

July 30, 2003 - Distribution Channel Commentary (DCC) # 33

Greetings:

If you know what these commentaries are about, go to "TOPICS" below; otherwise, read on.

◆ A NEW, FREE SERVICE

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◆ ADD OTHERS/DELETE ME

To make this free service continue to happen, we must reach more individuals who care about making independent distribution companies/channels more effective. If you know of others who might like to receive this service, please: forward this commentary on to them; encourage them to email karen@merrifield.com to have her add their email address to our list; or, send them to our web site. If you don't like this type of mail, ask her to delete you, and we actually will.

◆ COPIES OF PAST COMMENTARIES, OUR E-BOOKLET, etc.

Past DCC's are posted. The "DCC Abstracts" is a brief summary of all 83 individual comments to date as well as all previously offered e-documents that we will continue to email upon request to karen@merrifield.com.

◆ RE-PUBLISHING/RE-PURPOSING ANY COMMENTARY CONTENT? YES YOU MAY!

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THIS WEEK'S TOPIC:

1. **First-Half of Chapter One of forthcoming book, "Reinventing Distributor Profitability"**
2. **Popular Thinking vs. Profitable Thinking**
3. **Views on the Current Recovery:**
 - a. **One page that tells it clearly how it really is.**
 - b. **Two pages on why the quality of the "bounce" will not be there**

1. First ½ of Chapter One

Introductory comments:

As some of you may know, I'm grinding away on a book that I plan to self-publish this fall in a rather open way. The book will have its own web site at which the first two chapters will be given away, plus there will be other real time, follow-up features with guest contributors (hopefully) from the press, the pros and distribution executives. We will sell the book direct plus through re-sellers who will have margin to push it at lower prices.

To start to generate interest and buzz (please tell your friends) I have posted the first half of chapter one below and the second half will be sent out next week. This is an advanced draft that still can be modified, so I'm hoping some of you will be self-selected editors for it. If you have comments or questions about content, intent, style, emotional reactions, please let me know.

Because Chapter One is an overview, I think you will be able to imagine a lot about what the book will include. At the cut-off point for this week, I have tacked on a simple outline of what will be covered next week in the second half of the chapter. Hope you enjoy and benefit from the read:

CH. 1: OUT OF CRISIS COMES, STRATEGIC CLARITY (?)

A FINANCIAL PROBLEM FOR DISTRIBUTORS

We are currently at a crisis point, in my opinion, within independent distribution channels in the US? Over 90% of wholesale distributors have a “strategy” that isn’t achieving enough profit power on a trend basis to survive. Is their necessity great enough to consider reinventing their “strategy” and their operational ways? Time will tell.

How do I measure my claim about a financial crisis for 90%+ of distributors? I checked in with my old friend and professional colleague of 20+ years, Al Bates, the founder and Chairman of The Profit Planning Group in Boulder, Colorado. Al runs comparative financial surveys for over 40 different distribution channel groups. He has amassed a 10+ year database of financial history for about 4000 companies with over 12,000 distribution locations. These firms vary in size from the smallest to the largest.¹

What does Al’s database tell us about financial profitability trends? The one best comparative ratio to use for all distributors is pre-tax return on total assets (ROTA)² for which the trend is not good. The ROTA averages for the entire database trended to a bottom in 2001 and appear to be, depending upon the channel, sliding a bit further or holding steady for year 2002 numbers that are starting to be published. In ’01, **the bottom 90%** of all distributors in the database averaged a measly **5.4% ROTA**, while the **top 10% averaged 15.4%**. With clever use of debt leverage, the top 10% actually made 4 to 6 times the after-tax return on shareholder’s investment (ROI) that the bottom 90% did in 2001, and they have been growing faster. Good comparative performance in tough times is possible with the right strategy!

THE ROOT CAUSE OF WEAK FINANCIAL RESULTS; LOW CUSTOMER IQ?

Poor ROTA numbers are actually symptoms of what root cause problems? Many distributors are quick to portray themselves as victims of a truly poor economic environment. Supply exceeds demand and is still growing. There is, at least, a 25% domestic, excess capacity to make and perhaps distribute tangible goods in all channels. Meanwhile, less expensive capacity to manufacture most tangible goods is and will continue to grow much faster than global demand for a number of reasons.³

Many smaller, domestic manufacturers are now starting to shift production to China before big distributors beat them to it with their own label brands from the same Chinese factories. I have seen equally excellent products from China that have had landed costs of 10 to 15% of what domestic manufacturers have been charging (for how much longer?).

¹ Al Bates authored a big study on 10 year trends entitled “Improving Distributor Profitability” available from www.nawpubs.org.

² Productivity is output (profit before interest and taxes) of a system (firm) divided by input (total dollars of assets invested). The capital invested doesn’t care about sales, margin %, expenses – just give it a high enough return and it will stay. Too low and it will convert back into cash and seek a higher return somewhere else.

³ To understand how the “dollar standard” global economy over-stimulates third world manufacturing capacity headed for the US, check out: The Dollar Crisis by Richard Duncan. Wiley, 2003.

With hard pressed end-users shopping more aggressively, pricing power will not exist for the foreseeable future, and the margin erosion game will continue. The game goes like this:

- A good customer of yours puts business out for bid.
- A “dumb competitor” using marginal cost thinking bids lower;
- You get a chance to meet the low bid and do to keep the business using marginal math.
- Having lost margin dollars needed to pay the bills, you go after some new business with marginal cost thinking and get to play the “dumb competitor” role to some other entrenched distributor.
- The result is a downward spiral “started by the other guy” with the “dumbest, most desperate competitor” determining the bottom price for 90%+ of distributors who are price takers.

What happened to getting paid for “service value”? I think the root cause problem for poor ROTA numbers is that most distributors can’t define and achieve “service value” in way that is both meaningful to the customer and profitable to the distributor. The definition of “value” will vary generally by customer niche and then more specifically by each customer within a target niche. Most distributors could do a much better job of:

- Describing service value for their most “profitable customer niche(s)”
- Measuring, achieving and selling that service definition better than anyone else
- Executing at the lowest cost, because of focused economics
- Making a sustainable, good profit from the value cost difference
- Re-deploying resources from permanent losing accounts to ones at which true or more profits are at least a possibility

The alternative default strategy is to claim “good service” for too many different kinds of customers and become a price taker for selling commodities in hopes of being a survivor.

If you have been blaming the economy for your weak numbers and think you compete effectively with a general statement of “good service”, your temperature may now be rising. I apologize, and encourage you to relax, because you are in good company; all of us, even the top 10%, are guilty of the same shortcomings to some degree. Take, instead, a deep breath, and skim through the “customer IQ quiz” at the end of this chapter. If it is any comfort, perhaps 1% of all distributors would pass the quiz, the rest of us have lots of upside opportunity if we choose to explore it.

SURVIVAL RETURNS AREN’T ADEQUATE; A GOOD ROTA TARGET?

Isn’t a 5.4% ROTA average for the bottom 90% at least survival? For now, yes; long term no. The return isn’t enough to give shareholders a minimum return on their investment considering the risk that they are incurring for being in a typically private, illiquid investment. Good capitalistic stewardship demands that shareholders should sell, exit, liquidate or fix the bottom 90% of distributors as soon as possible. (How’s that for a thoughtful shareholder challenge, especially in a family business?)

If the shareholders don’t do something, then the best employees, customers and suppliers will leave for greener pastures (like the top 10% of distributors) as soon as they can. A 5.4% ROTA will not generate enough re-invested profits to finance even a mediocre improvement path for these other stakeholder groups.

The top performing distributors, in the meantime, are not only making and reinvesting more money with the same tough economy, they are growing faster than their industry average as they slowly take from the bottom 90% on a profitable basis. Because they presumably have a more precise definition of a best strategy for their firm, they have been innovating, investing and investing in a more directed, effective

way than the bottom 90%. If the bottom 90% don't stop waiting for the economy to get better and settling for being survivors, then most share the risk of frogs sitting in a pot of slowly heated water, being unable to jump before being boiled.⁴

What is a minimum average ROTA that a distributor needs to keep all of his stakeholders – employees, customers, suppliers and shareholders – satisfied (although not the company of choice for the best quality stakeholders) for the long run? In our current total investment environment, I would guess about **a 10% average ROTA**, which isn't easy to achieve when you are trying to survive a tough economy.

Can anyone achieve successful turnarounds in tough times aside from outsiders with no previous commitments and chainsaws? Most distributor executives are compromised for two reasons: ethics and lack of slack resources. Distributor CEOs/principals are, generally speaking, a conservative, hard-working, upright and conscientious group that has made past commitments during better times. When wage cuts have had to be done over the past few years, CEOs have often taken the first and biggest reductions. They then have been the ones to lead by example by putting in more hours to shoulder more tasks that used to be done by those who are now gone.

Most executives that I have visited with also know how to run their businesses a lot better than they are doing, but they don't have or feel that they can afford the up-front investment in resources – time, talent and treasure – during these tough times. When we are underwater breathing through a bent reed it is tough to rethink how we might get to high ROTA land. We, instead, tend to reflexively just hunker down, do what we know how to do harder, faster, more cost effectively in an effort to survive while waiting for a recovering economy to provide some relief and flexibility as it always has since WW2.

AN ECONOMIC RECOVERY, IF IT COMES, WILL IT HELP

Hunkering down and waiting for economic recovery relief hasn't worked so far in the “post-bubble” period since there hasn't been a strong recovery! (Distributors of MRO goods to industry have weathered 35 straight months of manufacturing layoffs and counting). According to the “normal recovery” pattern since WW2, our current economy was supposed to respond to each of three rounds of economic stimulus – lower interest rates, more money supply and tax cuts – in each of the past three years. However, for the first time since 1929, the medicine has not worked. As I write this (07/03), economists are still hoping that their consensus forecast for a “second half recovery” will happen the third time around. Well, the second half of '03 is here, but any bounce will run into the following headwinds:

- Rising factory unemployment due to still accelerating Asian import growth to the US;
- Our growing, collective debt mountain of \$38T of interest bearing debt supported by a \$10T economy. Debt is currently growing five times faster than the economy; can we borrow and consume our way to prosperity and a sustainable recovery?
- 25% + excess plant capacity

Modest recovery or not, the global excess capacity for physical products coupled with slow growth, at best, guarantees no pricing power for sometime. Instead of using hope for a strategy, perhaps it is time to systematically re-think our company strategy using some different lens or “strategy maps”. Most every distribution location has hidden upside potential and a best affordable, do-able path out of the swamp to a higher ROTA point in the marketplace, if we could just see it with new perspectives.

⁴ Biological phenomenon: when frogs are placed in a room temperature pot of water that is slowly heated, the warmer water makes the frogs groggy and unable to jump when the heat finally becomes sufficient to boil them to death.

For generating new strategic perspectives, let's take a superficial, overview of six "strategy maps". Most of you may know a lot of the theory behind these maps, at least in an intuitive way, but that is not enough. Your eventual educational challenge will be to ensure that all of your employees understand and believe what's behind all of these maps in a comprehensive, integrated way; otherwise, you will not be able to generate the collective will to give up the old ways for the new.

NEW LENSES; SIX, "STRATEGY MAPS"


After reviewing the six "strategy maps" that follow, we will systematically apply them against our "traditional thinking and practices" in Chapter 2. This exercise will help us to name and claim the weaknesses in our current cultural habits that will hopefully be a first step towards overhauling self-limiting practices. With more open minds, we will then be able to revisit and apply strategy map wisdom in far greater detail in later chapters.

MAP #1: CUSTOMER PROFITABILITY RANKING REPORTS ("PBIT/CUSTOMER")

If asked:

- "Where do you make your profits?
- From your products or your customers?"
- What is your answer?

In one sense, we make money on both, but if we had to choose one of the two as the primary driver, most distributors today would say "customers". As for the profitability of customers, most distributors know that not all customers are profitable and that the profitable ones vary in degree. Few would know of or believe the "150/20 rule" which states that: on average 20% of a distributor's customers will generate 150% of their profit before interest and tax (PBIT). To that end, below is a case study slide. This slide summarizes what I discovered from a customer profitability ranking report for a turnaround situation that I managed in the early '80's.

| A DISTRIBUTOR CUSTOMER PROFIT RANKING  | | |
|--|-----------------------|-------------------------|
| | % of Customers | What % of "PBIT" |
| Top | 10% | 95% |
| Top | 20 | 145% |
| Top | 40 | 155% |
| | | |
| Bottom | 60 | (55%) |
| | 100% | 100% |

PBIT = Profit before interest & tax Book Chapter 1

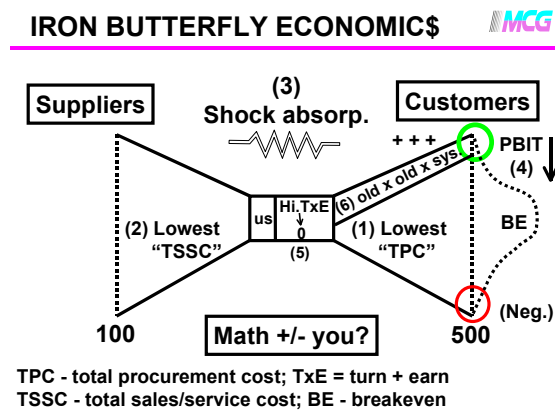
Every distributor's top 10, most profitable customers are unique to them. The distributor and its top 10 accounts have, perhaps unknowingly, trained each other to match up inventory breadth and depth fill-rate capability with customer needs. This match is a unique, local-stocking, service value proposition that no other distributor happens to have at the moment.

These 10 accounts will be the key guides for helping any distributor to better define and execute what their historic, here-to-fore, hidden, best strategy has been. (Key underlying assumption: "strategy" is where you make your money.) Customer profitability ranking reports will generate 7 different plays

covered in Chapter 3 that will help to reweave a distributor into to being a truly “customer profitability centric” business. No strategy map’s total implications will be more important to strategic reinvention, then what I will refer to “PBIT/customer”.

Ah! I can here the “Yes, but” questions popping up in your mind already. Most of them will be answered in Chapter 3. For now, lets move on with the overview so we can use the maps to surface our cultural thinking habits in Chapter 3.

MAP #2: MAXIMIZING “IRON BUTTERFLY ECONOMIC\$”⁵



This slide helps us to understand:

- Why the physical distribution function is forever (“iron”), because the intermediary...
- lowers TPC for customers(1),
- lowers TSSC for suppliers (2)
- serves as the outsourced, pain-removal, economy-of-solution provider for imperfect product flow issues collectively referred to as “shock absorption” services (3).
- Why most profitable customers (4) are the ones who buy a common-basket of items in large systematically generated order sizes which gives them the lowest TPC for those items, and gives the distributor the lowest TSSC for those customers and items.
- Why the difference between maximum customer value and lowest TSSC makes the highest sustainable profits for the distributor possible. **High value – low cost = best structural PBIT**

We can further infer from the slide that a distributor:

- Could further maximize butterfly economic\$ by selling yet more “old items to more old (common niche need) customers on a more systematic, routinized, automated basis.
- Has high turn x earn items, because a common group of customers' collective demand is making those items perform.
- Would make a lot more money by having a high share (50 to 85%- we will later learn) of a customer niche that turns and earns a common basket of items than by having the same total sales spread over a number of different niches of customers.
- Could more finely tune a total service offering built on a more robust one-stop-shop, high fill rate basket of items for each niche of customers they chose to target.

⁵ “Iron Butterfly Economics” may confuse you for two reasons: the “Iron Butterfly” is a heavy metal rock group that released its first album in '67. In July of '68, the released a second one with their biggest hit, *In-A-Gadda-Da-Vida*. Then, there is a book entitled “Butterfly Economics” which is on chaos theory. My hope is that you won’t forget to use and teach channel partners about “iron butterfly economics”.

More on butterfly economic\$ is in Chapter 4. For now, the first two maps explain a paradoxical promise of the book. Strategy by definition is what makes your business have a profit producing unique competitive value offering. How can one recipe for reinventing distributor profitability give all distributors different strategic outcomes?

Think of it this way. Most distributors have been spraying product promotions to too many customers for a long time just like spraying spaghetti at a wide wall hoping some will profitably stick. For accidental and mysterious reasons some clumps have stuck better than most. The PBIT/customer drill reveals a unique starting point for any distributor, and butterfly economics applications will help any distributor to figure out:

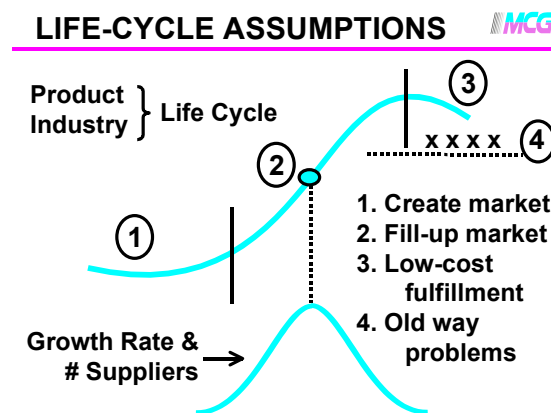
- Why the profitable accounts that they dominate are that way, and
- What unique common item baskets can be sold more thoroughly to what unique, local niche of customers on a high-value, low-cost basis

This book is a process book that is aimed at helping every motivated, open-minded distributor find their unique, elemental value-paths to pursue in a continuously innovating and differentiating way.

MAP #3: CORPORATE CAPABILITY LAGS THE LIFE-CYCLE BY HOW MUCH?

Most of you have seen the s-shaped life cycle curve below. It can be applied to the growth rates for: new products, new industries and originally for the population growth rate of a new species introduced into an environment without natural predators (e.g. rabbits in Australia).

This diagram has some additional features added to it. The bell shaped curve at the bottom illustrates how an industry's year-to-year growth rate will continue to accelerate to the inflection point in the S-curve (2), then decelerate to some mature replacement grow rate (3). The bell curve also reflects the growth rate for the number of individual competitors that jump in to an exploding market opportunity before they then consolidate or exit as the economic competition intensifies during the maturing stage. Most distribution channels are now in the 3rd or 4th stage having experienced: consolidation, eroding margins, and a customer priority shift to buying established commodities for the lowest total procurement cost (TPC).



As we look at this slide, a big question is how much does are corporate – thinking or culture habits (how we do things and what we believe) and capabilities – lag behind what our customers really want and will pay for? Most all companies in mature industries lag customer needs by varying degrees. The bottom 90% of the performers in a mature industry are typically more mired in the past than the high performers that have lagged less.

Lagging the life-cycle curve is a big reason why many of yesterday's star companies are today's losers. Sears once was the Wal-Mart of America. Corner grocers once controlled the industry with their intimate,

trust relationships with their customers, but eventually lost out to bigger stores at the edge of town. The corner guys held fast; they couldn't imagine customers would want to drive to a store where no one knew their name, etc. On balance, however, the customers had new cars to use and liked the wider, better selections and lower prices. Over ninety percent of the corner grocers went down in denial.

A star-to-loser story is happening as I write this chapter. The still top selling book, Good to Great by Jim Collins, focused on 11 star companies including Circuit City (CC) which had the best stock performance of them all. Since the book's research confirmed CC's greatness 3+ years ago, CC's results and stock price have been blown away by a surging Best Buy. One day last February ('03), CC fired ALL of their commissioned sales people. They are now trying to reinvent themselves by mimicking Best Buy's formula of bigger stores, more inventory, help yourself to lower every day prices with hourly employee assistance. CC salespeople were vital to selling \$1000 VHS or Beta machines in 1980, but apparently half the floor personnel costing half as much are sufficient for customer's buying electronics today.

Our strategy, systems and culture are potentially two-edged swords. Yesterday's heroes always had the best-defined strategic capabilities for the times. This allowed them to grow faster with better and more consistent execution. The people who executed and fine-tuned the strategy the best were promoted and became the guardians of the culture and the past. Many of today's execs do see the need to change through minimizing lenses, and then shy away from the task of trying to unfreeze, reconstitute and then refreeze corporate capabilities for a good run in the next stage of the life-cycle.

We will spend a lot of time in later chapters on "change management" and how to fill the gaps for: information needs, educational needs and political resistance needs. But, first we have to see clearly how we lag the life-cycle curve in Chapter Two.

My guess is that 99% of all distributors could better re-synch their corporate capabilities with life-cycle curve realities, especially those that still rely primarily on commissioned, outside sales reps working geographic territories. Number 4 on the diagram above, the shelf with the "X's", is meant to symbolize the behind-the-curve problems that have been growing in number and size within our businesses because our traditional, largely unconscious thinking is not perfectly matched with our customers' current needs.

If your PBIT ranking report reveals, for example, super winners at the top and super losers at the bottom, those extremes are caused by catch-up opportunities, or "X's", on the #4 shelf. In chapter 2, we will systematically uncover and name a number of the "X's" that many distributors have.

(THIS IS THE END OF THE FIRST HALF OF CH. 1)

NEXT WEEK, THE SECOND HALF OF CH. 1 WILL INCLUDE DISCUSSIONS ON:

Map # 4: Service Retention Theory (main diagram)

Map # 5 The Service Value Improvement Process (and eight step diagram/process)

5.1 The Wheel of Learning

5.2 3 types of new problems to solve

5.3 Making Good Mistakes

Map # 6 Strategy first, best practices and good ideas second

Case Study of ABC Distribution Co.'s Turnaround Using the Six Maps in an Integrated Way For Breakthrough Results

Chapter Conclusions

2. Popular Thinking vs. Profitable Thinking

Because my book is all about overcoming traditional distribution management thinking in order to embrace new strategy maps, I came across a short, good, relevant article by Tom Pryor. Tom has done a little work on the distribution circuit; he is an expert in applying “activity based costing” especially to determine actual customer profitability. I think you will enjoy this short, pithy and inspirational note at: http://www.icms.net/popular_vs_profitable.htm

3. Views on the Current Recovery

Many regular readers know that I am on record as to why we are in a different kind of downturn going back to the Spring of 2001 at great personal cost to me. The distribution circuit is loaded with cheerleading, optimistic sales types who don't want to hear that a post-bubble economy is different than all of the other ones that we have had since WW2. Nor, have they wanted to hear that Greenspan's huge efforts to reflate the economy have caused a housing bubble that is now starting to unwind in many cities.

Optimism is great! I have always seen myself as a can do, don't quit, turn negatives into positives, push the wheel of learning and fail forward kind of guy. But, I'm also a realist and pragmatist who has a professional responsibility to assess environmental conditions for business strategy formulation the way that I really see them and not as others wish that the economy would be.

Right now the global economy is due for a bit of an economic bounce. It has had three very sub-par quarters and the most massive economic stimulus in the US, Japan and now Euroland that has ever been proportionately applied in economic history. Will the stimulus work, or, will it be like “pushing on a string”? Because the structural problems that need to be unwound go back arguably to the beginning of the “dollar standard” in 1973, it could be a rather muted bounce.

You can listen to cheerleaders from Wall Street and the Bush Administration or you can read the two short latest views on this recovery from people who have been right (and cursed) for the past three years, because they haven't chosen to go along with their paymasters' party line.

I really like the incisiveness, the brevity and the hard cold data in this first article dated 7-29 from the Comstock Fund principals. Here's the link:

<http://www.comstockfunds.com/screenprint.cfm?newsletterid=1013>

A bit more loaded with econo-babble, but still hitting the right issues and making the right assessment as he has since early 2001 is Stephen Roach's latest. Roach is the chief global economist for Morgan, Stanley. I think they let him do his unvarnished reporting as a way to limit the liability they have for trying to get clients to invest based on the rest of their analysts' rosy, conflict-of-interest promotional activity. Here's the link to his 7-28 thoughts on what will likely be a wimpy recovery at best; his title is “The Quality of Economic Recovery”: <http://www.morganstanley.com/GEFdata/digests/20030728-mon.html>

That's all for this week.

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