

# The New Financial Normal May Well Be the Old Normal

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The “New Normal” has easily become the catch phrase of 2020. In distribution, pundits have used it to suggest that working from home will become the norm, that electronic ordering will dominate, that the traditional sales force will be replaced by a “new sales model” and that many other dramatic changes will occur.

Only time will tell if these new work modes continue or if business reverts to a more traditional manner of operating. However, from a financial perspective it makes no real difference which reality holds true. The major drivers of profitability will continue to function in the same manner as before. Further, providing the crucial services which influences the Critical Profit Variables (CPVs) remains essential.

This report will provide a reminder of the interaction between the key components of customer service and the CPVs. It will do so from two distinct perspectives:

- **What Customers Really Want**—A review of the services that customers desire, regardless of how they are provided.
- **The Economics of Customer Service**—An analysis of how meeting these service needs works through the profit structure of the firm.

## What Customers Really Want

Sophisticated customer research has been conducted in distribution for more than fifty years. During that period, in good economic times and bad, in every single line of trade, the same four customer needs rise to the top. They are as close to absolutes as anything in distribution.

These four needs, in order of importance are listed below. Interestingly, price is not one of them. If these four can be met, price becomes a somewhat secondary factor.

**Fill Rate (Service Level)**—Overwhelming the most important service to customers is to have product available when needed. Interestingly, this desire for product availability holds true in industries where fill rates are already high as well as those industries in which product availability is an on-going challenge. In the absence of improved inventory control systems, this top-ranked factor suggests the need for an increase in the firm’s investment in inventory.

**Depth of Assortment**—The second-highest rated factor is the desire for a one-stop shopping experience. This is clearly related to the procurement cost associated with working with numerous suppliers. This finding also suggests that the concept of buyers spending time in front of computers looking from one supplier to another may be somewhat overstated. Meeting this need may also require additional inventory.

**Speed of Delivery**—This is the one area where most distributors have worked to improve performance. In fact, “order today/receive tomorrow” is a fact of life in most industries. This service requirement reflects the fact that customers very often do not plan ahead in their needs for product. It is a reality that a low service level makes providing next-day delivery nearly impossible.

**Order Accuracy**—It makes no difference if suppliers have product in stock and deliver quickly if the wrong item is delivered. Clearly, this is an operating systems issue.

It is important to note that none of the factors involve a desire for distributors to have the world’s best web site. Customers continue to value great service more than the vehicle by which that service is provided.

## **The Economics of Customer Service**

Improving the most-important services has the potential to generate higher sales. At the same time, though, they would seem to argue for an increase in the firm’s inventory. For about the last ten years there has been a push in distribution to reduce inventory rather than increase it. It is useful to see how addressing the service requirements impacts the CPVs of the firm and thereby profit—either positively or negatively.

Exhibit 1 examines the economics of using inventory availability to drive higher sales. The exhibit provides results for an illustrative distributor. As can be seen in the first column of numbers, the firm currently generates \$20.0 million in sales, operates on a gross margin of 25.0% of sales and produces a pre-tax profit of 2.5% of sales or \$500,000.

To understand how sales and margin changes work through 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 are relatively constant in the short run, even if sales rise or fall.

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 firm are assumed to be \$3,500,000 while variable expenses are 5.0% of sales. While these are only estimates, they represent a serviceable approximation for many distribution firms.

The last column of numbers look at the profit implications of a sales increase of exactly 5.0%, while maintaining the same gross margin percentage. It is assumed that the increase arises from better inventory control that does not necessitate a larger investment in inventory itself. In essence, it involves having things that customers want to buy when they want to buy them by refocusing the inventory.

As can be seen, profit before taxes increases from \$500,000 to \$700,000. This is an improvement of a very significant 40.0%. However, this is before any increase in inventory to support the added sales and the inventory carrying cost associated with that increase in the inventory.

The bottom part of the first column examines the inventory investment the firm currently has. For the illustrative firm this is \$3,000,000. Below that is the cost of carrying the inventory—interest, obsolescence, shrinkage and the like. In today's economy this figure is probably no more than 10.0%. This dollar figure is already included in the fixed expenses in the top part of the exhibit.

The last column in the bottom part of the exhibit examines how much of an increase in inventory the firm could absorb in order to generate the 5.0% sales increase. This part of the exhibit assumes that the entire increase in profit in the top part is taken up by additional inventory carrying costs. That is the carrying costs increase by the same \$200,000 that resulted from the 5.0% sales increase. The result is that inventory could increase by a rather staggering \$2,000,000, or 66.7%.

It seems unlikely that the firm would require anything close to a 66.7% increase in inventory to generate 5.0% more sales from enhanced service. In short, meeting customer needs for a higher fill rate and a broader depth of assortment should be attainable. The economics are overwhelmingly in favor of increasing inventory somewhat, or possibly even significantly to generate more sales.

## Moving Forward

Managers in distribution are under strong pressures to hold the line on the investment in inventory, or possibly even to reduce the investment. However, customers are continually making service demands that may necessitate more investment. Further the trade-off of increasing inventory to support higher sales is overwhelmingly positive.

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### About the Author:

Dr. Albert D. Bates is founder and Principal of the Distribution Performance Project, a distribution research firm headquartered in Boulder, Colorado. He is the author of *Breaking Down the Profit Barriers in Distribution*, a book that should be read by all operating managers.

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**Exhibit 1**  
**The Profit Impact of a Sales to Inventory Trade-off**

<b>Dollars</b>	<b>Current Results</b>	<b>Sales to Inventory Trade-Off</b>
Net Sales	\$20,000,000	\$21,000,000
Cost of Goods Sold	<u>15,000,000</u>	<u>15,750,000</u>
Gross Margin	5,000,000	5,250,000
Variable Expenses (5%)	1,000,000	1,050,000
Fixed Expenses	<u>3,500,000</u>	<u>3,500,000</u>
Total Expenses	<u>4,500,000</u>	<u>4,550,000</u>
Profit Before Taxes	\$500,000	\$700,000
Increase in Profit--%		40.0
<b>Percent of Sales</b>		
Net Sales	100.0	100.0
Cost of Goods Sold	<u>75.0</u>	<u>75.0</u>
Gross Margin	25.0	25.0
Variable Expenses (5%)	5.0	5.0
Fixed Expenses	<u>17.5</u>	<u>16.7</u>
Total Expenses	<u>22.5</u>	<u>21.7</u>
Profit Before Taxes	2.5	3.3
Inventory	\$3,000,000	\$5,000,000
Carrying Cost (10%)	\$300,000	\$500,000
Increase In Inventory--%		66.7