KS ADVISOR BLOG

The Power of Margins

By Steve Ritchie, *Managing Partner*
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I regularly visit with my clients about the secrets of their success, and I learn something from almost every one of them. Several years ago, during one of these visits, I learned something that changed my entire perspective on business. The secret to this client's success was both obvious and a complete revelation to me. His secret … margins!

Here's a quick primer on margin: Margin measures the difference between the cost of goods sold (COGS) and the selling price of a product or service, and it represents the profit that a business makes from each sale. A high margin means that a business is making a significant profit from each sale, while a low margin indicates that a business is only making a small profit from each sale.

I have spent a great deal of time throughout my career consulting with clients on how to improve their profitability. The conversations usually go something like this: I tell the client that they should be more profitable for their efforts, money invested and risk they have in their business. They tell me that they agree but have cut all of the costs they can and can't raise their prices for fear of losing business. What they fail to realize is that profitability is much more directly influenced by margin than by units sold.

Scenarios to consider

Here's a brain teaser for you … which of these 2 businesses would you rather own:

- Business 1 – Sells 20,000 units per year at $1,000 per unit. The cost per unit is $900.
- Business 2 – Had identical sales, pricing, and cost as Business 1 but raised their prices by 10% and lost 50% of their sales … yikes!

If you deduced that Business 2 is likely the more profitable business, that would be a pretty good guess. Even though Business 2 sells only 50% as many units as Business 1, Business 2 doubled their gross profit per unit by raising their prices by just 10%. It's business magic! Here's the math:

	Business 1	**Business 2**
Sales price per unit	1,000	1,100
Cost per unit	(900)	(900)
Gross profit per unit	100	200
Units sold	20,000	10,000
Gross profit	2,000,000	2,000,000

Business 2 also has the advantage of lower fixed and variable costs (fewer salespeople, less warehouse space, lower carrying costs for inventory, etc.) and thus is almost certainly a more profitable (and less complicated) business to run.

I used an extreme example here to demonstrate the power of margins. Raising prices by 10% would not likely result in losing 50% of sales for most businesses. I recognize that not every business can raise their prices by 10%. Some are in highly commoditized markets where price is the key determinate to a sale. For instance, I wouldn't suggest that a gas station raise their prices by 10% over their competitor across the street. That said, many (most) businesses only think they are in this type of market when, in reality, there is something unique about the product, reputation, quality or service they provide. They can have a higher price than their competitor because they provide a greater value to the consumer. Further, even if their primary product is a highly commoditized market, the ancillary sales they make are likely not (think beer at the gas station's convenience store).

Conclusion

When chasing profitability, most businesses get hyper-focused on cutting costs and not on strategically pricing their products and services. Can you put the power of margins to work for you?