Why Not Give Customers What They Want?

An increasingly competitive environment has caused distributors to rethink their service profile with the idea of providing exactly what customers want. Overwhelmingly, this leads to the conclusion that customers want lower prices.

That conclusion may or may not be correct. In fact, there is a large body of evidence that suggests customers want something much more important than better pricing. The key is to identify exactly what that is and how to provide it in an affordable way.

This report will examine the nature of customer needs and the economics of meeting them. It does so from two perspectives:

- **Understanding Customer Needs–** A review of the large body of research examining customer needs.
- **The Economics of Need Fulfillment–**An analysis of how the essential customer needs can be met at a profit.

UNDERSTANDING CUSTOMER NEEDS

Every distributor has wrestled with the issue of determining exactly what their customer set really wants. This question has been researched in multiple lines of trade with amazingly consistent results.

About a dozen years ago the author was commissioned by a major distribution trade association to examine the adequacy of the existing service profile of distributors. The specific task was to identify the additional services that would strengthen customer loyalty.

The results from the research were surprising. Almost no customers had a desire for any additional services. Instead, they wanted the distributors to offer a broader selection of products and to be in-stock more often. That is, they wanted distributors to do better at what they were already doing.

As it turns out, this was not a one-off finding particular to this individual association. Research across multiple lines of trade produces an almost identical conclusion. Customer needs from their distributors can be put into the following hierarchy, ranked from most to least important:

- **In-stock–**Having items available whenever they are needed.
- **Depth of Assortment–**Facilitating "one-stop shopping" with a wide array of items.
- **Speed of Delivery–**Providing merchandise on a real-time basis.
- **Order Accuracy–**Eliminating errors in both order picking and billing.
- **Price–**A fair, as opposed to the absolutely lowest, price.

Despite coming in last place in this hierarchy, price is invariably regarded as being more important than it is. The reason is that too many firms have an almost identical service profile with regard to the first four items. Therein lies the opportunity. Giving customers greater certainty on the first four can somewhat negate the very real price pressures in today's economy.

Addressing the customer needs requires a number of actions. The most important of these is the almost inevitable requirement to increase the investment in inventory to support the in-stock and assortment-depth needs.

THE ECONOMICS OF NEED FULFILLMENT

Enhancing the in-stock position and the depth of assortment should have an important impact on sales volume. The concern among distributors is whether the "more inventory for more sales" trade-off is advantageous economically.

To address that concern, **Exhibit 1** looks at the economics of the typical DHI member. According to the most recent PROFIT report, the typical firm generates

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$18,700,000 in sales as shown in the first column of numbers. It operates on a gross margin percentage of 31.4 percent of sales. Finally, it produces a pre-tax profit of $748,000 or 4 percent of sales. This requires inventory of $1,730,000.

Any effort to increase sales can take two paths. First, try to generate more orders. Second, make each order larger. Both can be effective. However, only the second involves giving customers what they want.

The next two columns of numbers reflect the impact of a 5 percent increase in the average order size. There is no increase in the number of orders, simply an increase in the size of each order. Ideally, inventory expansion, through a higher fill rate and a more extensive assortment, should lead directly to this increase. It is the payoff from meeting the first two customer needs.

With the increase in the average order size, dollar sales also increase by 5 percent. There is also an operating cost impact. Specifically, the variable expenses, which are assumed to be 5 percent of sales, rise right along with sales. Such variable expenses include commissions, increased order handling and delivery, and the like. While the variable expenses increase, the fixed expense, such as rent, depreciation and the like, do not increase.

The net impact is a major increase in profit, from $748,000 originally to $994,840. This $246,800 increase represents a gain of 33 percent. If there were no increase in the inventory, the entire increase in profit from operations would go directly to the bottom line. However, inventory will almost certainly increase.

The last two columns reflect the mitigating impact of an increase in inventory.

The middle column of numbers assumes that the inventory investment rises at the same 5 percent rate as sales. In this case, inventory increases from $1,730,000 to $1,816,000, or $86,500.

The bottom of the column assumes that there is an inventory carrying cost of 20 percent of the increase in inventory. That means that carrying the additional inventory cuts into the profit increase by $17,300. While it is a sizeable number, it still results in a net profit gain of $229,540.

The final column of numbers assumes that inventory goes up twice as fast as sales, or a 10 percent increase. Even in this extreme case, the cost of carrying more inventory is "only" $34,600. The firm still comes out well ahead by engaging in the tradeoff of carrying more inventory to meet customer expectations.

The exhibit reflects a reality that has been true in distribution for many years. Namely, the risk associated with increasing the inventory investment to drive higher sales volume is almost always rewarded.

It can be argued that distributors are inevitably short on cash and that an increase in investment such as the $173,000 in the last column cannot be managed. It is, however a one-time increase. The increase in profit of $212,240, in sharp contrast, represents an annual, ongoing improvement

MOVING FORWARD

The competitive environment is not likely to become any easier anytime soon. In addition, distribution, in every line of trade, is a mature business. These two factors combine to suggest that steady sales growth is a key profit driver.

Generating sales growth involves a number of important issues. However, none is more important than providing the services that customers really want. That package revolves around having more products when customers want them. +

EXHIBIT 1 THE IMPACT OF INCREASING THE AVERAGE ORDER SIZE FOR THE TYPICAL DHI MEMBER

Income Statement–$	Current Results	5.0% Increase In Inventory	10.0% Increase In Inventory
Net Sales	$18,700,000	$19,635,000	$19,635,000
Cost of Goods Sold	12,828,200	13,469,610	13,469,610
Gross Margin	5,871,800	6,165,390	6,165,390
Variable Expenses (5.0% of Sales)	935,000	981,750	981,750
Fixed Expenses	4,188,800	4,188,800	4,188,800
Total Expenses	5,123,800	5,170,550	5,170,550
Profit Before Taxes	$748,000	$994,840	$994,840
Inventory	$1,730,000	$1,816,500	1,903,000
Increase in Inventory		$86,500	$173,000
Carrying Cost %		20.0%	20.0%
Increase in Carrying Cost		$17,300	$34,600
Net Increase in Profit		$229,540	$212,240