The Race to Provide Services Nobody Really Wants

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Distributors in virtually every line of trade have worked hard to increase their service profile through the years. As one obvious example, the time between receipt of a customer's order and delivery has shrunk dramatically. The list of other, equally significant, service enhancements is lengthy.

Today, distributors continue to look for additional ways to enhance "service" in order to lock in their customers. The problem is that all of these new and better services increase payroll costs with no guarantee of actually locking in the revenue. If they don't, distributors will suffer from payroll expense creep.

This report examines the nature of the service revenue/service cost issue. It will do so from two important perspectives:

- **The Revenue/Payroll Relationship**—A analysis of how sales and payroll growth interact to drive profit in the firm.
- **A Profitable Service Profile**—Some specific suggestions for ensuring that service enhancements actually lead to profit improvement.

The Revenue/Payroll Relationship

Throughout the distribution industry payroll is the overwhelming expense factor. This can be seen clearly in **Exhibit 1** which presents the current performance of a typical distribution firm.

As can be seen in the first column of numbers, the typical firm generates $20,000,000 in sales, operates on a gross margin of 25.0% of sales and produces a bottom line profit of 2.5% of sales or $500,000. Of most significance, payroll is 15.0% of sales or 66.7% of the total expense load for the firm.

In some instances distributors may feel they are forced to enhance their service profile in the face of new offering by competitors. In other instances, firms are seeking to establish their own competitive advantage. In either instance, the key profitability issue is how much of a sales increase can be generated, if any, in relationship to the payroll cost associated with providing the additional service.

The last two columns of numbers in Exhibit 1 present the potential good and bad results associated with an increase in payroll expense. In both columns it is assumed that the increase in costs is associated with an additional service. Further, in both columns payroll costs are assumed to increase by exactly 3.0%.

The middle column of numbers represents a situation where the increased payroll costs are offset by a 5.0% increase in sales. In short, the firm has developed a service-enhancement profile. Total profit increases by 32.0% and the bottom line rises to 3.1% of sales.

The final column, in very sharp contrast, reflects a situation where payroll costs increase due to the additional services offered, but revenue is stagnant. This might represent a situation where all of the competitors increase services at the same time resulting in no measurable change in market share.

The economic impact is dramatic. Profit declines by $90,000 or 18.0%, even though the increase in payroll was only 3.0%. In short, service expansion programs must generate the revenue to cover their costs and produce enough additional revenue to drive higher profit.

Research in distribution suggests that in many instances service expansions are less likely to reflect second-column economics in Exhibit 1 than third-column ones. Simply put, the value of the additional services may not be there.

A Profitable Service Profile

In building a service profile that drives sales growth faster than payroll growth there are two opposing strategies that can be followed. First, add or strengthen truly profitable services. Second, minimize or eliminate unprofitable ones. As simple as this may sound, it actually has somewhat counter-intuitive implications in terms of the potential changes in the service profile.

Service Strengthening—Research conducted by the Profit Planning Group indicates that with very few exceptions, customers do not desire any additional services from distributors. Instead, they would like some existing service components strengthened. In particular they want better performance with regard to inventory.

The inventory needs expressed were two-fold. First and foremost they desired an improved in-stock position. Second, they desired a broader assortment to facilitate the ability to engage in one-stop shopping.

To a real extent this is a serious condemnation of distributor performance. The most essential role of distribution is product availability. Failure to perform adequately in this arena is simply unacceptable. The pressures associated with cash flow are an excuse for inventory inadequacy, but not a valid reason.

The economics of improving service through better inventory performance are extremely compelling. Additional inventory investment comes with a carrying cost implication. However, in today's environment of low interest rates, carrying costs are dramatically reduced from previous periods.

On the positive side, a higher fill rate is one of the few services enhancements that automatically generates higher sales volume. Every lost sale, whether caused by being out of stock or anything else, is a pure loss of volume. Eliminating lost sales reverses the economics of the third column in Exhibit 1.

Service Elimination—While it is heresy to suggest, but there may be some services that everybody in the firm thinks are wonderful, but customers find to be without benefit. This is often a surprisingly fertile field for profit enhancement.

In service elimination a reasonable motto would be to "copy the banks, not the airlines." Banks no longer return checks with the monthly statement. Most customers find having less to throw away to be an actual benefit. ATM machines have largely, but not completely, replaced tellers. Self-service means better service for the preponderance of customers.

Airlines, in sharp contrast, have started charging extra for meals, blankets, checked bags and just about everything else. Customers go along with the add-on charges because they have to. Even if fares are lower, there is a continual bitterness about the service reductions.

The best way to determine if a service elimination decision is a bank action or an airline action is to ask customers. Often the feedback is enlightening. When the firm discovers it has been able to brilliantly providing a service that nobody really cares about, it is an eye-opener.

Moving Forward

All distributors sell products. The best ones also provide an array of services that customers value. The challenge is to identify exactly which services are truly important to customers and which ones are not.

The valued services must be provided with absolute precision. The ones that are non essential should be bid adieu.

About the Author:
Dr. Albert D. Bates is founder and president of Profit Planning Group. His latest book, ***Breaking Down the Profit Barriers in Distribution***, is available at Amazon and Barnes & Noble.

Exhibit 1
The Impact of 3% Payroll Expense Creep
For a Typical Distribution Firm

Income Statement--$	Current Results	5% Sales Growth	No Sales Growth
Net Sales	$20,000,000	$21,000,000	20,000,000
Cost of Goods Sold	15,000,000	15,750,000	15,000,000
Gross Margin	5,000,000	5,250,000	5,000,000
Payroll and Fringe Benefits	3,000,000	3,090,000	3,090,000
All Other Expenses	1,500,000	1,500,000	1,500,000
Total Expenses	4,500,000	4,590,000	4,590,000
Profit Before Taxes	$500,000	$660,000	$410,000
Income Statement--%			
Net Sales	100.0	100.0	100.0
Cost of Goods Sold	75.0	75.0	75.0
Gross Margin	25.0	25.0	25.0
Payroll and Fringe Benefits	15.0	14.7	15.5
All Other Expenses	7.5	7.1	7.5
Total Expenses	22.5	21.9	23.0
Profit Before Taxes	2.5	3.1	2.1
Change in Profit--%		32.0	-18.0