Profit Improvement Report

Prepared for WFFSA
Vol. 22, No. 3
September 2013

Taking It To The Street

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The economy still seems to be taking the proverbial two steps forward and one step backward on a daily basis. In such an environment, important opportunities to purchase merchandise opportunistically are widespread.

Such opportunities should result in a strong improvement in profitability for distributors. However, in too many cases enhanced buying leads to stagnant or even declining profit. The problem is that distributors simply can't seem to overcome the urge to take lower supplier prices directly "to the street." That is, they reflexively pass through lower prices to their customers.

This report examines the nature of the take it to the street issue. It will do so from two important perspectives:

- **Price Reduction Rationales**—A discussion of the two different thought processes that cause firms to pass along price reductions in a seemingly automatic fashion.
- **Profit Implications**—An analysis of the economic impact of supplier price reductions, both good and bad.

Price Reduction Rationales

There are two major reasons that firms pass along price reductions routinely. One of the reasons is strategic, the other operational.

Strategic—The strategic rationale is that price competition is endemic in distribution. A supplier price reduction provides the opportunity for firms to demonstrate their price aggressiveness to their customers.

Since the supplier price reduction is often short lived, some distributors view the price reduction as an opportunity to be "on sale." That is, they can develop a price position that will provide a competitive advantage over competition.
This rather blissfully ignores the fact that every other distributor has also had the same opportunity to purchase at lower prices.

Operational—The operational factor is that firms are still addicted to standardized mark-ups despite the rather substantial increase in pricing sophistication over the last ten years or so.

If an item generated a 36.0% gross margin before the supplier price reduction, then it should generate about the same gross margin after the price reduction. Gross margin targets vary by product velocity, of course. They also usually vary by customer type. However, once the margin is locked in, it tends to remain somewhat sacrosanct as product costs change.

The crux of the problem is that firms have to put prices on thousands of SKUs, the cost of which may rise and fall several times during the year. Few firms have the luxury of leisurely contemplating each individual pricing change.

Unfortunately, the advent of new technology has not changed the culture of standardized mark-ups. Again, the sheer magnitude of the pricing decisions to be made gets in the way. Such technology has made static-margin pricing decisions faster, but not better.

Whether the decision to pass along price reductions is strategic or operational, it still has the same impact on profit. Namely, it decimates it. Unfortunately, too many managers continue to believe that passing along price decreases associated with opportunistic buying "doesn't cost us anything."

The Profit Implications

An understanding of the economics of passing through price reductions is provided by the ORR report conducted by WFFSA. **Exhibit 1** (see Report) examines the result for the typical WFFSA member based upon that report.

As can be seen in the first column of numbers, this typical firm generates $3,500,000 in sales, operates on a gross margin of 36.0% of sales and produces a bottom line profit of 0.7% of sales or $25,000. In short, profit performance is adequate, but somewhat unexciting.

In looking at changes in pricing, it is necessary to break expenses out into their fixed and variable components. Fixed expenses are overhead items, or the cost of getting ready to sell. They only change when management takes an action.

In contrast, variable expenses are items which increase or decrease at the same rate as sales increases or decreases. The most obvious example is sales commissions. Other variable items include interest on accounts receivable, bad debts and a few additional, incidental items.

In most distribution businesses, fixed expenses account for about 80.0% of total operating expenses. In Exhibit 1 fixed expenses are assumed to be a constant $1,060,000 across modest increases or decreases in sales. Variable expenses are assumed to be 5.0% of revenue.

The last two columns of numbers in Exhibit 1 present the potential results, both good and bad, associated with an opportunistic purchasing opportunity. To demonstrate the impact clearly, it is best to examine the total firm. The same results would be produced for a segment of the business.

It is assumed that the firm is now able to buy everything that it sells at a price that is 2.0% lower than before. As a result, the cost of goods sold had been reduced by 2.0% for the entire firm. This is true in both of the last two columns.

The first column of potential results has been labeled *No Price Changes*. It really should be labeled *Do This and Don't Even Think About Doing Anything Else*. In this column the firm is using the supplier price reduction as an opportunity to enhance both its gross margin and its profit.

All of the reduction in cost of goods has been driven to both the gross margin line and the bottom line. The resulting increase in profit is dramatic. Profit has increased from the $25,000 original figure to $69,800, an increase of 179.2%.

The final column of numbers reflects the same opportunistic buying situation. However, prices outbound have been cut by 2.0% to mirror the 2.0% price reduction from suppliers. Again, this could occur either for strategic reasons or for operational ones. It makes no difference what the reason is. Profit takes a significant hit.

While the gross margin percentage remains the same, the gross margin is being generated on sales which have been lowered by the amount of the price reduction. Some expense reduction is attainable because of lower variable expenses, but fixed expenses hold constant. The overall result is that profit decreases by 86.8%, falling to $3,300. Whatever the good intentions of the reduction, profit suffers. Buying and pricing must be separate decisions.

Moving Forward

Pricing will probably always be the most difficult decision process for distributors. From a marketing perspective no firm wants to be under-priced. From an operational perspective, there are lots of pricing decisions to be made.

Despite these issues, there is a substantial gross margin and profit opportunity to be seized by avoiding an automatic response to opportunistic buying situations. Such situations must be used as a profit generator.

About the Author:
Dr. Albert D. Bates is founder and president of Profit Planning Group. His latest book, ***Triple Your Profit!***, is available at Amazon and Barnes & Noble. It includes Excel® templates for understanding the profit structure of the firm and developing meaningful financial plans.

A Managerial Sidebar:
A Price Cut That Would Maintain Profit

It is possible to estimate how much firms can cut their prices and keep profits exactly where they are at present. Unfortunately, an estimate is all that can be provided without some extensive financial manipulations.

The formula for holding profits steady is:

Current Cost of Goods Percentage
x
Size of the Supplier Price Reduction

=

64.0%
x
2.0%

=

1.3%

To a certain extent, this represents something that maybe nobody should know. It creates a real temptation to cut prices "just a little bit" when opportunistic buying situations arise. Firms should not try to simply hold the line on profit. They should use supplier price reductions as a vehicle to improve profit.