



Purchasing Intelligence for the Industrial Distributor

Procurement Cost Reduction: A Strategic Tool for Bottom Line Improvement in Industrial Distribution

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Overview

This document is intended to discuss the current state of gross margin pressure within the industrial distribution sector of the US economy. It briefly describes the basic structure of distribution and then it describes the intensity of gross margin pressure on distribution and suggests key concepts and tools to reverse this trend. The document offers a solution for the small and medium-sized distributor to fight the growing economic pressures on gross margins and to effectively increase their own profits and grow their businesses.

The State of Distribution Industry

An analysis of the Industrial Equipment Wholesale sector (as defined by HooversTM) shows that the publicly held industrial distributors in the U.S. had a net profit margin of 3% in 2004 (figure-1)¹. Although this data is based on publicly traded companies, it is highly unlikely privately held firms are doing significantly better. The industry, like many others, is facing rising employee wage and benefits costs, in addition to the increasing demands of manufacturers requiring their

Figure -1: Distribution Industry Financial Performance - 2004

Return on Assets	3.80%
Return on Equity	7.40%
Return on Investments	5.50%
Profit Margin	3.00%

distributors to sell more volume on lower margins. The US independent distribution sector is witnessing unprecedented margin pressure as it tackles the double pressures of price squeezes from customers, and manufacturers demanding tighter margins and increasing volumes. Even with a rebounding economy, these pressures are being felt throughout the country.

In addition, many domestic manufacturers have either shifted production to China or are in the process of doing so. As the factories move overseas, many US based distributors are seeing their traditional business change dramatically. Transportation costs and order quantities have continued to grow. In many cases, these same aggressive manufactures have also contracted directly with the largest end-customers, effectively bypassing distribution partners and removing an important source of revenue from the sector. All of these factors are leading to an erosion in distributors' pricing power. The trend does not look to be getting any better in the near future as many industry analysts predict continued pressure on gross margins throughout the coming decade. This is in stark contrast to the '60s and '70s when managing and growing a distribution operation was easier and more profitable. During this period, partners steadily invested resources in supporting one another to grow profitably. As the overall consumption rate slows and many of the growth industries of yesteryear mature, the emphasis is shifting to cost rather than growth. Business is becoming more impersonal and more focused on short-term results rather than long-term relationships.

Most distributors and manufacturers are experiencing consolidation, eroding margins, and a customer purchasing shift to buying established products at the lowest cost and on demand. Some of the key trends being observed in the industry today are:

- A large number of distributors have a product line that is largely commoditized and therefore easily replaceable by a competitor

¹ Charles Schwab Industry Analysis Report

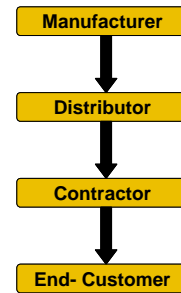
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- Most of the products are standardized and facing increasing pricing pressure
- The customer base is shrinking because of consolidation, leading to more concentrated customer buying power

Industry Structure

The industrial distribution industry comprises three or four major players depending on the sector –

- The Manufacturer, who produces the goods
- The Distributor, who buys from multiple Manufacturers, maintains stock and resells to the local trade and contractors
- The Contractor, who in many sectors buy from distributors and install products at the end-customer's premises, whether the end-customer is considered commercial or residential
- The End-customer, who is the target of all the goods and services produced by the chain and enjoys its benefits



The distributors solve the complex problem of bringing the buyers and sellers together. An efficient market (no excess profit) develops when all parties know the price to all goods. This efficiency occurs through the price discovery process as the distributor communicates with the end-customers about the products available at specific prices. The process of price discovery is complex and can be extremely time consuming.

As an example, consider an industry where there are 10 manufacturers and 50 end-customers. If there is no distributor, it will take 500, or 10 multiplied by 50, relationships for an efficient market to develop where everyone knows the price on each item being sold.

Now consider a distributor in the middle who buys from all 10 manufacturers in bulk and sells in small quantities to all 50 customers. It takes only 60, or 10 plus 50, relationships for the same price discovery process to occur. Clearly the distributor is adding a lot of value by reducing the transaction costs involved in building and maintaining 440, or 500 minus 60, relationships and allowing the customers to purchase in smaller quantities.

Additionally, the distributor allows the manufacturer to ship in bulk, reducing the manufacturer's cost of bulk breaking and freight. In many cases, the distributor educates contractors and end customers, provides additional support services, and provides valuable market data to the manufacturer. In addition, since the distributor is in the local market, he is able to more effectively give trade credit and greatly reduce non-payment risk.

Given the value the distributor is adding, you would expect him to make a good return on investment. However, this is not the case in today's market. Because of today's short-term focus, distributors are being squeezed from both sides of the market – Manufacturers and Contractors/End-Customers. Driving this trend is the lack of price information at the wholesale level (Distributors' Buy side) and an abundance of price information at the end-user level (Distributors' Sell side.) This information asymmetry skews the market dynamics and makes it less efficient on the distributor's Buy side than his Sell side. Consequently, this market dynamic protects the Manufacturers and End-Customers, but causes a margin squeeze on the distributors.

Let's look at another market – financial instruments – to understand how price discovery leads to an efficient market and its implications for the distribution industry.

What happens when you want to buy shares of GE on the NYSE? There are multiple buyers and sellers of the stock on the market. They all have access to similar, if not exactly the same, information about the company's operations. This information can come from the company, analyst reports or other sources such as regulatory filings. The information symmetry, where both sides of a trade have similar information, leads to similar expectations. This, coupled with large numbers of transactions and the transparency of prices on each of these transactions, ensures that every one knows the price at which shares are being bought and sold. That means everyone, including you, pays the same price for the same shares no matter how much you buy.

A similar mechanism exists for many commodities such as oil and corn in the form of the Commodities Exchange, where the sharing of pricing knowledge leads to more efficiency and thus a more competitive market. However, we do not have similar markets for industrial products. The distribution industry is the part of the supply chain that tries to create such a market.

Now, let's look at the distributor buying and selling within the industrial supply markets. While selling, the distributor has to compete with other distributors of the same manufacturer or those selling similar products within the same geography. Since contractors and customers can easily contact multiple distributors and negotiate prices, they are generally able to play one distributor against the other and get a lower price. This leads to lower selling prices as there is price competition for the Contractor/End-Customer in the market. Distributors, on the other hand, do not have such an advantage.

Because of the confidential pricing nature of the relationships with the manufacturers, the distributor does not know what other distributors are paying for the same product. This policy is established by the manufacturers, for the benefit of the manufacturers. The manufacturers then establish sales volume as the only allowable method for negotiating discounts. The control exerted by the manufacturers prevents price discovery and consequently an efficient market does not develop. Distributors are expected to negotiate pricing blindly, never truly knowing if they are receiving the market price. This is a big problem for any distributor, and not just the small ones who are being undercut by their larger competitors with more buying clout and lower procurement costs.

Improving Distributor Profitability

To improve profitability, distributors can address two sides of the equation – revenues and costs. They can either increase revenues faster than the increase in cost or reduce costs while holding or improving the top line. Clearly a combination of the two is required to achieve sustainable growth in profitability. This paper focuses on procurement cost reduction as a strategic lever to improve profitability.

While figure –1 illustrates the poor financial performance of the industry as a whole, it hides an emerging divergent trend. A select group of distributors are actually making double-digit margins while the majority are barely able to generate enough margin to meet payroll and provide economic returns for their owners. How are the better ones doing it? Their ability to earn higher revenues is clearly one of the drivers. However, they are also able to buy cheaper than their competitors. And they are not necessarily big. The key to their smarter buying is the availability of the right information and its application to negotiate a better price. We are not talking gouging or



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underhanded negotiation techniques. These companies are getting better prices just by knowing the discounts already available.

Impact of Procurement Cost Reduction

For a typical industrial distribution company, the cost of goods sold accounts for 75% or a 25% gross margin². Even a small reduction in the cost of goods sold can lead to a dramatic increase in net income (fig-2).

As the example in fig-2 demonstrates, a distributor with \$10million in revenue can achieve a significantly higher Net Income by reducing the Cost of Goods Sold by a very small amount. In the example, the distributor was able to save 5% on just 25% of their stocked items. This savings amounted to an overall gross margin increase of 1.3% yet still delivered an additional \$125,000 to the bottom line.

Fig-2	Now	Saving 5% on 25% of SKUs	Pricingnet Improvement
Revenue	\$10,000,000	\$10,000,000	
Cost of Goods	\$7,500,000	\$7,375,000	
Gross Margin	\$2,500,000	\$2,625,000	
GM%	25%	26.30%	+1.3%
Overhead	\$2,200,000	\$2,200,000	
Net Income	\$300,000	\$425,000	+\$125,000

The Pricingnet Approach

Pricingnet helps distributors ‘discover’ the price of products for their line of SKUs. Since there is no efficient market on the buy side of the distributors, such price discovery can be a source of competitive advantage.

Pricingnet collects reliable industry data from various sources for your basket of goods. You can then use this information to intelligently negotiate a lower price with the manufacturers. For example, let’s assume you are currently buying widget A for \$1 per unit, and you buy 2,000 of them every month. In the current situation, you have no way of knowing whether this is a competitive price to pay.

With Pricingnet, you find out that other companies are paying between \$1 a widget and \$0.95 a widget. Now you know that your prices should be between \$1 and \$0.95 and can negotiate a lower price, say \$0.97. The service has thus saved you \$60 on the item every month, or \$720 a year. More importantly, by knowing your ‘Potential to Save’ as expressed by the PNI™ on various products, you can prioritize where to focus your time and effort. You can target only those SKUs where the potential savings are more than expected costs to negotiate the new price.

Our service, therefore, allows you to not only reduce procurement costs, but also helps you do so intelligently and in a focused manner.

Conclusion

² Based on data from Bloomberg and S&P

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Purchasing Intelligence for the Industrial Distributor

Faced with increasing price and service pressures from buyers and manufacturers, distributors need to cut costs to maintain and improve margins. Negotiating reduction in prices of procured material is one of the most effective ways to do that. However, an inefficient market prevents distributors from finding out the right price for the name-brand products they buy. Pricingnet's service provides the kind of market data that allows distributors to estimate and negotiate better prices with their suppliers. These opportunities can lead to a sustainable cost reduction through an educated and intelligent negotiation between distributors and suppliers.

A number of distributors have benefited from our service, and you can too. For additional information, please contact us by telephone (650) 853-0742 or visit our website www.pricingnet.com.