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The Importance of Gross Profit Margin

To find the fair value of a common stock, we need to determine the net profit generated by a firm. Dissecting income statement will give us the steps required to find net profit. One of the critical component of income statement is gross profit.

What is gross profit? Gross profit is the profit obtained after subtracting all variable costs with revenue. For a retail firm, it is the difference between the selling price of an item and the price the firm bought the item. In other words, the difference between what it sells and what it bought.

Gross profit itself does not give us a lot of information about the strength of a firm. Gross profit is frequently expressed in term of percentage. This is called gross profit margin (GPM). Gross profit margin varies among industries. Retailers normally have a slimmer gross profit margin than a software company.

So, how can investors use gross profit margin to analyze a company? Investors can use this tool to explain the competitive strength of a company. By analyzing gross profit margin trend, the health of a specific company can be determined. There are only three trends in gross profit margin. Gross profit margin can go up, down or stay the same. I will explain the implication two of those trends.

Increasing Gross Profit Margin. It is never a bad thing when a firm can increase its gross profit margin. Increasing gross profit margin can mean two things for the company. First, the company has a favorable pricing power. When a firm raise price due to overwhelming demand, gross profit margin will increase. Of course, this assumes that variable costs do not increase. Secondly, increasing gross profit margin may mean that a firm is getting more efficient in production. When price per unit stays the same while the cost of variable unit drops, gross profit margin will increase.

Decreasing Gross Profit Margin. Deteriorating gross profit margin is not favorable to a firm. This normally means two things. First, it may mean that the variable cost has risen due to the change in commodity prices. When selling price stays constant while variable cost increases, gross profit margin will drop. Second, decreasing gross profit margin also implies that a firm has no pricing power. When a firm has to cut price to generate sales, this is not a good thing. When selling price per unit decreases while variable cost stays constant, gross profit margin will decrease.

When estimating gross profit margin for fair value calculation, we need to look at other things such as the industry competitiveness, the firm's inventory level, new products that are coming out and so forth.

For example, when a firm has a high inventory level, there is a good chance that gross profit margin will eventually suffer. The reasoning is that when you have too much of unsold items, you have to sell it at a lower price (price cut) to clear your inventory. Meanwhile, variable cost stays constant since the item has been produced a while ago.

Estimating a reasonable gross profit margin is crucial in determining the fair value of your investment. If company A historically possess a 20% gross profit margin, you better have a pretty good explanation if you estimate next year's gross profit margin to be in the range of 60%. Perhaps, a new patented product will be released. Or, its largest competitors may just shut its door, therefore allowing the firm to raise price. Whatever it is, it is important for investors to know what causes gross profit margin to change.

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