

Out of the Fire

The first of three articles on repositioning independent distribution after the economic calamity.



As Billy Joel said, “We didn’t start the fire. No, we didn’t light it but we tried to fight it.”

Before fire intervention techniques were introduced to the Long Island Pine Barrens of Suffolk County, N.Y., fire would break out every 15-25 years. The fires would naturally eliminate weaker trees and brush and fire resistant, well-rooted trees prevailed. In 1995, despite intervention efforts, a really nasty fire dubbed “The Sunrise Wildfire” ravaged Long Island’s Pine Barrens and threatened bordering commercial property.

An expert attributed that event to fire intervention, which allowed too many weak trees to survive over the years. He argued that the forest would have been better off if the “pitch pine,” a particularly fire-resistant species, was allowed to dominate and weaker trees were left to perish in the fires. The Pine Barrens also sit on top of the major drinking water aquifer for Long Island.

The tragedy of our current economic situation is like that of the fire. Economic intervention represented by liberalized

credit, relaxed financial regulation and political stimulation of housing demand created an unsustainable bubble with huge risk to the financial system. Underlying mortgage loans ignited, spreading to their parent mortgage-backed securities (MBS), then to the credit default swaps “insuring” the MBS bonds. Financial institutions worldwide were up to their necks in each other’s credit default swaps, so they were all holding guns to each other’s heads. Then they held a gun to our heads by getting Congress to approve TARP bailouts. We fought the fire, creating more “flammable” assets from unsustainable debt.

Tragedy or teacher? Instead of looking at the economic “fire” as a tragedy, let’s learn from it. Sustaining profitable growth over the years requires nurturing extensive roots, developing a strong productive core business and distributing “seeds” to grow in new places close enough to the tree. This three-part series will help you do this with your business.

We recently surveyed senior executives at distributorships in multiple distribution channels about how they made it through the recession and what they need to do now. Distributors want to dig out of the rubble, but they

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CHART 1: AN INWARD FOCUS

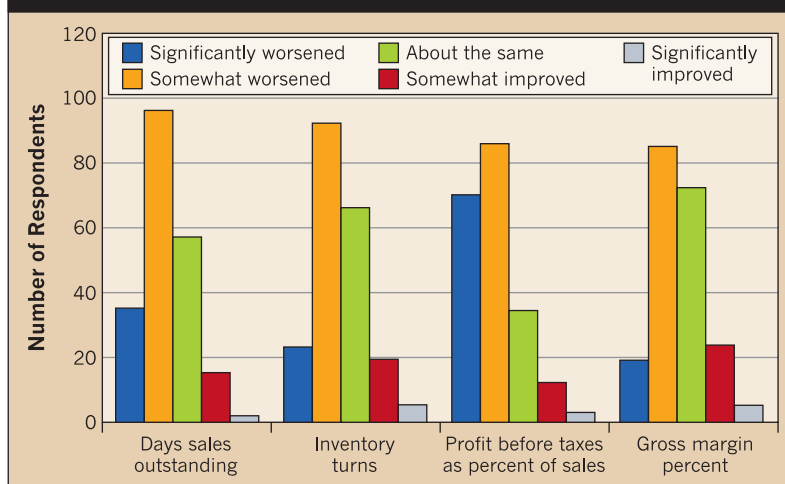


are reluctant to invest in growth until the national economic picture clears up. We suspect they would rather be sure about the devil they're dealing with before betting the farm again. A few respondents looked like they were on to something, and were looking at their businesses as a number of niches. There's hope in that line of thinking, and we will build on that in this series.

Let's get our bearings. We surveyed distributors, (primarily owners and C-level management) from industrial, electrical, safety, HVAC and several other trades and received a good representation of responses from each channel. They provided their sales and market performance variances from 2009 over 2008, and we further divided these into good performers (-5 percent and better) and poor performers (-20 percent or worse). We discovered 10 major trends in their responses:

1. Past growth was largely artificial, and the new planning baseline is -20 percent or worse.
2. Distributor reactions were primarily defensive.
3. Gross-profit percentage, inventory turns and receivables performance slipped a bit, but net profit slipped a lot.
4. Good performers tended to be realists, not unbridled optimists.

CHART 2: OPERATING MEASURES



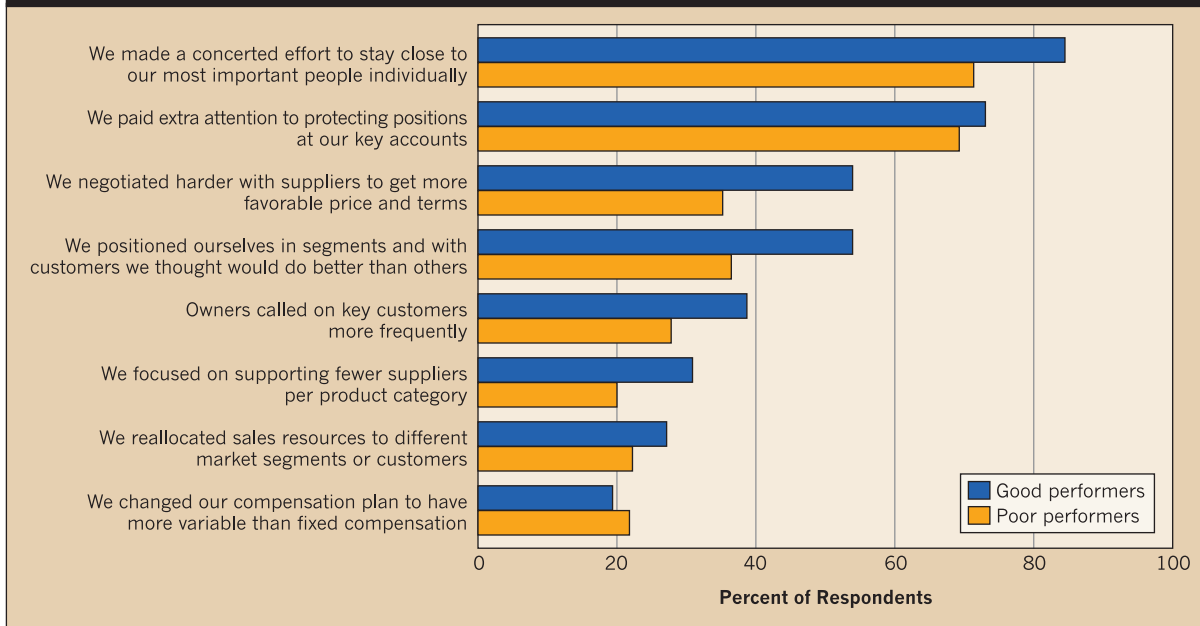
5. Good performers looked deeper and in more places for answers.
6. Good performers cut more sales-people.
7. Everyone is afraid of "the weather" (the direction of the nation).
8. With growth opportunities, the usual sources won't deliver, and the new sources are still suspect.
9. Distributors need to broaden their growth horizons while improving productivity to turn gross margin into profits at an increasing rate.
10. Manufacturers executed their usual tactics to curtail expenses.

1. The new planning baseline is

-20 percent or worse. The reported sales decline from 2009 versus 2008 was -20 percent to -29 percent, but the real market decline may actually have been closer to -30 percent to -35 percent. Naturally, most distributors want to believe they did better than the market and will report this. But let's not split hairs. It was really bad, the worst decline of our lifetimes. There are few tricks left in the government's bag of fiscal and monetary tools to change things for the better.

Much of the growth distributors enjoyed from 2003-2008 was artificially stimulated, irresponsibly financed and

CHART 3: ACTIONS TAKEN IN THE MARKET



in a word, unsustainable. The result is that distributors' markets shrunk back to 2003 levels, so their new planning baseline is 20 percent down or more. They will have to grow from there by doing things differently from what they have ever done before. They can't act like surfers waiting for the big waves to return, and instead must look for more beaches.

2. Distributor reactions were primarily defensive.

It's natural to retreat and protect your own backyard when threatened. Thieves go on the prowl when the economy declines. Your first move before venturing farther is to "get your rear elements in order" — protect your own accounts by paying more attention to them. Respondents tended to do less as the suggested actions became more outwardly focused and strategic versus tactical (See Chart 1: "An Inward Focus" on page 31). This is to be expected. The upper five percent of distributors that substantially outperform the rest take the trouble to understand and execute the tougher strategies with the higher upside potential. But everybody needs to start with protecting key accounts.

Conclusion: *Learn more ways to grow than just concentrating on existing accounts and paying more attention when threatened. Pay more attention to opportunities to add value and penetrate different segments when sales are healthy before you need to panic in a recession. The high performers executed strategies in more directions in response to the recession.*

3. Component measures of profit slipped a little, but net profit slipped a lot. Distributors reported that while their gross profit rates, inventory turnover and receivables collection rates slipped a bit their net profit slipped much more (See Chart 2: "Operating Measures" on page 31). On further analysis, this reveals a thin understanding or practice of "scalability." Companies that simply added people during the recovery of 2003-2008 versus automating processes with

technology did nothing to flatten the variable cost line in their break-even chart. The difficulty in a deep recession is that it's much harder to unravel people from work processes on the way down. You add people on the way up to perform one role, but they end up performing more roles than expected. When you need to cut, you often cut things you may not want to cut. Customers end up disappointed and your team gets irritated as they scramble to fill the holes.

When you substitute fixed investment like technology for variable cost (headcount) you gain "operating leverage" — net profit percentage increases with volume due to the reduced slope of the variable cost curve. During 2003-2008, distributor net profit percentages probably went up with the little bit of operating leverage they had. If distributors had automated more back in 2002-2004, they would have taken more of their sales growth home as net profit.

Conclusion: *Productivity and scalability are critical. Don't grow sales without them.*

4. Good performers tend to be realists, not unbridled optimists. More good performers reported that they saw the recession coming. In addition, they either predicted its severity or predicted it would be worse. They prepared for the worst and then some, but also took more initiative to get out on the front to grow sales. Their realism flies in the face of the usual tendency to exhibit unbridled optimism, the kind that says, "There's a recession on but I'm not participating."

Our survey results show the opposite works better. Better performers face the recession and adjust resources intelligently while executing more than a defensive strategy to protect customers. You wouldn't be impressed with the percentage difference between good performers and poor performers

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on individual actions. The difference is that good performers took greater action and in more areas.

Trees grow primarily at the tips of their branches. Prolific growers do it by putting out more buds. The better performers tend to do this, but they could mature their skills to pursue a broader set of growth opportunities and simultaneously drive greater productivity. How many distributors are investigating what's going on at customers and prospective new segments, which are at the "tips of their branches"?

Conclusion: *A fire's a fire. Be realistic, cut off the burning parts fast, and get out on more growth fronts.*

5. Good performers looked deeper. Both groups focused on staying close to their best accounts and best people, but then it gets interesting (See Chart 3: "Actions Taken in the Market" on page 32.) By a wider margin, better performers tended to negotiate with suppliers more and approached how they stayed close to customers differently. They didn't just focus on key customers by volume. They thought about a customer's business prospects and the business segments that had a better chance of weathering the storm, maybe even growing through it. They applied the same realistic analysis of the economy to their customers' current and future business prospects.

Conclusion: *As Wayne Gretzky said, "I don't go where the puck is, I go where I think the puck is going to be." How about predicting which segments will fare better than others and adding more customers there?*

Next month's article. We also discovered good performers cut more salespeople and that distributors have issues growing on multiple fronts. The old sources of growth probably won't deliver this time, so everyone will have to look in different places. Next month's article will explore where respondents are looking for and finding new growth and our analysis of some growth opportunities. Until then, do some research on tree growth, including "meristems." You will be amazed at how this analogy may apply to your business. ■

Neil Gillespie is a veteran distribution consultant, speaker and author. He worked for GE and Eaton Corp. before launching his distributor consulting practice in 1995. Gillespie helped Roden Electrical Supply, Knoxville, Tenn., to grow more than 500 percent over 11 years while more than tripling EBITDA percentage. Neil has distilled his profitable growth methods in his "Eight Steps to Breakthrough Growth" strategy. His book "Discover Your Core, Then Go For More" will be available in early 2010. You can contact him at neilg@shamrockgrowth.com.

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