White Paper

Supply Chain White Paper

5 Keys to Making Money in Distribution

iCepts Technology Group, Inc.
100% Employee Owned
www.icepts.com | info@icepts.com | 717.704.1000

After spending the last 10 years working with independent distribution companies in a consulting capacity, I have seen a few great business practices. I have seen a few bad business practices. And, I have seen the downright ugly business practices that have caused many companies to falter in challenging economic times. I recently interviewed a third generation distributor and asked him to talk about what their company has done to stay healthy over so many years. He told me that it was all down to the fundamentals of distribution. Companies need to understand their core competency and then stay true to that focus. Points of uncertainty and instability can attributed to the times they took their eye off the ball.

After my conversation with this gentleman, I started to think about all the times someone has said that you need to get back to the fundamentals. Sounds great, where do I sign up? The biggest problem with this statement is that some of us simply don't know what these magical fundamentals are. This is especially true if our education has been limited to one employer or company in the distribution industry. Over the course of this article, I will give you an overview of five basic fundamentals in distribution.

Understand Distribution Financials

It took me many years to understand distribution financials because I frankly was not exposed to them as a distributor. They just weren't emphasized in my family business. It was only when I started seeking outside coursework and seminars that I began to understand that making money in distribution went way beyond selling something for more than I bought it for.

Start with the income statement. It will make most sense once someone explains it to you. I often find it the most useful tool to look for leaking cash. Once you get a feel for what you are looking at, start combing through the operating expenses for areas to correct. A good friend of mine spent about 6 months pouring through his. He made changes in telecommunications, vehicles, and office supplies – even garbage service. When all was said and done, he wound up saving his company almost $20,000 per month. It was well worth his time.

Budgeting in distribution is a tough exercise. Most of us get hung up on the income side. Since we usually feel like our income projections are tantamount to pixie dust, we discredit the whole exercise. The real key is in the expense side the exercise. As we see the flow of income in previous years, we can see where we might be running tight going forward. Cash flow trouble keeps most business owners sleeping like babies – waking up and bawling every 2 hours.

A great deal of this anxiety is fear of the unknown. A budget helps alleviate some of that fear. Again, the income may be significantly different than your budget. As it moves around, you can make adjustments within the framework of a bigger plan. Going without a financial plan is a recipe for a lot of sleepless nights.

Skipping cash discounts is like signing up for a high interest credit card. It should be avoided when possible. When we skip a discount, and hold on to our money for an additional 20-25 days, we are essentially signing up for a loan from the supplier. If we are offered cash terms of 2% 10 net 30, the supplier is willing to give us a 2% discount on the entire invoice if we pay within 10 days. If we skip the discount and pay in 30 days, we forfeit the 2% savings. Holding on to our money for the 20 days at a 2% penalty doesn't sound like much – until you take that interest rate out to a full annual percentage rate. Let me save you some time. The rate comes out to around 37%. Ouch. Most of us can borrow at a much better rate than this. This is a great use of your line of credit. By the way, this works the same way if you are giving out cash discounts to customers. Quit doing this. At least quit giving cash terms to your least profitable customers. Need some more incentive? Go ask your AR people how many customers take the cash discount and still pay you in 25 days or more.

If you don't feel comfortable around financials, ask for help. Most distribution companies were started by salespeople who thought they could do it better than their previous employer. Let's face it, most salespeople are not closet accountants. This tends to be where most distributors fail – they can't manage the money. Time to swallow your pride and get some education. There are some great seminars and workshops out there that focus on finance for non-financial managers. There are great books written in plain common sense language. Finally, ask your CPA for some help. Understanding cash flow will help you survive some of the deepest sales recessions.

Understand Your Core Competencies

Why do your customers buy from you instead of your competitors? Have you ever asked? Most distributors think they can answer this question, but have never done the research to back it up. I have recently been helping a client understand the difference between sales and marketing. When I grew up, the two activities were often used in the same sentence to describe a bunch of folks selling things for more than we bought them for. Marketing is not sales. Marketing makes sales more effective.

You will learn a great deal about your company, both positive and negative, by asking your customers. If you have an internet savvy customer base, web based surveys might be your best bet. If you have a customer base that prefers personal interaction, you might have to do phone based interviews or focus groups. The point is – don't guess about your core competencies, ask your customers.

Many of us have tried to take our company way outside the current market. Sometimes this means that we look at another trade type or customer segment. Other times, we do geographic moves that cause us to lose our identity. I have personally experienced both.

As many of you know, I grew up in construction supply. Every few years, we would lose our sanity and decide to court the industrial contractor. The products were the same – why not? There was a very big why not. Industrial contractors do not have the same service needs as the jobsite contractor. It's like apples and oranges. Both are fruit, but the two are very different.

In a similar bearing of my soul, I also got my backside handed to me by trying to go into a different geographic market. In this example I was working with the same type of customer; but the geographic differences in application proved to be the insurmountable obstacle.

In both cases, I did not honor what had made me successful all along. Don't get me wrong, I am not advocating that we rest on our laurels. Do the research and ask yourself if it fits within your core competencies. Are you built to do business the way that the market requires? If not, you might be trying to jam a square peg into a round hole.

Every once in a while, a customer comes along that only wants to deal with the low cost provider. Know any of these? They want the lowest price and they could care less about our "total procurement cost" rationale. When this happens, one of our salespeople usually wants to bring up the volume vs. price debate. Can you support this type of customer? What have you built your company on? If you are a high service company, this scenario will cause you endless frustration. Know who you are. Be willing to pass up some business opportunities that go against your service model. I have seen people try to develop a multi-tiered service approach, but they ultimately wound up blending them back into one melting pot.

Analyze Customer Profitability

Are your biggest volume customers really the most profitable? You would be amazed how many people in your organization subscribe to that correlation. If fact, it is often our largest customers that have the highest cost to serve and the lowest contribution to net profit. If you haven't done this exercise, you may want to get the Maalox ready. If you follow through with this, there may be some tough decisions in store.

In order to rank your customers by net profit, we need to understand cost to serve. What does it cost us to process an order? There are a couple of ways to get a number: the hard way or the easy way. The hard way involves using activity based costing software to account for the amount of money allocated to every order processing function. It involves time studies and process analysis. Although it can be highly accurate, the time involved and the hornet's nest you stir up is generally not worth the aggravation. The easy way is to take your annual operating expenses and divide it by the number of orders you processed in the last year. This will give you a ballpark number. This ballpark is suitable for making decisions. It isn't perfect, not does it have to be. Don't go into analysis paralysis here.

Once you know how much it costs to process an order, look at the number of orders you have processed for a customer. Take that amount of money and subtract it from annual gross profit received from selling this customer. If it is positive, rejoice in the knowledge that someone is helping your bottom line. If it is negative, time to start making some decisions.

Once I determine the profitability of each customer, I break them down into logical groups. Group A are the net profitable customers.

Group B are the large group of customers that are negative contributors, but provide volume. Group C are the customers that are very negative and tend to string us out on payment. These are the bloodsuckers of your bottom line. The next step is to determine a course of action for each group. We simply can't service them all the same.

Let's start at the bottom. Fire them. Ok, perhaps that is a tough pill to swallow. After all, it doesn't feel natural to fire a customer. Unless you like making donations to them on a monthly basis, you need to start evening the playing field. There are all sorts of ways to fire a bloodsucker. The easiest way is to raise their prices. Unless we want to inflate our accounts receivable, we need to quit giving them credit. Don't spend extra processing dollars on these accounts. No special orders. No transfers. Invoke minimum purchases. You would think they would get the hint and just leave. Some of them will stay. This time it will be on your terms.

Group B isn't as cut and dried. Subtle changes will help change the profit picture. With this group, I tend to look at price increases. Not the draconian moves as illustrated in Group C. With this group I tend to fly below the radar. Look for margin improvement in slower moving inventory. What percentage of a category or vendor line do you think your customers actually know what they should pay? Chances are the percentage is very low. They know the price on a few dozen highly competitive items. As the popularity of an item goes down, the margin can go up.

Group A is the precious list of customers that actually contribute to your bottom line. They pay for everyone else to use your services. They need to be rewarded – not with discounts, but with praise and attention. Some of you invest in season tickets to sports. These are the folks we want to take. Golf outings, lunches and other miscellaneous sales expenses should be reserved for this elite group. If you don't tell them you care, they will leave you. When you try to get them back, it will be the most expensive next sale of your relationship.

Is it easier to sell deeper into an existing account or go out and sign up a new customer? Any salesperson worth their salt will tell you the former is true. Sell deeper. Better yet, sell deeper into the accounts that are actually profitable. This stuff comes full circle. I have recently been working with a client on this very concept. We began to analyze their Group A customers as to how deep the company is selling into them. Out of a potential 39 categories, we found that most customers had sales in less than 10 categories in the last year. I am being generous here. We counted all sales in a category – even if the participation was under $100. The point here is simple. Your best customers are probably not aware of everything you have to offer them. Let's enlighten them.

Utilize Variable Compensation Programs

Where is all the money stored in a distribution company? The warehouse, of course. This is why I encourage all distributors to refer to it as a vault. Who are typically the lowest paid employees in a distribution organization? That's right – the folks who manage all your money. Worse yet, we typically pay simple hourly wages for this category of employee. Let's be honest for a moment, can we expect superior results when we provide less than superior compensation?

Now I am not advocating that we jack up the hourly rates on our material handling teams. I am advocating that we take a little time to create incentives based on desired behaviors. I am a huge fan of team incentives. We all win or we all lose. I generally set up no more than 5 criteria when I am designing an incentive program. The 5 criteria can change over time, but I find that too many criteria become confusing. If all 5 are met, then the full bonus is paid to every member of the team. If 4 out of 5 are met, each team member receives 80% of the bonus. This philosophy lends itself to a little self-policing.

Cleanliness is next to godliness in wholesale distribution. I generally make this my first criteria. I can usually tell the accuracy and efficiency of a facility the moment I walk in the door. After that, you can look at several other criteria: inventory accuracy, damage, picking accuracy, shipping accuracy, time loss accidents, equipment maintenance, etc. Again, keep it to 5 and adjust as needed.

Is the warehouse the only place a variable compensation plan can work? I challenge you to look at several other teams. Could you come up with performance criteria for purchasing agents? What about accounts receivable professionals? I am not advocating that we convert their entire income to variable comp. Try a small percentage, perhaps 20%, of overall compensation. Make sure that these bonuses come on a monthly basis. Anything longer in duration will diminish the effectiveness of your program. Again, we are trying to modify behavior. If I am signing the check, please pay attention to the things I want you to watch.

Learn to Manage Your Inventory

As I mentioned before, the largest cash asset in a wholesale distribution company is in the inventory. Nothing is more fundamental than that. I have worked with several clients who neglect basic inventory management during times of prosperity only to be thrown into a financial crisis when the economy goes south. They find themselves saddled with a mountain of aging inventory and very few places to turn it into cash. All this could have been avoided with a perpetual inventory management program. The good news is that most of you have already paid for it.

The distribution software package is the cornerstone of any inventory management program. A majority of them have adequate inventory replenishment and performance measurement modules. Unfortunately, many distributors don't know how to tap into these resources. I have seen more Excel spreadsheet work around solutions than I care to admit. I am stunned at how few distributors perform regular system audits. This is where you invite your software provider to visit your company, for a small fee, so that they can assess your utilization of the package. Understanding the inventory management controls and settings is how you make the system work for you. A little time spent up front will allow you to manage several thousand skus with a very small staff. If you are going to buy the package, make sure that you know what it can do for you.

Learn to measure inventory performance. Get very familiar with the terms: inventory turn, hits, carrying cost, service percentage and return on investment. These are all measurements of the largest cash asset. Monitoring them and looking for slight improvements will help you avoid trapped cash when the sales folks are looking at a bleak forecast.

Never get emotionally attached to inventory. Every item has a product life cycle. Products are hot sellers one year, dogs the next. This is due to the fickle nature of customer preference. When a product is no longer being sold, we consider this item to be dead inventory. The date of death is up for some debate. Most distributors define death as zero sales in the last 12 months. Some tighten up that date to zero sales in 6 or 7 months, while others push the death envelope out to 18 to 24 months. I had one client try to negotiate a 36 month date of death with me.

Unless you are in the appliance parts business, where things don't start moving until they have been out for 7 years, 36 months is a bit long in the tooth.

Dead and slow stock management is how distributors take unproductive assets and reinvest those dollars into high turning products. I generally like to see distributors carry less than 3% dead inventory by the 12 month definition. I also like to track slow moving inventory. Why not get ahead of the problem? Items with fewer than 4 hits (orders in the last 12 months) are usually on their way to the great warehouse in the sky. Scrutinize these products and decide whether you should get out before the market dies on you. Inventory is just cash – the trick is to turn it back into the green stuff.

Finally, know what you have in the warehouse. If we can all agree that inventory is really just cash in another form, then imagine your warehouse full of actual currency. Pallets of bills. If it was truly filled with money, would we treat it just a little different than we do today? You bet we would. We probably wouldn't run the forks through a pallet of Jacksons. I doubt that we would kick spare Lincolns under the pallet rack – no matter how dirty and crumpled up they were. Most importantly, at the end of each day, we would know how much money we had in that warehouse. Do we do that today?

Inventory accuracy isn't something we do to appease the bean counters. What is the cost of inaccuracy? I believe that we employ one additional inside sales person just to check on inventory when a customer places an order. Now this doesn't happen all the time. Just when the quantity requested is dangerously close to what our computer says we have on the shelf. A lack of inventory accuracy affects our ability to serve our customers. What about our inventory investors? How does an inaccurate inventory affect their purchasing habits? I guarantee that they add a little padding to each order because they just can't trust the numbers in the system. Extra labor and padded inventory. These are the types of things that bleed a company dry.

The distribution business is a relatively simple business. We buy stuff, we consolidate stuff and we sell it to someone else. We tend to get screwed up in the details. We add cost by making the business more complicated than necessary. I challenge you to go back and look at your processes. Have you added more steps than necessary? Are these steps stealing net profit? I have given you 5 fundamental areas to explore. Whether you are new to the game, or an old hat, I urge you to take a critical look at the things that made your company successful. Its time to get back to basics.

Article by
Jason Bader
Principal
The Distribution Team
http://www.distributionteam.com/

Provided by
iCepts Technology Group, Inc.
100% Employee Owned
Supply Chain & Technology Experts
www.icepts.com | info@icepts.com | 717.704.1000