

Understanding the Cost of Operations

Part One: Introduction

New businesses in the transportation and warehousing industries experience a high failure rate. In particular:

- 25% fail in their first year
- 35% fail in their second year
- 60% fail in their fifth year

The most common reasons that small business fail are (1) lack of capital, (2) Inadequate management, and (3) poor business planning. All of which relate to knowing your cost of operations. A business can make money but still fail because their costs are beyond their income. It is critical to know your costs and to continually search for ways to reduce, or control, those costs. Without this knowledge, how will you know what you need to earn in order to cover your costs and pay yourself?

Controlling your costs is often more profitable than gaining new business. Always remember, “This is **not** a money made business, it is a money **saved** business.”

If two carriers receive the same rate, the carrier with the lowest expense is making the most money. In the next segment, we will discuss two types of costs, fixed versus variable.

Part Two: Fixed vs. Variable

To understand how much it costs you to drive your truck down the road, you need to breakdown your overall costs into two distinct segments, fixed and variable. Let us first start with fixed.

Fixed Costs must be paid every month regardless of miles or income, such as truck and trailer payment, insurance payment, plates, permits, etc. The lower a carrier’s fixed costs are, the easier it is for them to make a profit. If a carrier lives on the edge of their income, it eventually will catch up with them, especially if they encounter unexpected health issues, market or regulatory changes, or an accident.

It is important to be practical when purchasing a truck or trailer, or when deciding your scope of operation in order to keep fixed costs down. It is also critical to have adequate cash flow. An owner-operator should have 30 to 60 days or more of cash on hand, or working capital, to pay for costs to cover ongoing expenses.

Another option to consider is to obtain a business line-of-credit (LOC) for emergency situations. A LOC allows the borrower to take out money as needed until the borrowing limit is reached. This way the borrower only owes interest on the amount they draw, not the entire credit line. While this grants flexibility, be aware of potential problems, such as higher interest rates and severe penalties for late-payments.

Variable Costs fluctuate according to conditions, thus they are costs that a business has more control over, such as fuel, meals, tolls, tires, repair and maintenance, and miscellaneous items. A company can

increase its net profit by decreasing its total costs or expenses. However, fixed costs are more challenging to reduce. Most companies will seek to reduce their variable costs. Hence, decreasing costs usually refers to decreasing *variable costs*. It is critical for businesses to give themselves flexibility in their budgets to cover variable costs.

A carrier might be able to reduce their variable costs through items such as aerodynamics, a portable refrigerator, preventative maintenance, an auxiliary power unit, etc. Nevertheless, it is important to consider the return on investment. Meaning, will the item pay for itself and help the carrier to become more profitable? If so, how quickly will the carrier receive a return? These are other items to consider when reducing costs.

Next we will discuss net profit margin and operating ratio.

Part Three: Net Profit Margin

A net profit margin, also known as a contribution margin, represents the point at which revenue received per mile equals the costs associated with driving the truck down the road. A carrier might utilize the net profit margin to determine how much they need to earn for each mile they operate.

A carrier can calculate the margin by simply subtracting the amount they earn per mile to deliver any given load by the variable and fixed costs associated with the delivery (Gross Revenue – Variable Costs – Fixed Costs = Net Profit).

If a shipper offers to pay an owner-operator \$1.50 per mile in order to deliver a load, and the owner-operator knows that their variable costs are \$0.92 per mile and fixed costs are \$0.38, then their gross profit will be \$0.20 per mile ($\$1.50 - \$0.92 - \$0.38 = \0.20). Thus, a carrier knows how much revenue and net profit they can earn for each mile of the delivery and how much they can earn if they decreased their costs of operations.

To determine what percentage of the revenue is contributing to the owner-operator's profit, they only need to divide the net profit by amount earned per mile (Net Profit ÷ Gross Revenue = Contribution Margin Ratio). Utilizing the example above, the owner-operator would divide the net profit per mile (\$0.20) by the gross revenue per mile (\$1.50) to determine that 13% of their expected revenue is contributing to their net profit. In other words, the carrier will net \$0.13 for every dollar of revenue they generate. Net profits increase when the contribution margin increases.

A business can make money but still fail because their costs are beyond their income. Next, we will discuss the operating ratio and how it can help you control your costs. "This is not a money made business, it is a money saved business."

Part Four: Operating Ratio

A business can make money but still fail because their costs are beyond their income. Again, controlling costs can be more profitable than gaining new business. You can use the ***operating ratio*** to measure how efficient you are at keeping your costs low [(Total Operating Expenses ÷ Total Operating Revenues) × 100 = Operating Ratio].

The smaller the ratio, the more efficient the carrier is at generating revenue versus total expenses. A high operating ratio indicates that expenses are increasing in relation to revenue, while a low ratio indicates that either expenses are decreasing, revenue is increasing, or some combination of the two.

If an owner-operator incurred \$16,000 in operating expenses in the previous month (including paying themselves), and earned \$17,000 in revenue, their operating ratio is 94 ($\$16,000 \div \$17,000 = 0.94 \times 100 = 94$).

A motor carrier's operating ratio must fall under 100 to realize a profit. The more successful, larger, carriers will have an operating ratio around 90. Owner-operators will want to keep their operating ratio around 95. In other words, an owner-operator needs to make at least 5% net profit, or better, to succeed.

There are other ratios to consider when calculating your cost of operations which can help give you a more accurate and complete picture of what an owner-operator will need in order to both start and maintain a successful business. These are discussed in Truck to Success.

Ultimately, the cost of equipment, supplies, fuel, and materials are constantly changing and can have a huge effect on an owner-operator's cost of operations. With the information presented in this series, an owner-operator now has more power to negotiate or renegotiate their rate because now they have a target to shoot for.