Playing the Percentages

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For several years, I have been pushing members of the oilheat industry to focus on building a sensible profit margin. Happily, many dealers seem to have heard and accepted the message. Results of our annual survey of dealers shows that profit margins, expressed in “cents per gallon,” have slowly been creeping upward.

Now I want to throw the industry a curveball. Given the record high cost of oil, I believe that profit margins have not adequately kept up. Dealers have been pushing margins up a few cents per gallon while their costs have soared. Diesel fuel for delivery trucks, employee health benefits, insurance, taxes – almost all have risen faster than margin.

An especially heavy burden comes in the cost of financing bulk oil purchases. When the per gallon cost of oil doubles, so does the amount you are paying to finance that contract purchase, a cost that is often overlooked.

I am not one to “cry wolf” and point out a problem without also offering a solution. In this case, the fix could be a very simple one. Oilheat dealers need to abandon the “cents per gallon” method and begin calculating their profit margins the way most businesses do – by percentage.

Let me use an example of how it might work. Using a wholesale cost per gallon of $2.08 for oil, a target profit margin of $0.50 per gallon would make the selling price $2.58. Many dealers would be satisfied with this result. But they would be shortchanging themselves.

If we calculate profit margin using the percentage method, with a target margin of 32%, the numbers change dramatically. To figure the correct selling price to achieve a 32% margin, we must divide the wholesale cost ($2.08) by .68, which is the difference between 32% and 100%. The result is a selling price of $3.05.

It is interesting to note that, if you are retailing a gallon of oil that costs you $2.08 at a selling price $2.58, your profit margin is just 19%. That is a quick way to go out of business.

Don’t confuse “margin” with “markup.” Markup is gross profit above cost, expressed as a percentage of cost. Margin is gross profit expressed as a

percentage of the selling price. Sell an item for $1.50 when it only costs you $1.00, and your markup is 50%. Your margin, however, is only 33.3%. This is because the same $50 gross profit represents 50% of your cost (markup) but only 33.3% of the selling price (margin.)

So you cannot accurately determine your margin by simply multiplying cost by the target percentage, then adding the results. The true margin is the difference between the selling price and the cost, expressed as a percentage of the selling price. In the example above, multiplying the $3.05 selling price by a 32% margin results in a margin of $0.97. Subtract this from the selling price and you get the actual wholesale cost of $2.08. If you had simply multiplied $2.08 by 32%, your selling price would have been only $2.75 – a $0.30 shortfall.

Some dealers are reluctant to raise prices for fear of revenue loss. But remember, if your prices are higher, you can sell less oil and still meet your revenue goals. If your margin is 50% and you increase your prices by 20%, you can afford a 29% drop in revenue and still maintain the same overall profitability.

Using the percentage method of calculating profit margin, the “gains” of the past few years disappear. In 2003, the average oilheat dealer’s profit margin was approximately 34%. In 2004, that had dropped to 31.5%, and in 2005 had fallen further to 30%. This is a reflection of rising costs that are not being offset by an equivalent increase in profit margin.

The percentage method of margin calculation could help alleviate this imbalance. As wholesale product cost increases, raising the selling price to maintain a steady margin percentage will help cover the higher associated overhead costs.

Don’t take my word for it. Go back and calculate your own margin for the past few years on a percentage basis. See if you are gaining ground or losing. My guess is that you will quickly see the value in abandoning the archaic “cents per gallon” method and tying your profit margin to a percentage basis.

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