Profit Improvement Report

Prepared for NFDA
Vol. 29, No. 1
March 2020

Meeting the Commoditization Challenge

By Dr. Albert D. Bates
Principal, Distribution Performance Project

Probably the most widely discussed term in distribution today is commoditization. The issue suggests a new era in which firms face margin declines that make profitability challenging. Worst case such price pressures call into question the very survival of more than a few firms.

Despite the widespread discussion, nobody has really addressed the extent to which commoditization will impact profit. Of equal importance, there has been no real discussion as to the degree to which commoditization is truly inevitable. Is commodization a fait accompli or simply a recurring issue that will pass.

This report attempts to provide an objective perspective regarding the issue of commoditization. It will do so by considering two different aspects of the price aggressiveness issue:

- **The Profit Impact of Price Pressures—**An examination of the degree to which changes in sales and gross margin associated with heightened price aggressiveness impact profit.
- **Meeting Commoditization Head On—**Suggestions for establishing a set of actions that will at least partially shield the firm from intensified price competition.

The Profit Impact of Price Pressures

The pressures of commoditization work through distribution in two—often interrelated—ways. The first is that sales may fall if the firm does not meet price competition directly. The second, is that margin dollars will fall if the firm responds directly to the pricing challenge. While the two pressures often interact, it is useful to look at them independently.

Exhibit 1 examines these two scenarios for the typical NFDA distributor based upon the latest PROFIT Report. As can be seen in the first column, the typical firm currently generates $15.0 million in sales, operates on a gross margin of 34.0% of sales and produces a bottom-line profit of 5.0% of sales or $750,000.

To understand how sales and margin changes work though the profit structure of the firm, it is necessary to break expenses out into their fixed and variable components. Fixed expenses are overhead expenses that will not fall if the firm faces a sales or margin decline. Clearly, if there is a massive decline, any and all expenses can change. However, in the short run the firm will incur these expenses even in a declining sales environment.

Variable expenses are those that will change automatically along with sales during the year. Items such as sales commissions and bad debts fall into this category. They tend to be a relatively consistent percentage of sales.

Fixed expenses for this typical NFDA firm are assumed to be $3,450,000 while variable expenses are 6.0% of sales. While these are only estimates, they represent a serviceable approximation for the typical NFDA member.

The last two columns of numbers look at the profit implications of a sales or gross margin decline. In each instance the analysis identifies how much of a change would cause the firm to move to break even where profit is eliminated.

For the sales decline column, the first three lines on the income statement—sales, cost of goods sold and the resulting gross margin—all decrease by 17.9%. The fixed expenses remain the same, while variable expenses are still 6.0% of the sales and therefore all fall by 17.9%, the same as the sales decline. As a result, profit falls to zero. The break-even point mentioned earlier.

For the price cutting scenario in the last column, sales only fall by 5.3%. However, the entire sales decline is due to cutting prices not losing physical sales volume. Therefore, cost of goods remains the same. The result is that the 5.3% sales decline because of the price cuts also causes profit to disappear.

The two scenarios represent a truism for <u>all</u> NFDA firms. The profit impact of losing gross margin is much more severe than the impact associated with losing sales. Both are bad; however gross margin is a much more sensitive profit driver than is sales volume.

Meeting Commoditization Head On

If the two options associated with commoditization are either bad or terrible, it is logical to look for a third way. That approach is to position the firm such that the price pressures are eliminated or at least negated. There are two major actions required to support the third way option.

Account Selectivity—It is hard to conceive of a customer that wants to pay too much for the items the purchase. However, price sensitivity is not distributed equally among potential customers. Some are very sensitive, other less so.

Work done by a wide range of analysts suggest that somewhere around twenty percent of all customers, across a range of industries, are almost pure price buyers. For these accounts, commoditization inevitably leads to the quest for ever lower prices across the entire product line.

Another twenty percent of customers are heavy, but alas not pure, service buyers. Commoditization of distribution will influence their buying decisions only modestly. They still do not want to overpay but need real service.

That leaves sixty percent in the middle who vacillate between service-based decisions and price-based ones. It is essential to provide a service profile that justifies “fair” prices to hold onto this customer set.

If firms can stake out a strong position among the service-oriented and mixed buyers, it can afford to lose the pure price buyers. The firm can actually thrive in the commoditization world. However, a share gain is essential.

Gaining share here requires a significant service analysis/service intensification effort. Firms should stop providing services that are not really needed and maintain an outstanding service profile on all others. It also requires ensuring that the sales force is a customer-solutions group and not simply order takers.

Pricing of Slower-Selling Items—The author has discussed this point so many times in the past that long-term readers could probably write this section. Despite the redundancy, this continues to be a major profit opportunity.

The slowest selling 5% to 10% of the SKUs remain a profit wonderland. They combine two sensational characteristics. Namely, they are bought infrequently, and they are low-price, “why worry about it” type items. Availability is a powerful value added, even among price-sensitive customers.

Virtually every distributor pays lip service to this concept but doesn’t fully implement the concept. There is a concern that these items will be perceived as overpriced. The reality is that price perceptions are not built on these items. Price perceptions are built on the fastest-selling items in the product line. For the so-called “dogs” in the product line the key to success is availability, not price.

Moving Forward

Commoditization represents a real-world threat to most distributors. The fact that almost everything is available on the internet makes price pressures an even grater challenge. However, price has never been the only thing that distributors have to offer. A strong service profile, tailored to key customer needs, can help firms maintain and even gain market share. The economics of commoditization suggest it is a challenge that must be met.

About the Author:
Dr. Albert D. Bates is Principal of the Distribution Performance Project and a Senior Advisor to Benchmarking Analytics. His latest book, ***Breaking Down the Profit Barriers in Distribution***, is available online at Amazon and Barnes & Noble. It covers concepts that every decision maker should understand.

Exhibit 1
The Profit Impact of Two Commoditization Challenges for the Typical NFDA Member

Income Statement--$	**Current Results**	**Sales Erosion**	**Margin Erosion**
Net Sales	$15,000,000	$12,321,429	$14,202,128
Cost of Goods Sold	9,900,000	8,132,143	9,900,000
Gross Margin	5,100,000	4,189,286	4,302,128
Fixed Expenses	3,450,000	3,450,000	3,450,000
Variable Expenses (6% of Sales)	900,000	739,286	852,128
Total Expenses	4,350,000	4,189,286	4,302,128
Profit Before Taxes	$750,000	$0	$0
Sales Decline--%		17.9	5.3
Income Statement--%			
Net Sales	100.0	100.0	100.0
Cost of Goods Sold	66.0	66.0	69.7
Gross Margin	34.0	34.0	30.3
Fixed Expenses	23.0	28.0	24.3
Variable Expenses (6% of Sales)	6.0	6.0	6.0
Total Expenses	29.0	34.0	30.3
Profit Before Taxes	5.0	0.0	0.0