GETTING INTO A GROSS MARGIN STATE OF MIND

BY JASON BADER, PRINCIPAL - THE DISTRIBUTION TEAM

THE DISTRIBUTION TEAM

When I walk around conventions I generally hear conversations regarding how the business climate is going. I hear a lot of talk about how sales are up or sales are down. In good years, there is a bit of chest puffing and general peacock behavior. In the down years, there is a whole lot of blame on the economy and other external forces. What I don't hear is a whole lot of discussion about profit or profitability. Sure, you might hear some comments about dwindling margins; but when was the last time you heard someone talk about success in terms of gross margin dollars? Isn't that what is really important? If I can draw a correlation to a golf analogy "drive for show, putt for dough", aren't top line sales really just for show?

At a very young age, working in my family distributorship, the importance of gross margin dollars was drilled into my head. We occasionally talked about sales when it came to an extraordinary order, but the next question out of every mouth was – how did we do on it? In other words, did we make any gross margin on it or are we nurturing our charitable side? I think this awareness of gross margin came from an open attitude regarding financials and how income worked in the company. When your team understands how we pay for the operation of the company, gross margin begins to take on a whole new meaning. My brother and I spoke about this recently and he agreed. As the president of the company, he is the only one allowed to talk about top line sales. It only becomes relevant when speaking with banking partners, accountants or legal advisors.

I am currently working with a client on changing the mindset from top line sales to gross margin dollars. Eventually, we will drive down to net profit; but for today, we need to start with the basic concept of gross margin importance. Part of the process had to begin with the owner. He freely admits that he falls into the gross sales trap. It's a big number. It's fun to talk about. It just doesn't do him a whole lot of good. When you want to change the mindset of the people that work with you and for you, it is important to talk the talk.

The transformation with this client began with education. With the help of the owner, we gathered the team and discussed how the income statement worked. Although I had a basic income statement generated, based on actual year end numbers, we needed to make sure they understood the concept. When I discuss income statements in any teaching setting, I typically use the dollar bill trick to get the point across. For those of you who haven't seen this done, here is the quick and dirty: Hold up a dollar and tell the group that we just sold something for a dollar and we paid the supplier 75 cents for it. Tear off about ¾ of the bill and drop it on the floor. By the way, if you use a larger denomination, you will really get their attention. Holding the remaining ¼ of the bill, you explain that this represents gross margin. At this point, I ask the group if the owner of the company gets to put the gross margin in their back pocket at the end of the month. I usually see a shaking of the heads, but I would bet that there are a few that might believe this to be true. Sad but true, many people that work with you and for you believe that the owner pockets the gross margin dollars every month. Obviously, this isn't the case. I then start asking about the expenses that come out of the gross margin before it becomes net profit. While they list off some items (wages, benefits, rent, utilities, etc), I am consistently ripping off bits of the bill and dropping it on the floor. I also make comments on each of the expense items and help them come up with a few they might have overlooked. Ultimately, you wind up with a very small chunk representing net profit. This leads to a discussion of the importance of gross and net profit. This demonstration is a great way to start changing the mindset.

Once the team understood how the income flowed, we talked about the income statement of the location. We talked about how a slight improvement in gross margin would really change the net profit picture in the company. The next step in changing the mindset was to create gross profit goals in the company. We started with the least profitable location and developed a daily gross margin goal based on the current expenses for the location. We bumped it up a bit in order to foster some downstream profitability. By creating a daily gross margin goal, we provide a constant reminder of what we want to accomplish. In this case, we came up with a goal and then created a simple feedback method designed to show the location how they were doing. Each day, the branch manager reviews the sales report from the previous day and writes the gross margin dollar total for the day on a wall calendar in his office. For those of you beginning to twitch in your seats, the number has no dollar designation or decimal points. In order to tie the number in with our goal, the number is either written in black pen (for gross margin dollars exceeding the goal) or red pen (for gross margin dollars below goal). The calendar is visible to the employees because you have to walk through the manager's office to get to the refrigerator. It doesn't get much simpler than this.

One of the ways to make sure that we are driving a gross margin mentality is to insure that the sales compensation methodology supports our efforts. What are you basing sales compensation on? If the commission is a percentage of gross sales dollars, you are going to have a difficult time changing the mentality. Although many of you have created compensation plans based on gross margin, there are still a few hold outs. I often see this in companies where cost is not shared with the sales team. This type of scheme can also be found in companies where deviation from established sales pricing is rare or non-existent. I hate to say it, but both of these scenarios lead me to believe that there are some real control issues in the executive team. When you don't empower your people to do their job, your potential is severely retarded.

When we put an emphasis on gross margin with our sales team, there may be a shift in product focus. Hopefully, we will see a greater interest in higher profit products. Even when a low profit product is sold, there will be more incentive to round out the sale with complimentary high margin products. A swift way to emphasize margin importance is to modify sales compensation. I recently had the opportunity to meet the CEO of Fastenal, Will Oberton. For those of you unfamiliar with the company, they are a multi-billion dollar industrial fastener and supply distributor boasting over 20 percent net profit before taxes. In the words of my father, that's some pretty tall cotton. He was speaking at an event that I was involved with and I sat in on his presentation. He spoke about a bold program that he recently instituted with their sales compensation. Essentially, if a sales order posted less than 20 percent gross margin, the order was not eligible for commission. As you can probably imagine, this caused a huge ruckus in the sales department. Some of his regional managers were very vocal in their opposition. Oberton held his ground. He stated, "If the company can't make money on the sale, why am I going to pay the sales person?" The results worked in his favor. By the end of the year, their overall margins had improved and some of the most vocal opponents said that it was the best thing they had done in years.

A gross margin mentality can also have an effect on your accounts receivable performance. I was recently discussing the benefits of moving to a gross margin focus with a different client of mine. He is in the plywood and shop supply business. There had been some recent focus on driving the sheet goods product category in order to boost sales. This is a high sales dollar, low margin category. In the past, the perceived performance of the company was tied to top line sales. He pointed out that this mentality was really making collections difficult. He explained that a $2000 sheet goods sale might generate $140 in gross margin while a $300 sand paper order might generate that same $140 in gross margin. When it came time to collect on that order, which bill is your customer more likely to pay in a timely fashion? It sure made a lot of sense to me.

In a recent article, Tips to Improve Gross Margins, I shared several ways to boost gross margin percentages without bringing the hammer down on your suppliers. I was recently reminded of another way to preserve diminishing margins. One of the regional managers in my family business used to talk about pricing strategies inside sales people could use when confronted with a price objection. The natural reaction when discounting is to think in increments of 5 – such as 5% off or 10% off. If you are forced into a discount, try to think in terms of a 3% discount or 7% discount. Those additional 2 or 3 points can really add up at the end of the month.

Once the gross margin mentality has begun to seep into the daily lexicon of your employees, you can cement the transformation by using it to measure performance. I am a huge advocate of metrics using gross margin as a basis. The first one that comes to mind is the gross margin dollars per head measurement. Once a manager has established a goal, staffing decisions become easier. The same regional manager mentioned earlier had a benchmark of $10,500 gross margin dollars per head on a monthly basis. If the gross margin dollars began to trend up, and the per head figure was rising significantly, he knew that it was time to add a body. If the gross margin dollars were diminishing, he knew when it was time to make cuts.

For those of you familiar with my work, you know that I am a huge advocate of GMROII or gross margin return on inventory investment. This metric tells us how many gross margin dollars we expect to earn for every dollar invested in inventory. By understanding where we achieve the highest returns, we can alter our sales direction. We can also use this information to identify lines where changes in pricing and replenishment should occur. Since gross margin dollars drive the operation, it is in our best interest to drive the highest return.

Adopting a gross margin state of mind is not an overnight task. It will take months of education and reform. Old habits die hard and you will find yourself falling back on the top line sales verbiage. Catch yourself and keep driving to change your own mentality. Open dialogue with your team, setting short term profit goals and establishing margin based performance standards will help you make the shift. Just remember – sales are for show, gross margins are for dough. Good luck and I am always here to help..

About the Author:
Jason Bader is the principal of The Distribution Team. He is a holistic distribution advisor who is passionate about helping business owners solve challenges, generate wealth and achieve personal goals. He can be found speaking at several industry events throughout the year, providing executive coaching services to private clients and letting his thoughts be known in an industry publication or two. He recently launched his first podcast, Distribution Talk. Episodes can be found at www.distributiontalk.com. He can be reached at (503) 282-2333 or via email at jason@distributionteam.com. You can find additional resources on his website: www.thedistributionteam.com