

## Is Gross Profit is Overrated?

Did you ever watch a rivalry college basketball game when the opposing team has a superstar player? The fans “jeer” and yell to distract him. If he misses a foul shot or shoots an “air-ball” the crowd goes into a frenzy and chants; “**O V E R- R A T E D**”. Well in in a distribution business the same can be said about gross profit. Yes, there it is, I said it, gross profit is overrated. Now most of you are reading this and say, really? Any fool knows that gross profit is the main ingredient for a successful business, so how is it overrated? Gross profit is important and by no means do I suggest, imply or even believe that it is not. I would be foolish to think otherwise. Where am I going with this?

If you are an executive, manager or business owner and I propose to you that Customer “A” and Customer “B” have the same sales and the same GP, is their profitability the same? It’s not a trick question, but many will believe that it is. The first and immediate answer is yes, they do have same profit, but the chances that they have the same net profit are not as obvious.

Those that look at the profitability analysis at a 30,000-foot view or look at averages of data, using a “thumbnail view” to create sub-P/L’s in their costing analysis will always be enamored and skewed by gross profit. If you place value in averaging everything, then just expect to be average! In the example above, those managers will always say that Customers “A” & “B” are the same. The answer is maybe they are, but the reality is that they probably are not. Why? The characteristics of your customers are different. Customer “A” may give you twenty (20) orders a year with five (5) line items on each and Customer “B” may give you ninety (90) orders a year with ten (10) line items on each. Just from a pure manpower perspective, it will cost more to service Customer “B” than it will Customer “A”. But there are certainly more and deeper issues to look at when evaluating this. Let’s start with the CSR taking the order, did Customer “A” call in the orders knowing exactly what they wanted, not question the pricing and it was a typical 3-minute phone call, or was it Customer “B” getting a quote for every item (also with multiple vendors) and then calling back again attempting to negotiate? The 3-minute phone call is now 1-2 hours of a CSR’s time. Seems like a big difference to me.

The cost to pick a line item in a warehouse certainly varies, but it is not out of the question to suggest that the cost is \$20-25 dollars per line. Depending on your warehouse efficiency it could be more (or less), but it probably won’t be much less unless you have good automation and a killer WMS. So, with that little cost factor, look at the characteristics of the two (2) customers. If their sales are similar and “B” gives you nine (9) times the amount of lines, the probability is that many of those lines are small-dollar and unprofitable! The cost to service this customer “B” is not only more labor intensive, but many of the items they purchase may not even have enough GP to cover the cost to pick! There are even more factors, such as do you get their orders late in the day, thus causing overtime to do order entry, pick and ship? Does the customer expect this to be delivered for free and at a specific time and you’re paying driver overtime? I won’t get into what it cost you serve your customers, that is for you to do, and you should. This is just an example of 2-similar customers. If customer “B” continued to ask for additional services (obviously with no cost the them) the sales rep assigned to customer “B” will champion for them

without any realization of the real profitability of the customer. After all, the rep is probably being paid on gross profit! Do you think that they are recognizing the real cost to service this customer, or even care?

The truth is many of your line-items, orders and customers are unprofitable and they are subsidized by the profitable line-items, orders and customers. There are theories and case-studies that suggest that you get rid of these items and fire your unprofitable customers. I look at it much different. I say that you should identify, evaluate and do something to change the characteristics of the customers. I am aware that is not easy, but you should spend the time and effort to make it better, even if it takes years. Then, and only then, will your company be sustaining growth and performing in such a way that customers will want to do business with you, and your efficiency and performance will provide you the leverage to take on more business and scale even greater.

You see, the superstar that threw up the air-ball isn't going to bury his head in the sand, he is going to go back and practice to make sure it doesn't happen again. And the next air-ball that is heard will have a "swishing" sound. Nothing but NET (PROFIT).