PRICE INCREASE MANAGEMENT GUIDE FOR DISTRIBUTORS

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INTRODUCTION

January/February is price increase season for many distributors. A small difference in how effectively the price increase is implemented can make a tremendous difference on the how the rest of the year will shape up financially for the distributor.

- If the price increase is not implemented effectively, the distributor may be in for a year of chasing volume, just to make up for lower-than-planned margins, so overall EBIDTA goals are achieved. To compensate for a 1% "miss" in pricing-driven margin performance vs. plan, a distributor operating at a 20% margin needs to generate 5% incremental sales just to break even vs. plan at the EBIDTA line.
- On the other hand, an increase that results in transactional price points that are sustained at higher, planned levels can be a key driver of successful financial performance for the year, allowing the business to focus its resources on important strategic initiatives.

Given the substantial financial impact, many distributors would benefit from increased attention to managing the price increase process in their business. In our experience, successful price increase management processes for distributors can be implemented in the following 5 steps, as described in this Guide:

1. Plan/Define Increase Objectives by Major Market
2. Segment and Analyze
3. Communicate
4. Negotiate
5. Monitor and Manage the Process

This document provides and overview of best practices in relation to each step in the strategic distributor price management process.

1. PLAN/DEFINE INCREASE OBJECTIVES BY MAJOR MARKET

Distributors start by defining high-level objectives for the price increase. What does "success" mean for the pricing action being planned? Many distributors simply look to pass on product cost increases to the market (either as dollar for dollar, or percent for percent). Margin targets might also be defined in the financial plan for the year.

Pricing excellence in a typical distribution business means more than simply passing on inflation. Strong pricing practices involve continually looking for opportunities to expand margins where market can bear higher price levels. Given typical "stick rates" associated with price increases in the distribution industry, this type of mindset of **shooting to "outperform" product cost inflation is often necessary,** when it comes to setting nominal price increase targets for distributor pricing actions. Due to discounting/exceptions, many distributors end up realizing only a portion (say 50%) of the nominal price increases they attempt to implement. In these situations, planning for the price increase should involve developing estimates (based on past performance) of projected actual "stick rates" (see the "Monitor/Manage" section of this Guide for a description of the "stick rate" metric). Absent taking proactive steps upfront to make up for expectable "less than 100%" stick rate performance, the business risks falling behind established profitability goals.

The effectiveness of the pricing action can be further enhanced by **refining the top-down, high-level plan by major markets/business segments**, such as major product categories and customer categories:

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(1) Establish "actual" (invoice-level) price increase targets by major market/business segment, in line with general business strategies (which markets does management want to grow/protect over others, etc.)

(2) Project "stick rates" by market (e.g., stick rates in markets dominated by larger/strategic customers, more sensitive products may be lower – consider past performance by market)

(3) Calculate what "nominal" (system) price increase is needed to achieve targeted actual price increase levels in each major market, given projected market-specific stick rates.

Pricing professionals should typically take the first stab a presenting a high-level "price increase" plan at this level of detail, which executive management can review and tweak as appropriate.

2. SEGMENT AND ANALYZE

Once high-level objectives are set by major market, each market/business segment should be analyzed in more detail, using segmentation techniques. A detailed discussion of segmentation for pricing in distribution is beyond the scope of this document. Generally speaking, the analysis should **segment both customers and products** in each major market, using factors/attributes that

- are believed to drive **price sensitivity** in the business, and
- allow to differentiate pricing strategies and tactics to reflect applicable **business strategies,** which can vary between major markets.

There are many factors that can drive price sensitivity in distribution, and each distribution business (like a "snowflake") is somewhat unique as to the mix of relevant attributes and the interactions among them (thus, we recommend developing segmentation models customized to the characteristics of the particular distribution business). Business strategies can vary widely as well. Here are some general rules of thumb that can help get a segmentation analysis started in a typical distribution business:

	Product Segmentation	Customer Segmentation
Price Sensitivity Factors	- Purchase frequency - How widely product is carried by competitors (differentiated vs. more "commodity" type) - Cost range (most likely to "catch the eye" on an invoice), may want to pass on cost hike $s (rather than cost hike %) on higher-cost items. - Product categories in product hierarchies	- Competitive landscape (may vary by geography), and anticipated reaction/activity of competitors relevant at that customer - How the customer uses the product (at times may correspond to customer industry classification). Is it simple for customer to pass on the cost hike? - Is the customer's spend with us a large part of their total spend? - Does the customer understand and appreciate the benefits associated distributor's value-add services? Are there switching cost?
Strategic Factors	- "New"/"Growth" products, where management especially wants to grow volume - More profitable products - Stocking levels (avoid price hikes on SKUs with excessive stock levels) - Complimentary products (e.g., the losing the sale for one product can lead to lost sales on other SKUs) - Availability of lower-priced substitutes (if price is an issue, can a lower-priced alternative be suggested)	- Larger accounts (more volume at risk) - High visibility/"flagship" accounts (losing these may affect the perception of the business in the market generally) - More profitable accounts (after considering cost to serve, such as freight, returns, rebates, etc.) - How likely are they to share pricing data with others? If we give them a discount, will others learn and demand the same?

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System records can be updated based on the output of the segmentation analysis. System updates typically involve records relating to both cost and price fields. Product cost records are typically updated in line with actual supplier cost changes (though for items with excessive stock positions, further discussion may be warranted before applying cost increase updates).

Many distributors who operate cost/margin-based pricing structures also have special "cost fields" and/or cost elements they use to manipulate product cost data that is visible to the sales force. The objective of manipulating these cost fields is often to attempt to raise prices in the absence of real supplier-driven product cost-hikes, by trying to "trick" the sales force and customers into believing that an actual cost hike occurred. In our experience, relying on this type of **cost field manipulation is not an optimal price execution strategy** in the long run. The sales force almost inevitably learns about the manipulated cost factors. When they do, they lose confidence in the validity of system cost- and price information, which in turn makes them more prone to discounting. There are other proven, effective ways to address situations where cost-based pricing mentality becomes an impediment to extracting willingness to pay (that discussion is beyond the scope of this Guide, however).

At the time of updating the cost fields, strong pricers also look for **opportunities for refining/updating price multipliers/markups/discounts**, so resulting system prices are more in line with willingness to pay. Price optimization methods are especially powerful in this type of exercise, and their application typically suggest price reductions (lower markups/multipliers, or higher discounts off list prices) for certain customer/item combinations. They tend to highlight situations where the distributor's competitive price position is already too high (these situations are often possible to pinpoint through optimization, even in the absence of direct competitive pricing data), where attempts to raise prices further is likely to lead to volume loss. Price drop opportunities may also exist for items that are being phased out and/or are in excess stock positions. To the extent price drops are implemented on a subset of customer/item combinations, an opportunity may exist to "message"/"position" the pricing action as a price update/adjustment, which incorporates vendor increases but also includes price drops on select items (rather than a pure "price increase").

3. COMMUNICATE

Once there is alignment on what the pricing action will entail, the business should prepare to communicate to customers and to the market.

Customer-facing communications on price increases should be **worded in a matter of fact (but not arrogant) fashion**. While sales professionals may show empathy for their customers, they should not be apologetic when it comes to discussing the price increase.

Sales professionals should **be prepared to communicate details** regarding the increase (what products/product types are affected at specific customers), and be able to correctly message the rationale for the pricing action. Messaging typically should involve at least the following two topics:

1. **The price increase is not unfair**: The overall message here is that the increase is not about the distributor getting "greedy." Explain that the increase is prompted by supplier cost actions, and make select materials from suppliers available (cost increase notifications, public announcements, commodity indexes, etc.). Point out that the increase is within the realm of reason on key items ("few percent" price change), and be ready to describe specific items that

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may be dropping in price pursuant to optimization analysis. Also describe any steps that the distributor has taken/is taking in an attempt to avoid/delay a price increase.

2. **The price increase is not optional:** The overall message here is that it is necessary to pass on the cost increase in order for the distributor to continue providing the level of service the customer needs and has come to expect. Review the value proposition of the business, and be prepared to discuss specific, recent examples showing how you are continuing to invest your profits to better serve your customers. Have you launched a new web-based customer service portal? Opened a new branch? Improved your fill-rates? Developed a new, state-of-the-art catalogue? Gone beyond the call of duty to deliver products after-hours, or to find suppliers for unusual client needs? Improved your fill-rates? If so, don't hold back from touting your horn, so you can show the valuable investments you are making to better serve your customers!

Distributors vary greatly in their approach to how much detail they proactively share with specific customers. What's the most effective approach? That depends on factors specific to each distributor's business. Among other things, these factors include consideration to past price increase communication practices, which may have created expectations in the customer base as to the level of communication customers should expect concerning distributor pricing actions.

As a general rule of thumb, larger, more **strategic customers tend to receive more detailed communications**. This is often necessary given EDI relationships, contractual obligations, and as a way of ensuring these accounts do not get a "surprise" they may negatively react to. Price increase communications with such larger, more strategic customers may be formal or informal, and at times may involve contacts from upper management levels from both the distributor and the customer organizations. Smaller accounts, less frequent buyers may not always be given formal notices.

In addition to communicating to customers, some distributors – especially those in a market/price leadership position – may also choose to issue **public announcements** describing their pricing action. Communicating to the market the rationale for price changes can help ensure the same, consistent message is received by all market players, including customers and competitors. While there are legal considerations in ensuring that these communications are not perceived as anti-competitive behavior (and companies are advised to consult with their legal counsels on these matters), there are legitimate and at times useful ways to inform markets of certain aspects of general pricing actions.

4. NEGOTIATE

Distributors should anticipate, and be prepared to manage push-back when they implement significant pricing actions. Some concessions that may be granted could include delaying/reducing/foregoing the price increase on certain especially painful items (not all items, however), doing the same for the entire increase, and in the worst case scenario retracting the increase altogether. To maintain pricing integrity, such **concessions should not be available to be given away** blindly:

1. **Any concession granted by the rep/distributor should be accompanied by some adjustment of value.** That value adjustment can be in the form of either:
    a. Something of value from the customer, such as commitment to giving the distributor more business, opportunity to penetrate the customer with other product lines (be sure to measure performance vs. such pledges); or

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   b. Reducing the value to the customer, such as by way of substituting lower-quality alternative SKUs, or by "unbundling" service elements the distributor might have been providing "for free" (for example, free shipping now tied to larger minimum order quantity thresholds).

2. The distributors should use **objective criteria in deciding what (if any) concession is appropriate,** and how hard to negotiate for value adjustments. Thanks to the segmentation groundwork, such objective criteria are available (segmentation factors such as profitability after considering all cost-to-serve elements, customer size, competitiveness of local markets, likelihood of spreading the word to other customers about exception discounts, etc.), and they are readily available to consult in deciding on what stance to take in negotiating with individual customers.

   When facing customer-specific push back, some distributors take the segmentation analysis further, to better understand when it makes sense to walk away from specific deals, and where to draw hard lines in specific negotiations. Of course, it never makes sense to take hard stances in negotiating with high-volume/highly profitable accounts in highly competitive geographic markets. However, other, sporadic-buyer "cherry-picker"-type accounts might never turn into truly profitable business relationships. When distributors take a harder stance at these types of accounts, they often find little real volume loss. And, does it make business sense for the distributor to reward patterns of "price objection"-behaviors by cherry-pickers, by granting them prices that in some cases may be lower than those charged at larger, strategic customers?

5. MONITOR AND MANAGE THE PROCESS

Setting up the analytics correctly can go a long way towards successful implementation of a pricing action. Still, distributors should monitor how effectively the pricing action is being implemented, and make adjustments where necessary.

One of the most widely used, effective KPIs in this area is the **"stick rate" metric**. Stick rate measures the percentage of the attempted increase that is actually being realized. For instance, if nominal system prices are being increased by 2%, but due to discounting only a 1% increase ends up showing up at the invoice level, then a 50% stick rate would result. Competitors' reactions are also often monitored, to help gauge how different market players behave (do they follow right away, do they aggressively try to take advantage of the situation, etc.).

Measuring the effectiveness of the increase by price segment can help inform the planning processes for future price action rounds. The ability to measure performance by sales rep on the other hand often enables the distributor to **leverage controls and incentives** to improve results.

In organizations where the sales force is compensated based on volume, reps are especially prone to push for discounts. They should not be blamed for doing what makes sense to them. From their perspective, the risks to their compensation associated with the possibility of losing the customer or damaging the relationship grossly outweigh any gains from a modest volume increase that would result from a small (say 2%-3%) successful price hike. Accordingly, it will make much more sense for them to try to negotiate with management to reduce or eliminate the proposed increase, possibly even before attempting to "sell" the increase to their key customers.

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Unfortunately, sales professional often show similar discounting behaviors even in situations where compensation schemes include stronger profit- or price-based elements. This happens frequently, when reps are provided with only aggregate-level information on compensation calculations, and they have no real appreciation for how their everyday pricing decisions actually affect their compensation levels. In addition to training, more detailed, real-time information sharing on compensation calculations can help drive improvement in these situations.

In distribution businesses where incentive schemes are not being leveraged to manage discounting behaviors, other tools are often used to manage rep performance. In some instances, increased visibility to rep-specific “stick rate” performance, along with some type of a “contest” can be considered. However, more frequently, management simply leverages control structures to help keep rep discounting activity in check.

Many distributors have achieved success by **holding reps more accountable** for their discounting decisions, and/or by implementing more stringent rules on **approval-thresholds for discounting**. However, excessive reliance on controls is typically a sub-optimal approach long-term, relative to getting things done by way of incentives, solid analytics, and creating organizational alignment. When pricing processes are managed excessively by way of controls, over time this can lead to inefficient, bureaucratic processes, as well as to unnecessarily building up tensions between departments, which in turn can impede cross-functional team work in the organization. And, if the analytics are done right, the real need for discounting should dissipate, limiting these discussions to be truly “exceptions” rather being part of routine daily operations.

CLOSING THOUGHTS

The effectiveness of price management generally, and of price increase process management specifically, can be improved by investing in organizational capabilities. Leadership, and the availability/development of effective analytical tools, are foundational to success. Once these foundational elements are in place, it should be possible to develop a true partnership between the pricing function and the sales organization. A strong **pricing function can become an ally to the sales organization**, supplying the field with key information, tools, and training materials, enabling them to more effectively compete in the marketplace.

In the area of price increase management, this can translate into providing the field with high-level information on the strategies behind pricing actions (FAQs, guidelines, etc.), practical tools/tactics/talk tracks for use in real-life negotiations, and a fair, practical approach to managing exception requests for exceptions. In many situations, this can also include real-life examples to help sales reps better understand/manage the quantifiable relationships between how they exercise their pricing discretion on the one hand, and how their pricing decisions impact their compensation levels on the other. Training events, formal and informal communication channels, and “pricing councils” are examples of tools to enable productive dialogues around price management in the organization.

ABOUT THE INNOVATIVE PRICING GROUP

The Innovative Pricing Group delivers high-ROI price optimization, value-based pricing, and strategic price management solutions to the distribution and manufacturing businesses.

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