GROSS MARGIN ENHANCEMENT

IT'S WORTH THE EFFORT

by Jason Bader

PHOTO: OLIVIER LE MOAL

As a distributor, you meet competitive pressures on a daily basis. Some of this margin decline comes from the market you serve. As I travel, I have heard many distributors complain that I don't understand. They are in "a really competitive market."

Let's face it, everywhere you work, there will be a really tough market. Unfortunately, it is self-defeating statements like this that contribute to that majority of margin stagnation or decline. Yes, I said it, you are doing it to yourself.

A renewed focus on gross margin enhancement is the very best thing you can do for the bottom line. Many of you know me as the inventory guy. There are some great things you can do to optimize the inventory asset and these will definitely drive bottom line performance. There are operational efficiencies that will improve net profit dollars.

But if I really want to kick that net into high gear, I need to create a wider gap between what I bought it for and what I sell it for. Here is the two-by-four to the back of the head: A 1-percent improvement in gross margin will often translate to a 40-percent improvement in net profit. This is the kind of ratio I can get excited about.

Now that we recognize the impact, it's time to prioritize our activities. The most successful companies understand that data analysis is the key to profit improvement. Fortunately, modern distribution software packages are rivers of information. You just need to know how to dip your net. I recommend that you designate an individual to be this data guru. More and more companies have moved people away from the clerical function of purchasing and created more analytical job functions.

This data analyst can help you discover holes in sales penetration, inventory trends and, most importantly, gross margin opportunities. This requires a desire to get dirty with the data. Your ideal candidate must be one with the spreadsheet. They have to love the hunt and be able to communicate their findings in a way that provokes action. This may be the most difficult aspect of the job. I have met some brilliant analysts over the years that have struggled with sharing their findings. They expect others to see what they see in the reporting. While it may make perfect sense to the data driven, sometimes others have a difficult time arriving at the same conclusions. You may have to coach this person on how to share their conclusions in a way that others can take action.

I have been doing a lot of this work with clients lately. As I stated before, I was primarily involved with inventory and operational management coaching. Over the last couple of years, more and more clients have been asking for assistance with margin enhancement. The approaches differed a bit, but there were some common themes. I thought it would be a good point of discussion to run through a few of them.

SENSITIVITY-BASED PRICING

This particular approach requires that the analyst review a ranking of the most- and least-popular items in a location. This is only counting the number of transactions against an item rather than the quantity sold. This report is commonly referred to as a hits ranking. Since this company was a single location entity, it was fairly straightforward.

The first step was to rank the items on a spreadsheet. The basic premise here is that only the highest hit items are price sensitive. Everything else is an opportunity to raise prices. That is just how the company approached the exercise. In the first round, the company decided to raise the prices by 2 percent on the bottom 80 percent of the ranking. Relatively bold move here.

When they received no dip in volume or customer complaint, they bumped the same group by another 2 percent. By the final month of their selling season, they had achieved the highest gross margin percentage in company history — over two points greater than the previous record.

VENDOR PRICE INCREASE

In another client, the company used the sensitivity approach to raise prices when the manufacturer presented the new price sheet. One of the most common mistakes is that distributors only raise their prices by the same percentage as the vendor price increase. Don't overlook this golden opportunity to raise prices and blame someone else.

This company recognized that only a small percentage of the entire line, less than 5 percent, is highly competitive in the marketspace. Using the hits ranking, they broke up the vendor line into sensitivity groups. With the first 5 percent, they matched the vendor price increase percentage. With the next 5 percent of the Skus, they added 2 percent to the vendor price increase percentage.

With the next 20 percent, they added 4 percent to the vendor price increase percentage. With the remaining Skus in the line, they added 7 percent to the vendor increase. Last month, this client stated that their average gross margin percentage was the highest it has been since 2008.

EDUCATION

In one of my first margin focused client relationships, the president of the company challenged me to help them raise gross margin percentage by 200 basis points. I must admit that I had to look that one up. It really just meant 2 percent, but I need to verify what he was asking for. In order to meet this goal, we had to start with the sales teams, both inside and outside.

Although their system pricing matrix was very solid, the pricing concessions given by team members

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had driven the percentage down. In fact, one of the outcomes of our work is that the company tracks pricing deviations on a monthly basis. Branches are rewarded for having the fewest dollars of price deviation.

With this company, I spent time teaching the team about the impact of gross margin on the bottom line. We worked on finding ways to raise prices and how to overcome pricing challenges. Ultimately, we analyzed customer profitability by contribution to net. This last one can be a very scary realization. Beyond my exposure to the financial side of the distributorship, we started driving more product education by the manufacturers.

Again, this was a data driven approach. We recognized where most deviation had occurred and invited those vendors in for training. The premise was that the pricing was being ignored because the sales teams did not truly understand how to sell the product. I am proud to say that we met the goal and they are continuing to raise those basis points.

LOADING THE COST

In this approach, we created a cost field that was slightly higher than the actual invoiced cost from the manufacturer. This is commonly referred to as a standard or loaded cost. It can often become known as a commissionable cost. In this company, the sales team was given access to all the costs in the system. They would often quote based on the lowest cost without regard for future replacement.

The first step was to mask all the different cost fields and give the team visibility to one cost field. This new standard cost field was populated by taking the current replacement cost and adding a small percentage. Even without the small bump, the sales teams would at least start at a realistic cost.

In order to help the sales teams drive prices up, a multiplier was added to the replacement cost. The percentage varied based on the product category. More sensitive categories were given a smaller multiplier, such as 1.005. Some less sensitive categories received multipliers as high as 1.055. Again, the difference in percentage between replacement and standard cost was designed to help quoting sales people raise prices.

This company was very smart in the implementation phase. They were very transparent in what they were doing. After our gross margin training session, the company explained how this program would actually help the sales people earn higher commission dollars.

They also explained how this additional margin capture would allow the company to invest in better facilities, new lines and upgraded technology. By committing to transparency, the salespeople became partners in the program.

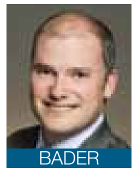
This company has improved their actual gross margin, based on moving average cost, by over 2.4 percent over the same period last year. They are considering going more granular within each product category and basing the multiplier on sensitivity within the category.

In all of these examples, the clients realized that their gross margin success has more to do with internal influences rather than external pressures. This doesn't mean that you can keep raising prices without respect to the market, but you have more control than you think. By using a combination of thoughtful data analysis and a healthy dose of financial education, you can find yourself breaking margin records just like these companies.

Simply stated, gross margin enhancement is the fastest way to improving net profit. And that, my friends, is what we are in business to do. Good luck and know that I am always here to help you along the way. **CS**

Jason Bader is the managing partner of The Distribution Team, a firm that specializes in helping distributors become more profitable through strategic planning and operating efficiencies. The first 20 years of his career were spent working as a distribution executive. Today, he is a regular speaker at industry events and spends much of his time coaching individual distribution companies.

For more information, call (503) 282-2333 or contact him by e-mail at Jason@Distribution-team.com. Also visit The Distribution Team's website at www.thedistributionteam.com.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