When the Going Gets Tough,
The Tough Still Produce a Profit

For most firms, 2008 qualifies as a year to file and forget. The financial results for recession years, however, offer some extremely valuable insights into what distinguishes the outstanding firm from the more typical firm. An analysis of the results for 2008, therefore, can be very insightful.

The recently completed **2009 GAWDA** financial benchmarking study provides detailed financial and operating benchmarks for the industry. It indicates that many firms struggled to some extent. Some firms, however, continued to prosper despite sales and margin pressures. The differences between the typical firm and the high-profit firm are significant.

Typical Versus High Profit

The typical firm in the survey is the firm with a financial result in the exact middle of the financial results for all participating firms. That is, half of the firms performed better than the typical firm and half performed worse.

The typical firm generates sales of $17,195,552. On that sales base, it produces a pre-tax profit of $1,031,733. This means the firm produces a profit margin of 6.0% of sales. Stated somewhat differently, every $1.00 of sales results in 6.0 cents of profit.

Most firms tend to produce results that are relatively close to the typical firm’s results. The challenge, especially in troubled economic times, is that being typical is not good enough. To see why, it is useful to compare typical and high-profit results.

The high-profit firm, operating with the exact same set of economic and competitive challenges, generates a profit margin of 10.6%. This means that even if the high-profit firm had the same sales as the typical firm, it would generate more profit for reinvestment in the firm allowing it to produce even more sales and profit. This is an on-going advantage which is magnified over time. It is an advantage which becomes magnified in tougher economic times.

The Route to High Profit

In good economic times, firms have the advantage of a strong sales tail wind. To a certain extent, this advantage provides firms with a margin for error. They can rely on sales growth to overcome poorly managed financial aspects of the business to remain profitable. In tougher time, profits are much more problematic.

In tougher economic times, reaching high-profit performance is a matter of identifying what is most important to achieve profit and developing a plan to perform better in those areas. While other factors cannot be forgotten, they are given a strong dose of benign neglect. In benchmarking terms, the important items are called the critical profit variables (CPVs).

The CPV results for this study for the typical firm and high-profit firm are summarized in exhibit 1.

The Critical Profit Variables		
	Typical	**High Profit**
Performance Results		
Net Sales	$17,195,552	$32,294,256
Profit Margin (pre-tax)	6.0%	10.6%
The Critical Profit Variables		
Sales Change	7.3%	8.8%
Gross Margin	44.2%	45.4%
Payroll Expense	23.7%	21.9%
Non-Payroll Expenses	14.5%	12.8%

Exhibit 1

One caution is always in order when comparing typical and high-profit firms. No firm produces superior results for every single CPV in good times or bad. It is simply not possible. Successful firms combine CPV performance in ways that maximize overall profitability.

Planning

In planning CPV goals in a soft market, four factors have the greatest potential impact on profit. These must be the center of planning attention. These factors are sales growth, gross margin, payroll expenses and non-payroll expenses.

You will notice that these factors are all from the income statement rather than the balance sheet. This does not mean that balance sheet factors such as accounts receivable, inventory and fixed assets should be ignored. It is just that the profit pressures associated with recession tend to make them secondary concerns.

Firms that successfully control these four critical factors have a major financial advantage in slow times which tends to carry over into good times.

- **Sales Growth**

Clearly, sales growth is a precious commodity in a sluggish economy. But to a large degree, the need for rapid sales growth has been overstated. It is possible to increase profits with slow growth. The real challenge occurs when growth becomes negative making profit improvement impossible.

Managers need to stop thinking about sales growth in absolute terms. Rather than targeting 5% growth, for example, they should focus on relative sales growth in relationship to expense growth. Ideally, firms should target sales increases somewhere between one to two percent *faster* than operating expenses. If they do, profits will improve. This is a realistic objective for most firms even in slow-growth markets.

- **Gross Margin**

The ability to generate adequate gross margin continues to be a major determinant of profitability. Financial success over the long term demands strong gross margin performance. In periods of slow growth, there are intense pressures on gross margin but most firms can still find opportunities for significant margin enhancement.

- **Payroll Expenses**

Payroll is by far the most important expense factor, which means that controlling payroll is essential to controlling expenses. In recent years payroll has rivaled gross margin in importance as a driver of profitability. This is because payroll expenses, especially fringe benefit components, have increased relentlessly in both good times and bad.

- **Non-Payroll**

Most non-payroll expenses usually require only minor adjustment. Unfortunately, numerous expense categories must be examined and adjusted. Controlling non-payroll expenses will probably always involve examining every expense category with a goal of making modest improvements in a number of different areas.

Nobody ever claimed that managing in a sluggish economy was easy. The economy's impact on performance, however, can be minimized with proper for planning and control.