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Creating Profitable Products

How many products do you need and where should you focus your sales efforts?

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Companies often believe that they require a substantial range of products to compete, but more often than not they are better off with a smaller product range which will allow for increased business and sales focus and ultimately profitability.

In determining what products to sell, there are a number of questions to consider:

- What is the cost of manufacturing or purchasing a product?
- What is the gross profit of each product?
- How many of each product is being sold?
- How much effort (time) is required to sell a product?
- How should sales staff be incentivised?

What is the cost of manufacturing or purchasing a product?

The calculation of the cost of manufacturing or purchasing a product (the cost of sales) for a wholesale or retail business is very different to that of a manufacturing business.

In the case of a wholesale or retail business, the actual cost of a product is the purchase price less any discounts received plus all costs incurred in getting the product to your warehouse or store (transport, insurance, import duty, equipment hired or purchased to unload, the cost of labour used to unload stock etc).

In the case of a manufacturing business, the calculation of the cost of sales is much more complex as one has to take into account direct material, direct labour and other manufacturing overheads. The calculation of the cost of sales will be covered in more detail in a future article.

Why is the manufacturing or purchasing cost important?

The cost of manufacturing or purchasing a product is key because once a products cost is known, then you can establish a selling price. Over or under pricing can also be avoided.

What is the gross profit of each product?

The gross profit of a product is essentially the selling price less the manufacturing or purchasing cost (cost of sales) of the product.

Why is gross profit per product important?

Frequently we hear that “the market determines the selling price” and often this is true, but it is essential that the product costs are such that you earn a gross profit on the product at the current market price. If you cannot earn a gross profit on a product then your options are:

- Differentiate the product so that it can be sold at a premium to the current market price,
- Reduce costs by improving business and manufacturing processes so that sufficient profit can be made on the product.
- Stop selling the product.

In your business would you buy a product for R100 and sell it for R50? No. Yet how many companies sell products for less than cost because they never knew what the product cost in the first place. If your revenues are increasing and your profits are declining then that new product you introduced that is selling like hot cakes is probably being sold for below cost.

You should almost never sell a product at below cost. The exception to this is the loss leader. Loss leaders are frequently used in retail. They are products sold at cost or below cost with the intention of attracting customers into the store to buy more profitable products. Examples include bread and milk. The loss leader is also often packaged together with another product, for example, companies who sell razor blades will provide the handle for free because they make their money selling the blades.

How many of each product is being sold?

Sales figures by product are important so that you know what is selling and what is not. However companies often focus exclusively on sales, while ignoring profits. Do so at your peril.

Knowing the gross profit for each product allows for a focused sales effort. A sales effort focused on the most profitable products as opposed to the most expensive products.

How much effort (time) is required to sell a product?

Another criteria to look at is the selling effort or time required to sell a product. The driver here is volume and products which require too much effort or time to sell and thus are sold in low volumes should have less effort spent on them or be discontinued. See Table 1 below where initially there is a sales revenue focus. Then look at Table 2 where the focus has shifted to a profit focus. The same amount of time is till spent selling, but the focus has changed from sales revenue to profit.

TABLE 1: SALES REVENUE FOCUS

Product	Selling price	Gross Margin	Sales	Gross profit	Hours selling product
A	R 1 000	20%	R 50 000	R 10 000	60
B	R 800	50%	R 30 000	R 15 000	20
C	R 1 200	10%	R 120 000	R 12 000	120
Total		18.5%	R 200 000	R 37 000	200

TABLE 2: PROFIT FOCUS

Product	Selling price	Gross Margin	Sales	Gross profit	Hours selling product
A	R 1 000	20%	R 55 000	R 11 000	70
B	R 800	50%	R 100 000	R 50 000	80
C	R 1 200	10%	R 70 000	R 7 000	50
Total		30 %	R 225 000	R 68 000	200

The exception to the above would be in a business where the sheer volume of product sold is what drives profitability. Here the volume of the lower profit products results in profits exceeding the profits of the higher margin products. A typical example of this is a retailer such as Pick n Pay where the products have low profit margins, but are sold in high volumes.

How should sales staff be incentivised?

Sales staff should not be incentivised on sales revenue, but rather on gross profit. This ensures that the most profitable products are sold and not the most expensive. The goals of the company and the sales people are thus aligned. In Table 1 above it is clear that the best product for the company to sell is B which at R 400 (50% of R 800) has the biggest gross profit and margin. However, if someone is incentivised based on sales revenue then they will focus on C which at R 120 (10% of R 1200) has the smallest gross profit and margin.