

# Gross Margin Isn't Enough

Presented to



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Bill Muehlbauer  
Distribution Strategies  
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I'm Bill Muehlbauer

I'd like to thank the LAFA board for inviting me to speak this evening

I've been in the software industry for 30 years, specializing in software for distribution companies since 1991. I actually started in manufacturing, moved to small business, and then to distribution.

You all know the information I'm going to present this evening. You look at it every day.

My goal is to challenge you to think differently about how you measure customer value and move you to take specific actions to improve profitability. The information I am going to present is pretty straight-forward; just about anybody can replicate the analysis methods I will demonstrate.

Feel free to interrupt me at any point if you'd like to add something, challenge something I say, or ask a question.



## How Do You Measure Customer Value?

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- Sales?
- Gross margin percent?
- Gross margin dollars?
- Other?
  
- How about net profit?



## Example One

- |                       |                       |
|-----------------------|-----------------------|
| ■ Customer A          | ■ Customer B          |
| ■ \$100,000 sales     | ■ \$100,000 sales     |
| ■ 40% GM              | ■ 45% GM              |
| ■ \$40,000 GM         | ■ \$45,000 GM         |
| ■ 100 orders per year | ■ 300 orders per year |
| ■ \$140 order cost    | ■ \$140 order cost    |
| ■ \$14,000 cost       | ■ \$42,000 cost       |
| ■ \$26,000 net profit | ■ \$3,000 net profit  |

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Customer A \$400 GM/order

Customer B \$150 GM/order

Customer B looks like the more valuable customer when measured by gross margin contribution. Things look different when you look a little deeper.

\$140 per order is the industry average cost to process an order. This includes the cost to take the order, pick, pack, ship, and invoice the order, carry the inventory and receivable, collections, overhead --- all operating costs spread across all orders.



## Example Two

- |                       |                       |
|-----------------------|-----------------------|
| ■ Customer A          | ■ Customer B          |
| ■ \$100,000 @ 40% GM  | ■ \$100,000 @ 40% GM  |
| ■ \$40,000 GM         | ■ \$40,000 GM         |
| ■ 100 orders per year | ■ 100 orders per year |
| ■ 4 lines per order   | ■ 12 lines per order  |
| ■ \$35.00 line cost   | ■ \$35.00 line cost   |
| ■ \$14,000 cost       | ■ \$42,000 cost       |
| ■ \$26,000 net profit | ■ (\$2,000) net loss  |

A & B look to be of equal value when measured on gross margin contribution, but not so when you consider the extra work to process the extra order lines for B.

A has the industry average 4 lines per order.

These are simplistic ways to look at order costs and they are not the only two ways to look at allocating order costs.



# Order Cost Variations

- Order and line cost components
- Branch variations
- Fixed vs. variable costs
- Business variations
  - Counter sales                      Government
  - OEM                                      Web store
  - MRO                                      Internet / EDI

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Actually there is an order and a line component to the cost of processing an order.

Both costs will vary by branch if you have a multi-branch operation.

You may also look at fixed vs. variable costs associated with an order. Variable are primarily the COGS and labor costs. Fixed costs are those that do not change because you take (or don't take) one more order, such as building, phone system, and computer. An unprofitable customer that at least covers variable order costs, and therefore contributes something to cover fixed costs may bring the added volume you need allowing you to buy in larger quantities. For example – assume an order costs \$140 to process and the variable portion of that is \$75. As long as the average gross margin per order is greater than \$75.00 that customer is contributing to covering fixed costs. Be careful - Looking at all customers this way can lead to disaster.

Order costs will also likely vary based on the different ways you do business – for example, counter sales orders vs. MRO orders vs. OEM orders, or call-in/fax orders vs. orders received over the Internet, or government business vs. commercial business

There are other factors that need to be considered when evaluating the contribution a customer makes -



## Other Considerations

- Special packaging
- Labeling
- Special services
- Payment terms
- Consignment inventory
- Free freight or delivery

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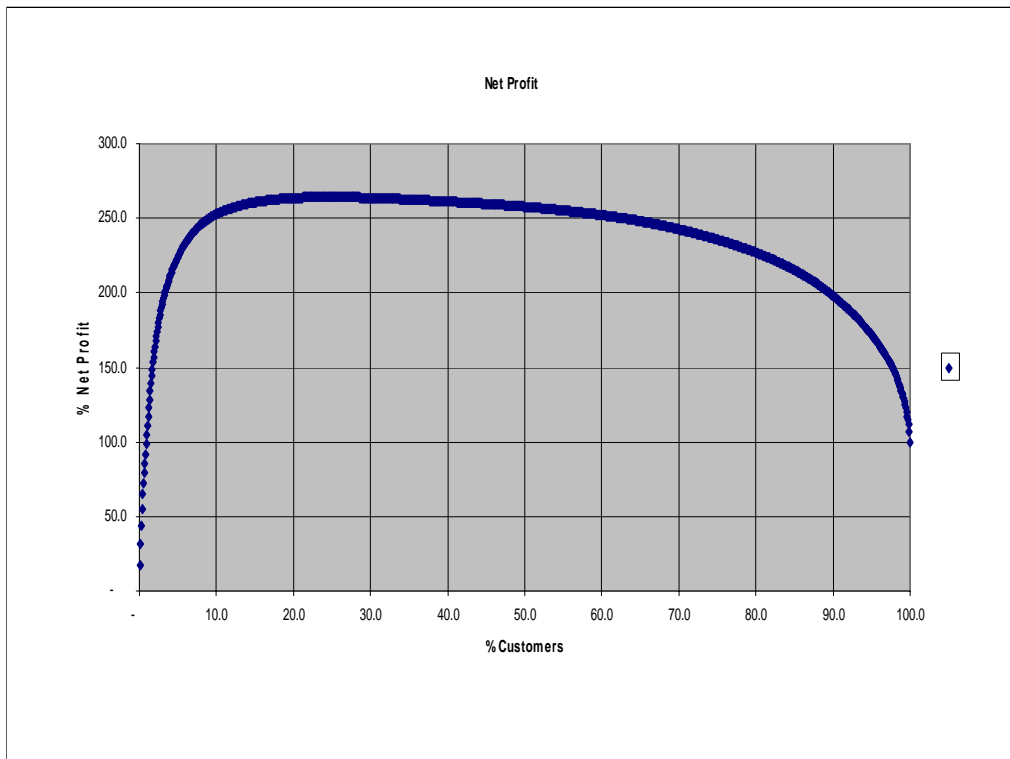
Order processing costs for specific customers can also vary based on other factors. These include such things as requirements for packaging, labeling, on-site services (bin stocking, stock checking), special payment terms (extended or quick-pay), consigned or dedicated inventory, free freight, delivery, or will-call.

I advocate starting your analysis simple. Start with the order and line level cost analysis. Look at line of business and branch variations. This will provide you with a surprising view of your business that will move you to start thinking differently about how you sell and service customers. Then start to spread these costs across the customers that use/drive them.

This isn't an issue of trying to say some customers are bad for requiring extra services. This is to make sure you know which customers are driving your costs so you have the information you need to negotiate contract extensions that are a win for both parties.

Then, after the first round, consider spreading these costs to fine tune your analysis. You don't have to be perfect and you don't need to implement an activity based costing system to accomplish this. Most distributors are too small to be able to afford the expense of an ABC system, even though the resulting value can be significant.

I've heard some people profess a strategy of firing the bottom 25% of your customers. I don't like this generic approach, first because which bottom 25%? Lowest sales dollars? Lowest GM%? Lowest GM contribution? Lowest net profit? How about a different approach?



This graph shows net profit contribution versus number of customers. This is a composite graph from several of my customers.

25% of customers contribute 270% of net profit

Next 50% of customers drain away profits equal to 40% of net profit

Next 15% of customers drain away profits equal to 30% of net profit

Last 10% of customers drain away profits equal to 100% of net profit! These are not little customers!

The middle 50% of customers tend to be the smaller based on sales, so firing them will not have much impact.

At least 1/3 of the bottom 25% will have a better than average GM, so firing based on GM doesn't help.

You need to have a separate strategy to deal with each group.

- Individual account retention programs for the top group
- General strategy to make profitable for the second group
- Raise prices or dump the third group
- Radical evaluation of the nature of the relationship with the bottom performing group – this relationship is probably hurting your customer as well



## Conclusion

- There is more to measuring customer value than gross margin
- Start simple and build on
- Take action each step of the way
- The possibilities for improving profits are significant

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I hope I have been able to demonstrate that there is more to measuring customer value than gross margin.

Start simple and build on. You do not have to start with a full-blown Activity Based Costing system.

Take action each step of the way – you will learn something each time you refine the process. Act on that to improve profitability.

One-to-one account management is key. There is no single approach for all distributors. Each distributor has its own personality.

There is no single approach that even works for all of your branch locations. And, there certainly isn't a single approach that works for all customers.

Yup, this is work. But, the rewards in improved profits, company stability, and customer relationships is worth it.

- The average fastener distributor has net profit before taxes of 2.6%
- The top 25% of fastener distributors average 7.4%
- Every distributor has the opportunity to perform as if in the top 25%

Thank you for your time.



Bill Muehlbauer, principal consultant for Distribution Strategies, has more than 30 years experience helping companies implement information systems to improve bottom line results

[Bill@distributionstrategies.net](mailto:Bill@distributionstrategies.net)

[www.distributionstrategies.net](http://www.distributionstrategies.net)

(920) 922-7499