

Improving Gross Margins – Without Harassing Your Suppliers (Part 2)

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When I work with private distributors or groups, I almost always hear someone complaining about shrinking margins or margin squeeze. They want to point fingers all over the place - the infidelity of the suppliers, the cost of transportation, the saturation of distribution in the market, etc. I always find it humorous when every city I visit is “a really competitive market”, as if there was some utopia where competition didn’t occur.

While it is true that there has been clear margin erosion over the last several decades, I feel that distributors have become narrowly focused on the silver bullet of improving gross profit percentages – negotiating better buys with their suppliers. This “club in hand” approach to margin improvement may buoy margins temporarily, but it doesn’t produce lasting results. Perhaps a shotgun approach would be more effective.

Over the last several years, I have been exposed to several ways to improve gross margins in a distribution organization without asking the suppliers for lower prices. Over the course of this two part article, I will outline several ways to improve gross margins using internal operating methods. All of these methods are time tested and can be implemented with very little cost. I will just take some concentrated effort and diligence.

Promote a Pricing Matrix Guru

One of the most underutilized features in any software package is the pricing matrix. In most packages, this module has a huge capacity for capturing additional gross margin. A good matrix can handle 80 to 85 percent of the transactions. The remaining transactions will need some sort of sales pricing intervention. Unfortunately, most distributors ran out of steam when they were setting the matrix up and settled for something less simple and ultimately less effective. It’s time to reenergize your pricing matrix.

The first step is creating a pricing matrix guru. This person must be detail oriented and profit motivated. They must be willing to get into the matrix and figure out how it really functions. The guru will be responsible for updating all pricing from the suppliers, implementing price increases and creating special pricing agreements. This will probably require some additional training with your software provider, but the return on investment will be phenomenal.

One of the best ways to maximize gross margin potential is to adopt a velocity based, or popularity based, pricing model in the company. For example, many of us set up our matrix where a particular customer type receives a flat discount off of list price, or multiplier on cost, for the entire line. Unfortunately, we tend to base this discount on the most popular item in the line. What percentage of a vendor line do you think your customers know what they should be paying? I suspect that it is less than 5 percent of the line. It is the most popular items that get shopped around. These items should receive an attractive discount. Everything after that should receive a lesser discount or higher gross margin. This is what a good price matrix set up can do for you.

Building Packages

Individual items on a quotation can be scrutinized and shopped around; but bundles and packages tend to make your customers look more at the total value versus cost of the components. In order to create effective packages, sales teams need to understand how the customer will utilize the products. How can the package reduce the cost of implementation or utilization? When creating a package, think in terms of application.

As many of you know, I grew up in the construction supply business. On job sites OSHA requires that contactors regularly test electrical extension cords for grounding. Specific colors are used for each quarter. The cords are generally marked with colored electrical tape around one or both ends. This shows the inspector that the cord has been tested and is fit for use.

In order to help contractors stay in compliance, we put together a little kit that included the different colored electrical tape and a card with the chart for each quarter. The idea was to sell tape. Rather than slugging it out with every other contractor supply house on tape, the kit masked the price of the tape and created an overall improved gross margin.

When doing bid work, resist the urge to show component prices. Bid the entire package when applicable. This may require reviewing building plans or drawings. You may be successful bidding individual details on a drawing. If you can include light fabrication to the package, it just helps improve the overall value of the bundle.

Sales Compensation

Sales compensation plans can be fairly complicated and are generally a pain to administer. On the contrary, a well thought out plan can help you achieve goals in your organization. I have said this for years, managing sales people is not difficult – you grab them by their wallet and direct them where to go. Ok, this is overly simplified; but the basic premise is true. Productive sales people will focus on individual compensation opportunities.

When designing compensation methods, distributors have a tendency to flat line the percentage of compensation. They may offer short term rewards for promoting specific product, but most of the time, compensation is based on some fixed percentage of gross profit. Why don't we reward those who help us improve our overall gross margin percentage?

I would like you to focus on a graduated compensation plan based on improvement in gross margin. For example, the current plan pays 5 percent of the gross margin at an average of 25 percent gross margin. The sales person who averages 22 percent gets the same rate as the sales person who achieves 28 percent. Establish a base line gross profit average for the company. In this example, it is 25 percent. Reward those who are pushing the average. Offer a rate of 5.5 percent to a sales rep who hits 27 percent. Offer a 6 percent rate on anyone who hits 29 percent.

A graduated compensation methodology helps drive your overall margin improvement, rather than promote the status quo. Sales people are the catalyst to margin improvement. We just need to get creative and give them the opportunity to shine.

Promote Education

Several times a year, I teach a class designed to help manufacturer sales reps work with distribution companies. We talk at length about margin erosion and what they can do to help sell through distribution. I remind them that it all boils down to mindshare with the sales people. Product knowledge is the cure for weak margins.

When a sales person doesn't understand the features and benefits of a product, they generally resort to price reduction. This is a zero sum game. Someone will always have a better price or a lower cost of distribution. Unfortunately, price wars establish low price points throughout the market and they take a long time to recover.

On the contrary, when a sales person understands the application of the product and can speak intelligently on the value proposition, margins can improve. As familiarity becomes stronger, the sales person will learn to recognize new opportunities for the product or group. The value of product knowledge can't be discarded. As I am constantly reminded, distribution is still a face to face business. People buy from people – educated, confident, solutions oriented people.

Every one of these solutions is an internal change in the status quo. The good news is that you are not reliant on asking for some price concession from your suppliers. Rather than bemoaning the poor economy or lamenting the good old days, refocus your energy on the internal opportunities. Don't let the market dictate how much money you are going to make. There are plenty of nickels, dimes and quarters available for those of you willing to look. If you missed part 1, please drop me a note and I will send you a copy. As always, I am here to help. Good luck.