Driving enterprise value in wholesale distribution—Part II

The need to balance SG&A efficiency and effectiveness

Introduction

Albert Einstein used to say that "everything should be made as simple as possible, but not simpler." A similar principle applies to managing selling, general and administrative (SG&A) expenses in wholesale distribution (WD). Companies should strive to leverage SG&A spend to effectively execute their business strategies, while controlling SG&A cost, which in case of wholesale distributors includes distribution operations as well. In many cases, this means spending more than the bare minimum on SG&A. This finding seems to fly in the face of conventional wisdom, which has long viewed lower SG&A costs as the key to improving return on operating capital. So what's really going on?

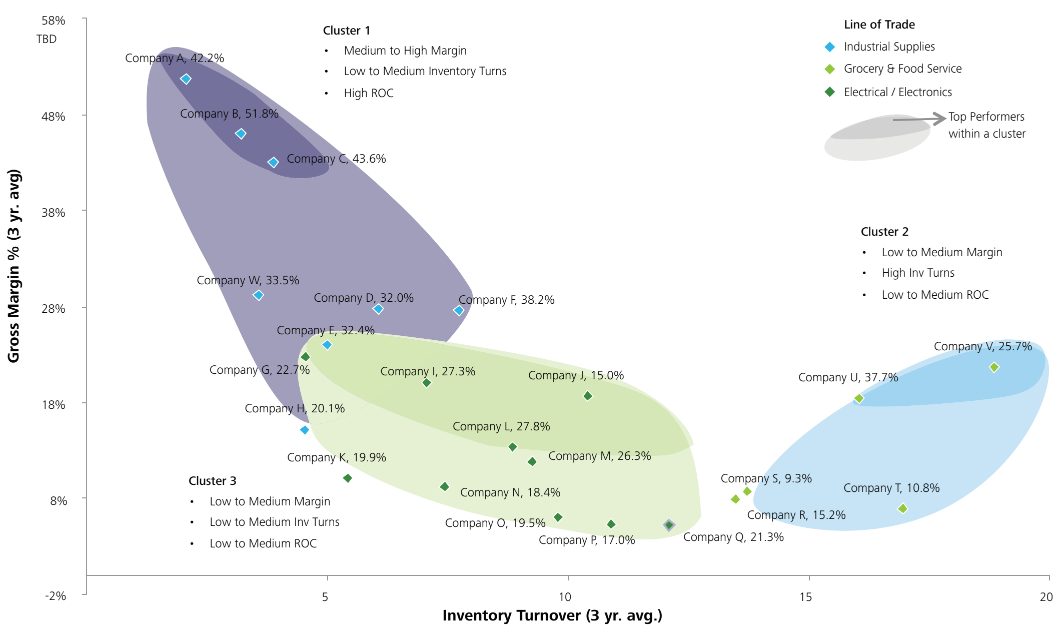
Our research[1] shows that top-performing wholesale distributors—those with the highest return on operating capital (ROC)–tend to have higher SG&A-to-revenue ratios than their peers with lower ROC. Is this because top performers enjoy the luxury of larger profit margins and can thus get away with less than optimal SG&A efficiency? In part, yes. But the bigger reason is that top WD performers typically feature a much broader product portfolio and larger geographic footprint, enabling them to serve customers more effectively. This service-oriented strategy generates much higher margins, but also increases overall complexity which in turn drives SG&A costs as a result of a more skilled sales force, wider distribution network, and supporting capabilities such as pricing, category management and network optimization.

In this second article in our series on "Driving Enterprise Value in Wholesale Distribution," we take a detailed look at the industry's SG&A practices, and offer new insights into how companies at every performance level can manage SG&A costs more effectively to support their business strategies and improve their return on operating capital.

A contrarian finding on capital efficiency and SG&A

The first article in our series[2] revealed that the traditional mantras of operational excellence and cost reduction are no longer the keys to success in wholesale distribution. In fact, our analysis of three different WD lines-of-trade (denoted by the large bubbles in figure 1) showed that companies that emphasize revenue quality over pure operations excellence (denoted by the darker shaded smaller bubbles) often deliver increased returns on capital. We identified four strategies-product portfolio expansion, price optimization, sales-force effectiveness and operations excellence – to drive higher returns. As is obvious, supporting these strategies will require re-thinking of SG&A infrastructure.

Figure 1: Performance in wholesale distribution varies widely



(1) Deloitte Consulting Survey, 2014
(2) Driving Enterprise Value in Wholesale Distribution—Sanjay Agarwal and Raj Nagarajan, January 2014

	SG&A as a % of sales		
Peer set	Top RoC performers	Rest	Overall
Electrical/Electronics	18%	8%	11%
Grocery & Food Services	22%	11%	15%
Industrial Supplies	21%	18%	17%

Note: 3 year averages for Gross Margin, Inventory Turnover and ROC considered based on FY10, FY11, FY12 figures; ROC = EBIT/(NFA + NWC)

Source: Deloitte Consulting Analysis; S&P Capital IQ Database

According to our in-depth analysis[1] of SG&A spending in the wholesale distribution industry, top performers have made a strategic choice to feature a broader product selection, greater geographic coverage, and superior customer service (i.e., one-stop shopping, better fill rates, faster delivery times, and more knowledgeable sales team), which helps them grow revenue and market share while earning higher gross margins. Of course, these superior capabilities don't magically appear out of thin air; they require a higher level of investment and ongoing spending in SG&A. The good news for top performers is that their increased SG&A spending is more than offset by faster revenue growth (4x) and higher gross margins (nearly 2x), resulting in higher financial results and return on capital (figure 2).

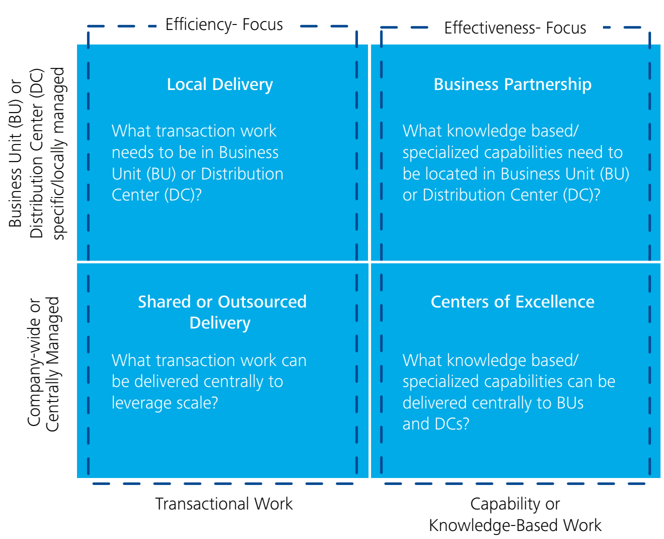
Figure 2: Higher rates of SG&A spending correlate with faster revenue growth and higher gross margins

Peer set	Rev CAGR	SG&A CAGR	Gross margin
Top performers	6.7%	5.5%	29.1%
Rest	1.6%	2.2%	15.0%

This is not to suggest that wholesale distributors should go on a mindless SG&A spending spree. Far from it. The key is to strike a balance between efficiency and effectiveness: spending as little as possible on SG&A to effectively support a winning business strategy. Wild spending on SG&A in single-minded pursuit of growth can be recipe for poor performance. But so can single-mindedly focusing on SG&A cost reduction at the expense of strategy.

To help companies identify a targeted balance, we have developed a simple framework that categorizes SG&A activities and capabilities based on two dimensions: (1) centralization vs. decentralization (locally managed) that impacts the ability to leverage scale—across Y-axis in figure 3, and (2) efficiency vs. effectiveness across X-axis, which impacts the focus between transactional and value-added capabilities. Activities for each SG&A function can be evaluated by mapping them to the framework based on where they are performed within the organization, and whether they primarily focus on efficiency or effectiveness.

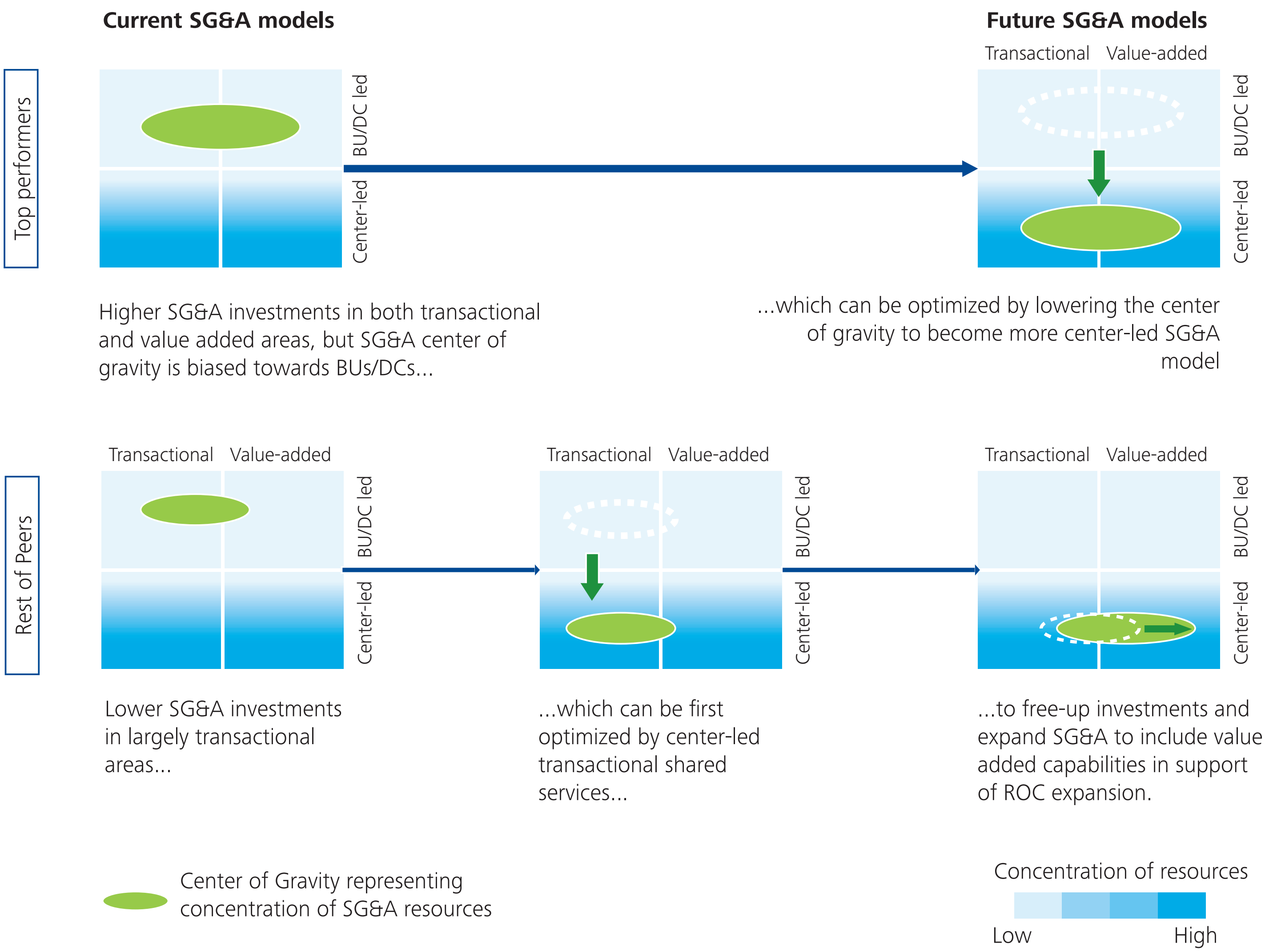
Figure 3: SG&A Framework: Balancing efficiency and effectiveness through SG&A service delivery model



Efficiency-focused initiatives typically contribute to overall performance by reducing transaction costs in SG&A activities such as payables and collections by leveraging economies of scale and labor arbitrage through centralization in a shared services center or outsourcing. Effectiveness-focused initiatives typically contribute to overall performance by improving business competitiveness and building strategic capabilities in knowledge-intensive areas such as pricing and category management that are delivered centrally through "centers of excellence."

Top performers, who have already made significant investments in SG&A as part of transforming their business models, should focus on optimizing their SG&A platforms by leveraging scale in transactional shared services and centers of excellence. This implies that they would need to shift the center of gravity of their SG&A models towards the bottom of our SG&A framework. The rest of the peers have a more challenging proposition. They will not only need to shift to the bottom of our framework to optimize their current SG&A models, but also build out SG&A capabilities towards the right of SG&A framework in support of transforming their business models to realize ROCs similar to top performance.

Figure 4: Transitioning from current to future models for top performers and rest of peers

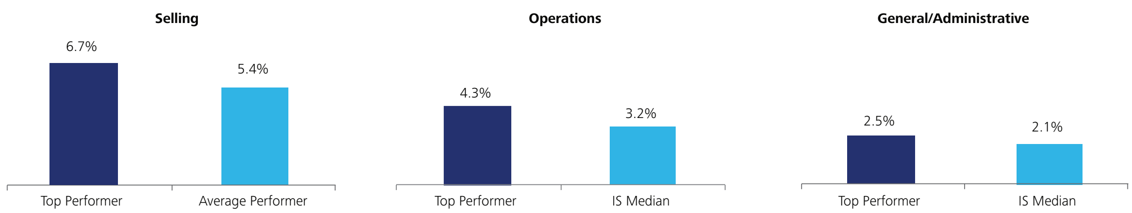


Digging deeper into SG&A spending

As we discussed, top performers tend to spend more on SG&A in order to support their high margin business strategies. But SG&A is a very broad cost category. Where exactly are they focusing their spend?

To find out, we conducted an in-depth SG&A survey[1] to better understand what top performers are doing differently than the rest of the pack. The survey looked at companies in similar and adjacent lines of trade, dividing SG&A spending into three major categories: Selling, Operations, and General/Administrative (figure 5). The survey results show that top performers focus most of their additional SG&A spending on Selling (about 25% higher than their peer group of wholesale distribution companies across Industrial supplies, Electrical/Electronics and Grocer/Food Services), and on Operations, (about 35% higher than peer group). For General/Administrative, the spend levels are comparable, implying that top performers are generally competitive with peer group.

Figure 5: Selling, Operations, and General/Administrative comparisons as % of revenue



Further analysis of the survey data reveals specific capability areas within each cost category where top wholesale distributors are out-investing and out-performing their lower-performing peers.

"Selling" capabilities where top WDs out-invest and out-perform their peers

To support their high margin strategies, top performers significantly outspend their peers on selling costs as a percentage of revenue. Their investments in selling are targeted in three areas, each supported by comparing a relevant metric between top performers and their peers in the survey. First, investing in a capable and skilled sales-force that is able to leverage a broader product portfolio to cross-sell and up-sell – as observed in higher average sales rep compensation from our survey. Second, investing in sales expertise and account management capabilities for growing national accounts – as observed in allocation of selling expenses between national, field and inside sales segments. And finally, higher technology investments in sales capabilities – as observed in technology investments as a percent of revenue.

These strategies contribute to top performers realizing 30-60% higher gross margins per sales rep. A sales support center of excellence with supporting pricing and analytics is key to increasing the return from these investments. Mapping these investments and resulting capabilities onto our SG&A framework shows that when it comes to selling, top performers primarily focus on improving effectiveness. At the same time, top performers are delivering these capabilities (e.g., pricing, territory optimization, request for proposal (RFP) response, customer service) through central centers of excellence (CoE) to leverage economies of scale.

"Operations" capabilities where top WDs out-invest and out-perform their peers

According to our survey, for distribution operations, top performers spend twice as much as average. In particular, they spend 90% more on operations staff in order to support a more expansive distribution network that puts them closer to their customers, enabling them to provide high service levels across a wide geographic market. Also, they pay 30% more for product supply labor in order to maintain the higher category management and product supply capabilities required to support their broad portfolio of product offerings. In making these investments, top perfomers are adopting efficiency measures through evaluating outsourcing models to not only optimize operating costs of the expanded network, but also to exercise flexibility in network design where needed.

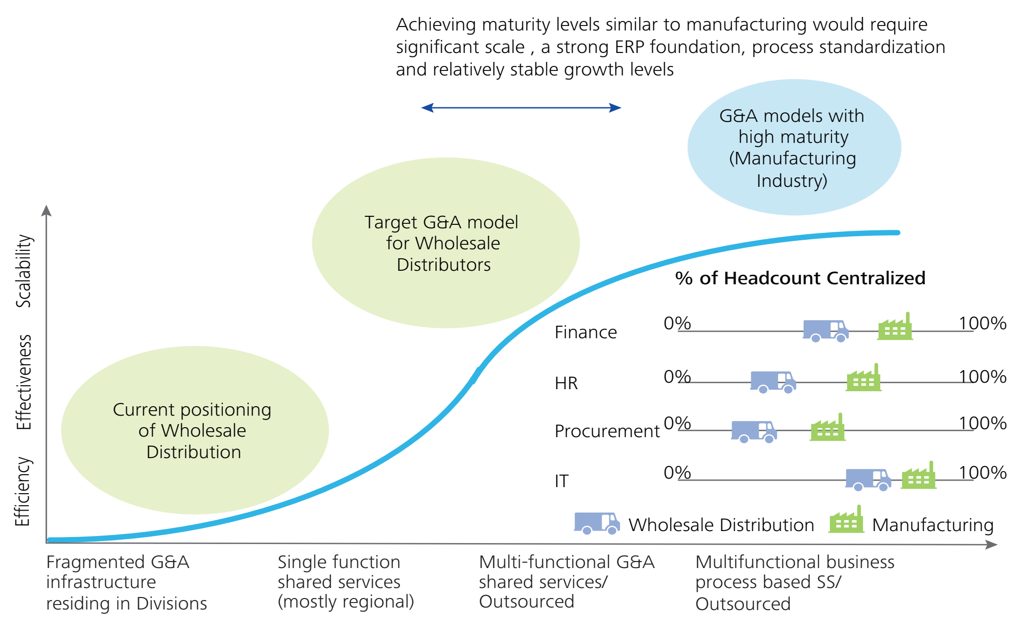
This higher level of spending on distribution operations results in higher on-time delivery rates and fill rates, both contributing to higher customer service levels and gross margins. These results often offset the additional spending required to achieve them, enabling top performers to produce higher market growth, capital efficiency and bottom-line profitability.

Top performers are focusing on efficiency by balancing captive and outsourcing mix for warehousing and logistics and also improving effectiveness by delivering network planning and route optimization capabilities through "centers of excellence" (CoE) to leverage economies of scale.

Improvement opportunities for "General/Administrative" spending

Given the relatively small difference in General/Administrative spending between top performers and the rest of the pack, it is difficult to draw conclusions that are statistically significant. However, a cross-industry benchmarking analysis suggests that wholesale distributors as a group have significant room for improvement. The manufacturing industry provides a particularly good benchmark in this area, since manufacturers have faced severe cost pressure and global competition for decades and thus have invested a tremendous amount of time and effort moving up the maturity curve to reduce and optimize their G&A spending. If wholesale distributors can achieve maturity levels anywhere near those of the manufacturing industry, the positive financial impact could be significant (figure 6).

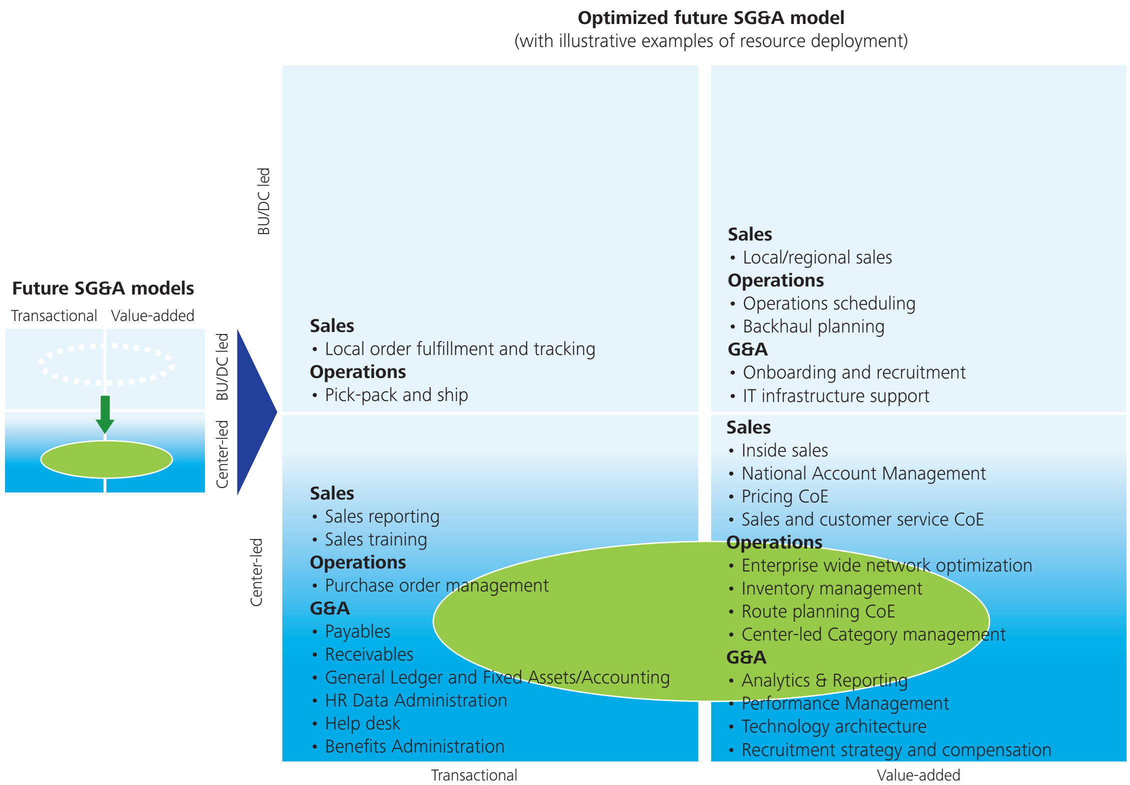
Figure 6: Moving up the G&A maturity curve



Potential Future State SG&A Model

An optimized SG&A model with positive impact on both efficiency and effectiveness across all three SG&A cost drivers of Sales, Operations and G&A is shown in Figure 7.

Figure 7: Future optimized SG&A models with a bias for center led capabilities



Moving forward

Our research and analysis highlights the importance of aligning SG&A spending with business strategy. To achieve the higher returns, wholesale distributors need strategies with the potential to deliver improved margins and market growth. But they also need to support those strategies with adequate levels of SG&A spending. Blindly focusing on SG&A cost reduction at the expense of the business strategy is likely a losing formula.

Wholesale distributors in the middle or bottom of the pack might want to follow the lead of top performers and move toward a high-margin business model that features a broader product portfolio to enable one-stop shopping, a more expansive distribution network to enable higher fill rates and faster delivery times, and a more knowledgeable sales staff capable of supporting a broad category of products and delivering superior customer service. Key investment areas to support this new business model include selling, distribution operations, product supply, and category management. Such an approach has the potential to deliver much higher margins, but will almost certainly require a company to increase its SG&A spending -- a bold choice that flies in the face of conventional wisdom for managing SG&A costs.

On the other end of the spectrum, many top performers face the opposite challenge. Having moved to the front of the pack through a combination of organic and inorganic growth, these leading companies may need to take some time to consolidate their complex SG&A activities and infrastructure to improve efficiency and scalability. Although their SG&A investments to date may have been purposeful and rational, in many cases their absolute SG&A levels have grown rapidly and inefficiencies may be somewhat masked by strong revenue growth. In the future, complexities and inefficiencies could multiply -- or growth could slow -- causing SG&A costs to quickly eat away at their margins.

At every performance level, managing SG&A successfully involves a delicate balancing act between optimizing efficiency and enabling an effective business strategy. This means keeping SG&A costs as low as possible -- but not lower.

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A special thanks to Karan Rao, Consultant, Deloitte Consulting LLP, for his contributions to this article