WHAT DOES ONE PERCENT
MEAN TO YOUR BUSINESS

"What's the difference between water and steam? At 99 degrees water is merely hot, at 100 degrees it turns to steam and can move locomotives. Just one degree, a one percent change, makes the difference."

This is a great metaphor for business. It is always the little things, the small improvements that get the big results. In this short article we look at the impact that small improvements in the key drivers of profitability have on the bottom line. The key drivers of profitability are price, variable costs, the physical volume of sales and fixed costs.

To illustrate this, consider a business that has the following financial performance characteristics:

Revenue	2,500,000
Cost of sales	1,700,000
Gross profit	800,000
Fixed expenses	700,000
Net profit	100,000
Gross profit margin	32%
Net profit margin	4%

A 1% improvement in each of the four profit drivers for this hypothetical business will yield a **40% improvement in net profit**! What's really important to notice is the fact that for this business, the 1% improvement in price has more than 3 times the impact of a 1% increase in sales volume and nearly 4 times the impact of a 1% reduction in fixed costs. While the relative impact of price compared to variable costs, volume and fixed costs will depend on the financial characteristics of the business, it will always have a greater impact than any of the other drivers and usually that impact will be in the order of more than two to three times the effect.

The reason for this is quite straightforward. An increase in price for a given volume of transactions means that not only will total revenue increase but so too will the margin (price minus variable cost) on each transaction. A reduction in variable cost will change the margin but not the level of revenue. An increase in volume will increase revenue, but will not change the gross profit margin, and a reduction in fixed costs will have no impact on gross profit at all.

Interestingly, reducing fixed costs will always have the smallest impact. For example, in this hypothetical business, fixed costs would have to reduce to R625, 000 to achieve the same result as a 1% increase in price. If you look at a larger change such as a 10% improvement that will take your GP% to 38.18%, the differences are even more dramatic. With this scenario, a 10% price increase will increase net profit to R350, 000 whereas a reduction in fixed costs of R350, 000 (43% reduction) would be needed to yield the same profit.

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If I put my prices up by 10% how much business would I lose?

You might be thinking, "that's all well and good in theory, but if I put my prices up by 10%, how much business would I lose?" That's a good question but a far better one is, "how many customers could I afford to lose without being any worse off?" For this business, the answer is 24%. This would result in a reduction in total revenue of about 16% given a current GP% of 32%. In other words, you could lose 24 out of every 100 of your "average" customers and be no worse off. And if that were to happen, which 24 customers do you think you might lose - we suspect it will be the 24 people who are price sensitive and who keep reminding you and your team of that. You might also want to remember that a 24% reduction in the number of people you service will take the pressure off you and your team members and will, in all likelihood, enable you to cut back on some of your fixed costs.

The strategic implications of this type of analysis are very important. Most business people are pre-occupied with getting more revenue, often from new customers. They pay very little regard to the customers they already have and usually adopt the view that price is something over which they have very little control because of competitive pressure. They also believe that seeking ways to reduce costs is the most effective way to build a profitable business. This is absolutely the wrong way to run a business even though it may seem to make intuitive sense that the more revenue you generate the bigger, and therefore the better, your business will be.

We have clearly demonstrated that this is not the way to go. Why not give us a call to review which of your profit drivers can affect your business.