GUIDE:

THE DISTRIBUTOR'S MARGIN RECOVERY ROADMAP

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MARGIN RECOVERY ROADMAP: 5 RULES FOR A MUCH-NEEDED PRICING RESET

By Pradip Krishnadevarajan

Crises present an opportunity for a forced reset. As we have accepted and learned to adapt to COVID-19, now is the time to make decisions and move forward in these critical areas: revenue recovery, pricing decisions, capability building, significant investments, and talent development. The first thing is revenue recovery, which we cover in our eBook Revenue Recovery Roadmap: 4 Steps for Transitioning Your Sales Team to Remote Selling. However, in your race to revenue recovery, don't lose sight of profitability.

In the past, distributors would often sacrifice margins to gain market share and drive the topline. However, such tactics negate a strategic pricing process, rendering it nearly nonexistent. Without process, your people must make pricing decisions in a vacuum. And as hard as they might try to compensate for and cope with inefficiencies, and as effective as their efforts might be in the short-term, you can't expect them to sustain healthy margins in the long run. They need process, training and support.

That process should shift strategy away from taking a top line approach that prioritizes winning customers before vetting their value and toward a data-driven approach. And it should be managed by effective pricing leaders who can interpret data closely, drive action and provide direct support, rather than relying too heavily on external software or technology.

WHAT SHOULD YOUR PRICING PROCESS ACCOMPLISH?

As outlined in our research (www.naw.org/po), a pricing process should help distributors achieve healthy margins where they are warranted and ensure their cost to serve does not get out of control. This means focusing on a critical set of customers. Yes, in several cases, less is more. With the right tools and data to offer customer-specific prices, as opposed to one-size-fits-all prices, a well-educated sales force will capture higher margins. During this crisis, your pricing process should seek to control:

- Overdiscounting based on the perceived benefits of volume. (Avoid the classic top line approach.)
- Overdiscounting due to fear of customer churn. (No, we do not need all customers.)
- Undercharging for or overdelivering services. (Balance your value creation and value capture.)

Without process, your people must make pricing decisions in a vacuum.

Pricing can be a complex and multifaceted process. Many individuals influence pricing decisions, including management, salespeople, suppliers and customers. This complexity is both a problem and an opportunity. Complexity could leave room for many things to go unseen or be poorly understood; for example, if the sales force makes simplistic decisions in such an environment, profitability will suffer. However, if you seek to optimize the information and actions of all influencers with a process that employs the right data, you can achieve clarity, understanding and superior profitability.

THE 5 RULES OF PRICING STRATEGY

To help with your margin recovery and deliver a much-needed pricing reset, we have identified five rules for your success: visibility, control, ownership, focus and balance. Let's take a close look at each of these rules.

Your people cannot optimize what they cannot see. At the same time, it's not practical to provide them all the cost elements before they gravitate to a price and offer quotes to customers. What's the solution? Breaking down the price equation. Generally, we only pay attention to the gross margin percentage and dollars. However, there are more ingredients to the price equation. If you try to optimize the result (the recipe) without optimizing the pricing drivers (the ingredients), you are setting yourself up to fail.

Let's break this down:

RULE OF VISIBILITY

Your people cannot optimize what they cannot see. Provide visibility to your team by ranking customers. Use sales, gross margin, alignment, and cost to serve to segment your customers. Possible categories include core, opportunistic, marginal, and service drain.

Start applying the rule of visibility by providing information about your customer types with customer segmentation. This segmentation is the first step in getting to a stable pricing process. It is no longer a 'good to have.' It is a must-have. Use more than sales to segment your customers (sales, cost of goods sold, gross margin and cost to serve). Possible categories include: core, opportunistic, marginal and service drain. Doing this will help you be consistent with price, at least across customer segments, and begin streamlining your pricing process overall.

WHAT YOUR SALESPEOPLE SEE:

Price =

Cost of Goods Sold **+** Gross Margin

WHAT YOUR CFO OR PRICING ANALYST SEES:

Overall Profit =

Cost of Goods Sold **+** Gross Margin

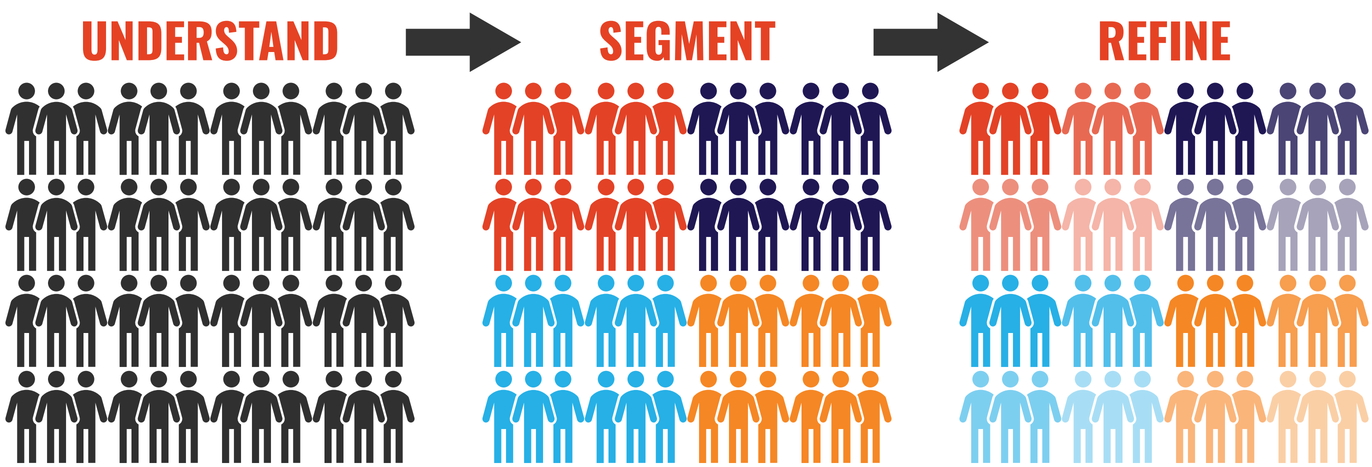
– Cost to Serve **+** Vendor Rebates

– Customer Rebates/Discounts

A container distributor based in Atlanta, Ga., segmented their customers into four groups: high volume (21% markup), high growth potential (23% markup), low volume (30% markup), and low growth potential (27% markup). They set up pricing actions that they internally called the 4i plan:

- **Insulate (low growth potential and some high volume customers):** Protect and insulate these customers from the competition. They receive the best price—always. Minimal price increases are recommended periodically (1%-3% price increases).

- **Increase (high growth potential customers):** The sales force will aim to increase business with them. Controlled price reductions are permitted to gain volume and increase market share.



- **Identify (high growth potential and some high volume customers):** The sales force will identify five customers who are high growth customers and put a pricing plan in motion.

- **Investigate (low volume and some low growth potential):** The sales force is requested to investigate the reason for doing business with them. If nothing works, they will receive the highest price, and inside sales will work with these customers.

RULE OF CONTROL

You cannot preserve profit if you do not lock costs. Cost-plus pricing has been a staple approach for distributors, but for it to work, you need to lock costs for a specific period so that your sales team does not mark up a cost that is the result of better purchasing.

Establishing a cost-lock is a must for pricing discipline. Cost-plus pricing has been a staple approach for distributors, and it will continue to be so, but how it's applied can make or break your bottom line.

Distributors always complain that there are too many prices in the market that they provide to customers. The immediate reaction is to point fingers at the sales team. We fail to realize that there is as much cost fluctuation (cost of goods sold) as there is price fluctuation. Our value to procure items from vendors varies significantly based on time, allocation, lead-time, volume, payment terms, freight terms and more. However, we maintain a cost in the system that changes, either going up or down. This cost may be called replacement cost, next buy cost, standard cost, average cost, and so on. The price to buy from suppliers may go down because of the purchasing team's efforts. When that new cost is in the system, the problem begins. Let's look at these common scenarios:

- If the cost of the item is $80, the sales team does a cost-plus to markup by 25%. The resulting price is $106.67.
- If the purchasing team makes a huge volume buy and it lowers the cost of the item down to $70, the resulting price with the same 25% markup is $93.33.

Automating a fractured pricing process will take you down.

What did we just do? The purchasing team optimized the buying cost, and the pricing process just deoptimized it. We gave away the savings and much more to the customer. We cannot blame the customers for this failure. It is our fault for running with a broken process in the first place. Unfortunately, this process has been automated for most distributors. Automating a fractured pricing process will take you down. You need to lock in the cost for a specific period to avoid this breakdown.

Here's an example:

An industrial distributor performed a cost markup in their system before making the numbers available to their sales and operations teams. For instance, if an item cost them $80 to buy, the system cost for six months was 15% more, or $92. They added another 10% to cover cost-to-serve (receiving, checking, storing). The resulting cost is $101.20, which gets applied to cost-plus pricing decisions. The cost markup is established at unit cost levels and sometimes at vendor levels. Freezing the cost will help you reduce the cost variability in your system.

RULE OF OWNERSHIP

You cannot achieve results if you do not create accountability. It is essential to create accountability and transparency in your pricing process. Only 1 in 15 distributors today have someone responsible for pricing.

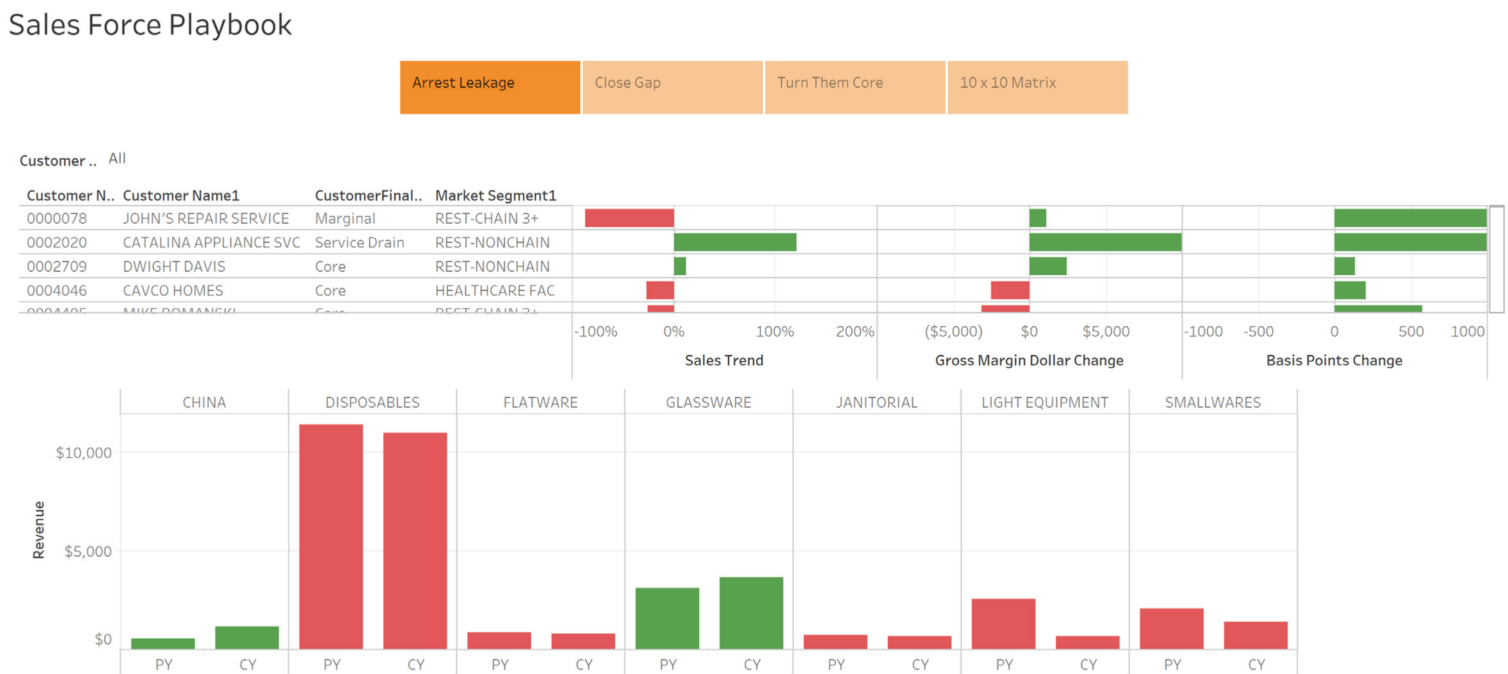
Creating accountability and transparency in your pricing process is essential. Only 1 in 15 distributors today have someone responsible for pricing. When we say responsible, it's not just about having pricing in their job title, as in pricing analyst (most common), pricing manager or director of pricing (less common). This person should: wake up thinking about pricing, be able to communicate to sales and operations effectively, and influence pricing at the field level. This person should also help identify and define the variables that drive pricing decisions.

It's often difficult for pricing analysts to play this role. So, to fill the gap, many companies introduce new pricing software or technology. But distributors also like to be in control and have ownership of every tool and product they purchase, which in effect turns these pricing tools into "black boxes." Without proper access to and understanding of these tools, their value won't be actualized, as many people are averse to using tools they don't understand. Establishing the role of Chief Profit Officer, Chief Pricing Officer and other similar titles has helped companies create accountability for developing others' understanding of any relevant pricing tools and processes. Such a pricing leader can communicate with marketing, sales and operations to achieve common pricing goals based on strategic metrics.

We all agree that technology, in some form, is required to manage and optimize pricing. However, when technology is left in the hands of untrained individuals, it is not sustainable. Companies must share what is driving the pricing recommendations, exercising transparency and offering education and training. If companies don't know what metrics or variables drive their pricing decisions, bringing in a new system will not solve the problem.

Here's an example:

A building materials distributor during this current COVID-19 crisis created a Pricing Improvement Team to determine the three key drivers of their pricing process before introducing technology. They are now working with a technology provider to help set up pricing in their system. The three metrics will form the backbone – or science behind their pricing – and the rest will be the art of the process. People will still make the decisions, but they will have information to support their decision making.



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RULE OF FOCUS

You cannot win big by not starting with your core business. Apply the 80-20 rule to the separate the value from the noise to stabilize pricing in your core business. Establish a consistent process for strategic customers, critical products, and preferred suppliers.

Avoiding margin erosion in your core business is a perennial challenge. Value creation for distributors primarily comes from customers, inventory and suppliers. Distributors cannot address one without the other. For instance, when an item's inventory is reduced by the purchasing team, the sales force might express concern that the reduction will affect their top customers. These teams might work together to fix the issue, but then the supplier management team could express concern that reduced inventory will affect their volume discounts with key suppliers. Commonly, this results in intense negotiations with suppliers and unsatisfied customers. Having unsatisfied customers often drives distributors to lower prices and give up on prioritizing value creation.

To avoid losing sight of value creation and spiraling toward uncontrolled pricing, distributors must consider customers, inventory and suppliers at once, rather than separately. It's time to separate the value from the noise to stabilize pricing in your core business, remembering that those firms which handle complexity well will be better equipped to maintain healthy business and attain profitable growth. Applying centralized pricing to your core business is the best way forward.

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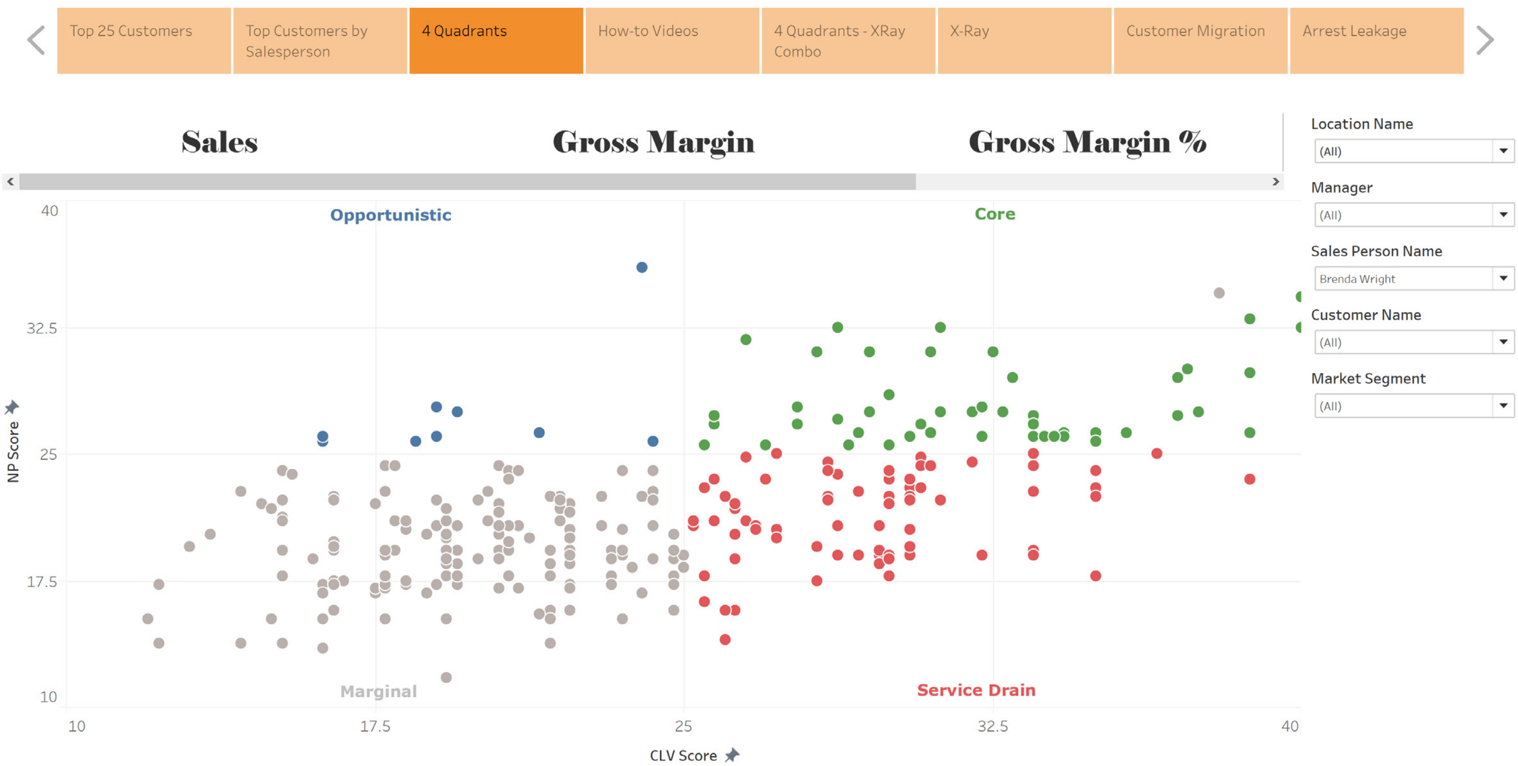

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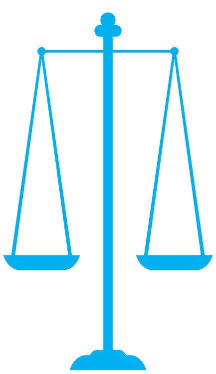
Here’s an example:

During this crisis, an electrical distributor set up a centralized pricing approach for their core business that comprised the following: top 30 customers, top 250 items, and top 20 vendors. The pricing matrix for them was almost set in stone to reduce variability. Any price changes required the CFO’s approval. The goal was to limit margin erosion for this core segment. Their next step was to work on their value message to keep the customer conversation away from price as much as possible. Value messages for their key customers were centered around the following:

- Transportation: Orders are always delivered using distributor-owned trucks.
- Sales Support: Key customers have dedicated sales and technical support teams.
- Product Returns: There is no re-stocking fee or penalty.
- Order Quality: There are no order minimums.
- Service: Same-day and next-day deliveries are available for no additional fee.



RULE OF BALANCE

You cannot ignore the role of autonomy. You need to customize and balance your pricing strategy with where your company stands in a pricing autonomy (low or high) vs. sales management (low or high) matrix.

It’s time to recognize that sales management and pricing autonomy are two independent influencers of profitability. Pricing autonomy can be at two levels:

1. Low-level autonomy, in which case salespeople have less power to change price.
2. High-level autonomy, in which case salespeople have more control over price.

Sales management has two levels:

1. Low-level management, in which case they have little to no access to tools/guidance.
2. High-level management, in which case they have greater access to tools and guideposts.

Creating a two-by-two matrix of sales management and pricing autonomy results in four possible “zones.” You should first identify your zone by knowing where you reside across these two influencers. Depending on the zone, your investments, strategies, and tactics will vary significantly. The majority of distributors fall in the “competition” zone. The four zones are as follows:

- Consistency (High-High): Process guidelines drive long term pricing sustainability. An indispensable pricing band is provided to guide decisions. Cost-to-serve is kept under control.
- Compensation (Low-Low): Pricing individual or team is present. Customer segmentation is rudimentary (sales-based). Communication with salesforce is through compensation.
- Competition (High pricing autonomy and Low sales management): Pricing practices are inconsistent. No clear value proposition and customer conversations revolve around price. Competitors drive pricing decisions. Most distributors are in this zone.
- Control (Low pricing autonomy and High sales management): Pricing decisions are more disciplined. The focus is on market share growth. Management by objectives (MBOs) is a vital part of sales compensation.

These five rules are the pillars of your pricing strategy. In times like this, a pricing reset is vital for your business survival. As you race for topline (revenue) coming out of this crisis, you do not want to sacrifice margins by not focusing on your pricing tactics.

SALES MANAGEMENT

ACCESS to tools and guideposts

CONTROL

- There is more discipline to pricing
- Focus is on market share growth
- Management by objectives (MBOs) are a vital part of compensation

CONSISTENCY

- Process guidelines are established for long term pricing sustainability
- Providing a price band is imperative in this scenario
- Cost-to-serve should be kept under control

Little to No guidance from managers

COMPENSATION

- Less prevalent in distribution
- Rudimentary customer segmentation (sales based)
- Communication with salesforce is through compensation
- Pricing individual or team is present

COMPETITION

- Inconsistent pricing practices
- Lack of a clear value proposition
- Customer conversations tend to end up with price
- Competition drives pricing due to the lack of process discipline
- Most distributors are in this zone

Salespeople have LESS power to change price

Salespeople have MORE control over price

PRICING AUTONOMY

Pradip Krishnadevarajan is co-founder of ActVantage, which helps distributors drive profitable growth through analytics. He has more than 15 years of experience helping hundreds of distributors while co-authoring seven books for the National Association of Wholesaler-Distributors. Before joining ActVantage, he co-founded the wholesale distribution-focused research lab at Texas A&M University's Industrial Distribution Program. Contact Pradip at pradip@actvantage.com.

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HERE'S WHAT SOME OF OUR READERS HAD TO SAY:

"This study has been an invaluable tool for highlighting opportunities to improve margins. Implementing the principles in a pilot location raised gross margins by more than 3% in less than a year. It has been an eye-opening experience for those salespeople using the cost-plus method for determining sales price."

—Kevin Martin, Vice President of Operations, Pipeline Packaging

"Given the complexity of pricing, it is impossible for a salesperson to mentally juggle all the relevant elements of a pricing decision—such as customer segment information, product visibility for the branch and for the customer, historical pricing, target prices, etc. This Pricing Optimization study has gone a long way to specifying these elements and, more importantly, putting them into terms that can be quantified and managed. If you want to be profitable in a competitive market, you must understand where and when you can optimize your pricing. You can't pull your numbers from thin air. This book can help you understand the variables and the math of distribution pricing. Don't get on the phone without reading this study!"

—Lawrence Mohr, Senior Vice President (retired), F.W. Webb Company