose operating expenses are at least slightly better than the typical firm. That is, they are in the upper 50% on expense control. It can be thought of as a 40%/50% model.
- **Adequate Gross Margin/Good Operating Expenses—**This is simply the mirror image of the previous scenario. It includes firms whose gross margin is at least slightly better than the typical firm and is in the top 40% in controlling operating expenses. This is a 50%/40% model.
- **Good Gross Margin and Operating Expenses—**This raises the performance bar significantly by requiring results in the top 40% on both factors. This can be characterized as the 40%/40% model or the 40/40 club.

It is important to note the percentages used in the three bullet points. Firms in the top 40% on gross margin do not have a gross margin that is 40% higher than the industry norm. They “simply” outperform 60% of their peers with regard to the gross margin percentage.

The payoff for being somewhat better than the industry norm is substantial, regardless of which of the three combinations a firm produces. The impact is reflected in both profit before taxes (PBT) and return on assets (ROA):

Gross Margin	Oper. Exp.	Improvement In PBT (%)	ROA(%)
Top 40%	Top 50%	163.5	128.6
Top 50%	Top 40%	154.7	151.5
Top 40%	Top 40%	226.3	189.7

As stated before, being in the top 40% with regard to either gross margin or expenses does not represent dramatically superior performance. It simply reflects being a little bit better than the norm. The challenge is being better on both factors at the same time.

Management needs to develop plans to produce somewhat better than typical performance. To start the process the firm must first know where it stands in the industry. This necessitates a close annual review of any financial benchmarking reports available in the industry. That report provides percentile rankings for both margin and expenses for each participating firm.

Moving Forward

Simply put, gross margin and expenses are the name of the game in improving profitability. However, margin and expenses cannot be viewed as an either/or proposition. They must be managed simultaneously.

About the Author:
Dr. Albert D. Bates is founder and president of Profit Planning Group. His recent book, ***The Real Profit Drivers*** is the basis for this report. It is a book every C-Level manager should read. It is available in trade-paper format from Amazon.

Exhibit 1
The Relationship Between
Gross Margin and Expense Percentages