White Paper
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Follow the Value Streams or Risk Selling the Distributorship for Asset Value

Scott Benfield

The Author contends that Wholesale Distribution is entering a new phase of its life cycle where technology has changed value propositions and costs will be driven out of the operating platform. Bundling many losing investments with winning ones is a model that is being broken apart by technology, advanced costing knowledge, and global supply chains where product cost is deflating. Many distributors will, because of these changes and demands of generational ownership, want to sell the firm. However, a fundamental misunderstanding of how to define and drive value will cause many firms to sell for asset value and hence give shareholders the lowest possible price.

The operating environment for B2B wholesalers is entering its fourth year of tepid growth. Most companies have weathered the storm having cut expenses and invested sparingly in the business and only where absolutely necessary. Future forecasts have sup-par GDP growth through 2012 and beyond.[i] While housing is likely to stage a comeback of sorts, nothing will approach the starts of 2006-07, and the sector which, in years past has been 25% or so of the GDP, is likely to remain at levels well shy of the one million plus mark. Our belief is that sup-par economic growth of 2% or less and persistently high unemployment will be the defining environment of the second decade of the new millennium.

During this period, many B2B wholesalers will be entering their third and fourth generations. Private firms, in this stage of their life cycle, have unique attributes including:

- Capabilities of family management become constrained as the size and complexity of the business often outgrows the family gene pool.
- Numerous family shareholders, often not part of the business, increasingly depend on the earnings of the business to fund lifestyle choices.
- Executive family management often develops a portfolio of outside investments and interests. They become increasingly disenchanted with running the core business.
- Outside investors are often courted but the cost of capital for junior investors is often well above what the firm could generate on their own if they were financially sound.

- Second and third generation family businesses have been shown to destroy or limit value compared to public or non-family structures.[ii]

These events, from our consulting, often compound and render the extended generation family firm vulnerable to competition. Many private wholesalers, in the new environment, are not increasing sales growth to any great extent and earnings are, on average, well below a 3% ROS. Our work in evaluating the returns of B2B wholesalers for the past decade, finds that returns below this level earn less than the yield of the public markets when compensating for liquidity and diversification. Furthermore, firms at this level tend to sell at asset value. The value of the business, at asset value, is an admission that management did not add value to the firm above the market value of its assets. Our work since the Great Recession has found that a significant number of privately held firms want to sell, however, they will fetch little more than asset value and family members will walk away with something much less than they think the firm is worth. The subject of this White Paper is to give family owners a broadened perspective on how to increase the value of their firms, in a slow growth environment, with new knowledge and a new approach.

It's About the Value Streams

Value, for most wholesalers, is a nebulous concept. Indeed most wholesalers are familiar with the term of value added but, while the phrase has a general meaning, it is often used as nothing more than to justify the various services and products sold to the end user. Our work has been to define value, in tangible terms, and use the definitions to drive the market value of the generational wholesale firm. Our belief is that without a focus on value, specifically as it relates to tangible value and return on invested capital (ROIC), the wholesale firm will **generate something less than an acceptable value in the marketplace.** Our approach is not without controversy; however, the strategy on targeting value has been shown, in parallel industries, to deliver a higher valuation (stock price) than similar approaches focusing on operating profit, EBITDA, and contribution to operating profit of discrete investments.[iii]

Targeting value is not possible without a change in the measurements currently used by most wholesalers to manage the business. Value, or return on invested capital, is not possible without two changes in the headset of most wholesalers. First, wholesalers will need to consider that expenses of inside and outside sellers, vendors and branches, signify investments as well as marketing and sales entities of territories, customers, segments, marketing programs, and transaction types. Without considering these entities as investments, it is impossible to understand if investment in them provides an acceptable return. Second, wholesalers need a valid and accurate cost allocation model to place expenses against the margins generated by investments. Without a valid cost allocation logic, management has no good idea if the investment yields value or not. The concentration on

investment returns of sales, operations, and marketing entities for their value contribution is termed "following the value streams."

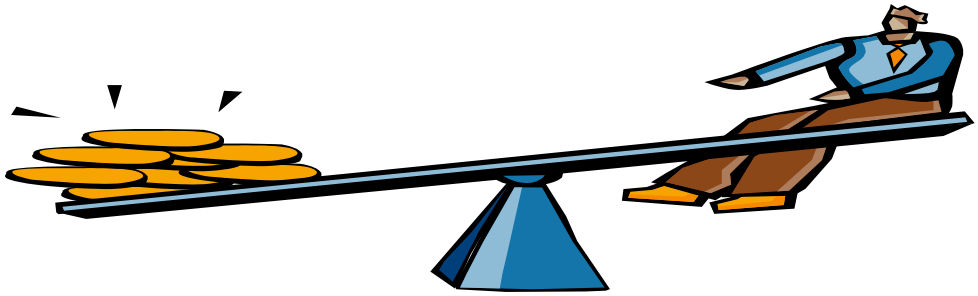
Value streams can't be analyzed and a judgment made on their attractiveness using financial or period based accounting. In fact, the focus on financial accounting is often found to destroy value almost as fast as it is generated. Return on invested capital is multi-faceted as investment definitions can be viewed in any number of different ways. For instance, if Big Wholesaler has a sales territory for Maury Muellenheim that generates 3 million dollars at a 25% margin the ensuing margin dollars of $750,000 is, for many wholesalers, acceptable performance. The value approach, however, considers sales and margins as secondary measures. Value or capital returns/capital investment takes new numbers not found on standard financial statements. Consider that the cost of operating the territory is $685,000 dollars which means the individual profit of the territory is $65,000. Most cost-to-serve advocates stop at this point saying that the territory generated value or a **return on sales of 2.2%** which is **acceptable** in most wholesale industries. The value approach however looks at the contribution of $65,000 juxtaposed to the investment (operating expense) of $685,000. The return on capital for the territory is 9.4%. If the hurdle rate for Big Wholesaler is 15% on invested capital, the territory is a **sub-par investment**. Investments of all types can be evaluated using the value approach and once the value streams are identified, the wholesaler can begin to target investments with the greatest return(s).

Without the value approach, however, the wholesaler is likely to destroy value and **never realize it.** Therein lies the great opportunity and risk for distribution as the transparency through the internet doesn't allow for much, if any, information asymmetries on price and availability. Hence, the distributor's ability to charge a higher price than the competition is very limited. As industries become more astute regarding their costs, they begin to de-emphasize, shed, or limit exposure to investments that don't generate value.

In times past, distributors led a type of Robin Hood existence in that they borrowed from a small portion of exceedingly profitable investments to fund a large pool of investments that yielded poor or negative value. In a real sense they took investments that were less risky and used them to cover those that were very risky. But advanced costing, globalization of supply, and information transparency through the internet is putting an end to this practice. To illustrate the problem, we introduce Exhibit 1 titled the Teeter-Totter Profit Drain. In the Exhibit, we depict four common areas of investment including accounts, transactions, sales territories, and segments. In each area, we find where 40% of investment is wildly profitable, 20% contributes to operating profit but is below the corporate hurdle rate, and 40% of the investments destroy value. The prevailing investment philosophy that bundles a minority of high value and winning investments with a majority of low or negative value investments resembles a teeter totter. Substantial value of the firm, in the form of labor capacity, is sapped by poor investment but this is covered by a minority of high earning investments. With

information transparency from the internet, low cost global supply, and accurate cost to serve models, however, the competition heats up for the attractive investments which drives value downward. Hence the bundling of poor investments with winning ones comes under additional strain. The pooling/bundling model, for all intents and purposes, is coming to an end because of the confluence of e-commerce, global supply chains and costing of discrete investments.

The Teeter-Totter Profit Drain



	Bottom 40%	Middle 20%	Top 40%
Accounts	Unprofitable Transactions	Nominal Transaction Profits	High Transaction Profits
Transactions	Small, counter, non-stock transactions	Mixed transactions-smaller than average	Large stock and direct transactions
Sales Territories	Numerous small accounts	Accounts with poor controls and heavy counter activity	Large accounts or accounts with good controls
Segments	Poorly defined segments	Segments where wholesaler is 2nd.or 3rd. tier supplier	Core segments where wholesaler is lead supplier

Exhibit 1

These three events have been combined in a strategy called Transactional Distribution. The transactional distributor uses the low cost of e-commerce with little to no sales assistance, cost advantage of global supply chains, and knowledge of which investments create value to drive a low-cost/high quality service through the supply chain. Transactional distributors have cost advantages of 10% to 30% over full-service distributors who bundle all investments together. Our observations on cost advantages of transactional wholesalers are supported by parallel research in retail hard-goods. Harvard faculty members Lal and Alvarez predict the decline of "category-killer" retailers at the hands of internet based models supported with global supply chains.[iv]

According to their research, internet based models offer prices that are as much as 20% less than those given by category killers. Interestingly, the retail cost advantage falls within the middle of the observed range of pricing discounts for transactional wholesalers and we believe the Harvard research corroborates our findings from transactional strategies in the wholesale sector.

Transactional wholesalers often aim their cost advantage at the top 40% of traditional wholesalers' investment portfolio. This further disintermediates (breaks apart) the bundled model. In all instances where we have witnessed transactional wholesalers and their attack on the traditional bundled model, we have seen no long lasting effective strategy by traditional wholesalers to gain back the lost business. In summation, we see the traditional bundled model as highly vulnerable and hence it is imperative that distributors come to terms with investments that create value and ones that don't. Understanding value, however, has to be preceded by tangible and actionable definitions and this is the subject of our next section.

Facets of Value

Value is often defined as either shareholder value (ROIC) or as what the customer values. **We find the distinction trite and believe that value is maximized where the firm creates, generates and perpetuates value streams that the customer is willing to pay for as competitive substitutes are limited.** In taking this position, however, there are facets of value that need to be defined before distributors develop a plan. In our work, we contend that value can be measured, generated, communicated, perpetuated (solicited), and captured. Exhibit 2 depicts the Value Spectrum including strategic and tactical value. In strategic value the focus is on creating

		Value Spectrum	Exhibit 2
Level of Value	**Facet of Value**	**Activities**	**Funtional Responsibility**
Strategic	Creating Value	New Services, New Business Models, Net New Products	Marketing, Executive Management, Product Management, New Product Selling, Consultative Selling
Strategic	Generating Value	Acquisitions, Newer/Technical Product Applications	Executive Management, Product Management, New Product Selling,
Tactical	Perpetuating Value	Existing Account Sales, Existing Products In Existing Applications, Existing Services	Geographic or Route Selling, Enterprise Selling, Operations
	Capturing Value	Pricing Function	Marketing and Sales

and generating activities including new service development, new business models, acquisitions and technical expertise. In tactical value, the focus is on existing account sales, existing product sales and improving existing

services. The more profitable value is added at the strategic level, however, **we find where the vast majority of wholesalers concern themselves with tactical value and, because of this, suffer low returns.** Finally, there has been a recent and substantial interest in pricing. **Pricing can only capture value and cannot create, generate, or perpetuate it. Increasingly, while pricing is a powerful tool in capturing value, we believe that without a broader perspective of investment and return on capital, pricing can harm value in that it is misused by management for value creation and generation.** In this scenario, the market eventually realizes that their supplier has raised prices without corresponding development of a better value proposition and they take business elsewhere.

Once value is defined, it can be measured and a plan made for the wholesale firm to align shareholder value with the customers' value perceptions. Measurement of tactical value is key to the wholesaler's management of their investments and, unfortunately, much of the available information is misleading regarding cost allocations and measurements all of which leads to poor decision-making.

The Need for Accurate Cost-To-Serve Models and Standards

The subject of cost-to-serve came out of the Activity Costing models of the late 1980's and 1990's. During this period, large accounting firms with consulting arms developed Activity Costing models for wholesalers. We worked with one of the original models for four years in the late 1990's and found that, among other things, the measurements and modeling were tremendously complex with hundreds of variables to change and manage. Too, the use of "activities" as a subject was not actionable and not in the lexicon of the wholesaler. Lastly, the model did not measure labor capacity and made many assumptions regarding activities which distorted the output. Our observations were not without merit, however, and in 2006, Robert Kaplan of Harvard Business School along with Steve Anderson recanted the earlier models for their complexity and limitations. Kaplan and Anderson established new standards for cost-to-serve (activity models) including:[v]

1. Accurate modeling of "heterogeneity in activities" with one baseline logic
2. A reduced cost of maintenance and upkeep in the model
3. Measure capacity at "actual utilization" and not assume 100% capacity

To accomplish these goals, Kaplan and Anderson used time as their baseline logic. In 2006, after using traditional Activity Costing for a decade, we began to look for a logic that would adhere to Kaplans' standards while using actionable variables common to wholesalers. We settled on transactions and labor and have since developed and applied for patent on a model called Labor Differential Transaction Costing. Labor Differential

Transaction Costing (LDTC)is depicted in Exhibit 3 (Cost Template)where six transaction types are modeled over ten labor buckets.

					Labor Differential					
				Transaction Cost Template			Exhibit 3			
					Operation or					
					Function					
					Order Writing (OW)				Extend Credit	Warranty
Transaction	Purchase (PR)	Pay Vendor (PV)	Receive	Put Away (PW)	Inside Sales	Outside Sales (OS)	Shipping (SH)	Invoicing (IN)	Collections (CC)	Returns (WR)
Type										
Stock	PR	PV	R	PW	OW	OS	SH	IN	CC	WR
Stock Transfer	PR	PV	2R	2PW	2OW	OS	2SH	2IN	CC	1.15WR
Non-Stock	1.25PR	1.05PV	R	1.15PW	3OW	1.5OS	1.15SH	IN	CC	4WR
Cash/Counter	PR	PV	R	PW	OW			IN		1.5WR
Direct	PR	PV			OW	OS		1.25IN	CC	1.25WR
Back-Order					OW		SH	IN	CC	WR

The labor buckets or order cycle starts with purchasing and ends with warranties and returns. Looking at Direct Shipments, the model leaves out labor buckets of receiving, put away and shipping. For invoicing and warranty returns, the model uses labor coefficients (1.25IN) (1.25WR) to differentiate the cost of an operation specific to the transaction. LDTC closely measures labor consumption and measures trade-offs in labor capacity across the firm. Too, the use of transactions ensures one baseline logic that is actionable. Transactions are the fundamental unit of distribution's value added including the bundling of different products to create an order that generates more margin dollars than its cost to service.

An output example of the model is below in Exhibit 4 where we use disguised information from a Transaction Audit. The model output gives base transactions of stock, non-stock, drop ship, and rep along with identifiers of (assigned or unassigned to outside sales) and order processing method including inside seller (order writer) or through e-commerce. For instance the Stock-Assigned-Order Writer Transaction is $155.50 per invoice and $35.72 per line while the Stock Unassigned-Ecommerce Transaction is $21.71 per invoice and $35.72 per line.

		A-OK Supply Transaction Costs					
		by Transaction Type				Exhibit 4	
		From LDTC* Model					
Transaction Number	Transaction Type	Invoices	Lines	Invoice Costs	Line Costs	Invoice Costs in Total	Line Costs in Total
1	Stock Assigned Order Writer	24952	43137	$ 155.50	$ 35.72	$ 3,879,959.33	$ 1,541,053.01
2	Stock Unassigned Order Writer	10912	17927	$ 21.71	$ 35.72	$ 236,922.81	$ 640,438.72
3	Stock Assigned E-Commerce	535	661	$ 154.48	$ 19.17	$ 82,651.86	$ 12,668.58
4	Stock Unassigned E-Commerce	995	1592	$ 21.62	$ 19.17	$ 21,507.88	$ 30,516.43
5	Non-Stock Assigned Order Writer	27915	51446	$ 202.07	$ 46.44	$ 5,640,728.58	$ 2,389,263.59
6	Non-Stock Unassigned Order Writer	12207	21380	$ 28.05	$ 46.44	$ 342,375.01	$ 992,942.43
7	Non-Stock Assigned E-Commerce	599	788	$ 200.77	$ 30.15	$ 120,172.51	$ 23,760.96
8	Non-Stock Unassigned E-Commerce	1113	1898	$ 27.93	$ 22.69	$ 31,082.05	$ 43,060.20
9	Drop Ship Assigned Order Writer	5360	8734	$ 166.16	$ 26.42	$ 890,525.02	$ 230,763.53
10	Drop Ship Unassigned Order Writer	2486	3761	$ 18.28	$ 26.42	$ 45,434.43	$ 99,371.40
11	Drop Ship Assigned E-Commerce	1784	2010	$ 164.49	$ 7.47	$ 293,497.61	$ 15,010.92
12	Drop Ship Unassigned E-Commerce	3317	4842	$ 18.17	$ 7.47	$ 60,260.44	$ 36,158.73
13	Rep Unassigned Order Writer	1132	1660	$ 2.12	$ 24.02	$ 2,403.78	$ 39,882.65
14	Rep Assigned Order Writer	2913	4310	$ 136.10	$ 24.02	$ 396,440.84	$ 103,517.25
Totals		96219	164147			$ 12,043,962.16	$ 6,198,408.41
*Patent Pending, Benfield Consulting, 2011							

The costs of these variations on a stock order support our earlier statements regarding e-commerce with limited to no sales assistance giving a significant break on the cost to the customer. We have used LDTC for five years in the field and the results, to date, have been good in determining and mining value streams. Transactions can be rolled up to any number of marketing, sales, and operational entities to identify where value is being generated. **While we believe LDTC adheres to Kaplan's modern day suggestions for cost-to-serve logic, we continue to find many models that don't follow the new standards. Our opinion is that they give questionable output including a misunderstanding of labor and capacity and how it influences value. Our review of no less than six different models in the past three years finds that only one, outside of LDTC, met Kaplan's design standards. Most models were either too simplistic to be of use or fell back into definitions and complexity issues that dogged the original activity models. We can only advise wholesalers to question models as to their design standards and if they meet the modern day recommendations of the experts.**

Securing Value by Letting Customers Sort Themselves

Marketing, sales, and pricing approaches have to be, in large measure, rethought, reworked, and better co-ordinated in the new world of instant, accurate, and transparent information on price and availability. Having

sellers go out and negotiate deals on commodities without respect to the service cost of said deals is, in this new world, a recipe for value destruction. One bit of hope for wholesalers comes from the field of behavioral economics or the "economics of information."[vi] In the 1990's, University of Chicago economists began to move economics from the dry and theoretical science of microeconomics and apply it to real world behaviors. Readers may recognize the popular book *Freakonomics* forthcoming from this movement. Advanced information on the cost and risk of dealing with individual customers, customer groups, and sales and marketing investments was studied in the new field and especially health insurance. As knowledge of health risk was approximated with better information, health insurers began to move rates upward for those at higher risk. The problem, akin to wholesalers' bundling of customers, is that those who have the highest risk (poorest health) can't afford the cost of insurance**. In LDTC, we find that when unbundling customers, many of the 60% of marginal or losing accounts can't afford their cost of service**. In the health insurance field, researchers found that deductibles allowed customers to sort themselves into "risk" categories and thereby make coverage more affordable. We have used LDTC, sales promotion, and variable transaction size pricing to help low or negative value customers "sort" themselves to afford product pricing and cover their service costs. We discuss the metrics behind the sorting, briefly, in the next section.

Suppose Big Wholesaler has an account, Guido Speedo Manufacturing, that purchases 1MM in MRO supplies at a 30% margin. The problem with Guido Speedo (using statistics from Exhibit 4) is that their average stock transaction (Stock Assigned Order Writer) is $500 and has three lines. Hence the cost of the transaction is $155.50 in invoice costs plus (3 X $35.72) $107.16 in line costs for a total service cost of $262.66. The stock order incurs a transaction loss of $112.66 ($262.66-$150). Since Guido Speedo buys 2000 orders, the account loses (2000 x $112.66) or $225, 320 per year. Big Wholesaler develops a variable transaction size pricing program as follows:

- $1000 Stock Order at 28% margin; $17.34 in profit per order
- $1500 Stock Order at 25% margin; $112.34 profit per order
- $2000 Stock Order at 20% margin; $137.34 profit per order

Assuming 3 lines per order, each order size is set at a pre-determined margin on product cost and **ensures a profit. It is important to note that the costing model, to attempt variable sized transaction pricing , must be extremely accurate in measuring the consumption of labor. This stipulation supports the design recommendations forthcoming from Kaplan's earlier work.**

LDTC can be used with varying transaction sizes to help negative or low value customers sort themselves to ensure a profit. Since transaction sizes are not always easy to reach because of varying demand, we often bundle them with a sales promotion or annual volume program. For instance, if Guido Speedo has an

incremental $250,000 in MRO supplies given to a competitor, Big Wholesaler can sweeten the price discounting by offering a $2500 order at a 17% margin that would give $162.34 per order. For the additional business, Big Wholesaler allows stock rebalancing privileges during the course of the year with pre-determined times and levels.

Variable transaction size pricing, using LDTC, and sales promotion can be used to set the buying interface that allows customers to sort their risk preference and ensure a profit. **Like deductibles in health insurance, the variable pricing levels by transaction size and type help drive value and reduce risk.** As the bundled model of grouping customers begins to come apart (disintermediate), wholesalers are encouraged to use accurate cost to serve models, variable transaction size pricing, and sales promotion to help low or negative value customers sort their risk preference and, hopefully, ensure a profit.

Our work in LDTC has found many areas that drive value destruction and a few that generate exceptional profit. We introduce them in the next section.

Findings from the Field-What Adds Value and What Does Not

Using LDTC in the field for the past five years has given us a unique perspective on common entities, across wholesaling, and their value producing capabilities. It's important for the reader to understand that ROIC can't be estimated by looking at the sales, margins, margin percent, or even cost to serve profits of an entity. Capital returns have to be compared to their capital outlays to understand the value producing power of any one investment. To date, our common field findings for what adds value and what doesn't are included below with some suggestions for solutions.

1. Counter sales are perennial losers. The transaction sizes are too small to cover the basic fulfillment cost of the goods. Counters have been around wholesaling for generations to secure the spot buy, unfortunately, most of the transactions just aren't large enough. Solution sets include minimum order sizes and higher prices for counter sales but, for most wholesalers, these events diminish loss and really don't make the transactions positive contributors.
2. Small customers that purchase small sized stock orders are losers. If a small customer purchases one $1200 order at a time at a 25% margin it likely generates value. Many small customers, however, are perennial losers. The best bet for these customers is to identify them with LDTC and service them with the least amount of cost and variation which means making them place orders through e-commerce and having a minimum transaction size for free delivery.

3. Placing sales people on negative transaction profit accounts almost never works. Negative profit accounts typically have poor processes which causes them to order a lot and place many types of orders with a higher than average amount of returns. Placing sellers on these accounts makes little sense as the cost of the outside sales call makes the profitability worse. Generally, based on the size and loss of the account, it is best to raise price until the account goes away, or work on a one-to-one basis where supply chain asymmetries are smoothed out and costs of interaction are reduced.
4. Paying sellers on gross margin dollars is a loser. It drives margin hoarding at the expense of value generation. The more lucrative the sales comp plan with margin dollars, the greater the chance that shareholders don't earn much or earn less than they should. We advocate paying on a mixture of margin dollars, transaction profit dollars, and ROIC ratios.
5. National accounts, especially those secured by outside parties, are almost always losers. The problem with national accounts is that there are typically a handful of operations that purchase large order sizes while the rest purchase really small orders. This coupled with the fact that large accounts want special (read costly) service at a great price means the wholesaler loses out. It is much better for the firm to negotiate these accounts locally and turn down negotiations from a third party.
6. Drop shipments are a godsend. Wholesalers have always known this but never really known how profitable these transactions were. In one instance, for a 100MM distributor, drop shipments were 30% of the sales and over 200% of the profits. Our quip that the company should shut down the bricks and mortar locations and become a broker was not met with enthusiasm. Wholesalers should mine their drop shipments for who is purchasing them, why, what vendors offer drop ship policies, and what types of buying situations can handle the transaction type?
7. Non-stock specials and non-stock branch transfers are typically losers. Non-stock specials can be corrected by pricing as they are often less price sensitive since they don't have a reference price. Non-stock branch transfers essentially double the handling cost sans the cost of the sales call. A solution to transferring non-stock items between branches is simply to ship them direct to the customer from the stocking branch. This works well with small packages and less well with large or heavy items. This is a simple solution and typically saves $25 to $40 an order.
8. The absolute best customers purchase stock orders and drop shipments, have large transaction sizes in these transaction types, and at higher than average margins. Find these customers in your firm, learn what makes them tick, and send your sales force out with a new mission-**it's not just what a customer buys <u>but how they buy</u> (interact) with you that makes them high value generators.**

These events are the more prominent examples of losses and wins from using LDTC and analyzing value streams. Every wholesaler and sector is different, however, and there is no substitute for the firm engaging a new age cost to serve logic and following their value streams.

The final subject on following value streams is the problem with capacity and traditional financial accounting. Our work with LDTC has found that most wholesalers end up crashing their earnings because of a sales and margin mentality and never really know it. The value destruction takes place in the misunderstanding of operating expenses and time periods and we cover it in the next section.

Destroying Value by Sapping Capacity-The Spiral of the Pfft Bird

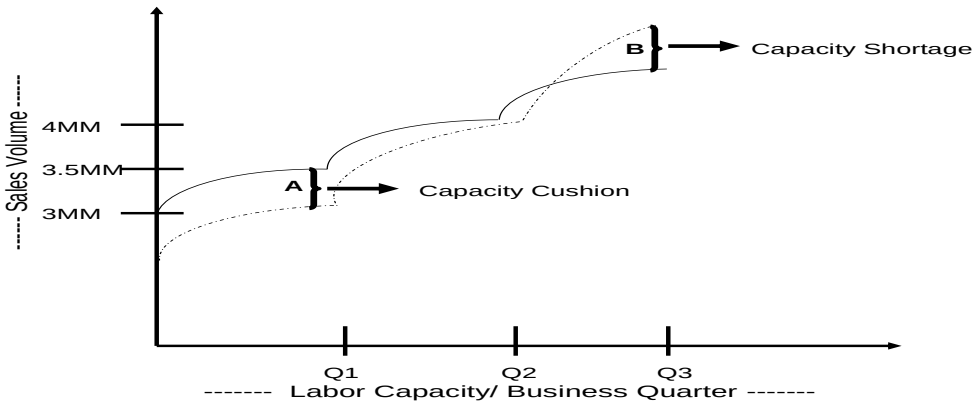
Avionics lore describes the short but spectacular life of a large bird, heavily feathered, with a long beak, missile shaped head, slim neck, average wingspan, and ample hind quarters. The bird is hatched at 40,000 ft. and begins a slow spiral glide toward earth. As altitude of the flight decreases, the spirals tighten, airspeed nears Mach 1, and fifty feet from the earth, the bird's head and neck fly into its hind parts followed by a burst of feathers and a loud Pfft! (foot)

Wholesalers have their own Pfft Bird event. It has to do with capacity and we describe it in this final section. Rewarding sellers on sales and margin dollars and stressing accumulation of sales and margins in a time period are a quick and sure means to destroy value. Most wholesalers don't consider the effect of transaction intensive sales on their long term value.

Exhibit 5 represents a disguised issue we ran into a few years ago at a wholesale branch. The branch had recently landed a 1MM account that would lift sales from 3MM to 4MM. We modeled the effect of the new account on the value generating ability of the branch over three quarters. In Q1, the branch has a 22% gross margin on 3MM in sales. Labor costs are $460,000 and margin dollars less labor costs are $200,000. In essence the ROIC on the branch is $200,000/$460,000 or 43%. The branch was operating at approximately 70% of capacity (A Dimension). When Q2 arrived, the new account sales added $500,000 but margins had fallen by 1% and labor cost remained at $460,000. The ROIC during the time period was $275,000/$460,000 or 59%. Labor capacity utilization has, however, gone up to 98%. In essence, the first $500,000 from the customer is labor intensive and has eaten into the capacity buffer. In Q3, the full 1MM of the new account is absorbed. Margin has fallen to 20% and labor cost has increased to $632,000. The ROIC for the period is $168,000/$632,000 or 26%. While still good, the ROIC has fallen significantly and transaction profit dollars dropped $107,000. What happened? Essentially, the labor intensity of the new account ate into the capacity buffer (labor excess) (B Dimension) and destroyed value. The real culprit of this is the focus on sales and margins by wholesalers who don't understand and consequently don't measure value streams.

Capacity and Profits
Bringing in Transaction Intensive Sales

Exhibit 5



	Q1	Q2	Q3
Sales Revenues	$ 3,000,000.00	$ 3,500,000.00	$ 4,000,000.00
Gross Margin Percent	22%	21%	20%
Gross Margin Percent	$ 660,000.00	$ 735,000.00	$ 800,000.00
Labor Cost	$ 460,000.00	$ 460,000.00	$ 632,000.00
Labor Capacity	70%	98%	125%
Margin Dollars (Labor Cost)	$ 200,000.00	$ 275,000.00	$ 168,000.00

The Exhibit illustrates a common and significant problem in distribution. Management is **constantly chasing capacity investment since they have little means to predict the transaction intensive nature of incremental sales**. **In essence, bottom line profits may boom in one time period, only to bust in later time periods all because sellers secure, in current time periods, transaction intensive business that saps service capacity. This shows up later as operating income is reduced.**

The destruction of value, or the increasing speed of the Pfft Bird spiral takes place after Q3 when branch management, looking at financial accounting reports, makes wrong-headed moves including:

1. Demanding sellers quickly pull in more business which is often sales the competition doesn't want (they've figured out it's too expensive to serve and let it go)
2. Raises prices indiscriminately which chases away the value generating customers
3. Lets sellers indiscriminately cut price for new business which has a 60% chance of being low or negative value generating
4. Or hack costs to keep bottom line income up which decreases service quality in the long run

Too often, these events are **the exact opposite of what is needed and exacerbate the problem.** They are common solutions for a time past where value streams could be bundled and risk of loss was covered by a small number of investments. In today's environment, however, these solutions are problematic and address

symptoms. They run counter to the core change in distribution where globalization, internet technology, transparency of cost and availability, and better costing information has irrevocably and quickly issued in a new operating environment. **In this new world, poor understanding of the value stream, poor costing models that don't accurately measure how investments consume capacity, and solution sets based on accounting metrics not only destroy value but perpetuate and accelerate its destruction.** And, in the thin margin environment of distribution the long term negative effect on shareholder wealth is severe.

A large contributor to the problem is that sales and margins for new accounts are rather poor measures to determine the attractiveness of new business. The problem is illustrated pictorially in Exhibit 6 below. In the Exhibit, incoming sales are considered "flow" orders as they literally move like water in between the existing capacity boundaries (solid lines) of the branch. If the orders are transaction intensive, they easily overflow the boundaries that act like levees to handle the incremental business. The overflow moves capacity boundaries outward to the dash lines where value is diminished or destroyed. The overarching problem is that sales and margins, the things sellers are measured on, **are inadequate filters to drive value**. We advocate for sellers and branch managers to profile new business on their current buying patterns including transaction type, size, and frequency. Teaching profiling techniques to line staff can give management a better idea of the value

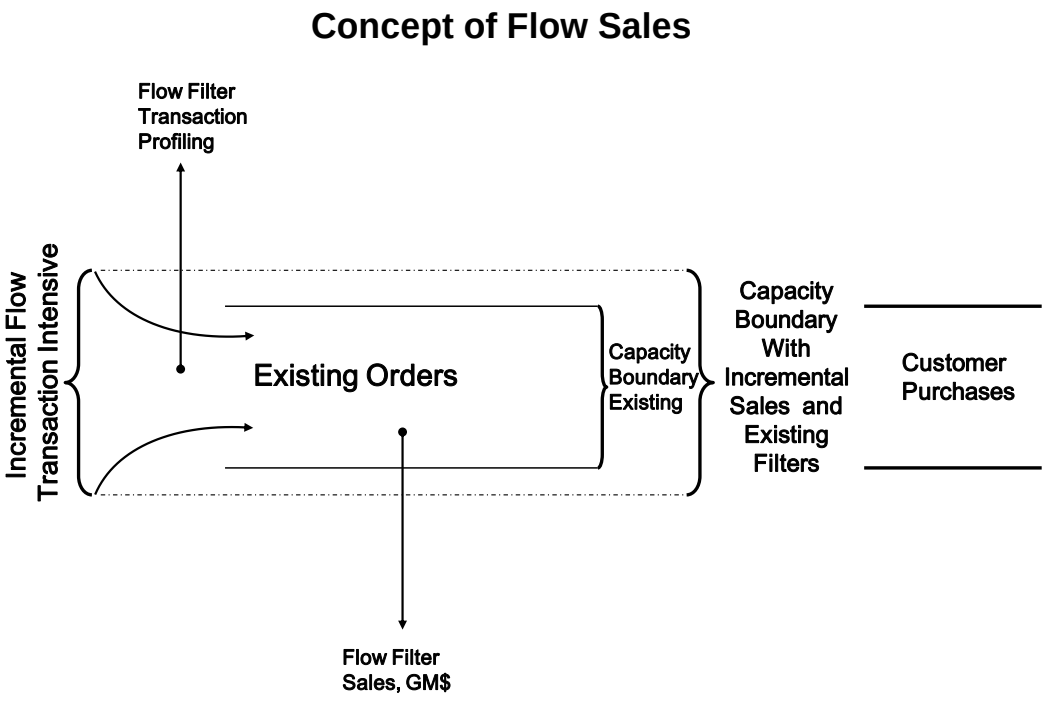


Exhibit 6

generating ability of incremental business. Without amending the sales and margin filters with new measures of transaction size, type, mix, and cost, line workers will continue to pull in business that saps capacity and, in many instances, mutes or destroys value.

The Future of Value Generation

In the current environment of slow growth, internet transparency on price and availability, global supply chains where product cost is deflating, and better costing estimates, the focus on value generation and following value streams is an essential discipline. Running a wholesaler with financial accounting metrics without understanding how labor capacity is consumed by various entities is a sure recipe for low shareholder wealth. Using yesterday's tactics of pricing, aggressive selling, cost hacking, and stumping for more rebate dollars are ham-handed and creates more problems than it solves. The outcome of using the income statement as a guide to run a thin margin business, with aggressive step costs, is too often a sale price of asset value. The use of accurate cost-to-serve models using modern day design principles and learning to invest in value streams that yield above hurdle rate returns is the best means of ensuring shareholders get something greater than the value of assets when the firm is put on the block.

Scott Benfield is a consultant for distributors. His firm Benfield Consulting is located in Chicago and he can be reached at (630) 428-9311, bnfldgp@aol.com and his website is at www.benfieldconsulting.com. *The following White Paper is taken from Scott's new book, to be released in early 2012 and titled Building Value: Driving Wholesaler Returns Through Strategic and Tactical Investment.*

[i] See Goldman-Sach's White Paper, The Outlook for the US Economy (October 2011), at: http://www2.goldmansachs.com/gsam/docs/fundsgeneral/general_education/economic_and_market_perspectives/wp_economic_outlook.pdf

[ii] Villalonga, B., Amit, R., "How do family ownership, control, and management affect firm value?" Journal of Financial Economics, December, 2004, pg. 21.

[iii] Koller, T., Dobbs, R., Huyett, B. "Value: The Four Cornerstones of Corporate Finance," McKinsey & Co., pg. 22, 2011, Wiley & Sons.

[iv] Lal, R., Alvarez, J. "Retailing Revolution: Category Killers on the Brink," HBS Working Knowledge, October 2011, page 3

[v] Kaplan, R., Anderson, S., "Time Driven Activity Based Costing," Abstract, 2003, pages 3-5 at: http://www.hbs.edu/research/facpubs/workingpapers/papers2/0304/04-045.pdf

[vi] Wheelan, C. "Naked Economics," Economics of Information, Chapter 5, pg. 104, Norton Publishing, 2010.