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The margins offered to distributors by most companies are in terms of percentage, directly linked to the price of the product. In case of an increase or decrease in price, the margins in absolute rupee terms also vary, regardless of the factors affecting the price change. If the cost of distribution is a factor affecting the price, change in the distributor’s margin is justified. But if the price change is due to other factors, then increase or decrease in the distributor’s margin is difficult to justify, unless the distributor’s investment, revenue expenditure and business volume are also considered. The author, in this article, proposes a comprehensive ‘Unit Rate’ model for calculating customized distributor margins that takes into account the above factors.

A survey of about 25 distributors of FMCG products in the city of Nagpur revealed that the distributors get their margins in some percentage that is directly proportional to the price of the product. These distributors deal in multiple brands in the same product category. The only difference was, some margins were calculated on markup basis, whereas some were markdown. The distributors were not even aware as to why a particular percentage was offered to them, and why not higher or lower. Although they had their own calculations about their estimated gross margins and net margins, there was no systematic evaluation of the fund flow in the entire distribution process. Given a particular gross margin, the estimated net margins differed from distributor to distributor, and there was little to justify their estimates. As a result,
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Some distributors were overspending on their operating expenses, whereas, some others were underspending even to the extent of affecting the quality of service and thus resulting in loss of sales.

Let us discuss the examples given in Exhibit. The exhibit clearly demonstrates that when the gross margin is calculated as a percentage of price, any change in the price of the product directly affects the distributor’s margin in absolute rupee terms, and alters the gross earnings of the distributor even if the percentage margin and business volume remain the same.

The following aspects apply to the situations shown in Exhibit:

- **Reasons for Price Change:**
  The reasons for increase or decrease in price may be due to the change in internal or external costs of the firm rather than any change in the distribution costs. The firm’s costs may include cost of raw material, labor, transportation, technology, interest on capital, etc., which are in no way related to the business of the firm’s distributors.

- **Distributor’s Cost:**
  The above model does not consider the actual cost of running the distributor’s business. Due to diverse nature of the Indian markets, the cost of running a distribution business differs from market to market. Some markets may have higher concentration of retailers in a few places, whereas the retailers may be widely scattered in some others, thereby affecting the transportation costs. In highly populous markets, the credit cycle speed may be high as compared to less populous markets, thereby affecting the working capital requirement. The congestion on urban roads, distribution time, manpower requirement, average order quantity, etc., also need particular consideration.

- **Return on Investment:**
  When the margin percentage is standardized, the ROI calculation is totally dependent on the volume of business. Company executives often inflate the targeted volume of business to meet the ROI expectations of the distributors. Many times, such inflated targets are unrealistic and unachievable, resulting in loss to the distributors. This leads to loss of trust and goodwill on the part of the firm and higher attrition rate among distributors.

- **Firm’s Marketing Strategy:**
  A firm may change its marketing strategy which may require price changes. Such strategies may include re-positioning, change in advertising budget, etc. These would affect the margins earned by the distributors, though their cost composition is not altered at all.

- **Technology:**
  A firm may adopt new technology or device new methods of operation, resulting in better quality product or improved efficiency. This could lead to a competitive advantage for the firm, providing scope for price reduction. The distributor’s margin would stand automatically reduced, though the cost of distribution remains the same as before.

- **Brand Equity:**
  It is easier for a distributor to distribute a firm’s products in markets where they enjoy higher brand equity and market acceptance, than in markets in which they have lower brand equity. This factor is not given consideration when the distributor’s margin is determined purely as a percentage of price.

- **Volume of Business:**
  The standardization of margins does not take into account the volume of business. The distributors having higher business volumes are paid the same percentage margins as the distributors having lower business volumes. This creates a distortion in the relative return on investments.

The pressures on Marginal Revenue Productivity (MRP) are compelling firms to take a re-look at their operating expenditures. Distribution cost is an important component of operating expenditure. Redesigning distributors’ margins to optimum level will definitely help in curtailing distribution cost and improving the bottom lines of the firms.

This article makes an effort to develop a model which can customize distributor margins individually for each distributor, so as to address all the above seven factors. The proposed new model of distributor margin reduces the influence of price in deciding the margins. It proposes to convert the margins from percentage terms to absolute rupee terms.

### Exhibit: Variation in Gross Margin in Proportion to Change in Price

<table>
<thead>
<tr>
<th>Situation</th>
<th>Unit Price (Rs.)</th>
<th>Distributor’s Margin (%)</th>
<th>Distributor’s Margin (Rs.)</th>
<th>Business Volume (Units)</th>
<th>Distributor’s Gross Margin (Rs.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>90</td>
<td>10</td>
<td>9.00</td>
<td>500,000</td>
<td>4,500,000</td>
</tr>
<tr>
<td>B</td>
<td>100</td>
<td>10</td>
<td>10.00</td>
<td>500,000</td>
<td>5,000,000</td>
</tr>
<tr>
<td>C</td>
<td>110</td>
<td>10</td>
<td>11.00</td>
<td>500,000</td>
<td>5,500,000</td>
</tr>
</tbody>
</table>
proposed model treats the fixed and variable expenditures separately. While maintaining the bottom line of the distributor, it passes on the advantage of lower per unit fixed costs when volumes grow to the firm. It also ensures the distributors’ survival when the volumes are low.

Calculation of Optimum Margin for Each Distributor

The optimum margin in absolute rupee terms is calculated by dividing the total projected expenditure of the distributor for the specified period by the total projected sale in units (pnu) which can be in kilograms, liters or numbers.

To calculate the projected expenditure for each distributor, first the firm has to project the distributor’s sales in the given territory for a specified future period, say one year. This sales projection should be in terms of numbers, weight or volume and not in terms of value. Then depending on the nature of the business, agreed terms and conditions, and the infrastructure required to achieve the projected volume of business, the distributor’s expenditure is projected in the form of investments, fixed expenses and variable expenses.

A. Distributor’s Investment

The amount of investment to be made by the distributor is decided. This investment is normally of three types—investment in fixed assets, working capital and deposit paid to the firm.

Capital Investment in Land, Buildings, Machinery, Vehicles, Technology, etc.: A notional annual rent on the fixed assets is payable to the distributor and is hence treated as an expenditure of the distributor. This notional rent is calculated as a percentage of the cost of the assets at the time of calculation. Normally the notional rent should be slightly higher than the banks’ prevailing rate of interest, charged on loans given to buy such assets. The notional rent remains fixed for a longer period and changes only if there is an additional investment in fixed assets or technology. The advantage of depreciation is given to the distributor and the advantage of appreciation is retained by the firm.

Working Capital Requirement which Takes into Account the Debtors as well as Inventory: While projecting the working capital requirement, the value of optimum level of inventory required to ensure smooth supply at the projected sales level is to be arrived at. The amount of debtors is calculated keeping in mind the business volume, prevailing prices, average order quantities and the credit period. The total value of inventory and debtors together form the requirement of working capital. The working capital requirement, thus, calculated is fixed for the period under consideration for the purpose of calculating the distributor’s margin, though it may actually vary within the period. For example, an ice-cream distributor may require more working capital during summer than in winter, or an apparel distributor may require more working capital during the festival season. In practice, such variable needs for working capital must be identified and provision should be made for obtaining necessary working capital accordingly. However, for the purpose of calculation, an average working capital requirement is used. Interest on working capital is treated as an expenditure of the distributor. Normally such interest is calculated at a rate slightly higher than the banks’ prevailing rate of interest charged on working capital loans or overdraft facility. The amount of working capital required is revised every year. It is dependent on the projected volume of business and the prevailing prices of the products. In case of multiple brands with different prices within the same product category, an average price per kilogram or per liter is to be arrived at, depending on the projected contribution of each such product to the total volume of business.

Deposit Paid to the Firm: Companies take deposits from their channel partners under various heads such as security deposit, brand deposit, etc. The loss of interest that might, otherwise, have been earned on the deposit amount should be treated as an expenditure of the distributor. Such interest should normally be calculated at the banks’ prevailing rate of interest on fixed deposit of one year for that particular amount. If the firm is extending any credit facility to the distributor within the deposit limits, then the ‘expenditure’ pertaining to interest on the deposit amount may be downscaled accordingly.

The interest on investments which is to be treated as an expenditure of the distributor can be altered and customized to ensure the achievement of projected Return On Investment (ROI) to the distributor. Normally such projected ROI depends either on the prevailing market conditions or is commensurate with the

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risk involved in the business. Higher the risk, higher the expected ROI.

B. Fixed and Variable Expenses

These are the recurring expenses which a distributor has to incur to ensure smooth functioning of his business. Such expenses include salaries, rent, telephone, courier, miscellaneous expenses, etc. Variable expenses, for this purpose, are also considered fixed for the given period, but actually vary within the period. For example, an ice cream distributor may require additional vehicles and manpower in summer and less vehicles and manpower during winter. Such temporary arrangement can be made by engaging ad hoc manpower and hiring additional vehicles for the peak period. Such varying requirements are properly identified so as to arrive at an average ‘fixed’ cost for the entire period (one year) under consideration. The projected cost of fuel required for running the distribution vehicles is also calculated by considering the expected distance to be traveled by each vehicle, average order quantity, number of vehicles, mileage of such vehicles and the prevailing price of fuel. The cost of hiring or maintenance of the vehicles is also projected and included in the expenditure of the distributor.

\[ \text{epu} = \frac{(A+B)}{\text{pnu}} \]

\[ \text{epu} = \frac{(A+B)}{\text{pnu}} \quad (1) \]

Now the firm has to calculate the average price per unit of its products. This is particularly necessary if the firm has multiple brands in the same product category. The unit of measurement should remain the same for multiple brands within the same product category. For example, a firm may have multiple brands of soap with different prices. The quantitative unit of measurement could be grams (gms) or kilograms (kgs). Therefore, based on the previous data and future plans, sales are projected for each brand of soap, in kgs, that may be sold by the distributor. The total value in price of all the brands of soaps put together divided by the quantity in kgs gives the average price per kg of soaps (apu).

Based on the apu, the firm has to decide what percentage of apu should be given to the distributor as his net profit. This percentage of net profit per unit is then converted into rupee value (npu). For example, if the average price per kg (apu) of soap is Rs. 100/- and the firm decides to allow 2% as net profit to the distributor, the npu will be Rs. 2.00. This figure will remain the same for the given period (i.e., one year) and will not be changed in case of interim price changes due to various factors. The percentage of net profit and the corresponding amount in terms of rupees per unit is decided taking into consideration the market conditions and the expected ROI of the distributor.

Now, the distributor’s gross margin per unit product (i.e., Unit Rate) = \( \text{epu} + \text{npu} \) \( (2) \)

The distributor’s margin is paid based on the number of units sold. Hence, this margin is termed as Unit Rate. In case the goods are sold by weight, it can be termed as Kg Rate; and if the goods are sold by volume, it can be termed as Liter Rate.

Advantages of the Unit Rate System

- The Indian market is very complex. The brand mix and quantities sold differ from place to place within the same product category. The Unit Rate system gives the firm an opportunity to customize each distributor’s gross margin depending upon his turnover in quantitative units, the geographic coverage, market density, credit cycle, average order quantity, transportation and manpower needs. It also defines the distributor’s investment and facilitates achievement of expected ROI.

- Any price revision made for reasons not related to the distributor’s business does not affect the distributor’s margins.

- If the projected sale (in units) in a particular distributor’s territory is high, the denominator in formula (1) would be higher. This would decrease the expenditure per unit (epu) and correspondingly, the distributor’s gross margin per unit would also be lower. If a firm invests heavily on its marketing activities, some part of the cost can be recovered from the distributor when the volumes increase. Thus, the advantage of economy of scale is retained by the firm, without affecting the bottom-line of the distributor.

- Any price revision made for reasons not related to the distributor’s business does not affect the distributor’s margins.
There may be disagreements over the Unit Rate applicable to a distributor's operations. A complete set of operating and fund flow guidelines are given to the distributors and operations of each distributor can be monitored closely.

The distributor must ensure the sale of projected units of goods in order to cover his gross expenditure and earn the desired net profit. The distributor also has an opportunity of savings from the projected expenditure through effective management of the business.

In urban markets where the sale of premium and mid-premium brands is comparatively high, the system saves on distribution costs.

If on the other hand, if the distributor's volumes contain a higher proportion of low-end products, the unit rate system ensures adequate ROI to the distributor, thereby ensuring survival of the distributor.

Initially if the distributor has a low volume of business, the unit rate system has a provision to recognize the same and ensure adequate ROI to the distributor.

Disadvantages of the Unit Rate System

The Unit Rate applicable to a distributor is fixed only for a particular period, mostly one year. Hence, the revision of unit rate is necessary every year, which the executives of the firm may find cumbersome. Also, the Unit Rate has to be calculated separately for each distributor.

There may be disagreements over the projected expenditure between the firm and the distributor.

The projected expenditure may turn out to be higher than the actual. In such case, the distributor may be paid higher margins, which the firm may find difficult to recover later on. If the actual expenditure is higher than the projected, the distributor may raise claims for reimbursement.

If the projected sale in units is not achieved, the distributor will not earn the total gross margin even if he achieves the projected sale in terms of value.

The system offers equal margins (by averaging) for lower and higher priced brands. There is no explicit incentive for the distributor to sell high-end brands.

In rural areas, the proportion of consumption of low priced goods is much higher. In such case, the firm may end up paying effectively higher margins to the distributor.

Any change in distributor's cost of inputs, say diesel, may require interim revision of the unit rate.

Normally firms plan and project their expenses as a percentage of the total revenue. Hence, giving margins to distributors as a percentage on price becomes easier for them to plan and project. With the Unit Rate system, it may not be possible for the firms to project an accurate picture of the distribution expenses during the initial years, as there will be multiple distributor margins and the margins will keep changing every year. But after a few years, say three to five years, the firms would be in a position to average out and then plan and project the distribution expenses as a percentage of the total projected revenue.

The distribution margins are designed to cover the gross expenditure of the distributors and ensure a surplus which is the net profit. There are certain Rates and Taxes which can be covered under the Unit Rate system. But with the advent of Value Added Tax (VAT), there is a question mark as to who would bear the cost of VAT. Actually VAT is applicable to and payable by the distributor on his gross margin. But the traditional distribution margins never took into account the element of VAT. Again, VAT is levied in certain states while it is not applicable in some other states of India. The Unit Rate system facilitates projection of VAT accurately as the gross margin per unit to the distributor remains fixed across all brands within the same product category and is also not affected by any interim price change. Hence, the firm which is reimbursing VAT to its distributors can make accurate provision for the same. The provision for tariffs and other local taxes can also be considered as per requirements.

The Unit Rate system has to be applied based on the quantity of contents for which the price is applicable. In some cases, we find that the containers are heavier than the contents. For example, the weight of glass container of a 500 gm content pack of Bournvita or Boost is almost equal to or higher than the weight of the content itself. The Unit Rate is applied based on the weight of the content, i.e., 500 gm of Bournvita or Boost in this case.

Conclusions

Though the Unit Rate system has its own advantages and disadvantages, it can work across a wide range of product categories. The system can be fine-tuned according to the product category the firm is engaged in. Even if a firm is unable to implement the system for any reasons, it can still use it to compare and evaluate the margins that it is offering based on the percentage method.

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