

## Making Money in a Tough Market: Know When to Hold 'Em, Know When to Fold 'Em

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One of the many challenges that all firms face in slower economic times is knowing what the appropriate response should be to stagnant sales. In some instances the correct action is to do nothing and simply wait for the economy to improve, as it always does eventually. In other cases, serious reductions in expenses may be required.

Most firms distinguish between these two options only at the last minute. That is, when profits turn to losses and cash begins to dry up, the firm takes drastic action, often in a reactive mode. Every ALA member would be well served to develop a response plan before sales and profits start to disappear.

This report will address how firms can become more proactive with regard to any potential sales downturn. It will do so from two perspectives:

**The Break-Even Point**—Calculating the level of sales decline that would cause the firm to shift from profitable to unprofitable operations.

**Appropriate Actions**—Identifying the things that a firm should do and should not do when a sales decline reaches the point where profits have been seriously eroded.

### The Break-Even Point

Every firm should know its break-even point—the sales level at which the firm produces no profit at all. The truth, of course, is that almost no firm ever bothers to calculate its break-even point. When things are going well, nobody cares. When things are going poorly, nobody has the time.

Exhibit 1 highlights the break-even point for the typical ALA showroom member. All of the information is taken directly from the latest Showroom Performance Report.

As can be seen in the first column of numbers, the firm currently generates \$3,000,000 in sales and produces a profit of \$105,000 or 3.5 percent of sales. It does so by operating on a gross margin of 43 percent of sales and total expenses of 39.5 percent of sales.

The exhibit shows that the firm has broken its expenses into fixed and variable components. Fixed expenses are those commitments for which the firm is liable, regardless of sales, such as rent and administrative salaries. Variable expenses are those that only arise when sales are made, such as commissions, bank-card charges and bad debts.

The sample firm (a typical ALA member) has fixed expenses of \$945,000 per year. In addition, it has variable expenses that are equal to eight percent of sales.

Exhibit 1			
Current and Break-Even Performance for a Typical Firm			
Income Statement	Current Results	Break-Even Point Current	5% Price Cut
<b>Dollars</b>			
Net Sales	\$3,000,000	\$2,700,000	\$2,953,125
Cost of Goods Sold	1,710,000	1,539,000	1,771,875
Gross Margin	1,290,000	1,161,000	1,181,250
Expenses			
Variable Expenses	240,000	216,000	236,250
Fixed Expenses	945,000	945,000	945,000
Total Expenses	1,185,000	1,161,000	1,181,250
Profit Before Taxes	\$105,000	\$0	\$0
<b>Percent of Sales</b>			
Net Sales	100.0 %	100.0 %	100.0 %
Cost of Goods Sold	57.0	57.0	60.0
Gross Margin	43.0	43.0	40.0
Expenses			
Variable Expenses	8.0	8.0	8.0
Fixed Expenses	31.5	35.0	32.0
Total Expenses	39.5	43.0	40.0
Profit Before Taxes	3.5 %	0.0 %	0.0 %

The second column of numbers in the exhibit indicates that the typical firm would have to experience a sales decline of 10 percent before the firm would shift from profitable to unprofitable operations. Knowing this allows the firm to make realistic decisions regarding the future.

If sales are anticipated only to be sluggish—experiencing a decline of say five percent—then the firm would probably be well advised to continue to operate as it always has and wait for the inevitable recovery. Profits will decline, but the firm will still generate some profit.

In contrast, if sales are expected to decline by 15 percent, then strong measures are required. In particular, expenses must be reduced in an effort to offset the sales decline.

Calculating the break-even point may seem difficult and tedious. However, it is a relatively easy computation if the firm knows its fixed and variable expenses. The following figures for the typical ALA member demonstrate the calculation for the break-even point:

$$\begin{aligned} \text{Break-Even Point} &= \frac{\text{Fixed Expenses}-\$}{\text{GM}\% - \text{Var.}\%} \\ &= \\ &= \frac{\$945,000}{43.0\% - 8.0\%} \\ &= \\ &= \$2,700,000 \end{aligned}$$

### Taking Appropriate Actions

Knowing when action is required is one thing; knowing what to do is yet another. While every firm is unique, there are three general guidelines that apply to all ALA members.

**Cut Once, Cut Large**—If expense reductions are needed, they should be large enough to overcome the entire decline in sales volume. The focus must be on fixed

expenses since the variable expenses (8 percent of sales) will automatically decline as sales fall. The percentage reduction in fixed expenses needs to be at least as large as the decline in sales. If sales are expected to drop by 15 percent, then a 15 percent fixed expense cut is needed. If at all possible, expenses should only be cut once. Several small cuts will sap the morale of even the strongest organization.

**Don't Sell Out the Future**—Anything that is associated with sales generation should be cut only if the situation is desperate.

Too many firms reduce their marketing expenditures only to find that when the market begins to turn up, they have lost all of their visibility to potential customers. Cuts may be unavoidable, but they should be made only to the degree that is absolutely necessary for survival.

**Avoid Price Battles**—The inevitable result of any sales sluggishness is a rush to reduce prices. A visit to any shopping mall will testify to that fact. The reality, though, is that price reductions in down markets generally do nothing more than lower profits even further. The final column of numbers indicates that for the typical ALA member a five percent price reduction will increase its break-even point from the current \$2,700,000 to \$2,953,125, a 9.4 percent jump.

While the numbers behind this calculation are not obvious, they reflect reality—a massive sales increase is necessary to offset a price cut. The new break-even point is actually higher than the original level of sales.

### Moving Forward

Recession is a fundamental part of the business cycle. However, recovery is just as fundamental. ALA members would be well served to know when to hold 'em (continue business as usual because the sales decline can be managed) and know when to fold 'em (make targeted expense reductions). Only by understanding the break-even point can the firm know which action to take.

It is also essential that firms know the types of actions to take and which actions to avoid. It will not make the recession any less pleasant. However, it will ensure that the firm maximizes its profits across the entire business cycle.

About the Author: Dr. Albert D. Bates is founder and president of Profit Planning Group, a distribution research firm headquartered in Boulder, Colorado. ©2009 Profit Planning Group.