**Chapter Four**

**Managing the Big Three, Part Two:**

**Gross Margin**

Time to deal with a sad, immutable law that has hounded the entire book. Namely, the greater the impact of a CPV, the more difficult it is to improve. Conversely, “If it were easy, everybody would do it.”

Welcome to gross margin. The king of the CPVs, but ferociously resistant to improvement.

This discussion will be divided into two different sections with two very different topics. The first address gross margin slippages. That is, how gross margin can deteriorate in even the best-run businesses. The second will cover two specific methods for enhancing gross margin.

**Gross Margin Slippages**

As just stated, it is important to understand exactly how gross margin slips away, often without knowing it is happening. There are three primary opportunities for slippages. The first, and most infuriating, is assuming that price cuts can be offset by volume increases. The second is the inability of the sales force to hold the line on prices. The final slippage is handling short-term vendor price reductions incorrectly.

The intent at this point is not to increase gross margin. The challenge is to stop the bleeding as gross margin slowly wanders downhill.

**Making It Up With Volume**

The primary slippage revolves around the fact that many employees—let’s call them sales reps for want of a better term—feel that the company can “make it up with volume.” If prices are lowered enough to generate additional volume, the result will be measurably higher profit.

The role model for this thinking is Walmart. After all, it has employed a low-price strategy and has been incredibly successful while full-price competitors have fallen by the wayside. The text will review Walmart as a role model at the end of this section. But first, let’s spend some time with the illustrative distributor that every reader has come to know and love.

**Exhibit 12** provides a look at the implications of making it up with volume for this distributor. Egads! There are a lot of numbers there. Not as tough as it looks, though. No skimming.

The first column reviews the firm in its present condition, numbers that have been shown ad infinitum. The top of the exhibit has a few additions. The first is the average line value, $250.00, which was seen before in Exhibit 10 on the discussion of order economics.

The next is the cost of goods sold per line. Since the firm has a gross margin of 25.0%, this number must be 75.0% of the average line value or $187.50. Finally, to get to $10.0 million in sales the firm must process 40,000 order lines annually. Everything on the income statement flows from these input items.

The last two columns examine the impact of a 5.0% price reduction, implemented across the board. That is, all prices to all customers on all items are reduced by 5.0%. Admittedly, this is an off-the-wall assumption, but it demonstrates the challenge of cutting prices. The concept applies equally when a few price reductions are offered to a few customers.



The middle column has been labeled *Worst Case* and is what often happens when prices are cut. Frequently, that result is no increase in sales. The most likely explanation is that competitors refuse to be underpriced. They respond in kind and everybody keeps about the same market share as before.

With the same number of transactions, or lines filled, as before, but with a 5.0% lower price per line, dollar sales fall by 5.0%. Cost of goods sold stays the same, however, as the supplier’s price per item sold does not fall. The supplier has nothing to do with the situation so far. The net result is that gross margin dollars fall by the same exact amount as sales fall. In this case, $500,000. Already trouble brewing.

Variable expenses also fall by 5.0%, but fixed expenses remain the same. The net result is that the $200,000 profit turns into a $275,000 loss, a percentage drop of 237.5%. Somewhat more than a modest decline.

**Selling More—**The immediate and obvious conclusion is that if prices are going to be cut, then volume needs to increase enough to offset the price reduction. This necessitates having incredibly stupid competitors who will watch the company take market share. This is a weird assumption, at best, but let’s go along with the gag. The challenge is determining how much of a volume increase is required to “make it up with volume.”

Since the middle column was labeled *Worst Case*, parallel construction demands thatthe final column be labeled *Best Case*. No such luck. That would require understanding the nature of the demand curve which is well beyond this discussion and way beyond the author’s skill set.

Instead, the last column is labeled *Possible Case*. It is a specific scenario which has been chosen to represent yet another profit homily: “We need to get a bigger truck.”

The average transaction still reflects the 5.0% price cut while the inbound price from suppliers is still unchanged. The number of order lines has risen to 52,459, an increase of 31.1%. Admittedly, this uneven number seemingly is pulled at random from the ether. With any luck there will be a method to the madness. Stick with it.

Dollar sales increase by 24.6%. While there is 31.1% more work to be done, part of that extra effort is offset by the 5.0% price reduction. Yet another trade-off in life.

While dollar sales are only up 24.6%, cost of goods sold rises by the 31.1% figure. The company is purchasing 31.1% more product at the same price. This is good for the suppliers, but maybe not so good for the distributor. In essence at this point the distributor is working for the man.

Variable expenses do what they do automatically and rise by the same 24.6% as sales, while fixed expenses remain constant. The final result is that profit remains the same $200,000 as before.

Yes, Virginia, there really is a method to the madness. The price cut wasn’t really all that wonderful. The firm had to process 31.1% more transactions to keep profit the same as it was before the price cut. No problem, that’s what Sundays are for.

**Reality Check—**Good old Exhibit 12 has two key items that could be challenged. One says it might be even worse than shown, the other says it might be better. With any luck they will offset each other.

How could it possibly get any worse? Even though the number of transactions rose a lot in the final column, the fixed expenses did not change. That seems like a stretch. If the firm can process 31.1% additional activity with no increase in the fixed expenses, then a more immediate profit solution comes to mind. Fire 31.1% of the employees.

How about making it better? When the number of transactions was increased by 31.1%, the firm did not lower its cost of goods per transaction. Suppliers did not respond to the increase in purchases (31.1% more) with lower prices. Instead, they offered the distributor a free round of golf at the next trade association convention.

With some effort there likely would be an opportunity to “reason together” with suppliers to buy more advantageously. That is an extremely important point that will rear its anointed head in the next major section. Stay tuned.

So, did the two factors balance out? Every reader will have to make that decision individually. The author feels they are pretty close or the exhibit would not have been put forward. Like most topics, the author’s opinion is no better than the reader’s opinion.

**Moving Beyond a 5.0% Price Cut—**In the exhibit, the price cut employed was exactly 5.0%. That is nothing more than one of many figures that could have been used. As it turns out, the relationship between the price reduction used and the increase in the number of transactions required to maintain profit has an unexpected relationship. That relationship is shown in lucky **Exhibit 13**.

The exhibit matches up any choice of a price cut with the necessary increase in the number of transactions required to merely maintain profit right where it was originally. The price cuts shown in the exhibit range from 1.0% to 10.0%.

At the minimal 1.0% price cut level the increase in workload (number of transactions) is a relatively modest 5.0%. The firm might well be able to increase the workload by this amount without having to increase the fixed expenses. At the same time, though, a 1.0% price reduction might be greeted with a big yawn in the marketplace.



When the price reduction is increased from 1.0% to 5.0% the workload required to maintain profit is not five times as large. That would be a 25.0% increase. Instead, the workload increase is the 31.1% figure first seen back in Exhibit 12.

In the same fashion, if the 5.0% price cut is moved to 10.0%, the workload required does not double from 31.1% to 62.2%. Instead, it bumps up to 90.5%. The relationship is not linear, it is geometric. The larger the price cut the more dramatic the increase in workload required to maintain profit.

There is an old (and probably dumb) saying in management: “The hurrier I go, the behinder I get.” It seems to apply here.

At this point the reader is still wondering about Walmart. Did the author let it slip? The author is not senile, merely senescent (the author’s doctor uses this term instead of very old). Walmart is way too big to be forgotten.

Walmart delivers on the low price/high volume strategy with two major efforts. First, it beats the suppliers to a bloody pulp. Second, it guts every expense that is not essential. Distributors might enjoy the beating up part, but the expense cutting is problematic.

To cut expenses to the extent needed requires a “nothing is sacred” view of expenses. Eliminate delivery, credit and the sales force for starters. After that, go after everything else. Maybe even management salaries. That’s probably a bridge too far.

The overwhelming majority of distributors are comfortable with the manner in which they operate now. They tend to think that a strong service profile is essential to meet customer needs. Eliminating a lot of services is the classic tiger changing its spots.

It is not inconceivable that distributors could morph into a low price/high volume operation. However, the risks are at least as high as the rewards. Might be best to maintain the business as it exists. Keep eliminating slippages, and as will be addressed in the last section, strive to actually increase