

# THE HIGH COST OF LOW PROFITS

Strategically managing inventory, pricing and gross profits can increase a distributor's bottom line by up to 2 percent. It takes some hard work, but it's possible. Here's how. Part 2 of 2

By Allen Ray

**A**lthough most electrical distributors with less than \$25 million in annual sales expect business to grow over the next five years, many aren't sure exactly what they need to do to increase profit margins. A recent survey of these smaller distributors conducted by Allen Ray Associates Ltd., Arlington, Texas, showed that although 99 percent of respondents want and need to increase profit margins, they haven't analyzed their basic pricing structure or business rules as they pertain to real cost and acceptable margins. Additionally, they haven't decided who has responsibility for profit margins. Instead, many electrical distributors are more concerned with inventory problems, collections and cash flow or controlling overhead.

Distributors often don't know where to get help to correct these problems; often the distributors that need help the most are the last to realize it.

Although many distributors expect their markets to grow, many say they don't have the resources to add sales

personnel or new locations. Fortunately, these electrical distributors may actually have the resources right under their noses. If they balance their inventory levels properly and



price products strategically, they can actually grow their business quickly. This article explores several concepts that can help distributors do this.

**Train employees to stop overcommitting inventory.** Many of the survey respondents said employees

continue to overcommit inventory by taking instant sales from committed inventory. This problem can cause customer-service problems and disrupt normal replenishment cycles for

purchasing agents. Part of this problem stems from employees not respecting the committed inventory, and selling it to satisfy an immediate order. This is a training and software issue, and it highlights the need for management to establish best business practices. Overcommitment of inventory adds inventory cost because it leads to inter-company transfers, increases unplanned labor costs and shipment expenses, and destroys preplanned purchasing cycles.

*The "no touch rules" of accountability.* Several respondents said it's not practical to keep their personnel from pulling product in inventory that's already committed to another customer when they

have customers waiting at the counter. We just don't want our customers to get mad at us and go away," they say. This is a real fear to salespeople and counter personnel, and it makes them distrust the inventory figure in the business system. But, if this behavior continues, the distributor never will get control of inventory. In fact, overall inventory — not to mention unprofitable excess inventory — will probably grow.

Many survey respondents let their purchasing agents "own" the inventory and make them responsible for the inventory's performance. This is a much more effective strategy. However, for it to work, "We cannot hold our purchasing agent responsible for

*Editor's note:* Market challenges are forcing small electrical distributors (\$25 million in annual sales or less) to squeeze more profit dollars from areas of their companies they had previously overlooked — such as dusty warehouse shelves holding slow-moving inventory.

That's one of the key findings of a survey of smaller distributors done by Allen Ray, president, Allen Ray Associates Ltd., Arlington, Texas. Ray, an electrical industry veteran who has spent much of his career helping electrical distributors improve the profitability of their businesses, says survey respondents were quite willing to speak out on their attempts to improve profitability. In this two-part article, he analyzes the results of this survey and offers tips to on how distributors can operate more profitably.

good use of company funds if we allow our counter people and salespeople to walk into the warehouse and pull inventory before committing it in the system," said one distributor.

Some inventory management tools help purchasing agents track vendor performance regarding completeness of orders, timely shipping, damaged shipments and returned merchandise. In addition, other software tools allow them to set customer service levels to avoid stock outs. Said one distributor, "With the current technology of manual, wired or wireless cycle counting, as well as receiving and shipping, it allows our purchasing agent to have instant up-to-date stock levels of committed and available inventory to make the intelligent purchasing decisions."

"The business rules that we put into place say the sales and counter personnel must not pull product before entering the item into the business system," said another distributor. "If the system says there is zero product to sell, even though there is product physically on the shelf, then they are not to sell it. That product is committed to another sale. We call it the 'no-touch rule.' It also means sales samples must be logged into the system. "Although the enforcement of this inventory business rule is proving hard to enforce, eventually it will pay off. We want control of our inventory and are prepared to assign accountability."

**Prune excess inventory from your warehouse shelves.** Many electrical distributors see a parallel between their businesses and a rose bush that has grown big but is supporting sick growth with small bloom potential. To make that rose bush strong again, it must be pruned and fertilized. The analogy works for an electrical distributor with ineffective inventory management. To gain strength, a distributor may have to "prune" his or her stock. They can do that by selling excess inventory.

Some survey respondents reported excess inventories as high as 28 percent. Many with extreme amounts of excess inventory don't know what to do about it. Of course, some distributors try to return some merchandise to the manufacturer. If they have been on a vendor-managed inventory program, they can get good cooperation from that vendor. Some respondents said they must pay return freight and

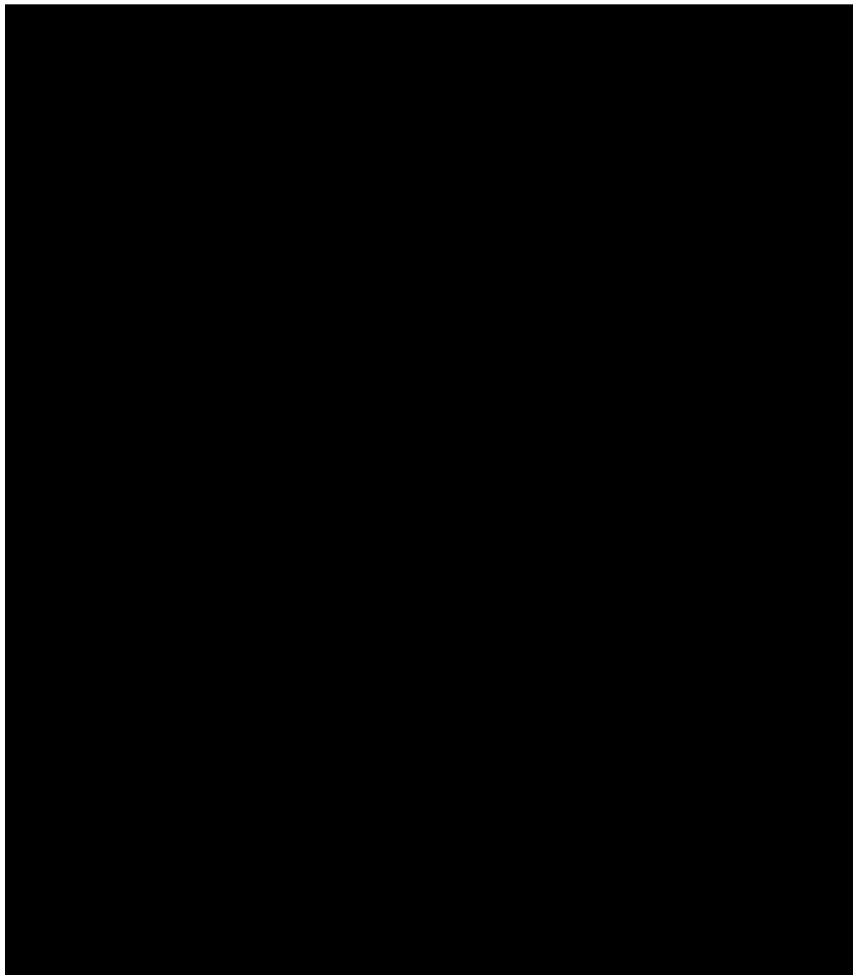
<b>BALANCED INVENTORY AND THE REPORTED RESULTS</b>			
<b>Inventory Velocity Codes based on yearly sales</b>	<b>Ideal balanced cumulative % for 12 months of sales</b>	<b>Reported lowest or worst case of imbalanced inventory</b>	<b>Reported highest or best balanced reported</b>
"A" Item	80%	50%	67%
"B" Item	15%	12%	20%
"C" Item	4%	2%	10%
"D" Item	1%	14%	2.5%
"X" Item dead stock	0%	22%	0.5%
Totals	100%	100%	100%

*Ranking and Ideal percentages provided by Jon Schreiberfeder, president, Effective Inventory Management Inc., Coppell, Texas. Obsolete products were reported in the "X" ranking.*

only receive partial credit. Other distributors said if they have a bank loan on their inventory, it could severely restrict how they manage it.

For those distributors that have not mortgaged their inventory, some real opportunities exist. They may even be able to hire another salesperson just by selling excess inventory.

One distributor said although he had \$4 million in inventory, 24 percent (\$960,000) was excess inventory. "Even if I sold it for 10 cents on the dollar, I would recoup \$96,000 and write off the balance," he said. "The assumption is that I might not sell all the excess. But I would start freeing up vitally needed cash. With cash



in hand, you begin to look at your business prospects differently.”

**Selling “negative” inventory.** Negative inventory — products for which employees take orders even though it’s not in stock — doesn’t exist in a good enterprise resources planning (ERP) system. Best business practices in an ERP system should not let employees sell what you don’t have on the shelves at that instance. That being said, many respondents said they must stop selling product if there is no real hope of filling it from timed stock replenishment or from product lines they don’t currently carry.

“Negative inventory” is in many cases not real inventory. This is not a drop shipment or a direct shipment.

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It has not been received from a vendor, and employees often fill the order from a “friendly” distributor.

Selling what you don’t have is a problem that a distributor often falls into by accident. The pattern starts when the distributor makes agreements with competing distributors to either pick up the “negative” product, or have that competitor ship it blind to their customer.

Distributors want to fill every order. If it’s nonstock product, some distributors mentally right it off as their companies providing customer service. The order has been filled, but the net profit is normally not at the acceptable margin level. When a distributor arranges with a competitor to fill the order, the margin has been reduced because the product carries the competing distributor’s markup.

One respondent asked, “At what cost do I reduce my margin for the sake of customer service?” A reduction in the net margin from this type of sale contributes to the total overall reduction of net margins at year-end.

**Velocity coding.** Inventory velocity coding, where distributors rank their inventory according to how fast it sells, continues to be a problem for some distributors.

If they have an older ERP software system, it may not have the ability to classify inventory. That means the distributor may give the job of manually classifying inventory to one or two employees. If these employees ever leave the company, they take with them much of the company’s inventory management capabilities and knowledge. The distributor may be left with an incomplete understanding about their inventory size, which product records are current, and the movement rates of various

products. Fixing this mess becomes a major project often performed under a great deal of pressure without a great deal of confidence.

Respondents who have purchased newer business software that accurately calculates the velocity of items say it has helped them gain control of their inventory. Identifying fast- and slow-moving inventory helps them control their inventory investment.

For typical inventory rankings, see the ranking chart, “Balanced inventory and the reported results,” on page 31. Each respondent gave different reasons for how they decide how much inventory to maintain, classify faster-moving vs. slower-moving items, and establish service levels.

**Manage margin and pricing.** Many respondents have lost touch with their pricing rules and margin levels. Several respondents said they let their ERP system manage their price levels. This dependency can sometimes lead to false conclusions. In addition, these distributors oftentimes let their salespeople set the market prices.

Several distributors said they struggle with their pricing in three major areas: special-order items, price management, and product and pricing.

**Special-order items.** Some distributors don’t realize they are giving away margin on special-order nonstock items. In some cases, these products contribute to excess inventory because distributors are not charging enough to cover the higher manufacturer order minimums. For example, a vendor’s minimum order size is three, but the distributor doesn’t price the item to the customer in order to cover the cost of the three items, plus freight. If the distributor breaks the price down to one and puts the other two on the shelf, then they have contributed to excess inventory.

**Price management.** Several respondents said they don’t spend enough time on their pricing rules and customer classification grouping. A recent distributor audit I did revealed that by tightening the “exceptions pricing” that allows discounting, a 2 percent to 3 percent increase in the net bottom line was possible, assuming the current operating ratios remain the same. Not all companies are the same, so the amount will vary.

Said one distributor, “We thought we were not discounting special-order items along with slow-moving inventory. It was a real eye-opener when the results of an outside audit showed us that we were in fact discounting ‘C’ and ‘D’ items about 85 percent of the time. If we had tightened our pricing rules and made someone accountable for our acceptable nets, it would have meant a 2.3 percent increase in our bottom line.”

Said another distributor, “Putting pricing rules in perspective requires surveying our net profits, making someone responsible for holding the line on prices, and not passing along ‘good buys’ to our customers.”

**Product and pricing.** Other respondents said if they can’t get timely and accurate pricing updates, their “cost-plus” contract business loses gross-margin dollars. For a distributor, it’s a constant struggle to get 100 percent electronic coverage of all vendors’ product and pricing data, and to get timely updates for this data, even when they pay an outside database company.

Data with misspelled words or inaccurate reference pricing and unit of measures, weights and warehouse

information is a big part of the problem. In addition, many distributors believe that with the increased use of special pricing authorizations (SPAs) by manufacturers, when there is a real cost increase, it's often masked or obscured because of the confusion that some manufacturers create.

The underlying problem is that many distributors don't understand that ERP systems were designed to handle business transactions and *not* to manage product data and pricing issues. Distributors with a basic understanding of their ERP systems have developed some processes that examine price increases before they upload product data. Others have added a "bolted on" back-office product, in front of their ERP system. One such offering worth noting is the offering from epaCUBE that allows for data synchronization (Synchronizer) and margin management (Margin Management). By proactively managing product data and margins, some distributors believe they will be able to pull two points of margin to the bottom line.

Make sure you really understand your true cost of doing business. Vir-

tually every respondent had at least one competitor in their market that really didn't seem to know what it cost them to operate. Many distributors said these competitors sell product based on price rather than on value. One-third of the respondents said they really don't know their true cost of doing business. Many take orders with the mistaken belief that they have profit in the order, but then they find out that it cost them money to fill it.

They don't always take into account how much it costs to cut wire, or that freight (which is not paid by manufacturer) is a real cost of doing business. Special-order items that should carry a higher margin many times have that margin compromised because a distributor doesn't charge freight or the manufacturer's minimum quantity.

**Gaining some perspective.** Forty-three percent of responding distributors are having problems with the size of their inventory investment and excess inventory. This sobering problem with excess inventory is revealing itself with cash-flow problems and imbalanced inventories, which keep

distributors from responding to positive market growth opportunities.

The sheer size of some distributors' inventories saps their companies of badly needed cash. Distributors that take decisive action to control the size of their inventory by turning excess inventory into cash can enjoy a wide range of profitable business options: lowering their cost to carry products, using available funds more strategically, freeing up cash to hire new personnel, and improving the company's cash flow.

Other areas that can improve distributor profitability are centered in the back office. They include synchronizing product data and managing profit margin prior to uploading this data into their ERP system and Internet storefronts.

The fact that so many respondents said they don't monitor or even understand their pricing rules should be a wake-up call. This can be labor-intensive and time-consuming, but software alternatives exist that make it very viable to manage this process and synchronize pricing and product data. The potential increase in real net profit could be as much as 2 percent. □