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Supplier Price Increases Are Your Friend

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Even in a sluggish economy, supplier prices increases occur fairly frequently. It is safe to say that most distributors approach such increases with a sense of dread if not unbridled hatred.

The reality is that supplier price increases are an unparalleled opportunity to increase profit. However, achieving that profit improvement requires a reversal in the thinking of distributors and a certain degree of fortitude in passing the price increases along to customers.

This report looks at the nature of the supplier price increase issue. It does so from two distinct perspectives:

- **The Emotionalism of Price Increase**—A discussion of the fact that price increases are often viewed with emotion rather than logic.
- **The Economics of Price Increases**—An analysis of the profit impact associated with the proper handling of such increases.

The Emotionalism of Price Increases

The typical response of distributors to supplier price increases can probably best be summarized by the old political phrase, "There you go again." This antipathy towards price increases arises from three distinct issues. First, there is something of a loss of control in the pricing process. Second, there is a substantial amount of activity that must support the price increases. Third, there is the unknown nature of the competitive response.

The issue of lost control arises because some other entity—namely a supplier, is making decisions that impact the fortunes of the distributor. The more the distributor's operation is functioning smoothly under current pricing arrangements, the lower the degree of eagerness to make changes. When changes are forced upon the distributor, some angst is inevitable.

The activity level associated with price changes has two separate components. First, there is simply the operational aspect of making changes in the

management information system to reflect the changes in cost, updating pricing information outbound and the like. It is a minor irritant, but still an irritant.

The more important aspect of the activity-based concern is the need to explain the resulting outbound price increases to customers. Even though blame can be laid clearly at the foot of suppliers, there is still apprehension about rocking the boat with customers who have seen too many price increases before.

Finally, the competitive response gets to the very heart of the economic issue. There is a high degree of uncertainty as to how competitors will respond. It is possible some will absorb a portion or even all of the price increase as a competitive tool. Any time things change, there is the potential for disaster.

The heading of this section used the term emotionalism for a reason. All three of these issues are perceived by distributors as being worse than they are. If the price increase can be viewed as a tool for profit improvement, then such emotionalism can be tempered. If it cannot, the emotionalism only increases.

The Economics of Price Increases

Exhibit 1 looks at the economics of a 5.0% supplier price increase. All of the figures in the exhibit are for the typical WF&FSA member, based upon the latest ORR Report. The first column of numbers reflects current results. The last two columns examine different responses to the price increase.

As a starting point, the typical firm generates $3,500,000 in sales volume. It operates on a gross margin percentage of 36.4% of sales. Finally, it produces a pre-tax profit of $25,000 or 0.7% of sales.

In order to fully understand the economic impact of price changes, it is first necessary to break expenses down into two components—fixed expenses and variable expenses. Fixed expenses remain constant for <u>this fiscal year</u>, unless the firm takes some sort of action. For the typical firm, these are $1,075,000.

In contrast, variable expenses tend to rise and fall automatically as sales rise and fall. As an estimation, these are assumed to be 5.0% of sales volume. As sales increase or decrease, they will continue to be 5.0% of the new sales volume.

The most common response is the second column of numbers labeled Dollar Pass Through. With this approach prices to customers are increased by the same <u>dollar</u> amount as prices inbound have been raised by the supplier. This is probably the most common approach used by distributors.

With the 5.0% price increase from suppliers, cost of goods sold increased from $2,225,000 to $2,336,250, an increase of $111,250. The result is that gross margin dollars remain constant. However, given higher sales volume (even though there is no more sales activity), variable expenses rise along with the price increase and profit falls to $19,438. In point of fact, the dollar-for-dollar approach will always cause profit to decline.

The last column of numbers is labeled Percent Pass Through but should be labeled Don't Ever Do Anything But This. It involves passing through a 5.0% outbound price increase because of the 5.0% inbound supplier price increase. In doing so, sales, cost of goods and gross margin all increase by 5.0%.

Once again there is an automatic increase in variable expenses because of the higher sales volume. Even with this increase in variable expenses, profit rises to $80,000 and the pre-tax profit margin increases to 2.2% of sales.

What this means is that when suppliers increase prices their distributors should actually thank them for their actions. The distributor has the potential to make a lot more money. On top of that, the distributor can also blame the price increase on the idiot supplier. The best of all possible worlds.

In reality, the congratulations are offset by the emotional panic that sets in when raising prices sets in. If it were only one SKU increasing in price then the firm's MIS system could simply apply the same set mark-up and raise the price of the item by 5.0%. Unfortunately, it is usually an entire product line or an entire product segment that is affected. It is big and it is noticeable.

When competition is hot and heavy, firms often retreat back to the dollar-for-dollar pass through. Strategically the goal is to find the level of a price increase that will not cause any customer complaints. It is an admirable strategic approach, but an ill-fated profit approach.

All of this leads to an important rule. When prices are rising, follow the percent-for-percent price increase formula to drive higher profit. So easy to understand, so difficult to do. Like so many other things in life.

Moving Forward

Pricing will probably always be the most difficult decision process for distributors. Simply put, no firm wants to be perceived as charging excessive prices. This means that when a supplier price increase materializes there will be the inevitable temptation to raise prices dollar for dollar. Whenever possible, the percent-for-percent approach needs to be substituted.

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:
The Price Increase That Would Maintain Profit

It is possible to estimate how much firms must raise their prices to keep profit exactly where it is in the face of a supplier price increase. The estimation process if relatively straight forward.

The formula for holding profit steady, using a 2.0% price increase as an example, is simply:

Current Cost of Goods Percentage

x

Percentage Increase in the Supplier Price

=

63.6%

x

2.0%

=

1.3%

Extreme care should be taken when employing this ratio. While it holds profit constant, the intent should always be to try to increase profit via supplier price increases.