Improving Profits in a Tight Labor Market

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Center for Private Company Excellence®

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Learning Agenda

1. Current Labor Situation
2. Revenue Management Concepts
3. Customer Profitability Research
4. Pricing
5. Cost to Serve Analysis
6. Live Case Study – Any Plastics
7. Q&A (if time permits)

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Current Environment

The Great Resignation

- Approximately 4.3M people have left the workforce during the pandemic
  US Labor Participation Rate
  February 2020 = 63.3% vs.
  September 2021 = 61.6% – *WSJ.com*
- "Roughly 47 million people quit their jobs in 2021" – *CNBC.com*
- "December 2021 – 6.3 million people were hired into new jobs out of 10.9 million job openings" – *CNBC.com*
- "At least 4 million Americans have quit their jobs every month since July 2021. In January, about 4.3 million Americans, or 2.8% of workers" – *Fortune.com*

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U.S. Dept. of Labor – Bureau of Labor Statistics (March)

Chart 1. Unemployment rate, seasonally adjusted, March 2019 – March 2022

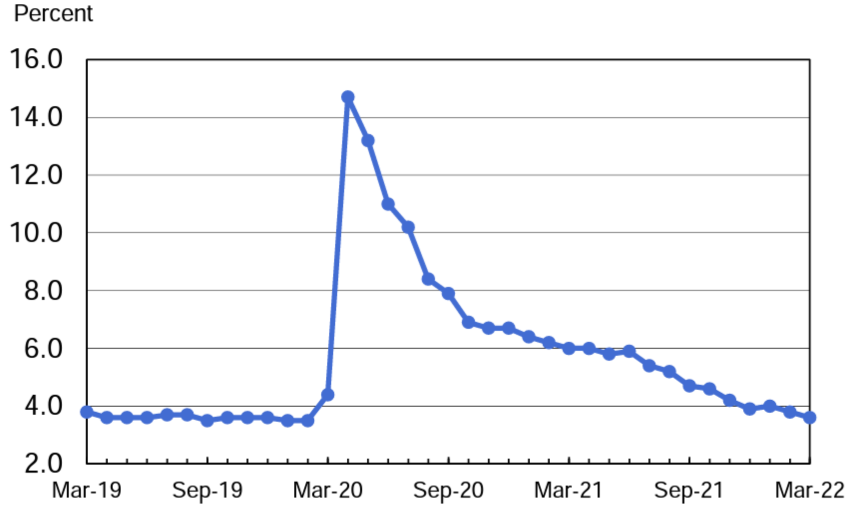
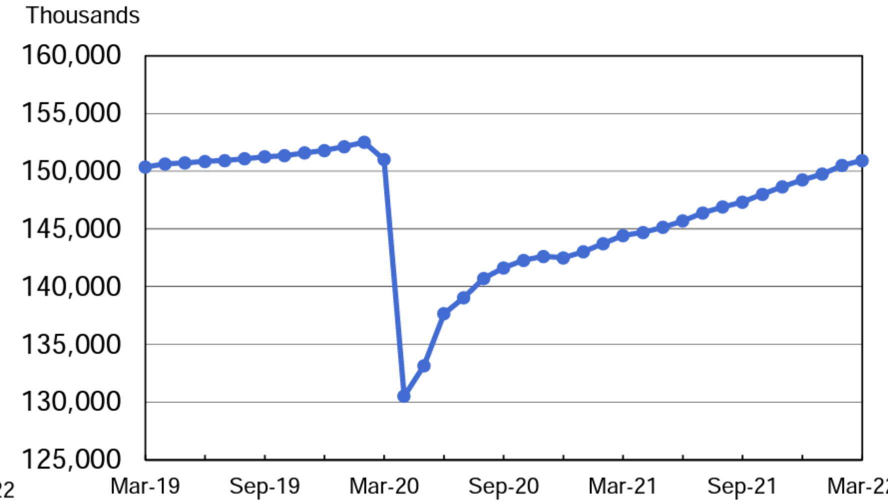


Chart 2. Nonfarm payroll employment, seasonally adjusted, March 2019 – March 2022



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Kreischer Miller Blog Post (June 2021)

- High-level options to deal with labor shortage:
  - Outsource
  - Technology adoption
  - Geographic expansion for employees via remote work
  - Revenue management

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3 Pictures of Growth…Or Not

1> Top Line Growth								
	YEAR 1			YEAR 2			YEAR 3	
Sales	100,000	100%		110,000	100%		121,000	100%
CGS	75,000	75%		82,500	75%		90,750	75%
GP	25,000	25%		27,500	25%		30,250	25%
2> Labor Constrained								
Sales	100,000	100%		100,000	100%		95,000	100%
CGS	75,000	75%		75,000	75%		71,250	75%
GP	25,000	25%		25,000	25%		23,750	25%
3> Revenue Management								
Sales	100,000	100%		100,000	100%		95,000	100%
CGS	75,000	75%		72,000	72%		67,450	71%
GP	25,000	25%		28,000	28%		27,550	29%

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Revenue Management

- Goal - optimize available capacity by selling the highest yielding product and customer mix
- Revenue management – common term in airline and hospitality industries
- Also called "segment analysis"
- For larger public companies, typically, part of Financial Planning and Analysis (FP&A) function
- Many private companies either are not aware of it or don't have the data to analyze it

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Revenue Management Concepts

#1: Think of Your Business in Segments

- Think of every sale as its own P&L
- Look at your business as:
  - A portfolio of smaller businesses
  - With different profit characteristics
  - With different cost drivers and behaviors
- Break the business down into logical smaller pieces to learn which elements of the business contribute differently to profit; example:
  - Customer – size of relationship/avg. transaction size
  - Customer – profitability of relationship
  - Customer – fit/ease of business relationship
  - Sales channel
  - Market
  - Salesperson/project manager
  - Geography
  - Product volume
  - Product profits
  - Etc.

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#2: All Customers Are Not Equal

- **All customers are not equal** in terms of what they contribute to the company's profit what it takes to serve them

- It is **critical to have <u>DATA</u> on your customers**, including:
  - ✓ Volume
  - ✓ Pricing
  - ✓ Margins
  - ✓ Costs to serve
  - ✓ Etc.

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Customer Data is Critical

- You must have **great data about your customers** and what they buy from you
- In a format that can be **easily sorted and analyzed**
- So, you can make **customer-specific decisions**

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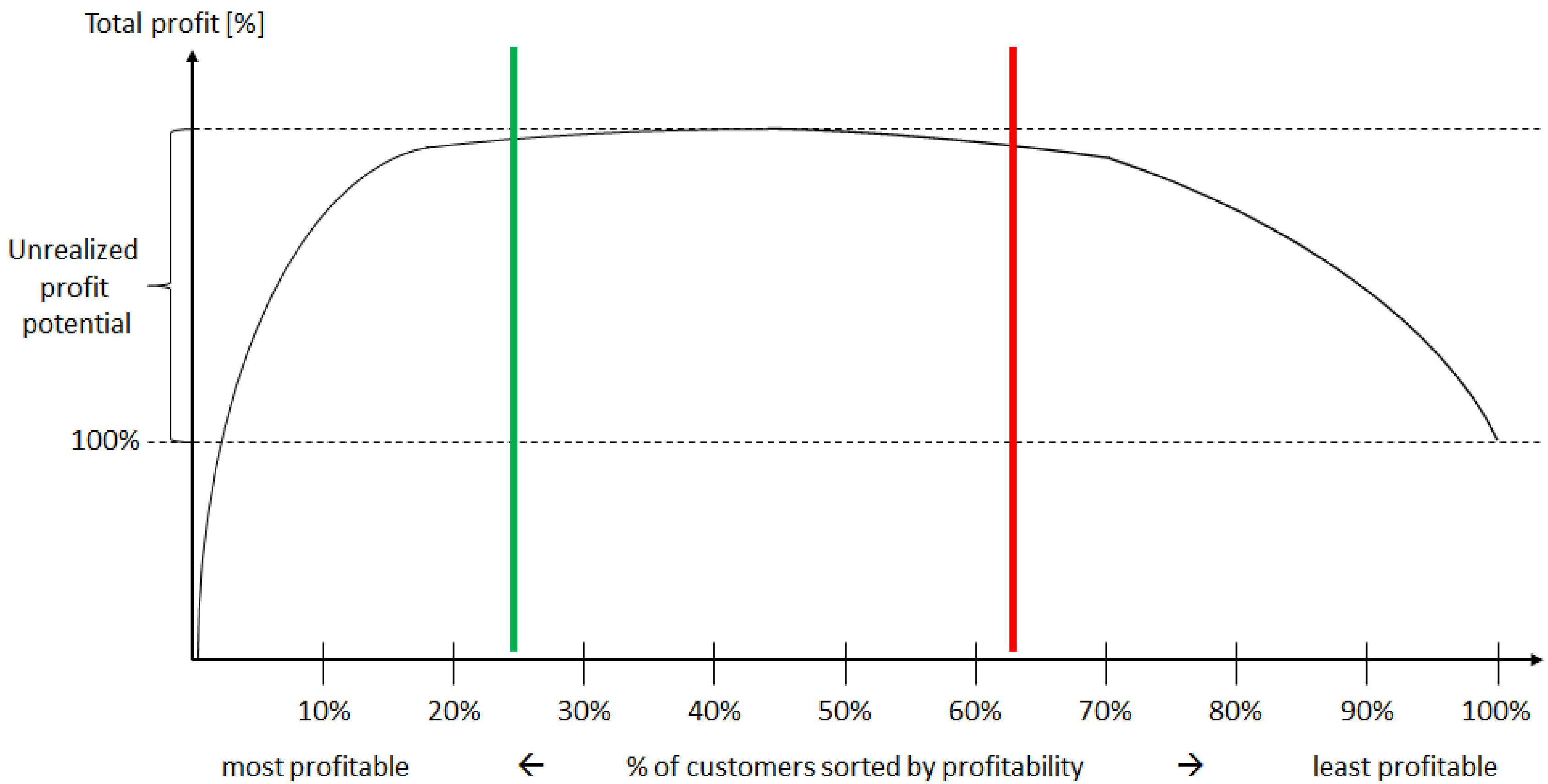
The “Whale Curve”



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#3: Chasing Volume is a Bad Idea (for most businesses)

- Increases in sales volume definitely
    1. **Create more work**
    2. **Require more overhead**

- …but **not necessarily more profit**

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Comparison P&Ls

	Company A		Company B	
Sales	$50,000	100%	$72,000	100%
Cost of Sales	$37,000	64%	$59,000	82%
Gross Margin	$13,000	26%	$13,000	18%
Overhead	$7,000		$9,000	
Profit	$6,000		4,000	
Work/Effort	Less		More	
Risk	Less		More	
# People	Less		More	
Capital Required	Less		More	
Return on Capital	More		Less	
Profitability	More		Less	

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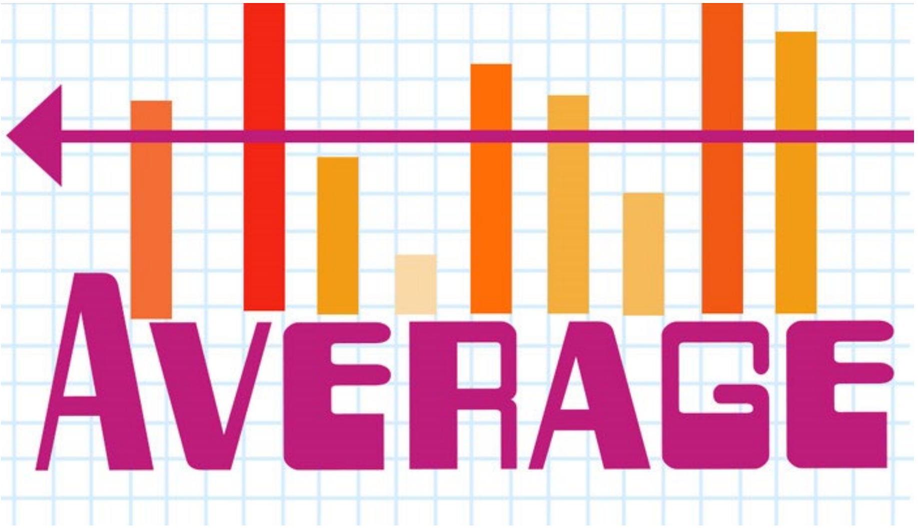
#4: Gross Profit is an Average

- Your company's **gross profit is an average**…

- And an average serves **no basis to make decisions** about your business



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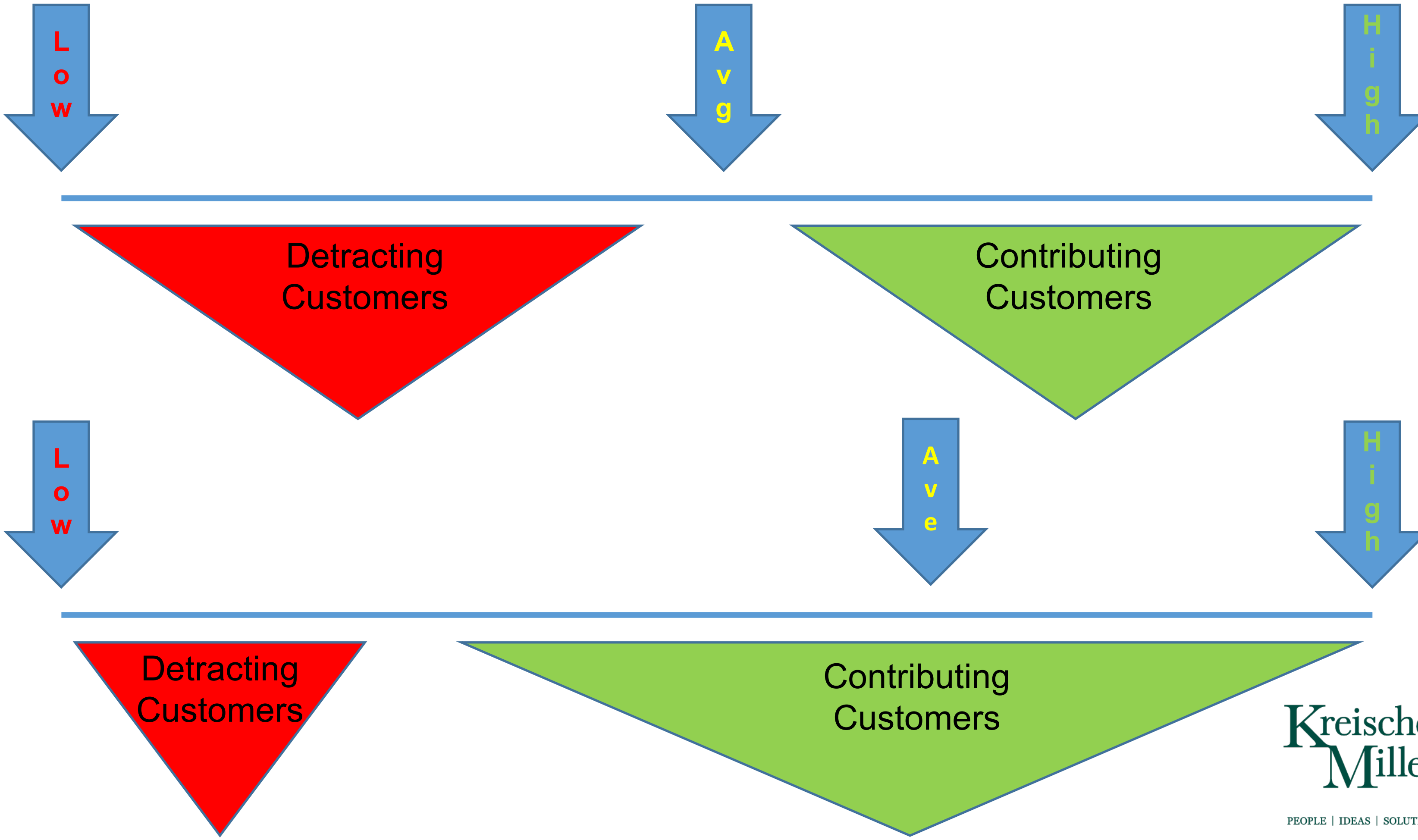
To Increase the Average, Focus on the Profit Detracting Customers



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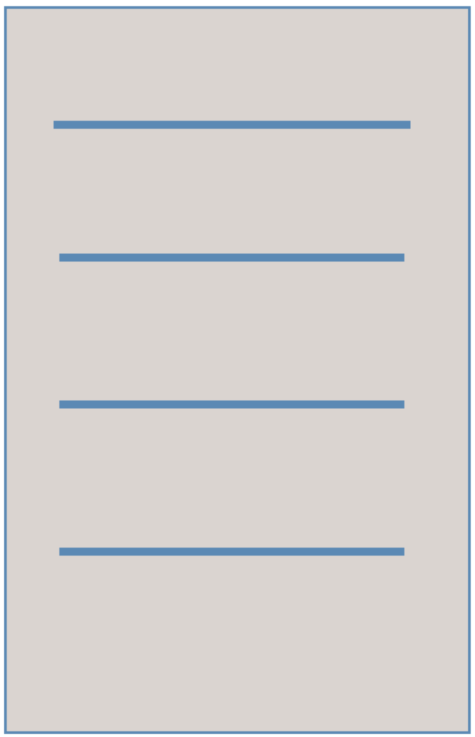
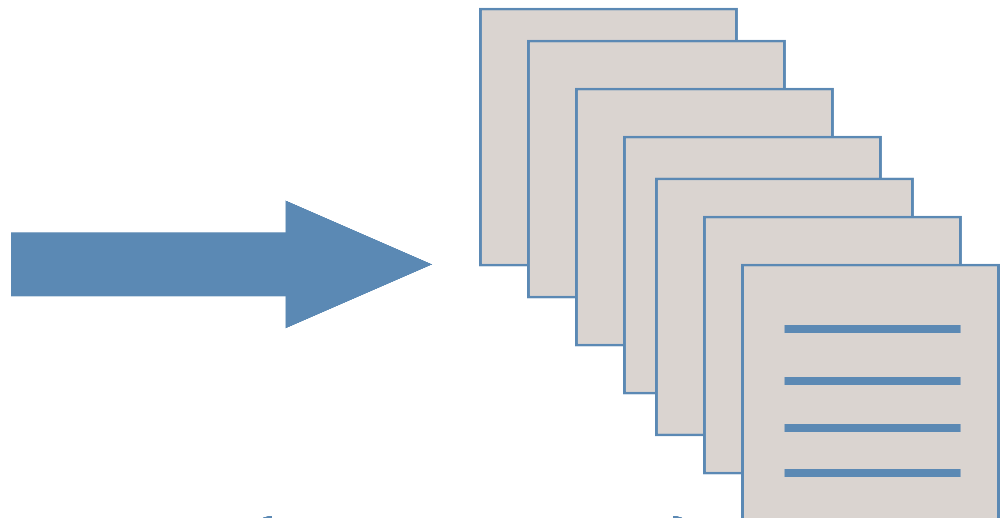
Deconstructing Gross Profit

Your P&L …



…can be deconstructed into a P&L for each of your <u>customers</u>



… or products
… or regions
… or salespeople
… or project managers
… or transactions
… etc.

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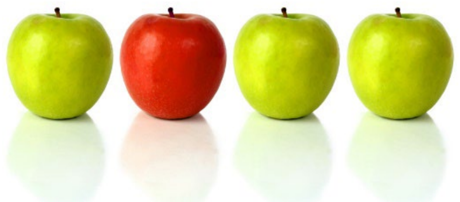
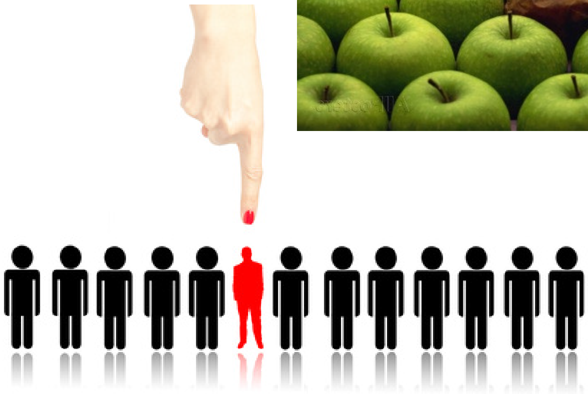
#5: You Decide the Customers to Focus On

- It is **your decision**…



- …to **select** the **customers and markets** you **choose to serve** and those you do not…

- ..on the **commercial terms that are acceptable to you** and those that are not



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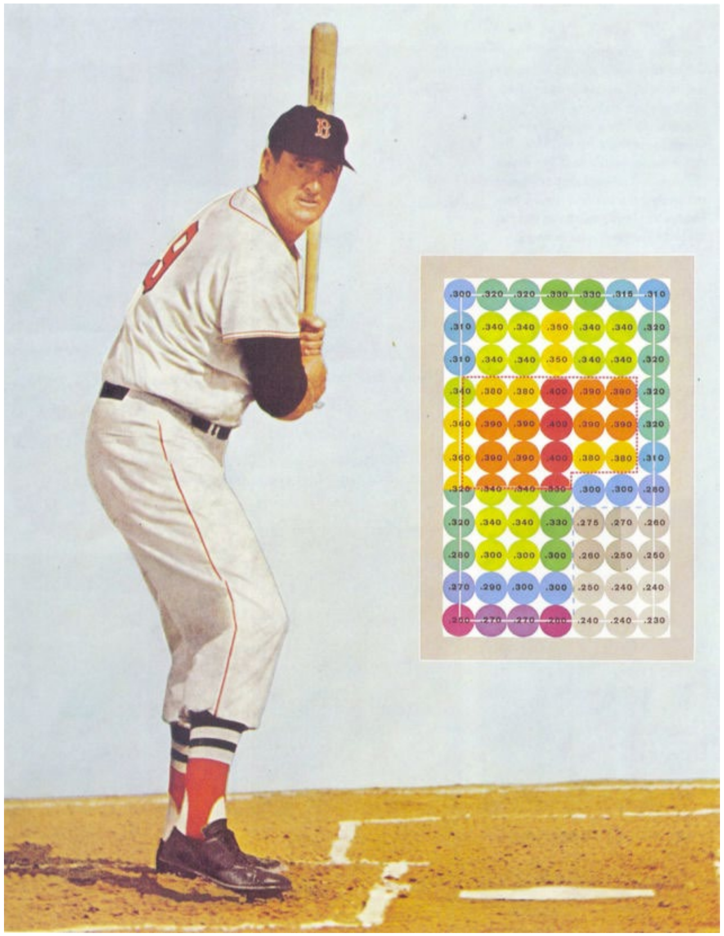
Target Customers: Considerations



- Strategic
  - ❑ Fit with Strategy
  - ❑ Fit with Business Model
  - ❑ Fit with Core Competencies
  - ❑ Product/Services Mix
  - ❑ Markets/Channels
- Economic
  - ❑ Pricing
  - ❑ Margins
  - ❑ Size of Relationship
  - ❑ Costs to Serve
  - ❑ Payment Terms, etc.
  - ❑ Scalability
  - ❑ Future Potential
- Qualitative
  - ❑ Affect on Your People
  - ❑ Business Risks
  - ❑ Compatible Values/Approach
  - ❑ Mindshare
  - ❑ Relationship Capital
  - ❑ Etc.

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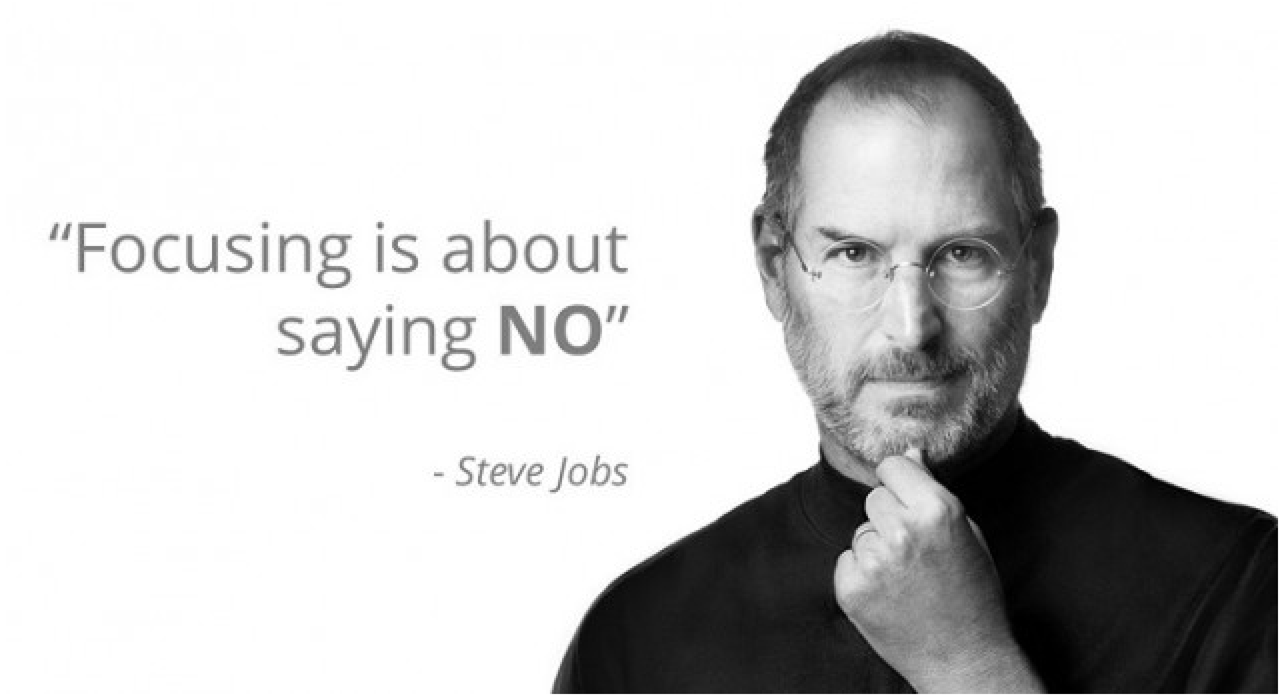
Saying No Takes Discipline



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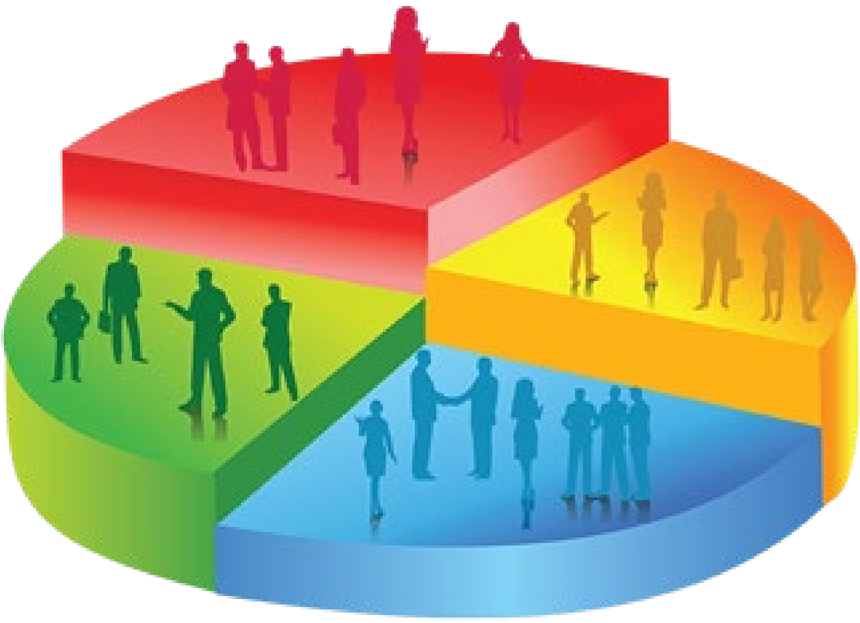
#6: Treat Customers Differently

- **All customers are not equal** in terms of what they contribute to profit and the cost to do business with them…
- …it is **OK to treat different customers differently** in commercial terms…
- …and you **don't need them all to be successful**



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Approach to Customer Decisions?

One Size Fits All

or

Based on Different Customer Types?

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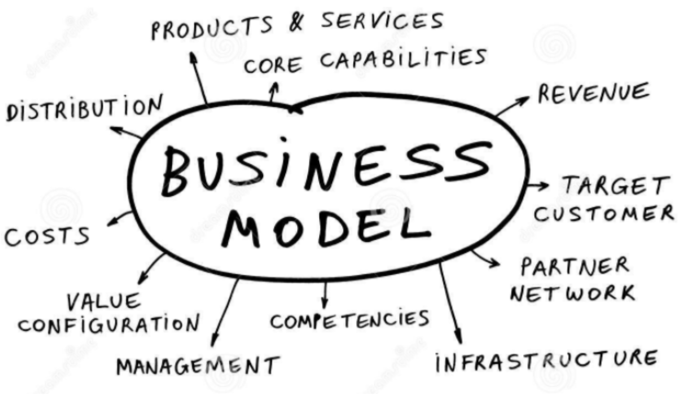
#7: Get Crystal Clear on Your Strategy & Business Model

- You cannot gain **clarity on the right customers and markets** to serve…

- .. unless you first have clarity about your **strategy and business model**



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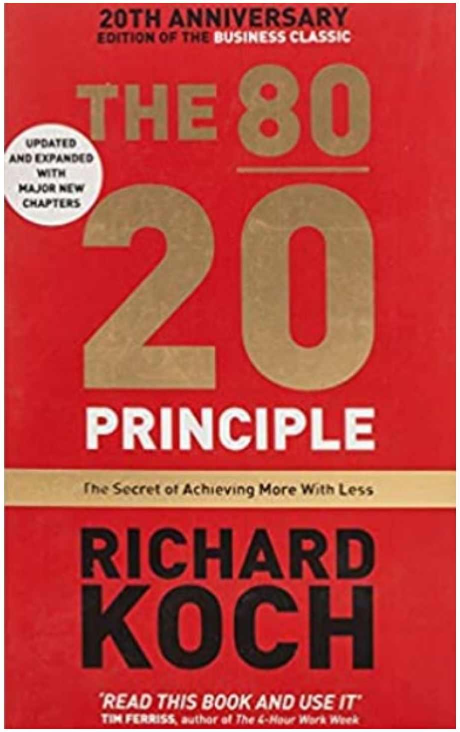
Customer Profitability Research

80/20 (Pareto) Principle

- In 1896, Italian Economist Vilfredo Pareto discovered that:
  - ✓ 80% of the land in Italy was owned by 20% of the people
- Pareto Principle
  - 80% of the Consequences come from 20% of the Causes
  - Power Law

- **How might it apply to our customers, sales, margins and profits?**



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- Kaplan and Narayanan Study (2001):
    - **“Generally, the top 20% of customers generate 150% - 300% of the total profits, whereas the middle 70% of customers break even and the bottom 10% of customers reduce firm profits by 50% - 200%.”**

- McKinsey Study (1995):
    - **“Bad customers account for 30%-40% of a typical firm’s revenues.”**

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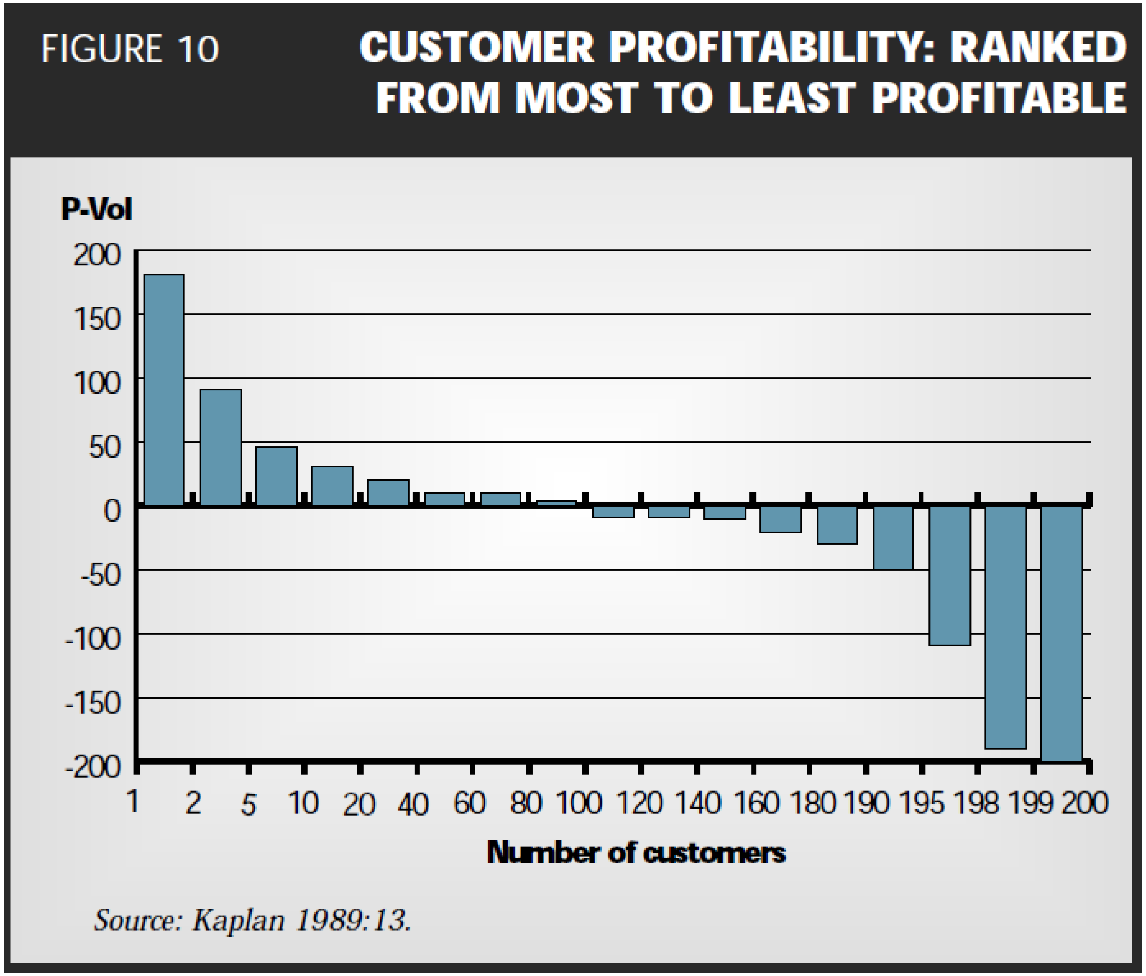
Customer Profitability Research



Source: Customer Profitability Analysis, The Institute of Chartered Accountants in England and Wales, March 2002

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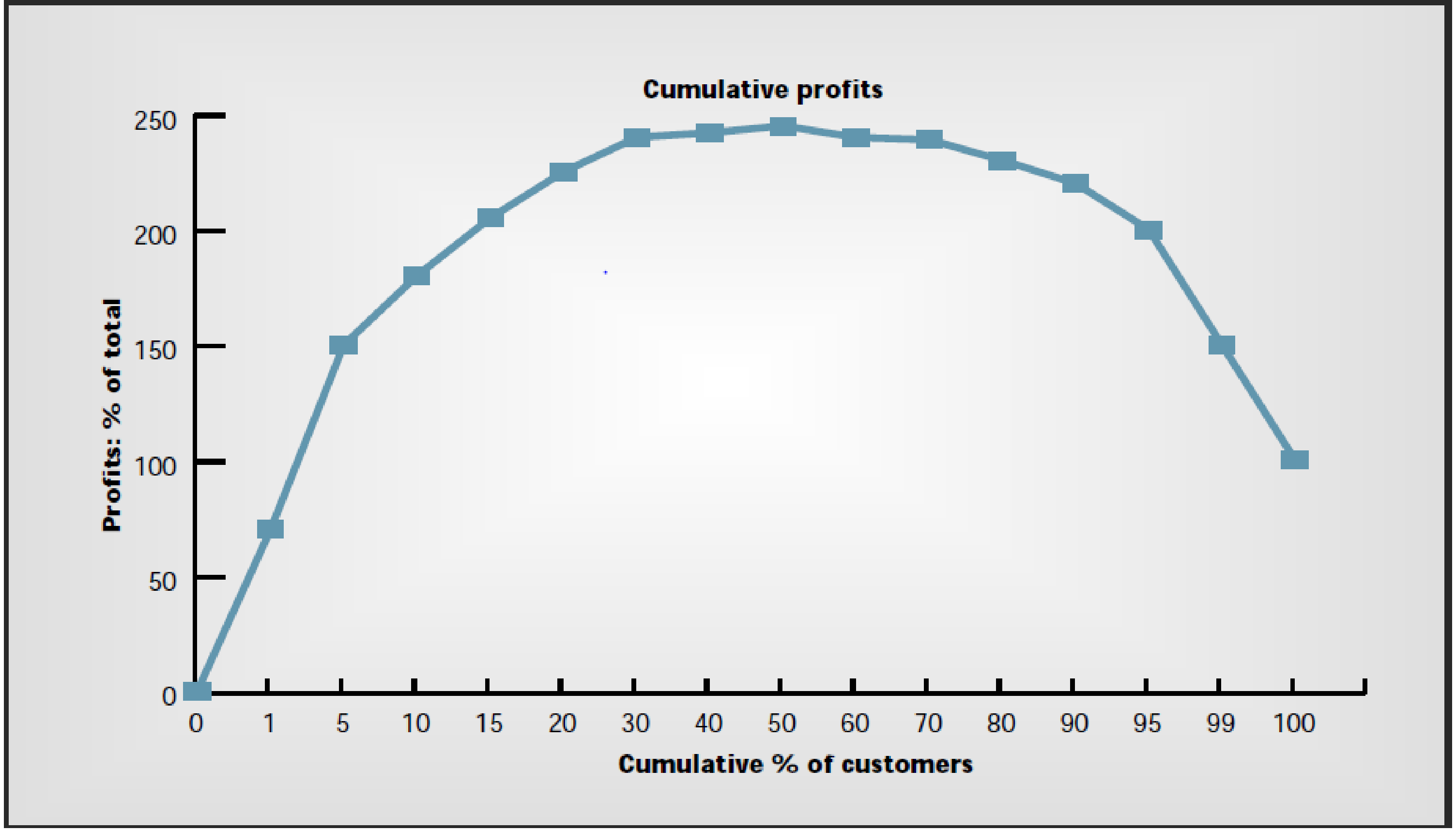
Customer Profitability Research

FIGURE 12 **CUMULATIVE PROFITABILITY BY CUSTOMERS**



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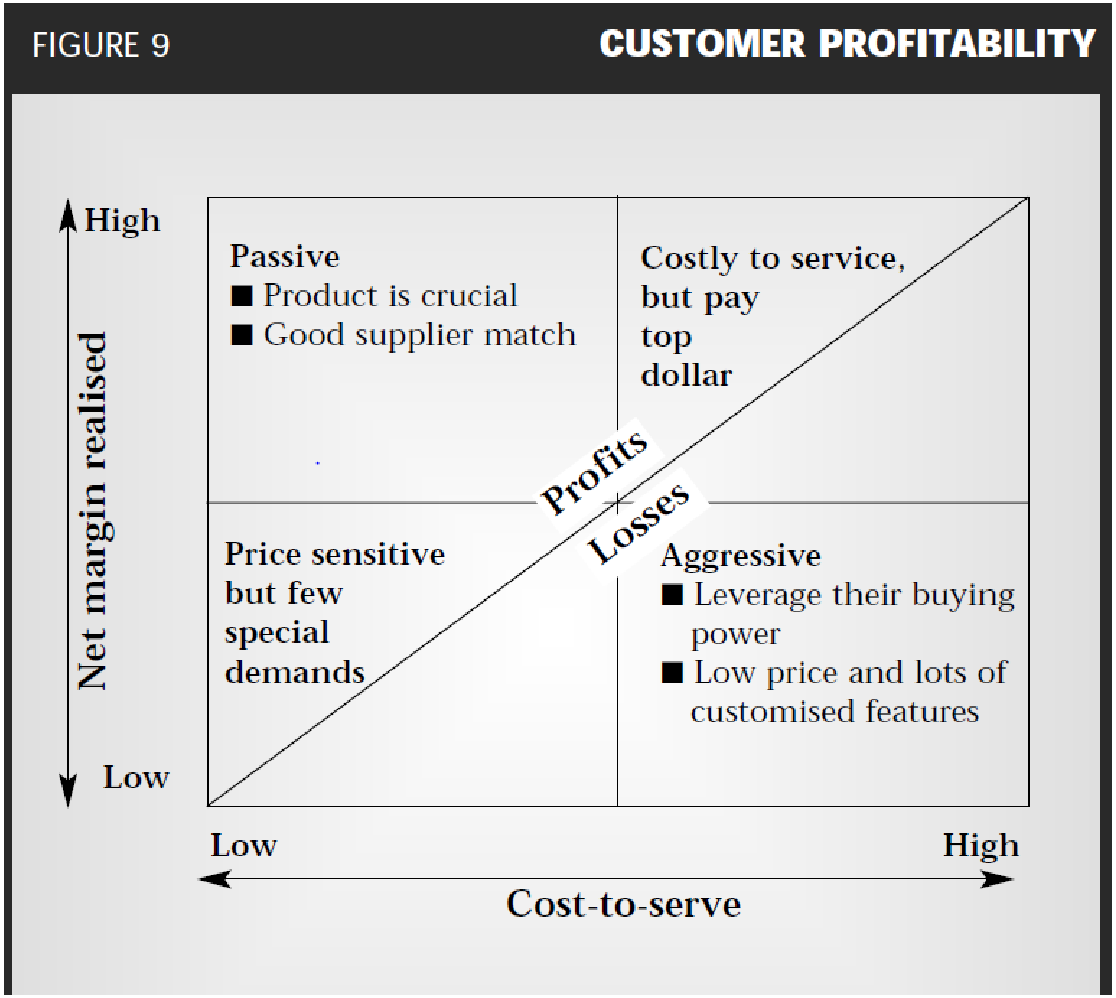
Customer Profitability Research



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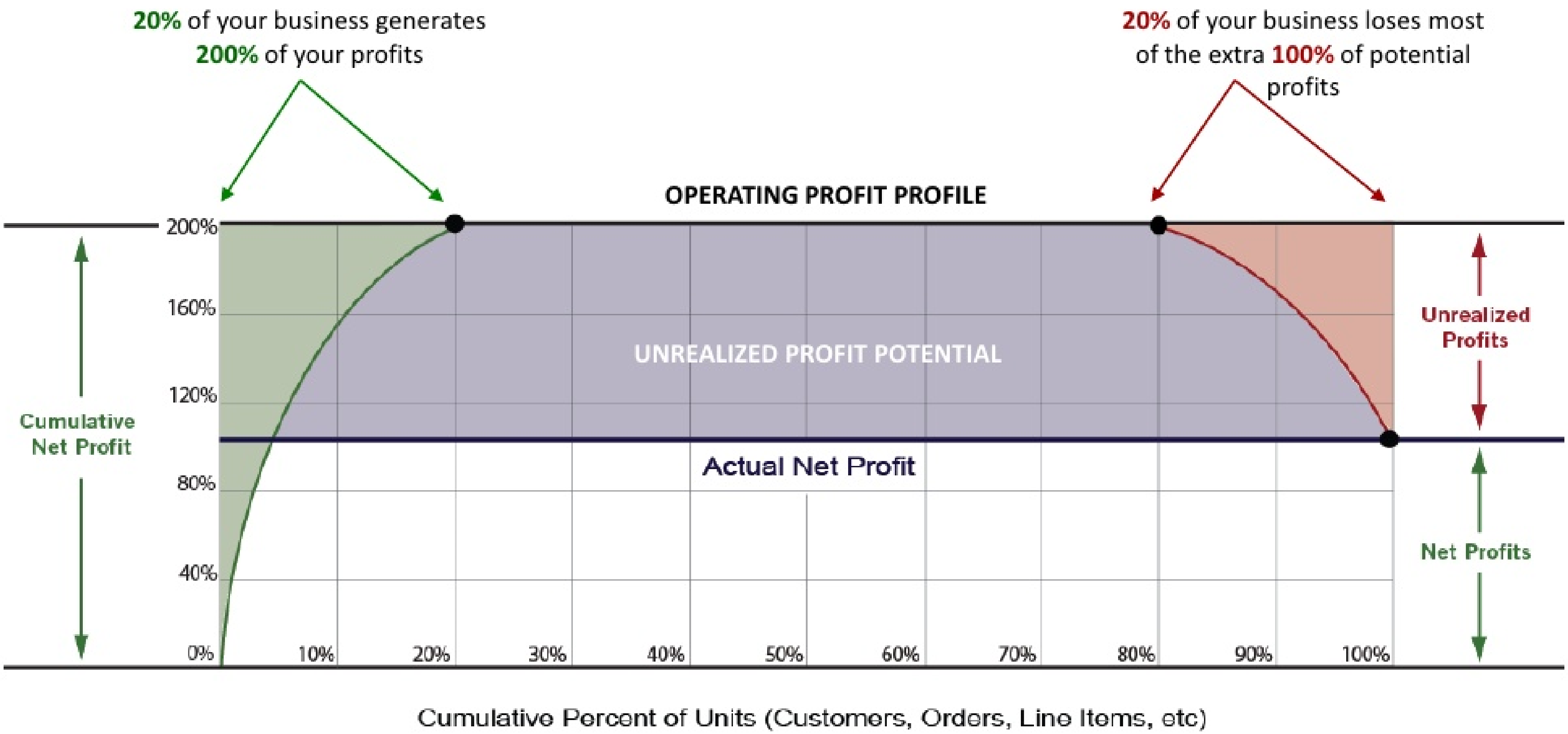
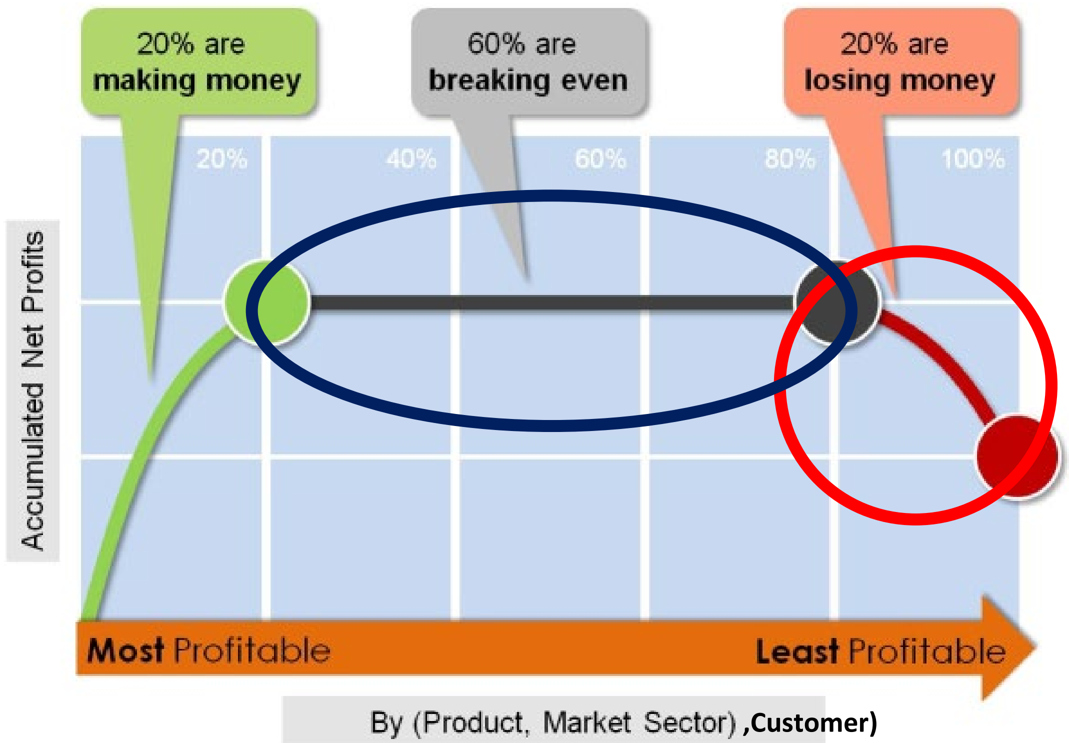
10% - 30% of Customers Lose Money



Focus on the Profit Opportunities



What to Do: Segment Customers

- ✓ Raise prices
- ✓ Discriminate on price and terms
- ✓ Rate customers in groups
- ✓ Renegotiate agreements/contracts
- ✓ Restructure distribution channels
- ✓ Shifting the customer's purchase mix toward richer, higher-margin products and service lines
- ✓ Discount to gain more volume with low cost-to-serve customers
- ✓ Abandoning certain products, services
- ✓ Fire customers

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Pricing

A Few Words on Pricing

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The following table **indicates the increase in sales that is required to compensate for a price discounting policy**. If your gross margin is 30% and you reduce price by 10%, you need sales volume to increase by 50% to maintain your initial profit. Rarely has such a strategy worked in the past, and it's unlikely that it will work in the future.

	If your present margin is								
	20%	**25%**	**30%**	**35%**	**40%**	**45%**	**50%**	**55%**	**60%**
And you reduce price by	**To produce the same exact profit, your sales volume must increase by**								
2%	11%	9%	7%	6%	5%	5%	4%	4%	3%
4%	25%	19%	15%	13%	11%	10%	9%	8%	7%
6%	43%	32%	25%	21%	18%	15%	14%	12%	11%
8%	67%	47%	36%	30%	25%	22%	19%	17%	15%
10%	100%	67%	50%	40%	33%	29%	25%	22%	20%
12%	150%	92%	67%	52%	43%	36%	32%	28%	25%
14%	233%	127%	88%	67%	54%	45%	39%	34%	30%
16%	400%	178%	114%	84%	67%	55%	47%	41%	36%
18%	900%	257%	150%	106%	82%	67%	56%	49%	43%
20%	-	400%	200%	133%	100%	80%	67%	57%	50%
25%	-	-	500%	250%	167%	125%	100%	83%	71%
30%	-	-	-	600%	300%	200%	150%	120%	100%

On the other hand, the next table **shows the amount by which your sales would have to decline following a price increase before your gross profit is reduced below its previous level**. At a 30% margin and a 10% increase in price, you could sustain a 25% reduction in sales volume before your profit is reduced to the previous level…

	If your present margin is								
	20%	**25%**	**30%**	**35%**	**40%**	**45%**	**50%**	**55%**	**60%**
And you increase price by	**To produce the same exact profit, your sales volume must be reduced by**								
2%	9%	7%	6%	5%	5%	4%	4%	4%	3%
4%	17%	14%	12%	10%	9%	8%	7%	7%	6%
6%	23%	19%	17%	15%	13%	12%	11%	10%	9%
8%	29%	24%	21%	19%	17%	15%	14%	13%	12%
10%	33%	29%	25%	22%	20%	18%	17%	15%	14%
12%	38%	32%	29%	26%	23%	21%	19%	18%	17%
14%	41%	36%	32%	29%	26%	24%	22%	20%	19%
16%	44%	39%	35%	31%	29%	26%	24%	23%	21%
18%	47%	42%	38%	34%	31%	29%	26%	25%	23%
20%	50%	44%	40%	36%	33%	31%	29%	27%	25%
25%	56%	50%	45%	42%	38%	36%	33%	31%	29%
30%	60%	55%	50%	46%	43%	40%	38%	35%	33%

Pricing and Volume Changes

PRICE DECREASE	10%	
A		
Sales	$ 100,000	100.00%
Direct Costs	$ 70,000	70.00%
Gross Profit	$ 30,000	30.00%
B		
Sales	$ 90,000	100.00%
Direct Costs	$ 70,000	77.78%
Gross Profit	$ 20,000	22.22%
C		
Sales	$ 135,000	100.00%
Direct Costs	$ 105,000	77.78%
Gross Profit	$ 30,000	22.22%
Price Decrease	10%	
Volume Increase	$ 45,000	
Volume % Change	50%	

PRICE INCREASE	10%	
A		
Sales	$ 100,000	100.00%
Direct Costs	$ 70,000	70.00%
Gross Profit	$ 30,000	30.00%
B		
Sales	$ 110,000	100.00%
Direct Costs	$ 70,000	63.64%
Gross Profit	$ 40,000	36.36%
C		
Sales	$ 82,500	100.00%
Direct Costs	$ 52,500	63.64%
Gross Profit	$ 30,000	36.36%
Price Decrease	10%	
Volume Decrease	$ (27,500)	
Volume % Change	-25%	

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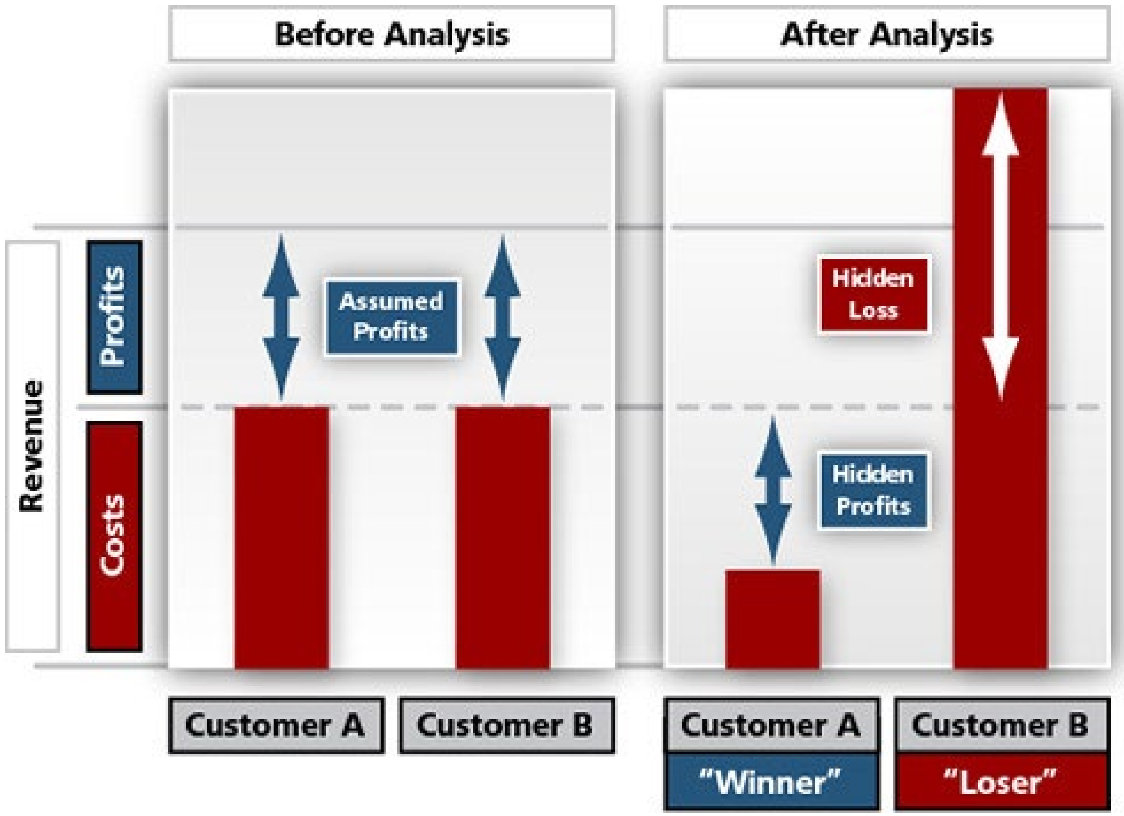
Cost to Serve Analysis



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Cost to Serve

- A company's Sales, CGS, and GM are **<u>only a summary of many</u> transactions with many customers**.
- It is a **mistake to use summary data to make decisions** about customers.
- Traditional **GAAP accounting is <u>not useful</u>** for decision-making inside the business.
- The objective is to calculate the **end-to-end cost of delivering a product or service to a customer**, taking into consideration **all activities necessary to complete delivery and collect product revenue**, and identifying which customers are profitable and which are actually generating losses.
- Identify cost drivers
  - **Costs are <u>not driven by dollar volume</u>.**
  - **Costs are <u>driven by specific activities and overhead consumption</u>.**

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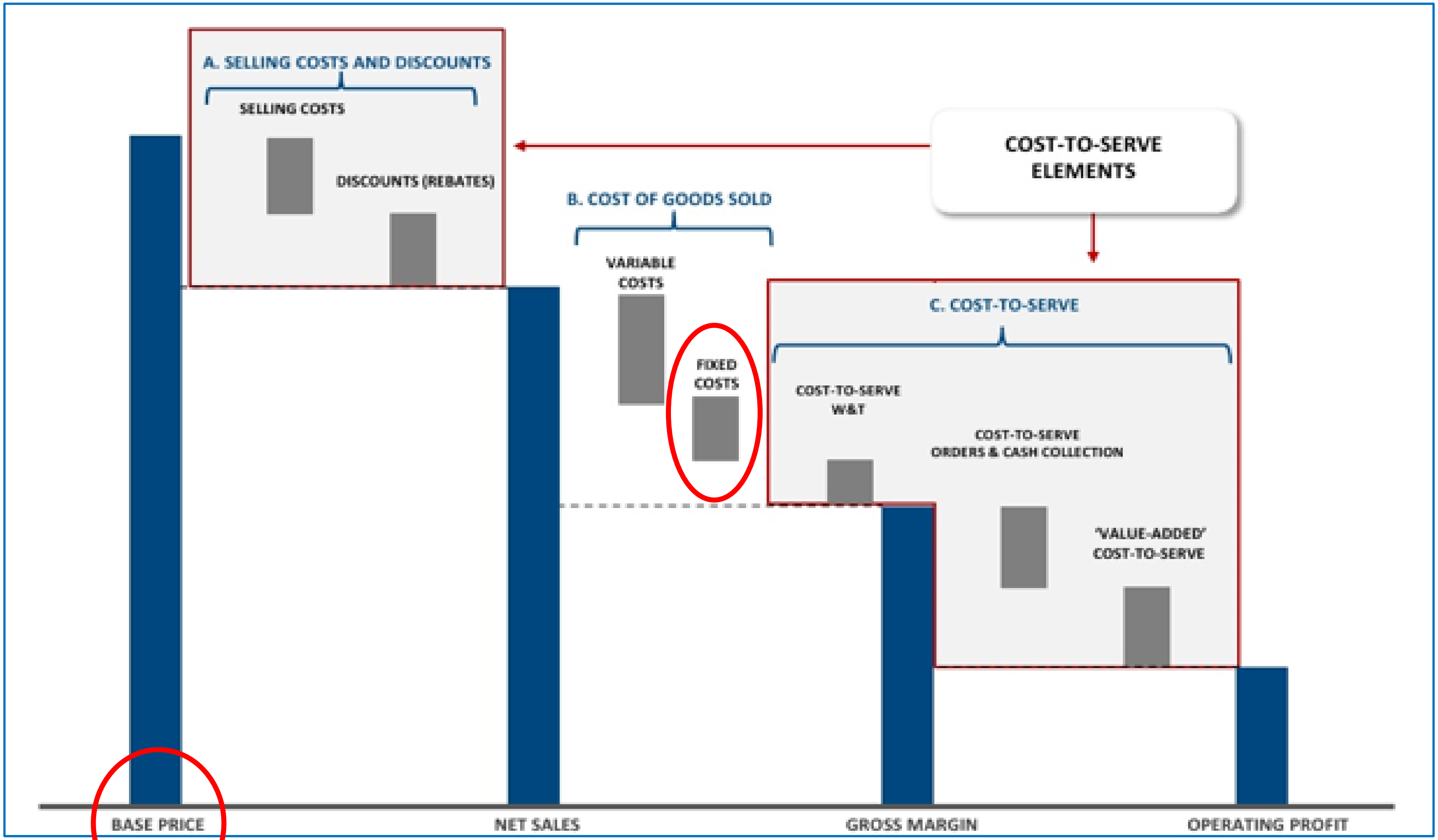
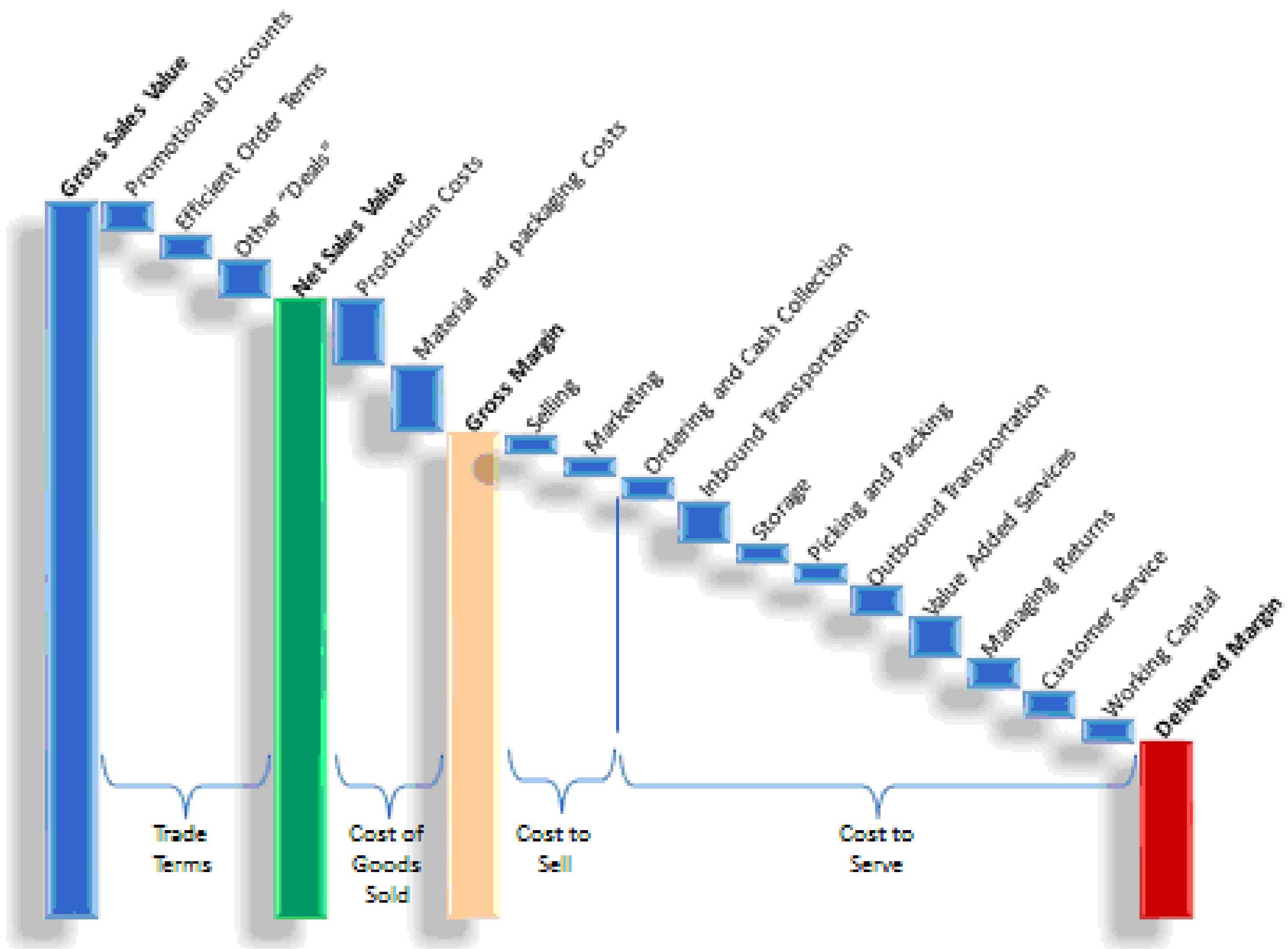
Cost to Serve: High Level



Cost to Serve: Details



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Disconnects Between Activities & Revenues

- Pre-sales costs (sales calls, quotes, visits to customers, etc.)
- Order processing costs
- Special delivery
- Picking and packing costs
- Storage and handling costs
- Transportation/delivery costs
- Returns management costs
- Marketing costs
- Collection costs
- Special packaging

- Low material yields
- Dedicated equipment
- Dedicated personnel
- Freight efficiency
- Setup costs
- Run time
- Breakage
- Warranty repairs
- Intangible:
  - Misalignment with Company Values
  - Strain on People
  - Bad Behavior

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Cost to Serve Example

EXAMPLE - COST TO SERVE CUSTOMER PROFITABILITY

		Customer A	Customer B	Customer C
	Net Sales	300,000	270,000	330,000
	(-) Cost of Goods Sold	234,000	207,900	255,750
	(=) Gross Margin	66,000	62,100	74,250
(-) Cost to Serve	Sales visits	150	250	900
	Order processing	650	700	800
	Expedited order	-	-	2,500
	Packaging	725	430	300
	Delivery	1,000	600	3,000
	Customer support calls	30	20	200
	Sales returns	250	1,000	8,000
	Monthly Billings	10	10	10
	Total CTS	2,815	3,010	15,710
	(=) **Net profitability margin**	**63,185**	**59,090**	**58,540**

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Case Study

Live Case Study: Background

- Plastics manufacturer – G2 owner
- Lifestyle business owned G1
- Purchased by G2 (at $4-5M of Revenues)
- Pursuing high-growth strategy
- $16-$17M in Revenues
- Revenue Growth/Margin Shrink
- On-time Delivery/Customer Satisfaction Declining
- Profits flat to shrinking
- Not generating cash

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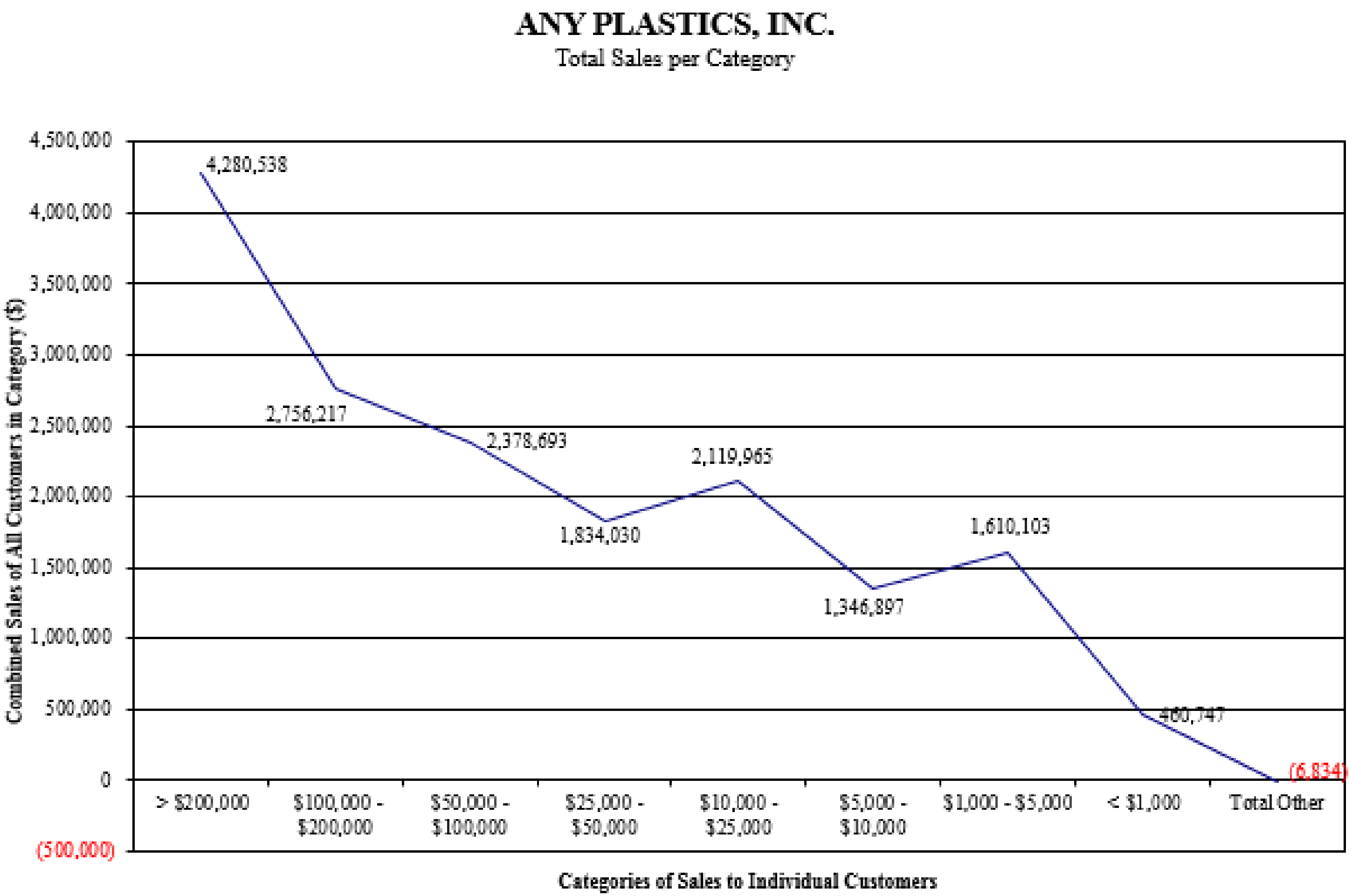
Case Study: Any Plastics, Inc.

Customer Annual Spend	> $200	$100 - $200	$50 - 100	$25 -$50	$10 - $25	$5 – $10	$1 – $5	< $1
% Revenue	26%	16%	14%	11%	13%	8%	10%	3%
Cumulative % Revenue	26%	42%	56%	67%	80%	88%	97%	100%
% Transactions	16%	12%	11%	9%	13%	11%	17%	10%
Cumulative % Transactions	16%	28%	39%	49%	62%	73%	90%	100%
# of Customers	13	21	35	52	134	193	681	1,172
Cumulative # of Customers	13	34	69	121	255	448	1,129	2,301

Example: Any Plastics, Inc.



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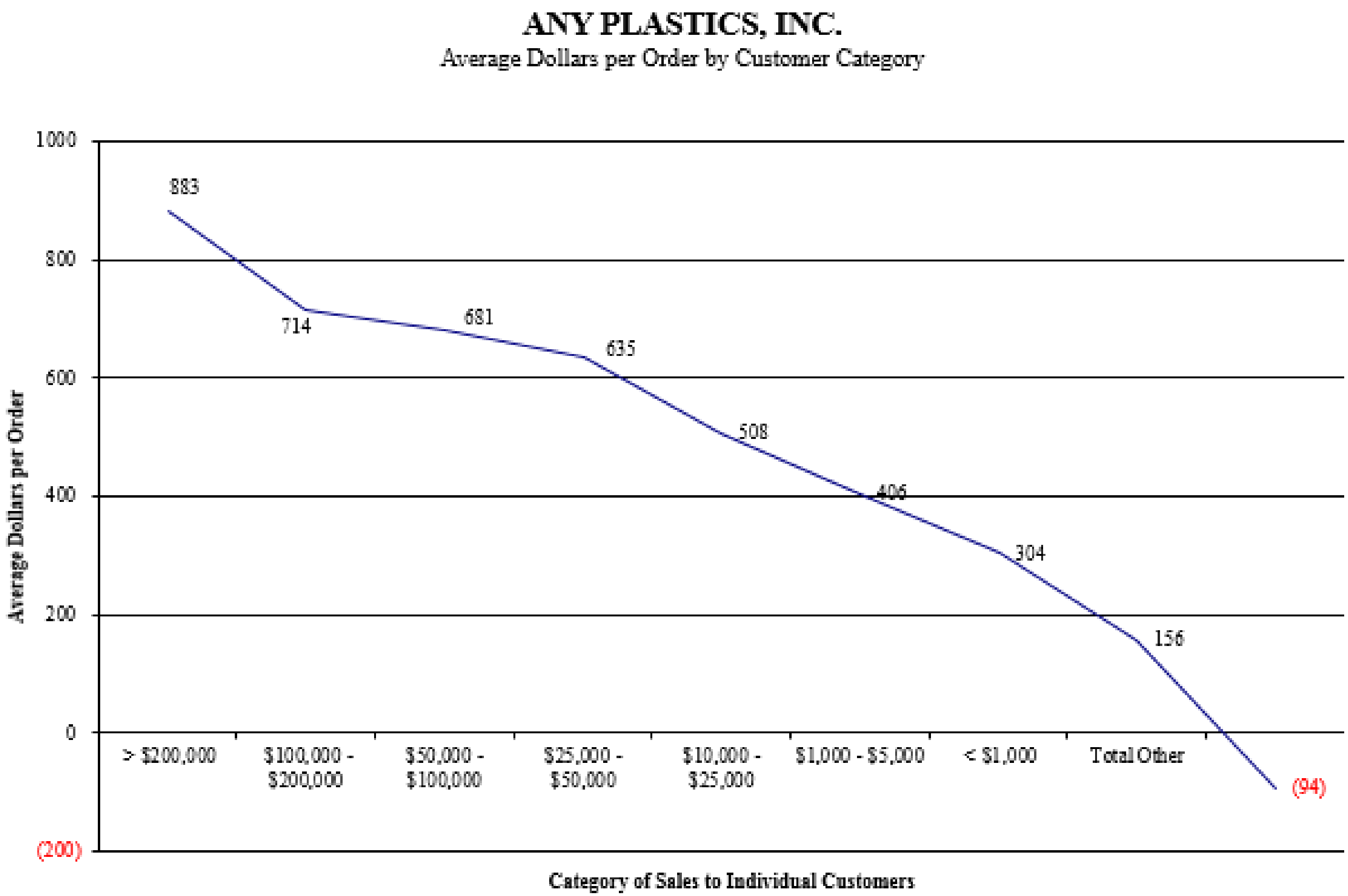
Example: Any Plastics, Inc.



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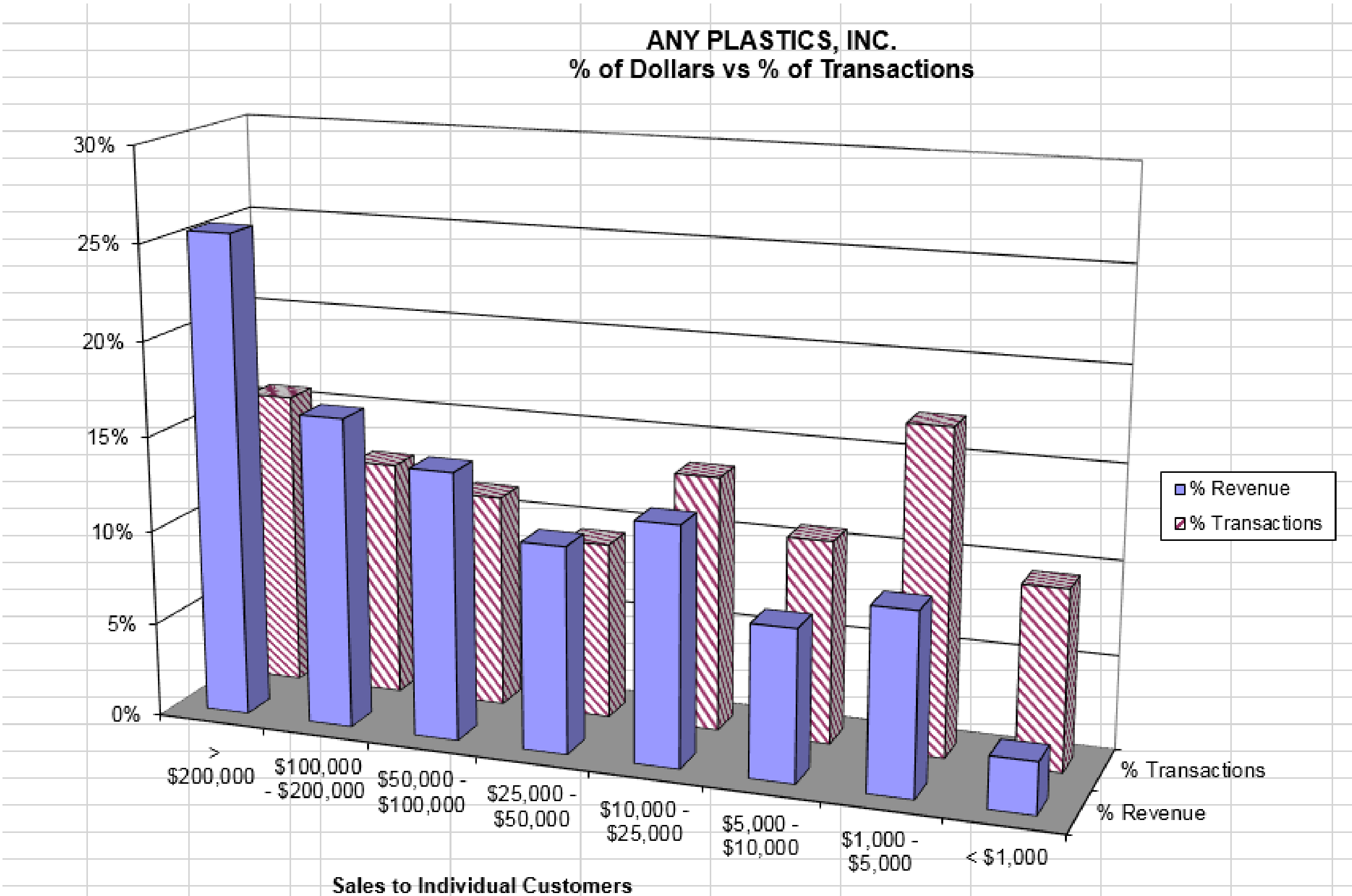
Example: Any Plastics, Inc.



Any Plastics: Process and Outcome

1. Established Target Customer Criteria for The Business
2. Segmented/Ranked Customers with an A - F Rating Scale
   - A's – Best Customers – Priority in the Queue/Continued Pricing – Focus to sell them more
   - B's – Great Customers – Priority in the Queue/Continued Pricing – Focus to sell them more
   - C's – Good Customers – Price Increase based on Level of Business – Focus to sell them more at better prices
   - D's – Bad Customers – Dramatic Price Increase to Continue Many Fired/Self Selected Out
   - F's – Worst Customers – Ridiculous Price Increase and Many Fired/Self Selected Out

<u>Outcomes - 1 Year Out</u>

- On Time Delivery Problem Eliminated
- Customer Satisfaction (for customers that mattered) Higher
- Lost Many D's and F's but many stayed and paid a much higher price – profits from those groups were dramatically higher
- Margins Significantly Higher
- Net Profit and Cash Flow Records

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Discussion

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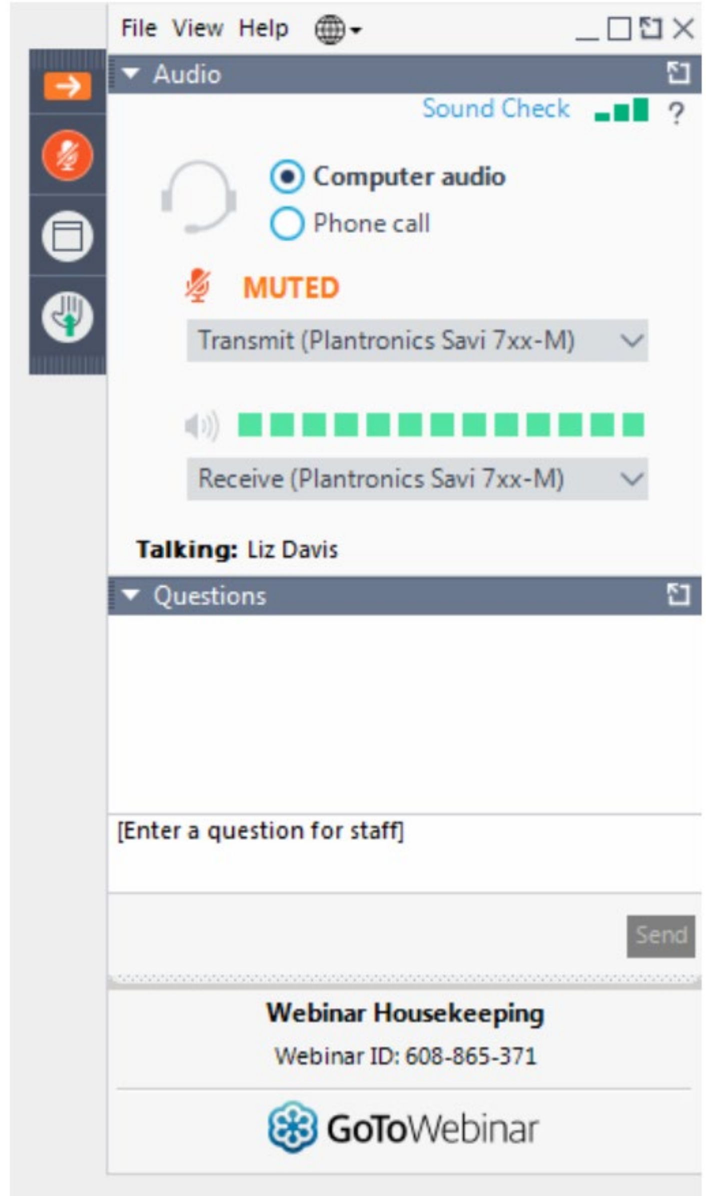
Attendee Control Panel

Microphone

Click this button (after we call your name) to unmute yourself and ask your question.

Raise Hand Feature

Click this button to let us know you have a question for Mario



Contact the Presenter

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Mario is a business advisor to privately-held companies, helping them to address the unique challenges they face as they grow and to create value for their owners. He has over 30 years of experience working with entrepreneurs and private and family-owned companies in a variety of industries including construction, manufacturing, distribution, and services. His principal focus is on assisting companies in maximizing value for their owners and realizing that value through a clear transfer and exit strategy. Mario is expert in private company transfer strategies and methods, and his work includes a wide range of business advisory services including finance, valuation, strategy, and transaction structure.

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About Kreischer Miller

Kreischer Miller is an accounting, tax, and business advisory firm that has been serving clients in the Greater Philadelphia region since 1975. We've built our firm to respond to the unique needs of growth-oriented private companies, helping you smoothly transition through growth phases, business cycles, and ownership changes. The companies we work with need to be able to quickly adapt and respond to changing market opportunities and challenges. That's why our focus is on being responsive, decisive, and forward-thinking. We're up to the challenge—always looking at the road ahead, not in the rear-view mirror. **Learn more at www.kmco.com.**

The Center for Private Company Excellence is a community—live and virtual—created by Kreischer Miller exclusively for privately-held companies. We recognize that private companies are different. You face unique challenges in building your business and you have a distinct point of view. The Center for Private Company Excellence provides a forum for business owners to interact and network with peers as well as gain access to knowledgeable experts who provide valuable information, tools, and resources to help you navigate these challenges and build your business. **Learn more at www.kmco.com/cpce.**

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