Managing with the PERSONNEL PRODUCTIVITY RATIO

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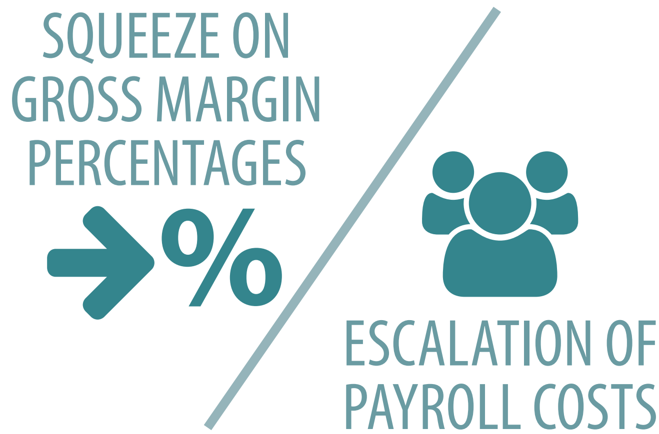

Many distribution managers see two challenges to profitability over the course of the next few years. The first is an anticipated squeeze on gross margin percentages. The second is an escalation of payroll costs. While they are troublesome individually, they are threatening in combination.

The PROFIT Report conducted by DHI provides the basis for understanding these challenges and overcoming them. The most useful of those insights is provided by a little-understood metric called the Personnel Productivity Ratio (PPR). Managing with the PPR will be a key to enhancing profitability.

This report will examine the insights provided by the PPR. It will do so from two distinct perspectives:

- **Understanding the PPR**—An explanation of the ratio and some suggestions for setting a reasonable target.
- **Improving the PPR**—A discussion of the key ways in which the PPR, and overall profitability, can be improved.

Understanding the PPR

The PPR is a simple ratio which encompasses some enormous implications for distributors. The ratio expresses total payroll costs (all direct compensation to employees and fringe benefits—FICA, Medicare, 401(k) contributions and health insurance) expressed as a percentage of the gross margin generated by the firm.

Exhibit 1 examines the income statement performance of a typical DHI member based upon the latest PROFIT Report. At the bottom of the income statement there is a calculation for the PPR. As can be seen, the ratio is 66.7 percent. This means that for every $1.00 of gross margin generated, 66.7 cents must be spent on payroll. It is one of the few financial ratios where lower is better than higher. The objective of the firm is to minimize the payroll expenditure required to generate the gross margin dollars.

One of the very first challenges in using the PPR as a management tool is in setting a realistic goal. A number of generic guidelines have been suggested by distribution consultants. Virtually all such generic goals are useless or, in many cases, actually harmful.

The most commonly prescribed goal is that the PPR should be under 50 percent. However, the PPR varies widely by line of trade making a one-size-fits-all number meaningless. For an industry in which the PPR is 55 percent, that might be a useful guideline. However, for an industry with a PPR of 45 percent, it is nonsensical. The PPR target must always be industry specific.

Setting a useful objective starts with the industry-average PPR. As indicated earlier, for DHI members this figure is 66.7 percent. Research suggests that the most successful firms in an industry tend to operate, in aggregate, on a PPR that is about 10 percent lower than the industry norm. Using that guideline, a realistic goal for DHI member would be around 60 percent. Once a goal is set, there is still the issue of exactly how the goal can be achieved. There is also the issue of the time frame for achievement.

Improving the PPR

From a timing perspective, it is useful to take the 10 percent improvement and break it down into one-year components of around two percent each. Clearly this is somewhat arbitrary, but it does reflect the reality that improvements in any area of a distribution business take both time and effort.

In terms of strategies for improvement it is obvious that there are two levers. Namely, the firm can increase its gross margin or it can lower its payroll expenses. These seemingly simple ideas run headlong into reality.

Research conducted by the Distribution Performance Project indicates that within every distribution segment, including DHI, there are wide operating differences between firms. Some firms have relatively high gross margins versus their peers in the same line of trade, while others have lower margins. Similarly, some firms have relatively low payroll expenses (which leads to higher total expenses) while others have high expenses.

The major obstacle to improvement is that the payroll percentage and the gross margin percentage are highly correlated. That is, the firms with high gross margin percentages also tend to have high operating expense percentages, especially payroll. At the same time, firms with low operating expense percentages tend to have low gross margin percentages. The two factors are linked.

Success in improving the PPR comes from finding ways to increase the gross margin that are as close to expense-free as possible while simultaneously finding ways to lower payroll expenses that do not impact the gross margin negatively. Looking for such opportunities is not part of a business as usual mentality. It requires rethinking the business.

Gross Margin

Increasing the gross margin percentage is almost entirely a pricing issue. Efforts at improve margins via service enhancements and the like inevitably lead to higher payroll expenses. This is why gross margin and expenses tend to rise and fall in tandem in virtually every line of trade in distribution.

Margin enhancement through pricing changes must involve stretching the price matrix. In simplest terms, distributors tend to be price aggressive on fast-selling items, which they should be. However, they tend to under-price slower selling items. It is a substantial opportunity to raise gross margin. Of even greater consequence, it is payroll-expense free. The PPR improves immediately.

Expenses

The key to expense control (without margin degradation) is to focus heavily on transaction economics. Simply put, most distributors do too much work for the revenue being generated.

Transaction economics focuses on two key issues—the number of lines per order and the average line extension. In short, increasing the number of SKUs on each transaction and selling more of each SKU. The former is less difficult, but improves transaction economics only a little. The latter is much harder but significantly improves the economics of the transaction.

Both the number of lines per order and the average line value are largely a selling issue. Every sales force (outside and inside) argues that they are maximizing suggestion selling and trying to sell more of each item. On-site research suggests that every salesperson eventually gets a little sloppy with regard to this. Continual measurement and monitoring is necessary.

EXHIBIT 1: CALCULATING THE PPR FOR A TYPICAL DHI MEMBER

Income Statement	Dollars	Percent of Sales
Net Sales	$15,000,000	100.0
Cost of Goods Sold	10,500,000	70.0
Gross Margin	4,500,000	30.0
Expenses		
Payroll and Fringe Benefits	3,000,000	20.0
All Other Expenses	1,225,000	8.2
Total Expenses	4,225,000	28.2
Profit Before Taxes	$275,000	1.8
PPR Calculation		
Payroll and Fringe Benefits	3,000,000	
Gross Margin	4,500,000	
PPR	66.7	

Moving Forward

The downward pressure on gross margin and upward pressure on payroll is not likely to go away. The proper use of the PPR as a measurement tool can help alleviate those pressures. However, improvement will only be made by paying close attention to the factors that help improve the PPR—stretching the price matrix, and increasing the number of lines per order and the line extension. ■

DR. ALBERT D. BATES is Director of Research for the Profit Planning Group. His recent book, *Breaking Down the Profit Barriers in Distribution*, is the basis for this report. It is a book every manager and key operating employee should read. It is available in trade-paper format from Amazon and Barnes & Noble.