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Watch out! Forcing a company to increase its revenue can destroy it

Every time you receive a mandate to increase a company's revenue, remember that if you do it without thinking about it carefully, you could kill the goose that lays the golden eggs.

By Floris Iking*

It seems that everyone agrees to say that increasing a company's revenue solves many problems. When Private Equity Funds - which usually are focused on increasing revenue over profits - face profitability problems, the common train of thought is "we have to grow to get out of this trouble." However, if not done correctly, they might end up killing the goose that lays the golden eggs.

Organizations with this mantra tend to lose attention on determining if the incremental revenue is profitable. Additionally, they are intrinsically taking the risk of adding more costs and complexity to the operation boosting the original problem. Growing and adding profitable revenue to a Company normally solves many problems, but not in all the cases. Let's take a look at this real-life case study without revealing the Company's name:

Company "C" produces consumer goods for the retail industry. It was backed by the Private Equity Fund "I" (PEFI) and during the last 5 years consistently delivered positive results. In 2016, the company reported the highest EBITDA (Earnings before Interests, Taxes, Depreciation and Amortization) since its foundation, even though its sales remained relatively flat. However, since PEFI was in the last phase of its tenure as leading investor, EBITDA was put aside, and they were only focused on increasing the sales volume of Company "C".

Immediately, Company "C" started operating in new markets and opened new commercial channels. However, both the Company "C" and PEFI did not identify the new capabilities that should have being developed in order to achieve such expansion. For example, they sought to increase sales volume without increasing its production. Orders were late, key products were sold out and customers who used to ordered large volumes were extremely unsatisfied. Overall, this new complexity made Company's operations extremely inefficient - especially in product delivery – which is an extremely relevant variable in the consumer products industry.

At the same time, the main business faced challenges with key customers that demanded preferential prices and product customization, increasing the complexity of the operations. Managers started dedicating their workdays to put out fires; while the business was losing more than 60 percent of its EBITDA… in just two years.

In this example, the intrinsic cause of the decrease in EBITDA was not the lack of additional revenue, but the absence of profitable revenue. The lack of scalable platforms that could add profitability was the real problem in this case. Revenue increased, but the complexity of business operations increased even more causing an important impact on the profitability of the business.

Usually, the desire to increase the revenue of a certain company is so big that executives do not realize the problems that come with it and how problems such as proliferation of new products, dilution of customers and the absence of discipline to manage profitability margins can decrease the value of the Company. These problems tend to be visible when costs start to consume profits.

In our experience, there is not a common cause for this type of situations, it is a set of variables that generate multiple problems that spread to the commercial side of the business.

Here are some of the most common factors that add costs and complications to the operation and have a negative impact on profitability.

Limited knowledge and unreal expectations: Generally, there is a little clarity about the true causes of profitability of the company. Each area focuses on its individual objectives without seeing and analyzing the value of the whole organization. Additionally, there is a limited understanding of costs by business area. Also, there are unreasonable expectations of revenue when compared to the reality of the market.

Precipitated growth strategies: Companies expand into new markets without having a commercial discipline and operational capacity that efficiently contributes to revenue increase. On the other hand, it is common to launch new product extensions without a carefully consideration of the costs they will have and the additional operational complexity.

Prices and clients are poorly managed: Customers who generate fewer annual sales receive the same attention and focus as those who generate the highest sales volume. Furthermore, there is a lack of strategy on price management and profitability margins that tends to privilege fixed prices strategies and discounts by volume on earnings.

Selling for the only purpose of selling more: Commercial teams focus on selling, at any cost, with incentives designed to close large volume sales, even if it is not profitable. Redundant business models have also been seen where “everyone sells everything” to achieve the sale of any product on any channel to any customer.

To avoid making the aforementioned mistakes, growth strategies must be based on understanding profitability by product and by customer. Understand what the hidden costs are of serving each client are, whether due to logistical emergencies, product concessions or special requests.

Customers with higher volumes should have access to better prices and conditions than those who buy smaller volumes. The reality of many companies is governed by the Pareto principle (80-20) and there is nothing wrong with it, if and only if the margins generated cover the difficulties of serving that 20 percent of the clients.

The platforms where the company's value proposition is located should be fully utilized to grow on them before accessing others that have not yet been properly developed and which development could take years.

Therefore, every time you hear the mandate to increase revenue, remember that if you do it without thinking about it, you could be killing the goose that lays the golden eggs.

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