BusinessPlus+ Newsletter

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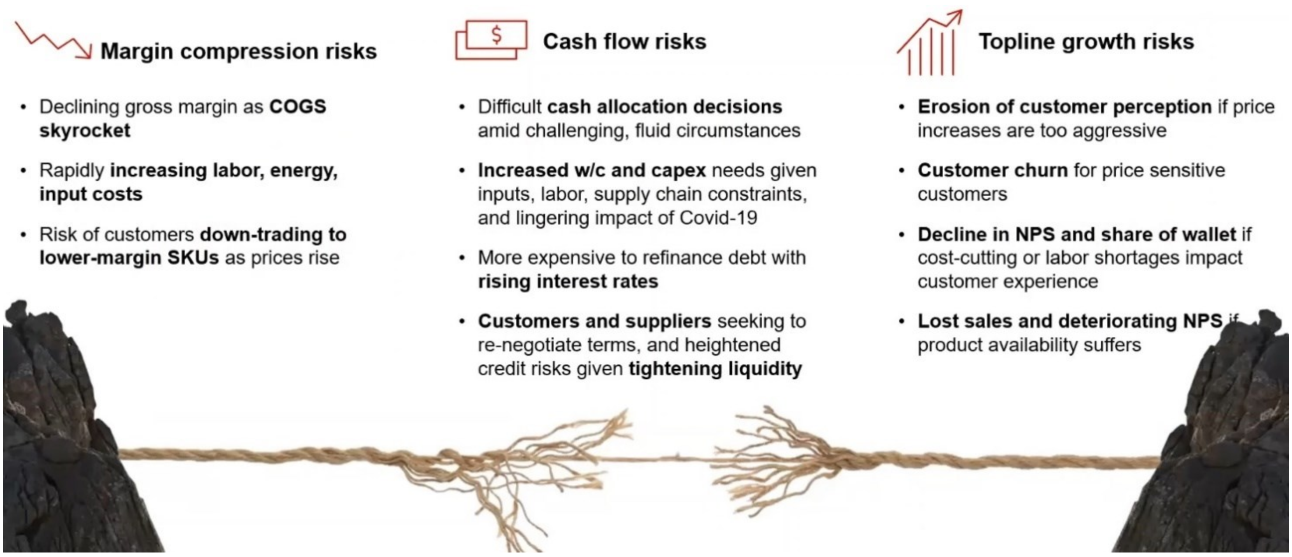
Addressing Business Margin Challenges

How factors are coming together to squeeze margins across Australia's economy, and why it matters to think about your short- and long-term responses.



*A stock-keeping unit (**SKU**) is a scannable bar code, most often seen printed on product labels in a retail store. The label allows vendors to automatically track the movement of inventory.*

Macro-Economic Changes Are Driving Margin Compression

With apologies for stating the obvious, the Australian macroeconomic picture is challenging. Rising costs, without accompanying or insufficient revenue increases, are creating margin compression for many businesses.

"Uncertainty reigns in market commentaries and half year result presentations"

However, what is less obvious, is that approaches to margin management have come a long way since the GFC, our greatest economic challenge in living memory. As leaders you have far more options to manage your short-term cost profile in a manner that is consistent with your longer-term aspirations. There are now better thinking frameworks for the challenge, better methods, and better tools.

For instance, we have the wisdom of "anti-fragility", where organisations can use the pressure they are under not just to survive, but to become fundamentally stronger. We have new process and role design tools, with technological support, that help us take out waste. Furthermore, we have intelligent software agents becoming increasingly available, and they are not just **ChatGPT** (as impressive as that is).

Understanding Different Business Margins

Profit margins are essential when evaluating profitability. Gross, operating and net profit margins contribute to a company's financial statements and showcase efficiency with cash flow. Improving these profitability metrics can benefit a range of business processes that support growth and development.

Gross profit margin: The gross profit margin is the profit value of all sales less the cost of goods/services sold (COGS). For example, if a business generates $2,000,000 in sales revenue and has $1,200,000 in COGS (including direct labour), then gross profit is $800,000 giving a gross profit margin of 40%.

Operating margin: The operating margin results from the operating profit, which is the amount you get from subtracting operational expenses and COGS from sales revenue. For instance, if you have a sales revenue of $2,000,000 and operational expenses ($450,000) and COGS ($1,200,000), then the operating profit is $350,000 and gives an operating margin of 17.5%.

Net profit margin: The net profit margin is the operating profit, less company tax and interest on business debt. For example, if operating profit is $350,000 and company tax and interest total $200,000, this gives you a net operating profit of $150,000 – a net profit margin of 7.5%.

Why Is Profit Margin Important?

Each profit margin is important for evaluating a range of processes within a business. Consider several applications for which profit margin is important:

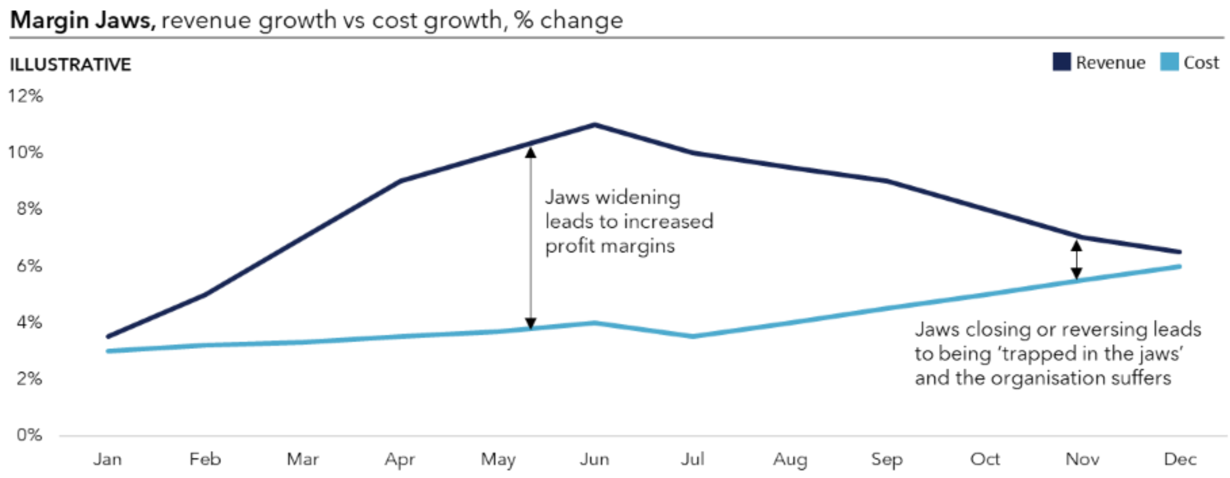
Evaluating cash efficiency: Profit margins are essential when evaluating cash flow efficiency. Businesses often use profit margins to understand the efficiency of reinvestments back into business activities.

Estimating financial health: The profit margin is also important for evaluating the overall financial position of a company. For instance, a company may analyse its profit margins to determine how its profitability affects its financial standing in its industry.

Providing insight into productivity: The profit margin can also be an important indicator of business productivity – particularly by using gross profit margin (where direct labour costs are included in calculating COGS). Operational processes, customer service and sales activities all support revenue generation, so tracking marginal rates can help improve productivity in these areas.

Supporting decision-making: Businesses also use profit margin values and other financial metrics to assist in making important decisions. Budgeting, resource allocation and investment activities are several metrics you can analyse along with profit margins to make cost-saving decisions.

The Pressure to Adapt Is Real and Building

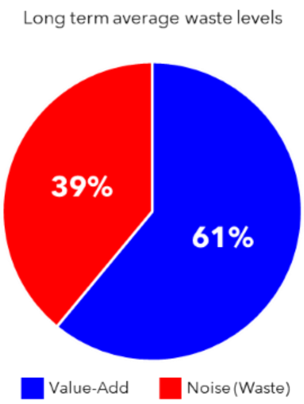


Many CEOs report that their organisations are already adjusting course in reaction to the closing of the margin jaws. Early cost-cutting interventions may include aggressive inventory management, reduction of discretionary spending, and adjustment of service levels. Some organisations are acting to directly reduce staffing costs via recruitment freezes, salary cuts and suspension of bonuses, or even emergency redundancies. In the medium term, more sustained cost reductions may be sought through geographic consolidation, rapid restructuring, channel-switching, or changes to asset ownership and utilisation models, amongst other approaches.

Rapid, disruptive change does not come without risks – and these risks can run deep. Reactive changes to structure and business processes, focused on short-term cost-cutting, can create the sort of challenges seen in the illustration below.

Many good ideas, and the resulting well-intentioned change initiatives, fail to achieve the desired results due to poor execution – and these failures may leave your organisation worse off than where it started. This begs the question, if your organisation must change, but executing the obvious changes in isolation are likely to be problematic, what are the changes that *can* steer you through these turbulent waters – without capsizing the boat?

Reducing Costs Now, With A Longer-Term Benefit

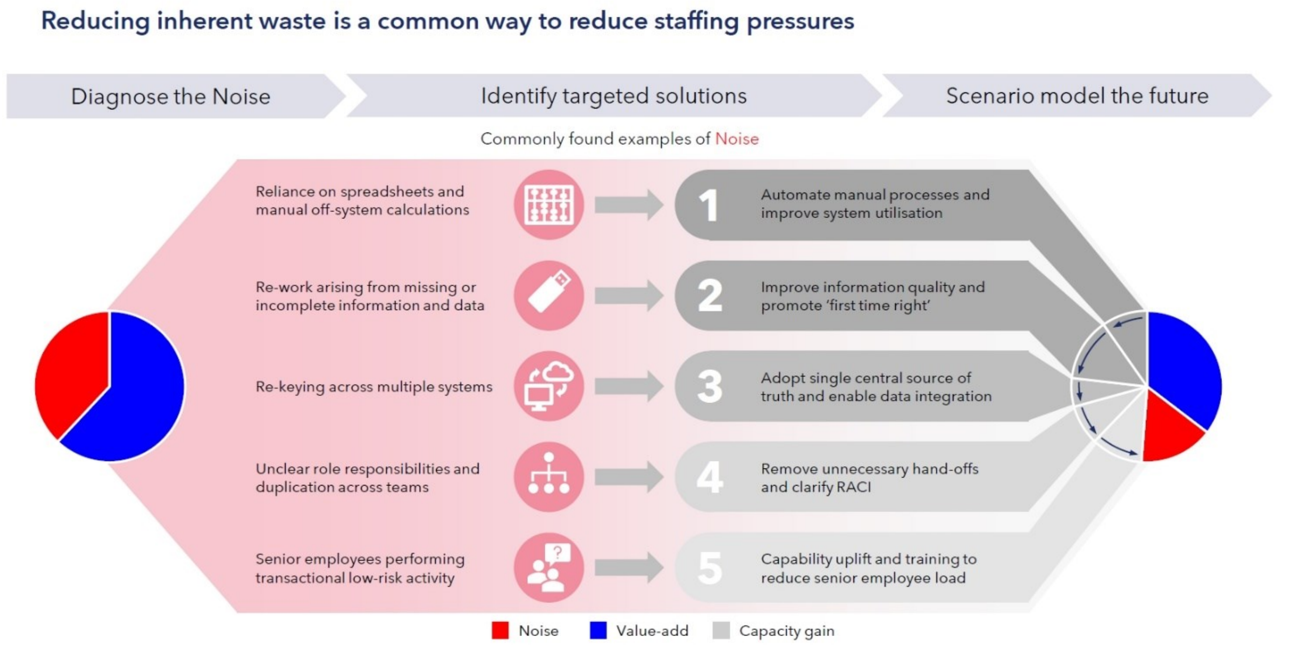


Source: Bevington Group

Most enterprises have substantial internal "**Noise**" – activities that do not add value or contribute to the organisation's mission. Across industries, this waste absorbs effort at an average of 39% of organisational FTE. Removing this waste can reduce FTE requirements without adding pressure to workloads, because the idea is to remove the non-value adding work. The benefits are real for your organisation, your employees, and your customers, who can experience the benefit of more streamlined processes.

"Eliminating internal Noise is not just about cutting costs, it's about unlocking the untapped potential of your people and processes."

By targeting waste, you can contain the execution risks that come with rapid cost-cutting initiatives. Your people know what the problems are, as they are the ones experiencing them day-to-day. If you recruit them to isolate and excise the noise, you gain their insight and simultaneously empower them with the opportunity to reduce their operational frustrations, while increasing productivity.



A RACI chart (or matrix), is a type of responsibility assignment matrix in project management – *Responsible, Accountable, Consulted,Informed (RACI)*

Source: Bevington Group

XeP3 is a cloud based, productivity improvement tool which helps organisations to quantify and eliminate their process waste. XeP3 is designed to transform complex processes, facilitate enterprise-wide process re-engineering and organise change management programs.

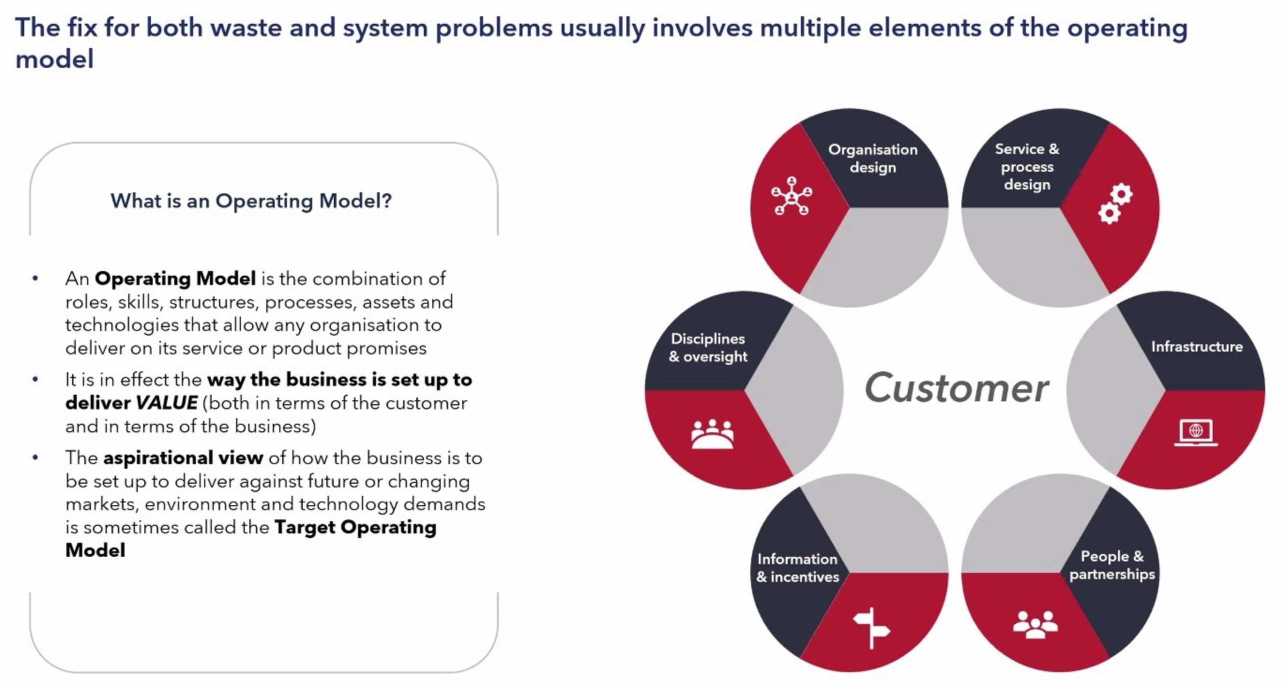
Change is disruptive. A distinct advantage of XeP3 is that it allows you to minimise the change impact on everyday business operations. Giving you unrivalled data to rebuild your process and Operating Model, simply and easily, brick-by-brick. XeP3 quantifies the size of opportunity for capacity creation through change, allowing you to model and execute your transformation with accuracy and assurance.

But What About the Long-Term?

While you may need to react quickly and tactically to the current environment to remain sustainable, at some point in the future the macroeconomic outlook will be more positive, and you want to position yourself to take advantage of this to build an organisation that can thrive long-term. Removing waste is generally a "no-regret" option, however, it is possible to do much more.

“As you navigate the challenges of today’s environment, don’t lose sight of the opportunities for tomorrow.”

Operating model thinking is an excellent approach to take. An operating model is the sum of the parts of an organisation and how those parts work together. It incorporates all that you need to achieve your mission consistent with strategy, including structure, role design, technology, and process. Critically, operating model thinking is systems thinking, which recognises that changing just one part in isolation can have unexpected consequences. By considering the whole, rather than isolated factors, you can identify the system-level opportunities to institute powerful change.



For example, changing your geographic footprint may represent an immediate cost saving, but it could also lead to negative customer reactions or erosion of key process dependencies whose reliance on the existing organisational structure was not immediately obvious. By taking a holistic view, you see the synergies and interdependencies and the overall pathways through which your organisation delivers value.

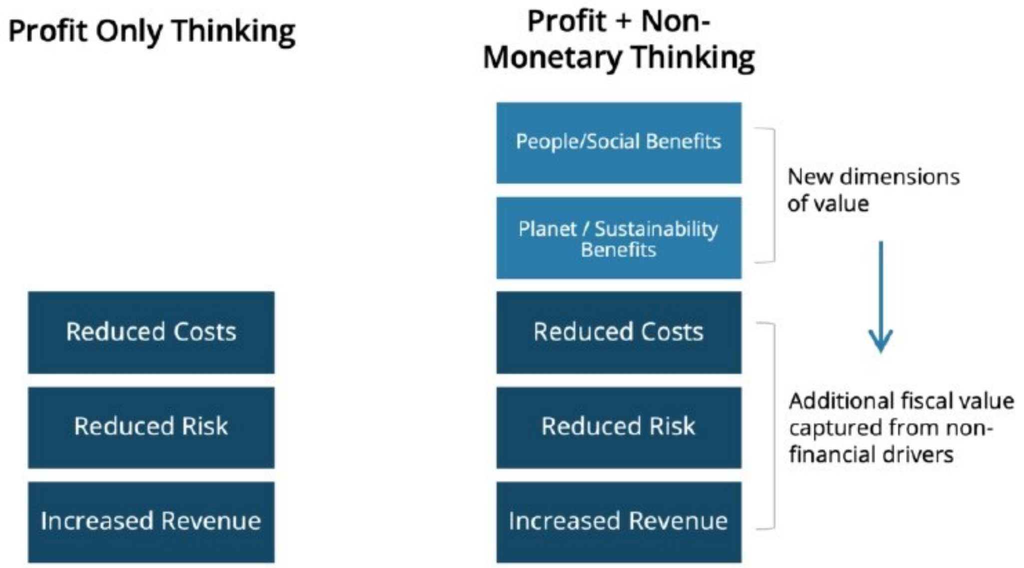
Beginning with smaller changes – focused on the elimination of waste – can warm up your teams for action with some early successes. This process may also reveal where you might need some additional capacity. As you liberate time from reduced waste, you can start to reinvest some of that capacity into deeper operating model change. For instance, waste may be removed from a process, but your next step might be to introduce intelligent automation, thus fundamentally changing the cost and capacity profile of that process.

Adopting a Different Approach

The approaches to margin management have come a long way since the GFC. The challenge for leaders is to access what we now know about how to deal with difficulties, as an opportunity for deeper changes, which enhance longer term resilience.

In a B2B context, definitions of value traditionally focus on the financial benefits (reduced costs, reduced risks, increased revenue opportunities) an offering provides. **But increasingly consumers and businesses are recognising sources of value in the areas of sustainability, quality of life, and making a positive social impact. While financial assessment of value remains critical, quantifying non-monetary value drivers will increasingly unlock new opportunities for value capture and differentiation.**

The triple-bottom-line model (Profit-People-Planet) is currently one of many well-known frameworks that can be employed for identifying and quantifying important non-monetary value drivers. While the ‘Profit’ component refers to the familiar financial impact of an offering, whilst the ‘People’ and ‘Planet’ components can help us systematically identify non-monetary factors.



The **'People' component** refers to the social impact of an offering. How does your offering contribute to the common good? An example would be enabling an increased time with patients in a medical setting.

The **'Planet' component** refers to the environmental impact of an offering. How does your offering contribute to environmental sustainability? A common example today would be implementing carbon emissions reductions in the business.

While incorporating non-monetary value drivers requires far more creativity and effort, there are many reasons to make this a part of your value quantification process.

Benefits Of Improving Profit Margins

Improving the gross, operational and net profit margins is crucial for adding to business growth and financial health. Consider several more reasons why evaluating and improving profit margins is beneficial:

- **Adds to profitability:** Improving the profit margin can add to the bottom line of a company's income statement, indicating its ability to invest in business growth and ongoing activities.
- **Supports investment activities:** Improving lower profit margins can also benefit a business's ability to reinvest its revenues into growth and development, further adding to its total value.
- **Helps business owners evaluate risk:** Business owners can use profit margins to get an idea of how risky a certain business is for investing in, and how improvements to the profit margin can show them a specific business operation can have a lower investment risk.

Additional Resources

- For further information on **XeP3** go to xep3.com
- You can access an article by McKinsey & Co on "***What is Productivity?***" HERE
- You can access a detailed guide – "***Improving Business Performance***," prepared by CPA Australia HERE
- An article – "***Seven Questions about ChatGPT Answered***," can be accessed HERE
- A paper from Jedox – "***Preparing for the future: The power of Scenario Planning***" can be accessed HERE