TRUSTED ADVICE. PROVEN METHODS. IMPROVED PROFITABILITY.

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Mind the Gap!

This strange title came out of something I had been thinking about for a while when I finally made it into an official concept about 15 years ago.

I must be a slow learner(!) as I have been staring at Profit and Loss accounts of garden retailers for over 30 years! At the same time owners and managers would ask me "What should my labor costs run as a percentage of sales?" Retailers were constantly asking whether a certain percentage of sales was too low or high and it eventually dawned on me. The actual percentage of labor to sales isn't really the question; it depends on the Gross Margin the company is achieving. Rather than "What should I be spending on labor?" the question should be, "What is the maximum can I afford to spend?" That is where 'The Gap' concept comes into play.

So after years of looking at the most successful garden retailers I came to the following conclusion:

To achieve even a modest "bottom line" or Net Profit (i.e. EBITDA - Earnings Before Taxes, Depreciation and Amortization) of 6-8% of Sales, an independent retailer has to consistently achieve a 26% "Gap" between Gross Profit Margin (or GM) as a percentage of Sales and Total Labor Costs as a percentage of Sales.

This is assuming that Labor costs include employment costs (and other "burden") and the GM number includes inventory adjustments - as in a physical inventory count.

GM (as % of Sales) – Labor costs (as a % sales) = 26% minimum

The word "consistent" is key here to a Gap result. One or two years at 23% or 25.6% doesn't mean a disaster but companies which consistently fail to beat the 26 point target are perpetually short of investment funds to improve, upgrade and expand, unless the owner forgoes their remunerations or the company saves money in other expenses such as marketing – not a good strategy!

In effect, the more progressive companies are consistently returning a 28% to 35% Gap by achieving an inventory-adjusted GM of 45% – 55%, with Labor coming in between 15% - 20% of Sales.

The Gap concept should also align with the image or customer perception of the company: higher prices, usually giving a higher Gap, suggests higher quality service, lower prices suggest a more self-service environment. So a 42% GM with a Labor cost of 13% still gives a good Gap of 29% but at a lower service model, which maybe exactly the company's strategy.

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It is worth noting that because the Gap metric depends on an actualized or inventory-adjusted Gross Margin, this is really a one or two times per year metric, no a weekly or monthly one. Managers who track this during the year may see a higher number than at their fiscal year end. Similarly when applied to individual departments this concept can also be misleading for obvious reasons of a lower GM category that takes more labor than others.

Interestingly this concept seems to apply to a wider retail world than just garden retailers. Home centers stores report GMs in the 30-34% range but probably have labor costs in the 4-6% range, yielding a 26%+ Gap. Supermarkets also have a similar Gap but lower down the scale.

As our clients and Garden Center University graduates know too well, while percentages are interesting, it's dollars that pay the bills, so we bring a realism to this theory by tracking and acting upon **Gap dollars**. The growth in Gap dollars by increasing GM dollars and/or reducing labor dollars is at the heart of most day-to-day decisions in garden retail; much more so than the variations in Sales Dollars or "Top Line".

All retail businesses have certain irreducible overheads (the old name "Fixed Costs" still says it best) and the only long-term opportunity for profitable expansion is in the relationship between Gross Margin (through buying/selling/inventory management) and the biggest single cost, Labor.

By creating a target range for this crucial relationship, The Gap concept can be very helpful for retail planning and analysis in an industry very short of comparative standards and data.

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