# How Industrial Distributors Can Double Their Profits in Complex Contract Negotiations

By Dan Barlow, PROS Strategic Consultant

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## Managing sales negotiations gets complicated for distributors

In a world where competitive pressures do not exist, pricing for distributors would be simple and straightforward. Manufacturers would publish List Prices for their products and provide their distributors with Net Prices. The distributor would use the Manufacturer's Suggested Sell Price to establish customer pricing, with the gross margin covering operational costs and profit targets.

The real world however, can function very differently for a couple of reasons: The dynamics of a competitive marketplace and the complexity of negotiating sales contracts between manufacturers, distributors and their customers. For this reason, industrial distributors' sales organizations are often tasked with not only establishing customer contracts, but sometimes in arbitrating annual customer price agreements where vendors are actively involved in the process. Many sales people have historically negotiated these more complex contractual price agreements involving vendors and customers with limited resources, but the growing volume and complexity of these type negotiations now go beyond traditional spreadsheet analysis and ill-informed price assessments.

For distributors to properly manage complex contract negotiations, they must provide their sales people with pricing information and guidance that address both sides of the negotiation process--- manufacturer costs as well as the customer price. Leaving out the vendor side of negotiations, means that distributors are only looking at half of the profit equation or potential.

The goal is to simply empower the sales person to quickly and profitably negotiate these types of agreements. But, before you can determine the solution, you must first understand the challenge a sales person faces. In these types of negotiations, a distributor sales person has to decide:

- **How to evaluate a complex contract negotiation:** Because the duration of most contracts are annual, it is important to calculate and evaluate price agreements correctly, in order to avoid long-term financial losses that are difficult to trace to a root cause.

- **What specific items are important to negotiate:** The 80/20 rule of distribution applies to the principle of selecting the items to negotiate on a contract. While a contract might contain many items, typically only a few items represent the majority of the profit. Determining which items to focus on and negotiate is nearly impossible without help.

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- **How to price key items to maximize the profit target:** Once sales people know the correct techniques to use in evaluating the margin position of the deal, and what items or product family groups are important, they must be able to balance the cost and sell prices to achieve the most desired outcome.

## Evaluating a negotiation: Why contract negotiations often fail the profitability test

There are several challenges that must be overcome in order to negotiate a profitable agreement. The first involves the creation of a Gross Margin dollar neutral or greater position.  Consider a sales representative that is selling to a customer at a 20% Gross Margin rate on $100,000 annually and competitive pressures drive them to seek off-book pricing from the vendor to secure their existing market share.  If the sales person receives cost reductions from the manufacturer, but maintains the existing Gross Margin percentage, the impact is negative in Gross Margin dollars as illustrated in Figure 1.

**Figure 1 - Revenue Negative Negotiation with Consistant Margin Percentage**

| | List Price | Sales | Costs | GM% | Margin* |
|---|---|---|---|---|---|
| Existing | $110,000 | $ 100,000 | $ 80,000 | 20% | $ 20,000 |
| Negotiated | $110,000 | $ 75,000 | $ 60,000 | 20% | $ 15,000 |
| | | | | | |
| | *Change in Operational Revenues | | | | $ (5,000) |
| | | | | or | -25% |

**Figure 2 - Incorrect Calcualtion for Contracts**

| | Old | | New |
|---|---|---|---|
| Sell | 0.909 | = | X |
| Cost | 0.727 | | 0.545 |
| | | | |
| | .909 x .545 | = | X |
| | 0.727 | | |
| | | | |
| New Sell | 0.681 | = | X |

This result may occur unintentionally if the sales person uses, for example, the original discount multipliers from list price in a way that preserves the margin ratio as illustrated in the equation shown in Figure 2.  Here the sales person takes the existing sell and cost multiplier in relation to the new cost multiplier to calculate the new sell multiplier. When calculations are made using this formula, the result is flat margin rate and a loss in revenues and margin dollars. If unchecked, the contract could be approved and losses incurred and unnoticed since the typical sales manager’s report shows that the account continues to provide 20% margins.  Furthermore, when the overall revenues go down after contract implementation, this loss of revenue is easily perceived by sales management as an account where purchase volumes are lagging rather than a contract that was poorly negotiated.

To properly negotiate contracts where manufacturers are subsidizing costs to meet market levels, the distributor must attempt to hold a gross margin neutral or greater position with existing service requirements.  In the examples above, the distributor sales person should have at least pursued a $20,000 margin and $80,000 sell price increasing the gross margin percentage to 25%, rather than stay at 20%, in order to remain neutral on total margin dollars from this customer. If margin dollars are reduced, the distributor must consider a reduction in services to decrease the customer cost-to-serve in order to maintain the existing cash flow from the account. It is for this reason that cost-to-serve visibility has such high value. Therefore, knowing what to negotiate can make all the difference.

## What items are important to negotiate? Lack of visibility kills profits

Contracts usually have a large number of line items and encompass either a range of products, vendor-defined product family groups, or both. Contracts created solely at the product family group level do not provide clear visibility into anticipated product mix and volumes. This combination of factors force manufacturers to consider profit risks in negotiating an unknown mix and volume, and therefore they tend to offer less aggressive cost levels to the distributor.

Contracts that define only specific products can also create wide gaps in competitive pricing by product omission. Products that have to be added after a contract is signed lead to an increased frequency of price maintenance, compounding customer dissatisfaction with continual price corrections. For this reason many contracts contain both product groups and individual products within a price agreement.

Assuming they are able to get timely reports, distributor sales people can gain visibility into the weight of contribution for specific product items or product groups by sorting in descending order of sales volume. The purpose of the report is to readily identify those items that are important and those that are inconsequential to overall profitability in any negotiated deal. A sales person without this kind of information is only guessing about which products and pricing are important to a negotiated contract---and the result can mean the difference between a profitable agreement and one that loses money for the distributor.

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Key information can be added to a report to offer clarity, such as the number of line items where the product was purchased, or the overall quantity purchased within a timeframe. Both of these values can assist in determining the worth in negotiating a given product. If an item has large quantities, but few lines associated, it likely represents a job and is not necessarily an item to be considered. Ideally, the item would be purchased regularly and generate significant revenues so that small adjustments result in larger and predictable impacts that improve overall profit.

In Figure 3, the first and sixth products have reasonably high sales dollars, but a relatively low number of times they have shown up as a line item on orders (LINE CT). On the other hand, report rows two through five have a significant number of line counts (LINE CT), large enough quantities (QTY) and total dollars (SALES) that they should be negotiated at the product level rather than the common group level (PGC) to increase the Gross Margin percentage. However, there are still key factors that typical reports fail to produce.

**Figure 3 – Sample Report of Contract and Non-Contract Items by Sales Revenue**

| PRODUCT | PGC1 | PGC2 | PGC3 | LINE CT | QTY | COST | SALES | MARGIN | GM % |
|---|---|---|---|---|---|---|---|---|---|
| BRG2205HGHM | G7 | H65 | 548 | 8 | 16 | $57,939 | $72,916 | $14,977 | 20.54% |
| BRG3456ENBH | G6 | H57 | 539 | 32 | 55 | $48,695 | $55,676 | $6,980 | 12.54% |
| BRG3456PB55 | G6 | H57 | 539 | 24 | 76 | $37,739 | $42,864 | $5,126 | 11.96% |
| BRG3456IF16 | G6 | H57 | 539 | 19 | 52 | $36,137 | $41,086 | $4,949 | 12.05% |
| BRG3456OF8 | G6 | H57 | 539 | 18 | 34 | $27,774 | $31,655 | $3,881 | 12.26% |
| BRG3455SRM | G5 | C96 | 776 | 3 | 8 | $21,084 | $21,137 | $53 | 0.25% |
| BRG3486HPR | G6 | H56 | 538 | 26 | 305 | $19,114 | $20,951 | $1,837 | 8.77% |
| BRG3456IB32 | G6 | H57 | 539 | 18 | 73 | $14,203 | $16,590 | $2,387 | 14.39% |
| BRG3439AHNR15 | G6 | H63 | 545 | 12 | 32 | $13,121 | $15,723 | $2,602 | 16.55% |
| BRG3439IH8 | G6 | H63 | 545 | 4 | 16 | $12,154 | $14,183 | $2,029 | 14.31% |
| BRG3469L35E | L8 | H47 | 528 | 5 | 9 | $12,377 | $13,238 | $861 | 6.5% |
| BRG3439IE8 | G6 | H63 | 545 | 8 | 22 | $10,941 | $12,915 | $1,974 | 15.28% |
| BRG3456HFM | G6 | H57 | 539 | 8 | 13 | $10,582 | $12,214 | $1,632 | 13.36% |
| BRG3456HBHH | G6 | H57 | 539 | 21 | 230 | $8,953 | $10,168 | $1,216 | 11.95% |
| BRG2511PK15H15D2 | G8 | H68 | 561 | 1 | 2 | $9,572 | $9,620 | $48 | 0.5% |

## Negotiating the right price: It's too often anybody's guess

Imagine the difficulty in negotiating a contract where the customer has no prior purchasing history. One place most sales people start in developing pricing for a new contract is by searching for existing contracts with customers of similar profile and sales volumes. However, this kind of informal peer group analysis is limited in scope to the sales representatives existing base of customers. Copying an existing customer contract therefore, makes assumptions that may or may not be valid, and the result can be compounded lost margin opportunities if the initial contract has not been optimized.

Beyond determining the proper product family or item mix, the sales person still has to determine the right asking price of the customer. If he or she has successfully identified those items that would have the greatest impact to overall profitability, what prices should they assign to these items? Raising the sell price outside of reasonable levels obviously risks losing revenue for the entire contract. Likewise, a price established below what the customer is willing to pay results in lost profits.

Ignoring the bi-directional nature of complex contract negotiations is a significant missed opportunity for many distributors---an opportunity that can add up to more than 200 basis points to the profit margin on a negotiated contract.

## We're not done yet: What about negotiating with the manufacturer?

So far, we've covered the many variables involved in negotiating prices with the end user or customer. But in terms of missed opportunities for maximizing margins that's only half the story!

That's because while negotiating price with a customer, the sales person is also negotiating with the supplying manufacturer at the same time. Ignoring the bi-directional nature of complex contract negotiations is a significant missed opportunity for many distributors---an opportunity that can add up to more than 200 basis points to the profit margin on a negotiated contract.

In cases where the manufacturer has not applied either a pricing strategy or segmentation, the distributor can offer further value by organizing contracts according to segments, establishing reasonable market costs, and driving off-book pricing requests to acceptable targets. This would streamline negotiations and allow immediate visibility on lagging cost performers in the segment. When contracts are negotiated with a clear understanding of the items that are critical, the quantities anticipated, and the overall share gain, rather than simply asking for lower pricing across all products, many manufacturers are willing to offer their best prices.

## The good news: automated pricing tools can help

Considering the amount of data evaluation necessary in creating a single contract, distributors need automated tools to assist sales representatives in providing context and confidence in the negotiation process. Technology now provides sales organizations with the science necessary to quickly create optimized contracts and predict potential opportunities, empowering sales teams to maximize selling time---and profitability. Since most organizations that negotiate contractual off-book pricing are dealing with customers that represent significant revenues, it is critical that automated pricing tools provide several key capabilities listed here.

**Revenue Scoring**

- ❑ Score the Gross Margin dollars before and after the negotiation
- ❑ Score the net profitability of every Product Family on the contract
- ❑ Score the net profitability of every Product on the contract

**Deal Creation Guidance**

- ❑ Identify existing items with volume
- ❑ Recommend zero volume products that peers are buying
- ❑ Allow pricing at the Product Group and Product SKU level
- ❑ Allow discounting or fixed pricing at the SKU level
- ❑ Automate item list generation
- ❑ Provide linked analytics for contract evaluations

**Maximize Profits**

- ❑ Provide Segmentation for contextual price guidance
- ❑ Offer Price Guidance at Product Family and SKU levels
- ❑ Offer Price Guidance for customer sell
- ❑ Offer Cost Guidance for vendor cost

## PROS Pricing Solution Suite (PPS) delivers the prescriptive difference

LAmong pricing software options, one set of automated tools stands out for its unique capabilities in providing prescriptive pricing guidance at the corporate as well as field sales level: PROS Pricing Solutions Suite (PPS). The configurable design of PPS, for example, enables a prescriptive flow that guides users to recommended actions. Combined with Scientific Analytics, the PROS Deal Optimizer module provides the industrial distributor sales force with the information needed to conduct complex contract negotiations as explained in this white paper.

For example, using an intuitive user interface (Figure 4), distributor sales representatives can see items purchased historically in addition to recommended peer-group items, receiving both price and cost guidance at the Product Group and Product level. Scoring for negotiated contracts can be made at multiple levels, from line item, to overall contract and includes the ability to measure the Gross Margin dollar changes that result from any negotiation. Using the waterfall analysis provided in PROS Analytics module, the customer cost-to-serve can be easily viewed by sales representative in the field to gain additional negotiation power. The PROS Deal Optimizer module allows the sales representative to streamline negotiations, provides context for price guidance, and identifies opportunities for growth while leveraging an approval system that is both visual and intuitive.

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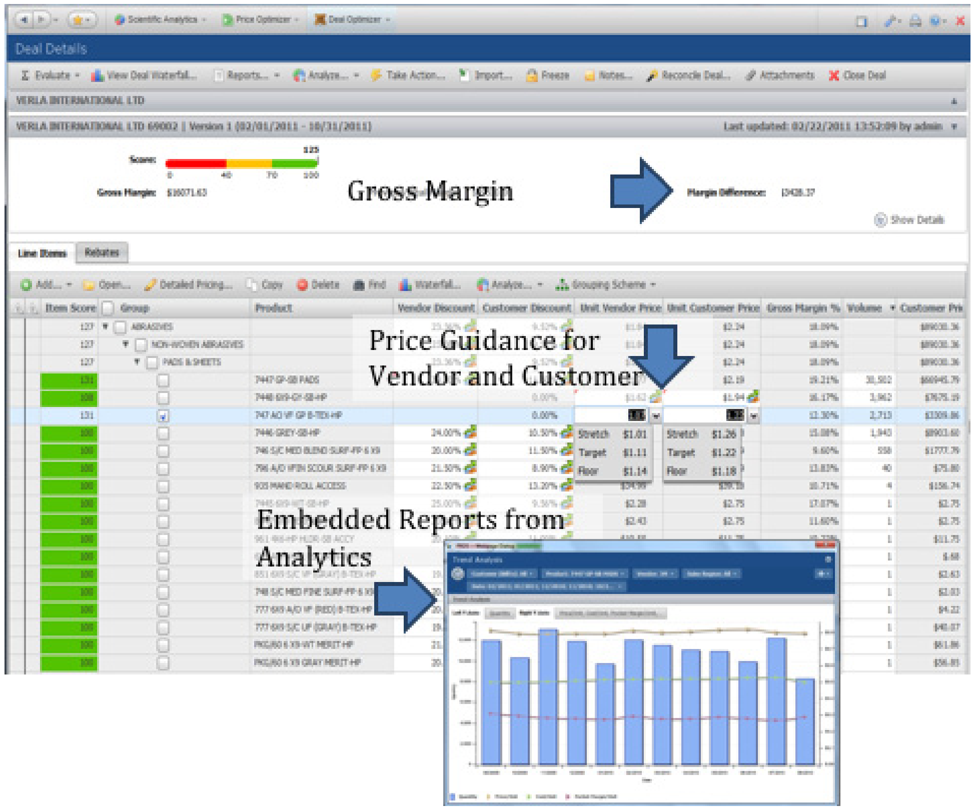
**Figure 4 – Price and cost guidance with PROS software**




Through an intuitive user interface, PROS software provides sales people with the critical information needed to properly negotiate contracts based on detailed analytics, including price and cost guidance at the Product Group and Product level.

## An opportunity that no distributor can afford to miss

Imagine a world where contracts with customers and manufacturers are easy to create, evaluate, and maximize profit with minimal effort; where sales representatives possess visual tools that allow them to spend less time collecting, sorting and interpreting data, and more time selling. The opportunity is clear: industrial distributors can no longer afford to risk margin exposure on significant contracts using traditional methods when current pricing technology could effectively double their profits.

To learn more about PROS prescriptive software solutions visit our website at www.prospricing.com or contact us at info@prospricing.com.

## About The Author

**Dan Barlow**, Strategic Consultant at PROS, has direct experience in pricing and revenue optimization for the distribution industry. Prior to joining PROS, he served as a pricing analyst and vice president of operations for a major distributor, bringing millions in new revenues to the bottom-line through margin corrections. Barlow is well-versed in all the methods distributors use to drive cost from their business, including the use of leading technologies. In addition to his 16 years in distribution, Dan spent 9 years in the manufacturing industry. He holds a degree in industrial distribution from Texas A&M.