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Musings

#40: Driving Margins
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There are some individuals who are good at growing revenue. These are often sales-oriented people who are watching the market and driving customer purchases. There are other individuals who are good at managing expenses. These are usually finance-oriented people who recognize that little expenses add up and pay attention to things like how much color toner costs.

The key to good margins is combining these two perspectives. You can't drive margins through cost containment only. You also can't drive revenue regardless of expenses (unless you are backed by Softbank).

Margins are a state of mind. You need to drive this mentality into the organization. Are we getting the maximum amount out of our expenses? How do our margins compare to the market? How can we get more out of every dollar?

I respect the cultures which *assume* annual improvement. The baseline for next year is that the same amount of people will produce 10% more. It is assumed. Continual improvement must occur. This drives leaders to constantly look at everything – what is sent by fedex, could you save money routing digital phone calls through the datacenter, do we need that same software seat license for all of those employees (Watch this one. Software companies like Salesforce are very good at persuading clients to over-license. Every seat is 100% profit for them.)

A big part of margins comes out of the annual budgeting exercise. Rather than "cost plus" budgeting where you start with this year's expenses then increment, consider "zero based" budgeting where every item must be justified like you are starting from scratch. In services businesses where the largest expense item is labor, make sure you work from productivity ratios. You can't operate in an environment where an executive says "we need another person in that department. People are working too hard." The question is whether they are working smart. How many customer service reps do you need per 1,000 customers? Can you create an FAQ to answer questions without labor expense? Can you use chat to provide more efficiency?

My experience is that most individuals look at the budgeting exercise like "asking for the wish list" because you are going to get scaled back. Expenses are always way overstated in round one of budgeting. Even when you get to the end, there is probably another 10-15% of expenses you could get if you really push.

Now, don't get too good at driving margins. They can get too high. That is right, margins can get too high and expose yourself to competition. Our Economics professors taught us that abnormal returns do not last in competitive markets. You should put more money into sales and marketing or product to block out competition and create a competitive moat if margins are extraordinarily high. In a labor-based professional services business, I do not think you can sustain EBIT margins over 20% -- the model is a 15-20% ebit margin model. Software companies can drive higher margins if they are early to a market.

Be safe.

Jml

Second Thoughts

Ad

Our IN2L business is doing great things getting technology into the hands of seniors to fight social isolation during this pandemic. We formed a great partnership with the Alzheimer's Association in Florida to get tablets to seniors. See News story on IN2L tablets