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Pricing: Distributors' most powerful value-creation lever

With new digital capabilities, distributors are finding that pricing can do more than traditional margin-expansion methods to create new value.

by Alex Abdelnour and Walter Baker

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Pricing is undergoing a revolution fueled by big data, advanced analytics tools, and powerful digital capabilities. Distribution businesses are well positioned to reap the benefits of this revolution, given the high volume of transactions they support and the breadth and complexity of both their product and customer portfolios. The pricing capability is critically important in a business where margins tend to be razor thin; no other lever can do more to raise earnings. But mind-sets haven't caught up. Many industry leaders still relegate pricing to a "deal desk" rather than making it the centerpiece of commercial excellence.

Distributors who embark on end-to-end pricing transformations can expand earnings by up to 50 percent with modest or negligible impact on volume. Their sales forces will be far more efficient and effective as they tailor pricing to each customer and situation, and they will provide accurate quotes more quickly, thereby improving the customer experience. Armed with additional capital, some companies will invest more in growth and differentiation. By offering new value-added services, these leaders can gain competitive advantage and build market share.

For many distributors, the traditional playbook of margin expansion has run its course

For years, distributors have pursued greater scale to expand margins by a few percentage points and return on sales in mergers that have significant overlap by up to 3 to 4 percent. Since the bottom of the Great Recession, nearly 30 percent of publicly traded distributors have acquired at least one other distributor (up from 20 percent in the decade before the recession), and revenue increases from the average acquisition today are roughly 35 percent larger.

In this industry-wide scramble for scale, attractive targets have become scarcer and thus more expensive, reducing returns on investment. Most industry leaders realize that once they have become the number-one or number-two player in a market, additional acquisitions can yield diminishing returns; indeed, many customers continue to use secondary suppliers to limit the risk of supply-chain disruption and sometimes to keep their primary suppliers honest. In addition, most acquirers face complex challenges as they try to merge far-flung sales organizations that make daily pricing decisions on hundreds of thousands of SKUs for thousands of customers and, at the same time, try to marry disparate IT systems, each with a patchwork of homegrown tools and expensive enterprise resource planning (ERP) solutions.

But even as building scale is delivering less value, raising margins through pricing is so complex that many big distributors have shied away from it. Instead, they allow sales teams to rely on their own knowledge and experience, assuming that each customer is unique and therefore no algorithm or dynamic pricing tool can offer useful insights. Mergers contribute to the problem when a focus on the challenges of integration causes managers to underinvest in data integration and analytical capabilities to optimize pricing across product catalogs, geographies, and organizational fiefdoms. Many focus on back-end margins—for example, maximizing supplier rebates and special pricing to expand margins—not realizing that gains in purchasing and procurement may be given away to customers due to a lack of pricing capabilities.

Pricing is distributors' most powerful value-creation lever

In contrast to past reliance on growth through M&A, the outperformers in the years ahead will be the distributors that see price optimization as the foundation of commercial excellence—speeding pricing approvals and helping salespeople make not just more and bigger deals but *more profitable* deals. For a distributor, pricing is by far the most powerful lever for improving overall margins and increasing profits. A 1 percent price increase across the product portfolio has more impact on bottom-line margins (earnings before interest, taxes, depreciation, and amortization, or

EBITDA) than a 1 percent uplift in volume or a 1 percent reduction in procurement cost or in selling, general, and administrative expense (SG&A).

Looking across our database of 130 global and publicly traded distributors, we estimate that a 1 percent price increase would yield a 22 percent increase in EBITDA margins (Exhibit 1), and a 25 percent uplift in stock price. Moreover, pricing has a disproportionate impact on a distributor's enterprise value, with an increase of 20 percent for a 1 percent increase in price.

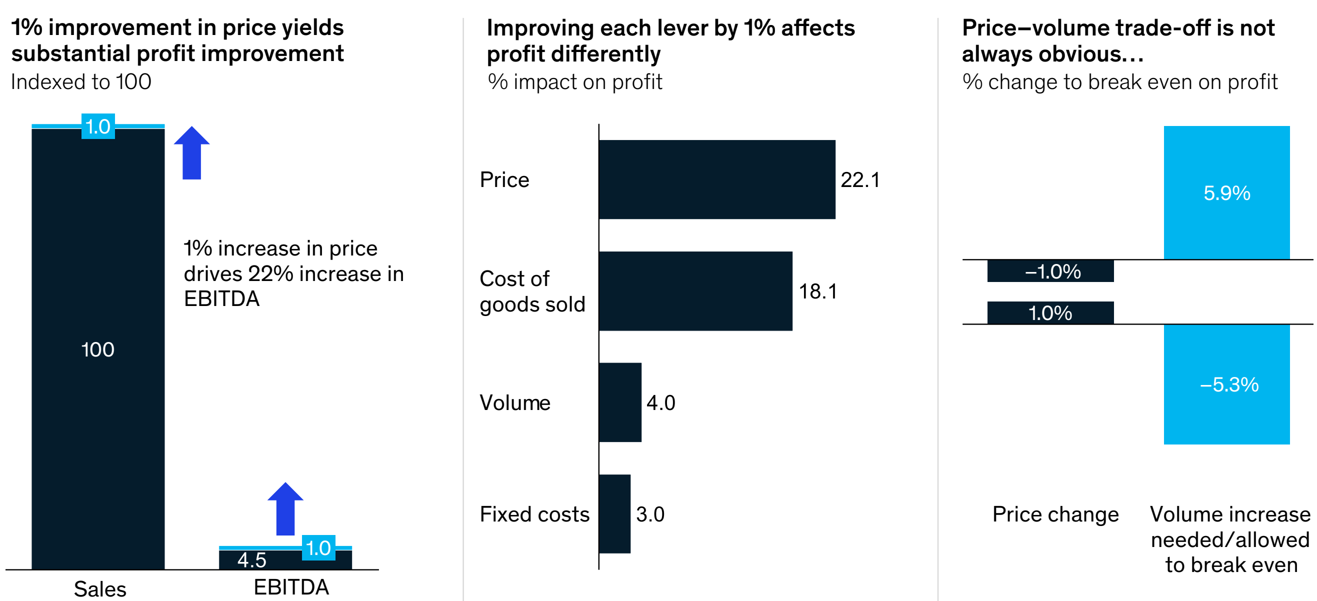
Achieving similar impact using other levers requires improvements of a larger order of magnitude. For example, an average distributor in 2018 would have to grow volume by 5.9 percent while holding operating expenses flat to achieve the same impact as a 1 percent price increase—no small feat, especially in mature markets where competition is fierce and growth often comes at the expense of profitability. That same distributor would have to reduce fixed costs by 7.5 percent or buy 22 percent of its own size (assuming similar P&L structure) to deliver an equivalent uplift in EBITDA. The only other lever with the same power as pricing is procurement, where similar results would require an aggregated cost reduction of nearly 1.2 percent across specialty and commodity products.

Optimizing price requires overcoming misconceptions

Even experienced salespeople may believe that raising prices means losing deals, especially when competitors offer similar products. They may argue for aggressive price cuts to keep large customers happy (and reach their own volume targets). Our qualitative and quantitative research reveals that the truth is more nuanced. A lack of product availability, poor service, and damaged customer relationships can scuttle more deals than high prices, for example, and low prices rarely win deals.

Exhibit 1

Pricing is the most powerful lever for distributors.



Source: 140 publicly traded distribution companies globally—10-K filings, McKinsey analysis

Our survey of more than 200 distribution customers across sectors indicates that pricing ranks sixth overall in what customers look for in a distributor (Exhibit 2). Price is the most important factor in winning deals on the key value items (KVIs) that represent the top 20 percent of products, which represent roughly 80 percent of an individual customer's purchases. But most customers are far less price sensitive on the many other items in their shopping baskets. This is where distributors have the biggest opportunities to raise margins.

Sophisticated sales teams can increase their win rates with a deeper understanding of each customer's willingness to pay for KVIs and the other value they provide, such as one-stop shopping across categories, convenient and prompt delivery, a breadth of brands and models, financial facilitation for small and medium-size businesses, flexible return policies, and, of course, product expertise.

Salespeople hungry to make deals may continually ask for price reductions, but cutting prices in a low-margin environment risks eroding margins without enough volume uplift to make up the difference. For a distributor with gross margins of 18 percent, for example, the volume uplift required to break even is roughly 6 percent for a 1 percent price cut. Continuously lowering prices is a race to zero margin. In the long run, it makes more sense to build pricing strategies on each customer's willingness to pay and a keen understanding of the nonprice factors that the customer values most.

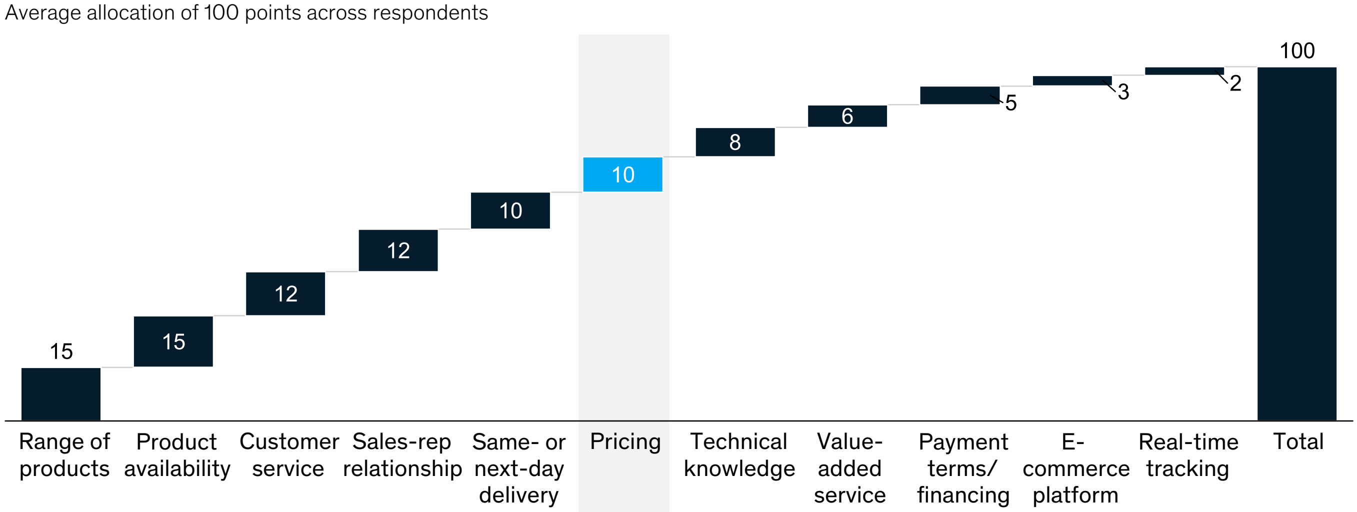
In distribution, of course, the number of customers and array of SKUs are too large for any human sales rep to know exactly how much to charge in each situation. Instead, most focus on a handful of high-turn products they know well, supplemented by a shorthand approach to the remaining thousands of items, such as using the same markup, margin, or discount percentages across all other products. This can mean overpricing some items (which can shake the trust of the customer) and underpricing other items (resulting in missed margin opportunities).

Exhibit 2

Customers rank 'pricing' sixth in importance.

What customers value most from distributors[1]

Average allocation of 100 points across respondents



[1] Based on the question: "Where do traditional distributors provide the most value?"

Source: 2018 McKinsey distribution service line customer survey, n=220

The distributors who outperform are those whose sales reps focus less on pricing thousands of items and more on selling, growing share of wallet, and delivering on the distributor's unique value propositions. Many of these winners have a pricing organization, digital tools, and analytical benchmarks to give sales reps the market and customer intelligence they need to drive volume and margins.

These distributors don't raise prices across the board. Instead, they look for pockets of strategic pricing opportunities and continuously improve their approaches and systems. For instance, in a business with a large transportation-cost component, sales reps have clear incentives to include the cost of freight at the transaction level to avoid underpricing items with a higher shipping cost. Leading distributors drive changes in measurement, incentives, and behaviors to improve price quality and achieve customer loyalty and other desired business outcomes.

Leaders also keep pace with their customers' rising procurement capabilities. Large companies have doubled their investments in procurement in just the past six years, giving their procurement teams new price-comparison tools, clean-sheeting techniques, and best practices in category management. Most companies would rather cut their own costs or persuade suppliers to drop theirs than ask customers to pay higher prices.

Best-in-class distributors use pricing to create value

A handful of distributors have been pioneers in adopting pricing as a discipline and have invested in building pricing organizations with a mandate to deliver year-over-year margin improvement. They have then embarked on journeys to build pricing discipline and exception routines in the sales organization and adopt analytics and other tools to capture value.

Based on our experience standing up pricing organizations and supporting several distributors on their pricing journeys, we have laid out five key elements of building a profit-generating pricing organization that creates substantial, steady uplifts in margins, even during challenging economic times:

1. *Build a dedicated pricing organization with organizational clout.* Distributors should consider standing up a pricing and margin-management organization to improve pricing processes and discipline. Using best practices, it can drive more consistent approaches to pricing routines and margin management across the organization, provide an end-to-end view of how pricing affects customers, and use new tools and technologies to help the sales organization capture value.

   For example, the sales organization of a leading food-service distributor had autonomy over pricing but limited sophistication. The company took a multiyear journey to build a centralized pricing organization with local support in branches. Reporting to the chief operating officer, the pricing organization had a mandate to drive yearly margin expansion, develop long-term pricing strategy, and fend off digital threats. The pricing organization started small, launching quick-win initiatives across pilot locations and creating enough excitement to develop a pull from various branch managers rather than a push from the ivory tower. Several years in, the pricing organization is a profit generator with strong credibility in the sales organization, consistently delivering margin improvements of 50 to 100 basis points.

2. *Embed best-in-class processes in the sales organization.* Pricing in many sales teams is often an art rather than a science and lacks the structure, thoroughness, or oversight needed for consistent profit maximization. The winners clearly define pricing processes, including steps, owners, inputs, and outputs.

   For example, an electrical distributor has implemented a rigorous performance-management routine with a layered escalation process to manage and control runaway exceptions more effectively. A pricing “war room” evaluates requests for exceptions, tracking their frequency and depth, analyzing deal economics, and providing sales reps with real-time guidance on prevailing prices. Adherence to pricing rules, policies, and targets is monitored and used for coaching at various levels of the organization, including sales reps, sales managers, branch managers, regional managers, and senior leadership.

3. *Embrace advanced analytics and the digital revolution.* As noted, it’s unrealistic to expect sales reps to get the best price in every transaction. Today, however, large distributors can run advanced analytics using their treasure troves of internal data enriched with readily available external data to identify pricing opportunities and arm sales reps with benchmarks and digital tools to make better pricing decisions.

   A high-tech distributor with hundreds of thousands of SKUs and thousands of customers invested in a dynamic deal-scoring solution to group customers and products in segments. It provides sales reps with pricing recommendations for each order, tailored to the order’s size, location, customer characteristics, end market, and suppliers. This has minimized human error and pricing variability, improving margins significantly. The dynamic deal-scoring algorithm is part of an easy-to-use tool that sales reps employ to get product information, price each product, and obtain real-time benchmarks showing how their pricing compares with similar transactions by colleagues, which builds their confidence in their ability to tailor prices to deal characteristics.

4. *Align sales incentives with margin expansion.* Sales-rep compensation has traditionally been tied to volume rather than margins, which sometimes leads to revenue growth at the expense of profit. Indeed, since the Great Recession, distributors have grown revenue by about 7.5 percent per year, on average, while margins remained low and well below those before the recession (Exhibit 3). Best-in-class sales organizations are increasingly tying compensation to both revenue and margin growth.

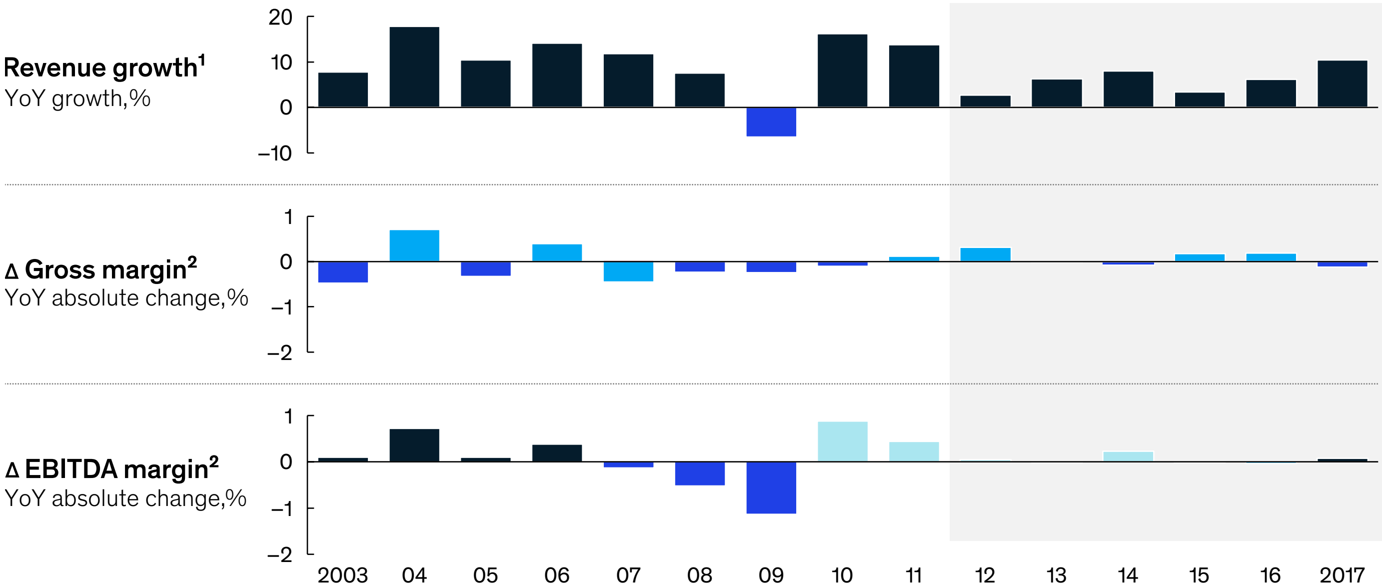
   An electronics distributor, facing significant margin erosion despite solid sales growth, realized that its thousands of sales reps, who were compensated solely on sales growth, were giving away free freight and expedited shipping and lowering prices to “win” deals. A shift in the compensation model and pricing policies, along with training and tools, has optimized both sales growth and margin expansion.

5. *Invest in sales reps’ pricing capabilities.* Sustained impact from pricing initiatives requires investment in sales reps’ capabilities to price based on value, negotiate, and manage contracts end to end—and success in wining sales reps’ hearts and minds. Pricing organizations can score quick wins across a distributed sales organization landscape by first piloting pricing initiatives in a few branches with willing general managers and pressure-testing them for impact. This builds credibility within the wider sales-and-marketing function, creating a pull from all other general managers.

   A plumbing distributor launched a major pricing transformation with new policies, processes, and tools that sales reps had to master quickly. The pricing organization worked with the sales operations team to build a “train the trainer” curriculum followed by online training, leadership videos, an online chat forum, and a hotline for urgent questions. Sales reps understood the rationale for the changes, the long-term vision, and—most important—how and why previous pricing approaches had cost the company money. Moreover, sales managers and branch managers were integral parts of the solution: after gaining an understanding of pricing levers and the rationale for change, they became pricing champions within their teams.

Exhibit 3

Margins have sputtered despite revenue growth.



[1] Revenue growth calculated in local currencies and weighted by average USD revenue over the period.
[2] Weighted by revenue in USD.

Source: McKinsey CPAnalytics

Pricing optimizers hold the competitive advantage

When we talk with decision makers at distributors that have not invested in pricing optimization, we ask what's holding them back. We caution them that if they maintain this stance, they will be at an increasing disadvantage as customers consolidate and invest in procurement capabilities and competitors arm *their* pricing organizations with highly effective new approaches and powerful digital tools.

Over the past ten years, the distribution marketplace has grown more competitive, with the average gross margin across a global index of distributors contracting by 100 basis points despite a stable and growing global economy. The contraction has not been universal, however: top performers have grown margins by an average of 400 basis points, widening the gap between distributors that excel in pricing and those that do not.

Distributors that understand the importance of pricing and have invested in a best-in-class pricing organization have seen margin uplifts of 200 to 500 basis points. Furthermore, they continue to drive margin improvement and expand their advantages over the laggards. For distributors, price optimization is an essential part of a winning strategy.

Alex Abdelnour is an associate partner in McKinsey's Atlanta office, where **Walter Baker** is a partner.