

Is there Margin in Merchanting?

By Paul Sheridan & Joachim Klein

1 Where have the merchant's margins gone?

The last decade has seen the merchants' margin decimated, with the leading players facing 2-3 % EBIT margin and the remainder barely breaking even. This is the result of increased competition in western markets and an erosion of first mover advantage in the eastern markets.

In the "good old days" of near monopolies and/or oligopolies, merchants owned their customers and were price setters based on paper supplier cost plus % margin. The value of the merchant to the customer lay in the provision of the widest possible assortment, maximum availability, indiscriminately short lead times, and financing services. To the paper supplier, the merchant was an essential sales channel into the local markets and niches. Prices were good and margins were sufficiently high to manage the business by using aggregations and averages, without thorough transparency and management of customer requirements and the true cost-to-serve.

Today, the European market is facing low demand growth rates in established markets and an over supply of paper resulting in stagnant and/or falling paper prices. Customers in the West are consolidating and business is shifting to the East (e.g. printing). The emergence of pan-European merchants with war chests has led to increased competition in individual country markets. The situation is augmented by increasing direct deliveries from paper producers to the most interesting customers. Alternative paper sales channels such as one-stop-shop office suppliers, electronic ordering and tenders have compounded the margin pressure. The result of these developments is that the merchant's environment has fundamentally changed.

Without the high prices and with continued supplier dependency, a more structured approach to demand management and cost-to-serve becomes critical for survival.

Typical challenges facing merchants are:

- Excessive inventory costs
- Low transport efficiency and historically grown logistics networks
- Tied-up working capital in payment terms
- High personnel costs and poor performance
- Supplier dependency due to ownership structure or long established relationships.

A lack of transparency in customer profitability leads to all customers being treated equally. Customers can be over-served, either by providing standard service levels in excess of requirements,

or providing additional services which were not paid for. This in effect means that profitable customers are subsidizing loss makers, resulting in the loss of good customers and opportunistic behavior among the less attractive ones. For this reason it is essential to have an informed but differentiated approach to different customers and segments.

Today, the margins have gone and the industry is now subjected to a Darwinian survival of the fittest. The industry is consolidating and companies are buying, being bought or closing. The challenge is to define the future role of the merchant.

2 What role does the merchant play moving forward?

Irrespective of whether the merchant is a profit centre driven purely by financial results or an arms-length divisional sales organization of a paper producer, the goal for the merchant is always the same – "to own the customer".

Ultimately, the merchant's role is to understand the customer and to provide him with the product and services that he is willing to pay for at the competitive rate. Not all customers are equal and not all customers require the same service. The successful merchant understands this and provides the product (even complex or small orders) and services, such as inventory/transport/financing solutions on a differentiated basis. Customer insight and segmentation is critical. The merchant is the link between the supplier and the myriad of customers and their specific complexities.

Merchants remain as the distribution channel for suppliers for a multitude of customers who are lead time sensitive, have complex order patterns or require financing. They also pioneer new markets with growth potential, e.g. Eastern Europe. Another key role which is not yet fully performed is the merchants' ability to reduce inventory levels across the paper value chain by providing producers with demand information for planning purposes and creating closer links into the supply chain of their customers. Ultimately, the value proposition to the suppliers is to shift high tonnage to gain product market share, to penetrate new / developing markets and to provide demand information.

3 How can the merchant shape its value proposition?

The successful merchant of tomorrow caters to pan-European as well as very local customers. It has a simple customer focused operation with strong local sales presence and centralized non-customer facing activities. It benefits from information driven processes & lean organizations supported by performance management systems and

combining its economies of scale & buying power with demand planning information to suppliers.

The industry is moving into this direction as witnessed through continued consolidation, the top 5 merchants owning 75% of the western European market. These “super” merchants are all facing the same improvement opportunities:

- Basic :
 - 3.1 Customer insight, sales channel strategy and demand management
 - 3.2 Supply Chain Management – optimizing the cost-to-serve model
- Advanced:
 - 3.3 Supplier Management
 - 3.4 Price setting and sales effectiveness
 - 3.5 Achievement of synergies benefits from acquisitions
- Excellence:
 - 3.6 Growth & alternative business models

3.1 Customer insight, sales channel strategy and demand management

Starting point to insight is transparency of customer and cost-to-serve data. In many cases merchants are now developing systems to reflect customer profitability. The question here is “how good and accurate is the data and what is it used for?” Frequently, profitability data is used for controlling purposes only and not as a proactive stating point for customer insight. Customer profitability insight is essential in establishing customer segmentation, i.e. answering the question “what service is the customer presently receiving, what is the related cost and what is he paying for?”

The next step is creating customer segments with similar requirements portfolios and similar willingness to pay for them. These segments are then matched against service levels to be provided by the merchant, which in turn defines resource allocation.

Equally important to profitability insights, is a well functioning customer relationship management process. It is endemic for the industry that customer information is held by one salesman and distributed in a non-standard and integrated way and at his discretion only. The key to owning the customer is understanding and jointly developing his requirements, this of course is based on complete documentation and institutionalized knowledge. The intensity of the customer relationship management will depend on the segment the customer belongs to, e.g. top segment customers are visited personally and tailor-made supply chain solutions are jointly-developed, bottom segment customers order volume per internet.

These insights provide a stepping stone to balancing price with service, i.e. avoiding provision of services in excess of requirements and/or providing additional services which are not paid for. Importantly, these insights also provide the basis for demand forecasting for own purposes such as assortment selection, inventory management and transport planning, as well as external purposes, e.g. production planning and inventory positions of paper producers.

3.2 Supply Chain Management – optimizing the cost-to-serve model

Of course, customer insight is only part of the equation, competitiveness in cost structure and process efficiency is of extreme significance. Major drivers of the cost structure are purchasing costs, headcount, holding and handling costs of inventory, transport costs, the physical asset network and financing costs. Presently, the focus of cost reduction trends in the industry includes;

- article rationalization based on product profitability analysis and differentiated service levels
- warehouse consolidation & inventory management based on collaborative forecasting, sharing of stock between locations and differentiated service levels
- transport cost optimization based on customer & product segmentation, defined service levels, transport sourcing strategy, coordination between dispatch and service centre
- review of sales channels, resource requirements and performance management, e.g. increased telesales for dealing with the long tail of profit neutral customers, freeing up outdoor sales to focus on “A” customers to establish detailed customer insights and structuring “winning” value propositions.
- increasing centralization of non-customer facing activities (e.g. finance, sourcing, inventory management and indoor sales activities)
- optimization of collection, receivable and credit management processes
- optimization of payables process, rebates and discounts
- organizational re-design, headcount reduction, performance measurement & management and training

3.3 Supplier management

The paradox of the industry is that merchants have seen their margins dwindle, and have accepted increased competition, lower prices and customer opportunities, yet leveraging purchasing power with suppliers remains a “no-no”.

The reasons are manifold, e.g. “our supplier is our parent”, “if the paper price falls we get less margin”, “if the supplier gives us a better price he has to do this with all merchants”, “we have a long standing relationship with our suppliers, we don’t want to push them too hard”, “any negotiated gains are off-set by the mandatory concessions”.

While these age-old pearls of wisdom may hold true in some cases, there is still plenty of potential for improvement. The universal levers for value capture in sourcing are "price", "process" and "usage", the three sides of the total cost of ownership (TCO) triangle. The TCO principle holds true also for the merchant industry.

The price lever can be revisited by looking at:

- segmenting suppliers into different groups and developing different negotiation processes for each group
- redefining the value proposition to the suppliers
- opening up the tendering process to new suppliers on a periodic basis
- the use of merchant own labels
- preparing analytical information on product profitability for each supplier in the negotiation process
- understanding the impact & sensitivities as well as establishing a clear strategy for payment terms, rebates and discounts
- negotiating basic paper price and subsequently adding further services (e.g. INCO terms)
- matching significance of the process with capability

The process and usage lever can be revisited by looking at:

- number of own people involved in the negotiation process
- additional complexity of multiple negotiations, i.e. central, regional and local negotiations
- number of active suppliers
- supplier costs of maintaining local representations
- optimizing ordering process for both direct and indirect business
- reducing the assortment and consolidation of articles based on profitability turn rates and obsolescence

Most companies in other industries have undergone several waves of procurement performance improvement. An overwhelming amount of publications and knowledge is available on the topic of supplier management, strategic sourcing and procurement transformation. Certainly, in the mer-

chant industry there is still value to be captured even if the starting point is with non-strategic suppliers.

3.4 Price setting and sales effectiveness

Price setting and sales effectiveness remain amongst the key challenges even for those companies with client insight and a lean cost structure. Pricing information is becoming increasingly transparent and an unjustifiably low price for one customer can have a knock on effect with others customers. Consistency is the key to mitigating pricing threats.

Management of prices & margins based on holistic supply chain, finance and sales cost information is the key to improved value generation. Knowing the cost drivers on a transactional basis will allow improved, fact based decision making and support solid customer negotiations.

In practice, however, sales forces seem to be resistant to informed differentiated pricing to different customers. This is often due to:

- sales force still rooted in the “old world” not yet accepted reason for change
- lack of sensitivity to and visibility of customer & product profitability
- lacking use or availability of analytical information on supply chain and financing cost drivers for each client in the negotiation process
- selection of ineffective performance metrics driving salesmen variable pay
- outdated or non cost-driven list prices
- requirement for additional training and non-monetary motivation

Price setting and customer negotiation is at the sharp end of the merchant business. Here the value of all the customer insight and cost-to-serve work is won or lost. It is essential for the merchant to focus on enhancing sales effectiveness based on the right information, the competitive cost structures, solid training and the right incentives.

3.5 Synergy achievement

Consolidation remains a key trend in the industry and with it the challenge of capturing planned, budgeted and communicated synergies. Many integration efforts have been ineffective resulting in parallel cultures, loss of market share, customer cannibalization and high costs due to process redundancies even years after the acquisition. The main reasons for lack of or delayed success have been quoted as follows:

- missing value focus and discipline to stick with the original plan

- resistance and inefficiency due to mismanagement of cultural alignment
- underestimated differences in company culture
- premature staffing resulting in loss of the capabilities and motivation
- exaggerated internal-focus resulting in loss of suppliers and customers
- lack of willingness to take tough decisions and force integration where necessary

These risks can be mitigated by a comprehensive and structured planning of the post merger efforts including cultural and external assessments before the go-live date of the merger. The first step to success is preparing a plan for the first 100 days, including value targets based on business cases, tough time line and milestones, defined integration structure and clear roles & responsibilities.

Implementation success will depend on sticking rigidly with the plan, staying focused on the original targets and taking the required decisions. Quick win integration projects should be proactively selected, implemented and communicated to boost morale and add credibility.

Following the first 100 days, more complex projects are tackled but the same project management structures remain in place. Communication is key to the level of buy-in for the changes. Dedicated communication teams need to be installed on top level to capture information requirements of staff but also feed back the mood of the people to management.

Succeeding in the first 100 days and beyond will require strong sponsorship from the highest level of management, who will take an active role in communication, motivation and success monitoring of the project teams against the originally defined targets. Tough decisions have to be taken fast to reduce levels of anxiety and demonstrate clarity of approach.

Correctly planned and executed integration management is the key to substantial business value and beating the poor average in the industry. Retaining focus and dedication during the integration and focusing on the key areas is the secret to success.

3.6 Growth & alternative business models

Growth comes in many shapes and sizes: organic growth, business start up in new markets, acquisitions to strengthen existing businesses, acquisitions to enter a new market and large scale mergers for strategic repositioning. All of the above actions are very current in the industry. Each type of

growth has pros. and cons. but all necessitate implementation of efficient and harmonized processes to ensure integration and business at scale.

A further recent trend is the development of alternative business models. Examples for this are the advent of one-stop-shop office suppliers and fighting merchants. Not all attempts at these new business models have been successful, but the threat of someone "getting it right" is still very much apparent. Both models rely on completely different operating models and cost structures than the traditional merchant. The one-stop-shop owns the customer by providing a holistic solution covering all office consumables. It uses loss leaders such as office paper to secure the business and cross-subsidizes with high value products. The fighting merchant competes predominantly on price. It is purely volume driven, has a very narrow product and service portfolio and therefore low cost-to-serve. It cherry picks large-volume, non complex customers. The success of the fighting merchant depends on having a low level of complexity and low-cost-to-serve on a sustainable basis, merely dropping prices is not the answer. These alternative models are being used by market entrants but also by incumbents in defense of their market share.

4 Moving towards making margin

The paper merchant industry like many others is exposed to the harsh realities of the market dynamics. Only informed and efficient demand- & supply-side processes combined with lean organizations & performance management will allow management of the controllable and provide the best possible assurance against surprises.

The role of the merchant as a sales channel to small and medium sized customers is assured, the profitability depends on a lean and effective operating model. Securing large customers will depend on tailoring competitive individual supply chain solutions.

StepChange Consulting can partner with you in developing and implementing a structured and holistic transformation of your merchant operations.

Paul Sheridan is a Managing Director at StepChange Consulting, a management consulting company focusing specifically on the fiber and paper value chain. He can be reached at paul.sheridan@stepchange.com

Joachim Klein is a Managing Director at StepChange Consulting, a management consulting company focusing specifically on the fiber and paper value chain. He can be reached at joachim.klein@stepchange.com