

Who Produces High Profit and Why?

Understanding the Three Key Profit Variables

By Dr. Al Bates



he just completed 2007 NSSEA Retail Store Report provides the most comprehensive set of benchmarks available on financial performance in the industry. The report suggests that there continues to be major differences between the typical firm and the high-profit firm. The differences are significant for both planning and control purposes.

What High Profit Means

The typical firm in the benchmarking survey is the firm exactly in the middle of all firms in terms of its financial results. That is, half of the companies will perform better than the typical one and half will perform worse. To a certain extent, typical can be thought of as “good enough.” After all, the firm is performing as well as half of the firms. In reality, though, typical is simply not good enough.

The typical firm generates sales of \$299,250. On that sales base, it produces an operating profit of \$12,569. This means the firm produces a profit margin of 4.2% of sales. Stated somewhat differently, each \$1.00 of sales results in 4.2 cents of operating profit.

The high-profit company generates a profit margin of 10.9%. This means that with the same sales base, the high-profit organization would produce \$32,618 in operating profit.

This would give the high-profit firm an annual profit advantage of \$20,049. However, this does not tell the entire story. The high-profit company has more money available to invest in additional assets. If the additional

assets are chosen properly, they will support higher sales. On those higher sales, the firm can then produce even higher profits. It is a cycle that allows the high-profit companies to move well ahead of the typical ones. Over time, the typical firm reaches the point where it simply can’t catch up.

How to Get There

Reaching high-profit performance is a matter of identifying what is important and developing a plan to do better on those factors. In common parlance, the items that are important are called the critical profit variables (CPVs). The CPVs are outlined in Exhibit 1 with specific information on the results produced by both the typical and high-profit firm.

When considering Exhibit 1, it is important to note that no single business produces superior results on every single CPV. The successful firms are those that can combine the CPVs in a way that maximizes overall profitability.

All of the CPVs have the potential to be important for any given firm. However, in industry after industry, two factors stand out as being the most important. These are gross margin and payroll expenses. Firms that can successfully control these items have a major financial advantage.

- **Gross Margin**—The ability to generate an adequate gross margin continues to be one of the major determinants of profitability. While the high-profit firm does not necessarily have a higher gross margin every year, it consistently has a higher gross margin over the long term. The pressures on gross margin, from both suppliers and customers, are not going to diminish. However, financial success necessitates producing small systematic improvements in the gross margin percentage every year.
- **Payroll Expenses**—Payroll is by far the most important expense factor, which means that controlling Salaries & Wages is essential to controlling operating expenses. In recent years payroll has replaced gross margin as the single most important driver of profitability as payroll expenses continue to increase relentlessly.

One of the major challenges facing NSSEA retailers is the pressure to expand the services provided to customers. Unfortunately, this increase in service, which also increases payroll costs, has not necessarily resulted in higher sales volumes. Of all the CPVs, Salaries & Wages are probably the most difficult to bring back into line.

Firms that can control gross margin
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Exhibit 1
The Critical Profit Variables

	Typical	High Profit
Net Sales	\$299,250	\$299,250
Operating Profit	\$12,569	\$32,618
Gross Margin (% sales)	46.7%	49.8%
Salaries, Wages & Bonuses (% sales)	17.6%	13.3%
Non-Payroll Expenses (% sales)	24.9%	25.6%
Inventory Turnover (times)	2.8	3.0

FIRMS THAT CAN CONTROL GROSS MARGIN AND PAYROLL ARE MUCH MORE LIKELY TO GENERATE HIGH PROFITS THAN THOSE THAT DO NOT.

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and payroll are much more likely to generate higher profits than those that do not. The other CPVs represent opportunities to fine-tune the business. They are important, but secondary to the big two identified above.

- **Non-Payroll Expenses**—In analyzing non-payroll expenses, companies typically measure them as a percent of sales. In most instances, non-payroll expenses need only minor adjustments. Unfortunately, there are numerous areas within the firm that need to be examined. Controlling non-payroll expenses will probably always involve examining every expense category with the hope of making modest improvements in a number of different areas.
- **Inventory Turnover**—The rate of inventory turnover has a dramatic impact on cash flow. As a result, it has been a major area of concern for the last several years. An annual goal of most firms is to generate at least a modest rate of sales growth. However, if that growth is to be maintained without running out of cash, then inventory turnover must be improved, at least slightly. For most businesses that slight increase in turnover will be enough to ensure financial integrity.

it should be remembered in reviewing Exhibit 1, that the high-profit company is far from perfect. Individual firms may far outperform the high-profit firm on individual factors. What the high-profit firm does is put together a set of CPVs that results in greater profitability. It is a pattern that every firm should use as a role model.

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