Too Much of a Good Thing

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Few distributors ever say no to additional sales. Not that sales solves all problems, but sales growth is a lot more fun than sales stagnation.

As it turns out, rapid growth creates as many problems as it solves. If the firm grows too fast it will face cash flow challenges. If it grows way too fast, it will probably die from a lack of cash. Those are ominous alternatives.

The idea that sales growth can be too fast is somewhat counterintuitive. Because of that it is necessary to understand exactly how sales growth impacts the firm's financial performance. The report will do so from two perspectives:

- **The Good and Bad of Sales Growth—**A discussion of how sales growth creates financial opportunities as well as financial challenges.
- **The Growth Potential Index—**An examination of a method to identify how fast the firm can afford to grow.

The Good and Bad of Sales Growth

Exhibit 1 outlines the impact of a 15.0% sales increase for a typical distributor. In the Current column, the firm has $20,000,000 in sales and earns a profit of $500,000. To generate this profit the firm must invest $6,500,000 in total assets, much of it in accounts receivable and inventory. This is somewhat offset by $1,000,000 of supplier financing.

The second column details what 15.0% sales growth does for the firm. Some of what happens is extremely positive. Other results are negative and need to be addressed.

The income results are all positive. The firm increased its sales by 15.0% while keeping the gross margin percentage the same. Payroll expenses were controlled so that they have only increased by 13.0%. In addition, the non-payroll expenses have only increased by 10.0%. The firm is leveraging its expenses. This would be outstanding performance based upon historical results.

The bottom of the income statement shows the payoff from this. Pre-tax profit goes from $500,000 to $710,000, an increase of 42.0%. After the obligatory income taxes (30%), the firm has $497,000 to reinvest back in the business.

To review the balance sheet it is necessary to start at the bottom. All of the after-tax profit ($497,000) has been reinvested in the business, so total assets are now $6,997,000. Working up from the bottom of the balance sheet, the All Other Assets category did not increase.

However, both inventory and accounts receivable have increased by 15.0% to support the increase in sales. As far as inventory is concerned, this is what will happen inevitably, albeit slowly. For accounts receivable this increase happens automatically and instantly.

The final assets category, Cash, is what is left over after subtracting up from the bottom. In this scenario, cash falls to a negative $15,500. It is a sobering situation.

The situation is not completely dire. The firm can count on additional supplier financing because of increased purchasing to support the increased sales. This is shown at the bottom of the exhibit. The firm can also use its line of credit. The challenge is that with the deteriorating cash situation, it may be forced to do so rather than choosing to do so.

The necessity for distributors is to avoid the cash challenge in the first place. This requires understanding exactly how fast the company can grow and what it might do to overcome the potential cash predicament.

The Growth Potential Index

Understanding how fast the firm can grow necessitates looking at a slightly complicated—but extremely important—formula called the Growth Potential Index (GPI). It provides an estimate of how fast the firm can grow without using up its precious cash reserves, which are currently $200,000.

$$\frac{\text{Profit After Taxes}}{\text{Accounts Receivable} + \text{Inventory} - \text{Accounts Payable}}$$

$$=$$

$$\frac{\$350{,}000}{\$2{,}000{,}000 + \$2{,}750{,}000 - \$1{,}000{,}000}$$

$$=$$

$$9.3\%$$

The formula relates the cash coming into the business to the cash that will be needed to finance growth. In the numerator cash coming into the business is the profit the firm generates on an after-tax basis.

The denominator reflects what cash is needed for: the two investment categories that rise along with sales. Inventory will increase with sales over time. Accounts receivable will automatically increase with sales on a real-time basis. Balancing out these investment requirements is the fact that as the firm grows it will purchase more merchandise from suppliers and have more accounts payable which offsets the need for additional cash.

For the typical firm in the industry, the resulting GPI is 9.3%. The implications of this ratio are highly counterintuitive. If the firm grows faster than its GPI, it will generate more profit on the higher sales. However, as was seen in the exhibit, the amount of cash on hand will actually decline. Conversely, growing slower than the GPI reverses the outcome—profit is not as high, but cash rises.

In no way does the GPI indicate how fast the firm must grow. Firms should almost always grow fast enough to maintain their position in the market place and possibly increase their market share.

What the ratio indicates is that when the firm's sales growth projection is larger than the GPI it needs to have a specific cash-maintenance plan in place. That plan should have three components:

- **Increasing Profit—**The greater the profit, the higher the GPI for the firm. Enhancing profit should always be the first priority of the firm. This is true regardless of the opportunity for sales growth.

- **Controlling Investment Levels—**If sales can be increased without requiring a commensurate increase in inventory and accounts receivable, the GPI can also be increased. However, care must be taken as excessive controls on either inventory or accounts receivable almost always slow actual sales growth.

- **Securing Financing—**If the firm must grow beyond its capacity, it is absolutely essential to have adequate financing arranged before the funds are needed, not after.

Moving Forward

Sales growth is essential for long-term success in distribution. Every firm must continue to grow. However, if that growth is unplanned, the firm may well end up worse off than it would be with no growth.

Every firm must know exactly how fast it can grow given its existing cash position. It should then work to improve its ability to grow, largely by enhancing its profit after taxes.

About the Author: Dr. Albert D. Bates is Director of Research at the Profit Planning Group and a Principal at the Distribution Performance Project. His recent book, ***Breaking Down the Profit Barriers in Distribution*** is the basis for this report. It is a book every manager and key operating employee should read. It is available in trade-paper format from Amazon and Barnes & Noble.

Exhibit 1
The Impact of 15.0% Sales Growth
Combined with a Profit Improvement Plan
For a Typical Distributor

Income Statement	Current Results	15.0% Growth	Percent Change
Net Sales	$20,000,000	$23,000,000	15.0
Cost of Goods Sold	15,000,000	17,250,000	15.0
Gross Margin	5,000,000	5,750,000	15.0
Expenses			
Payroll and Fringe Benefits	3,000,000	3,390,000	13.0
All Other Expenses	1,500,000	1,650,000	10.0
Total Expenses	4,500,000	5,040,000	12.0
Profit Before Taxes	500,000	710,000	42.0
Income Taxes (30.0% of PBT)	150,000	213,000	42.0
Profit After Taxes	$350,000	$497,000	42.0
Partial Balance Sheet			
Cash	$200,000	-$15,500	-107.8
Accounts Receivable	2,000,000	2,300,000	15.0
Inventory	2,750,000	3,162,500	15.0
All Other Assets	1,550,000	1,550,000	0.0
Total Assets	$6,500,000	$6,997,000	7.6
Accounts Payable	$1,000,000	$1,150,000	15.0