

Driving enterprise value
in wholesale distribution
Lead from the middle

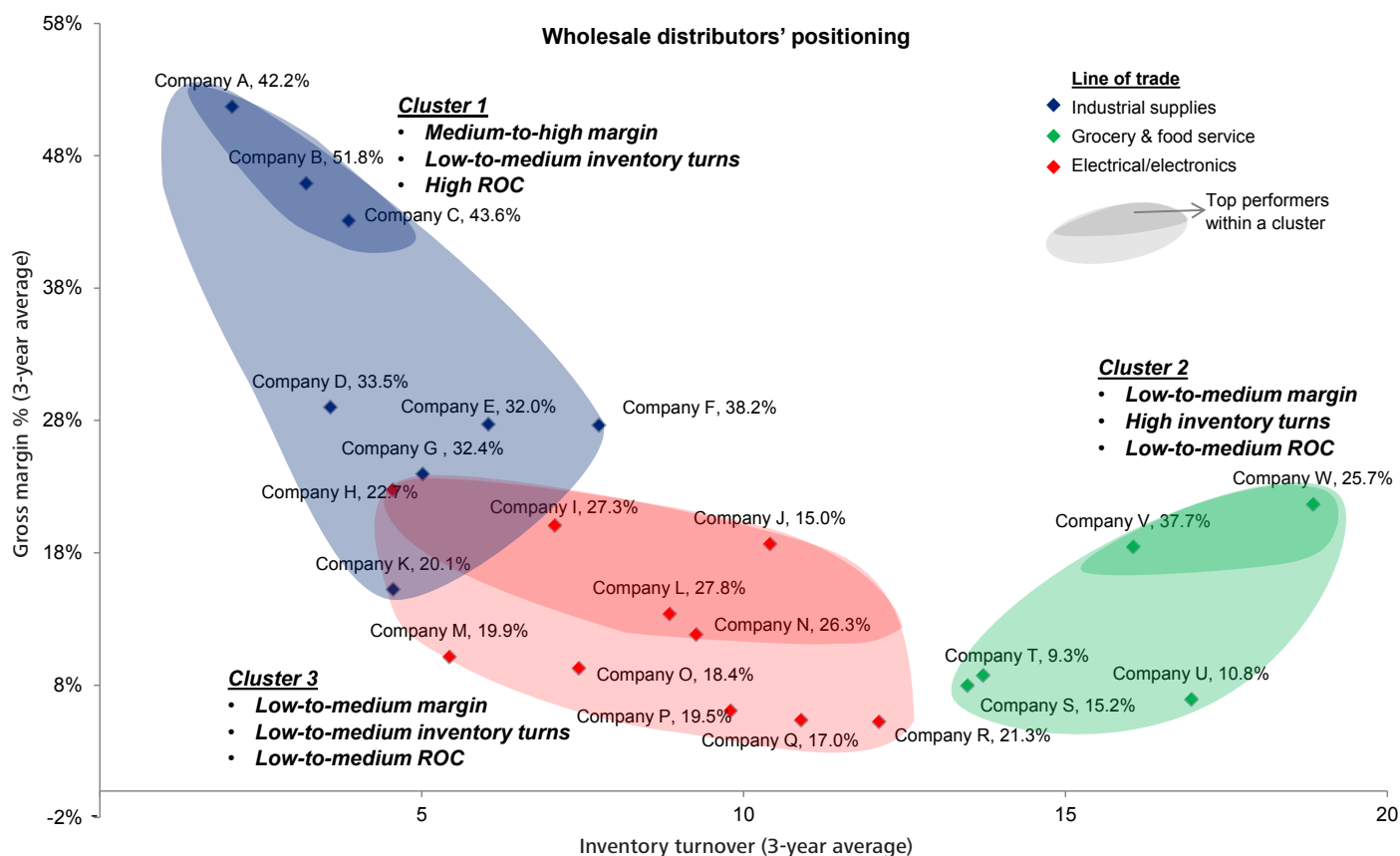


Traditional priorities of operational excellence and cost performance no longer appear to be the success mantra for wholesale distribution (WD) companies. Instead, Deloitte's industry review shows that companies which have prioritized revenue quality over pure operations excellence have delivered breakthrough value, despite the recent challenges of economic uncertainty, increased competition, and globalization.

This new mantra is discussed in a recent book, *The Three Rules—How Exceptional Companies Think*, by Michael Raynor and Mumtaz Ahmed. The authors have identified what they believe is "exceptional performance" and what actions companies take to achieve it. During the recent economic crisis, Raynor and Ahmed looked at why poor performers—those experiencing a decline in their return on assets (ROA)—were, relatively speaking, fairing far worse than top performers.

The book's discussion of performance disparity among industry peers is indicative of the current state of the wholesale distribution (WD) industry. Operating performance as measured by return on operating capital (ROC) shows wide dispersion across the industry. Although part of this performance dispersion can be attributed to lines of trade differences (such as food service, industrial supplies, electrical and electronics), it also is a result of strategic choices some companies are making regarding their business and operating models. Figure 1 illustrates this point and is based on publicly available financial data across a broad landscape of WD companies. Each data point represents a company; performance is measured on the dimensions of gross margin and inventory turns, both of which are key determinants of overall ROC. We chose ROC to be a key performance indicator because it correlates well with enterprise value.

Figure 1. Wholesale distribution companies' performance as measured by ROC



Note: Clusters determined by inspection. Three-year averages for gross margin, inventory turnover and ROC considered based on FY10, FY11, FY12 figures; ROC = EBIT/ (NFA + NWC)
 Source: Deloitte Consulting LLP Analysis; S&P Capital IQ Database.

The dispersion of wholesale distribution companies also points to a broad clustering of organizations belonging to specific lines of trade. This is natural, as each line of trade has unique operating characteristics. Grocery and foodservice distributors, for instance, have high inventory turns relative to electrical distributors due to the nature of their products. Industrial distributors, on the other hand, have extremely low inventory turns. Further, margins in each cluster are significantly influenced by competitive pressures as well as companies' ability to differentiate their offering in the marketplace. Cluster 1, industrial distributors, have medium-to-high margins and provide medium-to high-ROC, despite the low inventory turns. Cluster 2, grocery and foodservice distributors, have low-to-medium ROC driven by lower gross margins. Cluster 3, electrical and electronics distributors, are stuck in the middle with low-to-medium ROC driven by both low-to-medium gross margins and inventory turns.

In each cluster, there are top performers with significantly better ROC primarily driven by higher gross margins than others. Also, the top performers in Cluster 1 outperform everyone else by a wide margin. The key question is: How have the high performers in each cluster, particularly the high performers in Cluster 1, achieved such high ROC? What are they doing that other companies are not?

We identified a number of business and operating model choices that appear to have helped high performers break into the top of their cluster. Interestingly, these choices align with the rules of success in Raynor's and Ahmed's book.

After three years of research, Raynor and Ahmed summarized their findings about superior performance in three succinct rules:

- Better before cheaper: Don't compete on price, compete on value.*
- Revenue before cost: Don't drive profits by cutting cost, instead find ways to earn higher prices or higher volume.*
- There are no other rules: View all your other choices through the lens of the first two rules.*

What does “better before cheaper” mean for wholesale distribution?

We found that wholesale distributors with the highest ROC—the three companies at the top of Cluster 1—focused on gross margin. This appears to be a deliberate trade-off with asset efficiencies (e.g., inventory turns) relative to the rest of the companies.

To better understand the implications of this strategy, we looked deeper into the business and operational choices made by these leading performers over time.

As illustrated in Table 1, top performers in Cluster 1 have focused on strategic actions that improve gross margins—what products to sell and in what form; which markets to enter, including global expansion possibilities; and other growth-driven decisions, such as sales force quality as determined by contributions to the revenue base. We examined the impact of these strategic actions over a decade; there appears to be clear evidence of these three industrial companies improving their gross margin and, in doing so, more than doubling their ROC, while maintaining their asset efficiencies (measured by inventory turns).

Interestingly, these high performers also have increased revenue growth by three percentage points per year faster than others over the last decade.

The three high-performing industrial distributors have deliberately focused on improving gross margins and revenue growth while having the lowest inventory turns; this approach has rewarded them by improving ROC the most. In making this comparison, we must be cognizant of the differences in various lines of trade within wholesale distribution and recognize that the potential to lift ROC may differ between lines of trade given unique market dynamics. That said, there appears to be enough evidence that a deliberate focus on becoming better before cheaper and on driving revenue growth would yield significantly higher ROCs.

Table 1. Performance of companies over the last decade

	Revenue CAGR	Gross Margin		Inventory Turns		Return on Capital	
	2002–2012	2002	2012	2002	2012	2002	2012
Top Performers in Cluster 1	10%	43%	47%	3.0	3.2	23%	48%
All others	7%	16%	17%	7.4	8.9	16%	23%

How to become better?

Breakthrough performers have focused on specific business model strategies to achieve revenue growth, improving gross margins while maintaining operational excellence to extract greater value. These strategies include (see Figure 2):

- Expand market presence and proximity to customers:
 - Grow globally to expand revenue sources beyond the U.S. and leverage global sourcing
 - Location growth within markets to increase proximity to customers
- Focus on strategic category management:
 - Expand product portfolio and focus on end-to-end margin improvement in a category by addressing sourcing, product/supply mix, and pricing
 - Grow in private label to expand margins
- Improve sales force effectiveness:
 - Maximize overall revenue productivity of existing and future sales
 - Sales incentive and compensation
- Maintain and/or improve operations excellence to drive profitable growth:
 - Optimize network to manage operating costs and inventory turns
 - Leverage SG&A efficiencies to fund category and market expansion strategies

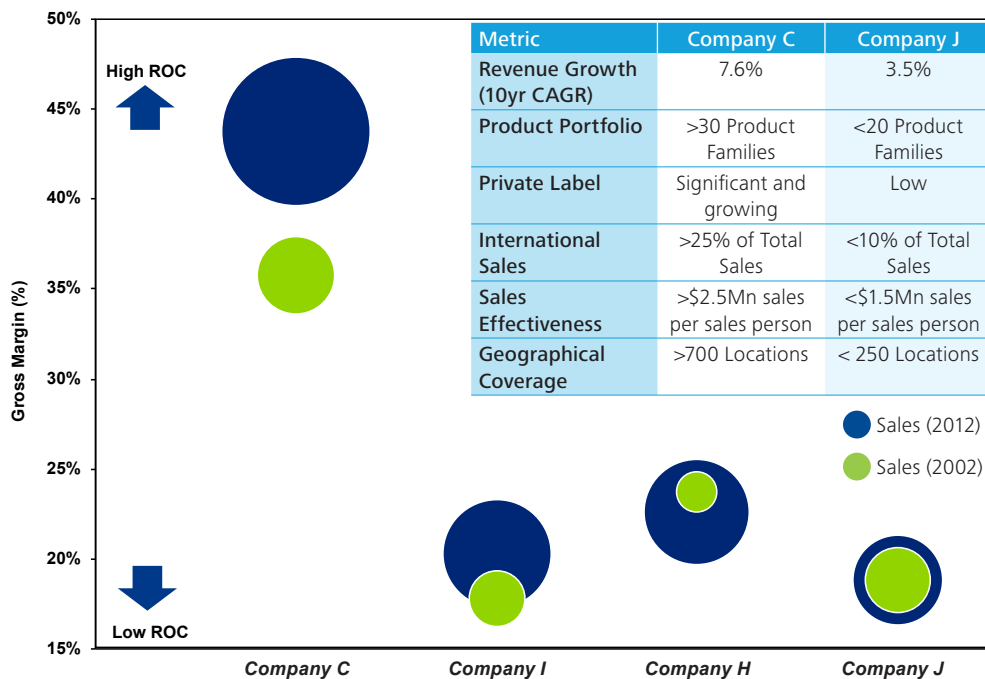
Figure 2. Strategies to improve enterprise value



We examined four wholesale distribution peers' business and operating model choices over the last decade (see Figure 3). We selected a high performer from Cluster 1 and compared with three companies from Cluster 3—the company from Cluster 1 has a broad product portfolio and competes with others across many product lines. The company from Cluster 1 (we call it Company C) has emerged as a breakthrough performer by making strategic choices that have now put it in the northwest corner of the matrix, with an ROC that is significantly higher than the other three companies.

We looked at breakthrough performer Company C relative to its peers across a number of dimensions that determine revenue quality. All values are rounded and somewhat qualitative to provide a directional representation of differences between Company C and its peers. Company C has accelerated gross margins and ROC improvement by enhancing revenue growth; by expanding product portfolio, private label offerings, and geographical coverage, including global expansions; and by improving sales effectiveness. Companies I, H and J have remained relatively flat over the last decade and their performance across many of the metrics discussed earlier is sub-par, as shown by the data for Company J on many metrics.

Figure 3. Case study graphic

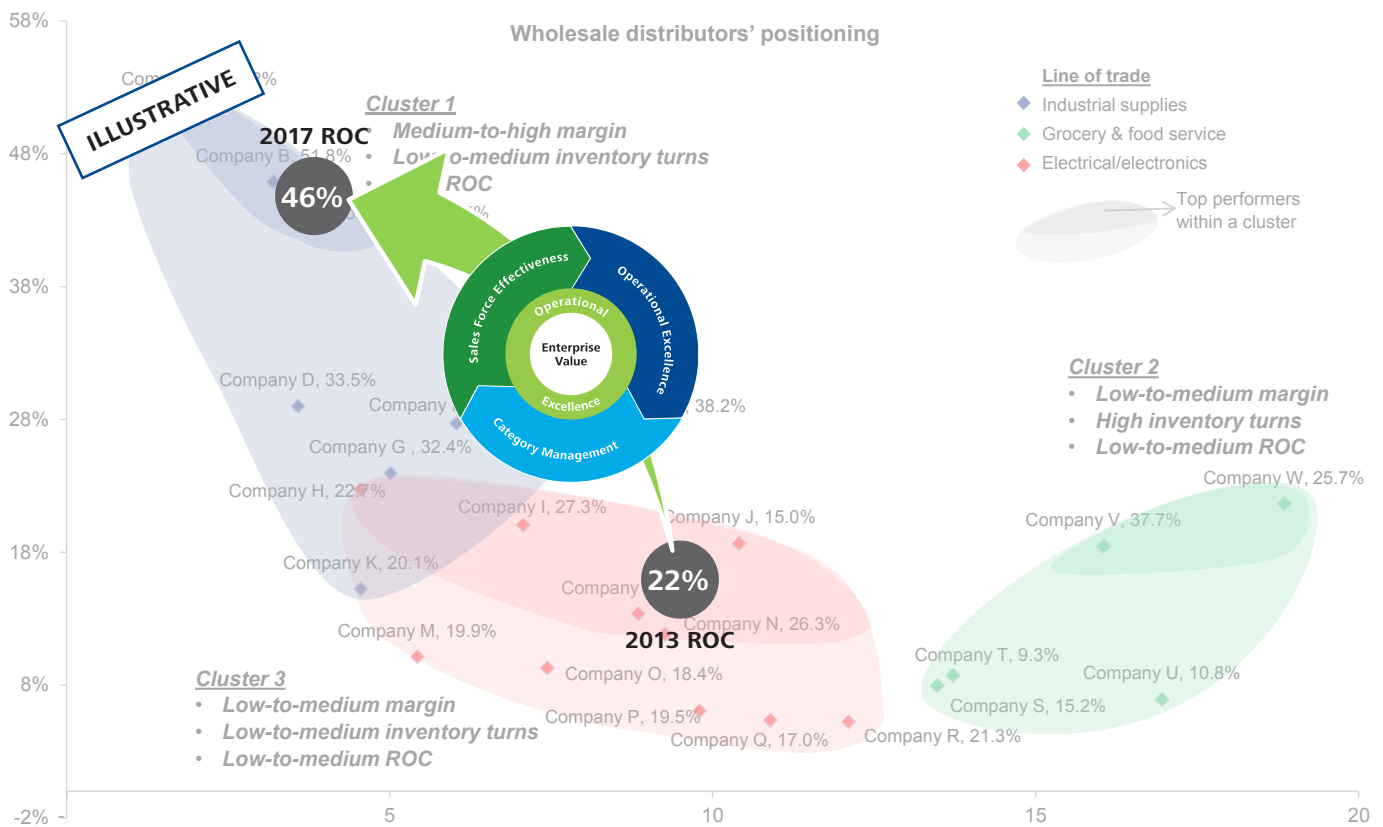


Pursuing one or many of the business model strategies mentioned earlier calls for leading from the middle—careful consideration as to where the company is today and where it desires to be in the future. Balance sheet health, investment potential, key trends in the line of trade and competitive landscape are some of the drivers that impact how a transformation should be architected.

One of the risks in pursuing certain strategies is that a company may compromise its operational and asset efficiencies. For example, having more locations to drive sales and service levels may require having more inventory and running the risk of lowering inventory turns. Company C and its companions appear to have improved the quality of their revenues without losing sight of cost and asset efficiencies and, thus, have avoided drifting to the left in the matrix. This focus on operational excellence not only improves overall returns, it can also improve operating cash flows that can be invested in pursuing the revenue-enhancing strategies discussed above.

The journey for each line of trade towards improving ROC most likely will be different, as will the future ROC potential, as each line of trade presents a unique set of operating dynamics which will influence margin expansion strategies. As a result, a company should assess strategies related to category management, global expansion, footprint optimization and sales effectiveness within its line of trade and carve its own trajectory (see Figure 4).

Figure 4. Path to improving shareholder value



Source: Deloitte Consulting LLP Analysis

Key takeaways

Deloitte's research shows that focusing solely, or even primarily, on operational excellence will not help a wholesale distribution company achieve greater ROC. This should be accomplished through a laser focus on revenue growth and margin improvements. Since most WD companies are middle-market organizations, they reside in a fragmented marketplace that provides opportunities for growth and acquisitions.

It appears that most companies are stalled in place because they focus too much on the operating model and not enough on growth and margins. Further, there are several key levers that may be optimized to help a company yield above-average ROC, including category management, product breadth, international sales, customer proximity, and sales force effectiveness.

It is also important to note that nothing lasts forever; the marketplace is constantly changing. The goal of this paper is to give wholesale distribution companies aiming for superior performance a foundation for doing better than they might otherwise do by blindly following unexamined or untested suppositions about their results. To borrow from Raynor and Ahmed, "Every glider lands eventually. But how long it stays up, how far it flies, and the heights it reaches are all profoundly affected by the pilot's choices."

The authors would like to thank Ankur Bhardwaj and Nikhil Ray for supporting analysis and insight.

"Every glider lands eventually. But how long it stays up, how far it flies, and the heights it reaches are all profoundly affected by the pilot's choices."

—Excerpt from the book, *The Three Rules—How Exceptional Companies Think*, by Michael Raynor and Mumtaz Ahmed

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