Watching Sales Growth
Go to Waste

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The last couple of years have seen distributors recover from the recession and enjoy some dramatically improved levels of sales growth. Some of that growth was the result of the acquisition of competitors weakened by the recession. However, most of the growth has been organic. The economy may not be completely back on track, but sales have increased at a reasonable pace.

Unfortunately, this sales growth has not translated into increased profits. While there was a very modest increase in dollar profits, profit growth lagged well behind sales growth across almost all of distribution during this period. Sales growth proved extremely hollow.

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

- **Profit Growth Pressure Points—**An exploration of the two key factors that were behind the lag in profitability.
- **Changing the Sales to Profit Relationship—**An identification of specific actions that firms must take to turn sales growth into profit growth.

Profit Growth Pressure Points

The profitability culprits for distributors 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 extremely small changes have a large cumulative effect on profit.

Exhibit 1 demonstrates the impact of sales growth on profit for the typical distributor. As can be seen, the firm generates $20,000,000 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 enjoy 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 total expenses all increase at the same 10.0% rate. The result is that dollar profit also increases by 10.0%. From a percent-of-revenue perspective, shown at the bottom, everything stays the same. Dollars up, but percentages flat.

The second scenario, *Profit Deterioration*, reflects the profit challenges currently facing distributors. 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 falls from the original $500,000 to $470,000, a decline of 6.0% which completely offsets the sales increase. The profit margin also declines, from the 2.5% starting point to just 2.1% of revenue. In simplest terms, even small, seemingly insignificant changes are not all that insignificant.

The final scenario, *Profit Enhancement*, 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 Profit Deterioration results. The impact is dramatic, with profit rising to $630,000, an increase of 26.0%.

In short, sales growth is nice. However, the factors underlying the sales growth are decidedly more important than the sales growth itself. The deterioration in gross margin and payroll expense performance must be reversed. If that can be achieved, the firm is positioned for strong profit result.

Changing 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 down period.

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—The total profit swing between the Profit Enhancement and Profit Deterioration scenarios in the exhibit is $160,000. Of that amount, $100,000, or 62.5% comes from gross margin.

Experience from prior periods of strong sales growth suggests that the gross margin issue is nothing more than one of focus. The sad reality is that gross margin walks out the door when strong sales growth walks in. Getting the margin focus back requires communication, analysis and emphasis on some mundane operational issues.

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 under-price their slowest selling items and special order merchandise. The improvement potential is more substantial than most firms believe.

Finally, it is also essential to deal with the pesky operational issues that are ignored when everybody is busy with growing sales volume. Pricing errors are endemic to firms with lots of SKUs. Cleaning them up creates “free” gross margin dollars. Tighter control of shrinkage also represents a significant opportunity. Neither of these topics are exciting, but both are important.

Payroll Control—The keys to payroll control are twofold. The first is euphoria. The second is an 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. In thinking about such-catch up situations, though, 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 (sometimes more correctly called adding overhead), then sales growth would be not just nice, but even more spectacular. The timing of such increases, in terms of additional sales staff, must be related directly to real sales potential, not to some vague desire for even more growth.

Moving Forward

Distributors in every line of trade are facing the challenge that sales growth is simply not translating into profit growth. It is a pattern that repeats itself every time a sluggish economy gives way to sales growth. The key for distributors is to maintain control over gross margin and payroll expenses. If that is done properly, strong profits will follow strong sales growth.

About the Author:
Dr. Albert D. Bates is founder and president of Profit Planning Group. His latest book, ***Triple Your Profit!***, is available at: www.tripleyourprofitbook.com, as well as Amazon and Barnes & Noble. It includes Excel templates for understanding the economics of the firm and planning future performance.

Exhibit 1
The Impact of 10.0% Sales Growth for a Typical Distribution Firm

Income Statement ($)	Current Results	10.0% Sales Increase: Business As Usual	10.0% Sales Increase: Profit Deterioration	10.0% Sales Increase: Profit Enhancement
Net Sales	$20,000,000	$22,000,000	$22,000,000	$22,000,000
Cost of Goods Sold	15,000,000	16,500,000	16,550,000	16,450,000
Gross Margin	5,000,000	5,500,000	5,450,000	5,550,000
Expenses				
Payroll and Fringe Benefits	3,000,000	3,300,000	3,330,000	3,270,000
All Other Expenses	1,500,000	1,650,000	1,650,000	1,650,000
Total Expenses	4,500,000	4,950,000	4,980,000	4,920,000
Profit Before Taxes	$500,000	$550,000	$470,000	$630,000
Income Statement (%)				
Net Sales	100.0	100.0	100.0	100.0
Cost of Goods Sold	75.0	75.0	75.2	74.8
Gross Margin	25.0	25.0	24.8	25.2
Expenses				
Payroll and Fringe Benefits	15.0	15.0	15.1	14.9
All Other Expenses	7.5	7.5	7.5	7.5
Total Expenses	22.5	22.5	22.6	22.4
Profit Before Taxes	2.5	2.5	2.1	2.9