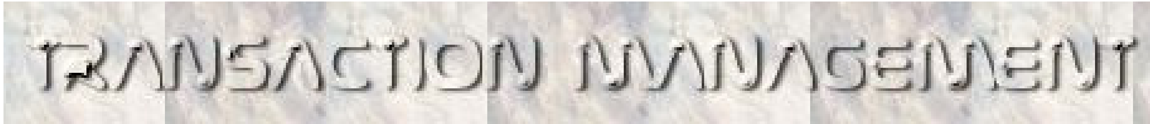


Why is Wholesale Distribution a Low Profit Business?

The authors contend that wholesale distribution is a low profit business not because of the type of firm, its historic value proposition, its place in the industrial channel, or private ownership, but largely because of misunderstanding and poor measurements of how profit is generated. Furthermore, the authors argue that distributors need to absolutely understand the new measures to compete in tomorrow's environment.

A White Paper by

Scott Benfield and Steve Griffith[1]

Wholesale Distribution is a vast industry in North America. Business to Business distribution covers some four dozen distinct vertical markets and as of 2006 was estimated to have 2.3 trillion dollars worth of goods passed through their warehouses with approximately 200,000 entities in existence.[2] However, some two thirds of these entities have failed to yield a pretax profit that approaches what the shareholders could get in the public markets and offer comparable liquidity and diversification.[3] For most vertical markets, distributors should earn in the range of 2.5% to 3% of sales in pretax income to approach the returns of the public markets.

The operative question is why do the majority of wholesalers fail to earn an acceptable return? Far from a criticism, the question is valid and deserves a plausible and scientific answer. Some claim that distribution is a low profit entity because of its place in the channel sandwiched between manufacturers and end users. Others believe that the historic value added services of distribution allow only the thinnest of margins. Finally, some contend that since distribution is largely privately held, shareholders don't compare their performance to public markets and don't necessarily desire the returns of public entities. While these hypotheses have their rationale and semblance of accuracy, the research and argument in this White Paper is that wholesale distribution yields low profits for two fundamental reasons. First, the understanding of profit generation is flawed as distributors focus on aggregated statements of income and second, distributors use financial accounting and its various tools to manage profitability and these tools give a very distorted view of how to increase operating profit.

Is Your P.A.R. Report Making You P.O.O.R.?

Wholesale Distribution Associations are replete with financial comparisons called P.A.R. reports. Essentially, these reports are compiled from member financial statements sent in confidence to firms that synthesize the data and report ratios to the members. In essence, participants can benchmark financial ratios from the income

statement and balance sheet within an industry and understand, with better clarity, how their profitability compares with peers. Additionally, distributors can use the ratios to improve their profitability through such conventions as increasing margin dollars, increasing margin percent, or reducing operating expenses. Most of the reports are quite extensive including the breakdown of expenses into categories such as executive salaries and bonuses, inside sales wages, utilities, rent, etc. The idea is to give added detail to the association member to compare and correct expenses that are above the norm.

P.A.R. reports are based on traditional financial statements that have been in existence, in some form or another, since Luca Pacioli, a Franciscan Friar, wrote the first recognized textbook on the accounting discipline in 1494.[4] However, the argument against standardized statements and especially the statement of income is that it forces a type of linear thinking where managers stress and reward employees on variables such as sales, gross margins, expense management, etc. The problem is that these entities are singular in measure. For example, rewarding sellers on generating margin dollars means little unless one associates expenses with the margin dollars generated by the seller in a specific time period. Or, holding expenses below average in a period lacks clarity as there is little to help understand what drives the expenses or how they are generated.

The Income statement is a period report in that it captures sales, margins and expenses and gives a profit for a specific time period. It is an aggregation of transactions in a time period and is primarily useful in estimating income and paying taxes. There is not sufficient detail on how profits are generated and why expenses (costs) behave as they do. Hence, P.A.R. reports don't always provide information in a format that helps to understand what drives operating profit and the linear thinking implied by the statement of income can actually mislead distributors into strategies that negate profits.

Activity Costing and Customer Profitability, Noble Attempts, Expensive Retreats

In the early 1980's, Robert Kaplan, of the Harvard Business School started Activity Costing. The discipline attempted to develop insight into what generated costs and if customers and other entities were profitable when activity costs were applied. Activities included events such as solving customer complaints, filling orders, customer solicitation activities, etc. The problem with these activities is that they required complex algorithms (formulas) to determine their cost and cost inputs were often estimated. Wholesalers began using activity costing in the late 1980's. Many of the models were custom designed and had hundreds if not thousands of data points that needed constant updating. Our work in the field found that five years after starting an activity costing exercise, two thirds of wholesalers quit. The complaints were that the modeling was too expensive, too costly, and too time consuming. In 2006, Robert Kaplan publicly recanted activity costing saying that the initial discipline was "…high cost…subjective…and difficult to maintain."[5] These complaints were essentially the same as those we had gathered in our field experience.

Customer profitability was an off-shoot of Activity Costing that used the logic to understand if customers were profitable when operating costs were allocated to their activities. Several well-known books and studies for distributors on the subject were done in the earlier part of the millennia. However, since the discipline is based on Activity Costing logic, it is subject to many of the limitations inherent in using activities

to allocate costs. Our work using Activity Costing and Customer Profitability modeling shows only scant correlation between Activity Profits and metrics such as increasing margin dollars, increasing sales, or managing activities. Hence, we moved away from any activity based work some years ago and began searching for a better discipline.

In fairness, Kaplan has resurfaced with a new discipline called Time Based ABC which is an attempt to erase the earlier problems with the knowledge base. We have not evaluated Time Based ABC. We are content to leave the field and activity logic. While the idea behind Activity Costing was noble in trying to allocate expenses to activities and customers, our field experience and recant by the originator (Kaplan) was enough to get us to drop the discipline. The substantial expense of developing Activity Based Costing for wholesalers and the debatable information is not something that we recommend for a slim margin enterprise. Instead, we moved to a little used but fundamental part of the distribution business, the transaction.

Transactions as Financial Building Blocks

The transaction is widely acknowledged as an entity that captures the fundamental economic value added of distribution. In essence, the transaction is comprised of line items from various manufacturers that develop an "order" which is shipped to the customer. The aggregation of different skus from different manufacturers into an order whose gross margin dollars exceed its costs is the fundamental value proposition of distribution. We refer to the transaction as the financial building block of the firm. Over time, distributors have developed different transaction types to add value in different ways including: stock transactions (original orders), stock transfers, non-stock transactions, drop shipments, counter sales, and backorders. Since transactions are the building block of value added by distributors, it was natural to choose them as a methodology to measure profit. Three years ago, we began financial modeling of transaction types using a convention called Differential Costing.[6] Differential Costing has three tenets that make it unique for measuring costs including:

1. Transactions are the fundamental entity of profitability in distribution. Transactions either make money or they don't.

2. There are different types of transactions with different costs and these can be measured and aggregated by branch, seller, segment, account or transaction type to give profitability insight.

3. Differential Costs use established transaction types and service definitions and largely avoid the confusion, cost, estimation, and complexity of Activity Costing.

To illustrate what we mean by Differential Costing we refer the reader to the Differential Cost Template below in Exhibit 1. In the Exhibit, we have in the far left column listed the transaction types. In the eighth row down, we have listed the service definition. Looking at the transaction of Stock (Original Order from one branch) we find that each service or operation has an x. In essence the stock (original order) is the most common and basic of transactions and uses a value of 1x. Looking at the second transaction of

Stock Transfer, we see that the services of receiving, put away, order writing, invoicing and shipping have 2x. This captures the added double costs of stock transfers. And, looking at the row denoting the direct or drop shipment, we see that there are no costs for receiving, put away, or shipping. In essence, the Differential Cost template measures the different costs of different transaction types and sets the stage for Transaction Profit Theory.

					Differential Cost Template		Exhibit 1			
					Operation or Function					
Transaction Type	Purchase	Pay Vendor	Receive	Put Away	Order Writing Inside Sales	Outside Sales	Shipping	Invoicing	Extend Credit Collections	Warranty/ Returns
Stock	X	X	X	X	X	X	X	X	X	X
Stock Transfer	X	X	2X	2X	2X	X	2X	2X	X	1.15X
Non-Stock	1.25X	1.05X	X	1.15X	3X	1.5X	1.15X	X	X	4X
Cash/Counter	X	X	X	X	X			X		1.5X
Direct	X	X			X	X		1.25X	X	1.25X
Back-Order					X		X	x	X	X

What Really Drives Operating Profit in Distribution?

After developing, honing, and testing Differential Costing in the field, we began applying the costs to marketing and operations entities in order to drive operating or Transaction Profit. (Note: Transaction profit is essentially the same as operating profit with the exception that we typically do not fully allocate fixed costs). The work led us to develop **Transaction Profit Theory** which states that profitability in a business with multiple transaction types and a step variable cost structure hinges on three basic measurements including:

1. Size of the transaction in margin dollars.

2. Type of transaction and its Differential Cost.

3. Mix of transactions when aggregated to a marketing or operations entity.

We illustrate the key drivers of Operating Profit in Exhibit 2 below. Most distributors intuitively agree with Transaction Profit Theory, however, we have found few wholesalers who can demonstrate valid measures and methodologies to determine transaction costs unique to a transaction type. The Three Pillars of Transaction profit must be measured, understood, and planned to be managed.

Three Pillars of Transaction Profit

Transaction Size in Margin Dollars

Transaction Type and Cost

Mix of Transactions

Transaction Profits-Benfield- Rights Reserved   Exhibit 2

Applying Transaction Profit Theory can have immediate impact on operating income. In Exhibit 3 below, we have included field data (disguised) from a Transaction Audit. The exhibit lists key statistics for annual transactions including transaction type, number of transactions, average sale, average cost, average profit, total profits and percent of total profits. In the far right column, we can see that the vast majority of profits in the firm (97.25%) are from direct (drop) shipments and the remainder are generated by stock original orders. To illustrate the effect of margin size on a transaction, if we took Stock Transfers and increased price 3% or approximately $5, when multiplied by 68,733 transactions, the net effect is $344, 665 to operating profits. Transaction type and cost can be illustrated by looking at Counter Sales. If the firm was able to reduce the cost of a counter sale by $6 with a self-serve counter and hold the current price, the operating profit effect on 48,977 transactions would equal $293,862. Finally, to illustrate transaction mix, consider that stock original orders are approx 72 MM in sales. If the company could switch 10 MM in stock original sales to Direct Shipments, the additional 3300 directs would have significant impact on the firm bringing in another $756,000 in

incremental income. (Note: For income to be realized in switching from stock to Direct shipments, management would have to reduce excess labor capacity or grow the business and use the excess capacity brought about by switching to a lower cost transaction). It's also important to realize that even though some of these events would still yield negative profits by transaction type (Stock Transfers and Counter Sales) the losses would be substantially less. The power of Transaction Management is in the thousands of transactions that benefit from the efforts to make them more profitable.

					Exhibit 3		
	Transaction Cost						
	Effect on Profitability						Transaction
			Average Transaction	Average Margin	Average	Total Transaction	Percent of Total
Transaction Type	Number of Transactions	Average Sale	Cost	Dollars	Transaction Profits	Profits	Transaction Profits
Stock (Original Order)	244,111	300	63	78	15	3661665	32.67%
Stock Transfer	68733	185	78	55	-23	-1580859	-14.11%
Counter Sale	48977	42	24	15	-9	-440793	-3.93%
Drop Shipment	28911	2970	35	412	377	10899447	97.25%
Non-Stock	25611	120	87	35	-52	-1331772	-11.88%
	416,343					11207688	100.00%

In our field work, and when presenting the Three Pillars concept, many distributors will chime in with statements about "drop shipments being the most profitable" or "non-stock shipments being unprofitable" or "just add another line item to the order and profit jumps way up." These statements, however, lack definition and impact and cannot be fully understood and acted upon unless measured. And, in our Transaction Audits, we have found common profit disconnects which, when illustrated with field data, give many distribution executives and managers significant pause.

The Cognitive Dissonance of Profit Generation

Cognitive dissonance is a psychology term "that refers to the discomfort felt at a discrepancy between what you already know or believe, and new information or interpretation."[7] In essence what distributors have been told by financial accountants on what drives profitability including sales, gross margin dollars, gross margin percent, and

operating expenses is being updated by Transaction Profit Theory. The result is a disconnect in the way, methods and measurements distributors have used and rewarded employees to drive profitability. A balanced perspective on profit doesn't throw out the accounting concepts, however. Financial accounting and accounting ratios have their place but too often these tools are stretched out of context to be useful in driving profit. And, our experience is that financial "linear thinking" dominates distribution markets and dampens profitability. In some instances, linear thinking can even destroy profitability and we will give some of the more common disconnects when using Differential Costing and the Transaction Profit Theory.

Gross Margin Dollars and/Gross Margin Percent Fallacies

Gross margin dollars and gross margin percent dominate distributor measurement and reward systems. Sellers are rewarded on margin dollar based systems from salary and bonus to straight commission, and it is common to reward part or all of seller compensation on margin dollars. The idea in compensating on sales or margin dollars is to give the seller a metric for performance and a feeling of ownership in the financial stake of the territory.

There has been considerable debate over the years as to which type of sales compensation system works best. The debate over straight commission, salary and bonus, salary and commission, salary, bonus and commission, and salary only compensation plans have been debated heavily regarding their relationship to profitability. In their 2003 book, *What's Your Plan,*[8] Indian River Consulting Authors Mike Marks and Mike Emerson reviewed these common compensation plans and found they had no appreciable correlation in "gain or loss of market share."[9] The research was hailed as revolutionary and we cited it along with our own findings recommending more balanced compensation systems in our book *Restructuring the Distribution Sales Effort.*[10] And, while we found market share a curious measure of compensation effectiveness, our own work at the time would support the general conclusion that compensation type as overrated in yielding performance. With Differential Costing and Transaction Profit Theory, however, it is now possible to measure individual sales territory contribution to operating profit. Exhibit 4 below is a cross-section of sales territories from our field work (disguised) that shows sales, margins, transaction profits and transaction profits as a percent of sales. In the exhibit, we view sales territories that have low gross margins as a percent of sales and positive transaction profits (Fairling Darling) and territories that have higher gross margin percents and negative activity profits (Rusty Bolt). We can find territories that are low in sales with high transaction profits (Pita Piper) or territories high in sales with negative transaction profits (Tom W. Boy). Our field work using Differential Costing finds that **there is only limited correlation between traditional compensation models of straight commission, salary and bonus, salary bonus and commission, salary and commission, or salary only to profitability.** In essence, traditional compensation structures may or may not influence operating profits. **When picking between compensation plans, we tell clients to forget the expensive compensation consulting or debate over the merits of any particular plan and instead flip a coin or draw from a hat as any option will do.** Typically, slightly over

40% of sales territories that have traditional plans are transaction negative. Looking at it another way, 40% of sellers should pay their employers for the opportunity to work.

The problem with most existing compensation plans is that they use metrics such as sales or margin dollars and **assume** these measures relate to operating profit. As we have argued in this paper, accounting measures don't mean much unless they are paired with expenses. Otherwise, they are singular numbers from the income statement and only measure one part of profitability typically, sales or margins. Differential Costing does, however, pair territories and sellers with expenses at a fundamental or transaction level. And our initial work in redesign around the new measures and associated training and work in Transaction Management have shown significant influence on operating profit.

		Seller Comparisons		Exhibit 4	
		Sales and Margins			
		To Transaction Profits			
Sales Person	**TOTAL**	**TOTAL**	**Margin Percent**	**Territory Transaction**	**Territory Transaction Profits**
	Sales	**Margin**	**on Sales**	**Profits**	**As a Percent of Sales**
Hodgpole Oshetzky	9047691.97	1355256.61	14.98%	46473.99	0.51%
Mervin Purvant	6553194.70	964711.21	14.72%	8699.40	0.13%
String Bean	5045697.59	944856.54	18.73%	23530.81	0.47%
Fairling Darling	4058356.82	616914.82	15.20%	165822.00	4.09%
Brick Mason	3395106.86	607096.45	17.88%	124994.94	3.68%
Tom W. Boy	3009583.40	507370.96	16.86%	-53519.40	-1.78%
Glitz Ringer	3227554.42	502883.77	15.58%	-111682.45	-3.46%
Christmas Bell	2658078.18	427955.43	16.10%	-9873.54	-0.37%
Hubb Capp	2305723.22	394827.53	17.12%	-11194.35	-0.49%
Rusty Bolt	1490304.36	332660.11	22.32%	-70268.94	-4.72%
Pita Piper	1871166.67	325832.35	17.41%	148129.45	7.92%
Omar Sheik	1535940.31	296660.46	19.31%	36015.94	2.34%
Elvis S. Yoakum	1350805.35	261284.50	19.34%	90901.59	6.73%
Twila Wilderman	1400344.07	260716.65	18.62%	-152736.68	-10.91%

Some Transactions Lose Money Consistently

In our field work, we develop a Transaction Profile of the distribution firm. A transaction profile is a view of the aggregated transaction types and their influence on operating or transaction income. Exhibit 5 below gives our average, to date, of transaction profiles as done from our Transaction Audits. The exhibit shows that of six transaction types, only three (Stock Original Order, Directs, and Stock Transfer) make any profit for the firm. The other transaction types, in aggregate, lose money and from our field data do so consistently. The insights and problems from this knowledge are profound. First, 127% of transaction profits are generated by stock orders (original) and

direct or drop shipments. Second, non-stock, counter sales and backorders lose money in aggregate and this poses a strategic problem. Why? In our work, we see backorders, non-stocks, and counter sales as specialized transactions that take extra cost (service value) including extra ordering, interruption of work flow, extra shipping and high ordering and warranty costs. **In essence, the transactions that take the most work or consume the most service value are largely, in aggregate, unprofitable**. The transactions that take the least amount of service value, including stock original order and direct shipments, generate the most profit and are coming under siege.

Based on the data, we now see full service distribution (produces all transaction types) as vulnerable. Why? The profitability is highly cross-subsidized. **In essence, the two transaction types producing the majority of the profits of the firm are where the least service value is added!** And the transaction type that far and away produces the most profit, direct shipments, don't require a warehouse, warehouse personnel or shipping facilities and assets. In essence, it is entirely possible to create a viable distribution entity that sells only direct shipments and can do so at much lower margins.

	Transaction Profits Contribution	Exhibit 5
		Transaction Profits as
Transaction Type	Sales Percent of Total Sales	Percent of Total Transaction Profits
Stock-Original Order	47%	58%
Stock Transfer	20%	15%
Directs (Drop Shipments)	10%	69%
Will Call (Counter)	5%	-10%
Non-Stock	15%	-25%
Backorders	3%	-7%
	100%	100%

We have warned full service distributors for several years that so called Transactional Distributors who specialize in high profit transaction types were on the rise. Recently, we heard from two such entities. One has a direct shipment model that undercuts full distribution model prices by 10% to 15% and another model concentrating on large stock orders and directs undercuts full service models' pricing between 10% to 25%. These distributors are growing rapidly as they slice apart the value chain, target the most profitable transactions, and pass the cost savings to the customer. Where do these distributors get their cost savings? Since they avoid costly and negative profit transaction(s), their operating expenses are low and this constitutes much of the price savings for the customer. In the end, we see full service distribution as a vulnerable business model because it is cross-subsidizes many of its unprofitable transactions with a

few of the more profitable. And the most profitable transactions are those easiest to service and copy.

Finally, in some distribution circles there is the concept of Average Order Value or AOV. The proponents of this measure offer generalist advice on increasing average order size as a way to superior profits. Unfortunately, we find that there is no such thing as an average order since different orders or transactions have vastly different costs. Average Order Value is one of the weaker concepts coming out of financial accounting and has limited meaning once Transaction Profit Theory is understood and used.

Does Your Branch Really Make Money?

Branch profitability and the compensation plans of branch managers are hotly debated and followed subjects in distribution. Our recent survey of electrical distributors found that when asked on which financial measures they compensated branch managers, 60% mentioned Return on Net Assets, 52% mentioned Branch Income, and 50% mentioned Return on Invested Capital (multiple responses permitted).[11] The problem we have encountered with Transaction Profit Theory is that much branch profitability is determined using allocations of corporate overhead and shared expenses. For instance, IT, purchasing, accounting, corporate management, administration, fleet and field management is often allocated based on margin dollars or sales dollars. And, when performing expense allocations based on sales or margin dollars, the profit picture can be quite different than that attained through Differential Costing.

	Branch Profitability Allocation Misinformation			
	Exhibit 6			
Wholesaler 1	**Branch 2**	**Branch 2 Transaction Mix**	**Branch 2 Transaction**	
			Profit	
102 Million in Sales	25 million in Sales or 24.5% total	35% Stock Sales	715,000	
23% Gross Margin or 23.46 Million	27% Gross Margin or 6.75 Million	30% Stock Transfers	398,000	
20.7% Operating Expenses to Sales or 21.11 Million	Operating expenses 5.17 Million (as percent of sales)	3% Drop Shipments	340,584	
Operating Income of 2.35 Million or 2.3% of Sales	Operating Income is 1.58 Million (67% of total)	15% Counter Sales	-478,000	
Branches are logistical points and trucks, sellers,		17% Non-Stock	-456,000	
and much inventory is shared between branches.				
Hence, direct expense allocations are difficult.			519,584	**Transaction Based**
				Operating Income

In Exhibit 6 above, we have taken disguised field data from a Transaction Audit. The company was 102MM in sales, 23% Gross Margin, 20.7% operating expenses and had an operating profit of 2.3% of sales. In the column labeled Branch 2, the branch was 25MM in sales, with a 27% gross margin and **expenses allocated as a percent of sales** of 5.17

million dollars. Hence the operating income of the branch was 1.58MM or 67% of the company's operating income in total. (Note: The company in question had few direct expenses at any one branch and significant sales, shipping, and management expenses were shared between branches.) However, when we recalibrated profitability using Differential Costs of transactions, we found that the branch yielded only $519,584 in transaction income. Why? Simply put, the branch had extensive sales from the counter and in non-stock items which are typically negative profit transactions. The problem with allocating expenses based on income or margin dollars is that the allocation methodology has little to do with the actual consumption of operating expenses. Transaction costs are a bottom up measure using the fundamental building blocks of profit; transaction size in margin dollars, transaction type and cost, and mix of transactions. **Therefore, our findings are that many metrics for branch profitability determined by using allocations of expenses to develop a branch level income statement are often skewed. It is very difficult to know, when allocating expenses on sales or margin dollars, if the branch is making money or not.** In some instances, if the branch has significant direct expenditures the profit can be reasonably estimated. However, the trend in distribution is to have the branch as a logistical outlet and share operating capacity with neighboring branches. Hence, the need for an accurate, reliable and easy to understand allocation methodology is prescient.

Rethinking Profitability in Wholesale Distribution

After extensive work in using Differential Costing and evaluating the profitability of sales territories, accounts, branches, and transactions, we are of the opinion that traditional measures of managing profit need revamping. It is seldom accurate, desirable, or profitable to rely on P.A.R. reports, financial statements, and accounting ratios alone to manage operating profit. We think that distributors would be well served to rethink and remake their approach to profitability. The biggest problem we encounter when presenting data from our Transaction Audits is one of stasis momentum[12] or the reliance on past procedures to drive increased performance. In essence, the domination of P.A.R. metrics, financial accounting and activity costing has created a dependence on these measures where profits are static but the comfort of management in using the discipline(s) override their desire to generate superior income with better knowledge and tools.

"Making a Profit" is Not Always Accurate

The linear thinking implied from the statement of income leads managers to believe that the firm "makes profits." In essence, revenue at an historic gross margin percent of sales exceeds the historic operating expense as a percent of sales and generates (makes) an operating profit. Differential Costing and Transaction Profit Theory often reject this logic. Hence the firm does not always make a profit but can **mitigate loss** for better income. In other words, if you lose less, you can make more and this is not semantics but a valid means toward better returns. The reduction of loss to make better profits is seldom discussed in distribution. Most efforts to drive profitability are stuck in the

language and assumptions based on financial accounting. In the closing portion of this paper, we introduce the field of Transaction Management which is the "how" for increasing Transaction Profits.

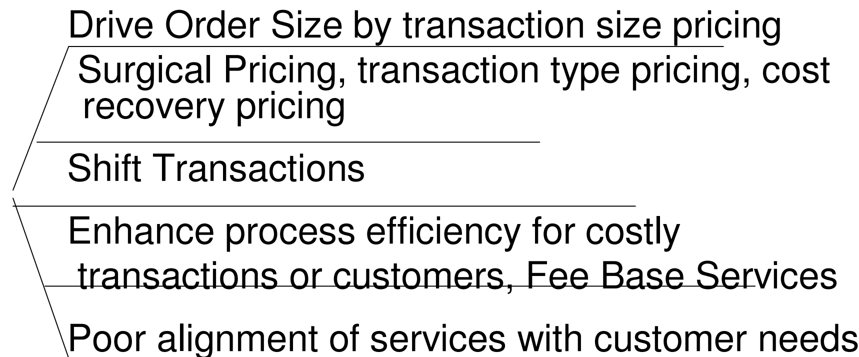
Transaction Management: Making a Profit and Mitigating Loss

When presenting our work on Transaction Management and Differential Costing, prospective wholesale clients often concede that the information confirms their suspicions of how profit is generated. They are also are greatly afraid that the solutions to the profit woes are more destructive than leaving the organization alone. Often managers have fears of stopping all counter or non-stock transactions, laying off 40% of the sales force, or firing a third of the customers. The solutions from Transaction Management are much more practical and prudent. Very seldom do we make drastic change to any one operation. Why? Because the loss of margin dollars and confusion created by major change can often exceed the positive profits earned from making the change. Transaction management seeks to mitigate loss and shift resources to operations that have the greatest return. Done well, Transaction Management prioritizes events that have the greatest return with the least amount of disruption.

Transaction Management Decision Tree

Transaction management first relies on identifying areas of loss and areas of gain. Without this basic understanding from Differential Costing, there is no reason to undergo Transaction Management. As one of our clients said, "I know that I lose money on 40% of the stuff I do, I just don't know which 40%." In Exhibit 7 below, we have included the common areas to increase Transaction Profits using Transaction Management. In essence, the manager can decide to use pricing, shift transactions, increase process efficiency or better align and perhaps elevate services to a fee basis. We elaborate on these areas below.

Exhibit 7



Drive Transactional Profits-
Benfield Consulting Copyright

Transaction Pricing

Transaction based pricing includes isolating transaction types and pricing them based on their dynamics of cost, price sensitivity, and segment. For instance non-stock transactions are price sensitive to order size and we spend time teaching clients how to set up and use an order sized based pricing model. Stock shipments can be priced according to segment and price sensitivity analyses and counter sales can be priced using specialized matrices to decrease loss. Pricing can also be used to drive transaction size. For instance, discounts can be given to drive a stated order size such as an extra 5% discount for a $300 order, etc. Pricing discounting to drive transaction profits is a new concept for many distributors but, often, the pricing discount can be used to greatly leverage operating income. In essence the discount granted is much less than the income earned as the transaction size is driven at a faster rate than operating expenses are consumed. Also the field of Cost Recovery Pricing can be used to great gain in Transaction Management. Cost Recovery Pricing is the use of service fees to cover legitimate costs not captured in the pricing system and includes areas such as freight, special handling, and specialized ordering. However, we caution readers that pricing is an often over used field in Transaction Management and cannot and should not cover all areas of loss.

Shifting Transactions and Process Efficiencies

Transactions can be shifted from one transaction type to another. Often direct shipments can be increased by working with customer to take shipments direct instead of

from the warehouse. Directs can also be sold using pricing incentives based on transaction economics specific to the order size and margins generated. Counter sales and non-stock items can be shifted to stock items and placed on a delivered order or they can be shipped direct. Shifting transactions takes work but it is often quite possible to develop means to transact a sale in a less costly manner and improve its profitability. When undergoing a Transaction Audit, we often find that stock transfers are too costly and the transfer branch would be better served in having a larger stock presence and limiting transfers from a distribution center.

Process efficiencies abound in transactions including placing non-stock purchases on a stock purchase order, shipping small stock orders by parcel post instead of on the company truck, and having a self-service counter area. There are any number of ways to increase profits by changing the way transactions are processed.

Poor Service Alignment

Once transaction profits and losses are mapped, it is common to look at how entities are served. It makes little financial sense to put significant sales effort into negative transaction customers unless there is a plan to mitigate the transaction loss. Otherwise, as sales are increased, more money is lost. Sometimes, it is better to approach a negative transaction customer with a less costly type of solicitation such as outbound telesales. Customers can be placed into segments and service templates developed that align the services with the ability of the customers to generate transaction profits. In many cases, wholesalers simply over-serve and the service should be reduced or elevated to a fee based offering.

Transaction Selling and Compensation Systems

Sales forces can be trained and compensated on selling larger and more profitable transactions. This work includes developing a Transaction Sweet-Spot map that gives the seller the transaction profits generated at various gross margin and transaction size levels. And paying off the profit pictured on the Sweet-Spot map can greatly influence sellers to negotiate more profitable transactions, shift transactions, or decrease negative transactions. Moving away from top line sales or gross margin dollar compensation is often difficult but not doing so too often rewards sellers for negative margin generation. We have worked toward transaction profit based or hybrid compensation systems using transaction profits and sales or margin dollars and transaction profits.

Finally, in industries where there are customers who stock for resale including dealers and MRO contractors, it is possible to develop year-long marketing programs that promise greater pricing and year end rebates if the customer orders larger transaction sizes. Also, these programs can be great ways to introduce new, higher margin products that enrich transaction profit. They can also be deadly to the competition as one wholesaler found out by filing Chapter 11 when a competitor used transaction based marketing programs and transaction pricing to put them out of business.

Summary and Advisement

To maximize gain from Transaction Profit theory, the distributor should have hard measures using Differential Costing, understand explicitly the areas of transaction profit and loss, and have a solid plan based on Transaction Management principles. Often we find wholesalers that "wing-it" with new knowledge or try to go it on their own and end up in worse shape than when they started. Transaction Management and Differential Costing are new fields. They are not hard to learn but they are not for amateurs or "windage" guesses.

Our forecast for the next five years is a slower growth economy with an appetite for value. It is very difficult for distributors to drop price in a slow growth environment unless they mitigate or stop loss. Differential Costing and Transaction Management help greatly in this endeavor. The past measurements of profitability using P.A.R. metrics, financial statements, and activity costing have their place. But they are old disciplines, offer little strategic advantage, and when used to drive operating profit on a finite basis, can often impede or destroy profits. We don't believe that distributors will be able to maintain and perpetuate full service models where they cross-subsidize losing transactions with profitable ones. Transactional distributors are on the increase and will work to take away the direct shipments and large stock orders that fund many of the losing transactions of the full service platform. And, the future economic environment will reward those who drive costs out and shore up losses by understanding the Transaction Profile of their firm.

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[6] Differential Costing is a trademarked and intellectual property applied for concept of Benfield Consulting and can only be used by permission.

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