

DIRECTORS' BRIEFING



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Increasing profitability

● Few people are in a position to sit back and watch the profits roll in. Creating and increasing profitability depends on doing a hundred little things better than the competition.

If you are lucky, a single change could provide an immediate boost to your profitability. More often, you will need to put the right building blocks in place to provide the framework for gradual, but continuous, improvements.

This briefing outlines:

- ◆ The best opportunities to increase your profitability directly.
- ◆ How to create a framework for increasing profitability.

1 The main chance

The best opportunities for increasing profitability vary from business to business.

- A** For many businesses, the best way to improve profitability is to **increase turnover** (see **2**).
- ◆ If you have a high gross profit margin, every sale is highly profitable.
Once your turnover reaches breakeven, profits will increase rapidly.
 - ◆ Reaching critical mass creates a virtuous circle.
Acquiring new customers is made easier by your market presence and reputation, and unit costs are reduced through economies of scale.
 - ◆ If your customers tend to be loyal, the value of each new customer lies not just in the immediate sale, but in future sales as well.

The cost of selling to existing customers is almost always lower than the cost of acquiring new customers.

- ◆ Defending a high market share against competitors is easier than defending high profit margins.

Focusing exclusively on margins is a common mistake. But so too is an over emphasis on turnover. Keep a sensible balance.

- B** For most businesses, the easiest way to increase profitability is to **reduce costs** (see **3**).
- ◆ If you have a low gross profit margin, reducing direct costs dramatically increases the profit on each sale.
 - ◆ Eliminating unnecessary overheads has an

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immediate impact on the bottom line.

- C** Every business can increase profitability by reducing **hidden costs** (see **4**).
- ◆ Small, young businesses and mature, stagnant businesses are particularly susceptible to hidden costs.
- D** Every business can increase profitability by creating an appropriate **framework**. This will help you to:
- ◆ Focus on profitability (see **5**).
 - ◆ Make the most of your employees (see **6**).
 - ◆ Manage for continuous improvement (see **7**).
 - ◆ Increase or optimise prices (see **Pricing**, MA 8).

2 Increasing turnover

- A** Focus on a **niche market**. (See **Planning your marketing**, MA 5.)
- ◆ Understand this market.
 - ◆ Segment your target market, so you can fine-tune what you offer.
- B** Invest resources in increasing sales **volume**.
- ◆ Use advertising and other promotional techniques, such as seminars and exhibitions. (See **Advertising strategy**,

MA 9, and **Exhibitions**, MA 2.)

- ◆ Actively sell. Do not just take orders. (See **Selling technique**, SE 2, and **Negotiating a sale**, SE 1.)
- ◆ Retain existing customers. (See **Building customer loyalty**, MA 4.)
- ◆ If appropriate, extend your product range (but see **5C**).

Review your credit limits if sales to a particular customer go up significantly and consider a credit check. You could be left in the lurch if the customer goes bust while owing you money.

- C** Maximise the **value** of your sales.
- ◆ Consider moving upmarket and providing a premium product and service. Add features to products if the perceived value to the user is greater than the cost to you.
 - ◆ Charge a full price. Get value from the extras you provide. (See **Pricing**, MA 8.)
 - ◆ Keep your product or service up to date. If possible, make sure it stays ahead of the competition. (See **Innovation**, ST 14.)
 - ◆ Compare price and quality with a competing product.
- D** Focus your efforts on your most **profitable customers**. Target customers who:
- ◆ Place large or frequent orders.
 - ◆ Pay the full price, on time.
 - ◆ Are low maintenance.
- Adjust your sales mix to favour your most profitable products (see box).

Aim for sustainable growth. See **Creating a valuable business**, ST 17.

3 Reducing costs

- A** Minimise **direct costs**, such as the purchase of raw materials.
- ◆ Specify supplies of the right quality and minimise wastage. Periodically compare suppliers. (See **Purchasing**, PU 2.)
 - ◆ Negotiate good prices. (See **Negotiating a purchase**, PU 1.)
 - ◆ Involve the person responsible for purchasing in product development to help reduce costs.
- B** Eliminate unnecessary costs to cut **overheads**. For example:
- ◆ Keep all costs under constant review. They tend to escalate if left alone.

"Some products are not price-elastic. For example, newsagents cannot raise the price of a newspaper. So they must look to increase turnover on other, high-margin products, such as chocolates."

Derek Lemay,
Baker Tilly

"Drop poor customers as they can consume a disproportionate amount of your efforts."

Andrew Jardine,
Atlantic Industries

"Constantly review costs. Make every penny count. But never be excessively mean or penny-pinching."

David Price,
Cosyfeet

The sales menu

Businesses which offer a menu of products can use a simple technique to improve overall profitability. Sales and profit margins are reviewed periodically, and products (menu items) are divided into four categories.

- A High percentage of sales and high profit margins.**
- ◆ Nurture these stars.
- B High percentage of sales but low profit margins.**
- ◆ Consider a price increase.
- C Low percentage of sales but high profit margins.**
- ◆ Consider a sales push.
- D Low percentage of sales and low profit margins.**
- ◆ Eliminate these dogs.

Take into account any knock-on effects before making decisions. For example, a 'dog' product might be the one which brings all the business from a major, highly profitable customer.

For example, check your energy usage regularly. If you are accidentally leaving equipment on overnight, it is better to find out now than when the bill arrives.

- ◆ Check that you are on the best tariff for all the utilities.
- ◆ Negotiate lower bank charges.
- ◆ Ask a different broker to conduct a review of your insurance.

The best way to reduce overheads can be to improve systems (see 4).

C Maximise the cost-effectiveness of **assets**.

- ◆ Base purchase decisions on lifetime costs. For example, the lifetime costs of a photocopier will depend on the cost per copy.
- ◆ The hidden costs of inappropriate equipment can be substantial (see 4E).
- ◆ Your human assets are crucial (see 6). Make sure you are using your employees effectively.
- ◆ Identify surplus space in your premises and consider sub-letting it.

See **Cost control**, ST 2.

4 Hidden costs

Few people would dream of running a production line where every item was made differently, and without the right tools. The effect on efficiency and quality would be disastrous. But in far too many cases, that is exactly how other parts of the business are managed.

Costs and costs and costs

The costs of not having effective systems and policies go on and on. For example, suppose you do your recruitment on an ad hoc basis. Employing the wrong person can be costly.

- A** The manager **wastes time** working out how to recruit.
- B** The process of recruitment is **less effective**, so you end up with a less than ideal recruit.
- C** Because of the employee's poor quality, you have to spend more on **training**.
- D** The employee still makes **mistakes**, with a knock-on effect on your business.
- E** Eventually, the employee **leaves** or is dismissed, so you have to start again.

A Create **systems** (eg procedures and methods) where possible. They will help you minimise errors and reduce time and money wasted fire-fighting.

- ◆ Time invested in creating systems is usually minimal compared to that spent solving a problem from scratch, and has a lasting effect.
- ◆ Systems are a vital part of quality control.
- ◆ Put checks in place to ensure that employees continue to follow systems. Never assume they are doing so.

Systems can improve every area of your business. The costs of not having them can be high (see box).

B Where appropriate, turn decisions into **policies** to avoid having to make the same decision again.

- ◆ Communicate your policies in writing to make them more effective.

C Keep systems and policies **simple**.

- ◆ Build systems from common components and apply them across the company. They will be easier to use and improve.
- ◆ Avoid overloading employees by creating too many systems or policies, or by making them excessively complex. They will waste time or be ignored.

D **Learn** from mistakes and problem areas.

- ◆ If systems go wrong, fix them. In any case, review systems periodically to see where improvements can be made.
- ◆ If policies have unwanted side effects, change them.
- ◆ If regular tasks are time-consuming, investigate how you can improve matters. Finding information is a common time-waster. (See **Filing and record management**, ST 15.)
- ◆ Prioritise systems in areas where costs, or the costs of mistakes, are high.

E Use labour-saving **equipment** to reduce costs and errors substantially.

- ◆ Information technology is a powerful way of improving efficiency and controlling processes.

F Be **decisive**, but think first.

- ◆ Putting off decisions, once you have the information you need, wastes time and delays progress.
- ◆ Indecisive leadership demoralises employees. (See **Leadership**, HR 12.)

"Those who consult before making a decision are more likely to be right, and the decision is more likely to stick."

Nick Roadnight,
Tellus

"Lots of companies only invoice customers at the end of the month. But if you want to give your cashflow a boost, send out your invoices as soon as you can."

Brian Hayden,
Hayden Associates

"It is the well-run companies that are the profitable ones. That is why venture capitalists back management teams, rather than products."

Rachel Murphy,
Alchemy

DIRECTORS'
BRIEFING

BRIEFING ST 16

5 Focus

- A** Simply focusing management **awareness** on profitability can have a dramatic impact.
- ◆ Even if cashflow is your top priority, this need not be at the expense of profitability.
 - ◆ Make sure all your employees are aware of the importance of profitability.
In particular, ensure that sales people focus on making profitable sales (rather than just pushing through volume).
- B** Understand the **key drivers** of profitability.
- ◆ Set and monitor performance indicators.
The three most commonly used key performance indicators are sales against budgets, gross margin and staff costs.
See **Key performance indicators**, ST 12.
 - ◆ Make sure they are the right indicators.
Staff tend to work towards them whether they are good for the business or not.
- C** Minimise the effect of **distractions**.
- ◆ Avoid unprofitable distractions.
For example, one-off projects that do not play to the company's strengths or contribute towards its strategic goals, or individuals' pet projects.
 - ◆ When managers must be distracted (for example, if you plan to float your company), act to control the impact.
You might nominate one individual to take charge or pay an outside consultant to free up staff and give an objective view.

6 Personnel

- A** Create an **effective team**.
- ◆ Recruit talented people. (See **Recruitment**, HR 34, and **Interviewing**, HR 3.)
 - ◆ Train them. (See **Using training effectively**, HR 28.)
 - ◆ Motivate them. (See **Leadership**, HR 12, **Motivating employees**, HR 27, and **Teambuilding**, HR 31.)
 - ◆ Monitor and measure their performance and productivity. (See **Performance appraisals**, HR 10.)
 - ◆ Think how you will allocate staff during peak sales periods.
- B** Create a **working environment** that maximises profitability.
- ◆ Reduce distractions (eg interruptions, unnecessary paperwork).

- C** Give employees the **support** they need.
- ◆ Provide effective equipment, especially communications.
 - ◆ Provide good support systems, especially information.
 - ◆ Get senior staff to delegate simple tasks more junior staff could do just as well.
- D** **Reward** your employees.
- ◆ Give appropriate remuneration by linking pay to effectiveness (see **Remuneration**, HR 26, and **Incentive pay**, HR 11).
 - ◆ Provide career progression.
 - ◆ Praise and thank staff when it is due.

7 Continuous improvement

- A** A simple **planning** cycle vastly enhances your ability to make continuous improvements.
- ◆ Base your plans on accurate information.
 - ◆ Consult, to improve the quality of your information and to involve employees or other key people in your decisions.
 - ◆ Set measurable, time-limited targets.
 - ◆ Monitor the effectiveness with which your plans are implemented.
 - ◆ Review what you have achieved.
Good planning also helps you to anticipate problems and adapt as things change.
- B** **Learn** from experience and make continuous improvements.
- ◆ Keep improving underlying systems and the planning process itself.
 - ◆ Be ready to alter your strategy if necessary.
- C** Apply lessons **company-wide**.
- ◆ Set up systems that encourage communication.
Agree action programmes that set out who is going to do what, and by when.
 - ◆ Benchmarking different parts of the business against each other can be a useful way of sharing best practice. (See **Benchmarking**, ST 4.)
 - ◆ Improve communications with your customers and suppliers. Your customers will be aware of any problems and can tell you what you need to improve.
Avoiding customers you know have problems may simply make matters worse.
In turn, your expertise may help them solve a problem they did not even know existed.

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BRIEFING ST 16