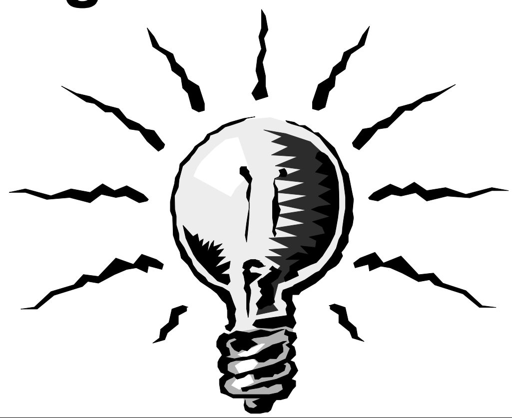
Fees For Services?

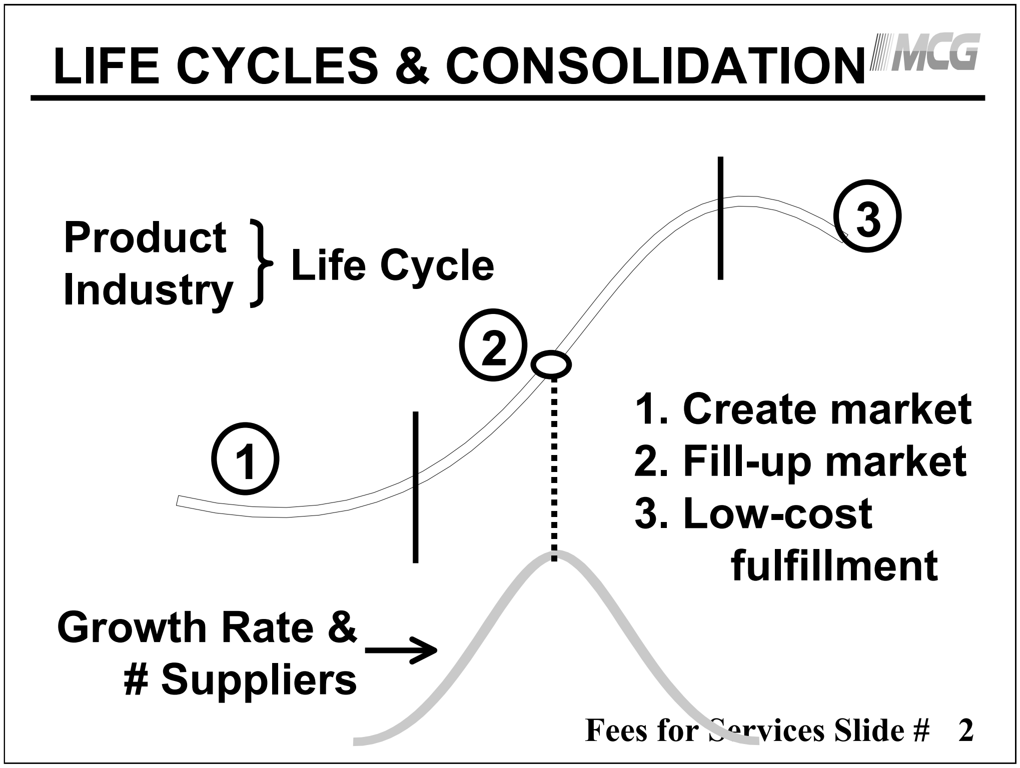
Some Thoughts:



Charging new fees for new or old services is like raising prices to a regular customer, only more difficult because we are asking the customer to pay more <u>and</u> change how they buy or evaluate a supplier. We know how difficult this is even with existing, smaller, growing-no-where, money-losing customers. Or, when we write-off interest rate charges for big, albeit slow-pay customers that consistently keep ignoring the charges and continue to pay X days late.

Another layer of difficulty is added if we decide to do the entrepreneurial, innovative act of creating a new service for one or more especially important customers and try to figure out how to sell it for a price that exceeds the true, full cost of delivering the new service.

Because fees for services are paid to distributors by both manufacturers and end-users in a number of channels, the idea of improving profits by this means in your channel is worth on-going consideration and experimentation. We hope the guidelines touched on in these slides will help you have some success in the fee-for-service direction.



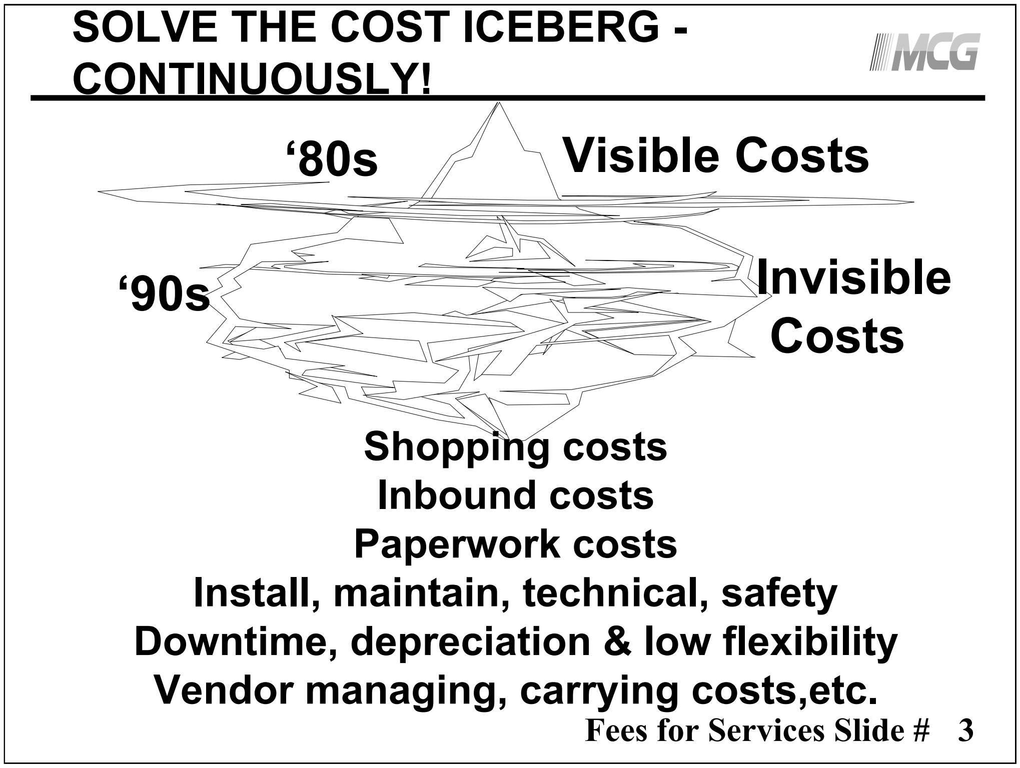
To be simplistic, most distributors exist in a channel that has or will go through three stages of a life cycle for both products and the one-stop-shop needs of a maturing end-user segment being served by a distributor. In stage 1, the product is new to the world and the end-user is often an entrepreneur who emerges to take care of a new need that traditional end-users don't see or want to address. Think of distributing sheet metal and welding supplies to new steamship manufacturers at the same harbor as clipper ship builders who don't think steam-powered, metal boats will ever work. The distributor of clipper ship supplies needs a new customer base for old products, or they need to take on new lines to take care of new types of customers.

In stage 2, the new market with its new needs is recognized and accepted by all, and there is a gold rush to fill it up the new need pail. Demand often exceeds supply. Goods are sold at "book price". Getting "extra allotment" is the key to more growth. And, growth in profits is equal to or sometimes greater than profits. Knock off manufacturing capacity explodes to compete for lush profits that the original manufacturer is enjoying. Distributors, for their part, hire more sales people per location (feet on the street) and open new locations before competitors do.

The growth curve inflection point (in the middle of the curve) happens when year to year growth rates for both industry sales and competitive entries stop accelerating and start to decelerate. Supply will now continue to grow faster than demand pressuring margins on the goods sold and forcing competitors to start selling the quality of both their goods and their basic services as the edge instead of selling exclusivity and extra-allotment if and when it is available.

The 3rd stage is reached when year-to-year growth rates slow to - maintenance, replacement and/or general economy consumption - growth rates. By this time, all products are excessively, equally excellent commodities; product standards have often emerged; customers are knowledgeable repeat buyers; most distributors have worked hard on having "good service"; and price buying/selling promotions become common. The excess, weakest competitors start to close down or sell out, and the consolidation of the players in each step of the channel start to occur. Taking total cost of the supply chain and buying at "the lowest total procurement cost"(TPC) become the battle cries.

A big problem is that a large majority of managers of stage 3 companies grew up in their industry by being personally successful with success assumptions/practices of earlier stages, so they continue to try to do stage 1 and 2 activities harder and better. They should instead be transforming their businesses to be the best at "low cost fulfillment" capabilities for the few, successful, customer consolidators or niche dominators, not the 80% or more of the customers who themselves want to perpetuate the past.



This slide depicts some of the invisible, process and utilization costs that go along with buying a commodity and its <u>one big visible cost which is "price".</u> If you go to http://www.valueaddedpartners.org, you will find case studies on both manufacturers and distributors who are quite dedicated to identifying, measuring and reducing all of the total procurement costs below the water line.

You can find more on both selling and buying with the TPC model at our web site articles #ed 4.2 and 4.3. Slide #5 in our slide show at the following URL shows how different elements of basic service excellence reduce different elements of TPC:

http://min.isisit.com/merrifield/articles/Dist_VAlue_proposition.pdf

EVOLUTION OF "VALUE-ADDED"

(Seller's agent)

1. Products
2. Services ....
3. Systems integration (fees?)
4. Process re-engineering (deeper integration)
5. Facility management (buyer's agent)

Impact on selling skills & compensation?

Fees for Services Slide # 4

The 5 stages in this slide could be super-imposed on the life-cycle slide (#2). Stages 3 – 5 in this slide are different levels of co-creating the lowest TPC with progressive, surviving customers in stage 3 of the life cycle slide. To expand on each of the five stages:

1. Distributors are "sellers' agents" or factory representatives in stages one and two. They have been awarded a franchise of some initial (and then gradually fading) worth, so they work hard to get more volume to keep the franchise from being given to some other agent. At first, they might sell a lot of the original or most popular #1 brand of goods, because they are the exclusive agent for that territory. This still is the case for Cat dealers, A/B beer distributors, Mercedes Benz dealers, etc.

2. When the customer has a choice of buying their preferred brand or an equivalent brand from 2 or more distributors, then who has a distinctively better, most consistent service capability in the customer's mind can become a big issue. Most distributors, instead, try to sell friendship to get last-look to meet the price and compete their return on investment down to minimal survival level.

3. Systems integration happens when a big customer tells you something like "no EDI link with us, no P.O.", so as a cost of doing business with the big customer, the distributor pays the up-front and on-going maintenance cost of automating away some of the customer's paperwork costs. But, this does not presume that the customer and the distributor sat down together to flow-chart and rethink how both of their buying and selling processes could be simplified or "re-engineered" for breakthrough savings. That is what is done in step 4.

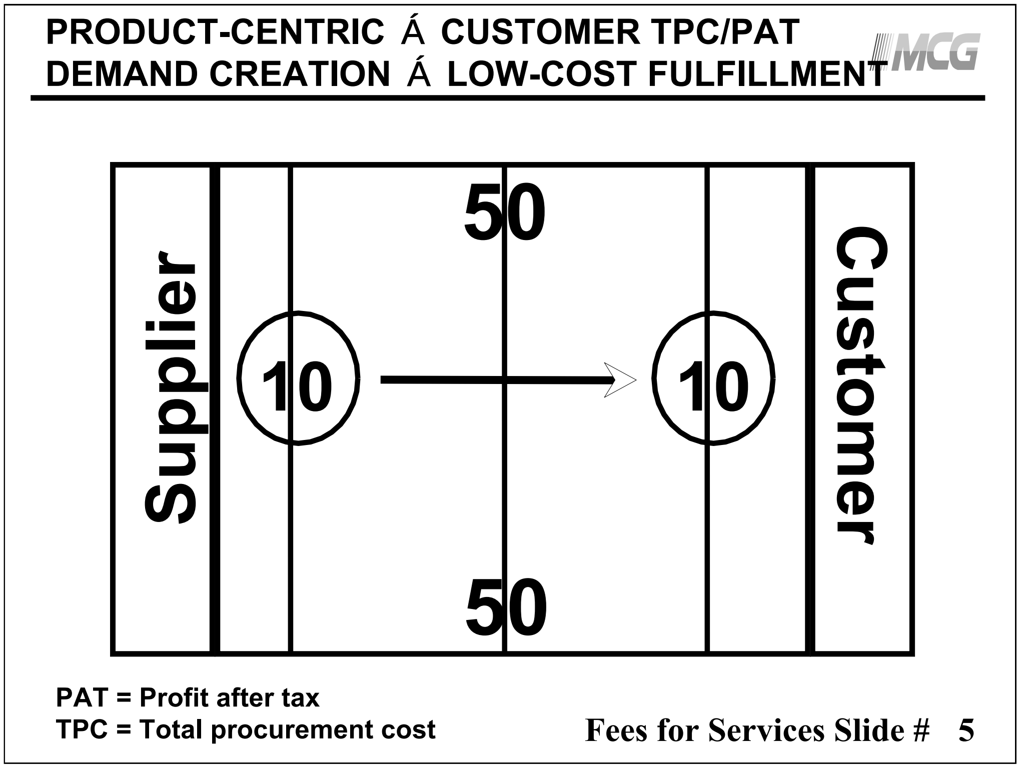
4. "Deeper integration" implies that the distributor does not just deliver goods to the customer's receiving dock in response to a purchase order. Rather, the distributor's personnel goes into the plant to install, maintain and create the P.O's from an inventory replenishment system for the customer. Then delivery of the goods is to the in-house system, not the back dock. The customer saves a lot by eliminating internal hand-offs and paperwork as well as beginning to outsource internal services to dedicated, disciplined, often lowered paid, motivated (don't execute, lose all of the business) supplier specialists.

5. "Facility management" suggests that one supplier may actually staff and run an in-plant store room in which the majority of the goods may come from the supplier's own warehouse, with the rest being bought out from different suppliers that the one chooses. The in-house inventory may well be owned by the chosen supplier and not billed to the customer until it actually is used. In retail environments, a category captain can do the same for both their and other suppliers' goods. P.S. In steps 3 -5, contracts often become "open-book". Goods are sold at cost(+). Customers can choose where they want to pay the distributors (guaranteed) return on sales, profit margin (not gross margin).

Some big under lying issues for these 5 steps:

1. Each stage requires a different set of (eventually team) selling skills and incentives for participating employees.

2. The customers within a maturing industry do not all consciously move into needing and being able to co-create lower total procurement cost relationships (steps 3 to 5) at the same time. 80% of the customers, who survived stage 2 of their industry life cycle, will not adapt well enough or soon enough to the consolidation stage. They will die for it and will resist or take and not pay for new total procurement cost reduction services. Distributors shouldn't take a simple, one customer, one vote poll for determining what customers want. Listen to the top 3% of the customers with a track record of successful, perpetual innovation capability and do the 5 steps above with them if and when they are ready.



This slide tries to illustrate that most distributors are still on their suppliers' 10-yard line, but need to be on their customers' 10. All of their printed materials are about suppliers and their products. The in-house, sales education is mostly free from suppliers on product knowledge and product promotional activities, etc.

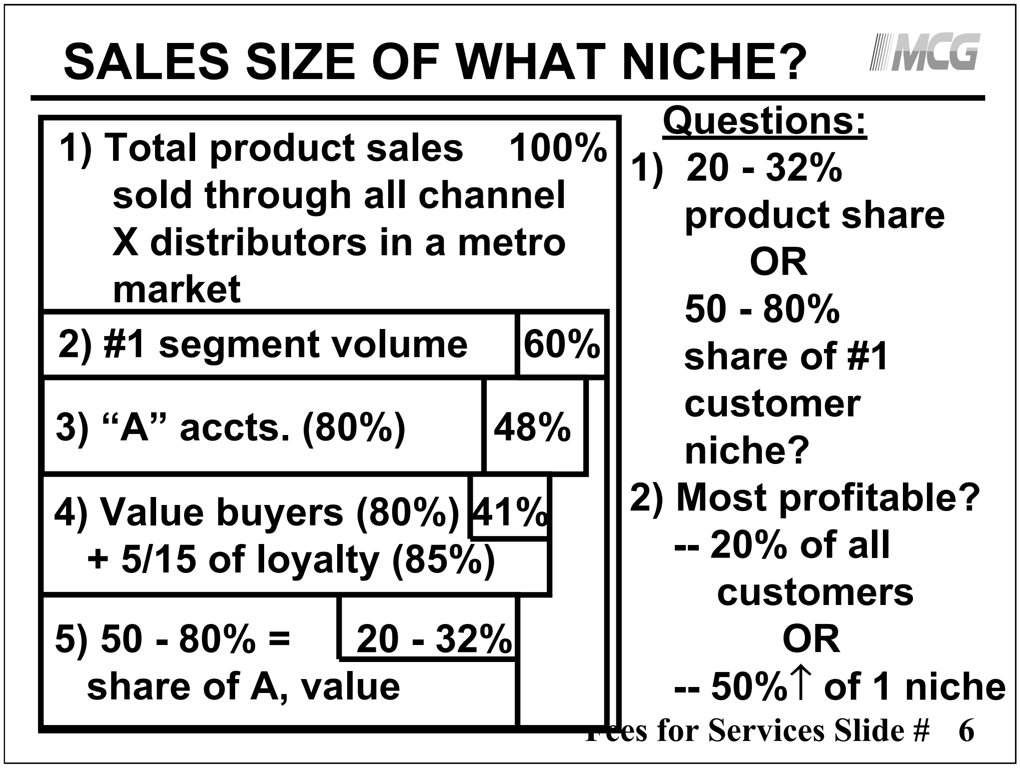
To play the fee-for-services game successfully, distributors are going to need to move down to the 10- yard line of the top 10% or less of their most progressive customers within their #1 historic niche of customers to find out where those customers' biggest, unmet needs are and fill them. 95%+ of these new needs will have nothing to do with finding new tangible product solutions, but rather:

1. Dramatically reducing the TPC of the mature commodity products they are already buying.

2. Outsourcing all non-core, internal (services) activities to dedicated specialist partners.

3. Capturing new, profitable growth. (Small customers can especially benefit from strategic, marketing support services from distributors. Think of all of the voluntary retail support programs from distributors to retailers: druggists, hardware, independent grocers, etc.)

<u>Distributors that are on their progressive customers' 10 yard line can not help but get into fee for services</u> as well as lots of special stocking of items some of which the customer may buy directly, but warehouse with their true, total, one-stop, just in time goods provider.



This slide is a hypothetical case study to illustrate why it is more profitable to own a big share of one customer niche instead of an equal amount of sales sold to all types of customers in a distribution market. How do we calculate a distributor's share of a customer niche? We zero in on it by starting with:

Box 1 – the total estimated volume of product volume sold through all of the distributors within a given channel in a given market. Call this "100%".

Box 2 – we identify the number one segment of customers that we sell and estimate that this segment buys 60% of all of the product volume.

Box 3 – within this given segment of customers, we further sub-divide them by primary mode of selling ("A"- outside sales; B – telesales; C – catalog; D – cash-carry/retail). We estimate that the "A" strata buys 80% of the segment's volume for a total product volume share of .60 x .80 = 48%.

Box 4 – we then only go proactively after the 85% of the A strata customers that buy "value" (or TPC) as best they can understand and measure it. We are assuming here that: 5% are pure price buyers and 15% are relationship loyalty buyers even if total service value is less the service value leading distributor's. But, we may get 5 of the 15 points of relationship buyers. So, 48% x 85% = about 40% of the total product volume sold in the market.

Box 5 – because we are so focused on the accounts that matter in our #1 customer niche, we have tuned our service metrics to offer the best total service value starring the highest effective fill rates on a robust one-stop-shop array of SKUs that this #1 niche buys. We win the retention war and achieve somewhere between 50 to 80% of this niche's total purchases. This allows us to get better turn x earn economics on our inventory, higher and better average order size economics and last look plus a bit more for our still best total value proposition. (More on all of this in our other annotated slide shows and our "strategy paper" free via e-mail request from karen@merrifield.com)

Our final share of the total product sales for the channel is 40% x 50 to 80 = 20 to 32%. This does not preclude that we can't then do the same process for a second niche that we choose to dominate; perhaps the value-buyers in the B strata of the same customer segment.

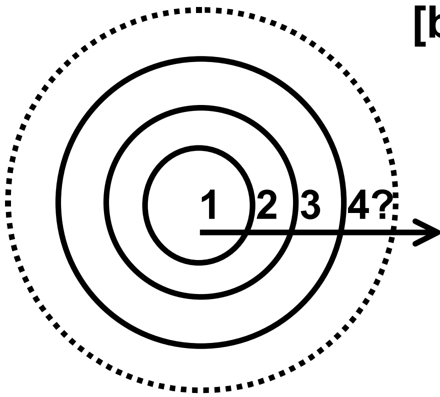
Big questions concerning fees-for services.

1) What extra services would the top 3% of the biggest profit producing accounts like to have? Considering how profitable these accounts are: do we do the extra services as part of our bundled offering or do we un-bundled them for a fee?

2) If we have been serving all customers within a segment, A – D, how many customers are we losing on by providing standard wholesale services for retail sized orders? By segmenting customers, we can also un-bundle standard services and charge for them – delivery, special orders, minimum order requirements, tighter credit terms and treatment. Lost margin dollars? See articles #ed: 2.19, 2.15, 2.3 and video modules 3.3 to 3.11 for the good news answers.

THE “AUGMENTED PRODUCT”

1. Generic product
2. Basic expected services
3. Extra services
4. Future possibilities [bundled & unbundled]



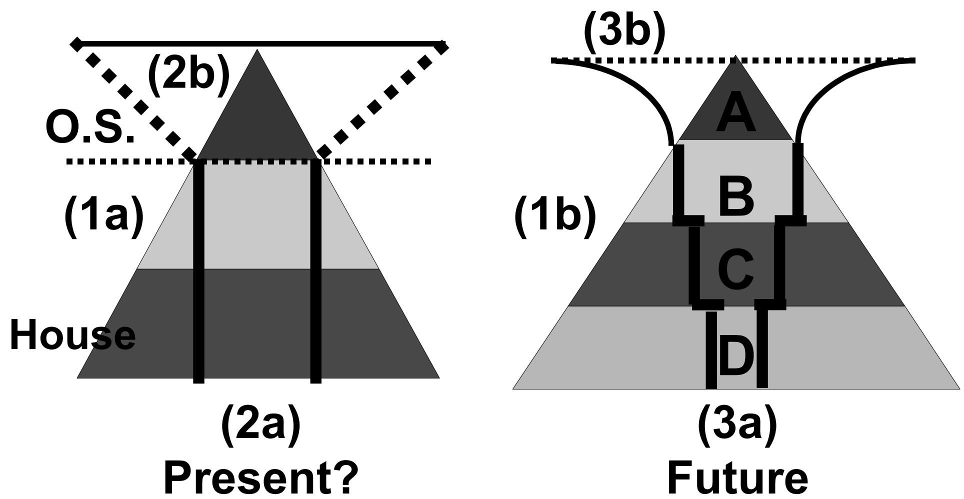
*Tuned to:
- Segments
- Strata of customer

Fees for Services Slide # 7

For lots of comments on this slide see slide # 2 in another slide show at our site at this link:

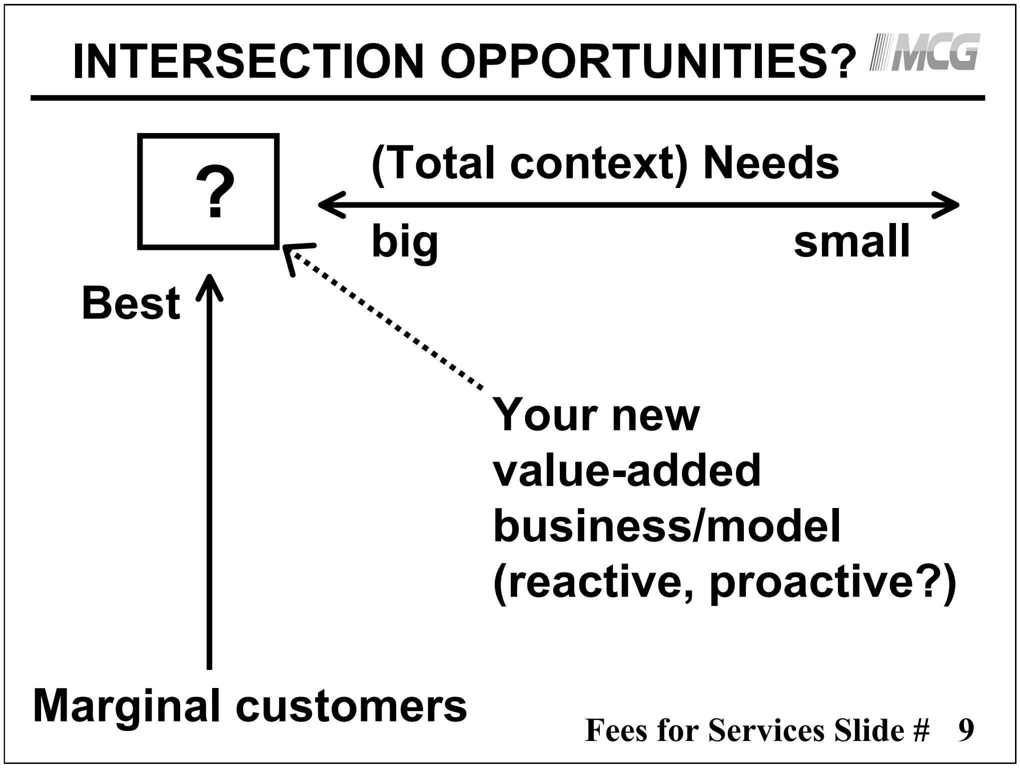
http://min.isisit.com/merrifield/articles/Dist_VAlue_proposition.pdf

SERVICE VALUE ALLOCATION MAPS: PRESENT & FUTURE



For comments on this slide see slides 6 and 7 in another slide show at our site at this link:

http://min.isisit.com/merrifield/articles/Dist_VAlue_proposition.pdf



This slide and the next present some customer-value innovation principles. First, leverage our trust relationships with our biggest, most progressive customers. Who are the accounts in which we can get access to the right, highest-up people with a track record for trying new ideas? Think how expensive it is for a newcomer to find these accounts, these people and to get a idea-sharing audience with them; these are big barriers to entry for would be competitors and big hidden business development assets for us. “Big” is important, because for the fixed cost of co-creating new win-win economics a bigger return is necessary.

Ask these few, key resources about their biggest needs in a broad, TPC, supply chain re-engineering sense. Progressive customers see the future first and have the ability to co-create necessary solutions with the right suppliers. If we can’t make new services work with these customers, then we probably can’t make it work with the non-progressive ones who won’t see us or share their lack of vision.

Second, “best” or most profitable is important, because the best defense to keep and grow these accounts is a good offense focusing on perpetual value improvement for them.

Third, be open to “new business model” opportunities. For example, when surveying for unfilled needs, we might widen the scope of questions to ask for the current list of all internal services that our customer has outsourced over the past 5 years with what type of measurable results (e.g. cafeteria, maintenance, payroll, etc. services). Then, ask what additional non-core services they are considering for outsourcing. If we can find new, important needs to potentially fill that are common to two or more of our existing customers in one market place, then potentially we might have a new business opportunity. If we discover that another local service provider is in a number of our core accounts, we can visit with them about: a) cross-reference marketing; or, b) buy them! CardinalHealth, for example, has bought service providers in one market and then introduced their new, in-house, service-for-fee capability to thousands of their similar type accounts across the country.

In the history of fees-for-services, an entrenched distributor has generally reacted to a request that an important customer (or supplier) has made for providing a new service that can then be sold to other similar type customers. Even when distributors have developed an extra service for fee capability for a few requesting customers, they generally have not been initially successful at productizing, branding and selling the new service to yet more customers on a proactive basis. When a distributor sets up, however, a separate service division with its own proactive marketing force to take the solution to the rest of the potential customers, sales may then start to take off.

DO 3 ENTREPRENURIAL RULES

1. Find a need (big pain) & fill it
2. Do it so: your cost < their price
3. Start with best, progressive customers
   - Leverage trust relationship (re-positioning problem?)
   - They see the future first (co-create solution)

Fees for Services Slide # 10

This slide is hopefully self-explanatory. Most innovative companies have no problem finding new needs to fill (1), but the most don't charge high enough prices to cover true total costs and insure an innovator's high profit margin (2). Most product-volume, sales-driven firms (and especially the reps) are happy to give away new services in order to win or maintain the product sales while lowering operating profits.

Distributors with the most mature portfolio of services-for-fees (e.g. SuperValu has 180+) have separate service division profit centers. If a customer insists on extra services for less or free, then the discount is charged against the product division's P and L, and that division then charges some of the cost against the sales reps compensation formula. This keeps everyone economically honest and selling value instead of giving it away.

DREAM EXTRA SERVICE CRITERIA (1)

1. Go on top of (guaranteed) basic service

2. 10+ customers want it - economy of solution/skill

3. Goods & services sell each other {e.g. CAT parts & repair guarantees)

4. Can be sold as unbundled, 3rd party at a profit
   -- Keeps inter-dept economics honest
   -- Case: buy bankrupt copy dealers. . .

Fees for Services Slide # 11

Comments on the first two bullets:

1. Referring back to the “augmented product” slide (# 7), total product value is built from the inside out. Don’t expect extra services to win and hold customers if we can’t get the right stuff to the right place on time with best local fill rates.

2. Doing extra services on a one-off basis does not offer any economy-of-solution economics for us, or a flexible, implementation expertise/value for the customer.

3. & 4. Self-explanatory

DREAM EXTRA SERVICE CRITERIA (2)

5. Difficult to copy; not:
    - -- Loyalty price (equivalent) deals
    - -- Novelty gimmicks

6. Locks in a long-term relationship

7. Platform for stream of repeat & new sales

8. Productize & brand it

Self explanatory(?)

FINDING & CO-CREATING EXTRA SERVICES

1. Find a willing partner
2. Flowchart & itemize total life-cycle process
   & economic activities surrounding product
3. Find & prioritize the pain & opportunity points
4. Brainstorm solutions
5. Rate them by dream criteria
6. Do rapid proto-typing (x) 1, 2, 3 customers
   no fees; maybe cost sharing (+)
   ROI testimonials

Fees for Services Slide # 13

Comments on the following bullets:

3. Different customers are going to have different, critical improvement measurements that they are going to want to focus on depending upon the agenda of their in-house champion. Doing more than the champion wants is OK, but don't expect these extra values to be fully appreciated. Nail what ever is at the top of the champion's list.

4. In discussing solutions, it is important to ask who will be their in-house project leader who will be joined at the hip with yours. Our person will play the tough cop for their guy, if necessary, because both managers will run into process and job-change resistance to make a new, inter-company buy-sell process work.

6. When you identify a common new need that a number of your bigger, better customers might eventually want and pay for, start with open-minded customers and low expectations. "We aren't going to get this comprehensively right the first time, let's crawl, walk and then run. In exchange, for your being a guinea pig, we aren't going to charge anything until it really works and measurably delivers savings out of which you will then be able to pay us fees. But, if we get it right, we do hope that you will be a testimonial reference for us to other customers in our portfolio. And, while we are working on this, would it be all right to bring in one or two of our next most likely target customers to help us in the co-creation process? This will allow us to get their input and pre-sell them on what we could do together".

CLOSING POINTS

1. Need product mgr./development <u>champion</u>
2. Focus on the new service's <u>different</u> niche
3. Solve conflicts with traditional sales reps
   -- not enough compensation for install. work
   -- give away service to get goods sale
   -- service failure risks goods sales anxiety
   -- passing rules of 5 to 7 (to know) &
   1 to 10 (to sell/do)
4. Treat like a new business start-up with strategic funding, separate P & L

Comments on the following bullets:

2. New extra services may have different cut-off points and pricing on the segment-and-serve pyramid (slide #8) within a given niche of customers that might value the service. The bigger, preliminary opportunity to extra services for fees is the un-bundling of standard services and higher terms for the many losing accounts in a distributor's portfolio. The how to's are in our: free strategy paper, site articles and high performance video.

3. Sales people will worry that if different people go into their account and bungle a service for fee implementation, then the product buyer will retaliate by switching product volume to another supplier. This is a real concern that must be anticipated and dealt with up-front with both the sales force and each customer to whom the extra service is offered. Mastering a new product to be sold to the same product buying influences has some degree of difficulty for a sales rep. Mastering, selling, installing and overseeing a new service with new contact people and new metrics within the same account is, relatively speaking, a lot more difficult. If we want one sales force for both old products and new services, then a lot of extra training will be necessary.

4. New services can't usually be developed and funded at the local or HQ level out of normal budgeted resources. Companies may have to see a new service as a new start-up that is funded with new, special talented people and money with its own P and L. New stuff always gets squeezed out by the needs of the old stuff when left in the same pen.