DISTRIBUTION STRATEGY GROUP

How to Optimize Distributor Profitability with 1% Improvements

By Al Bates

For decades, distributors have been stuck with a moderate profit of 3%. Even in periods of recession and recovery, where income fluctuates above or below 3%, profits always return to the same bottom line. Distributors have employed innovative technology. So, why haven't we been able to break free from this pattern? One of the reasons is that distribution is the most competitive sector of the American economy; as one company takes a revolutionary step forward, everyone else rushes forward to copy them, making it difficult to get ahead.

If firms are going to break out of the profit rut, they must control the six key drivers of profitability in distribution:

- Pricing
- Buying
- Unit Sales
- Total Expenses
- Inventory
- Accounts Receivable

What would happen if we made a 1% improvement in each area? What if we did better on pricing by raising outbound rates by 1%? What if our partners agreed to give us a 1% discount on the products we buy from them, or if we grew unit sales by 1%? What kind of impact would we see?

Studies show that if you raise prices by 1%, profits will increase by 30%-35%. Similarly, if you could buy products for 1% cheaper, profits would rise by 20%-25%.

A 1% improvement in unit sales would lead to a 7%-8% increase, a 1% decline in total expenses would lead to an 8%-9% increase, and a 1% improvement in inventory and accounts receivable would lead to a boost of only 0.6% and 0.3%, respectively.

The Profit Impact of 1% Improvements

Improvement Area	Increase in Profit
Pricing	30%-35%
Buying	20%-25%
Unit Sales	7%-8%
Total Expenses	8%-9%
Inventory	0.6%
Accounts Receivable	0.3%

Now, inventory and accounts receivable do not significantly affect profitability because as distributors lower inventory or accounts receivable, working capital (not profit) grows. The profit impact is only the cost savings associated with the reduction of interest, obsolescence, bad debts and the like.

However, if you focus on improving the first four drivers, especially pricing and buying, you will significantly improve bottom-line performance.

In this report, we will explore how distributors can optimize profitability by making minor improvements across pricing, buying, sales and expenses. Although 1% may seem insignificant, making small but consistent enhancements could push your income from 3% to 5.4%. With the proper steps, you could even double your profitability to 6%.

Profit Lever One: Sales and Expenses

For a distributor to maintain profitability, sales need to grow faster than payroll expenses. For instance, if your sales increase by 5% and your payroll only increases by 3% in the same period, you will see positive growth. However, if sales increase by 5% but payroll jumps by 7%, your bottom line will be negatively impacted.

The key to maintaining a healthy level of growth between sales and payroll is by producing a 2% wedge between the two. This structure allows you to maintain profitability because no matter how quickly sales grow, payroll growth will always be 2% less.

Historically, payroll comprises 15% of sales – the same was true 20 years ago and remains true today. With the help of technology, productivity per sales rep has risen. However, expenses grow as productivity and sales increase, canceling the positive growth from more productive reps. Without a permanent 2% wedge, payroll will always be 15% of sales, and you will struggle to scale.

There are three things we can look at to lower expenses and gain control of payroll:

- Order Economics
- Customer Profitability
- Sales force

Order Economics

Distributors work too much. Although many distributors have implemented fantastic productivity improvements, systems and procedures, they are still stuck processing a large number of orders, many of them too small.

Let's consider what would happen if we kept the same number of customers but added more lines to every order. By prioritizing upsells and cross-sells, improving customer education, expanding your product line and going above and beyond to ensure buyers are aware of your entire catalog, you could potentially increase the lines ordered from the same customer set by a significant amount.

In this model, you're not trying to raise sales per se; you're trying to increase sales at a faster rate than payroll expenses. With more lines, you will see a slight increase in payroll, but not a significant one because the firm is still dealing with the same number of orders.

The Sales Impact of Enhanced Order Economics

	Item		Current	Potential
1	Number of Orders		105,263	105,263
2	Lines per Order		2.0	2.1
3	Lines Ordered	[1 x 2]	210,526	221,053
4	Fill Rate		95.0%	95.2%
5	Lines Filled	[3 x 4]	200,000	210,442
6	Average Order Line		$250	$253
7	Net Sales	[5 x 6]	$50,000,000	$53,136,632
	Increase in Sales			6.3%

Customer Profitability

The second thing we should look at is customer profitability. Organize your customers into four groups: high profit, good profit, some profit and unprofitable. Once you do this, you will see that 15% of your customers give you 100% of your profit (which is partially offset by the high percentage of customers that lose you money). Your good-profit customers, which will make up another 15% of your customer base, will provide you with 35% of your profit. Another third of your customers will give you 10% of your profit. The final third, the unprofitable customers, will cost you 45% of your profits.

About 2% of your customers will always be unprofitable and will do nothing but drain resources and cause problems. Give these customers your competitor's contact information and send them on their way.

The remaining portion of your "unprofitable" customers may not even realize that they're costing you money. Because they make up nearly a third of your customer base, there is a significant opportunity to improve your relationship with these buyers and boost profitability.

The Reality of Customer Profitability

Customer Category	Percent of Customers	Percent of Profit	Number of Customers	Dollar Profit	Profit Per Customer
High Profit	15	100	150	1,500,000	10,000
Good Profit	15	35	150	525,000	3,500
Some Profit	35	10	350	150,000	429
Unprofitable	35	-45	350	-675,000	-1,929
Total	100	100	1,000	1,500,000	1,500

Generally speaking, the main problem with unprofitable customers is that they place too many small orders; these customers tie up your sales reps and are expensive to help. There are two ways to solve this problem. First, talk to them and explain that placing fewer, larger orders instead of several smaller ones will be more profitable to them and you. Most of your unprofitable customers don't want to cost you money and will do what they can to improve their relationship with you.

Secondly, change your pricing structure. Conduct a cost-to-serve analysis and pinpoint the customers costing you the most money. Then, put a new pricing structure in place, charging high-cost customers more and low-cost customers less. By doing this, you can reward the customers costing you less money while incentivizing higher-cost customers to change their ordering structure.

Sales Force

Although there are many wonderful salespeople in the industry, there are also plenty who consistently underperform.

Consider a salesperson who operates in a $5 million territory and only produces $4 million. That's not terrible – after all, they are still selling significant amounts of product. However, when you have an 80% producer in a $5 million territory, you will end up with a million dollars fewer sales, and that will translate to fewer margin dollars. Very likely it would be an unpredictable territory for your business.

The Profit Impact of Low Sales Performance

Summary Income Statement	Total Firm	Per Salesperson	80% Volume Producer
Net Sales	50,000,000	5,000,000	4,000,000
Cost of Goods Sold	37,500,000	3,750,000	3,000,000
Gross Margin	12,500,000	1,250,000	1,000,000
Commissions (10% of GM)	1,250,000	125,000	100,000
Other Payroll	6,250,000	625,000	625,000
All Other Expenses	3,500,000	350,000	350,000
Total Expenses	11,000,000	1,100,000	1,075,000
Net Profit	1,500,000	150,000	-75,000

If you could replace that sales rep with a typical (not great) salesperson, you could replace that $75,000 loss with a net gain at an average level of territory profit. Simply put, even small deviations from territory goals cause profit to rapidly disappear.

Another way to reduce expenses within your sales force is by gaining better control of their selling methods. For instance, if you give your sales force the ability to cut prices, they will take it. If your sales reps regularly cut prices to try and close sales, they will hurt both themselves and the business. This is because when a sales rep gives out unnecessary price cuts, the cost of goods, payroll and lateral expenses remain the same, but the sales rep's commission will plummet and take your profits with it.

A Traditional Approach to Controlling Sales Force Pricing Decisions

Summary Income Statement	Current	Unnecessary 5% Price Cut
Net Sales	5,000,000	4,750,000
Cost of Goods Sold	3,750,000	3,750,000
Gross Margin	1,250,000	1,000,000
Commissions (10% of GM)	125,000	100,000
Other Payroll	625,000	625,000
All Other Expenses	350,000	350,000
Total Expenses	1,100,000	1,075,000
Net Profit	150,000	-75,000

Profit Lever Two: Pricing

There are three ways to approach pricing: cutting prices, negotiating lower costs from supply partners or raising outbound prices.

To be competitive, many distributors will cut prices for their customers. Although this may make buyers happy in the short term, it will do nothing but hurt your profitability over time. This is because, as you cut prices, you have to sell more units to make up the difference. Unfortunately, regardless of your industry, making up lost profits with volume is nearly impossible.

You have two alternatives to improving profit margins with pricing: negotiating lower inbound prices costs and raising outbound prices. Both approaches increase profit but raising prices outbound has a larger impact than lowering prices inbound.

If you go to a supply partner and ask them to sell products to you at a cheaper rate, those savings will go directly to your gross margin. Unfortunately, suppliers are more hesitant to cut prices in today's environment. You can try to negotiate a discount, but it won't be easy to convince them.

Instead of cutting costs or negotiating with your supply partners, the best thing to do is raise outbound prices. When you raise prices, your gross margin rises; your expenses go up slightly and profits increase sharply. Even if you end up with the same gross margin percentage, raising prices as opposed to reducing the cost of goods sold will allow you to drive more profit.

Many people think that raising prices is impossible. While it is not easy, raising prices is achievable, attainable, realistic and doable with the right planning.

Every distributor has three types of items:

- A items that offer low margins but make up the bulk of sales volume
- B and C items, which have slightly higher margins and sell moderately well
- D items, which have incredibly high margins but do not sell well

You could try to raise the price of your A items, but customers will immediately notice the increase and likely push back against the change. So instead, the key to raising prices is to raise the outbound cost of D items.

Customers only buy D items when they have to have them. D products are essentially “blind” items, meaning customers don’t know how much they should cost and don’t care. If you raise the price of a $3 item by 1% to $3.30, no one will spend hours scouring the internet to compare prices – they will accept it and move on.

By focusing your price increases on high-margin items with low movement, you can improve profits while justifying the additional time these products have to sit in your warehouse.

Navigating Supplier Price Increases

In today’s market, distributors must handle supplier price increases with diligence. Years ago, distributors only had to deal with supplier price increases once or twice a year. Suppliers would send an advanced notice three weeks before the price increase was set to take effect, and distributors would have plenty of time to stock up on supplies.

Unfortunately, times have changed. Now, it seems like suppliers raise their rates every other week. For distributors to remain profitable amid this constant fluctuation, they must be careful about how they navigate these price increases.

Distributors can choose between three avenues when navigating these changes. The first is not to raise outbound prices and take the hit internally. This tactic will kill your business within a few months, if not sooner.

The second option is to pass along price increases dollar for dollar. Distributors tend to follow this method when multiple price increases are coming down the line. For example, with a dollar-for-dollar price increase, if your supplier raises their prices by $5, you will raise prices for your customers by $5 to reflect the change. With this method, you can keep your gross margin dollars consistent. However, profit will tend to fall slightly.

The best way to handle a supplier price change is to pass along the increase percent for percent. This means if a supplier raises your rates by 5%, you raise outbound prices by 5%. This method allows you to expand your gross margin and improve profits simultaneously – even if expenses grow.

The Mandate for Change

To raise profits, distributors must think about changing their economics. If you raise unit sales by 5%, lower expenses by at least 0.2% and create a sales-to-payroll gap of 2%, you will see positive growth. Remember, this won’t be a quick process; instead of striving for change within one year, orient your goals around a five-year plan.

The Mandate for Change During Each of the Next Five Years

Net Sales	+5%
Gross Margin %	0.0%
Sales to Payroll Gap	2%
Other Expense %	-0.2%
Inventory Turnover	0.0
Collection Period	0.0

For example, if you start with net sales of $50 million and have $1.5 million of profit before taxes, making improvements over five years will result in significant, compounding growth. By making systematic changes, you can grow profits from $1.5 million to $3.5 million – boosting earnings from 3% to 5.4%. If you could also raise your gross margin by just two-tenths of a percent, your profits would double.

Change is not easy, but it is achievable, attainable, doable and realistic. Small changes mean a lot. High-performing distributors are already using the techniques in this report to double their sales. With the correct planning and effort, you can as well.

Here are five final takeaways to consider:

- **Order economics needs constant attention:** Distributors do too much work. As a collective, we process too many small, unprofitable orders. We need to change our order economics by putting more lines on every order and improving fill rates.
- **Cost to serve is challenging but essential:** Take a step back and look more closely at your customer base. While there are computer programs available that can help you analyze the cost to serve, your sales force should be able to tell you which accounts take the most time to manage. In addition, your buying staff should be able to tell you which customers have a low gross margin. Fire 2% of unprofitable customers and work with the others to change their order economics.
- **Blind-item pricing is a major opportunity:** Customers buy blind items infrequently; they're low value, and very little pricing information is available on them. Use this opportunity to raise prices by at least 1% across D items.
- **Supplier price increases are a threat and an opportunity:** If distributors pass along prices dollar for dollar, rate increases become a threat. However, if distributors pass along these changes percent for percent, they become an opportunity.
- **Better sales force monitoring is needed:** Salespeople can either drive profit or become a liability. You don't have to fire all your mediocre or underperforming salespeople, but you should train, control, educate and monitor them.

About the Author

Al Bates has worked in distribution for more than 30 years. For the first portion of his career, he ran The Profit Planning Group, the largest benchmarking business in distribution, which was benchmarking nearly 2,000 companies a year through associations and buying groups. After selling the business, Bates started a think tank called The Distribution Performance Project. He and his colleagues analyze what causes some distributors to succeed and others to stagnate.

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	Customer Target Segm	GP Distribution	Historical					Opportunity
			Revenue	Margin	Rebates	GM%	Override%	
1	A		$11,220,853....	$2,850,313.19	$0.00	25.40%	11.29%	$1,052,440.84
2	B		$5,644,469.04	$1,673,398.56	$0.00	29.65%	34.98%	$599,418.13
3	C		$3,179,242.66	$924,389.25	$0.00	29.08%	25.33%	$318,846.43
4	D		$2,714,337.24	$928,154.74	$0.00	34.19%	28.39%	$283,998.81

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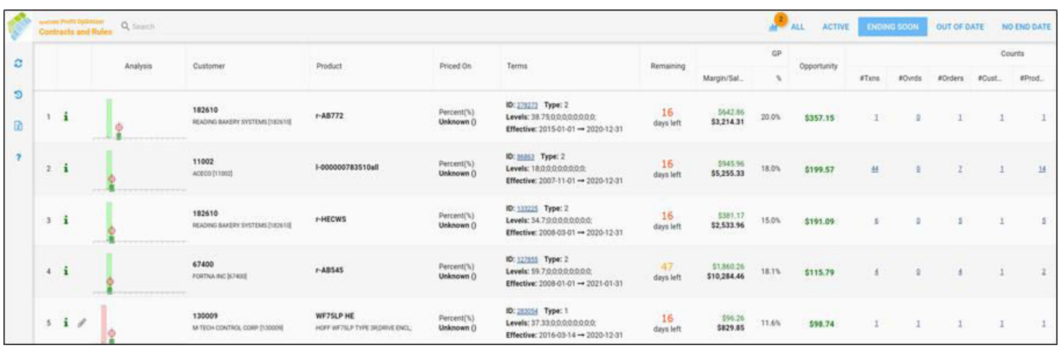

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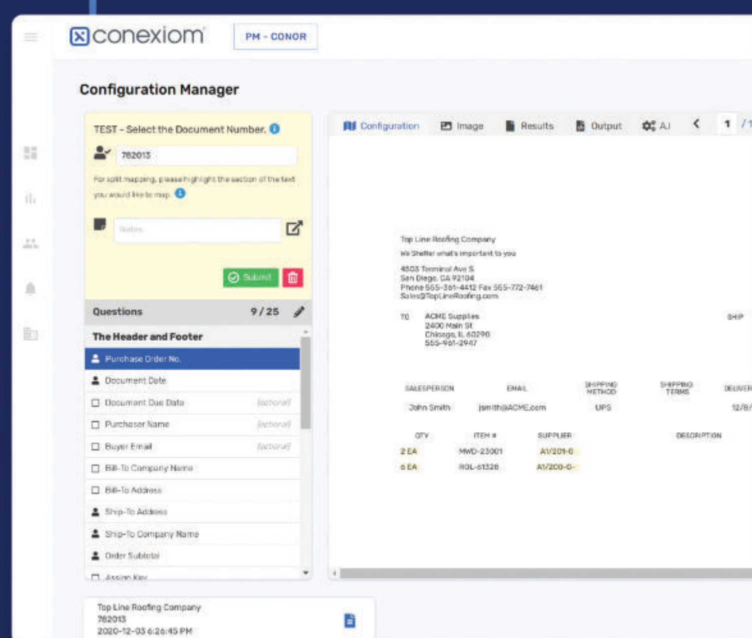

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