Six margin killers in wholesale distribution

An IBS Value Drivers eBook

www.ibs.net

The Big M.

The squeeze is on. If wholesale or distribution is your business, your profits are under pressure like never before:

- **The economic downturn is constricting revenues and growth.**
- **Costs are rising as you carry more product lines and support higher transaction volumes.**
- **The forces of change, complexity and competition are conspiring to inhibit your ability to maneuver.**

Now more than ever, each little decision you make and every slice of profit you gain or lose can swing your entire business towards success or failure.

At IBS, our experience with hundreds of distributors has convinced us that visibility is the answer. After all, you can't manage or improve what you can't see.

With this in mind, we're producing a series of guides and eBooks that throw light on the five main drivers of distribution value: margin, revenue, inventory, cash and expenses.

This, the first piece in the series, focuses on gross margin, arguably the single most important metric in the wholesale distribution business. We hope the eBook – and the entire series – will help you think about your business in new ways and give you some practical ideas to bring back to the battle.

Do let us know if you have anything to add. We'll issue updates as we receive feedback from the industry. And, of course, if the book makes you crave better process management, information and visibility, I happen to know of a terrific Distribution Resource Management suite that can help!

Clark Green, Jr.
Vice President, Marketing - IBS AMERICAS

We'd like to thank our customers throughout the world for the insights contained here, as well as the people behind the DuPont Model and, especially, Albert D. Bates and his excellent 'Profit Myths in Wholesale Distribution'.

Our tips are our own but we couldn't have made them without insight from these front-line practitioners.

Why margin is so important.

Wholesalers and distributors need to monitor and manage dozens of metrics and key performance indicators. And, while they all relate fairly directly to each other, different departments tend to focus on different metrics.

That's part of the problem. An accounts department that is exclusively focused on, say, credit risk, may achieve its goals at the expense of the metrics that the sales force is bonused against (and vice versa).

This 'metric clash' goes on in every distribution business, but the best performers seem to find ways to expose and resolve them.

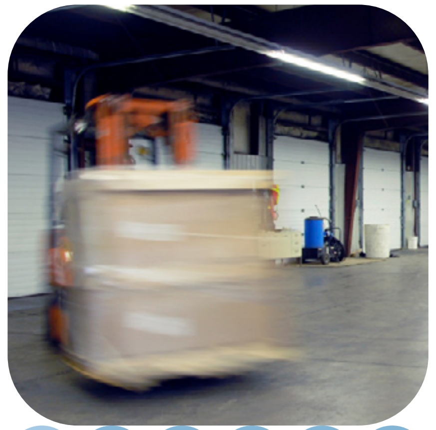
But, while some metrics are tactical, gross margins are strategic. Every department needs to understand them and every decision-maker needs to take them into account.

Let's see why…

Gross margin defined

Gross margin is simply revenue from goods sold minus the cost of goods sold. So if you buy or produce a widget for $7.50 and sell it for $10, your gross margin is 25%.

Gross margin leaves out the costs associated with warehousing and delivering the products. It's a big, chunky metric that can hide all sorts of issues – but it's also an incredibly important one that you need to keep at least one eye on (if not both).



Small changes in margin make a big impact.

Gross margin is one of those powerful metrics that make a seemingly disproportionate impact on bottom line profitability and the all-important Return on Assets - the 'vital signs' metric that investors, shareholders and the financial community most value.

"When fear sneaks into a salesperson's pricing decisions, the result is predictable: margin dollars you cannot afford to lose are left on the table."
Rafe VanDenBerg, Industrial Distribution

As the chart shows, a very small change in gross margin can drive wild swings in profitability for every wholesaler and distributor.

In the case below, we have assumed a wholesaler or distributor with $30 million in sales working on 25 per cent gross margins (i.e. the cost of goods is $22.5 million) and delivering pre-tax profits of five per cent of turnover.

Similar to a butterfly effect, the table shows how tiny percentage swings in the gross margin amount affect the company's pre-tax profit.

Change in Gross Margin Amount	Change in Company profit margin
-2%	-10%
-5%	-25%
-10%	-50%
+2%	+10%
+5%	+25%
+10%	+50%

This analysis is based on an extremely detailed, sophisticated and proprietary IBS modeling tool that allows our consultants to model changes in the relationships between sales, purchase costs, overheads, inventory, receivables and cash. If you would like to know more about how you can exploit the power of this tool, please contact your local IBS representative.

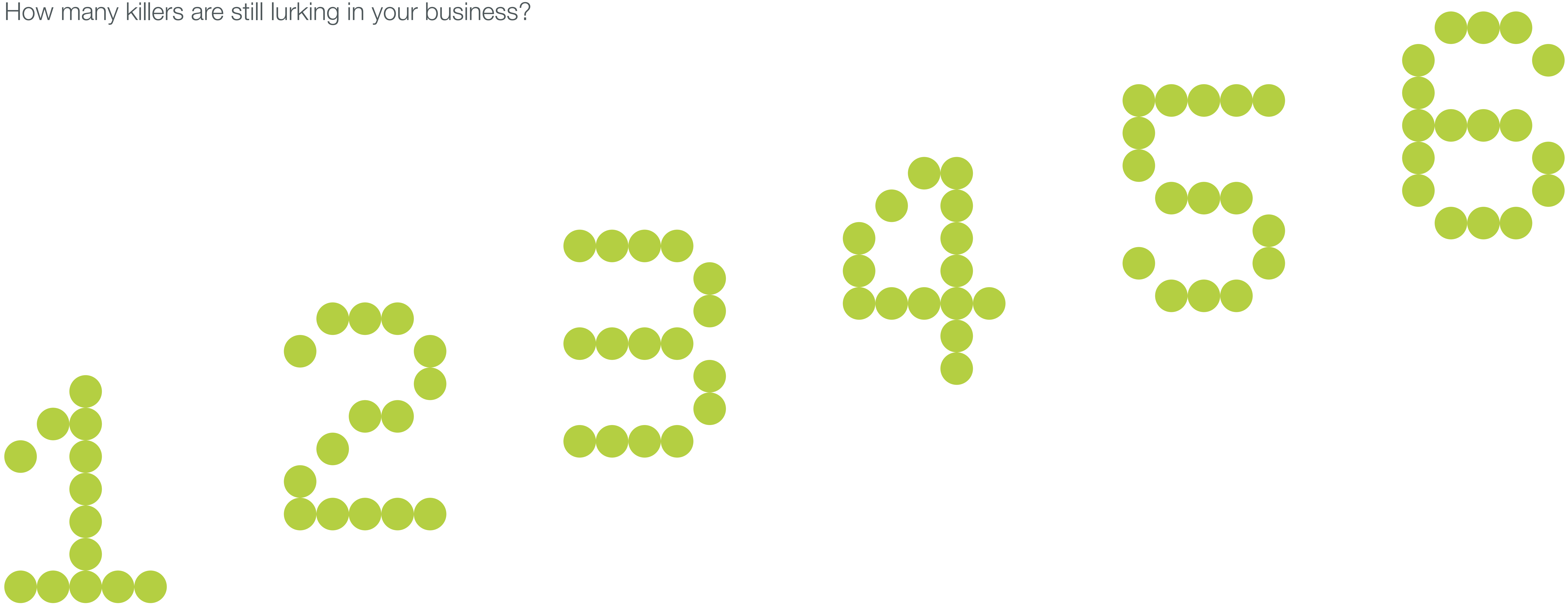
Wholesalers that don't keep this fundamental relationship in mind at every decision point are likely to sacrifice margins at the expense of things like revenues or market share. The effect can be fatal.

Six Killers.

Here are six margin killers that we often see in wholesale distribution companies.

Some may seem too obvious to mention but, in our experience,
they're still out there siphoning away profits in all too many companies.

How many killers are still lurking in your business?



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1 Using price cuts to increase sales volume.

This is probably one of the most common margin killers in the business and it's easy to see why it happens so often.

Revenues are seductive. Top line sales are still seen as a measure of success. So when they start to wobble, managers all too often leap in with a special promotion or discount.

The idea seems reasonable enough: any erosion in profit margin will be more than offset by an increase in sales volume.

But in reality, the sales spike caused by the discounting almost never compensates for the loss of margin:

Increase in sales needed to offset a price cut

The effect of a price reduction on companies with three different initial gross margins. The lower your initial gross margin, the harder it is to compensate for a small price cut.

Source: Albert D. Bates, DBA, Profit Myths in Wholesale Distribution, p.87

Using price cuts to increase sales volume. (continued)

Research studies (and painful experience) have shown that any price reduction big enough to effect sales will also be too big to be worth it.

The good news is that the opposite effect holds true as well. A small price increase has a dramatic impact on overall profits.

It may feel counterintuitive – and sales guys just hate to admit it – but losing some business because of ‘high’ prices may be a penalty well worth taking. Your overall profits will grow. Hold those prices!

Action Point

Take everyone in your organization that has a say in pricing through the Price Cut curve that applies to your own company (showing your own current profit margin). Show them the damage that even a small price cut causes.

Customer view

Luis Garraton, a diversified distributor providing pharmaceuticals and household products uses software to create, track and manage supplier and customer agreements to track the profitability of every sale at the item level.

Previously they tried to do this using complex manual processes based on spreadsheets. Managers can now easily and quickly see the real costs of every piece of business.

2 Letting prices slip through poor insight.

Strategic discounts and promotions are only one way that prices (and margins) can fall. Often, price cuts happen without anyone making an informed decision at all. And the effect on margins is just as disastrous.

"Establishing fact-based pricing, improving margin realization, and rectifying unprofitable pricing practices can help companies continue to be profitable during a downturn."
Pricing Optimization in a Down Economy: AMR Research

The most common cause of price and margin erosion comes from giving sales people un-monitored discretion on pricing to win deals.

Sales people are the engine of every wholesale distributor but, let's face it, they're carnivores. Once they smell the blood of a potential sale, they'll do anything to close it. Even if it means slashing your margins to the bone.

The most profitable distributors have tight controls on their sales force's ability to discount.

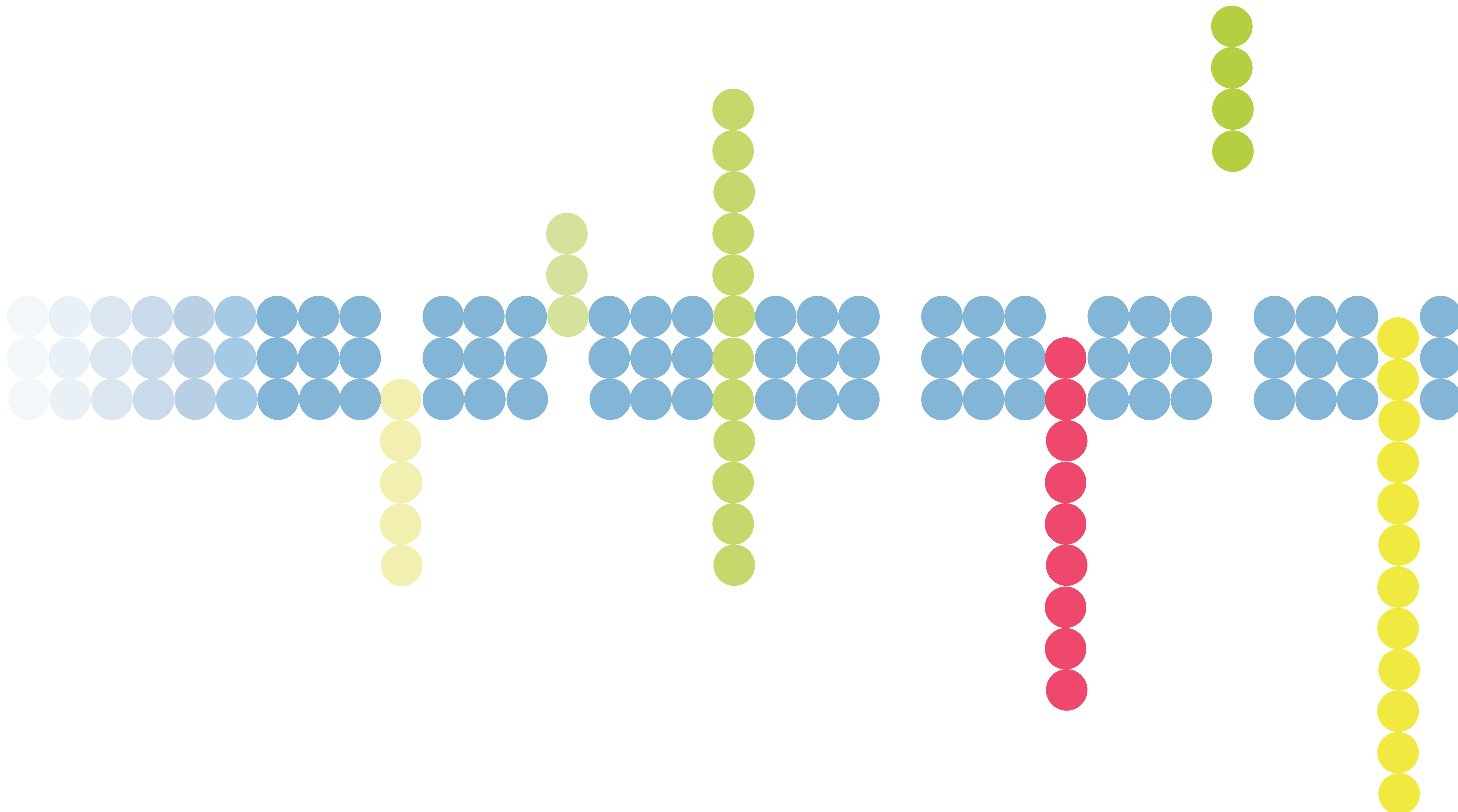
They also control for these similar price-lowering effects:

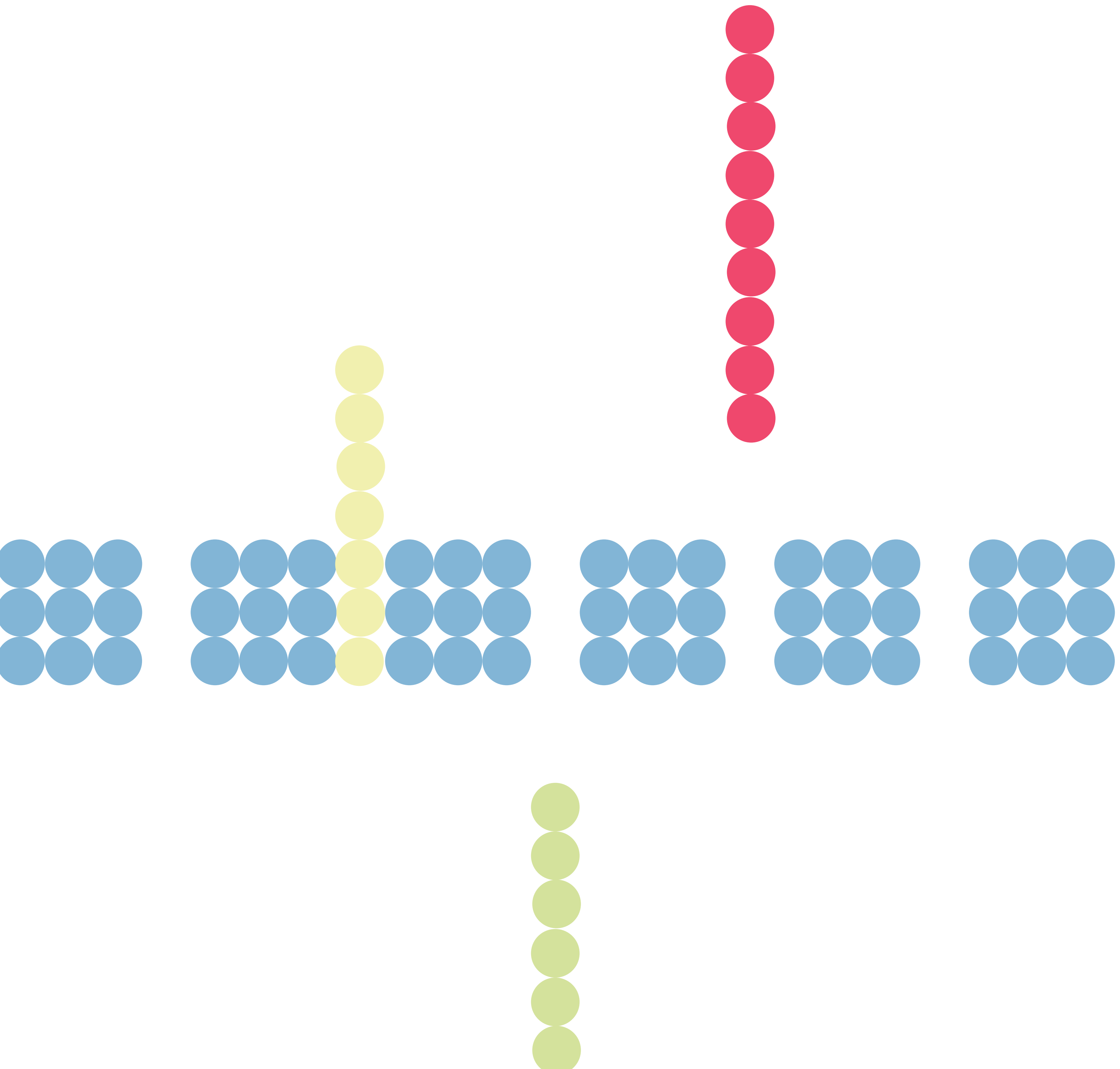
Pricing that ignores service costs

Some products incur much higher levels of service than others. Making everyone with pricing power aware of these relationships will help them hold the line on the most margin-vulnerable product lines.

Pricing that ignores velocity

High volume and fast moving goods sellers tend to be more price-sensitive and earn lower margins. Slow-moving items should earn higher margins (to capture the value of stocking them). A monolithic, inflexible pricing policy that adds the same margin for all products ignores this and leaves money and margin on the table.





Letting prices slip through poor insight. (continued)

Pricing that ignores other margin killers

Similarly, some products are much more prone to returns, repairs, damages and complaints – all of which drive up costs and kill real margins. Knowing exactly which products are most likely to cause these costly problems lets you make better pricing decisions.

Ad hoc pricing processes

Pricing is too strategic to leave to the typical, manual processes. The most profitable distributors have air-tight pricing processes informed by information and insight gained from every department.

Failure to charge for adding value

Last-minute orders, rush deals, custom configurations and extra assembly all add value, cost money and need to be charged for. Pricing that doesn't capture all your added value is money given away.

This category of margin killer all boils down to having real-time visibility into your entire business. The more granular you can be about this, the better. Understanding your actual costs and margins for each product line is essential.

Action Points

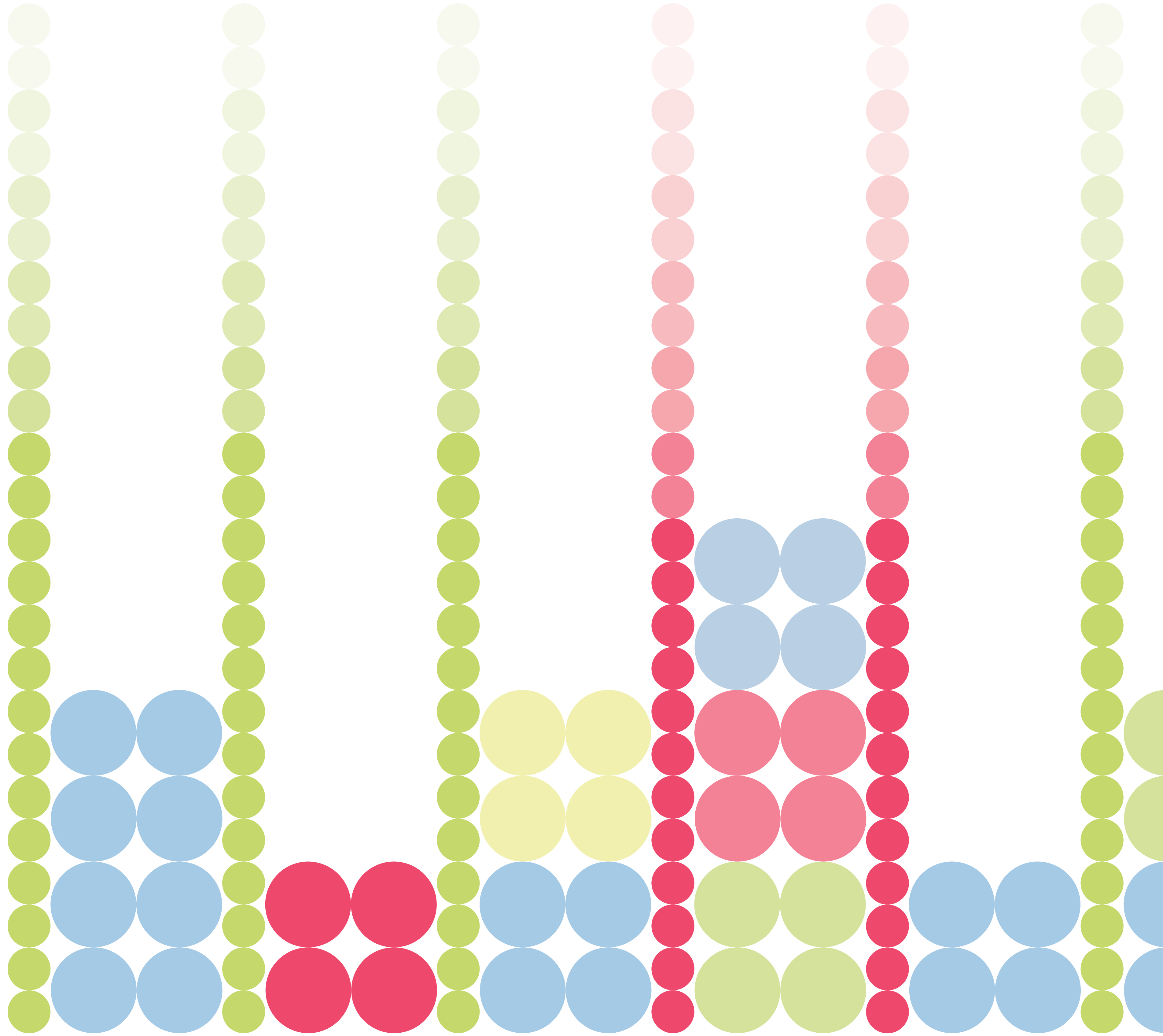
Ensure your ERP software is fit for purpose. If it can't give you real-time insight into every product line and customer sale in real time it's probably not optimized for wholesale distribution. You need Distribution Resource Planning, not just generic ERP.

True margin control. If you can't compare the sales value and cost value per item and per line during order entry, you can't ensure desired gross margins. Make sure your system alerts you automatically when the relationship between sales price and cost price moves out of balance.

Customer view

Selga, a close-to-E200 million electrical products distributor based in Sweden, used business intelligence tools to transform margin control across their product range.

3 Poor purchasing processes.



Just as pricing has a disproportionate effect on overall margins, sourcing costs play a massive role too.

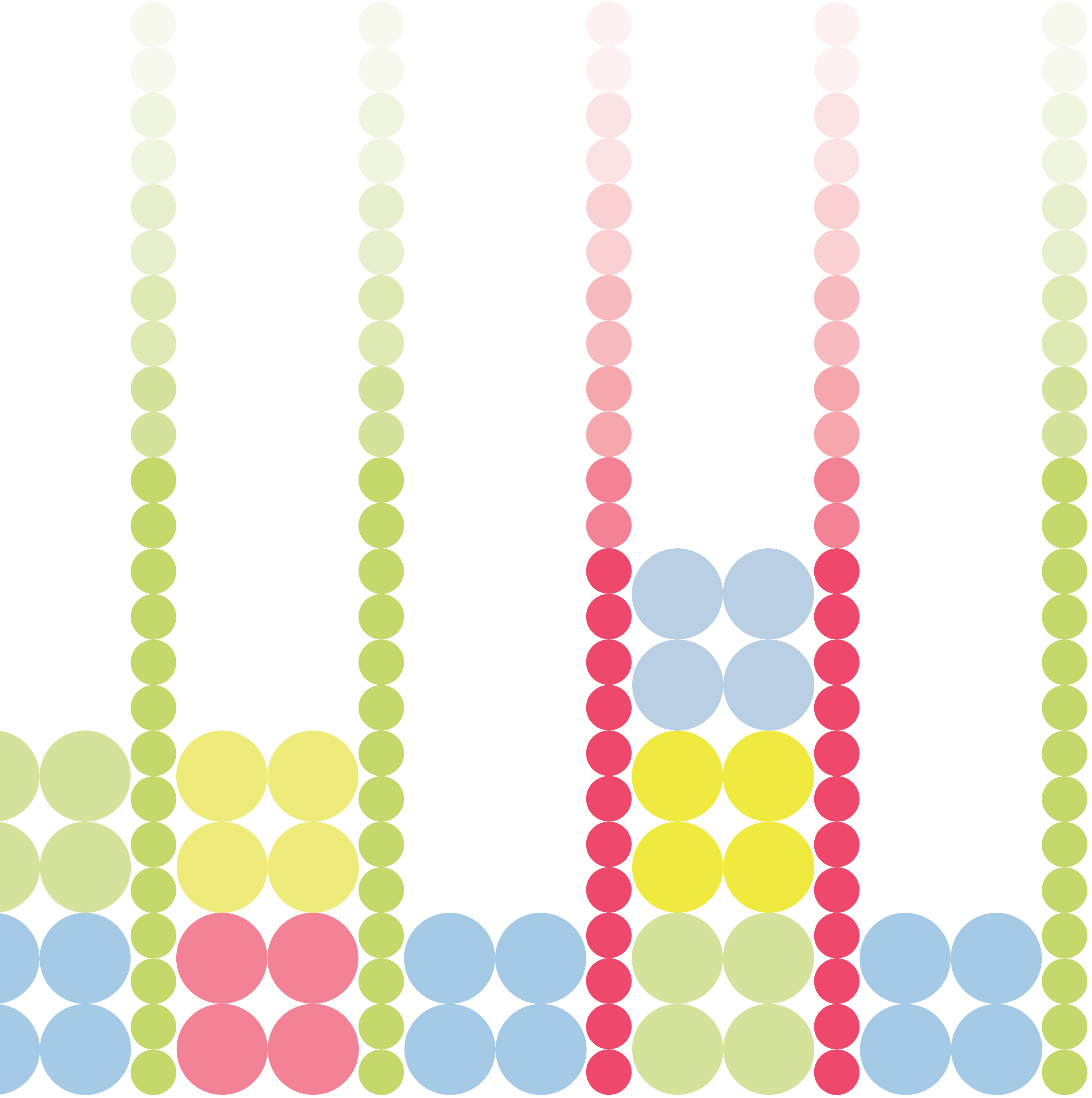
The principle is simple: the less you pay for your products and the less they cost you overall, the better your margins. But poor visibility into actual costs and inefficient purchasing processes can allow costs to creep up, killing margins. Some examples:

Purchasing that only sees price

Purchasing professionals are only as good as the information they're given. If your purchasers are buying on price alone, they're ignoring things like delivery performance or product return rates. These are real costs that eat real margin.

Turning strategic purchasers into order processors

Purchasing is a hugely important discipline for every distributor. But too many purchasing departments are prevented from adding value because inefficient, ad hoc and manual processes weigh them down. Handling suppliers, orders, RFQs, invoices and changes should be automated, centralized and streamlined. Only then can purchasers do what they're paid to do: buy strategically and improve your margins.



Poor purchasing processes. (continued)

Focusing on suppliers instead of product lines

Setting up contracts with preferred suppliers is an important part of doing business. But these contracts often hide inefficiencies and opportunities to buy better and improve margins. Check the details, in every product line and you're sure to find some margin hiding there.

Not sharing information with suppliers

The best suppliers can help you drive down costs – if you let them. Vendor Managed Inventory lets suppliers see your sales and stock levels before generating the order. It may mean they can offer better discounts. The savings can be considerable, but you need excellent information flows throughout your business to make it work. And the facility to make that available in real time to trusted outsiders.

Supplier Collaboration

Working in lockstep with suppliers in a true partnership often brings rewards that make an impact. Rebates, focused reward-based marketing activities (where you get money back from the supplier when selling their goods to specific target markets), and other such practices can all have a massive positive impact.

Action Points

Finding your profitable products. Evidence shows some alarming things about the typical distributor's product portfolio:

- 25% of product lines lose money
- 30-35% break even
- 25% make a small profit but not enough to cover activity-based costs
- Only 20% of products actually make sufficient profit

You must establish exactly which products are really making you money.

Explore closer electronic relationships with suppliers. The greater sales visibility that comes from exploiting modern supplier collaboration tools means you can benefit from pay-for-performance channel compensation schemes ('kick-backs'), as well as other supplier bonuses and loyalty incentives

Customer view

SKF reduced its supplier lead-times from 11 days to two with IBS software while gaining paperless purchasing, purchase order tracking, electronic supplier invoicing, EDI communications, and 24/7 access to a wider range of suppliers.

4 Inefficient transport and logistics.

Outside of product costs, transport is the largest cost component for most distributors – often in excess of 10% of gross sales.

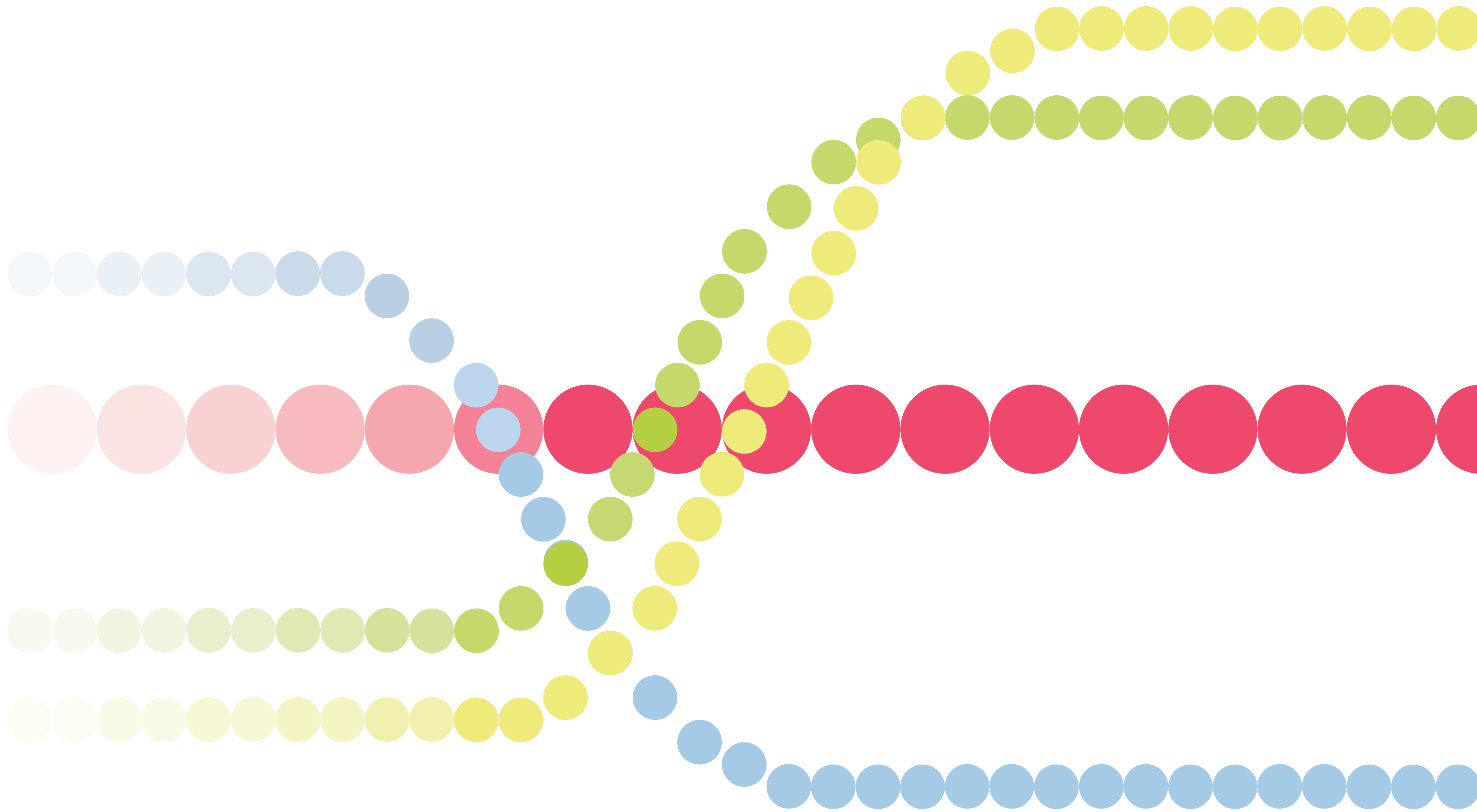
It's vital to have accurate, up-to-date and granular insight into your transport, delivery and logistics costs so you can manage them and protect your margins.

Many distributors start with an accurate view of their transport and logistics costs, but lose this accuracy over time as sales increase, geographical coverage expands, the product mix changes, or mergers and acquisitions change the company profile.

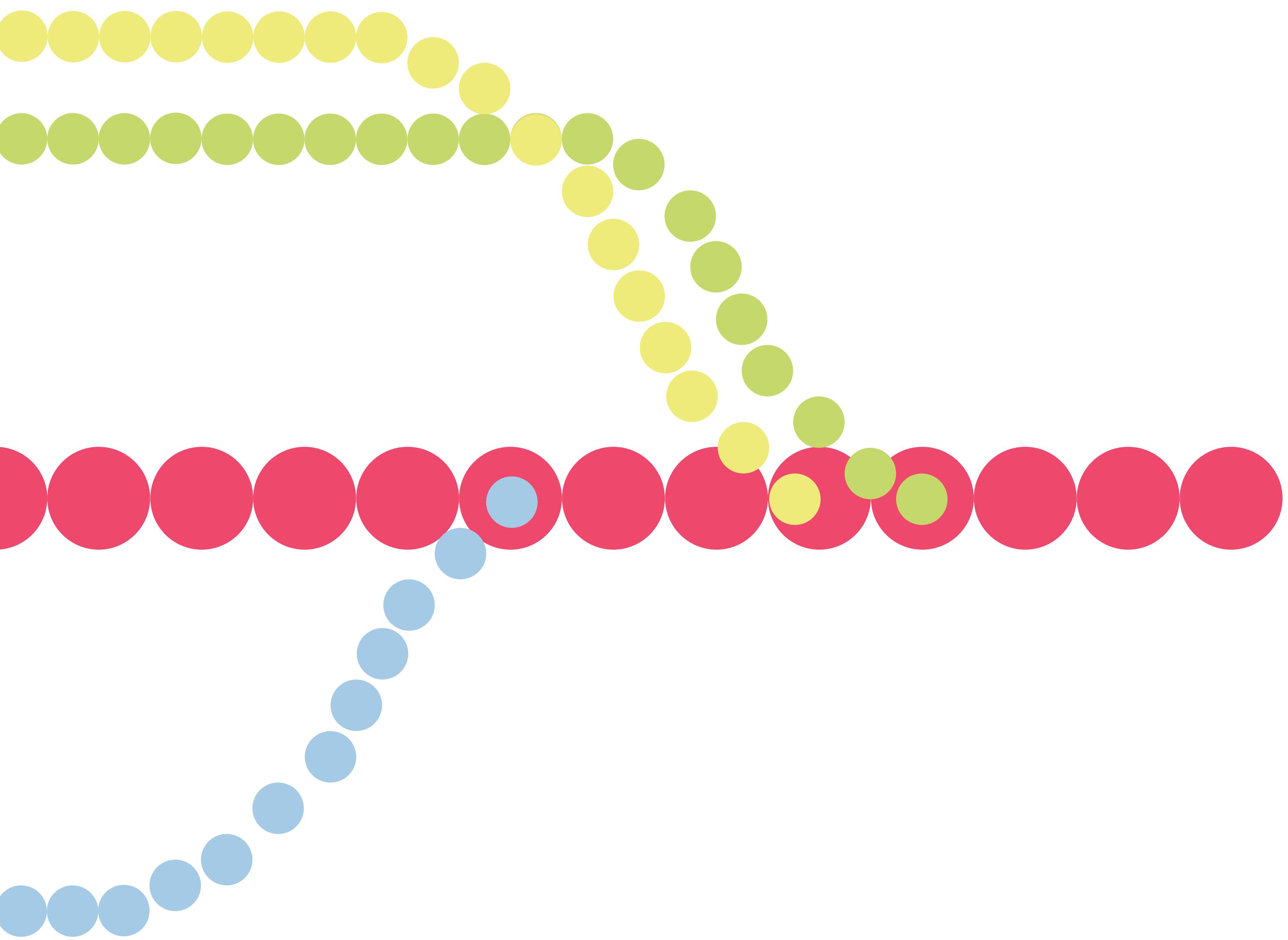
The most profitable distributors have a job title responsible for the strategic management of both inbound and outbound logistics costs. This role works closely with the purchasing department to make sure that all costs are taken into account when sourcing products.

Strategic, informed logistics also factor in variables such as import duty differences and the cost of delays and fines.

Leading-edge wholesalers and distributors exploit smart sourcing. Many distributors carry many of the same products in several regional warehouses or have it stored by the supplier. By using smart sourcing technologies and techniques, their systems match customers to warehouses ensuring quicker deliveries while guaranteeing lower transport costs. An even smarter sourcing is to delivery heavy and volume goods direct from the supplier to the customer.



Inefficient transport. (continued)



Smart sourcing also allows you to optimize inbound ordering and outbound delivery to prevent waste associated with less-than-full inbound containers and half-empty trucks for outbound delivery to customers.

Enterprises are also beginning to explore smart logistics and assembly to improve customer service and save money by locating warehouses closer to customers, even if this means expanding into new regions.

The wholesale distribution industry, particularly in the US, is beginning to exploit transportation portals that permit them to purchase and sell truck space on a day-to-day basis, ensuring that their trucks never leave or return to base with empty space. Being able to exploit the savings that this delivers depends on systems that can predict purchase and sales requirements with forensic accuracy.

Action Point

Hold regular reviews of transport costs and give overall responsibility to one person, along with the right information to do the job properly. The right Distribution Resource Management software can really help.

Customer view

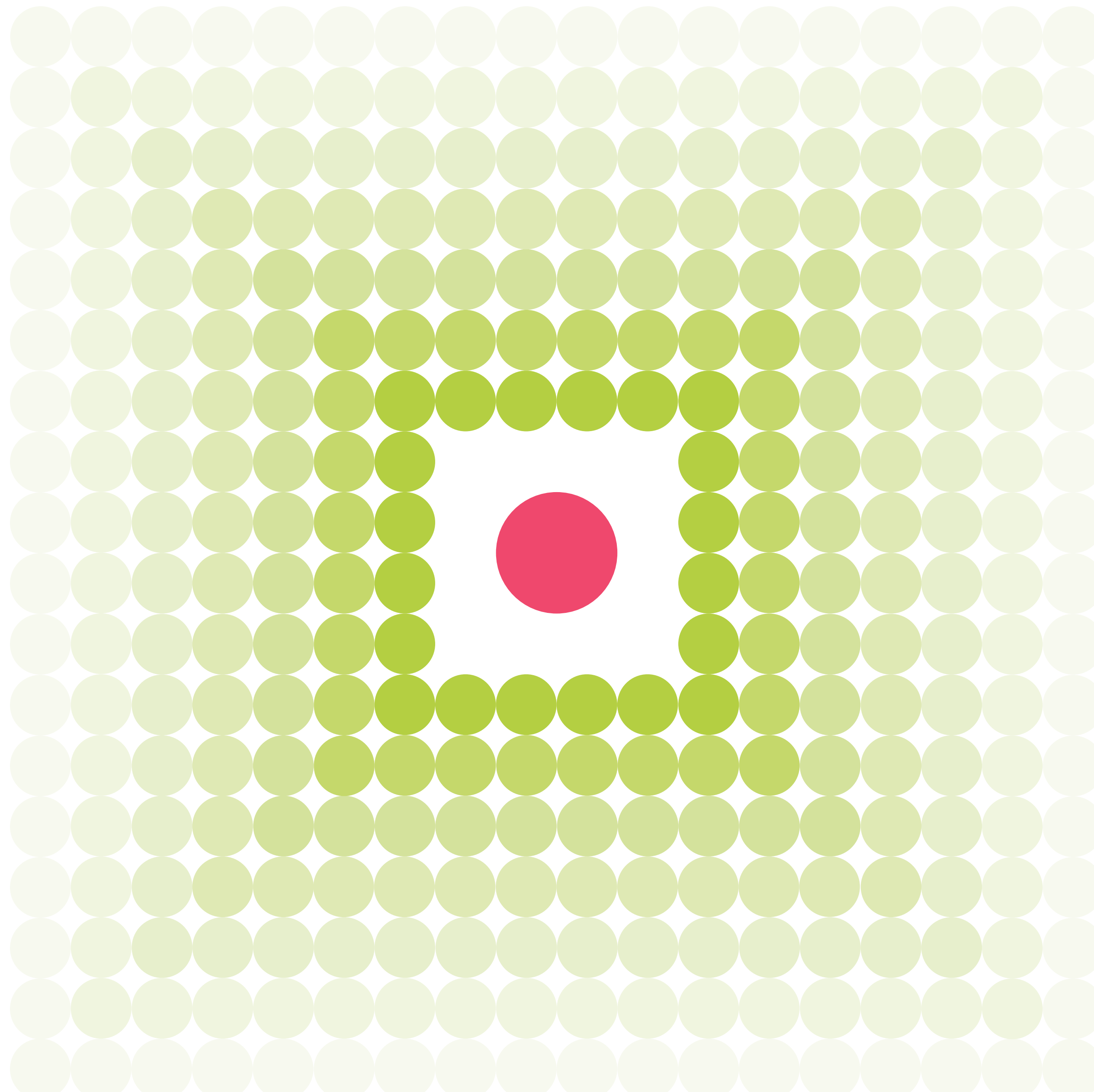
The IBS Enterprise Multi Distribution Centre (MDC) module helps the **Map Merchant Group** manage transport costs over the group's 33-country operations. Smart sourcing among international warehouses enables seamless inter-company transactions, helping Map Merchant cut costs and provide fast and accurate customer deliveries.

5 Treating landed costs as a lump sum.

Landed cost is the total cost of a product when it arrives at the buyer's door. This includes the original cost of the product, all brokerage costs, shipping, customs duties, tariffs, taxes, insurance, currency conversion, crating costs and handling fees. Many distributors don't actively manage landed cost as it relates to product cost and overall profit margins.

The best-performing wholesale distributors break down landed cost into its component parts and actively manage each one. Understanding and assigning accurate costs to each component of landed costs lets you optimize decisions across the entire product lifecycle.

'What if' scenarios and informed risk analysis often lead to surprising conclusions: that 'low-cost supplier' may actually be eroding your margins more than the higher cost competitor with a better landed cost profile.



Action Point

Accurate decision-making around landed costs means integrating information from finance, legal, shipping, purchasing and sales. Landed cost modeling can then optimize decisions for maximum margins.

Customer view

Heinz Belgium uses cost accounting to manage its complex pricing structures and then measures them against all related costs - by the minute.

Missing high-margin opportunities.

As a distributor, it's important not to constrain your business by a limited view of what you actually do for your customers. Expanding your business definition to 'solving problems for our customers' often highlights new opportunities for revenues that are much higher margin than your core services.

84% of US distributors offer support to customers but only 9% charge separately for it.
Pembroke Consulting

For example, added services and support are often bundled into product pricing with no regard for real added value. Think about:

New fee-based services
Such as set-up, installation or on-site fabrication.

Priority delivery services
A customer emergency needn't erode your margins.

Cross-sales
Think beyond your category. Are there any new product lines from related or entirely different categories that your customers buy?

Customization
Offer your customers unique products tailored to their own requirements with, for example, labelling that is different for each customer or bespoke product configurations that meet their needs more exactly.

Missing high-margin opportunities. (continued)

Vendor Managed Inventory

Make your customers more loyal by offering them automatic full service refilling of their warehouses without them having to spend time on purchase planning, purchase order processing or delivery scheduling. Taking total responsibility for management of the customer's warehouse refill creates the virtuous circle of happier, more loyal customers while allowing distributors to charge for this value added service.

Activity-Based Costing will help make sure that these new initiatives are as profitable as they look. But only a strategic view of your customers and their challenges will identify new, high-margin opportunities.

Customer view

Wever & Ducré produces and distributes architectural lighting systems with the help of IBS Enterprise. Thanks to the Product Configurator, the company can fit profile lighting and other products to each customer's specifications, helping Wever & Ducré offer top service and achieve optimal revenue opportunities.

Conclusion: kill the margin killers.

Gross margin is one of the most important metrics in any wholesale distribution company. The top performing distributors invariably are the ones that have a tight focus on margins and the systems needed to monitor and manage them.

The Six Margin Killers outlined here are present at some level in all too many distributors. And one of the main reasons is the lack of management information from across the entire business, made available to each discipline and department within the business.

For many distributors, the software that informs the business just isn’t up to the job. That’s why so many distributors are replacing their poorly integrated departmental solutions with an integrated suite optimized specifically for the wholesale distribution business.

More than ever before, information is the lifeblood of the distribution business. The most successful distributors are always the ones who treat it that way.

About IBS Enterprise.

Your business is distribution. You're not a supermarket, bank or a mining company, so the software you choose to run your business should be made for a business like yours. IBS Enterprise is a fully integrated software suite designed for wholesalers and distributors that provides total visibility and control of gross margins within your business.

Specifically our system provides:

Real-time, total visibility of gross margins by item, product line and by customer. Distributors and wholesalers can constantly monitor, alert and optimize the margin on all sales orders taking into account:

- The sales price with all discounts and expected customer rebates.
- The cost of goods sold, including expected rebates from the supplier.

Tight and seamless integration of all IBS processes ensures you achieve the best margins regardless of the complexity of your pricing policies, discount methods or agreements.

Product classification technology that classifies your products into different product segment allowing purchasers to concentrate on the product lines that deliver the best gross margins. Automated purchase suggestion that ensures you're sourcing the right products at the right gross margins.

Collaboration tools that facilitate tight relationships and inter-working with customers and suppliers with the goal of eliminating or streamlining processes to increase margin.

Embedded solutions for value added services, including extensive functionality to tailor additional services to your customers. Fully integrated processes allows you to customize your offerings, and covers demand driven configuration and production, project installation services, aftersales service including warranties and preventive service etc.

Extensive Supplier Marketing Support allows you to do joint marketing activities with your suppliers. As products are purchased by customers, the system automatically calculates the margins achieved per transaction and works out the bonuses or discounts - based on volume or other factors – you can claim from suppliers, based on agreements you have negotiated with them.

About IBS Enterprise. (continued)

Vendor Managed Inventory (VMI) harnesses efficiencies on both sides of the supply chain equation:

– EDI interfaces capture customers' demand in real time, permitting the system to calculate accurate demand forecasts and the optimal inventory levels required to meet the expected demand. The convenience this provides for customers not only increases loyalty, but also provides opportunities for extra revenues.
– At the same time, EDI or web integration with suppliers provides the information required to plan sourcing much more efficiently, reducing lead-times and often even lowering purchase prices.

Lower transportation and logistics costs by utilizing functionality such as:

– Sourcing policies that automatically suggest delivery from the closest warehouses.
– Linking sales orders directly to purchase orders to allow direct delivery from your supplier to your customer, with all liabilities, obligations, and rights of one order automatically mirrored in the second.
– Shipment preparation, where sales orders can automatically be consolidated in a single shipping request with validation checks on load limits, transport characteristics and terms of transportation.
– Interactive line buying, that automatically suggests additional products to include in a purchase order that fill containers or lorries.
– Ability to treat even the most highly distributed warehouse estate as a single virtual entity.

Make the most out of one time offerings, a "Special buy evaluation" helps you to evaluate and apply optimal purchase quantities and anticipate a one-time discount or a price increase e.g. how much more should you buy if your supplier has an special price, without overloading your stock.

Landed cost functionality covers the automatic inclusion of additional costs such as freight, duty, and insurance in gross margin calculations.

Strategic supplier sourcing offers rich functionality for automatic generation of Requests For Quote (RFQ) together with automated evaluation of supplier quotations to ensure best market prices. Supplier performance evaluation ensures that you work with the best suppliers by highlighting perfomance across a range of factors such as delivery, returns, breakages as well as price.

Modern GUI, that makes it easy to tailor the system to your specific needs and KPIs.

Thousands of wholesalers and distributors around the world have based their gross margin protection on software from IBS over the last 30 years.

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IBS has subsidiaries in 21 countries.
To view our global offices details, please visit:
www.ibs.net/global-offices

Resources.

The National Association of Wholesaler-Distributors
Publications, services, events and advice.
Visit www.naw.org

SCOR®
The Supply Chain Operations Reference model from the Supply Chain Council. The cross-industry de facto standard diagnostic tool for the supply chain industry.
Visit www.supply-chain.org

DuPont Analysis
A method of understanding the source of superior (or inferior) returns in comparison with companies in similar industries (or between industries).
See the Wikipedia entry

Industrial Distribution Magazine
From Reed Business Information, the leading publication for distributors of industrial products.
Visit www.inddist.com

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