



Insight.Action.Results.

SEVEN STRATEGIES FOR BETTER MARGIN MANAGEMENT

FROM THE ADVANOUS "MARGIN MINDSET" SERIES

APRIL 2005

SEVEN STRATEGIES FOR BETTER MARGIN MANAGEMENT

Overview

The primary goal of business is to maximize shareholder return. Shareholders may include investors, employees, and management to name a few. One critical driver of shareholder return is a company's ability to generate earnings or profits. These profits pay back the people who have invested in a company and provide the capital to allow companies to continue to grow, better serve their customers, and generate additional profits in the future. The reality of wholesale distribution is that none of this can happen until "someone sells something."

Sales professionals play an enormous role in generating profits for their companies. The result of their work is sales revenue and the gross profit generated as a result of this sales revenue. Of greater importance is the sales professionals' ability to have that gross profit exceed the company's cost to serve and thus generate earnings or profit. Central to accomplishing this goal and generating earnings are pricing strategies and practices.

Many distributor sales representatives have considerable pricing latitude. Some exceptional reps are able to maintain a high gross margin across most customers and most product categories. However, many salespeople find that competitive pressures and price-sensitive customers (much of which is perceived) force them to lower margins in order to grow and keep the business. Unfortunately this practice is all too typical and is the foundation for most margin degradation issues. To compound these problems, some reps, unbeknownst to them, even maintain a customer base that is largely unprofitable to the company, because the cost of serving them exceeds the gross margin dollars generated by the business.

Making a fair profit

Margin is grown or lost through pricing practices. Too often the fear of losing a customer or guilt of potentially overcharging a customer stops sales representatives from charging a price with an associated high margin. Simply put, even the most effective salespeople at times feel guilty about making a profit.

But the fact remains that many distribution companies continue to service unprofitable customers. Experts estimate that the average distributor makes 120% of their profits from 20% of their customers — the rest of them are either breakeven accounts or are actually taking away from the company's profits.

The typical net profit for distribution companies is in the low single digits (2-4%). That means for every dollar in sales revenue, the company generates around two to four cents in profit. So if you charge a comparatively high margin for a particular item, are you "gouging" the customer? Often, the answer is no. There is a difference between price gouging and making a healthy profit. A healthy profit is one that allows the sales rep and company to not only survive, but to invest in areas that will ultimately benefit the customer. It also more accurately reflects the cost to distribute that product to that customer. Not surprisingly, price gouging leads to lost opportunity. To price profitably without the risk of losing business, distributors must strike a balance between fairness to themselves, the market, and their customers.

This paper offers new ideas for distribution management and sales personnel to enhance margin through improved pricing concepts and methodologies. The seven core strategies outlined here can be immediately implemented to selectively increase margins and improve profitability while protecting a distributor's customer base.

Seven basic pricing concepts

Many distributors are now beginning to acknowledge that pricing effectiveness is a critical component of a profitable business. The following strategies provide a starting point to effectively address the complex problem of pricing.

Based on Advanous' collective experiences in providing pricing and margin solutions to the distribution industry, the following highlights seven key pricing principles that are commonly shared by successful sales individuals and organizations:

- Recognize "Cost to Serve" When Pricing
- Avoid the "Divide-by-.75" Mentality
- Charge a Higher Margin Percentage on Lower Cost Items
- Understand Price Sensitivity
- Understand the 80/20 Rule
- Balance Risk with Profitability
- Diversify Your Selling Margin by Item

1. Recognize "Cost to Serve" when Pricing

If there's one thing that cannot be overemphasized to those in charge of determining a selling margin, it is the cost of doing business. Distribution is expensive. Management understands this and strives to control costs to maximize the company's overall profitability. However, sales reps and others charged with the most effective margin driver – **pricing** – do not always understand the full cost to serve equation.

When sales reps think of distribution, here is their typical understanding of the process:

- 1) An order is taken from the customer.
- 2) The order is called into the warehouse.
- 3) The warehouse ships the order to the customer.
- 4) The sales representative receives commission.

Clearly there is something missing in the rep's understanding of the distribution process.

Here is a better overview of the cost of distribution:

- 1) Investments: warehouse, inventory, infrastructure, personnel
- 2) Vendor/product line decisions
- 3) Product ordered from vendor
- 4) Product received into warehouse
- 5) Product checked for accuracy of shipment
- 6) Product staged for shelf placement
- 7) Product put on shelf
- 8) Product stored on shelf (carry costs)
- 9) Vendor invoice received
- 10) Vendor invoice processed
- 11) Outdates, shrinkage, damaged goods
- 12) Reconciliation of errors from vendor (shipment and/or invoice)
- 13) Sales rep training/investment
- 14) Cold calls to prospective customers
- 15) Relationship building with customers
- 16) Rep takes order from customer
- 17) Rep calls order to warehouse
- 18) Customer service enters order into system
- 19) System produces pick ticket
- 20) Order picked

- 21) Order checked
- 22) Order packed
- 23) Order staged for shipment
- 24) Order shipped
- 25) Invoice to customer
- 26) Reconciliation of errors to customer (shipment and/or invoice)
- 27) Invoiced payment collected
- 28) Sales commission paid

The cost of all of these activities adds up fast. If the gross profit dollars for a particular order are less than the costs to fill the order, the distributor loses money. Those activity costs listed dictate **breakeven order size** — how big an order must be, based on a distributor’s average gross margin, just to pay for itself. It’s important to ask what the estimated breakeven order size is, and what gross margin was assumed in the calculation. If orders aren’t, on average, larger than this amount, the company is losing money. Similarly, an order that is barely over the breakeven size and written below the gross margin used in the calculation is also a money-loser.

As an example, let’s say the breakeven amount to service a five-line item order is \$60. Reviewing the five-line order example below, the GP\$ generated for Products A-E are right at the break-even amount (\$59.44).

Product	Cost	Price	GP	GP%
A	.50	1.43	.93	65%
B	2.50	5.56	3.56	55%
C	15.00	23.08	8.08	35%
D	50.00	68.49	18.49	27%
E	95.00	123.38	28.38	23%

Order	Cost	Price	GP\$	GP%
Total	162.50	221.94	59.44	26.8%

Is this good enough? On the surface, a 27% margin (26.8%) seems good. However, when compared to the true breakeven amount of \$60 in this scenario, the company would make no profit.

So, what does this mean? Is it right to charge a 27% margin per item? What about 60%? What about charging one customer 27% for an item and another customer 60% for the exact same item? The answer to all of the above questions is “it depends.” A customer with a very small order size should be expected to pay a higher price as it costs more to serve a small order than a larger one – handling costs, order entry time, etc. Conversely, a customer with a very large order should be less costly to manage and would warrant a lower price. The key is determining the true cost to serve each customer, and then setting the appropriate price relative to that customer’s cost.

One concept that will definitely build pricing confidence with sales reps or those in charge of setting a sell price is their understanding of cost to serve.

At an upcoming sales meeting, have the reps break up into teams of 3-4 and brain-storm on this topic and pose the question, “What are the steps of fulfilling an order?” Have them write on separate pieces of paper the steps involved in this process. After 10-15 minutes, consolidate each team’s steps and ask for the collective assistance of the entire group to post each step in sequential order. Be prepared to help fill in any gaps to demonstrate to multitude of steps in this process. This exercise to improve a rep’s understanding of the cost-to-serve can make a significant impact, especially on more junior salespeople.

2. Avoid the “Divide-by-.75” Mentality

First and foremost, a successful sales rep must avoid simple, reflexive responses to pricing. For example, a sales rep visits an existing customer and receives an order that includes a never-before-purchased item. What should the price be for that item?

In the absence of a default price in which the sales rep has confidence, a common answer at many distribution companies is to look at the cost of the item, take out a calculator, and “divide-by-.75”. In other words, calculate the price of the item by using a 25% gross profit percent (GP%). Is this a good strategy? Absolutely not. Then what is a good strategy for this case? The creation of a reliable default pricing strategy.

Reliable default pricing starts with homogenous customer groupings or customer segments. These segments can be based on an industry-derived metric or on performance metrics such as sales or gross profit. Next, within each of these customer segments, a distributor should generate specific item pricing for the top 100-500 items. A simple approach for this is to analyze existing pricing history for these types of customers and set a price towards the mid to high end of the market. To price the remaining items (lower volume), take the balance of the items and group them into homogenous groupings or item segments – a common approach is to group items by a product category or family. The price for these items should be to the high end of the market. The result? If a customer asks, “What is my price for this item?” the system should identify the type of customer, the item or type of item and produce a price that was accepted in the market place.

3. Charge a Higher Margin Percentage on Lower Cost Items

In an ideal situation, distributors should have a recommended “list” price that allows them to make an adequate profit that is realistic. If not, someone will have to thoroughly examine the costs associated with that sale. In general, lower-cost items require higher margins. A company’s costs are about the same amount to warehouse and handle a small box, whether that box holds an expensive product or inexpensive component. To cover the cost to order the item from the supplier, receive it, store it, sell it, and ship it out, distributors need about the same amount of revenue — which means a much higher margin for the low-cost item. Therefore, this is a general rule that should be utilized when pricing items:

- **Higher Margin Percentage on Low Cost Items**
- **Lower Margin Percentage on High Cost Items**

Following this rule, gross profit dollars (GP\$) will vary considerably by product. For example, a typical purchase order might be priced as shown in the chart below. Each item has a unit quantity of one.

Product	Cost	Price	GP	GP%
A	.50	1.43	.93	65%
B	2.50	5.56	3.56	55%
C	15.00	23.08	8.08	35%
D	50.00	68.49	18.49	27%
E	95.00	123.38	28.38	23%

By creating a pricing structure that allows for greater margin percentages on the lower cost items, distributors will remain competitive and profitable.

4. Understand Price Sensitivity

The next pricing concept to understand is that customers aren’t equally price-sensitive across all items they purchase. Consider a trip to the grocery store. The typical shopper knows the usual prices for frequently purchased items like a gallon of milk or loaf of bread. If the store raises the price of milk by 50 cents, it might cause the shopper to take notice.

Now, consider the price of items bought less frequently like vanilla extract, paprika, or artichoke hearts. Taking the same hypothetical shopper, they typically don’t know what a competitive price should be for these items and will buy them without much regard to price. Two exceptions to this rule would be if the item is very expensive, or if it is bought in large quantity. To continue the grocery store example, if a shopper needs to purchase a package of Filet

Mignon, they may be very price sensitive and may even look in several stores. Additionally, if the shopper needed to buy 15 bottles of vanilla extract, they would be more likely to price-compare as well.

This same theory can be applied to the purchasing of products from a distributor. Customers typically know and track the price on items they need on a regular basis. The sales person’s job is to understand this thinking and to identify the items that are less sensitive and under-priced. Typically, the more frequently purchased items and/or high-ticket items will result in a higher level of price sensitivity from the customer.

Listed below are some of the other factors that may affect a customer’s pricing sensitivity for an item along with a general weighting of the importance of each factor in the buying process.

Factor	Importance
1) Total sales dollars (price x quantity)	30%
2) Purchase frequency (number of times the item is ordered)	25%
3) Unit cost (higher cost items receive more scrutiny)	15%
4) Unit quantity	10%
5) Use frequency (how often the customer uses the item)	10%
6) Visibility of item (i.e., is it on the counter or in the closet?)	10%

Clearly, customers are most price-sensitive about items that represent the biggest part of their supply budget. Next in importance is how frequently the product is purchased. From there, it can be argued that there are four additional parameters: unit cost, unit quantity (an item that is purchased with 250 units vs an item with a quantity purchased of 1 unit will generally receive more scrutiny, all things equal), use frequency, and item visibility. Customers tend to be more price-sensitive to high-use/high-visibility products (for example, paper clips or pens) compared to low-visibility ones (gadgets stored in a drawer, for example).

Therefore, an item with high annual sales that it is purchased every week, used by the purchaser 20 times a day, and sits on the desk of the user is a highly price-sensitive item. Conversely, an item that is ordered twice a year, is moderately priced, and is not particularly visible is not likely to be a price-sensitive item.

To be successful and to ensure a company earns an adequate overall profit, a sales rep must offer market competitive pricing on these price-sensitive items as well as identify the items that have relatively low pricing sensitivity as candidates for higher margins.

5. Understand the 80/20 Rule

The “80/20 Rule” as it applies to a customer’s purchases states that 80% of the dollar volume of a customer’s purchases comes from 20% of the items sold. In other words, if a typical customer purchases 100 unique items, on average the top 20 items (those generating the highest sales revenue) represent about 80% of the total sales (dollar volume) for that customer.

Based on what we’ve already learned about the impact of purchase frequency and dollar volume affect on price sensitivity, a sale’s rep must recognize that the 80 items representing 20% of total sales provide the greatest opportunity for charging higher margins.

For example, a sales manager is reviewing the purchases of Customer X (300 items) and wants to raise the average gross margin for this account by 1%. How can this be done?

In theory, the price for all 300 items could be raised by 1% to achieve a 1% increase in margin. This may work fine on paper, but in reality, it is difficult to increase pricing across the board and make it stick.

In this example, the manager identifies 30 items representing 10% of the customer’s dollar volume. Rather than implementing a 1% price increase for 300 items, implement a 10% price increase for 30 low-price-sensitivity items. The predicted impact on the account’s profitability is the same with either strategy...

100% of the items x 1% additional margin identified = 1% additional margin identified
or

10% of the items x 10% margin increase = 1% additional margin identified

... but the second option carries much lower risk, because the customer isn't jolted by an across the board increase that includes highly price-sensitive items.

Rather than attack new pricing for 100% of the items, try to identify those that are less sensitive (typically lower dollar volume items) that are under-priced. Look for items that do not possess the following traits: high price, frequently purchased, and highly visible. Remember, these are also the items that have a higher cost to serve, and in order to price profitably may be significantly under-priced

6. Balance Risk with Profitability

There are two key goals when managing margin:

- 1) Maximize profitability; and
- 2) Minimize risk

What this means is that sales professionals must constantly weigh a company's goal of high margin against the possibility of overcharging — and possibly losing — a customer. Ultimately, the goal is to balance the two.

Too many sales reps focus only on risk. By keeping margins lower to avoid any chance of losing business on pricing, earnings potential is minimized and can create a shortfall in profits for the company.

On the other side of the spectrum, some sales professionals will sometimes inflate selling prices to an extreme. In this scenario, if the customer compares the price of an item to the price of the same item from a competitor, the distributor and rep are at risk of losing that customer. Clearly there are many more factors involved in determining a fair price, but most customers know when they are being grossly overcharged. Even the perception of being grossly overcharged on one item can jeopardize the entire relationship with a customer.

Again, the key is to seek balance between profit and risk. Companies and sales reps alike must not be afraid of making an honest profit, but should also be aware of big variances in price with the competition, particularly on high-visibility products.

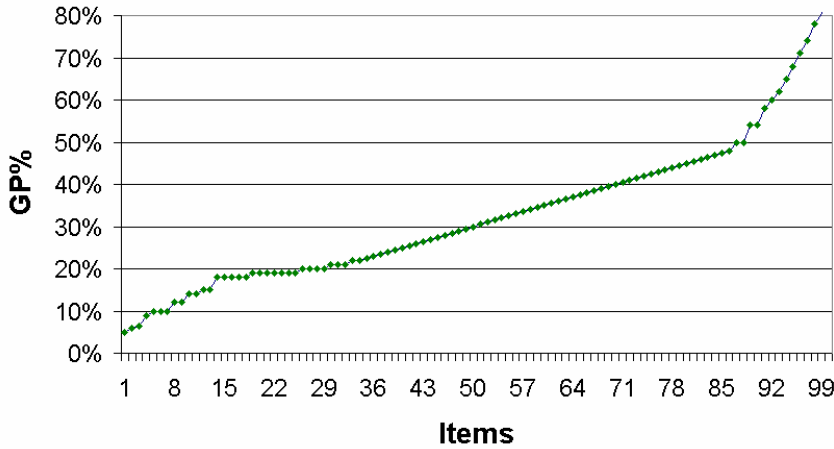
7. Diversify Your Selling Margin by Item

As you may have recognized already, the approach recommended here involves a highly diversified pricing strategy as opposed to a simple, across the board approach.

A sales professional who writes at a high average margin typically differentiates their margins by product. For example, if a customer purchases 100 items, some items will be sold at a very low margin (typically the higher cost, more sensitive items to that customer) and many more sold at higher margin (lower cost, less sensitive items). Sales professionals who write at lower margins often have little product pricing differentiation.

The chart on the top of page eight illustrates the GP% of 100 items sold to a typical customer.

Sales Rep with Higher Margin



Notice the higher margin sales rep establishes prices on some items at a very low margin, and others at high margin. This pricing practice is based on a combination of what the market will bear as well as the cost to serve those items. In addition, they are pricing the "20%" of the items (those that represent 50%-90% of the dollar volume) at a competitive price, as these are typically the more price sensitive items. By taking these steps, this sales rep will maximize profit and minimize risk.

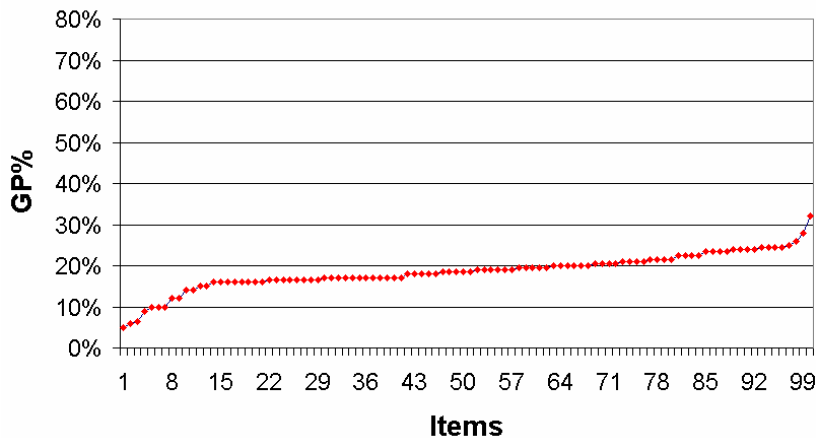
How does this minimize risk? If this customer decides to "shop" for lower prices, what are the items they will focus on? Typically the higher volume, more frequently purchased items. And what will they find? Not a lot of difference, because this sales rep is competitive on those items.

Additionally, if a competitor offers to give a quote to a customer on items, they will typically provide quotes on the most visible and sensitive items. And what will the comparison show? Probably not enough difference to warrant a switch, assuming the incumbent sales rep is doing a good job servicing the customer.

Even if there is a price comparison made on an infrequently purchased, high-margin item, justification can and should be made as to the costs involved to service that item. In addition, when it comes down to it, the customer must understand and be reminded that they are paying a premium for premium service. A key component of the sales person's job is to constantly give this service so as to warrant a difference in pricing.

Now take a look at the pricing practice of the lower margin writer. The sales rep will typically be competitive on a select grouping of items. However, when it comes to the balance of the product portfolio, the low margin salesperson will flat line and typically cap out at a predetermined margin (i.e., 25%).

Sales Rep with Lower Margin ("divide-by-.75" mentality)



The reason that some salespeople do this is a combination of:

- 1) Fear of overcharging and losing a customer
- 2) Inability to articulate their value to the customer
- 3) Pricing laziness/limitation (i.e., it's easy to "divide-by-.75")
- 4) Lack of analytical tools to identify low risk, low sensitive items

The obvious result of this action is lower margin. In addition, there is also the risk of revealing price points to the competition, which can be used to out-bid a distributor for business in the future.

So what's the conclusion? Price an account's sensitive items competitively and its non-sensitive items profitably. Doing this will allow a sales rep to achieve an overall acceptable profit for that customer, and deliver improved margins to the company's bottom line.

Putting the principles into practice

Now that the importance of margin management has been highlighted, and seven key pricing principles outlined, it is time to apply these techniques to business.

- Educate the sales force. Provide a good understanding of the business' cost to serve, which in turn will allow for more confidence in the prices being set. These tools will allow sales representatives to ultimately make the correct pricing decision
- Analyze accounts, identify under-priced items that are not generating an adequate profit, and begin moving margins up. DO NOT go into a system and raise hundreds of prices all at once.
- When implementing a price increase for a product that an account is already buying, it's important to be up front with the customer. If a price change notification is expected or required, make sure it is given within the designated timeframes.
- The best opportunity for margin enhancement is to change practices when customers *first* order a particular product — whether it's a brand-new customer or an existing account buying a new item. Find out how often the customer expects to order the item. If the customer isn't sure, it may be wise to err on the high side to start. If the customer begins to order the product more often, and therefore becomes more sensitive to the pricing, an adjustment can always be made at that point. If it's obviously a one-time purchase, and not a high-dollar item, it makes sense to charge an appropriately high margin.
- Incorporate pricing as a key performance metric. Companies often look at sales and gross profit but don't have adequate visibility into pricing. Make pricing decisions visible at all levels of the organization and create accountability around pricing decisions.

Conclusion

High-profit territories don't happen by accident. Sales reps who consistently outperform their peers on average gross profit margins do so through careful strategy and discipline. Pricing has been shown to be the most effective lever in improving margin and is gaining visibility throughout the marketplace. Distribution companies can gain a competitive advantage by focusing on the benefits derived from a successful pricing system and process. By using the ideas and strategies described in this module, and applying them consistently, companies can improve profitability.

About Advanous

Advanous, a division of EnterBridge™ Technologies, Inc. helps wholesale and business distributors generate higher profits through more effective margin management. Advanous delivers increased profits to its clients through Point to Profit™, a margin enhancement service that combines technology, analytics and industry expertise to increase margin performance across a company's existing scope of business.

Advanous is currently serving leading Fortune 1000 and other large and mid-sized distributor companies, and has delivered an average annual margin increase between 50 and 100 basis points on the targeted portion of our clients businesses and a 5-15 fold return on investment.

To learn more about Advanous and its pricing and margin management services, please contact:

Advanous
4198 Cox Road, Suite 202
Richmond, VA 23060
(804) 290-0546
info@advanous.com

www.advanous.com