

# Practical Post-Pandemic Pricing for Profit

---

By Al Bates



*News flash: Implementing a smarter pricing strategy might be the single most effective action you can take to boost your bottom line.*

*Why? Because the single most impactful driver of profit is gross margin. As an example, achieving a 2% improvement in gross margin would drive higher profit than making a commensurate improvement in either sales or expenses.*

So, how do you most efficiently improve margin? Buying wisely and pricing strategically are both important drivers here — but ultimately, price has a far greater impact on the bottom line than purchasing does.

That may seem counterintuitive, especially to sales teams that are used to focusing heavily on price competition. To understand why pricing is your secret weapon for boosting profit, and illuminate some smart approaches for strategic pricing, we'll explore:

- Why gross margin is king
- Why simply increasing sales volume isn't the answer
- The surprising truth about reducing expenses vs. raising prices
- Why pricing slow-selling items correctly is the key to success
- The importance of getting the sales force behind the strategy
- How to make sure that supplier price increases have a positive impact

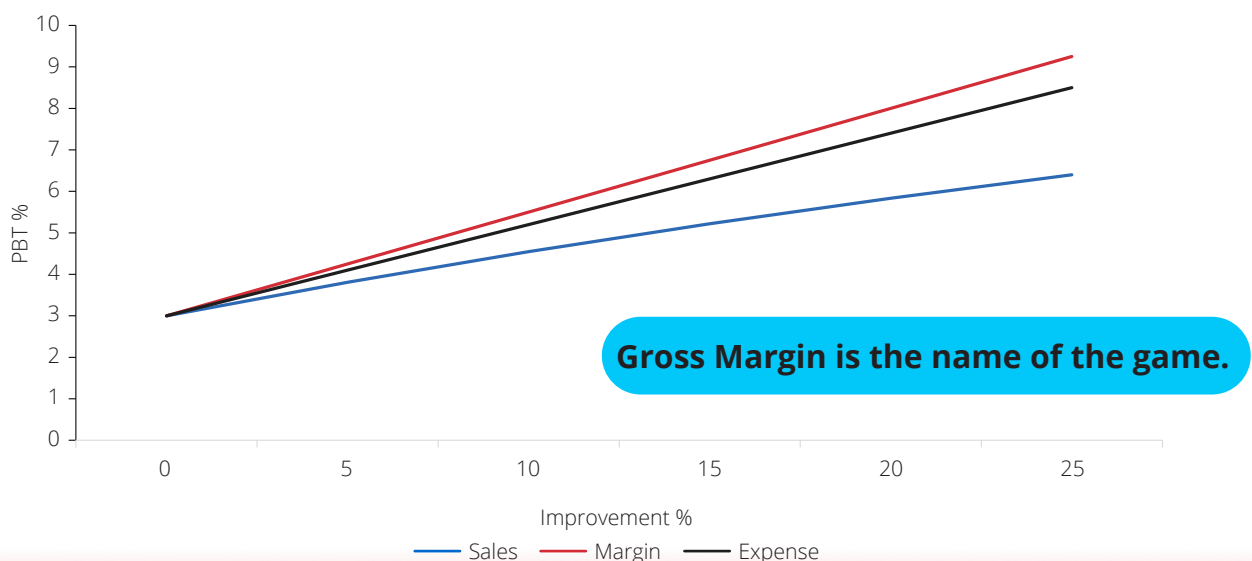
## Why Gross Margin is the Name of the Game

To understand what drives profits before tax (PBT) higher, let's look at the example of a distributor with a 3% bottom line. On the graphic below, the bottom line is sales, the middle line is expenses, and the top line is margin. And here's what we can see:

- **Sales:** Everyone loves increasing sales, but it's the least impactful way to boost the bottom line. This is largely because as you add sales, there are variable expenses that increase, as well. There are sales commissions, as well as possible interest on accounts receivable and inventory, and even bad debts.
- **Expense:** The middle line shows us that improvements in expenses are more impactful than sales — but the reality is that expense control can be a painful and difficult process of cost-cutting, and it's not always reliable.
- **Margin:** Fortunately, the gross margin line shows us a better path. Because if you can raise GM modestly, assuming sales stay the same, profits tend to explode — in a good way.

What this means is that ultimately, *gross margin is the quickest driver of profitability.*

### The Impact of Changes in Key Profit Indicators on Profits Before Tax



## The Fear Factor

The idea of increasing prices to boost margin may trigger some resistance.

- For one thing, raising prices may come with a certain amount of fear for salespeople. And the idea that keeping prices down is paramount in motivating not just sales teams, but other team members, as well.
- Also, we live in a business culture that conditions us to value market share and growth above all else. (And for publicly held companies, that focus on growth is a requirement.)
- Third, a lot of people think that it's possible to make up for lower prices with higher sales.

We'll address the first two points a little further on. But for the moment, let's look at why that third point doesn't hold as much water as you might expect.

## What the Isoprofit Line Reveals

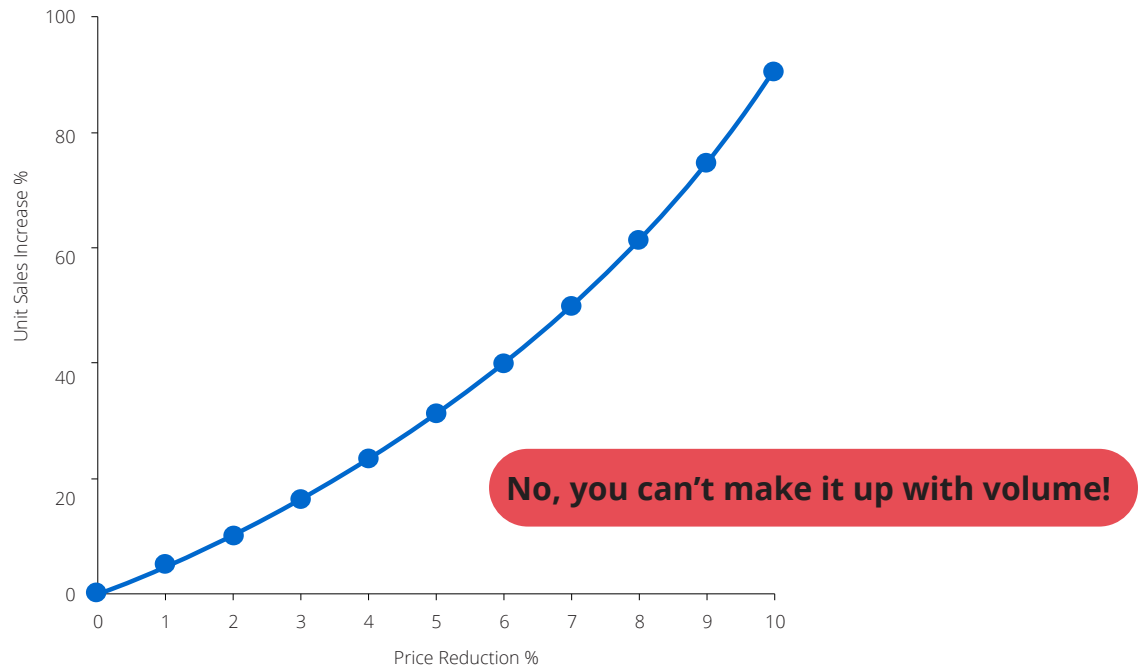
Many have the idea that it's a price-sensitive world out there, and if we could just get the prices down low enough, we could drive enough volume to be successful.

What the chart on the next page shows us is that pulling that trick off is harder than it looks. The line shown is what's known as the *isoprofit* line, which describes the increase in sales needed to make the same profit that you did before a price reduction.

This example is for a company with a 25% margin, which is fairly typical across a lot of industries. And as we can see, for just a 5% reduction in price, the company needs to do about 30% more volume just to break even and make the same profit it did before. (We're talking about an increase in physical sales units here, not dollars.)

But wait — there's another important consideration, as well.

## The Increase In Unit Sales Required to Exactly Offset A Price Reduction



## The Fine Print of Boosting Sales Volume

The chart above comes with a big assumption — that you can achieve that 30% increase in sales volume we looked at with no increase in your overhead.

The reality is, as you begin to move that isoprofit line substantially higher, your overhead will increase substantially, as well — further cutting into the positive benefits.

You may think of examples like, say, Burger King or McDonald's. But large-scale fast-food operations like those tend to have a much higher gross margin than 25% — in those cases it's more like 75%, and at that point the isoprofit line flattens dramatically. That gives them a lot more flexibility in terms of price-cutting promotions.

The reality is that making up price reductions with volume can't be done without a will to dramatically change the nature of the business — which could require drastic steps like getting rid of delivery or credit, or even cutting staff.

Fortunately, if you like the way your business is currently structured, there's a better approach.

## The Surprising Truth About Buying vs. Pricing

When you look at improving margin, there are really two paths to take: buying cheaper or raising prices. Of course, buying cheaper is wonderful if you can do it. But pricing higher will give you more bang for your buck.

Let's look at an example. We'll assume that in either case, we're going to take our gross margin from 25% to 25.5%.

- ✓ On the buying side, if you keep sales the same and you manage to buy it cheaply enough — in this case, \$100,000 cheaper — that raises your gross margin by the same amount. Assuming the same sales volume, the fixed and variable expenses stay the same, so it's dollar for dollar.
- ✓ But the pricing side is even better. Even keeping buying costs the same, if you get the 25.5% by pricing outbound rather than buying inbound, and even accounting for a slight increase in variable expense, you wind up with **an extra \$134,000 in GM**, and higher profit than with buying.

The phrase I like to use is: *Buying it cheaper is nifty, but selling it higher is niftier.*

### Improving The Gross Margin Percentage By Either Buying Or Pricing

Summary Income Statement	Current	Buying Potential	Pricing Potential
Gross Margin %	25.0	25.5	25.5
Net Sales	20,000,000	20,000,000	20,134,228
Cost of Goods Sold	<u>15,000,000</u>	<u>14,900,000</u>	<u>15,000,000</u>
Gross Margin	5,000,000	5,100,000	5,134,228
Fixed Expenses	3,400,000	3,400,000	3,400,000
Variable Expenses	<u>1,000,000</u>	<u>1,000,000</u>	<u>1,006,711</u>
Total Expense	<u>4,400,000</u>	<u>4,400,000</u>	<u>4,406,711</u>
Profit Before Taxes	600,000	700,000	727,517

## The Finer Points of Buying vs. Pricing

- An important point about the previous illustration is that it's not an either/or situation: In reality, you'll want to try to improve your margin on both sides. But it's worth knowing that the pricing side has more impact.
- It's also worth pointing out that when it comes to cutting expenses, there may be difficulty in getting suppliers to go along with the deal. Whereas you can do the outbound price increases unilaterally.
- On the other hand, if you're looking at that 25.5% and thinking that we're talking about doing an *across-the-board* price increase, you might understandably be worried about the impact on customer relationships.

But here's the thing: In reality, we can achieve this margin increase more successfully by doing it more selectively — by raising some prices and not others.

It's a selective world, and effective pricing strategy means finding the **best specific opportunities** to improve profitability via margin. That's what we'll look at next.



## The Velocity Code Structure

So how do we know where we can selectively (and effectively) raise prices, without causing a customer stampede or anxiety attacks for the sales force? That's where looking at velocity codes can be helpful.

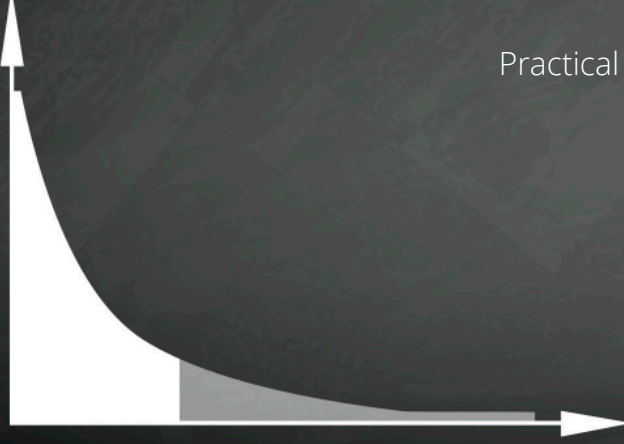
- **Code A:** Items in this category are best-sellers. They're also extremely price-sensitive. These are items where you don't want to raise the price a single penny, because that may create the impression that your prices are high across the board. So, in the variable pricing scheme below, these have the lowest margin.
- **Code B:** These are basic items, which still have a fairly low margin.
- **Code C:** These are slower-selling items, with a little more margin, and some pricing opportunities.
- **Code D:** These are the slowest-selling, most long-tailed items — and this is where there are some huge pricing opportunities.

## The Velocity Code Structure

**A items are commodities, D items are dogs**

Velocity Code	Percent of Sales	Sales	GM%	Percent of SKUs
A	60.0	12,000,000	20.0	5.0
B	20.0	4,000,000	25.0	15.0
C	15.0	3,000,000	35.0	30.0
D	<u>5.0</u>	<u>1,000,000</u>	55.0	<u>50.0</u>
Total	100.0	20,000,000	25.0	100.0





## Strategic Pricing Starts with the Long Tail

You might wonder why it's worth bothering to raise the prices on the D items, since they only represent 5% of sales, and the margin is already 55%. But they also represent half of our SKUs. That's a lot of inventory, a lot of time and effort, and a lot of warehouse space. It's worth making them as profitable as we can.

And here's the main thing about D items: These long-tail items are bought when somebody absolutely has to have them. They're not everyday purchases like the A category. And the D items are not nearly as price-sensitive as A items, because the customer who's looking for those harder-to-find D items is usually ready to buy them fast and grateful that you've got them in stock at all.

In the example below, we've raised the price for the D items by 10%. And in my experience, that's almost a slam dunk. It takes the margin on those items to just short of 60%, while the overall margin goes to 25.4% and translates to an extra \$100,000.

### Impacting Gross Margin with Blind-Item Pricing

Velocity Code	Current Performance			Potential Performance		
	Sales	GM%	GM Dollars	Sales	GM%	GM Dollars
A	12,000,000	20.0	2,400,000	12,000,000	20.0	2,400,000
B	4,000,000	25.0	1,000,000	4,000,000	25.0	1,000,000
C	3,000,000	35.0	1,050,000	3,000,000	35.0	1,050,000
D	<u>1,000,000</u>	<u>55.0</u>	<u>550,000</u>	<u>1,100,000</u>	<u>59.1</u>	<u>650,000</u>
Total	20,000,000	25.0	5,000,000	20,100,000	25.4	5,100,000

**Bump the D items 10%**

## A Slightly More Aggressive Move Leads to Bigger Rewards

If the D items are the low-hanging fruit, what happens if we move a little further out of our comfort zone and raise the C items, as well? That might trigger a little anxiety for the sales force — but it’s worth pushing through the panic. Because the D items are only 5% of our sales, whereas the C items are 15% of sales. And they’re still not very price-sensitive compared to A and B items.

Here’s what happens when we raise prices on the C items by 5%, which causes the margin on those items to rise the margin from 35% to 38%. Because they’re a much bigger chunk of our sales than the D items, the result is a \$150,000 increase in sales — and the overall gross margin goes up by another half of a percentage point.

Combined with the increase for D items, that takes us almost a full percentage point higher in gross margin than where we started out.

### Impacting Gross Margin with Blind-Item Pricing

Velocity Code	Current Performance			Potential Performance		
	Sales	GM%	Dollars	Sales	GM%	Dollars
A	12,000,000	20.0	2,400,000	12,000,000	20.0	2,400,000
B	4,000,000	25.0	1,000,000	4,000,000	25.0	1,000,000
C	3,000,000	35.0	1,050,000	3,150,000	38.1	1,200,000
D	<u>1,000,000</u>	<u>55.0</u>	<u>550,000</u>	<u>1,100,000</u>	<u>59.1</u>	<u>650,000</u>
Total	20,000,000	25.0	5,000,000	20,250,000	25.9	5,250,000



## The Characteristics of Blind Items

Ultimately, when we're trying to identify items whose prices can safely be raised, what we're looking for are blind items. Blind items have two fundamental characteristics. No. 1: Nobody knows what the price is. No. 2: Nobody cares.

Blind items also tend to be low-price items to begin with — which means customers are less likely to shop around and less likely to notice a price increase.

But to drill down a little deeper, I include a more detailed list of characteristics below that can help you identify those blind items.

(As a side note, this is an area where artificial intelligence could be skillfully deployed to achieve a real competitive advantage, by using it to home in on these characteristics and identify the right items.)

### Characteristic

- Low sales level
- Low price
- Bought only when needed
- Not heavily promoted
- Repair parts
- Unusual
- Non-seasonal
- Unbranded
- Discount

### Implication

- Bought rarely, unlikely to remember the last price paid
- No real concern about price
- Availability more important than price
- Almost no price information
- Buy something small; avoid buying something large
- Hard to find; availability is key
- No need to discount "in season"
- Difficult to obtain specific price information
- Don't always discount in round numbers, e.g. 5%, 10%

## Even Big Players Have Pricing Challenges

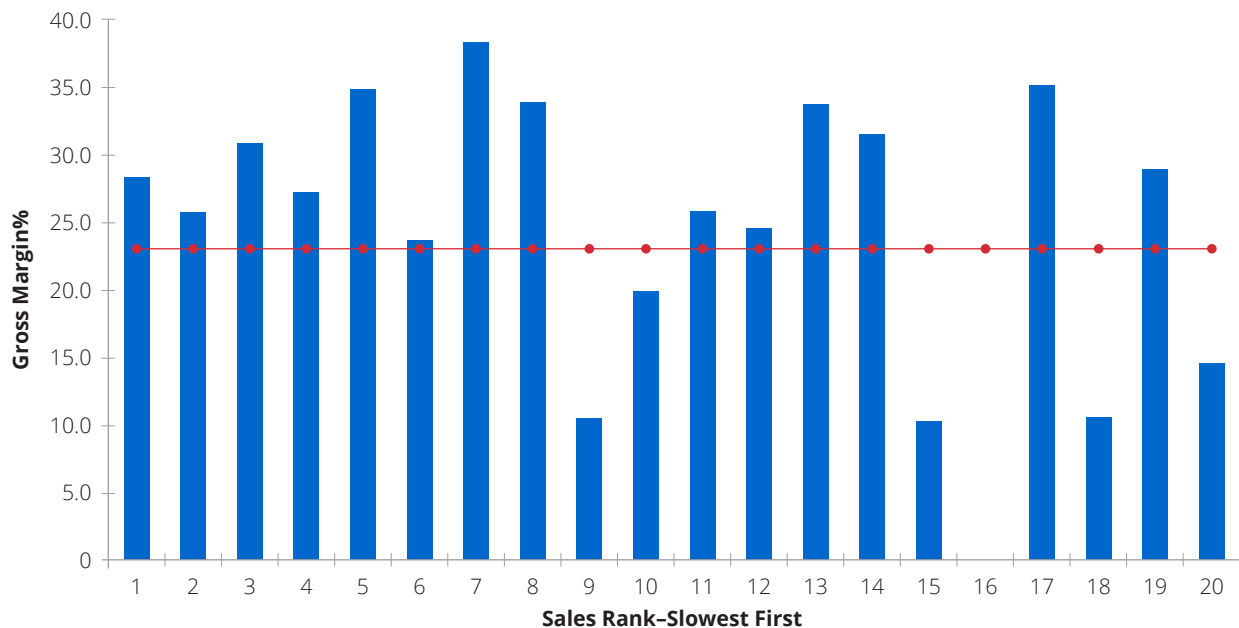
It's worth pointing that pricing can be challenging not just for the little guys, but for major players, as well.

As an example, this chart shows us the 20 slowest-selling SKUs for a giant distributor whose name would be familiar to anyone reading this — a very sophisticated and well-managed firm.

The horizontal line represents 24% — the overall gross margin for the entire firm. And if we look at the D items, we can see that the margin ranges from 40% all the way down to, well, zero. Obviously, there's a lot of inconsistency here and a lot of items that are below the firm average.

This kind of unevenness can have a lot of causes, from master accounts not being updated properly to scattershot decision-making or a gut-based approach to pricing specific items. But the point is that over time, margins tend to wear away. Correcting that requires attention and diligence. And even the biggest players aren't immune to this need.

### Often the Price is Not Right: Bottom 20 Items for a Large Distributor



## The 3 Levels of Sales Concerns

We should take a moment here to talk about the elephant in the room: the very real fear of raising prices. This can kick in at multiple levels, from customers who are focused on getting value for their money, to management who are worried about being dismissed as too expensive.

But the biggest factor by far is the sales force, because they're talking to customers every day — and they may be used to using price reductions as a tool for boosting sales. And they're likely to have a heightened sensitivity to customer concerns about price.

For that reason, getting their buy-in to the pricing strategy of critical importance. Let's look more closely at this.

### The 3 Levels of Price Concerns



Customers – **Concern**  
about excessive prices



Management – **Fear**  
about being perceived  
as overpriced



Sales Force – **Paranoia**  
about losing sales

## Salesperson Skill Set

The sales team is on the front line of pricing issues. In practice, the sales force is consistently inundated with “Gee, that seems a little high” or “If you can take 5 off, we can do this.” Being on the receiving end of such comments eventually takes a toll on behavior.

When the idea that prices are too high is repeated long enough, even the best salesperson falls prey to a kind of Stockholm Syndrome. Simply put, there's a natural tendency to believe that the firm's prices really are too high because everybody says they are.

Every effort needs to be taken to help sales reps avoid the Stockholm Syndrome issue. This must include explaining why prices must be maintained to ensure adequate profitability to the firm. And it helps to make sure they understand the subtleties of the pricing strategy: for example, why the C and D items have different margins from A and B items.

## The Impact of a Supplier Price Increase

Another issue worth addressing is supplier price increases. There are two common ways to handle them. Let's look at the example of a 5% supplier price increase.

- The first approach is a **dollar-for-dollar** pricing. That means that if a product goes up by a dollar inbound, you raise it by a dollar outbound. The downside of this is that fixed expenses stay the same but variable expenses increase — and the result is that you wind up making less money than you did before.
- The other, more effective approach, is **percent for percent**. That means that if the supplier raises the inbound price 5%, you raise your outbound price 5%, as well.

✓ **The percent-for-percent approach is superior** because the increase in variable expenses is compensated for as the gross margin goes up 5% — and as a result, the profit explodes.

- One caveat: As time goes by, there may be a limit to how many times supplier cost increases can be passed along before customers resist.

## The Impact of a 5% Supplier Price Increase

Summary Income Statement	Current	Dollar for Dollar	Percent for Percent
Net Sales	20,000,000	20,750,000	21,000,000
Cost of Goods Sold	<u>15,000,000</u>	<u>15,750,000</u>	<u>15,750,000</u>
Gross Margin	5,000,000	5,000,000	5,250,000
Fixed Expenses	3,400,000	3,400,000	3,400,000
Variable Expenses	<u>1,000,000</u>	<u>1,037,500</u>	<u>1,050,000</u>
Total Expense	<u>4,400,000</u>	<u>4,437,500</u>	<u>4,450,000</u>
Profit Before Taxes	600,000	562,500	800,000

## Maintaining Sales Profit: A Formula

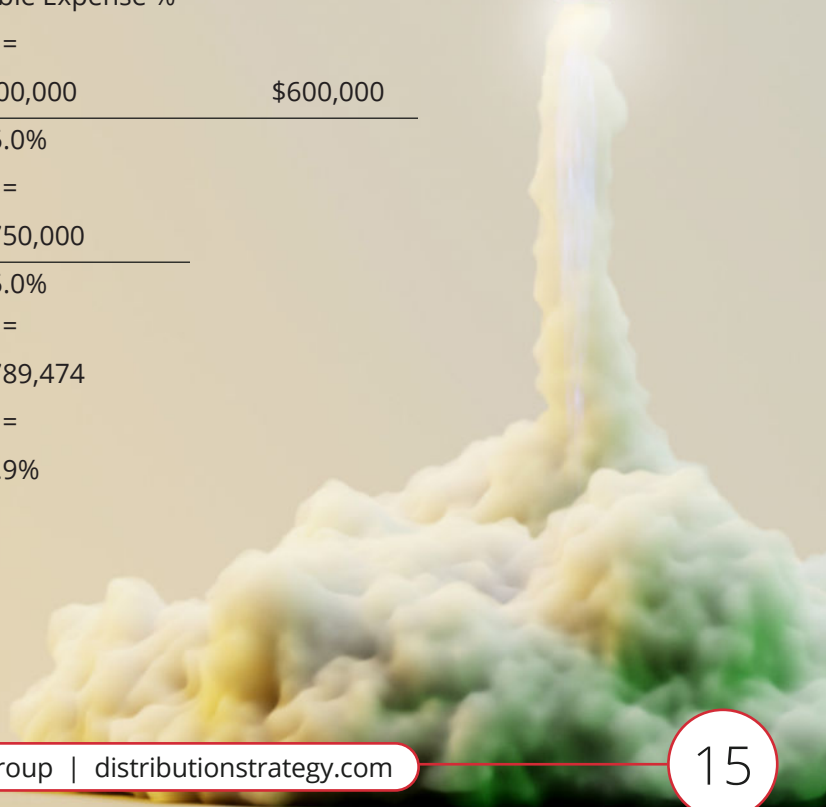
Here's one last tool to help you navigate these waters. What happens if you can't match the supplier's percentage increase exactly? How much do you have to match it to hold the line against the variable expenses?

The formula below shows you how to figure it out. In this example, the supplier raised the cost of goods (COGS) from \$15 million to \$15,750,000. Taking our fixed expenses of \$3.4 million and adding the profit we'd like to maintain, then we divide by 100% minus our variable expense percentage (in this case, 5%).

What our formula tells us is that if you have a 5% supplier increase, you need to raise your prices outbound by at least 3.9% to keep generating that same \$600,000 profit.

### Holding the Line on Profit from a Price Increase

<b>Sales to Maintain Profit</b>			
=			
New COGS	+	Fixed Expenses	+
\$15,750,000		\$3,400,000	
-----			
100% - Variable Expense %			
=			
95.0%			
-----			
\$19,750,000			
-----			
95.0%			
=			
\$20,789,474			
=			
3.9%			



## Some Final Observations

Gross margin is the single largest driver of profitability. It is also the one that is most challenging given the importance of price in distribution.

Meaningful improvements are possible. However, generating the improvements requires a sustained effort across a lot of action points — buying properly, increasing prices where appropriate, working with the sales force and understanding the economics of supplier price increases.





## About the Author



Dr. Albert Bates is Principal of the Distribution Performance Project, a research and education entity focusing on distribution. He makes about 100 presentations each year on topics such as Improving the Bottom Line, Doing More with Less and Pricing for Profit. He also heads the firm's investigation into profitability research for over 50 different trade associations. He has published widely in both the professional and trade press, including in the Harvard Business Review and the California Management Review. He has also authored eight books on financial planning for businesses.

# DISTRIBUTION STRATEGY **GROUP**

## About Distribution Strategy Group

Distribution Strategy Group's thought leadership, research and consulting services are provided by a team with decades of experience in the distribution industry. They have helped more than 70 distribution companies build a solid foundation to win in today's changing market.

Distribution Strategy Group offers strategic guidance for distributors in the face of disruption, including:

- Independent expert content
- Digital and ecommerce strategy
- Customer lifecycle management strategy
- Customer analytics

Contact us:

[distributionstrategy.com](http://distributionstrategy.com) | 303-898-8626 | [contact@distributionstrategy.com](mailto:contact@distributionstrategy.com)

Thank you to our sponsor:



