

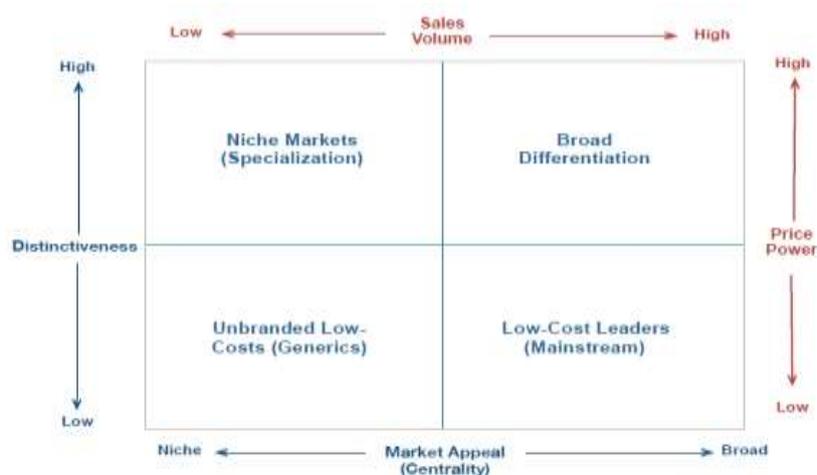
Critical Factors to Improving Profitability

For most SME businesses, profit improvement is one of their top 3 priorities. It is vital that business owners and managers understand the drivers of profit, as well as the connection between profitability and cash flow. Profitability is affected by sales and reducing costs. Within sales there are 3 critical areas: price, volume and customers. Each of these is connected and affects sales in different ways.

There are further ways to increase your profitability through monitoring and reviewing your business fixed and variable expenses and also your supplier management (your supply chain).

Price

To improve profitability and performance, price sets the scene. It will determine the volume of sales and ultimately attract different types of customers.



A Distinctiveness-Centrality map gives you two dimensions to move your market positioning strategy around

The most obvious part of profitability is the selling price. It is essential when determining the price to ensure that the price and sales volume allow the business to be profitable. **It is therefore, good practice to also review prices regularly and this is even more critical in this inflationary and supply chain disrupted economic environment.**

There are many factors that you need to consider when setting prices, for example, the balance of pricing across the product range. You may have a loss-leader (this is a product that makes little or no profit), which can be offset by other profitable products. Pricing should also consider the level of competition and relative pricing – reflecting the position you wish to take in your market segment.

When offering a discount to a customer, always remember that the discount may increase sales volume, but it will also eat into the profitability of the products. You should record all discounts and review them regularly - **and ideally eliminate discounting as a general practice**. More importantly, given the economy has entered an inflationary environment - businesses should be considering appropriate price increases. **The impacts of both price reductions and increases are illustrated in the tables below.**

The amount that sales can fall (%) before total gross profit reduces

Current Gross Profit %		10	15	20	25	30	35	40	50
Price Increase %	2	17	12	9	7	6	5	5	4
	3	23	17	13	11	9	8	7	6
	4	29	21	17	14	12	10	9	7
	5	33	25	20	17	14	12	11	9
	10	50	40	33	29	25	22	20	17
	15	60	50	43	37	33	30	27	23

The amount that sales must rise (%) before total gross profit increases

Current Gross Profit %		10	15	20	25	30	35	40	50
Price Reduction %	2	25	15	11	9	7	6	5	4
	3	43	25	18	14	11	9	8	6
	4	67	36	25	19	15	13	11	9
	5	100	50	33	25	20	17	14	11
	10		200	100	67	50	40	33	25
	15			300	150	100	75	60	43

There are two ways in which you can monitor pricing: gross profit margin and mark up. These can be linked through to your pricing strategy. Monitoring both will allow you to make sure they are both in line with the pricing strategy and make changes when necessary:

- Always review your gross and net margins against previous periods;
- Understand customer profitability for each customer and their behaviours;
- Eliminate discounting if possible;
- Implement and review a mark-up policy – this will ensure that you are in line with the policy;
- Analyse sales on a regular basis; and
- Use key financial indicators to identify any anomalies that may impact the sales price:

- (a) Cost of goods sold margin;
- (b) Gross margin;
- (c) Average stock turnover; and
- (d) Mark-up.

For a copy of Business Australia's "Pricing Strategy in Six Steps" document, please click on the link [HERE](#).

Sales Volume

There are two ways in which volume can be increase. The first is through increasing your current level of sales with your existing customers, and the other is sourcing new clients.

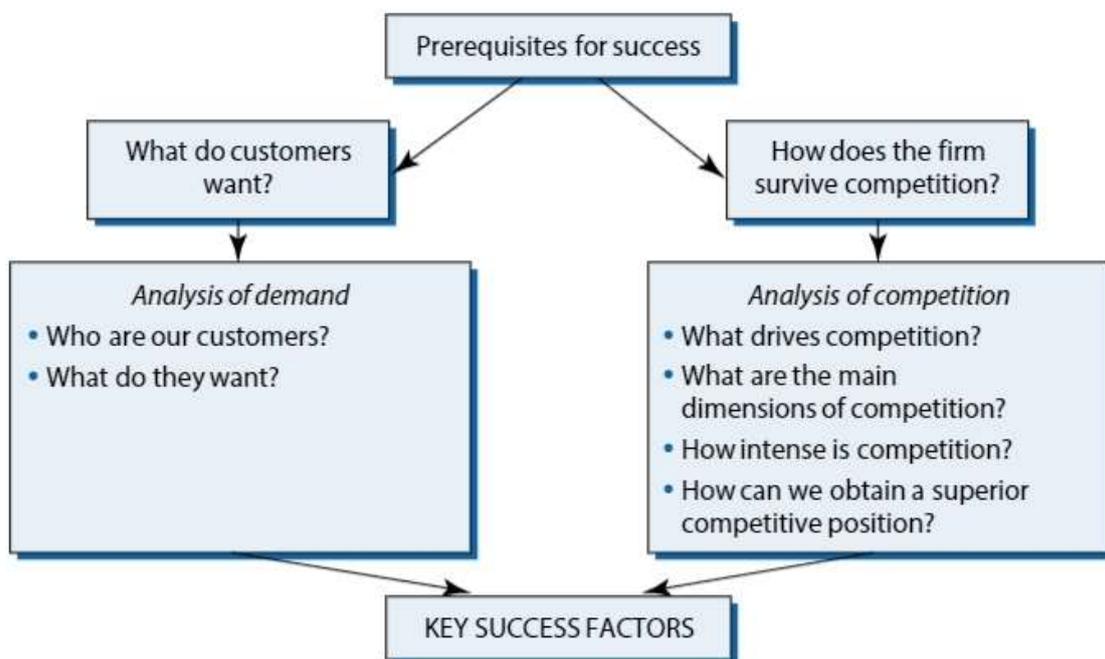
To increase sales to your current customers, you will need to implement a marketing strategy to entice more sales. Something that most businesses fail to see is the ability to up-sell to their existing customers. Making sure that all staff are trained in this area could be most beneficial for your business.

Selling targets are a way to monitor overall performance and enhance profitability. Therefore, I advise you to look at this carefully as it can have an impact on other areas of the business. Understanding your break-even point will allow for realistic targets to be set and ensure profit is maximised.

To help increase the sales volume:

- Understand the current customer buying patterns;
- Implement a marketing strategy to increase sales volumes;
- Introduce loyalty programs that encourage referrals;
- Train staff to up sell and make sure they are aware of the high-profit products;
- Use break-even calculations to set sales targets; and
- Always research to see if there are other markets that the business can move into.

Customers



First and foremost, excellent customer service is imperative to keeping and winning new customers. Understanding their needs and wants is a simple step to improving the performance of the business.

Having a Customer Relationship Management system will enable you to keep a wide range of information about your customer and their behaviours. If the business needs to increase the selling power, using this tool is the first step and can help you to:

- Understand the needs of the business customer and use this information to improve the customer service experience;
- Measure customer service levels, for example, there are many free tools such as Survey Monkey to gain these insights;
- Reward current customer for their loyalty;
- Consider using mystery shoppers to monitor customer service; and
- Have regular contact with your customers to make sure your business is front of mind.

Customers

1. Define them:

- to attract more like them
 - achieve greater fulfillment and \$\$
-

2. Segment them:

- 2-4 only
 - save money (be specific and relevant!)
-

3. Profile them:

- to understand them/their different needs
- to solve their key problems (build trust)
- to avoid mass marketing! (ineffective \$)

Customers want to know who you are, what you stand for, and the really important bit how you're going to make their lives better or easier (or both). And the only way you can know this answer - by understanding them as best as you can.

Customers

Why is segmenting a customer base important?

Dividing customers into similarity groups (segments) empowers businesses to:

- understand how each segment differs
 - to treat them relevantly (no mass marketing)
-

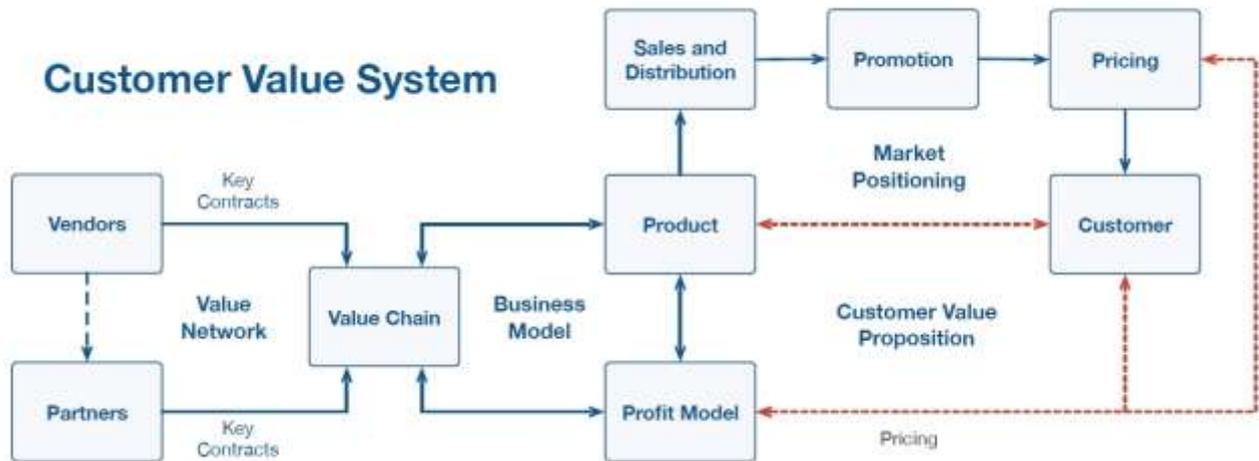
A better view of your business approach to a market is by thinking in terms of a **customer Value System** within which value is created by your business's products and services that are used by your customers. Within that value system your suppliers, sales and distribution channels, value chain, business models and customers all interact to create an efficient ecosystem.

Value systems are specifically designed to address the needs of a particular customer segment with a particular product. A beer company, for example, sells its products to women, young men, sports fanatics and other groups, but each segment must be approached through a distinctive and unique value system.

That said, it is the entire value system from suppliers to product disposal that needs to be optimised when seeking to maximise the value we extract from an opportunity, and they can play a critical role in the success of your business strategy.

One painful lesson from the failure of many companies, is that "transplanting" a business model from one product to another is sometimes a recipe for failure. Instead, each new product or business opportunity must be run on its own value system, entirely optimised for the customers it serves.

Customer Value System



To prevent tunnel vision and get the most out of new products you must embrace the fact that both products and customers must reside within a value system that is specifically designed to maximise the value that can be captured from a particular opportunity.

Within this value system, you must find a value proposition that creates **customers' incentive to buy**, a **market positioning plan** that sells those benefits and makes them available to the right customers, a **value network** that's optimised to deliver the promised value and a **business operating model** that captures a piece of the value created **and converts it into sustainable profits**. Fundamentally, adapting your business means improving your operating model – the key link between strategy and execution, as shown in the diagram below.



When developing new businesses all decisions count, from the selection of the right customers, and the optimisation of the job the product or service offers to do for them, to the determination of the right pricing for those customers, picking the right suppliers and the selection of the right sales and distribution channels. In the end, it is the entire value system that must be perfected, from suppliers to product/services distribution, if you want to maximise the value that the product/service creates for its users and for your company.

In conclusion, each business has their specific challenges when it comes to profitability – and this can be dependent upon many operating factors – both internal and external to the business.

If you have found this article valuable in understanding profitability and would like to learn more, then please reach out to your CBSW contact director for some further assistance.

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