

Walk Before You Run



THE SEVENTH COMMANDMENT

EXPAND METHODICALLY FROM
A PROFITABLE BASE TOWARD A
BALANCED BUSINESS.

Optimism is both the poison and the antidote of the growth company manager. It may be possible to accomplish all things, but not simultaneously. With limited resources, incremental growth over time is the judicious prescription for prosperity. Seek logical, extensions of existing activities, but avoid a growth-for-growth's-sake psychology. Bigger is not automatically better; more is not necessarily merrier. Make managing a competitive advantage. Increase customer dependency on the enterprise. Economic success can breed more of the same as well as other returns for the primary participants. Money is the traditional reward; life-style considerations are becoming more widely valued.

Walk before you run. Don't build your skyscraper on sand. Sometimes you have to bunt to get on first base. Avoid growing into trouble. Measure twice, cut once. All of these aphorisms tend to ring true in the cold light of day. But historically, expanding methodically has proven to be something of an unnatural act for those who grow new companies . . . and even sometimes for experienced entrepreneurs who try to turn around old ones. A few years back, Roy Ash, cofounder of Litton Industries and later director of the Office of Management and Budget in Washington, D.C., was fired as the chairman and chief executive officer of the money-losing AM International (formerly called Addressograph-Multigraph). As reported in *Fortune*:

“. . . Ash's big blunder was his failure to build a solid foundation of profits before making acquisitions.”

How does an entrepreneur protect himself or herself from the harmful side effects of optimism, the tendency to see an opportunity under every rock? First and foremost, he or she must have a deep sensitivity to the mechanics of profitability—to basic profit math.

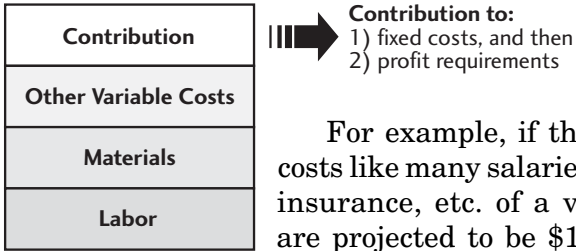
“We expect to make 20 percent on sales.” “Our new program is going to give us 30 percent before taxes.” “Product A will make money every day of the year.” These kinds of common statements reflect an important and widespread misconception that goes like this: Every dollar of sales has a portion of profit in it. Here's the picture:

Profit
Other Variable Costs*
Materials
Labor

* Note: Variable costs are those costs that vary with volume, e.g., some labor, raw materials, freight, sales commissions, packaging, etc.

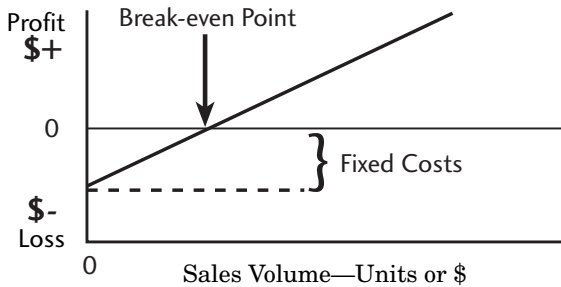
\$1 of Sales

Look familiar? The problem is, of course, that it is wrong. There are no pennies of profit in any \$1 of Sales until *all* the fixed costs of the enterprise are covered. A much more useful way to illustrate the situation is this:



For example, if the fixed costs like many salaries, rent, insurance, etc. of a venture are projected to be \$100,000 for the first year in business, no profit will be made until the \$100,000 is covered.

The mechanics of profitability can handily be summed up and illustrated by the following graph, a graph that at various times goes under the name of break-even chart and profit-volume chart.



The vertical axis is profit; the horizontal axis is sales volume. At zero sales, the amount of profit is a negative number, a loss.—≠ The loss is equal to the fixed cost of the time period under study.

If each unit sold and sales dollar received does indeed have a contribution (defined in more detail below), then the fixed cost is gradually whittled away until the

enterprise “breaks even.” After that point, the contribution from each unit sold and sales dollar received goes totally to profit.

Here is the idea expressed in formulas:

*Sales Price - Variable Costs = Contribution per sales
\$ or unit of sales*

*Fixed Costs ÷ Contribution = Break-even Point in
terms of sales \$ or units*

*Total Sales Income - (Total Variable Costs + Fixed
Costs) = Profit*

Now, for the purposes of Commandment Seven, the important issue to recognize is that there are three fundamental elements in the profitability of a company:

Sales Volume...in units or dollars

Fixed Costs...for the time period

Contribution...per unit of sale or sales dollar

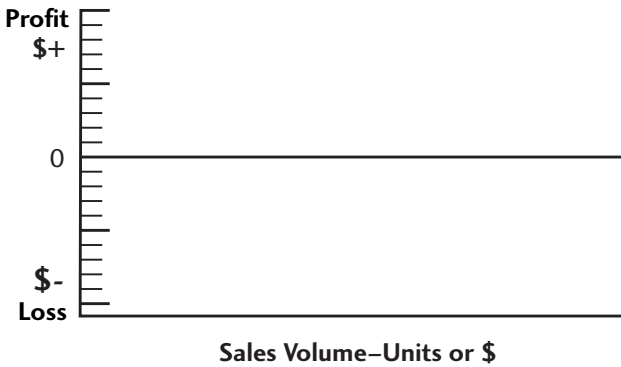
For example, suppose you are working on a new venture with these essential facts:

First year's fixed costs are projected to be \$550,000
Sales price of your product is projected to be \$100 per unit
Variable cost of product is projected to be \$45 per unit

Try graphing the above information in an effort to answer these questions:

How many units will have to be sold to break even?
What will be the sales volume in dollars at the break-even point?
How much profit will the company make if it sells 25,000 units during the first year?

Do your work on the graph on the following page.

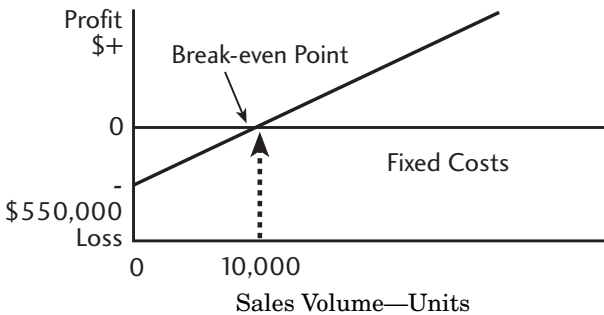


The math works out as follows:

Sales Price \$100
 Variable Costs -45
 Contribution \$55 per unit.

$$\frac{\text{Fixed Cost}}{\text{Contribution}} = \frac{\$550,000}{\$55 / \text{Unit}} = 10,000 \text{ units to break even.}$$

Graphically the above information can be presented like this:

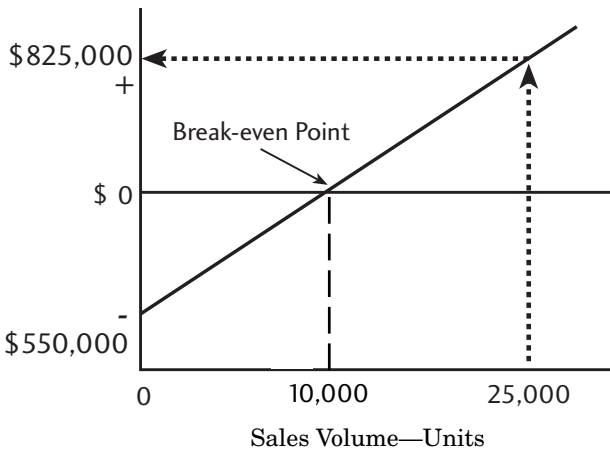


The sales volume at 10,000 units is 10,000 x \$100 sales price per unit or \$1 million. The new venture will have to reach \$1 million in sales volume before it starts making a profit.

If the entrepreneurs can sell 25,000 units, an amount well above the break-even point, the profit will be as follows:

$$\begin{aligned} & \$2,500,000 \text{ Sales Income} - (\$1,125,000 \text{ Variable Costs} \\ & \quad + \$550,000 \text{ Fixed Cost}) = \$825,000. \end{aligned}$$

At a sales volume of 25,000 units, the profit picture looks like this:



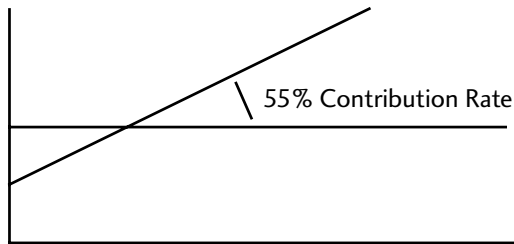
Not bad. Now here is one important refinement to understanding these basics. In actual practice, the contribution is usually converted to a percentage, a *contribution rate*.

$$\frac{\text{Contribution per unit}}{\text{Sales Price per unit}} = \text{Contribution Rate}$$

In this example, the contribution rate was:

$$\frac{\$55}{\$100} = 55\%$$

Graphically the contribution percentage looks like this:



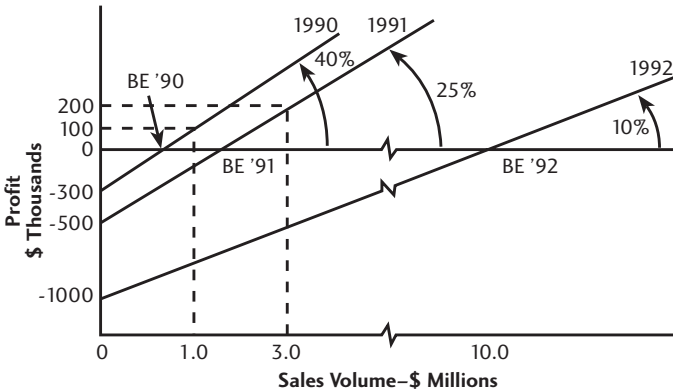
In effect what this picture says is that 55 percent out of every sales dollar is available to pay first, for the fixed costs and second, for the profit *requirements* of the enterprise. In a growth company, profit is indeed a requirement, not a luxury.

Think back over the ground that has been covered here in Commandment Seven. The crux of the matter of profitability fundamentals is simply this: An entrepreneurial team can harm, or kill, profitability by trying to do too much, too soon. For what often happens when opportunity-chasing overrules methodical growth is that overhead (fixed costs) goes up and the contribution rate comes down. This is a dangerous turn of events. The end result may well be greater sales volume for the enterprise, but it is paid for with eroding profitability. The combination of higher fixed costs and dropping contribution margin is typically not a formula for long-term happiness in terms of economic vitality.

Consider the following example of sales and profits for the Widgetronics Company, Inc.

	<u>1990</u>	<u>1991</u>	<u>1992</u>
Sales	\$1,000,000	\$3,000,000	\$10,000,000
Profits	\$100,000	\$200,000	0

Upon analysis, the deterioration of Widgetronic's profitability can be illustrated. (You don't have the figures to do the analysis, but please note the factors driving profitability down.)



In table form, the analysis looked like this:

	<u>1990</u>	<u>1991</u>	<u>1992</u>
Sales	\$1,000,000	\$3,000,000	\$10,000,000
Profits	\$100,000	\$200,000	0
Fixed Costs	\$300,000	\$550,000	\$1,000,000
Variable Costs	\$600,000	\$2,250,000	\$9,000,000
Contribution			
Rate	40%	25%	10%
Break-even			
Point	\$750,000	\$2,200,000	\$10,000,000

The company is going downhill quite dramatically.

What did Widgetronics' management do between 1990 and 1992? Certainly the team increased sales.

“Look at our 300 percent growth over last year.” But in the process, the fixed costs tripled, and perhaps more importantly, the contribution rate was allowed to drop precipitously from forty cents per sales dollar to ten cents. By 1992, Widgetronics had to sell \$10 million of business just to *break even* at year end. Unless there are compelling strategic reasons to do so and plenty of money in reserve, such performance is unacceptable if the enterprise is operating in a competitive industry.

An even more detailed analysis of how Widgetronics grew itself into trouble indicates that between 1990 and 1992 the management added two major new product lines, one closely related to the main business and one not. Here are the highlights of the impact the additions had on the contribution rate and the fixed costs. Note carefully what the new, unrelated product line brought to Widgetronics.

<i>Original Product Line</i>	<u>1990</u>	<u>1991</u>	<u>1992</u>
Sales	\$1,000,000	\$2,000,000	\$ 4,000,000
Contribution Rate	40%	30%	40%
Associated Fixed Costs	\$ 300,000	\$ 300,000	\$ 400,000
<i>New Product Line (Related)</i>			
Sales	0	\$ 500,000	\$ 2,000,000
Contribution Rate		20%	10%
Associated Fixed Costs		\$ 100,000	\$ 200,000
<i>New Product Line (Unrelated)</i>			
Sales	0	\$ 500,000	\$ 4,000,000
Contribution Rate		10%	-20%*
Associated Fixed Costs		\$ 150,000	\$ 400,000

*Variable costs exceeded selling price

<i>Totals for Widgetronics</i>			
Sales	\$1,000,000	\$3,000,000	\$10,000,000
Contribution Rate	40%	25%	10%
Fixed Costs	\$ 300,000	\$ 550,000	\$ 1,000,000
Break-even Point	\$ 750,000	\$2,200,000	\$10,000,000
Profits	\$ 100,000	\$ 200,000	0

In this example, a combination of factors hurt profitability. New, unrelated product lines are not categorically troublemakers. But they should be approached with caution. This is even more true now in the 2000s with the advent of the Internet and surprise competitors.

If you personally are not comfortable working with and manipulating numbers in the way illustrated above, make sure at least one of the primary participants on your entrepreneurial team is.

As in any business, Widgetronics management has but three basic ways to increase the profitability of the enterprise. They can seek to increase sales volume (of products with positive contribution rates), reduce fixed costs, or increase the contribution rate. And there are also three specific ways to increase the contribution rate:

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- Increase selling prices.
 - Decrease variable costs.
 - Change the product mix being sold so as to increase the net contribution rate for all products being sold.
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Of course, in the Widgetronics example, as in real life, a combination of actions is probably required.

Profits don't just happen. Like sales, they typically have to be made to happen. Entrepreneurs must have a sensitivity to the dynamics involved. Profitability isn't a luxury; it is a necessity in a growth company. Without it there are no earnings to "retain." Without earnings on today's business it is usually difficult to attract either equity or debt capital to finance tomorrow's business. Profitability is the progenitor of cash, and when you are out of cash, you increasingly tend to be out for good in our undulating, economic times.

Entrepreneurs are naturally disposed toward spotting opportunities in the form of new product possibilities, additional markets to pursue, processes to initiate,

exciting shortcuts to take, etc. Entrepreneurs move society from the old to the new. By definition, entrepreneurs are supposed to have the ability to see around corners! But a fragile new enterprise will be lucky if the people in it can do a single thing exceptionally well and consistently during the early years. It may be possible to accomplish all things, but not simultaneously. As one weary president put it, “We can do anything, but we can’t do everything.” With limited resources, incremental growth over time is the judicious prescription for prosperity.