PROFESSIONAL PRICING SOCIETY

The PRICING ADVISOR

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# How to Boost Distributors' Profits through Better Pricing

*Pricing is the most important profit lever for distributors. Despite this fact, many distributors do not manage their prices professionally. In this article, the author shows why pricing is particularly important for distributors and introduces three approaches that enable distributors to boost their profits through more effective price management. These pricing best practices can also be applied by pricers in multiple industries. Author Clemens Oberhammer Ph.D. is Managing Director at Simon-Kucher & Partners. He can be reached at Clemens.Oberhammer@simon-kucher.com.*

In no other sector does pricing so significantly affect profits as it does in the distributor sector. A price improvement of only 0.5% has the potential to boost a distributor's profits by an average of 50%. In contrast to the automotive sector, the same price increase yields only a 15% profit improvement (see figure 1).

When you factor in the distributor sector's tendency toward high revenues and small margins, it is clear that pricing is the number one profit lever. Yet, as industry behaviors have demonstrated, most distributors lack professional price management skills.

Distributors have neither the pricing tools nor the resources available (such as personnel and time) to develop a professional price management scheme. **The result: many leave money on the table when it comes to pricing.**

There are various ways in which distributors can increase their profit through more professional pricing. This article will reveal how distributors can:

- professionalize their list price calculation by segmenting their customers and products based on price elasticity and considering price elasticities when setting prices,
- use alternative price elements to generate additional profit streams, and

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## PPS Happenings

Serving the Pricing Community Since 1984

### Upcoming Events

**22nd Annual PPS Fall Conference:** Caesars Palace – Las Vegas, NV; October 25-28, 2011. Workshops and special events offered on Tuesday and Wednesday, October 25-26 include:

- **Core Pricing Skills** – Jim Saunders
- **Creating & Capturing Value in an Intellectual Capital Economy** – Ronald Baker & Ed Kless
- **Innovative Techniques for Estimating Elasticities** – Walter Paczkowski, Ph.D.
- **Rebuilding the Profit Power of Pricing** – Mark Burton
- **Extracting Full Value from New Product Launches** – Madhavan Ramanujam
- **3rd Annual Pricing for Executives Summit** – Stephan Liozu, Kellie Ecker, Darren Huxol, Eugene Zelek, Dick Braun

For the most up-to-date information about PPS events and programs, please visit our website at www.pricingsociety.com frequently.

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- use internal benchmarks to improve price implementation by sales reps.

## List price optimization

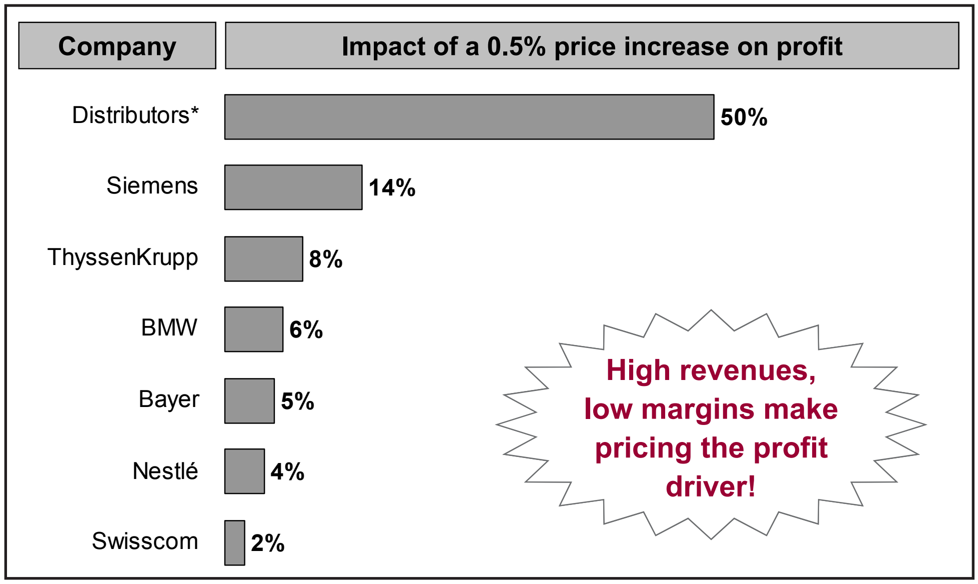
**Most distributors give their customers price lists. Depending on the product assortment, these lists are updated either on a daily, weekly or monthly basis.** Determining these price lists is a very complex task.

The reasons for this complexity are numerous: the high number of products, heterogeneous customer segments and regional differences require different price lists; constantly changing factors, e.g. availability, purchase costs, etc., also exacerbate the situation. As a result, most distributors focus on determining the optimal prices only for top-selling products.

For slow-moving products, they apply a simplified pricing approach such as cost-plus. This can be a fatal error, as slow-moving products have the highest margin potential – if you price them intelligently.

Figure 2 outlines a power pricing tool designed for distributors and retailers which allows them to set the optimal list prices for all their products. **Once the tool is set up, it allows the distributor to ascertain the optimal price for all products within minutes.** The approach consists of five steps:

**Figure 1: Profit Impact of a 0.5% Price Increase**

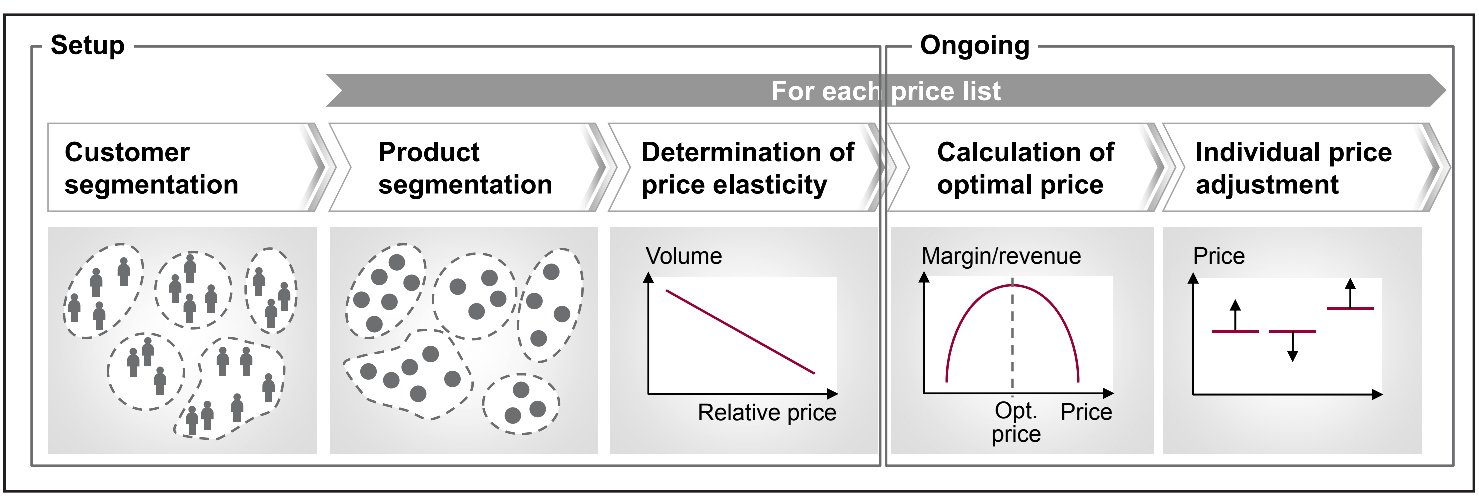



**Customer segmentation:** In the first step customers are segmented based on their willingness to pay. While most distributors today segment their customers based on revenue and maybe revenue potential, a segmentation based on willingness to pay needs to consider also other factors such as region, industry, product focus, etc. The goal is to create customer segments which can be targeted with one price list.

**Product segmentation:** Determining the optimal price requires having knowledge of the price elasticity. **The very high number of products a distributor sells makes determining the price elasticity for each product impossible. Therefore, criteria that affect price elasticity are identified.** Typical criteria are volume, market volume, availability and price level. Based on the identified criteria, products are segmented into groups of products with similar price elasticity. As a result, price elasticity has to be determined only for a limited number of product segments.

**Determining price elasticity:** First, the product segments are ranked based on their price elasticity. Second, the price elasticities (compared to competi-

**Figure 2: Power Pricing For Distributors**



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tor prices) for selected product segments are determined. There are various approaches that can be used to determine price elasticity: analysis of historical data (difficult), price tests and expert judgment with internal sales experts. To get the best results, it is recommended to combine at least two of the mentioned approaches. In the third step, the price elasticity of the remaining product segments is derived through an interpolation of the estimated elasticities.

**Calculating the optimal price:** Based on cost, price elasticity and competitor price, the optimal price can be calculated. To avoid optimizing short-term profits at the cost of the long-term profits, the approach also factors in price image effects when determining the optimal price. Revenue-optimal prices are calculated for focus products and products generating high cross-selling revenues. The profit-optimal price is determined for the remaining products.

**Price adjustment:** There are other criteria such as stock, manufacturer kickbacks, etc. that require a price different from the calculated price. These criteria are considered manually in the last step.

Once the approach is set up (customer segmentation, product segmentation and elasticity) it takes only minutes to calculate the optimal list price for all products and list prices.

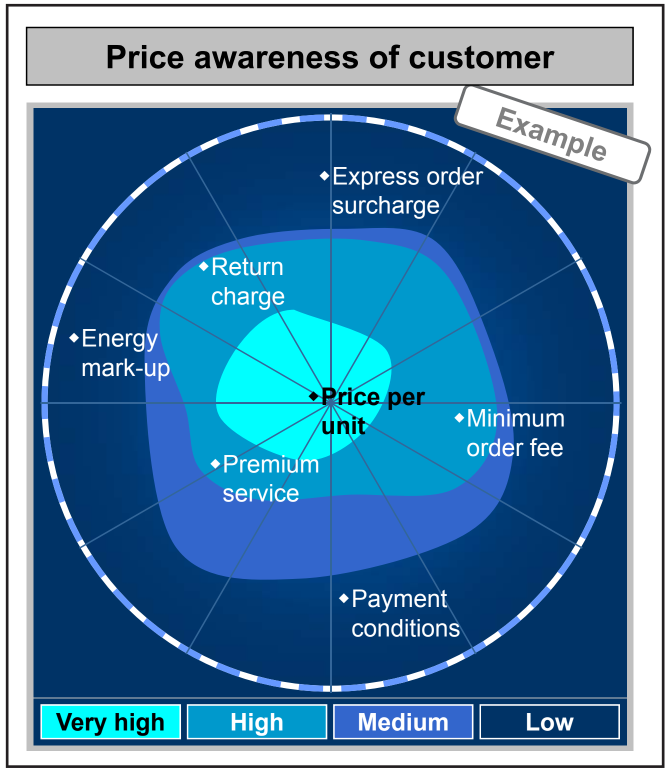
## Alternative price metrics

Customers tend to base their purchasing decisions largely on distributors' product prices. In many industries there are even software tools/Internet sites that enable companies to easily see and compare prices, giving distributors very little room to increase the prices per unit.

**A recent example demonstrated price elasticities of 35 when the distributor increased its price by 1%!** Keeping this in mind, you have to wonder: Are there alternative ways to increase the overall price level?

One possibility is to use alternative price metrics to charge for services such as small orders, express orders, payment terms, returns, etc. (e.g. fees and charges). As shown in figure 3, customers focus less on these price metrics than on the product price. In addition, these charges and fees are less transparent, i.e. it is more difficult to compare them between distributors.

Figure 3: Customer Radar




As a result, price elasticities of these price metrics are typically two to four times lower than the elasticity of the price per unit. Despite the potential of alternative price metrics, many distributors do not consequently apply these charges and fees. The following section shows how distributors can implement charges and fees in order to generate additional profit streams:

**Set up a service charge/fee list:** In the first step, you need to determine a price (charge/fee) for all services. To determine the optimal price you should quantify the value to the customer (and not look only at your cost), look at the prices of other distributors and simulate the impact of different price levels considering the charge/fee income and the customer reaction, e.g. churn, changed ordering behavior etc.

**Communicate price list:** In the second step, you should communicate the list prices to your customers but not necessarily start charging them. The goal is to make customers aware of the fact that they are currently getting services of value and should cost something. An attractive way of communicating the charges and fees at this stage is to show the charge/fee on the invoice and the (additional) discount the customer is given because he/she does not have to pay the charge/fee.

**Implement price list:** You start charging customers in the last step. It is important to have a segment-specific implementation strategy, i.e. implementation targets per customer segment. While the implementation rate for small customers should be 100%, important customers might not have to pay certain fees/charges. Furthermore, distributors must ensure that their sales teams have the right focus. In many companies we observe that sales reps focus primarily on costs when it comes to services. For instance, the customer does not get charged for a service, although it's of high value because the cost is very low. The focus of the sales team must shift from costs to value. To ensure that the sales reps stay consistently focused on value, a component of the sales rep's commission could be contingent on the amount of charges/fees successfully implemented.

## Price implementation

Another pricing challenge distributors face is how to determine the optimal price for each customer. With most distributors, it is the sales rep's job to determine and negotiate the price a cus-

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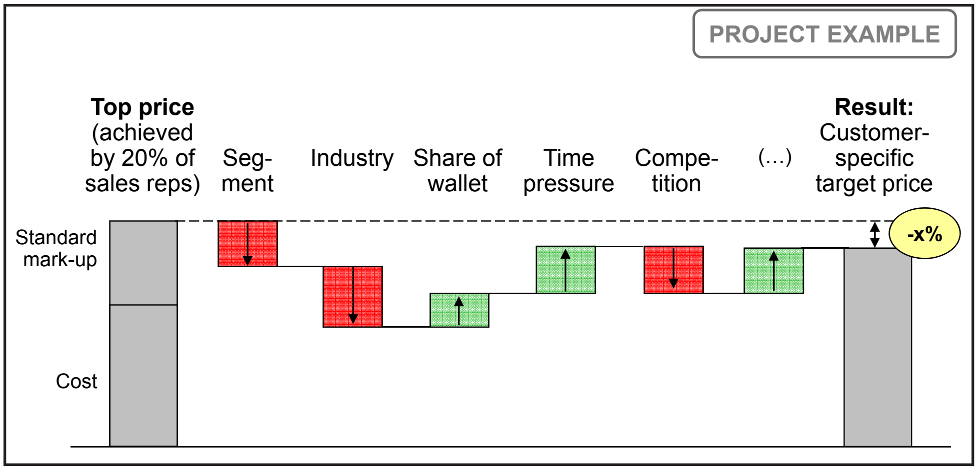
**Figure 4: Peer Pricing Approach**




tomer has to pay. However, experience shows that pricing quality varies greatly among sales reps. **That is, there is always a certain percentage of sales reps who achieve much higher prices than others, even when factors such as customer segment, turnover, region, etc. are the same. Yet some sales reps give unnecessarily high discounts and fail to differentiate prices across customers and transactions.**

Most approval processes set a minimum margin. As a result, sales reps set a price slightly higher than the minimum margin, thus avoiding having to ask for approval from their boss. The main reasons for this sub-optimal behavior are a lack of guidance and control as well as a misdirected focus on revenue instead of profit.

There are several ways to improve price implementation. One way is to introduce a stricter discount approval process including not only a minimum margin but customer segment-, product- and transaction-specific target prices. Furthermore, a company must offer its sales team better and more frequent support in pricing. The peer pricing approach, outlined in figure 4, is an example of a model that gives sales reps better support in pricing. The basic idea of this approach is to provide sales reps with price benchmarks for each situation. In other words, the price achieved by top sales reps in a certain situation is their benchmark.

The approach requires understanding the criteria that affect the optimal price; for example, regions, new or existing customers, transaction volume and urgency. Two approaches can identify these criteria and determine their impact on the optimal price. The first is a quantitative approach in which the criteria and their impact are calculated based on historical data using a multiple regression analysis. While the advantages of such an approach are its valid and precise results, the disadvantages are the considerable investment of time and effort and the sales reps' reluctance to accept the new target prices.

Alternatively, a more qualitative approach can be chosen. In this case, the criteria are determined through workshops with sales reps. The effect of the criteria on the price is determined using an internal survey among sales reps. This approach ensures the sales team's acceptance, but it causes much more imprecise results compared to the quantitative approach.

The new target prices are optimally implemented in a decision support tool for sales reps which shows them the real-time target price for a specific transaction. With the help of these target prices, sales reps gain a better understanding of what is feasible and become more confident when negotiating prices with customers. Companies that have implemented the peer pricing approach were able to increase their net margin by as much as 10%.

## Conclusion

Pricing is the number one profit lever for distributors. Despite this fact, many distributors lack professional price management knowledge.

This article introduced three approaches that help distributors improve their profits. One, the power pricing tool for distributors and retailers helps distributors set the profit-optimal price for thousands of products within minutes while considering all critical factors. Two, the use of alternative price metrics helps distributors increase prices — even in extremely competitive markets. Finally, the peer pricing approach enables distributors to use internal benchmarks to improve price implementation.