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Small steps to improving both profitability and company value.

Little Things Mean a Lot

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Distributors can grow their companies through disciplined focus on a small number of metrics. In particular, controlling operating expenses is a consistent indicator of steady growth, closely followed by a healthy gross margin. A necessary first step, however, is rigorous statistical benchmarking to find out where your company currently stands in its industry sector.

Distributor Profits: Adequate but Unexciting

When I was a young man I used to dance to a song by Kitty Kallen called “Little Things Mean a Lot.” Miss Kallen wasn’t singing about the distribution industry, of course, but I think the title of her song is good advice for those of us looking to grow our business. There are a few small measures we can take that, if we do them well and do them consistently, lead to steady and consistent growth.

Distributors, in the aggregate, have always produced adequate profits. At the same time, they have always produced unexciting profits. For the typical firm, good never gets to great. Research conducted by the Distribution Performance Project suggests that about 20 percent of distributors in any line of trade break out of the mold and produce outstanding profit.

As uninspiring as that sounds, it actually overstates the situation. Of the top 20 percent, about half come and go in terms of profit performance. That is, they are in the top 20 percent on profit one year and closer to typical the next. Only about ten percent of firms produce high profit on a consistent basis. It is important to understand how they do that.

There are some key pressure points where I think your focus needs to be if you want to be a part of that top percentile. And I’d like to make some suggestions about how you can move forward and improve your performance. Again, the key word to stress is “small”. Let’s review what I believe are the key analytical metrics that you need to work on, and then I’ll discuss how to go about getting them.

My firm did a project involving about 15 different lines of trade across distribution and we asked, what causes people to be profitable? We looked at six factors:

- Sales size
- Sales growth
- Gross margin percentage
- Operating expense percentage
- DSO (day sales outstanding)
- Inventory turnover

It's extremely important to note that all of these numbers were versus other people in the same industry. I didn't compare electrical with liquor or compare plumbing with door hardware, for example. Within those parameters, our research was trying to discover whether a particular business was doing better than half the people in their industry. It could be 51 percent or 95 percent, it just needed to be better than half.

Then our research showed that of those six, there were two factors that seem to be the most powerful in terms of driving profitability:

- Gross margin
- Operating expenses

Until I did this project, I was a person who said that there is no problem in life that you cannot solve with more gross margin. As it turned out, operating expenses are actually more important than gross margin. Together, these two factors have the potential to drive profitability in a major way if we work on them, hard.

If it's just a matter of two metrics, then, why don't we usually focus on what I'll call the Big Two? Because it is really difficult to get control of gross margin and expenses at the same time. It is easy to get gross margin improvement by itself; it is also easy to get operating expenses improvement by itself; but it is very tricky to improve them at the same time. And that's because the two of them are joined at the hip. It's as strong a relationship as I've ever come up across in the real world. I've done a lot of financial analysis and there is often so much noise in it that you can't figure out what's going on. In this case, the association is really clear.

Join the Club

I want to help you join the 50/50 club. That means you are doing better than half the companies in your line of trade on gross margin and expenses at the same time. It's very hard to do and I have a few pieces of advice about how to go about doing it. Specifically, if you're a distributor, I've got four goals for you. Bear in mind that the figures I'll use are what I'll call rack-suit figures, that is, I'll use them as a general example, but you're going to have to tailor them to your company.

Number one, you need to increase your sales by at least the inflation rate plus a safety factor of three percent. I think that's a good goal. I chose it for a reason, namely that non-payroll expenses in your business tend to rise with inflation, so you need to keep outpacing inflation if you can. Inflation is currently running at about two percent so that makes a total increase of five percent.

Number two, and this is a biggie, force payroll to grow more slowly than sales to create what I call a sales-to-payroll wedge. We desperately need sales to grow faster than payroll. If you look at payroll as a percent of sales in almost any industry in distribution, it is the same today as it was 20 years ago. We have made tremendous improvements in productivity, and sales per employee has gone way up, but every time sales per employee goes up, insurance costs go up, we give people raises, and so on. We need to break that linkage.

Number three, increase the gross margin percentage, not the gross margin dollars, by 0.4 percent. Again, this is a rack-suit percentage; you have to tailor it. Maybe your number is 0.1 percent. Maybe it's 0.5 percent, but you have to improve the gross margin percentage.

Number four, decrease the other expenses as a percent of sales (not expense dollars). Again, as a general rack-suit guide I'd say 0.3 percent.

Again, the key word is "small". Little things mean a lot. I would much rather grow slowly and consistently while making more money than to grow faster while not making much at all. Small increases in sales are good enough if you can also satisfy the other metrics I've been talking about.

In the sales generation process, there are three key analytics that we need to focus on and they are:

- Lines per order
- Fill rate
- Average order per line

Again, think modest increases. Let's assume your company is currently having 2.5 lines per order. I would like to take that to 2.6. Then let's take the second factor, fill rate, from 95 percent to 95.2 percent. And then let's raise the third factor, the average order line value, by 1 percent.

The big problem with achieving even these modest and realistic goals for many of us is that we don't have a clear picture of where we are with any of the benchmark data I've been discussing. We don't know how we are doing against the other companies in our industry, we're not clear on gross margin or operating expenses, and we have no idea about lines per order or fill rate.

Benchmarking is Critical

The firms that I discussed at the beginning of this article, those that are consistently the most profitable, tend to have a better understanding of how profit is affected in their particular line of trade. Overwhelmingly, they do this by benchmarking against their peers and then taking action on the benchmark results. Benchmarking can be done formally or informally. On an informal basis, publicly held firms can be tracked through financial reports and the like. However, such a process is sorely lacking in richness of information.

A much more effective approach is through a formal benchmarking program sponsored by either a trade association or buying group. Even here, the information is of limited value unless there is widespread participation. Generating that participation requires four elements in the benchmarking program.

- **Dashboard Format:** Different decision situations necessitate looking at different sets of information. The benchmarking effort must provide flexibility to slice and dice the information in different ways to help understand strengths and weaknesses.
- **Highlight What Matters:** Seemingly, everything is important to somebody in the firm. However, only a few of the Critical Profit Variables (CPVs), such as the gross margin percentage and expense percentage, really drive higher or lower profit. These must be emphasized so that firms focus on them.
- **Setting Priorities:** The program should also allow the firm to see where it stands on the Critical Profit Variables compared to its peers. That is, the firm may be in the top 25 percent, the bottom 30 percent or any other ranking. Such indicators of relative performance are essential.
- **Making Improvements:** Finally, an effective program should allow for what-if analysis. If the firm were to change its gross margin percentage, for example, how would its performance improve? With such capabilities, information takes on an action component.

Sadly, only a limited number of firms carefully benchmark their performance against their peers. Those that do, most likely, will remain in the top ten percent on profit. It is essential for trade associations and buying groups to structure benchmarking programs that facilitate participation by all.

It's possible for distributors to improve both ongoing profitability and the value of the company by executing the small but high-yield steps outlined here. But to get from good to great, company leaders must make these proven metrics part of their operating system. As much as my 30-plus jaded years of industry profitability data suggests otherwise, I am optimistic that analytics is finally getting its proper respect in distribution and that more firms will achieve steady and consistent growth through small measures.

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