# Pricing the Forgettable Last Five Percent


By Dr. Albert D. Bates

**Most distributors continue to lament the pervasive,** and possibly increasing, pressures on gross margin percentages. Seemingly, price is outweighing almost every other factor in the competitive arsenal.

At the same time, gross margin is one of the "big two" in increasing profits for distributors (the other being operating expenses). This creates an imperative for distributors to generate extra gross margin dollars whenever they can to offset the dollars lost from price competition.

A continually under-utilized margin opportunity for distributors involves raising prices on the slower-selling portion of the product mix. Many distributors may argue "been there, done that." Despite those protests, a major profit opportunity remains largely untapped.

This report will examine the potential for enhanced gross margin associated with slower-selling items. It will do so from two perspectives:

- **THE GROSS MARGIN POTENTIAL**—An analysis of how increasing prices on slow-selling products can influence the total firm gross margin percentage.
- F**INDING THE MARGIN OPPORTUNITIES**—A discussion of the types of items on which margins can be enhanced even with ongoing price pressures.

## The Gross Margin Potential

Within every line of trade in distribution, including DHI, there are wide variations in the gross margin percentage across different SKUs. In a typical variable pricing (or matrix pricing) scheme, fast-selling items have low gross margin percentages while slow-selling items command higher ones.

At the fast-selling end of the product line, the "A" items, there is virtually no opportunity to increase prices successfully. These items are frequently purchased, so customers are very knowledgeable of pricing. To use an unpleasant term, these items are commodities.

At the other end of the product spectrum, the "D" items represent a genuine margin-improvement opportunity. However, too often the profit potential is overlooked or even disparaged.

Frequently, the sobriquet "D stands for dog" prevails. After all, the D items are usually only about five percent of total company sales. Seemingly, there is nothing to capitalize on here. In fact, if anything, the firm would like to eliminate the D items because they are such slow movers.

The reality is that the D items represent a substantial opportunity. This can be understood by reviewing the results of the Profit Report published by DHI. That report presents a wealth of information on distributor profitability.

According to that report, the typical DHI member generates $15 million in sales and operates on an overall gross margin percentage of 30 percent of sales. This results in $4.5 million of gross margin dollars. *(For more on the Profit Report, an exclusive benefit of DHI membership, go to* *page 56**).*

The D items, comprising the last five percent of sales, only account for $750,000 in total revenue. Seemingly, this is not enough to impact the business in any meaningful way. This is why the D items become the "Forgettable Last Five Percent" mentioned in the title.

For many firms, a reasonable expectation is to increase the prices on the D items by 10 percent. At first blush, this may seem like an unrealistically large increase. However, experience throughout distribution suggests it is much more attainable than generally thought.

For the typical DHI member, a 10 percent price hike represents an increase in both sales and gross margin of $75,000. This is because the price increase raises sales even as the cost of goods sold remains constant. All of the price increase becomes a gross margin increase. This is the power of pricing.

The additional $75,000 from enhanced D-items pricing increases both total-firm sales and gross margin by the same amount. The result is that sales grow to $15,075,000, and gross margin becomes $4,575,000. The new gross margin percentage is 30.3 percent, an increase of 0.3 percentage points.

In a gross-margin sensitive world, it is a significant improvement. The only problem is that few firms feel it is attainable. There is a lingering sentiment that D items are also price sensitive.

## Finding the Margin Opportunities

The challenge in dealing with D items is to find what are commonly referred to as "blind items." These are the products for which customers have only a general idea regarding the price and are probably not price sensitive. Typically, product availability outweighs price as a value-added service to customers.

Exhibit 1 presents a list of the most common attributes of blind items. There are no SKUs that possess all of these characteristics. The key is to discern which SKUs have at least three or four of them.

At the very top of the exhibit, the most obvious characteristic is that they are slow selling. This criterion encompasses all of the D items and may well include an important portion of the C items as well. However, this combination of D and C items must be winnowed down to ensure they are truly blind.

The other factors in that analysis are outlined in Exhibit 1. As a practical matter, almost none of the D items and only a few of the potential blind C items will fall by the wayside. The reality is that there are a lot of blind items.

Two very real issues get in the way of raising prices on blind items, though. The first is identifying them. The second is believing that they are truly blind.

Finding items with three or four of the characteristics listed in Exhibit 1 can be an extremely tedious undertaking. This is especially true since most distributors carry a large number of SKUs which necessitates a lot of time spent reviewing.

The workload can be diminished by focusing on two factors first—low sales level and low price. SKUs can be screened on these criteria easily and quickly with any IT system. A few SKUs may be missed, but the impact should be modest. Then human intervention is only required to identify the SKUs that add a second or third component from Exhibit 1.

Believing that the items are truly blind is a much more serious issue. Inevitably, one customer will complain about the price of one random SKU. At this point, the entire margin-enhancement process lives or dies.

Price complaints come with the territory for any distribution organization. Complaints on A items can be fatal. Complaints on blind items can be overcome with commitment and discipline.

## Moving Forward

Gross margin pressures are not going to go away. The challenge—and opportunity—for distributors is to remain price competitive where necessary, while raising prices where possible. Blind items are the key to that approach. ■

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**EXHIBIT 1**

### The Common Characteristics of Blind Items

| CHARACTERISTIC | IMPLICATION |
|---|---|
| Low sales level | Bought rarely; unlikely to remember the last price paid |
| Not heavily promoted | Information about price not readily available |
| Bought only when needed | Availability more important than price |
| Low price | On a small item, no real concern about price |
| Repair parts | Buy something small; avoid replacing something large |
| Unusual | Hard to find; availability is key |
| Non-seasonal | No need to discount "in season" |
| Unbranded | Difficult to obtain specific price information |