

2010 White Paper Series

Finding New Answers to Old Questions

Eliminating items can increase profits | Topic 1

Accelerating failure | Topic 2

Getting value for everything you do | Topic 3

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2010 White Paper Series | **Part One**

Finding New Answers to Old Questions

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Introduction

This is the first in a two-part series of white papers related to innovation in the world of distribution. Each paper will examine concepts that can help any business do better. The common theme will be finding new and better ways in which we can accomplish any specific process or procedure.

The changes taking place in technology, the economy, and business in general require a new sense of flexibility in the way we think and act. The old truisms are no longer guaranteed to protect us. For example, “turn and earn” used to be considered the key to greater profits. Now we know that it is easy to increase turns, but in doing that, we may destroy our service levels. Simplistic sayings are not enough. We need new answers to the old questions. It is time to look at some of yesterday’s best practices and make sure they fit in today’s world and reality.

In this short paper, we will examine two such concepts. The first relates to how to buy product for a warehouse. It used to be believed that purchasing extra to get discounts or free shipping would make up for any additional handling or capital costs. That is not true anymore. We explore the real cost of “C” and “D” inventory and what a distributor can do about it.

Second is about the best way to fail. Yes, failure is a reality and not one to be feared. It is a logical result of experimenting. If we never fail, that just means we have not tried enough. So if failure is going to happen, it is best if we can accelerate the failure so we can refine and retry or move to another idea quickly and with as little expense as possible.

Finding New Answers

Eliminate “C” and “D” items from the warehouse and you can increase profits by paying more for inventory.

Heresy! Pay more than you have to for product? No way. If we do not have the lowest cost, we cannot compete. If we do not have it on the shelf, we will lose business. Buy from a competitor or a middleman? Can’t do it. We will not be able to sustain our gross margin.

These statements are heard every day. The problem is that they lead many distributors to make bad decisions. Today it is more important to have the right quantity of the right product at the right price, then to fill the warehouse with stock you cannot sell, but at the lowest cost possible.

In today’s economy, “just in case” inventory is too expensive. It needs to be eliminated or it has to be priced to turn a profit. Plus, in many cases of “D” items, when an order finally comes in, the product cannot be found in the warehouse. Then the distributor orders more inventory that will not move. Even worse, it will buy enough to get free shipping or the next price break. No matter how much money is saved, it will be lost in the end.

How can this be right? It is if one understands the true cost of inventory. There are two distinct types of cost: Capital costs (the value of money tied up in inventory) and non-capital costs (what it cost to get, store, and manage inventory).

Capital costs are the easiest to track. Most systems are capable of providing accurate data as to how much was spent on inventory purchases, including freight, special packaging, and the actual product cost. Subtract any

discounts or special pricing and allocate the freight or other handling charges on a per unit or weight basis. This will generate a “landed” cost.

Knowing the landed cost, it is possible to add interest charges for the amount of money necessary to keep an item on the shelf. While interest rates for Treasuries may be very low, the actual loan rate to a small or medium-sized business is much higher. Add all of the support functions associated with money management and most companies should be using a factor of at least 15% per year (or 1.25% per month).

That is a charge that must be added to the original cost for every month that a product sits on the shelf. This is a real and appropriate cost that is often ignored. Even on a smaller inventory, it can have a major impact. If a business no longer carried “C” or “D” inventory, how much cash could that free up for other purposes? What else could that space in the warehouse be used for? The opportunities are many and varied.

As a very simple example, say that a warehouse has \$50,000 worth of inventory with less than one turn per year. If there are no other inventory transactions, at the end of the year, the value of the inventory has climbed by 15% to \$57,500.

Next, one must consider the non capital costs of inventory. Following is a short list of the major elements. They are divided into two major subsections: Acquisition and other. Acquisition costs are what we have to spend to get the product in the door.

These include:

- Purchasing personnel
- Purchase order generation
- Receiving
- Inspection
- Put away
- Accounting (inventory and payables)
- Plus filing and matching of forms

The costs above do not affect our example below. No matter what our ordering strategy, the cost of getting product in the door is the same. Still, these are major costs that can be better managed in most organizations. (In most operations, special purchases are often drop-shipped, and there is actually less cost in the acquisition than for regular product that is put away and stored in the warehouse.)

Other costs include:

- Storage cost (rental for shelf space and a share of the HVAC costs, lighting, shelving, and other capital costs for the warehouse)
- Depreciation
- Shelf life
- Wear and tear
- Damage
- Taxes
- Theft
- Moving, losing, finding

Non-capital costs have been estimated at anywhere from 10% to 30% of the value of the inventory. For our examples, we will use a conservative estimate of 10% per year for the non-acquisition costs and a onetime charge of 5% for acquisition costs.

Now we can take a simple look at the math. For example, assume the normal gross margin (the difference between the cost of the goods based on price per unit plus shipping and handling and the revenue generated not counting sales tax or other recoverable costs such as shipping and handling) is 20%. Then an item that cost \$80 would sell for \$100.

But what is the real cost of a one-year old item? The \$80 cost is now increased by the cost of capital for a year (\$12 using the 15% per year cost of capital) plus \$8 (the 10% non capital, non acquisition cost per year) plus \$4 (the acquisition cost). The item really has cost the distributor \$104 and the gross margin (GM) is negative.

This is where the real trouble starts. If you pay a commission based on the incorrect GM, you end up losing even more money. It is actually very hard to make a profit on items that turn less than once per year. In our example above, one would have to charge the customer \$130 to maintain the 20% GM (\$26 is 20% of \$130).

So, here is your option. If you no longer carry any "D" inventory (products that sell less than one turn per year) you can purchase them from a jobber or other distributor. If the fair market retail is \$100 and you can obtain the product for \$85 when you need it, the actual cost is \$89.25. You only need to add the 5% acquisition cost because you will not put it into stock, only "cross dock" it when it arrives. Now, a \$100 sale provides a \$10.75 GM.

You make more money by paying more for the product. Now, this is a very simple example. It does not take into consideration costs of billing, customer support and numerous other charges that would be considered in a complete Activity Based Costing situation.

There are also special circumstances that make "D" inventory acceptable. If you have an "A" customer who has asked you to keep a special part on the shelf, you can decide to do that. The cost is considered in the context of the customer's total purchases.

Some companies will agree in advance to a price for the product that is above market so that it will be available when needed from a prime supplier. There are even cases where the customers pay for the item in advance and then are charged an annual fee to cover the non-capital, non-acquisition costs of the product.

Once this concept is understood, it is easy to carry it to other "C" and "D" items. The breakeven point depends on product mix, amount of excess storage available within a facility, specific industry requirements, and more. What is clear is that the old adage of buying extra- inventory to get a lower price no longer applies.

Today, our computing systems can provide the detail information necessary to truly understand the real cost of carrying inventory so that better, more profitable decision can be made.

Accelerated Failure

A process of learning how to try lots of new things

Trying new things can sometimes be scary. There are so many examples of co-workers who got into trouble. It is a rule of the universe that not all ideas will work. We cannot let that paralyze us, but we also cannot allow it to blind us to the reality. Too many business leaders are risk averse. They are afraid of being wrong so they do not know how to help others experiment. In the end (for them) it is easier to just say no rather than to try something unproven.

This leads to a second problem in many organizations. Once they commit to trying something, even if it is proving to be less than expected, they are reluctant to admit a mistake. Therefore, they keep trying even though there is little or no chance of turning the situation around. Why is this?

Most of us have been taught since a very early age that it is bad to be wrong. Think back to grade school. Do you remember the teacher asking a question and some student taking a chance? They raise their hand and try out their answer. But it is wrong. Does the teacher congratulate them for trying?

No! Usually the response is something like: "Is anyone in the room SMART enough to know the right answer?" After that experience, when will anyone try again? Not soon. It is beat into our brains that it is very bad to be wrong. Never give a wrong answer. If you are unsure, keep your mouth shut.

Move the clock forward 30 or 40 years. You are given a chance to try a new process. It looks good and you start making progress. All of the sudden, things are not right. The first reaction is defensive. What can be done to correct the problem? Then, what can be done to not admit failure. Finally, many individuals launch into how to shift the blame.

This process will not advance the cause of any operation. Instead, it has to be replaced with a realization that we do make mistakes, that projects can fail, that judgments may be wrong. Instead of condemning failures, we should accelerate their occurrence, then celebrate and learn from them.

The answer is simple: Define, Measure, and Manage. The first thing that has to be done is to start every project by defining how we will recognize success. The answer should be built around metrics. That way, we know when we have arrived. Metrics make it possible to define milestones or measurements along the way. When we know where we should be at any point in time, we can evaluate the actual results and make decisions about proceeding.

For example, one company with a large sales force could not add successful sales people quickly enough to meet their growth targets. Many new people were brought in all of the time. Of those who were accepted into the training program, success or failure was allowed to take about the same amount of time.

By looking at the actual cost of failure, it became evident that a long, drawn out failure cost a great deal of additional money. Losses to the company went far beyond the cost of training, lost sales or opportunity costs, but included misallocation of resources and fallout from abused customer relationships.

The company wanted everyone to succeed. It put extra effort into those who seemed to be falling behind with the idea that they might be the next superstar. Most of the time, the slow starters never caught up. There were only a few anecdotal results which everyone used to justify the time and effort put into all recruits. They kept asking: “What can we do to help more of the new people succeed?”

The real question should have been what could the top performers have achieved if they had the extra support and direction that was being lavished on those who would ultimately not make it? The only way to reallocate the resources to help the top performers become better was to accelerate the failure of those who probably were not going to make it anyway. In the long run, this approach proved to be much better for the employees and the company.

Using historical information, it became possible to create a graph of how the most successful salespeople progressed in their first 12 months. The results were really very consistent.

After much discussion, it was decided to accelerate the failure of those who were falling behind. Every new hire was provided the metrics and the tools to track themselves against the expectations of the firm. The average sales results of people who made it were used to create a set of minimum results for the “new guys” just coming in. If they did not measure up, they were counseled out of the program.

By accelerating failure, the company was able to identify the “keepers” in under 4-four months and reduced the impact on potential customers, increased the overall success rate from the 50% range to just over 90% and significantly reduced the cost of training.

Not all situations will be that clear cut, but what are you working on that could be measured and reevaluated more frequently? What is the value of making a good decision more quickly? More importantly, what is the value of being able to allocate limited resources to those projects with the greatest opportunity for long term success?

The main requirement for success is this is not used to blame people, but to recognize that not all decisions are right. Learn from what you have done in the past, apply metrics to know where you are going, and celebrate attempts to improve operations even when they do not work as planned. Done correctly, every possibility will be a learning opportunity. Over time, everyone will become better able to succeed and the failures that must occur will have less of a negative impact on the company.

Define, Measure, and Manage. It works.

About The Author

Steve Epner is the founder of the Brown Smith Wallace Consulting Group. Steve is the Innovator in Residence at Saint Louis University and a member of the faculty in the graduate school of business, at the University of Industrial Distribution, and at Arizona State University for the Certified Professional Manufacturers Representative program. Steve has a Bachelor of Science in Computer Science (1970) and a Master of Science (2005) from Purdue University.

About Brown Smith Wallace Consulting

The Brown Smith Wallace Consulting Group has been serving the distribution community for more than 20 years through the publication of various software guides, an online evaluation center and resource center at www.software4distributors.com and assisting companies who need help selecting the best software packages for their business and maximizing the benefits from their investment.

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2010 White Paper Series | **Part Two**

Finding New Answers to Old Questions

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Strategic pricing | Topic 2

Introduction

This is the second in a two-part series of articles related to innovation in the world of distribution. They examine four concepts that can help any business do better. The common thread is finding ways in which we can accomplish the required goals in new and better ways and breaking the boundaries to create new opportunities in established areas.

The changes taking place in technology, the economy, and business in general require a new sense of flexibility in the way we think and act. The old truisms are no longer guaranteed to protect us. We need new answers to the old questions. It is time to look at some of yesterday's best practices and make sure they fit in today's world and reality.

In the first part of this series, the discussion started with eliminating "C" and "D" inventory from the warehouse. It was shown that in many cases, it was more expensive than it was worth. Greater profits were available by paying more for inventory that did not have to be stored in the warehouse. "Just-in-case" inventory rarely adds to the gross margin.

The second topic concerned not being afraid to fail. Failure is a natural consequence of trying new things. By never trying anything, it is possible to keep from failing at a new thing, but it will plant the long-term seeds of business failure. No one can be right every time, so it is important to fail in the right way. The best way is accelerated failure. If it is not going to work, find out as quickly as possible. Then move to the next refinement of the idea or to another one.

In this short paper, two more concepts will be covered. The first relates to getting value from everything the business does. It is very easy to give away services and incremental dollars. It is more important to understand where it makes sense and how to do it in a manner that reaps the greatest benefit for the operation. At the same time it is appropriate to examine the idea of assigning a Pain In the bAckend (PITA) factor to every customer and use it to control pricing.

Second is a discussion about taking greater control of the pricing process. There is too much lost value. One practitioner has published results showing that most distributors can add anywhere from two to four percentage points to their bottom line (net before taxes). Using automation, it is easy to see where the opportunities are, and then it takes management to make the necessary cultural changes.

Finding New Answers

Getting value for everything you do.

Charging for all of the free things that are given away as good customer service scares most distributors. They see high levels of service as a competitive advantage—until they understand how little value they receive from it.

When a customer calls with an emergency, most distributors will open the warehouse at any hour to help solve the problem. When asked how much they charge for the special service, the answer is usually: "Nothing. I can't charge for it; it is just part of customer service. If I don't do it, my customers will go buy from someone else."

There are many problems with this statement. First it is usually incorrect—on many levels—and second, it is wrong thinking. If we examine what occurred, it becomes clear that there is a better way.

Start by understanding that customers value the services they receive based on the value established by the supplier or vendor. If the charge for a service is \$0, then the perceived value is zero. Whatever was done is regarded as having no extra value; it is just an expected service, business as usual. That is human nature. Free stuff is treated as having zero value. If a distributor charges nothing for a special service, it is worth just that—zero.

So step one is to change the perception. Add a charge on the invoice for the special service. It can read: “Emergency warehouse opening—\$500.” Heresy! “I can’t do that. My competition will kill me. I will lose the customer. You are crazy!”

STOP. Take a deep breath for a second. Listen to the second part of the change. For your best customers, add an invoice line that reads: “‘A’ Customer discount—\$500.” The end result for your best customer is still a no-cost service, but now you have changed the perception from its having no value to its being worth \$500. This is a big and valuable difference. For the first time, the customer is finding out what it really costs to take care of him or her.

Start to think about where else you can use this same concept. What if you offer special training on safety? Sure, you may do it for free. You justify it as a good opportunity to meet at the customer’s location. It gives you time to get to know the staff. But, if the staff does not value the opportunity, they may not show up or pay much attention.

To ratchet up the good feelings that are generated, the appreciation to be given, and the staff’s willingness to take the two hours, send an invoice along with the scheduling note showing that the two-hour training program is worth \$120 with an “A” Customer discount of \$120, and the perception is changed.

There are many activities in everyday operation that would qualify for some type of charge. Remember if the provider does not believe it has any value, neither will the customer. Now the most important part: You can actually charge for these services. Sure, you might want to give them away free to “A” customers and prospects, but that is not everyone.

Some charges to consider are:

- Restocking charge for unpicked-up will-call items
- Interest (really charge it) for late payments
- Special orders (may even require it to be paid in advance)
- Minimum order size before it can be invoiced
- Special handling or delivery

Take the example of opening the warehouse to solve an emergency situation. What if it is not for an “A” customer? What if the person requesting the help is barely a “C” customer? What if he normally buys from your competitor, but the competitor cannot help in this situation? Many distributors will believe, “If I help them out here, maybe they will start to buy more from me.”

It is a nice sentiment, but rarely proves true. The customer has been buying from the competitor for many reasons. This is an exception because of an emergency. Unless the salespeople are very good and use this to their advantage, it will have little or no effect on the long-term purchasing relationship.

In this case of a “C” customer, do not write off the extra charge. If it is a true emergency, the customer will be glad to pay it. Then you earn a return on your special services (and reinforce the value for your “A” customer when the word gets out—and it will). Follow up on the sale and make sure the buyer knows that “A” customers get the service at a discount of up to 100%. The exact discount depends on how much they purchase. Use it to try to move the account; just do not give away the income necessary to cover the cost of the service.

The same is true for every special service that is provided to customers and prospects. Make sure they all recognize the true value of what is being done for them and do not give it away unless the return is worthwhile.

Determining “worthwhile” is a core capability for most business intelligence (BI) tools. What is needed is a customer report card. This is an accounting of the true value of a customer. Not only does it include total purchases, but it shows gross margin, average days outstanding, number of returns, unpicked-up will-calls, and all special services received.

A document that pulls it all together will allow any distributor to really understand the profitability of each customer. It also will become apparent who takes advantage of too many specials without returning the favor. Do they send lots of prospects? Are they a willing reference site? Do they support other programs? Or do they just take?

From the gathered information, it is possible to create a PITA factor for every customer. PITA stands for Pain In The bAckend. Every customer can be assigned a factor from .95 all the way up to 2.0. Multiply the appropriate price in the system by the factor to get the selling price. A “best” customer (who buys the most, at the highest margins, always pays on time, never returns product, and is a pleasure to deal with) will get a 5% discount.

At the other end of the scale, the most difficult customers will pay double. The sales force will complain that it is a surefire way to force the buyer to switch to a competitor. That may be true, but then let the poor customer put someone else out of business. Any small customer that requires lots of handholding, extra service, is always late paying, and is a pain to deal with, is a customer you probably lose money on. At least make sure that if they continue to buy that the company is getting a fair profit for the effort put forth.

Strategic Pricing

Knowledge and discipline can add two or more points to the bottom line.

Most people would be surprised to learn what a graph of their sales pricing looks like. Take a single SKU and for every customer who bought it in the past year plot a single point showing the total quantity purchased and the average price paid, you would expect a graph that starts out at the top left and curves down to the lowest price paid by the largest purchaser. In reality you get a bell curve, and by moving the low-volume customer prices up to the pricing of the largest customer, you will earn on average over 2% of sales extra on the bottom line.

“The economy stinks. Business is down everywhere. Margins are under greater pressure. Everyone one wants a deal just to buy anything. Making money is almost impossible. Discounts are king. We just gotta hold on and do not rock the boat until this recession is over.

The above is heard all of the time. It is like the current best-selling song’s refrain. Fear has gripped the sales force, and they believe that only low price will sell.

Of course, you only hear it from those who are not doing well. The winners keep their success quiet. “Why announce what you are doing to the competition when it is not necessary. As long as the other companies want to fall back on the old tried and true excuses, let them.” That is what the best companies in many different verticals are saying internally.

Why the difference? There are a number of reasons. The first is attitude. The best companies recognize that excuses are like arm pits—everyone has a couple, and they all stink. As long as management accepts the standard excuses, the sales team has no worries. Just keep up the old whine, and management will leave everyone alone. Winners control pricing and margins. A recent executive forum looked at using statistical models to calculate pricing ranges. Based on a number of factors, it is possible to develop strategic and more consistent pricing. These models consider the sensitivity of products and customers to identify where companies are giving away margin when it is unnecessary.

It is amazing how many companies let salespeople charge a tiny customer a lower net price than a huge customer—or a reduced price on a low-sensitivity product—and never get penalized or even asked why?

In today’s competitive marketplace, smart companies focus their discounting on the most price-sensitive products and customers and develop a strategic pricing architecture to extract premiums from the less-sensitive customers and products with less price pressure.

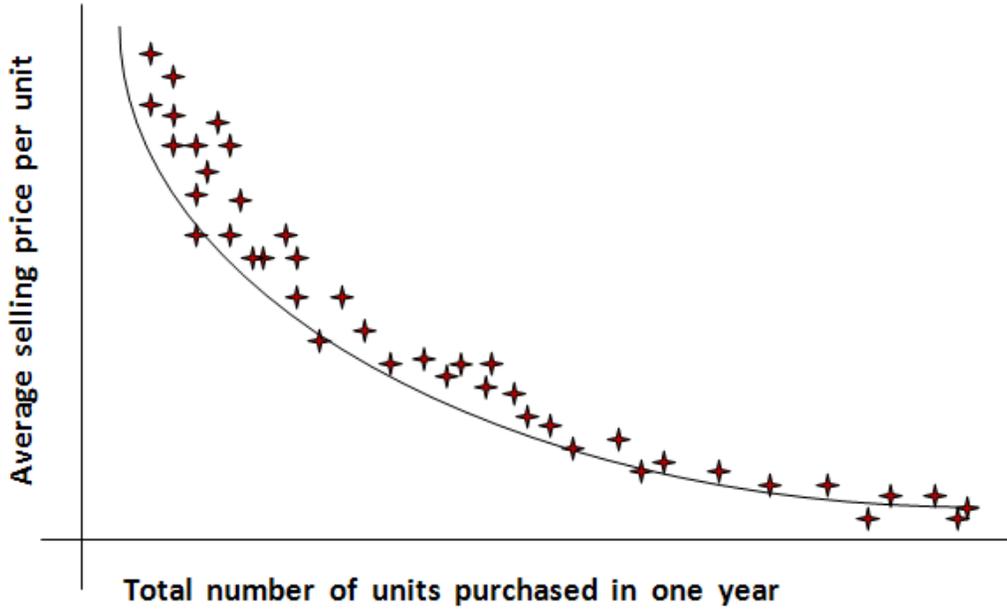
Top companies understand that pricing has the highest flow-through rate to earnings of any profit lever, and they manage it as such. Their profitability reflects it. They are the companies that are growing in this economy, acquiring those who cannot or will not get it.

Our computer systems today can provide all of the data and metrics necessary to whip a sales force into shape. No matter how old and stuck in the past they might be, given the right motivation, everyone can do better.

There are a number of simple statistical analyses that can be done to draw a very easy-to-understand picture. The first is to do a real study of their pricing over the last 12 months.

In the first example, create a graph of the sales results for a single product for the last year. Take all of the data and summarize it to plot a single point for each customer that bought the product during the year. The point is made up of the total number of units purchased and the average sales price paid.

In a perfect world, a company should see a graph that looks like this:



The average price paid by customers goes down until the largest buyer is getting the lowest price per unit. The reality is that few distributors will see a chart that looks like the one above.

Instead, on average, the graph will look more like the following:



The Y axis uses “1” as the best price paid by the largest purchaser. In this case, the distributor would hope that there would be no points below the “1” with less purchasing volume than the largest customer.

There will always be exceptions. There is always a great customer who buys major quantities of other products and is therefore given a special price on any product where it needs a small quantity. There are also times when a special price makes sense to get a new prospect to try a product.

The reality is that most companies do not control the pricing. Over thousands of products, the graphs always look more like a bell curve. There are a great many customers who pay significantly less than they should.

The problems that have been put in place over many years will not be fixed overnight. It will require discipline. It will require cooperation from the sales force. It will require top management (and ownership) support. And it will require execution of the plans. Over a very short period of time, the gross margins will begin to increase. All salespeople who live on commission will find they are making more money—money they would have given away.

The projected result for most companies studied is that 2 to 4 percent of sales can be added to the bottom line. Many companies find that that level of increase would double their net income from operations.

Summary

Through these two papers, we have tried to show how the average distributor doing average things better than most of its competitors can increase profits while preparing for the future.

The four simple concepts presented can be summarized as:

- Be willing to experiment, but fail and react quickly
- Do not carry inventory you cannot make a profit on
- Know and publicize the value that is delivered to the customer
- Use discipline and metrics to manage the pricing of product.

Take some time to prepare your company for tomorrow. Think about small steps you can take. Plan to make progress. Then enjoy a more profitable future.

About The Author

Steve Epner is the founder of the Brown Smith Wallace Consulting Group. Steve is the Innovator in Residence at Saint Louis University and a member of the faculty in the graduate school of business, at the University of Industrial Distribution, and at Arizona State University for the Certified Professional Manufacturers Representative program. Steve has a Bachelor of Science in Computer Science (1970) and a Master of Science (2005) from Purdue University.

About Brown Smith Wallace Consulting

The Brown Smith Wallace Consulting Group has been serving the distribution community for more than 20 years through the publication of various software guides, an online evaluation center and resource center at www.software4distributors.com and assisting companies who need help selecting the best software packages for their business and maximizing the benefits from their investment.

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