STERLAND
Building Solutions

Building Better Business Program

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Are Your Profit Margins Helping You Grow Or Pulling You Down?

The down turn in the global and local economy has seen consumers and businesses constrain their spending and actively search for the "best" deal. In times like these where there is fierce competition, significant pressure on margins and low sales growth you need to make sure that you're taking all the necessary steps to avoid margin leakage and to increase your profits.

Take a $5 million turnover company for example. If they could increase their gross margin rate by 3 percent, that would add $90k to the bottom line. A recent study in the US indicated that an improvement of 1 stock-turn in inventory results in an additional 8 points of gross profit margin so with some careful, commonsense planning this is quite achievable – even in these difficult times.

In the first of our Building Better Business series we share with you 4 proven drivers to protect and improve your profit margins. Each of these drivers is dependent on acceptance of best practice strategies and adherence to achievable and measurable Key Performance Indicators (KPI).

So how do we do this? Let's have a closer look at the critical drivers that control your margins:

Pricing Management

Experience has shown us that one of the main challenges building supply businesses face is margin leakage. Predominately this is caused by the lack of an efficient pricing management strategy and clearly documented operational procedures.

Cost Recovery Vs Value Based Pricing

There are two methods to set pricing;

» Cost recovery

» Value to your customer.

The cost recovery method is the method most commonly used in the timber, building and plumbing supplies industry because it's the easiest. Normally the process is to add a pre-defined margin to whatever the cost price is and cross your fingers and hope it sells. Understandably this method is used initially because no solid sales data exists on which to base value pricing.

However many businesses continue to use this method because either they don't have the time or energy to manually analyse the sales data or the data is simply not easily accessible from their systems. Over the years we have heard many companies ask "Why should we change?" "We're making money, or at least we were prior to the downturn".

Irrespective of whether the economy is booming or slowing down, the cost recovery method is not the best pricing model to protect margin. Why – because when business is booming products are bought in larger quantities and at a better price. Ironically in good times products are sold cheaper because companies buy better and simply add their margin. The product sells and the business gets the required margin no problem at all. But in tough times, like at present, many businesses are buying less with no price breaks, they then add the normal margin (because that is what the cost recovery method tells us to do) and try and sell it at a higher price. This doesn't work! The margin ends up being discounted anyway.

"Cost recovery pricing protects margin while Value based improves margin."

By basing your pricing on value to your customer you can optimise your margins and build an overall improvement in margin. The process is more complex and requires more analysis but the greater returns quickly justify the effort. If there is customer demand for a product it will sell and you can set a price that maximises your margin. Your strategy must be based on solid facts and not "gut-feel" because an overpriced product or a product with no value added cannot compete with the big box pricing. In contrast to the cost recovery method, when we buy better we increase our margin.

Special buy in products are a perfect example of where value based pricing is most applicable and by their very nature these sales should all be at healthy margin. It's important to remember that these products are often under the control of your sales team; therefore it's useful to put processes in place to manage them.

Value is being added to a product by ordering it in especially for a customer therefore it can attract a higher margin yet too often we see these products sold at a margin lower than its equivalent held in stock.

Special products account for about 20% of sales within the timber and building supplies industries and traditionally higher in plumbing supplies. If special products are handled efficiently and in a controlled manner, healthy bottom-line gains will follow.

The management of special products will be covered in more detail later in the Building Better Business series but their management is a critical driver in the effectiveness of the value pricing strategy.

What is fundamental to the success of any price management strategy is the ability to apply price changes quickly and accurately. This can be achieved simply through your business systems. A good business solution will ensure that you're selling product at the right price – every time! It will also free up your sales staffs valuable time to interact more with customers.

Do you have an effective pricing management strategy in place at your business? If your answer is no, don't panic you're not alone! What strategy you implement is largely dependent on your ability to correctly analyse your sales data and constantly measure performance against KPIs.

The 80/20 rule

In most businesses the old adage that 80% of the sales come from 20% of the product range is very true. Unfortunately in many cases, 80% of the Gross Margin comes from 20% of these sales. Figures like this suggest that as much as 40% of sales in these businesses are selling at break even or below. This occurs because a high percentage of stock is sold at a substantial loss as it has become 'slow moving' or 'dead' stock and needs to be cleared.

The challenges of the 80/20 rule

The first challenge is to identify what products constitute the 20% of products that account for the 80% of sales. Once you have this information you then need to dig deeper to analyse each individual product's contribution to the total Gross Margin. Examine your high turnover items and establish which items are not price sensitive and could sustain an increase in margin – without having a negative impact in your market.

One key point is to ensure you always have adequate stock of these top 20% of products. Stock outs of these popular products can lead to lost sales and have the potential to further damage your business relationships when you are unable to meet the demands of loyal customers.

The top 20% of products need to be constantly monitored and fine tuned as they are continually changing due to trends, seasons etc.

The second challenge is almost the reverse of the first, in that you need to identify what products represent the next band of products. Lets say the next 50%. Maybe you are selling these products at a good margin but not getting the stock turns that your business requires and your investment in the stock is too high for the return. This sort of analysis is performed very effectively using **GMROI** (Gross Margin Return on Investment) which will be explained in detail later in this series.

Lastly you need to identify all sales below your acceptable Gross Margin and determine why they had to be discounted. Learn from this and put controls in place to ensure the margin is retained in future. As a wise man once said: *"The reason that history repeats itself is because we didn't take notice the first time 'round!"*

Hot tip: If you currently don't have a system that can identify and track your top sellers, make sure you do it manually. These high demand products always sell so set a premium margin, especially on lower cost products. Customers tend not to price check small ticket items.

Smart Purchasing

One of the major reasons for a business going under is overstocking. This will be explored in greater detail later in this series but smart purchasing leads to both margin protection and improvement.

Put simply, smart purchasing is buying what your customers want, when they want it. Getting product where it needs to be, at the right time, in the right quantities, at optimal cost, and doing it all in the most efficient manner possible is the goal of every business. When achieved it adds value to your product offering and provides the basis for margin improvement.

Information and knowledge are key components to smart purchasing. Most suppliers now offer e-business solutions that ensure that you're always informed of any special discounts, promotions, price changes etc. These systems often also enable you to place orders directly into their system significantly reducing your admin costs. By using technology to give you a complete view of your stock levels, sales performance, seasonal demand, stock availability and pricing you will take much of the guesswork out of your purchasing function.

Get smart with your purchasing and always ensure you have the right stock on hand, within your planned stock levels and always at the optimal cost.

Your Customer Is King

Make it your business to know what your customers are buying and just as importantly what they're not buying! Your major customers will all have a profile, e.g. Project Builders. Analyse their sales history and check it against their profile and list products they are not buying.

Evaluate:

» What products are your major customers buying from you and in what quantities?

» What aren't they buying and do you stock these items?

» Could you stock all or some of these items and move towards being a "total supplier" of all their needs?

By getting your stock right and moving towards a one-stop shop for your customers you will not only increase your profit margin but also customer loyalty. Many customers don't mind paying a little extra for this kind of service so add a little extra margin on to some of your product lines and watch your GP go up!

By putting an effective pricing strategy in place that flows through to your product file and sales processes, your sales staff are able to spend extra time with the customer rather than looking up prices in catalogues. Aim to maximise the margin return of each sales opportunity by educating your sales staff on what products give the best return and what additional products complement their purchases.

Summary

The Sterland group have spent the last 90 years working in and around the building supplies industry. We know that times are tough and now more than ever business owners and managers are expected to do and know more than ever before. Margin management is an important part of helping you to maintain your market position and even grow your business. By implementing the strategies outlined here you will be taking the necessary steps to avoid margin leakage and improve your profits.

Contact us

If you would like more information on anything written here or have any general questions relating to how Sterland could help your building supplies business please contact us. It can cost as little as $1000 a month to implement a proven business management solution to manage your entire operation from the back office to the shop floor!

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