DISTRIBUTION STRATEGY GROUP

Best Practices in Pricing and Costing

By Greg Smith

For most distributors, 40% to 60% of invoices are losing money. It's time to go beyond cost-plus.

Aligning pricing strategies with true market value and demand is crucial for sustaining profitability and maintaining a competitive edge. Additionally, distributors must have a thorough understanding of their organizational costs and work diligently to minimize them.

A DSG survey showed 60% of distributors implemented new pricing strategies in the past year. Nearly 60% said they saw a moderate improvement in margins due to the effort; about 12% saw a significant improvement. The rest saw no change, or they are still evaluating the impact.

In many cases, distributors aren't seeing a significant improvement because they work on pricing or cost reduction for six months, and then move on. In reality, once distributors implement strategic pricing matrices, that's when the real heavy lifting starts if they want significant, long-term sustainable results.

This report provides actionable best practices to optimize pricing, lower costs and improve margins.

How do you measure the success of your pricing strategies?

Pricing Strategies

Strategic Pricing Matrix

A strategic pricing matrix is typically based on three dimensions: customer type, customer size and product price sensitivity. For example, a customer type could be as simple as residential contractor vs. commercial contractor. Customer size should be based on how much they buy from you, as well as their market potential. Products are segmented by price sensitivity (A, B, C and D), and can be further segmented based on their COGS. An example might be a product that costs 3 cents is less sensitive to the buyer than products that cost $300. That may sound obvious; however, I have seen many instances where the two products in the example have the same gross margin percent applied. This could be due to several factors such as bad sell groups, inexperience or just not understanding the data.

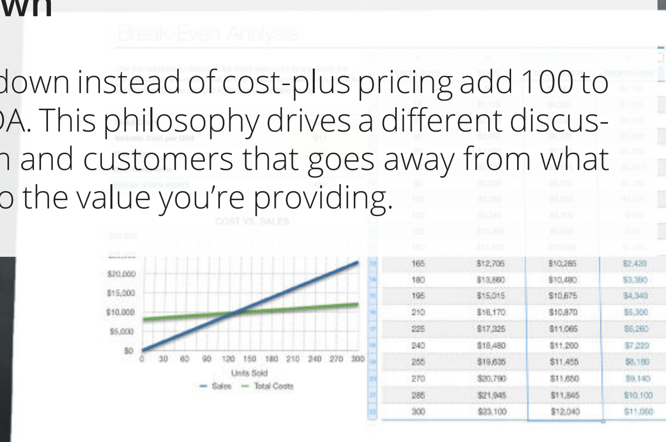
COGS

Distributors have many options for presenting COGS to sales reps and other customer-facing team members:

- Replacement cost
- Last paid
- Average
- Landed
- None (or by user authorization)
- Sales COGS (This could be replacement that adds a buffer or puff factor)

Cost Plus vs. List Down

Distributors that use list down instead of cost-plus pricing add 100 to 200 basis points to EBITDA. This philosophy drives a different discussion with your sales team and customers that goes away from what you paid for something to the value you're providing.



Sell Groups

Sell groups are segments of products that share similar characteristics. The challenge with using sell groups is that they are often built incorrectly. They may include products that sell at 33% gross margin and products that sell at 12%. To use sell groups effectively, this must be fixed. If you are using a third-party price analytics company, fixing your sell groups is paramount to achieving maximum results from your engagement. Not fixing substantially reduces your ROI.

Good, Better, Best

Implementing a Good-Better-Best pricing strategy offers advantages over a one-size-fits-all matrix pricing approach. This tiered pricing model allows distributor salespeople a broader range of flexibility when pricing customers.

Unlike matrix pricing, this flexible approach allows salespeople the ability to be responsive to market dynamics, ensuring that prices remain aligned with both customer expectations and competitive pressures.

Lock or Limit the Ability to Change Prices

Limiting users' ability to change prices via user authorization or other solutions is another pricing strategy that can preserve margin. This can be done gradually on less price sensitive items, with few exceptions allowed. Ask yourself this question: Should a newbie counter salesperson be allowed to lower your EBITDA? By giving them the ability to lower pricing, that is effectively what you are doing.

Gross Margin on Non-Stock Products

Many times, non-stock products, typically C and D items, are woefully underpriced and should have much higher gross margins than the average for an A or even B item. The average gross margin on non-stock products under $500 should be closer to 40% to 50%, or 500 basis points higher than the average gross margin of a B item.

Customers are typically less price sensitive on special order items; they generally need the item quickly, these products don't sell often, and your cost-to-serve is substantially higher. If your salespeople don't want to charge the higher margin or feel as though they are not able to, they can "ship the product direct" from the factory and have the customer pay the freight.

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Price Increases

Manufacturer-Led Price Increases:
When a manufacturer initiates a price increase, it is essential for the distributor to promptly adjust their pricing matrix to reflect the new costs. The only exception to this immediate adjustment may occur with contract pricing, where the frequency or amount of price increases is restricted.

In managing Special Pricing Agreements (SPAs), it's crucial not to lock in fixed prices. Instead, prices should be based on a gross margin percentage above either the landed Cost of Goods Sold (COGS) or, ideally, the replacement COGS. Additionally, for items that are classified as C or D products for your business, and where the manufacturer has implemented a modest price increase (e.g., 3%), consider raising prices by 5% or 6% to enhance profitability.

Distributor-Led Price Increases:
There are instances where a distributor may choose to implement a price increase independently of the manufacturer. However, avoid uniform price increases across all product categories, such as A, B, C and D items, as this approach is likely to encounter resistance from customers.

Instead, adopt a disciplined pricing strategy with targeted, selective price adjustments to mitigate customer pushback. By carefully managing these price changes, distributors can narrow the range of transaction highs and lows, leading to more consistent and predictable profitability.

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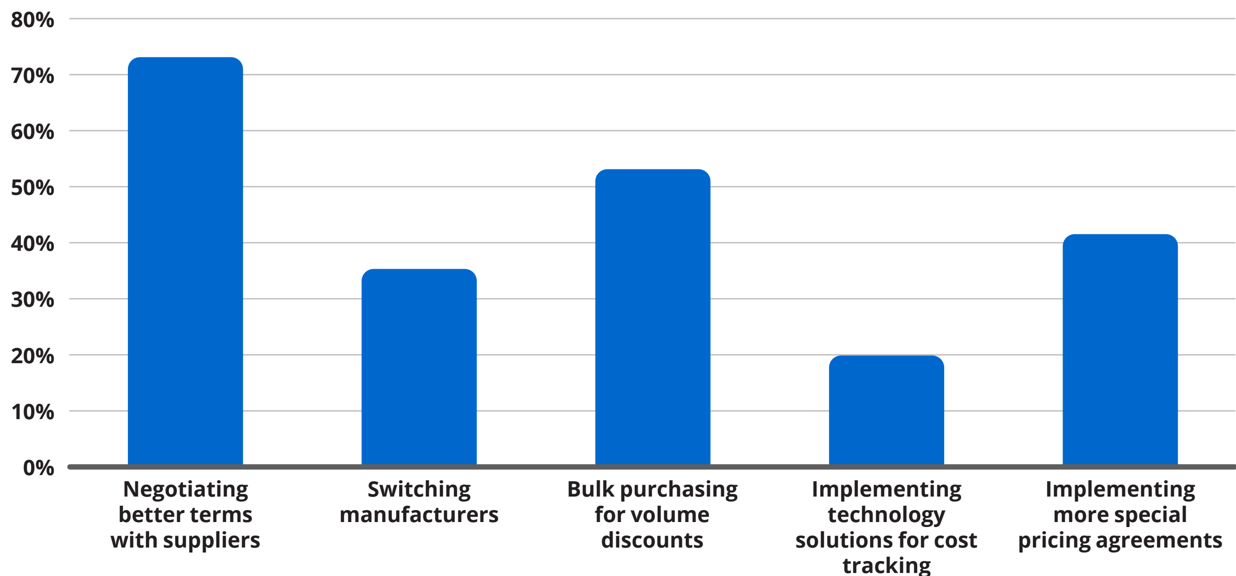
Tackling Product Costs

Product costs include more than just the price set by the supplier to the distributor. It includes all costs associated with acquiring, selling, servicing, storing and delivering products to customers.

In our survey, distributors said that negotiating better terms with suppliers and bulk purchasing are their two primary strategies for lower product costs. Implementing SPAs is also important.

What Strategies Have You Found Most Effective in Lowering Your Product Costs?



Here are three areas of opportunity:

Lowering Your Costs Across Your Footprint

The goal is to negotiate with the manufacturer so that you have the same COGS for a specific item across your geographic footprint rather than differing by region. When appropriately applied, cost normalization can add incremental margin.

One important caveat: If you lower your pricing, don't give the product away to your customer. Hide it from sales view so it doesn't affect pricing in the field.

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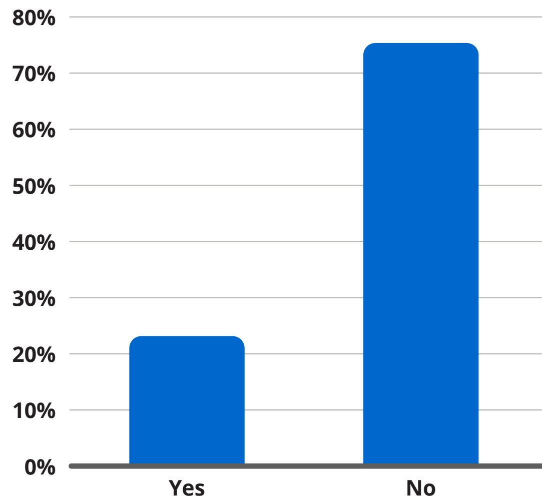
SPAs

Special Pricing Agreements (SPAs), where a manufacturer agrees to sell a product to a distributor's end customer at a lower COGS than your standard into-stock COGS. Depending on customer mix and distribution model, on average SPA sales make up 10% to 15% of through-stock sales. High-EBITDA distributors (>8%) have up to 70% of their through-stock sales tied to some sort of SPA.

SPAs can generate substantial margin, but they are a lot of work to implement correctly. For example, a manufacturer may provide a SPA for 1,000 items tied to a single or customer type. The key is in determining the top-selling items by customer. The resale pricing (based on GM) may be aggressive in nature, but it drives additional revenue and captures more market share. For the remainder of the products, use your standard matrix pricing and pick up the extra margin dollars when you sell the product. SPAs require a targeted approach to maximize their effectiveness.

Don't allow the sales team to lower the price for the rest of those

Do You Use Specific Tools or Software to Manage SPA?



products using the cost-plus approach just because the products have a SPA.

Big Buys

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Bulk purchasing is effective as a repeatable approach that can be done throughout the year. The goal should be to negotiate a one-time discount over and above any rebates, extended terms or other negotiated product reductions, such as free product or consignment.

4 Drivers That Impact Customer Profitability

Customer Profitability — and Why it Matters

If a customer is a high-volume purchaser, it does not mean that they are your most profitable. However, many distributors continue to dedicate the most resources to these customers.

We tend to treat those customers like gold while stepping over customers who don't have that volume. Without a thorough analysis by customer, you risk focusing on those that aren't nearly as profitable as you assume they are and, as a result, miss opportunities to grow your profitability. As a rule, the more attention to pay to a customer the higher your cost-to-serve.

Segmenting customers based on profitability helps distributors allocate resources more effectively. High-profit customers can receive premium services and pricing, while less profitable customers may require different strategies. Understanding your customers' profitability is essential to maximizing overall profitability.

Understanding Cost to Serve by Customer

The more complicated a cost-to-serve calculation is to use and apply to customers, the more difficult it will be to get buy-in from your sales force.

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Additionally, a more complex approach means more time and effort. For these reasons, distributors frequently downplay CTS and opt for cost-plus pricing. Some distributors try a more limited-factor approach to CTS. They'll use DSO, transaction or transportation costs to measure CTS. This can be a launchpad to a more detailed approach in phase two.

Here are two ways to calculate CTS:

Activity-Based Costing (ABC)

Activity-Based Costing is a widespread best practice for calculating CTS. However, ABC is notoriously complex and work-intensive, and calculating it requires a significant investment in time and resources.

ABC allocates expenses (e.g., warehouse, shipping expenses) to individual orders to arrive at a more exact customer CTS. Subtracting your CTS from gross margin determines your customer net profit (NP).

G Group Proxy Method

My method is a simpler, easier-to-use model for calculating CTS. Instead of ranking customers based on a more exact CTS, you rank them against data that distributors already have in their operating systems.

Directionally, it's as effective as the ABC approach but gets greater buy-in from your sales and leadership teams. The method's simplicity also makes it easier for salespeople to adopt.

The best factors for calculating CTS based on your organization and customer mix should:

- Have measurable data
- Be quantifiable at the customer level
- Apply to every customer
- Be easily understood by any sales or pricing influencer

At most distribution companies, these factors meet the criteria:

- **Average Order Size ($):** Order sizes affect CTS from a handling and delivery-cost standpoint. Frequent small orders create higher handling costs than less frequent, larger orders.
- **Average Number of Line Items:** Small orders with few line items can drive CTS up, particularly if a customer repeatedly places many small orders. Single-item orders have associated expenses, like picking, trucking and delivery. You get a lower

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CTS and more efficient business with more line items per order.

- **Days to Pay:** Days to pay is one of the most significant CTS factors, so distributors benefit from careful monitoring and improvement. The more days it takes for a customer to pay, the greater the opportunity cost (of capital). Minimizing days to pay can improve the cash conversion cycle.
- **Will-Call/Counter Pick-up Orders:** It's common for customers to pick products up from distributor facilities or warehouses instead of having them delivered, especially in contractor trades. These will-call orders affect CTS, reducing transportation and delivery expenses and lowering resource commitments.
- **Same-Day Deliveries:** Distributors need more sales resources and incur more significant transportation, inventory and order processing expenses.
- **Special Order Products:** Customers who order a product mix that contains a high percentage of special-order items tend to have a higher CTS than those whose product mix includes stock items.
- **Returns:** Customers who regularly return items have higher handling and possibly stock-out costs. Each return involves suppliers and requires paperwork and resources. Managing and monitoring this requires more data entry. If the cause is not accurately captured, customer stratification and analytics could penalize customers for the wrong reasons.

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Case Study: Putting CTS into Practice

A regional distributor had 22 stocking locations selling across two states. The distributor needed a consistent pricing mechanism for all locations. The leadership team wanted to deploy a pricing framework their sales force would readily adopt. The leadership team needed to help the sales force understand CTS and how it affects pricing.

First, they gathered stakeholders from departments, including sales, operations, finance and purchasing, to determine which CTS factors were most pertinent. The CFO preferred a comprehensive set of 11 metrics, but the vice president of sales wanted a more straightforward approach with only the most influential metrics.

They knew a more straightforward process would likely gain greater buy-in, so they selected the average order size, number of line items and days late.

These factors helped get sales and other customer-facing roles on the same page. We compared two customers with similar sales and gross margins side-by-side. Their sales and gross margin were alike, and pricing didn't need adjusting.

However, factoring in CTS told a different story. The first customer placed more than twice as many orders and paid late by an average of 12 days. Given this CTS explanation, the sales team could better understand the reason for this customer's higher pricing.

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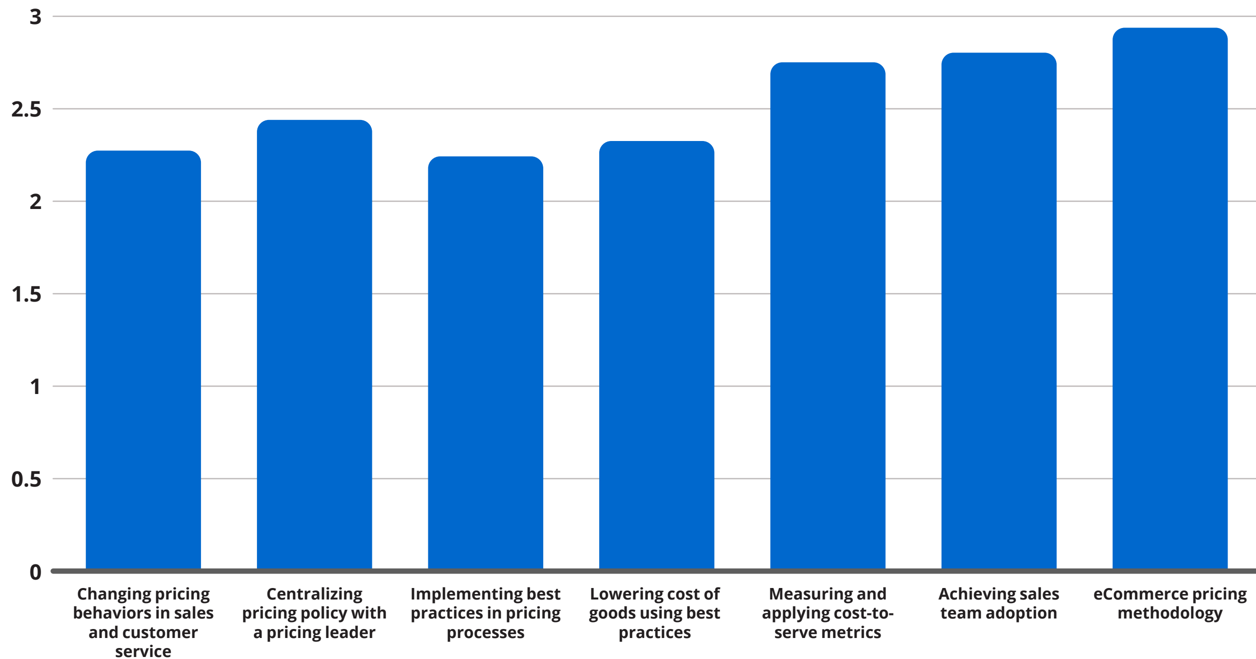
Strategies to Improve Customer Profitability

4 Highest Priority Objectives Related to Pricing and Costing



Once you've determined profitability by customer, you can develop targeted strategies to improve those numbers.

Tailored Pricing

Ensure your prices reflect the value and cost associated with serving different customers. This approach allows flexibility and better terms for high-profit customers while ensuring appropriate pricing for less profitable customers.

Service Level Adjustments

High-profit customers benefit from enhanced service levels, such as faster delivery times or dedicated account management, which can strengthen their loyalty and satisfaction. Conversely, service levels for less profitable customers can be adjusted to a more cost-effective model, ensuring that the cost to serve does not exceed the revenue generated from these customers.

Incentives for High-Profit Customers

Rewards and incentives, such as discounts on future purchases, exclusive deals or loyalty programs, can encourage these customers to continue doing business with you.

Cost Reduction for Less Profitable Customers

This might include optimizing delivery routes, consolidating shipments or using more cost-effective ordering solutions, such as EDI, Web OE or even reassigning a salesperson. By reducing the costs associated with serving these customers, you can improve their profitability while maintaining a satisfactory service level. These measures ensure that even less profitable customers contribute positively to the bottom line.

eCommerce Pricing

What is your ecommerce strategy? What market are you serving? Once you understand your ecommerce strategy, you can understand your pricing methodology.

There are two fundamental approaches here. First, is the branded ecommerce site serving your customers? Opaque pricing strategies place the lowest product costs behind a customer login. The idea is that these customers get the best price because they have an established customer relationship.

Make sure your pricing matrix syncs with ecommerce pricing so there's no conflict between the logged-in customer and standard (higher) pricing for the non-login customer. You don't want your customers with a login to see a lower price when they are not logged in.

One of the many obstacles many distributors find when launching an ecommerce site or even when they struggle to get traction above 10% of sales through ecommerce is salesperson fear. It is important to acknowledge this fear and address it head on. This fear is often compounded by the perception that ecommerce platforms reduce the need for traditional sales skills, such as negotiation, relationship-building and personalized service.

Salespeople may feel that their expertise and influence over the sales process are being de-emphasized, leading to anxiety about job security and long-term career prospects.

Additionally, there is often a concern that customers will prefer the ease and convenience of online purchasing over direct interactions with sales representatives, which can further erode the salesperson's role. This shift can create a sense of being replaced or sidelined, as the ecommerce platform takes on functions that were once within the salesperson's control.

To address these fears, it's important to emphasize that ecommerce is a tool that can complement and enhance the salesperson's role rather than replace it. By integrating ecommerce, salespeople can focus on higher-value activities, such as strategic account management, complex sales and deepening customer relationships, while the platform handles routine transactions. This approach can actually empower salespeople, allowing them to leverage technology to improve their effectiveness and provide even greater value to their customers.

You also don't want the customer turning to the sales rep to override the price on your ecommerce site. Ideally, between sales and marketing, you're driving traffic to register, log in and see their pricing. Your goal should be to train customers to use the website to process recurring orders. They can also use the website after hours. The website can lower your cost to serve.

A second approach is the non-branded ecommerce platform, where the distributor may focus instead on low pricing and a "spray and pray" approach that seeks to sell to everyone. The website is not associated with their regular go-to-market branding. Pricing is transparent and comparable — typically, you're selling on price, not service or relationship.

Next Steps

Profit drivers in distribution include:

1. Increase selling price (50% of the impact)
2. Reduce the cost of goods sold (COGS): 35% of the impact
3. Increasing sales volumes: 15% of the impact

(Note: The above figures assume 4% ROS, 30% average GM and 26% average SG&A.)

All three of these pricing strategies won't get you to the same end game without best practices that should include:

1. **Understand Cost to Serve:** Conduct a thorough cost-to-serve analysis to understand the true cost of serving each customer.

2. **Develop KPIs and Accountability:** Start developing key performance indicators (KPIs) and a level of accountability. Don't go down a rabbit hole. Include four to five metrics beyond just gross margin to track progress.

3. **Leverage Data-Driven Pricing:** Data will set you free. While the data you need is in your ERP, it's easy to become overwhelmed. Don't boil the ocean; start small. Use customer data to identify preferences, willingness to pay and buying patterns.

4. **Conduct Market Analysis:** Distributors must ask, "Are we strategically pricing items based on true market sensitivity and inventory strategy?" Due diligence helps distributors set competitive prices in line with current market conditions.

5. **Regularly Review Special Pricing Agreements:** Ensure they remain competitive and profitable. Closely monitor compliance to prevent margin leakage.

6. **Minimize Pricing Overrides:** Train employees on the importance of adhering to pricing policies. Educated employees are more likely to follow procedures and maintain pricing integrity. A tip: Most sales teams override prices with approaches that end in zeros and fives (10, 20, 25, 35). To incrementally increase margins, train sales teams to increase them by a percentage (11, 21, 26) and watch your bottom line improve. Even small, incremental approaches can add value.

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7. **Don't Forget About Sales Compensation:** The goal should be to develop pay structures tied to corporate profitability.

8. **Use a Fabricated Cost Basis:** You don't want your salespeople to see your replacement or average or landed average cost. You want them to see the sales cost of goods, which you control. The reason: Your price shouldn't be about what you paid for something. There's no correlation between that and the market price. This practice creates a buffer that enhances profitability by ensuring that the selling prices, which are often calculated as a markup over the cost basis, include this additional margin. It effectively protects against unforeseen costs and maintains healthier profit margins.

9. **Foster a Culture of Accountability:** Ensure your organization fosters a culture of accountability, where all employees understand the importance of pricing and costing in achieving profitability.

About the Author

Greg Smith, owner of G Group Holdings, LLC, brings over 30 years of experience leading startups and middle-market companies to exceed hundreds of millions in revenue. His expertise includes crafting effective pricing strategies, driving business growth to double-digit EBITDA and fostering team collaboration. Greg holds a BBA and various leadership, negotiation and talent optimization certifications.

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