

Is The Industry Model Obsolete?

Industry Squeeze Play hits Distributors Hardest

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Historically, electrical and other construction material distributors have largely acted as sales extensions for the manufacturers they represent. Judging by statistical evidence and the recent lament of distributors we know, the profitability of that relationship is beginning to break down for the distributor for two major reasons, in my opinion.

First, most construction and industrial material and equipment industries are highly fragmented. There are a lot of buyers and sellers, and that makes it hard to have an efficient supply chain with standardized processes and data. So, costs don't go down so easily. We might have exhausted the opportunities to exact productivity improvements from unilateral one manufacturer or one distributor efforts with their specific supply chain partners. Significant productivity improvements and resulting lower cost structures may depend on the industry's players getting together to standardize more data, processes and practices. But how can **that** happen in a highly fragmented industry?

Second, since the first merchant set up his tent in the Mediterranean, merchants bought at one price from the craftsman, and sold at market price. We'll call this markup pricing mentality. Its purpose is to cover your costs and leave some room for profit, or charge what the market will bear, hoping it's profitable.

Maybe markup pricing mentality has run its course, for two reasons. One, the market isn't bearing as much these days. The market can get access to more and more price information more quickly these days, and that will only get worse for sellers. The other reason is that distributors really don't have much control over price and margins any more. Fact is, they never really did, but it was OK because price pressure wasn't as bad as it is now. But price pressure is fierce, now, and the manufacturer controls 80% or more of that equation if

you believe the PAR reports statistics on average gross profit margins.

A shrinking industry economy has its effects, too. Distributors, hungry for business, will cut the margin to single digits to get gross margin in the door. Manufacturers can point fingers all day and say that distributors are out there "outdumbing" each other, as financial guru Ron Foster used to say. But these cases are the severe cases at the tip of the underlying iceberg that represent a larger, more serious problem with the industry model.

Distributors Don't Sell Their Value.

The manufacturer's value added is in the things they sell, and the direct labor, materials and manufacturing overhead is in excess of 55% of their total costs most of the time. So it makes sense to sell products for a price. But does it make sense for the distributor to do so, too? Maybe not in the face of the squeeze play that's been developing over the last decade as information technology helps customers make smarter, tougher buying decisions and enjoy increased access to competitive pricing among sellers.

Squeeze Play

Customers are asking for more services and a lower price... and getting them. On the other side of the squeeze play, responding to slowing demand, manufacturers are cutting back on shipping days, inventories, and are shifting sales and marketing activities to distributors, who often unwittingly bear the cost of these. Or, at best, are aware this is happening but are not well equipped to assess the cost, suffering the consequences later. The result will ultimately force distributors to cut people, inventory and customer service performance. And that's not good.

I repeat: Distributors have historically bought products at a certain price, and marked them up to hopefully cover their costs. As long as they covered their costs, things were fine. But "things" aren't fine any more.

Is There a Fix?

If the industry model is obsolete, what's the root of the problem? Since distributors don't sell their value added, that puts a lot of pressure on price to exceed costs, and a lot of pressure on knowing your costs for each kind of transaction, which is a problem. Most distributors don't know their costs.

Sure, distributors know their costs, you might say. But they only know them as an aggregated abstraction called the operating statement. If you have the PAR report, you can quote what percentage of sales each ledger account represents. (That goes for manufacturers, too, for the most part). However, few distributors have real knowledge of the cost of activities which make the operating statement come out the way it does. Maybe the fix is to calculate and sell your value added.

I'm not talking about selling quantified user benefits and cost avoidance from fewer mistakes. That's fine if you're bright and mathematically inclined enough to do it, and miraculous if you can get a customer to buy based on it. I'm talking about selling services as discrete line items as opposed to products only. The sole practice of pricing by marking up products can only serve to make an industry that doesn't have a good handle on its costs to eventually implode as customers put more and more pressure on price and manufacturers look to distributors to pick up more sales, marketing and logistics activities.

As extensions of manufacturers, distributors sell products, but it might be better for the industry if distributors invoiced the product at cost, and charged the customer for services. If you really knew your cost of services, it might be a lot easier to price these more accurately in relation to costs, hence easier to stay ahead of costs.

But that assumes a distributor knows what to charge for services. In order to know what to charge, you either price for value received, which is more nebulous and harder to prove, or, another way is to calculate what the cost of activities are and charge for these with a profit margin added on. That method might have a better chance of returning distributor to a higher state of profitability.

Ok, that's Utopia, you might say. You might also offer that it wouldn't stick, because too many distributors would continue to give the services away.

And, if the distributor invoiced the product at cost, that would expose cost. Ouch, if you're a manufacturer.

Oops, There Goes the Manufacturer's Cover.

That's another problem. If product cost were exposed to customers, the squeeze play could back up a lot more on the manufacturer. Customers would be giving

distributors last looks that exposed manufacturer costs, exposing the differences in price manufacturers offer to distributors when a customer got a price from two different distributors offering the same brand. Not to mention putting more pressure on manufacturers, which, as an industry, aren't terribly profitable, either.

However, if distributors behaved this way, manufacturers couldn't do much about it. Distributors can sell at whatever price they want to, for the most part. The federal legislature and Department of Justice took care of that in the early seventies.

This is all a lot to think about. It would work if everybody stepped forward and went to a different model at the same time. But, as the saying goes in golf, you have to "hit the ball from where it lies".

Right now, as much as I hate to mix metaphors, the industry model is in a bit of a sand trap, and not everyone sees that we may need to blast out of it.

What Do YOU Think?

If you'd like to comment or offer solutions to the "squeeze play", answer our survey at:
www.channelmkt.com/brokenmodel.htm

See how others answered the survey, too. Which you'll be privy to right after you answer the survey.

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