SB PARTNERS

PROFIT IMPROVEMENT GUIDE

In association with

HORTICULTURAL TRADES ASSOCIATION
landscape ontario.com
Green for Life!

IMPROVING PROFITABILITY FOR GARDEN CENTRES AND GROWERS

Growers typically know their total cost structure to operate their farm. Yet, how many growers can translate that cost to an individual plant? Understanding costing is important since you can't accurately determine your pricing strategy without understanding your cost. In the absence of this information, pricing becomes an estimate with the hopes that the grower will make a profit. Historically, this strategy may have worked, in recent years however, growers have experienced increased pressure to keep prices constant or even discount prices despite facing increased costs. While offering discounts to farm operations is perceived as a necessary reaction to market pressures, this strategy can negatively impact the bottom line.

The intent of this document is to provide the grower with a conceptual understanding of costing and the effect that discounting can have on the overall profit of their business.

What is profit?

Simply put, profit is what's left over after you've paid all your expenses. The important thing to note is that profit is 'what's left over'. In other words, profit is a residual and is affected by what happens in and to your business. Within your operation, some things are within your control (e.g. adding additional labour) and some are outside your control (e.g. property taxes). If you're going to have any impact on your profit, you have to focus on the things over which you have control. The obvious question is, what are they?

To answer this question, it is helpful to understand that there are only four specific factors that work together to determine your profit:

1. The ***price*** you charge for the products you sell.

2. The ***quantity*** (or volume) of products you sell.

3. The costs you incur directly in producing or buying the products and services you sell. These are called ***variable costs*** because they increase or decrease as your sales increase or decrease.

4. The costs you incur regardless of whether you make any sales. These are your ***fixed costs*** because they do not change with changes in sales volume-at least not on a day-to-day basis.

Let's put these four things together in an example. For simplicity, we'll assume you have only a single product but the conclusions we come to will apply whether you have one or one thousand products. In our example, a farm grows a single type of tree. It costs $60 to grow the tree and the farm sells it for $100. What you sell the tree for is the ***price***. The cost of growing it is the ***variable cost***.

If you sell 100 trees, your total variable costs will be $6,000 (i.e., $60 cost per tree multiplied by 100 trees). However, if you sell 50 trees, the total variable cost is only $3,000. The cost varies directly in accordance to your sales volume.

Now, if you sell a tree for $100 and it costs you $60, you've made a profit of $40 on each sale. This is called the ***gross profit*** or ***gross margin***. We use this term to remind us that we still have to meet our fixed costs before we end up with a net profit.

If you sell 100 trees and make a gross margin on each one of $40, your total gross margin is $4,000. If your fixed costs for rent, equipment leases, wages, insurance, etc. amount to $3,000, you end up with a 'net profit' of $1,000. On the other hand, if your fixed costs are more than $4,000, you will incur a loss.

How to increase profit

If you're looking for ways to increase your profitability, focus your attention on the four profit determining factors:

1. PRICE
2. VOLUME
3. VARIABLE COSTS
4. FIXED COSTS

It's important to note that profitability can be improved by either increasing or decreasing any of the four factors, as long as there isn't an offsetting increase or decrease in one of the other factors. In fact, a profit improvement strategy may involve increasing or decreasing one or more of the four factors.

It is important to understand that a favourable change in price and/or your variable costs will improve your gross margin per dollar of sales. On the other hand, a favourable change in your sales volume and/or your fixed costs indicates greater productivity. Therefore, the overhead you pay in running your business will cost you less on a per dollar of sales basis.

As a result, a profit improvement strategy must focus on one or both of two things:

- Achieving a higher gross margin per dollar of sales by increasing price and/or reducing variable costs, and/or
- Achieving greater sales per dollar of fixed costs by increasing sales volume or reducing your fixed costs.

FACTOR	ACTION	REQUIRED CONDITIONS FOR PROFITABILITY
Price	Increase	Sales volume for nursery stock could either remain unchanged or decline. If sales volume declined, the decline would have to be less than the offset created by the price and resulting profit increases.
	Decrease	The sales volume would have to increase sufficiently to compensate for the decline in price. If sales volume was to increase as a result of the lower price, there is a possibility of a decrease in the per unit fixed and variable costs because of increased economies of scale.
Variable Costs	Increase	The increased variable costs should lead to or be a result of improved product or service quality. The market would have to accept a higher price, or the heightened quality would have to attract enough new buyers to offset the increase in variable costs.
	Decrease	The sales volume would have to remain unchanged. The decrease in variable costs could not be allowed to affect product or service quality – as this would impact sales. If sales did decline, the fall in gross profit would have to be less than the decrease in variable costs.
Sales Volume	Increase	The price could either remain unchanged or decline. If the price was reduced, the reduction would have to be less than the offset created by the volume and resulting profit increases. Another possibility is to achieve a reduction in the per unit fixed and variable costs by benefiting from an increase in economies of scale.
	Decrease	A savings in fixed costs would have to be achieved by reducing the size of the business or evaluating production levels to determine the variable cost economies of scale. This savings would have to be greater than the reduction in gross profit due to the decreased sales volume.
Fixed Costs	Increase	The increase in fixed costs should lead to or be a result of improved product or service quality. The market would have to accept a higher price, or the heightened quality would have to attract enough new buyers to offset the increase in fixed costs.
	Decrease	Sales volume would have to remain unchanged. The decrease in fixed costs could not be allowed to affect product or service quality – or else suffer a consequential effect on sales. If sales did decline, the fall in gross profit would have to be less than the decrease in fixed costs.

Demonstrating profit improvement

Small changes can make a big difference to the bottom line. By way of example, consider the impact a 5% improvement in each of the four factors can have on the bottom line.

	BASE	% CHANGE	RESULT
Tree Price	100	5% increase	105
Sales Volume	100	5% increase	105
Total Revenue	10,000		11,025
Variable Costs ($60)	6,000	5% decrease ($57)	5,985
Gross Margin	4,000		5,040
Fixed Costs	3,000	5% decrease	2,850
Net Profit	$1,000		$2,190

The example above demonstrates that a 5% favourable change in each of the four factors doubles the profit from $1,000 to $2,190, resulting in an improvement of 119%! Growers should understand that the reverse is also true. If price is discounted coupled with a drop in sales volume, failure to control overhead or variable costs, then you can destroy a potentially profitable business. This can happen very quickly.

The key is leverage – a concept that can make or break a business. Getting all the little things right adds up to the big picture looking after itself. However, getting all the little things wrong can lead to financial trouble and you may not even understand how it happened.

Developing a profit improvement strategy

You'll recall that to improve your profitability you must either make a larger gross margin on each dollar of sales or sell more without increasing your fixed costs. It goes without saying that the biggest improvement will occur if you achieve both simultaneously.

Improving your gross margin

Your gross margin — the difference between the price of your plants and what it costs for you to grow them — can only increase if you sell your nursery stock at a higher price or reduce the cost of growing.

In most instances (but not all!) you will have limited ability to reduce growing costs. For this reason, your selling price is the critical variable. Without a doubt, the biggest single barrier preventing growers from making an acceptable profit is their refusal to charge a price that will enable them to achieve it. Trying to hold or win market share on the basis of price discounting is a destructive strategy that will result in declining profitability. This strategy is only applicable in one situation where you have both a definite cost advantage (either variable or fixed) over your competitors and your product or service is one where customers are very price sensitive.

The following table indicates the increase in sales that is required to compensate for a price discounting policy. The table is set up in a matrix format. Start with the gross margin across the top axis then move downward to the line corresponding with the price reduction to find the sales volume increase required to produce the same pre-discount profit. For example, if your gross margin is 30% and you reduce the price by 10%, you need the sales volume to increase by 50% to maintain your original profit.

COMPENSATING FOR PRICE DISCOUNTING									
	If your price margin is:								
	20%	25%	30%	35%	40%	45%	50%	55%	60%
And you reduce price by	To produce the same exact profit, 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%

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. This means you would have to lose one out of every four customers!

SALES DECLINE FOLLOWING A PRICE INCREASE									
	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, 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%

The perception of value

Many growers regard price as the only factor influencing the buying decision of their customers and as a result, reject the proposition that a high price strategy (and by implication, high value) will work. In reality, there isn't any business that does not have the potential to command a premium price for its products or services **if** it is able to market those products or services in such a way that **the customer perceives added value**.

If all of your marketing efforts, advertising and sales dialogue focus on price, then you will be beaten on price every time a competitor comes along with a lower one. By focusing customers on price, this becomes the critical factor in their purchasing decision. The only way to get out of the price trap is to promote the other features and benefits that you offer your customers. For example: better quality, longer life, satisfaction guarantees, and faster delivery due to convenience of location.

Your job as a marketer is to create the ***perception of value*** and then to back up what you sell with a superb product delivered with exceptional service. Remember: price is only important when all other things are equal. Some customers only think in terms of price. If that is the case, they are better left to your competitors. Focus efforts on those purchasers who are happy to pay for value. This means two things: i) you have to deliver value and ii) you have to educate your customers to understand that they are receiving value. One without the other will leave you exposed.

Improving productivity

This is all about getting more sales per dollar of fixed costs. It can be achieved by increasing your sales at a faster rate than your fixed costs increase and/or reducing your fixed costs without affecting your sales.

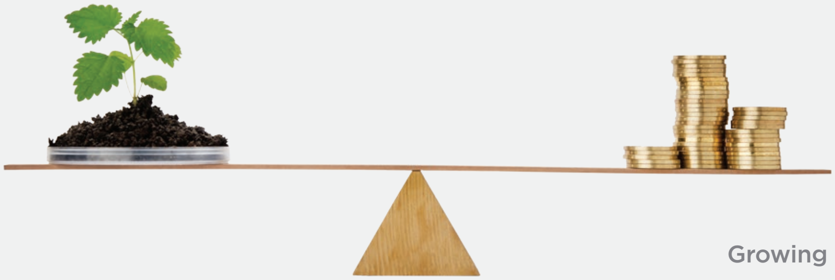
Fixed costs are the charges incurred for you to remain in business. In the short-run, they do not change as your volume of sales changes. Examples include rent, interest, equipment lease costs, etc. Some of these costs are discretionary in the sense that you can make a decision to reduce them simply by cutting back. Others are committed and you cannot avoid them.

Reviewing fixed costs

To understand the critical aspects about each fixed cost, answer these questions:

- What service or value does this cost provide to my business?
- Can I obtain the same service from another source at a lower cost? If so, is it feasible to switch to another supplier of that service?
- If I did switch to another supplier, would I get equivalent quality and would this affect the overall quality of my product or service?
- If I were to spend more on this service, would it generate additional gross profit that exceeds the additional cost?

All of the questions are directed toward what you're getting for what you're spending. They are not concerned simply with whether or not you can eliminate or reduce the cost.



The Return Customer

One of the key aspects of increasing sales is to get your customers to buy more often. The best way to get customers to come back and act as advocates for your business is to give them superb service. Customers need to feel you really care about them and that your only goal is to look after their interests. Most businesses fall short of this ideal but it is an objective well worth striving to deliver.

Almost seventy per cent or seven out of ten customers, cease to patronize a business because of perceived indifference. When you (personally) interact with various businesses, are you not inclined to deal with those who take the trouble to show they care about you? Do you 'shop around' when you are already delighted with the service you receive?

It is sobering to note that most businesses spend six times more money trying to attract new customers than they do looking after the ones they already have. They believe they have to attract new customers since their existing ones keep leaving. Take for example, a customer base of one thousand people who spend an average of $250 per year with you. Suppose that you have a customer loss rate of just 10% each year, and your typical customer stays with you for an average of ten years. Forgetting about inflation, each customer has a lifetime value to you of $2,500. Therefore, a 10% attrition rate is costing you $250,000 in potential future revenue each year.

Another consideration often overlooked by businesses is the simple act of asking the customer to buy. It is no accident that McDonalds is one of the largest and most profitable businesses in the world. The reason for this certainly cannot be found by looking at the uniqueness of their product. McDonalds found that by asking the question "... and will you be having fries and a drink with your meal today?" resulted in people saying "yes" almost thirty per cent of the time, even though it may not have been on their mind. The result? A thirty per cent increase in sales of fries or drinks and an over 100% increase in profit from those lines.

Most people do not fully appreciate the powerful dynamics of customer retention and frequency of contact. The table below demonstrates the powerful effect on total sales revenue of relatively small improvements in the critical variables of customer attrition rate, new customer attraction rate, frequency of customer purchasing and the average value of each sale.

THE COMPONENTS OF SALES	PRESENT RATE	PRESENT POSITION	POSSIBLE RATE	POSSIBLE POSITION
Number of Customers		1,000		1,000
Less Customers Lost	10%	100	5%	50
	900		950	
Add New Customers	10%	100	12%	120
Total Customers		1,000		1,070
Sales Frequency	10	10	11	11
Number of Transactions		10,000		11,770
Average Sale ($)	$25	$25	$27.50	$27.50
Total Revenue		$250,000		$363,675

Perhaps the best-kept secret in the business world is that it is very simple to improve the profitability of a business; but there's a catch. What to do is the easy part — being willing to do it is the stumbling block.

In every case, business success stories have been associated with people who have had the courage to change their way of doing business. In the case of failures, it has been their refusal to try something different. Have you ever said, ***"That sounds okay in theory, but it won't work in my business"?***

If what you're doing now isn't working, then you must do something different!

The following is an example of a profit improvement case where a grower focused on the four profit factors:

A PROFIT STUDY IMPROVEMENT CASE				
	Before	After	Change	See note #
Sales	$242,750	$279,462	15.1%	1
Gross Profit Margin	36%	39%	8.3%	2
Fixed Overheads	$61,358	$67,886	10.6%	3
Capital Employed	$194,885	$201,179	3.2%	4
Net Profit	$26,032	$41,104	57.9%	5
Return on Capital Employed	13.4%	20.4%	52.2%	

Analysis of the Profit Improvement

Increased Sales Volume and Prices	14,317
Improved Gross Profit Margin	7,283
	21,600
Less Increased Overheads	6,528
Increase in Profit	$15,072

Analysis notes

1. Sales Strategies:

- More effective advertising: a budget was established, market was segmented and targeted, and analysis of advertising effectiveness was undertaken to understand the best return on advertising dollars spent.
- Attention was devoted to team training (with respect to product knowledge, selling skills and customer courtesy).
- Performance standards and targets were established and closely monitored.

Result: 15.1% increase in dollar value of sales (some of which was due to selective price increases on key products).

2. Gross Profit Margin Strategies:

- A detailed analysis of the major profit contributors was undertaken (with regard to both the nursery stock and customer segments). Nursery stocks which were not achieving required margins and/or which did not fit the business model were dropped.
- Team members were acquainted with the major profit contributors so that they could focus on these products.
- More selective purchasing was established with greater attention given to volume discounts.
- Selective price increases improved margins and enabled better service to be delivered at the point of sale
- Advertising and selling was directed to higher profit lines and targeted to properly qualified customers.

Result: 8.3% improvement on gross margin due to improved margins from selected price increases enabling better service to be delivered at point of sale.

3. Fixed Overheads Strategies:

- All costs were analyzed as a percentage of sales over the last three years using information available to determine the major cost areas. Each area of cost was examined on a cost/benefit basis to determine whether the same result could be achieved at a lower cost from an alternative source, or whether it was appropriate to increase costs to deliver more customer orientated service value.
- Detailed cost budgets were prepared on a cash flow basis.
- Actual costs were monitored against monthly budgets, and detailed reviews were undertaken quarterly.

Result: Fixed costs increased by 10.6% which was in line with normal inflation at the time – in real terms fixed costs remained constant (even though sales increased by about 5% in real terms and 15% in nominal terms).

4. Capital Employed Strategies:

- A post-sale credit control was put in place. Customers who failed to pay within the prescribed term were politely brought into line. Some customers left, and that was an added bonus (they were the ones that increased servicing costs).
- As part of gross margin analysis (see note 2, Gross Profit Margin) inventory lines that were not achieving turnover targets were evaluated, and some duplicate lines were dropped.
- Tighter control was instituted for inventory and the lead-time for inventory purchasing orders.
- Old slow-moving inventory was disposed of quickly (this released valuable space and increased cash flow).

Result: Inventory levels and receivables were reduced relative to the increase in sales. This released cash that was then used to reduce bank loans and payables. Relationships with the bank and creditors improved significantly. Although actual capital employed increased by 3%, the volume of sales it supported increased by 15%. In other words, a 3% increase in resources supported a 15% increase in sales volume.

5. Net Profit – The Final Result

The net profit improved by $15,072 – a 58% increase over the previous year. This example illustrates how small marginal changes, although modest in themselves, can combine to result in a huge difference.

Profit turn-arounds of this magnitude cannot be achieved year-in and year-out, but every business has room for improvement. The choice is up to the owner/manager.

Estimate your profit improvement potential

Relatively small changes can have a tremendous affect on your bottom line. The following example shows how you can quantify the profit improvement potential of your business.

COMPONENTS OF PROFIT	PRESENT POSITION		CHANGE FACTOR		POSSIBLE POSITION
Number of Customers	1,000	X	1.05[1]	=	1,050
	X				X
*multiply this by the average purchase frequency	10	X	1.05[2]	=	10.5
	=				=
Number of Sales Transactions	10,000				11,025
	X				X
*multiply this by the average value of a sale	$62.50	X	1.05[3]	=	$65.63
	=				=
Total Sales Revenue	$625,000				$723,570
	X				X
*multiply this by the gross margin	40%	X	1.05[4]	=	42%
	=				=
Total Gross Margin	$250,000				$303,899.72
	—				—
*subtract the fixed overhead from this	$220,000	X	1.10[5]	=	$242,000
	=				=
Net Profit	$30,000				$61,899.72
Take the Net Profit in the "Present Position" and subtract it from the Net Profit in the "Possible Position"					Owner $30,000
Profit Improvement Potential					

Change Factor Notes

1. To determine a 5% increase, the change factor is 1.05. Ideas for increasing the number of customers are: selling additional ‘add-ons’ such as sleeves and decor; cultivating referral sources, creating host-beneficiary relationships, using mailing lists, and improving inbound conversion rates. Examples of decreasing the number of lost customers include providing excellent service, creating extraordinary guarantees and collecting customer surveys or feedback forms.

2. To determine a 5% increase, the change factor is 1.05. Ideas for increasing the frequency of purchases are: sending direct mailers to existing clients, creating buyer or user clubs, improving customer relationships and systematizing post-purchase interactions.

3. To determine a 5% increase, the change factor is 1.05. Ideas for increasing the average value of each sale are: product recommendations through cross-selling and up-selling, reorganizing product/service displays and menus and systematizing service deliveries.

4. To determine a 5% increase, the change factor is 1.05. Ideas for increasing the gross margin are raising prices and lowering variable costs. Variable costs could be lowered through improvement of production, supply, or distribution schedules (renegotiation of supplier contracts) and evaluation of material usage.

5. To determine a 10% increase, the change factor is 1.10. The increase in fixed costs is being shown to allow for the increased level of team training and systems that may be necessary to produce the noted changes.

See what the results could be for your business!

COMPONENTS OF PROFIT	PRESENT POSITION		CHANGE FACTOR		POSSIBLE POSITION
Number of Customers		X		=	$ 0
	X				X
*multiply this by the average purchase frequency		X		=	0.0
	=				=
Number of Sales Transactions	0				0
	X				X
*multiply this by the average value of a sale		X		=	$ 0.00
	=				=
Total Sales Revenue	$ 0				$ 0.00
	X				X
*multiply this by the gross margin		X		=	0%
	=				=
Total Gross Margin	$ 0				$ 0.00
	—				—
*subtract the fixed overhead from this		X		=	$ 0
	=				=
Net Profit	$ 0				$ 0.00

Take the Net Profit in the "Present Position" and subtract it from the Net Profit in the "Possible Position" — $ 0.00

Profit Improvement Potential $ 0.00

RESET

Your plan of attack

Even if you are already the leader in your industry, there is always opportunity to improve the profitability of your business starting with a plan of attack. Specifically, you need to find out exactly what your existing and potential customers want and it's not always the lowest possible price. This will form the basis of your marketing plan.

You then need to organize your business so that you can delight your customers; this forms the basis of your operations plan. This requires giving attention to your team members and equipping them with the resources and skills they need to excel in what they do — you must systematize your business.

Finally, you need a management control plan in place to make sure everything is working the way you designed it to work. This plan should focus on the things you must get right to succeed. These are your critical success factors and are used to measure how your business is performing along with key performance indicators.

As Michael Gerber, author of The E-Myth, said, "The reason most businesses don't work is that the people who are supposed to be managing them are too busy working in them rather than working on them." He means that they're doing the technical work. They're working with their hands, rather than their heads. There's a limit to what their hands can do, but no limit to what their head can do.

We believe that as your accountant, our job is to help you re-engineer your business so that it runs like a well-oiled machine. And once that's achieved, we want to help you keep it there!

This publication was prepared by SB Partners in partnership with Landscape Ontario

It's been said that every successful business owner has a good accountant and a good lawyer in their corner. Since 1974, SB Partners has been in the corner of family-owned businesses, privately-held companies, non-profit organizations and high-net-worth individuals. A full-service accounting firm, we provide strategic business advice and comprehensive accounting and tax services. We're here to help you and your business achieve your goals.

Landscape Ontario is the province's premier horticultural trade association. With more than 2000 members, they represent wholesale growers, garden centres, landscape designers landscape contractors, grounds maintenance firms, lawn care companies, irrigation contractors and interior plantscapers. The mission of Landscape Ontario is to be the leader in representing, promoting and fostering a favourable climate for the advancement of the horticultural industry in Ontario. Members benefit from the association's unified industry voice, marketing and awareness programs, promotional and network opportunities, education and professional development.

SB PARTNERS

sbpartners.ca

3600 Billings Court, Suite 301, Burlington, Ontario, L7N 3N6
P: (905) 632-5978 **P**: (866) 823-9990 **F**: (905) 632-9068

HORTICULTURAL TRADES ASSOCIATION
landscape ontario.com
Green for Life!

v2 August 2017