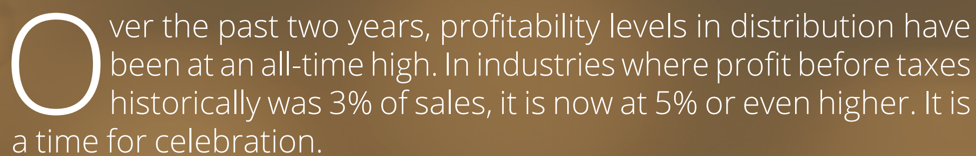
DISTRIBUTION STRATEGY GROUP

The 4 Pillars of Profit Improvement

By Dr. Albert Bates



Over the past two years, profitability levels in distribution have been at an all-time high. In industries where profit before taxes historically was 3% of sales, it is now at 5% or even higher. It is a time for celebration.

Part of the improvement is due to management actions. However, the lion's share is due to unique and highly favorable economic conditions. The challenge for distributors is to keep profit at the current high levels as the positive external factors wane. Without proper actions, profit levels seem destined to regress to the mean. In English, that means retreating back to 3%.

This report will briefly examine the key external factor that has led to higher profit. It will then focus on the actions required to maintain profit at this high level, or even higher, as economic conditions change.

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The Major Driver of High Profit

Probably the most hated economic term today is inflation. Disliked though it may be, it is also the key factor that has driven distributor profits to unprecedented levels. The impact of inflation cannot be overstated.

The exhibit below considers the impact of 10% inflation in a single year on a representative distributor organization. Before inflation, this illustrative firm generated $20 million in sales, operated on a 25% gross margin and maintained a long-term pre-tax bottom line of 3%. Absent inflation, this 3% figure is relatively constant over time.

The Impact of 10% Inflation on an Illustrative Distributor's Income Statement

Dollar Statement	**Current**	**10% Inflation**
Net Sales	$20,000,000	$22,000,000
Cost of Goods Sold	15,000,000	16,500,000
Gross Margin	5,000,000	5,500,000
Total Expenses	4,400,000	4,488,000
Profit Before Taxes	$600,000	$1,012,000

Percent of Sales		
Net Sales	100%	100%
Cost of Goods Sold	75.0	75.0
Gross Margin	25.0	25.0
Total Expenses	22.0	20.4
Profit Before Taxes	3.0	4.6

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The exhibit is based upon the actual results produced by distributors as shown in the financial benchmarking reports conducted in various lines of trade. While every line of trade is slightly different, the results reflect the performance of nearly every industry.

As can be seen, sales, cost of goods sold and gross margin all increased by 10% due to inflation. As an important note, the exhibit assumes no actual sales growth. This is done to demonstrate the impact of inflation by itself.

The reality in distribution as shown in the financial benchmarking surveys is that the expense increases associated with inflation lagged well behind the increase in sales driven by inflation. They may well catch up in the future, but in the short run, expenses did not keep pace with inflation.

For most lines of trade, the inflation-driven increase in expenses was on the order of 2%. This represents the normal expense changes of the previous few years, while there was a sudden 10% increase in sales due to inflation. But there was no real sales increase that would have driven expenses up more.

The result is that profit before taxes increased by more than 68.7%. It is a massive increase in profit, but one that has little to do with the operation of the organization. It has to do with outside factors, namely inflation.

As mentioned before, distributors have had difficulty making significant improvements in profitability. For decades, distributors have been stuck with a moderate profit of 3%.

This is not to say that distributors have stood idly by while profits stagnated. In fact, firms made incredible advances in technology and analytical tools. They continue to do so. It is simply that the changes didn't have a large impact on performance.

The underlying reason is that distribution is the most competitive sector of the American economy. As one company takes a revolutionary step forward, everyone else rushes forward to copy those steps, making it difficult to get ahead.

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It would be ideal if there were new ways to improve internal operations to actually enhance profitability. Realistically, there are no entirely new ways. Instead, there is the potential to increase profits with a new approach to planning.

The new approach should revolve around four critical ideas. For want of a better phrase, they are the four pillars of profit improvement. Some of the pillars are actually easy to achieve. Others are somewhere around a 9.9 degree of difficulty. All are attainable with proper attention, though.

The Essential Elements of Profit Planning

Virtually every distribution firm plans, of course. Most plan carefully and effectively. The unfortunate result is that, minus inflation, the majority of distributors do not improve profitability year to year. It is a 3% bottom line as far back as history has been recorded and as far ahead as the eye can see.

The underlying issue is that there are no clear guidelines for each of the items that must be planned — sales, gross margin and expenses. The result too often is that the plan for sales is to increase it as much as possible, while adding some margin and controlling expenses in any way possible.

A careful analysis of the financial benchmarking surveys conducted throughout distribution over the course of the past 30 years suggests that it is possible to set specific goals for each aspect of the plan. The same surveys suggest the goals are somewhat constant across all lines of trade. With planning, and proper implementation of course, it is possible to systematically drive higher profits.

In developing a profit plan there are four key elements, or pillars to the plan:

- **Sales:** Maintaining sales growth at a reasonable rate
- **Gross Margin:** Increasing the gross margin percentage slightly
- **Payroll Expenses:** Controlling payroll expenses in relation to sales
- **Non-payroll Expenses:** Using proper sales growth to automatically control these expenses

If each of these is systematically planned and controlled, then significant and permanent bottom-line improvements are possible. Once again, the emphasis is on possible. Easy will not enter the discussion. The paragraph below will discuss specific goals for each of these factors. As stated previously, the goals are based on an analysis of financial benchmarking studies. Alas, space limitations mean that the discussion will focus on what to do and skirt the important topic of how to do it.

Sales Growth

Inadequate sales growth leads to diminished profits, as increased expenses overcome the modest increase in sales. At the same time, excessive sales growth leads to serious cash flow issues due to higher investment in inventory and accounts receivable.

It is impossible to identify the Goldilocks level of sales growth. However, it is possible to suggest a reasonable level of sales growth that should lead to higher profit.

Ideally, sales should increase by at least the rate of inflation plus a safety factor. The inflation rate should be the projected increase in the consumer price index (CPI), not the inflation rate in the products the firm sells.

The safety factor does not represent any accounting for errors in the projection for inflation. Instead, it is a goal for the rate at which the firm's own sales — including its internal inflation — will exceed the increase in the CPI. Basically, it is the rate by which sales can lead to increased profit. The higher the goal, the greater the profit impact. While it is not written in stone, a realistic safety factor is 3%. Assuming that the anticipated CPI is 2% (possibly wishful thinking), then the addition of the 3% safety factor leads to a minimum level of sales growth of 5%.

This suggested target is not as arbitrary as it seems. Most of the non-payroll expenses tend to rise in step with the CPI. By targeting for sales growth in excess of the CPI, these non-payroll expenses should decline as a percent of sales. As they do so, profit will increase accordingly.

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Gross Margin

Improving gross margin is always an objective of any financial plan. Once again, the key issue is how much of an improvement is realistic in a competitive business. This is where an analysis of results from financial benchmarking surveys proves invaluable as a basis for such a projection.

Realistically, distributors increase the gross margin percentage — not gross margin dollars — by about 1% in a single year. This is a small, but extremely powerful change in performance.

The 1% figure needs to be understood clearly. For a firm with a gross margin of 20% of sales, the 1% improvement would be to target for an increase of 0.2% or 20.2%. Note that this is 20% times 1%, not 20% plus 1%.

For any other gross margin level, the process would be the same. For 10% gross margin commodity-oriented firms the increase would be 0.1%. For firms in high service and high-margin industries, a 40% margin would be increased by 0.4%.

In recent years a widespread belief has developed that the gross margin percentage does not matter. Instead, the gross margin dollars must be maximized. Such a belief is 100% wrong. In virtually every financial benchmarking survey in every industry, the high-profit firms have a higher gross margin percentage than the typical one. The gross margin percentage needs to be properly controlled.

Payroll Expenses

Payroll is the 500-pound gorilla lurking in the corner of the financial planning process. First and foremost, payroll is the largest expense category. In nearly every line of trade, payroll represents around two-thirds of total expenses. It also represents the most difficult expense improvement area by far.

A legitimate goal is to drive a wedge (or delta of gap) between sales growth and payroll growth. That is, sales growth would exceed payroll growth by the size of the wedge. An ideal, but exasperating goal is a 2% wedge. Again, this is based upon analysis of financial benchmarking surveys.

Quite obviously, the level of allowable payroll expense depends upon the level of sales growth target set back in step one. With a conservative sales forecast of 5% the target for payroll growth would be 3%. With 10% growth in the sales plan, the payroll growth target would be 8%.

Both options are fraught with challenges. The low sales projection leads to a low payroll growth plan which might create employee retention problems. The high sales growth plan leads to a high payroll growth plan. If sales fall short of the plan, profits evaporate. As Mark Twain so elegantly put it, "You pays your money and you takes your choices."

Non-Payroll Expenses

Nothing is a slam dunk in distribution. However, non-payroll expenses represent something akin to an uncontested layup. If sales actually grow faster than the CPI and non-payroll expenses are linked in aggregate to the CPI, then these expenses have to fall as a percent of sales. This does not mean these expenses should be blissfully ignored. Like all expenses, they need constant attention. What it does say is that the firm has a leg up on controlling these expenses if it meets its sales goal.

Putting It All Together

If the four pillars of profit improvement are combined effectively, they can dramatically improve profit. This is true for firms struggling with profit performance, firms happily in the middle, or firms that have already generated strong results.

The following exhibit demonstrates the impact for the firm identified earlier in this report. That firm had enjoyed strong profit improvement due to inflation. Without some sort of systematic action, it very well could have reverted back to 3% performance. Instead, it chose the four goals outlined here:

- **Sales Growth:** Inflation level of 2% plus 3% to reach a 5% target
- **Gross Margin:** Adding 1% to the margin percentage
- **Payroll Expenses:** Allowing payroll to only grow by 3%, producing a 2% sales-to-payroll wedge
- **Non-Payroll Expense:** Declining by 0.1% of sales due to sales growth

The Impact of 4 Performance Goals on an Illustrative Distributor's Profit Performance

Income Statement	Dollars	Percent	Dollars	Percent
Net Sales	$20,000,000	100%	$23,000,000	100%
Cost of Goods Sold	16,500,000	75.0	17,255,700	74.7
Gross Margin	5,500,000	25.0	5,844,300	25.3
Payroll and Fringes	3,000,000	13.6	3,090,000	13.4
All Other Expenses	1,488,000	6.8	1,547,700	6.7
Total Expenses	4,488,000	20.4	4,637,700	20.1
Profit Before Taxes	$1,012,000	4.6	$1,206,600	5.2

The result is that profit increases by 19.2% to reach a PBT of 5.2% of sales. This is outstanding. With effort, a distributor could repeat this performance in subsequent years.

The goals outlined may well have to be modified slightly by individual firms to adapt to unique circumstances. However, the four items outlined here should be part of any firm's financial plan moving forward.

About the Author

Dr. Albert D. Bates is a principal in the Distribution Performance Project, a research group devoted to distribution issues. His website, distperf.com, contains numerous free Excel templates that can help distributors manage their business more profitably.

He is a frequent convention speaker and is one of the highest-rated speakers at the University of Innovative Distribution. His two latest books, “Breaking Down the Profit Barriers in Distribution” and “Profit Guide for the Small Distributor” are available on Amazon.

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