TOO MUCH OF A GOOD THING

By Dr. Albert D. Bates

Few distributors ever say no to additional sales. Not that sales solves all problems, but sales growth is a lot more fun than sales stagnation.

As it turns out, rapid growth creates as many problems as it solves. If the firm grows too fast it will face cash flow challenges. If it grows way too fast, it will probably die from a lack of cash. Those are ominous alternatives.

The idea that sales growth can be too fast is somewhat counterintuitive. Because of that it is necessary to understand exactly how sales growth impacts the firm's financial performance. The report will do so from two perspectives:

- **The Good and Bad of Sales Growth:** A discussion of how sales growth creates financial opportunities as well as financial challenges.
- **The Growth Potential Index:** An examination of a method to identify how fast the firm can afford to grow.

The Good and Bad of Sales Growth

Exhibit 1 outlines the impact of a 15 percent sales increase for a typical DHI member based upon the latest Profit Report. In the *Current* column, the firm has $15 million in sales and earns a profit of $275,000. To generate this profit, the firm must invest $5,750,000 in total assets, much of it in accounts receivable and inventory. This is somewhat offset by $1 million of supplier financing.

The second column details what 15 percent sales growth does for the firm. Some of what happens is extremely positive. Other results are negative and need to be addressed.

The income results are all positive. The firm increased its sales by 15 percent while keeping the gross margin percentage the same. Payroll expenses were controlled so that they have only increased by 13 percent. In addition, the non-payroll expenses have only increased by 10 percent. The firm is leveraging its expenses. This would be outstanding performance based upon historical results.

The bottom of the income statement shows the payoff from this. Pre-tax profit goes from $275,000 to $437,500, an increase of 59.1 percent. After the obligatory income taxes (30 percent), the firm has $306,250 to reinvest back in the business.

To review the balance sheet, it is necessary to start at the bottom. All of the after-tax profit ($306,250) has been reinvested in the business, so total assets are now $6,056,250. Working up from the bottom of the balance sheet, the *All Other Assets* category did not increase.

However, both inventory and accounts receivable have increased by 15 percent to support the increase in sales. As far as inventory is concerned, this is what will happen inevitably, albeit slowly. For accounts receivable this increase happens automatically and instantly.

EXHIBIT 1: The Impact of 15.0% Sales Growth Combined with a Profit Improvement Plan For a Typical DHI Member

Income Statement	Current Results	15.0% Growth	Percent Change
Net Sales	$15,000,000	$17,250,000	15.0
Cost of Goods Sold	10,500,000	12,075,000	15.0
Gross Margin	4,500,000	5,175,000	15.0
Expenses			
Payroll and Fringe Benefits	3,000,000	3,390,000	13.0
All Other Expenses	1,225,000	1,347,500	10.0
Total Expenses	4,225,000	4,737,500	12.1
Profit Before Taxes	275,000	437,500	59.1
Income Taxes (30.0% of PBT)	82,500	131,250	59.1
Profit After Taxes	$192,500	$306,250	59.1
Partial Balance Sheet			
Cash	$550,000	$196,250	–64.3
Accounts Receivable	3,000,000	3,450,000	15.0
Inventory	1,400,000	1,610,000	15.0
All Other Assets	800,000	800,000	0.0
Total Assets	$5,750,000	$6,056,250	5.3
Accounts Payable	$1,000,000	$1,150,000	15.0

The final assets category, *Cash*, is what is left over after subtracting up from the bottom. In this scenario, cash falls to $196,250. It is a sobering situation.

The situation is not completely dire. The firm can count on additional supplier financing because of increased purchasing to support the increased sales. This is shown at the bottom of the exhibit. The firm can also use its line of credit. The challenge is that with the deteriorating cash situation, it may be forced to do so rather than choosing to do so.

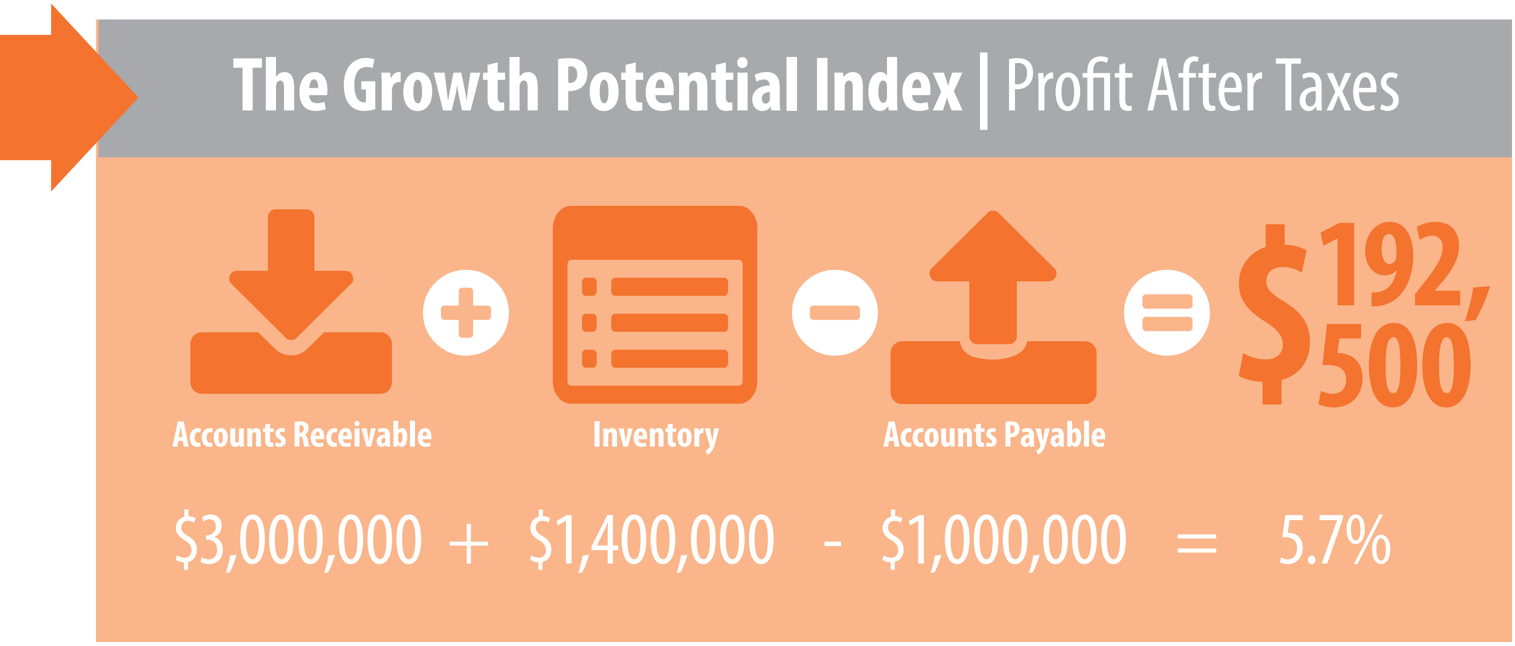
The necessity for distributors is to avoid the cash challenge in the first place. This requires understanding exactly how fast the company can grow and what it might do to overcome the potential cash predicament.

The Growth Potential Index

Understanding how fast the firm can grow necessitates looking at a slightly complicated—but extremely important—formula called the Growth Potential Index (GPI). It provides an *estimate* of how fast the firm can grow without using up its precious cash reserves, which are currently $550,000.

The formula relates the cash coming into the business to the cash that will be needed to finance growth. In the numerator, cash coming into the business is the profit the firm generates on an *after-tax* basis.

The denominator reflects what cash is needed for: the two investment categories that rise along with sales. Inventory will increase with sales over time. Accounts receivable will



automatically increase with sales on a real-time basis. Balancing out these investment requirements is the fact that as the firm grows it will purchase more merchandise from suppliers and have more accounts payable which offsets the need for additional cash.

For the typical firm in the industry, the resulting GPI is 5.7 percent. The implications of this ratio are highly counterintuitive. If the firm grows faster than its GPI, it will generate more profit on the higher sales. However, as was seen in the exhibit, the amount of cash on hand will actually decline. Conversely, growing slower than the GPI reverses the outcome—profit is not as high, but cash rises.

In no way does the GPI indicate how fast the firm must grow. Firms should almost always grow fast enough to maintain their position in the market place and possibly increase their market share.

What the ratio indicates is that when the firm's sales growth projection is larger than the GPI, it needs to have a specific cash-maintenance plan in place. That plan should have three components:

- **Increasing Profit**—The greater the profit, the higher the GPI for the firm. Enhancing profit should always be the first priority of the firm. This is true regardless of the opportunity for sales growth.
- **Controlling Investment Levels**—If sales can be increased without requiring a commensurate increase in inventory and accounts receivable, the GPI can also be increased. However, care must be taken as excessive controls on either inventory or accounts receivable almost always slow actual sales growth.
- **Securing Financing**—If the firm must grow beyond its capacity, it is absolutely essential to have adequate financing arranged *before* the funds are needed, not after.

Moving Forward

Sales growth is essential for long-term success in distribution. Every firm must continue to grow. However, if that growth is unplanned, the firm may well end up worse off than it would be with no growth.

Every firm must know exactly how fast it can grow given its existing cash position. It should then work to improve its ability to grow, largely by enhancing its profit after taxes. ■

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