Who's Afraid of the Big Bad Price Increase?

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Given the current economic environment, it seems likely that some important price increases will work their way through almost every line of trade in the economy. Most distributors tend to approach supplier price increases with more than a little trepidation. The more the distributor's operation is functioning smoothly under current inbound and outbound pricing arrangements, the lower the degree of eagerness to make changes.

Despite these concerns, the reality is that supplier price increases are an unparalleled opportunity to increase profit. However, achieving that profit improvement requires a reversal in the thinking of distributors. Price increases may never be welcomed, but the profit potential they represent should be.

This report looks at the nature of the supplier price increase issue. It does so from two distinct perspectives:

- **The Short-term Profit Impact**—A discussion of the ways that supplier price increases can provide a one-time boost to profit.
- **The Long-term Profit Impact**—An analysis of the profit impact that supplier price increases can produce over an extended period.

THE SHORT-TERM PROFIT IMPACT

Almost all supplier price increases are announced ahead of time, or at least there are strong hints that a price increase is coming. This provides an opportunity for distributors to engage in advance buying. Additional product can be purchased at current supplier prices. That product can then be marked up to a higher price level when the price increase is announced formally. Advance buying has been a margin-enhancement strategy for as long as there have been distributors.

However, this tried and true approach has fallen into disfavor. In recent years distributors have placed an increasing emphasis on keeping inventory levels as low as possible to a strong cash position. In the trade-off between gross margin and inventory turnover, the victor has been turnover.

The reality, though, is that gross margin is a much more powerful profit driver than is inventory turnover. This can be seen by examining the economics of a hypothetical advance purchasing opportunity.

Assume the firm purchased an additional $10,000 of merchandise today in anticipation of a subsequent 5 percent price increase. The profit impact would be $500 ($10,000 x 5 percent). If the $10,000 represented an additional three months of inventory, the average increase in inventory over the three months would be $5,000. With a carrying cost of one percent per month, the additional cost is 3 percent of $5,000 or $150. Even this cost is overstated as some portion of the inventory investment would be offset by supplier financing.

Clearly, advance buying is a critical strategy to the extent the firm has the financial capacity to make the additional purchase. It is a short-term strategy that needs to come back in favor. With lots of price increases, there are lots of such opportunities.

THE LONG-TERM PROFIT IMPACT

The short-term impact is modest and a one-time event. The long-term impact can be substantial and permanent. Exactly how a price increase impacts a distributors profit hinges on exactly how the distributor responds. There are two distinct responses that produce two very different profit levels.

Exhibit 1 looks at the economics of a 5 percent supplier price increase. All of the figures in the exhibit are for the typical DHI member, based upon the latest Profit Report. The first column of numbers reflects current results. The last two columns examine the two different responses to the price increase.

As a starting point, the typical firm generates $20,000,000 in sales volume. It operates on a gross margin percentage of 30 percent of sales. Finally, it produces a pre-tax profit of $700,000 or 3.5 percent of sales.

The most common response to a supplier price increase is shown in the second column of numbers, labeled Dollar Pass Through. With this approach prices to customers are increased by the same *dollar* amount as prices inbound have been raised by the supplier. It minimizes the "sticker shock" to customers of the new, and higher, price.

With the 5 percent price increase from suppliers, cost of goods sold rose from $14,000,000 to $14,700,000, an increase of $700,000. Sales volume goes up by the exact same amount. The result is that gross margin dollars remain constant. Assuming that expenses remain the same, profit also remains the same dollar amount. If expenses increase with higher sales, profit would actually fall.

The last column of numbers is labeled Percent Pass Through but should be labeled "Don't Ever Do Anything But This." It involves passing through a 5 percent outbound price increase because of the 5 percent inbound supplier price increase. In doing so, sales, cost of goods and gross margin all rise by 5 percent.

Assuming once again that expenses remain the same, profit literally explodes, growing by 42.9 percent to $1,000,000. The new pre-tax profit margin is 4.8 percent of sales. This approach changes the entire profit structure of the firm. The change is not a one-time event; it is permanent.

What this means is that supplier price increase have the potential to provide a major enhancement to bottom-line profit. Theoretically, distributors should welcome the inevitable price increases.

In reality, the potential jubilation is offset by the emotional panic that sets in when higher prices have to be communicated to customers. If it were only one SKU with a price increase, then the firm's MIS system could simply apply the same set mark-up and raise the price of the item by 5 percent. Perhaps the increase would go unnoticed. Unfortunately, it is usually an entire product line or an entire product segment that is affected. It is big and noticeable to the entire world.

The perception among distributors today is that competition is more vicious than it has ever been. In such an environment, firms often retreat back to the dollar-for-dollar pass through. Strategically the goal is to find the level of a price increase that will minimize customer complaints. It is an admirable strategic approach, but an ill-fated profit approach.

All of this leads to an important rule: When prices are rising, follow the percent-for-percent price increase formula to drive higher profit. So easy to understand; so difficult to do. Like so many other things in life.

MOVING FORWARD

Pricing will probably always be the most difficult decision process for distributors. Simply put, no firm wants to be perceived as charging excessive prices. This means that when a supplier price increase materializes there will be the inevitable temptation to raise prices using the dollar-for-dollar approach. Whenever possible, the percent-for-percent approach needs to be substituted. +

EXHIBIT 1

THE IMPACT OF DIFFERENT PRICE STRATEGIES FOR THE TYPICAL DHI MEMBER

		5.0% Vendor Price Increase	
Income Statement–$	**Current Results**	**Dollar Pass Through**	**Percent Pass Through**
Net Sales	$20,000,000	$20,700,000	$21,000,000
Cost of Goods Sold	14,000,000	14,700,000	14,700,000
Gross Margin	6,000,000	6,000,000	6,300,000
Total Expenses	5,300,000	5,300,000	5,300,000
Profit Before Taxes	$700,000	$700,000	$1,000,000
Income Statement–%	**Current Results**	**Dollar Pass Through**	**Percent Pass Through**
Net Sales	100.0	100.0	100.0
Cost of Goods Sold	70.0	71.0	70.0
Gross Margin	30.0	29.0	30.0
Total Expenses	26.5	25.6	25.2
Profit Before Taxes	3.5	3.4	4.8