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May 2020 - In This Issue:

LOW OR INCONSISTENT GROSS MARGINS

MAY 2020 THINGS... By John Zoellner

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By John Zoellner, BCA, MCMEA

I'm pretty much done listening to reports from Governors, the President and others with their prognostications about US Businesses as we deal with the effects of coronavirus. Why you might ask? For me it is about what to rely on, to believe, and how to proceed in a way that's most likely to be positive.

I'm reminded of a certain Mark Twain quote: "Get your facts first, then you can distort them as you please." I've little confidence in what are *portrayed* as **"facts"**. Another quote attributed to Mark Twain, although it was attributed earlier to others, is "Lies, damn lies, and statistics". Are we getting accurate information? And how is it being received, interpreted and applied? The **"applied"** part is most concerning to me.

In the world of business, we often hear about projections and forecasts. A **Projection** is defined as a prediction or estimate of

Low Or Inconsistent Gross Margins

Low or Inconsistent Gross Margins When Selling a Business

Most of the time, Inadequate Seller's Discretionary Earnings (SDE) in a small business is due to one of two reasons: (1) Low or Inconsistent Gross Margins; and/or (2) Inadequate Marketing and Sales Efforts. In many cases, it is a combination of both.

Low or Inconsistent Gross Margins

If an owner is dedicated to maintaining a strong gross margin, the company's financial statements will show a consistent (or increasing) percentage of gross margin from year to year.

An example of a $3,000,000 increase in business valuation by increasing gross margins

Let's look at a real life example of the effects of a low gross margin for a company that has 25 employees and about $1,000,000 in overhead:

Sales	15,000 units@ $167		$2,500,000
Cost of Goods Sold	15,000 units @ $100	60%	$(1,500,000)
Gross Margin	15,000 units @ $67	40%	$1,000,000
Overhead	(1,000,000)		$(1,000,000)
Net Profit			**$0**

Value of business: minimal or not saleable at all

something in the future, based on present data or trends. **Forecast** definition is to calculate or predict some future event or condition usually as a result of study and analysis of available pertinent data. Note an "estimate" - it could happen - versus a "prediction" - it will happen.

Businesses are dealing with coronavirus in various ways such as closure, changing their way of doing business, sanitizing requirements, social distancing, wearing protective masks and shields, etc. We are beginning to hopefully head back toward what we previously considered "normal". The return for the most part is related to using present and pertinent data to make decisions about how to get back toward normal; virtually no one is saying it will be the normal we previously experienced. To the best of my knowledge there has never been an event that literally shut down businesses, houses of worship, and sports that dramatically changed things like coronavirus has done. As a result, there definitely will be a "new normal".

Business owners are being asked to do things that may or may not bring good results. Each of us should look at our business and evaluate to the best of our ability how to move forward. We should be asking ourselves, "Do we have sufficient and reliable information to make informed decisions about moving forward?" Maybe we already do, but it's often not what information we have but what we don't have that could change the decisions we make. Have ideas and formats to go forward been discussed and various outcomes

Over a period of time, the owner decided to increase his gross margins by raising selling prices. It was uncomfortable for his salespeople, but he stuck to his guns and over five years raised his prices by 28%. (The original sale price was $167, and at the end of the five-year period that same $100 product was being sold for $215.) Here's what happened:

Sales	15,000 units @ $215		$3,225,000
Cost of Goods Sold	15,000 units @ $100	46.5%	$(1,500,000)
Gross Margin	15,000 units @ $115	53.5%	$1,725,000
Overhead			$1,000,000
Net Profit			**$ 725,000**

Value of business: almost $3,000,000

Over a five-year timeframe, the Seller increased the value of his company by almost $3,000,000!!! He cashed out and, in retirement, he is very happy.

I've personally participated in the above scenario, though the example has been simplified. It was not a single product company. It's just easier to understand an example of the effects of a conscious effort to raise gross margins by using a single product company.

Losing low-margin customers can be a good thing

For whatever reason, in my experience, most small business owners are not paying nearly enough attention to their gross margin line. Nothing can increase profitability more than a determined effort to increase the percentage made on each sale. Most organizations underestimate their overhead expenses and the value being provided to their customers. The majority of small businesses are afraid to raise margins for fear of losing customers. It's the easy, laid-back way to sell a product or service, but does not maximize profit. If you're only making the easy sales and not pushing your margins to the max, it will not reflect well on your bottom line. Some customer turnover can be a good thing. Sometimes you need to trade a marginally profitable customer for a better customer. Losing a marginal customer to a price increase forces you to look for the new customer.

Commit to increasing your gross margins

(***projections***) evaluated before proceeding? Let's hope so
An outsider's point of view is always beneficial - no prejudice of the past as it relates to the future. We have been advising business owners for literally decades, and are available to meet and discuss issues, options, and possible outcomes - all from an outsider's point of view. Please contact us - no obligation, just a chance to discuss your specific situation.

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If an owner is dedicated to maintaining a strong gross margin, the company's financial statements will show a consistent (or increasing) percentage of gross margin from year to year. But in my experience in evaluating businesses, more often than not I saw inconsistent or decreasing levels of gross margin. Simply stated, small business owners typically are not paying enough attention to that aspect of their business.

NEXT ISSUE

Inadequate Sales & Marketing Initiatives

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