White Paper:

A Profit Improvement Roadmap for Distributors

What are leading distribution companies doing to improve their bottom line profits? During the past ten years, Acorn Systems and Oak Forest Ventures have worked with over three hundred companies in more than ten segments of the distribution industry. While we would like to claim that all of these projects were universal successes, the fact is that some achieved more impact than others.

What separates companies who achieved superior profit improvement from those who did not? The **actions** they took to improve profitability, based on the **right insight**.

In this white paper we share Acorn and OFV's insights about the most successful actions distributors have taken to maximize profit improvement, or as we say at Acorn and OFV,"Value Capture." Included are frameworks you can use to help determine the best approach for you.

Steven R. Anderson

January 2007

Author's Disclosure

The material covered in this paper represents the culmination of over 20 years of Steve Anderson's experience in the distribution space. Mr. Anderson's family owned several distributors. He is an owner of a large distributor, and has served as a board member for three additional distributors. But most of his knowledge regarding profit improvement in distribution came from his work at Acorn Systems, Inc (a software company that he founded and ran from 1996-2002) and Oak Forest Ventures (a consulting / value capture firm he founded in 2001, and has run since 2002). That experience is defined by the scope of work routinely performed by Acorn and OFV, and covers 20 different industry segments of distribution. While the lessons learned can apply to the entire industry, he realizes that there are nuances within industry segments and geographic markets that prevent universal application of the solutions. The perspective of this paper is obviously slanted towards OFV which specializes in value capture, not because other solutions are not successful, but because this experience has provided the foundation of Mr. Anderson's knowledge.

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Introduction

Every decade there is a new set of three-letter acronyms that promises revenue growth, happier customers and suppliers, more responsible employees, and better products. However, these are surrogates for the ultimate goal – increased profitability. Most of these programs are carried in by industry consultants or academic pariahs. Like a new vegetable presented to a child at dinner, these programs are greeted with understandable suspicion. Some gain traction (e.g., ABC, CRM, TQM, JIT, ISO, EVA, SOX, and BSC), while others get swallowed up (e.g., EFR, ECR, BPR, CPM, and EPM) by larger initiatives.

One industry that is fertile ground for the three-letter onslaught is distribution/wholesaling. Why? First, it is a mature industry with extremely low margins. A one percent increase in EBITDA can double profits. Distribution executives are understandably hungry for change. Second, their problems tend to be bigger. A typical distributor may have several locations spanning a single region, serve over 10,000 customers, stock over 20,000 SKUs, and process over one million transactions. If a new program can help one customer, it can be replicated across the company and have a huge impact. Acorn and OFV understands this opportunity very well. For the past ten years, they have worked with more than two hundred companies in over ten segments of the distribution industry.

Acorn provides software solutions, consulting services and a world-class partner network that enable leading companies to improve profitability and performance. These solutions can target specific business processes, address the entire enterprise or anything in between.

Oak Forest leverages software from firms like Acorn to analyze the business, and then focuses on capturing value. This may include working with management to make dramatic changes, assist with acquiring new companies, or consolidating operations.

Acorn /OFV help distribution clients gain new insight about where they are making and losing money, and why. They work with these companies to take the actions necessary to improve profits. The scope of their work is varied, and has included addressing product mix and inventory, reengineering business processes, applying lean management techniques, analyzing customer profitability, benchmarking performance, optimizing pricing, consolidating facilities, and analyzing acquisition opportunities. While we like to claim that all of these projects were successes, the fact is that some achieved more impact than others.

What separates companies that achieved superior profit improvement from those that did not? **The ability to convert new insight (on true costs, profits, and capacity) into actions to capture the value.**

The purpose of this white paper is to share Acorn and OFV's insights about which actions have been most successful at improving a distributor's profits (or as we like to say value capture).

ABOUT THIS GUIDE

This how-to guide for improving profitability includes:

- A case study of a successful distributor that dramatically improved its bottom line through a series of initiatives that other distributors can use. We identify several key success factors.
- A discussion of successful profit improvement initiatives for distributors, including Acorn and OFV's Value Capture Process and Value Capture Matrix
- An explanation of how a distributor can use the new Value Capture Strategy Roadmap to determine what strategy is best for them
- A case study example of a food distributor that used this methodology to launch its profit improvement plans and showed immediate returns.

Industry Case Study: Turning Around Stateside Metals

Stateside Metals (disguised company) looked like most steel service centers during the past 10 years. Organic growth within the industry was in the single digits. Business was regional. Competition was fierce. Pricing was low. To fuel growth, the company did two things that many distributors do. It explored acquisition opportunities within and adjacent to its core region. Stateside also expanded its product and services to grab a larger portion of its customer plate and increase margins. For example, in the 1990's, Stateside merged with a competitor, acquiring two more companies. This allowed them to expand into extruded steel products, and to leap into the UK market.

This growth came at a high cost. The company expanded to over 40 locations. With steel prices and regional demand still depressed, the business was close to defaulting on its bank covenants. Many of its competitors had filed for Chapter 11 bankruptcy protection. Real change was needed and fast.

Consider the situation facing the Stateside CEO, Tom Parker.

- **Stateside needed to demonstrate an ROI for their investors.** The company was owned by a private equity group that was actively involved and extremely analytical. They would put pressure on Tom to create a game plan and take action.

- **The company had a best-of-breed information system**. They had invested millions of dollars upgrading their ERP system to integrate all of their facilities. Their CIO was extremely capable and had integrated add-on functionality to optimize their supply chain, inventory, and business processes.

- **Tom's senior management team were competent, industry-seasoned veterans** who were fully committed to the change effort.

- **Stateside had a strong relationship with its customers**. The company had been in business for almost 100 years, and had developed a reputation for high quality tubular and sheet products. Management believed that customers would support needed change.

With a sprawling organization that was now in two continents, and a customer base that exceeded 10,000, Tom struggled with where to begin. Did he have too many facilities and people? Could he get the product cheaper? Were some customers too costly to serve? Should he raise prices on certain products? When it came down to it, Tom did not know where he was making money at the net margin level. He was not alone. Many of his industry peers were in a similar predicament.

Their industry association, SSCI, launched an initiative to assist by providing industry benchmarks for different processes, and by demonstrating how firms could implement activity-based costing. This made sense to Tom. The executive team at Stateside decided to implement ABC to help turn around the company. Tom knew there were three key success factors to the effort: **organizational buy-in**, **good information**, and a **clear plan of attack**.

Establish a Strong Team and Vision

First, Tom defined the project's scope and assigned a core team. He believed the problems that Stateside faced were widespread across all facilities, departments, processes, customers and products, and that the timing was urgent. Tom needed an overall view of the company. **His vision was to build an enterprise-wide model within six months**. After he and his VP of Operations, Rob Newsome, spoke with Acorn consultants, they created a plan to build a pilot model for one region (with six facilities) in two months. To accomplish this, they needed an ABC team that included three members from the region, and three from corporate. Their intention was to always keep the end game in mind.

Generate Great Information

The next step was to lay a foundation of reliable information that his executives could use to measure their performance and understand where opportunities existed for profit enhancement. Nigel Faulkner, the company's CIO, and Denise Turner, the company's CFO, spearheaded an activity-based costing project. The team leveraged an outside consulting and software firm that had already assisted over 20 other steel service centers.

This ABC implementation at Stateside was different than conventional ABC projects that had been attempted by many distributors since the late 1980's because the consulting firm they hired, Acorn Systems, proposed to use its new Time-Driven methodology[1]. TDABC enabled the team to:

- **Analyze the profitability** of customers and products across all facilities (standard to most ABC implementations)
- Use the principles of lean management (through time equations) to **identify inefficiency in each process** (unique to TDABC)
- Perform **process benchmarking** across each facility and compare not only rates (e.g., cost per cut), but identify what is truly different (set-up time variance) across facilities (unique to TDABC)
- Measure the **capacity utilization** of each department and process to determine where resources could be shifted (unique to TDABC)

[1] For more information on Time-Driven Activity-Based Costing, we recommend visiting www.oakforestventures.com and downloading the article "Time-Driven Activity-Based Costing" by Robert S. Kaplan and Steven R. Anderson. This article also appeared in the Harvard Business Review (November 2004) and has been expanded into a book by Harvard Business School Press (Spring 2007)

Identify Profit Improvement Opportunities

At the end of the day, analysis is only valuable if it:

- Has organizational buy-in
- Identifies specific opportunities
- Highlights root causes

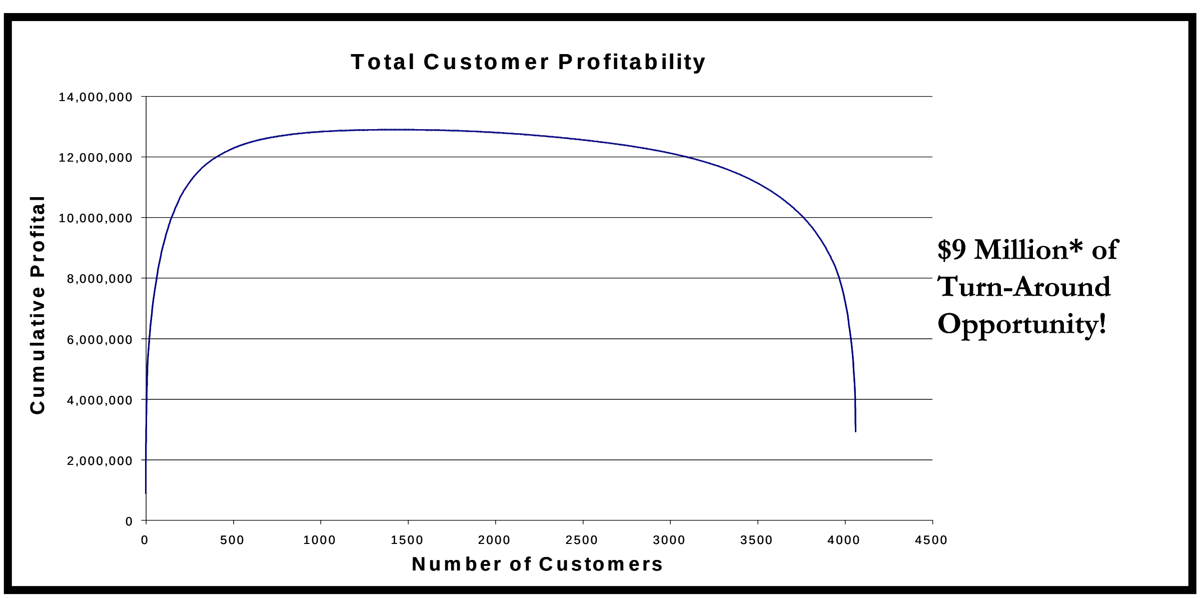
To satisfy the first requirement, the team led a validation session with members from applicable departments to verify that results reconciled with actual financial and operational data. To meet the second and third requirements, the pilot concluded with a value identification session, during which the team (with operating personnel) presented to regional and corporate management the findings and profit improvement opportunities with specific implementation steps. If the findings were not significant, the project could end there. However, the team identified several million dollars of opportunity.

Exhibit 1 is a whalebone chart that shows cumulative profitability across the entire customer base. The most profitable clients are on the left side of the chart.

- Roughly 20% of Stateside customers amassed close to 480% of the company's profit.
- The next 60% of customers roughly broke even.
- The final 20% lost 380% to ultimately settle the company at 100% (or in this case $3 million).

Quantifying the potential impact and time/effort required for each of the initiatives helped to prioritize efforts and maximize impact.

Exhibit 1: Sample Pilot Findings



Execute Swiftly

Armed with this information, the team launched two parallel efforts:

1) <u>Implement profit improvement opportunities identified in the pilot</u>. Some of the opportunities identified during the pilot were easy to address (e.g., freight surcharges, small orders) and/or were time-sensitive (e.g., price discrepancies). Examples include:

    - Consolidate orders
        - Backhaul
        - Selling excess trucks
    - Align pricing with cost to serve, particularly for unprofitable accounts
    - Create transparent pricing
    - Establish minimum order sizes
    - For unprofitable product lines: cut them, discourage pushing them, or push profitable product mixes
    - Target profitable accounts
    - Align order processing with machine based on profitability

2) <u>Roll-out Time-Driven ABC profitability model</u>. The team had four months to roll-out Time-Driven ABC and build an enterprise-wide model across 40+ facilities. With a company-wide model, the team had the following:

    - Benchmarking data to identify best practices in their processes
    - Holistic view of customer, product, and service profitability
    - Estimates of capacity utilization

Rob Newsome commented,

> "The Time-Driven ABC models helped benchmark our equipment utilization and costs across our processes and our facilities…this helped us refocus our efforts on where they needed to be spent."

The roll-out was a success. They modeled all locations within four months, and identified tens of millions of dollars of opportunity. But more importantly, there was great alignment between Tom's executive team and the operations personnel at the branches regarding what needed to be done. Enterprise-wide performance information for each department and process helped corporate and branch management identify consolidation opportunities.

Track Performance and Share Success Stories

Tom Parker knew that when it comes to any company-wide initiative, **success breeds success**. It was not enough to demonstrate initial gains from the pilot and put into place a roll-out methodology. The organization needed constant reminders of the impact that Time-Driven ABC was having on their organization. This information could help gain greater buy-in from employees who were implementing changes. For example, Stateside management fully supported raising order sizes. It was not just helpful internally, but also good for customers. Receiving one shipment of 10 steel plates was less expensive than receiving ten shipments of one plate each, due to the fixed time required for setting up the receipt. However, if inside sales did not understand this value, employees might be tempted to process ten separate orders. Tom instructed the ABC Team to document and communicate the successes they were having across the company. The team provided details of how the changes were being made. Tom had another reason for communicating this good news. He knew that the changes were not going to be limited to local tactics. Facility consolidation was required, and in the end, Stateside closed over 10 facilities. Anticipating the morale hit, he wanted the results of the profit improvement efforts to inspire existing employees to keep faith.

Lessons Learned from Stateside

Tom had much to be proud of. In less than one year he identified and captured $10 million of profit improvement opportunity (through facility consolidation, price changes, and service adjustments), aligned his organization around profits, and still protected his most valued customers. To put this in perspective, they achieved $10 million of incremental net new profits compared to $12 million in "business-as-usual" profits, for an increase of over 80%.

Why was Stateside successful so quickly? What were the key success factors?

- Did superior leadership rally the troops to make necessary changes?
- Did better profit and cost information lead to greater organizational buy-in to make changes?
- Was it the respect that Stateside commanded in the marketplace that made it easy to convince customers to accept the changes?
- Or was it the profit improvement process that fast-tracked the entire effort?

Stateside was good in these areas, but didn't excel. We believe that none of these factors stood out, but **together, they contributed to success**. While they had significant industry experience, *the management team members were not stand-outs*. While their existing systems were adequate to build an ABC model, there were *entire pieces of information missing* (e.g., how much time a sales representative and driver were spending at a customer). Given the competitive nature of the steel industry, a service center like *Stateside would have little ability to drive customer behavior*. Most jobs were put to bid based on price. Steel was steel. Product quality differences between service centers did not exist. And service quality differences were shrinking. Finally, the *profit improvement process was not unique*. Most corporate initiatives follow the same path that Stateside used. Define the vision, test the approach, roll-out, and measure success.

What should inspire executives at other distribution companies is that Stateside succeeded with <u>just enough</u> of each of these.

- You don't have to have an all-star executive team. Perhaps **the experienced team you already have can lead the change effort**.
- You don't need to spend millions of dollars to install an integrated ERP system with advanced reporting capabilities. You can **leverage the data from your existing systems to populate an ABC model** that will provide the true profit and cost information that you really need.
- You can **share this information with your employees and customers to drive change**.
- You don't need the latest three letter acronym, or the premiere consulting firm to implement this across your company. **Take baby steps first, and then rely on organization to roll it out**.

Profit Improvement Strategies that Work in Distribution

Now that we have reviewed Stateside's experience, it may be useful to understand the range of profit improvement tools available to distributors. We focus only on <u>techniques that directly impact profitability</u>. The solution must either increase revenue or decrease cost.

Strategies that work include:

- Selling to new customers
- Selling more product
- Increasing price
- Charging more for services
- Reducing headcount
- Buying at lower costs
- Reducing benefits
- Paying less interest
- Increasing rebate dollars

What does not work:

- Firing a customer
- Dropping a product
- Reducing activity
- Improving efficiency
- Shifting resources

While these strategies may sound intuitive and simple, they're not. Their successful execution depends on detailed analysis. For example, let's look at price increases. We want to raise prices for products losing money with customers who are also losing money. To accomplish that, we need profitability analysis of all items and customers over multiple periods in order to negate seasonality. The ABC model that would derive profitability would factor in all costs across the organization related to a particular product being sold. It would include the fully loaded cost of purchasing, receiving, stocking, picking, assembly, order processing, shipping, and collecting.

Assumptions

When we talk about profit improvement (value capture), we need to point out some important assumptions.

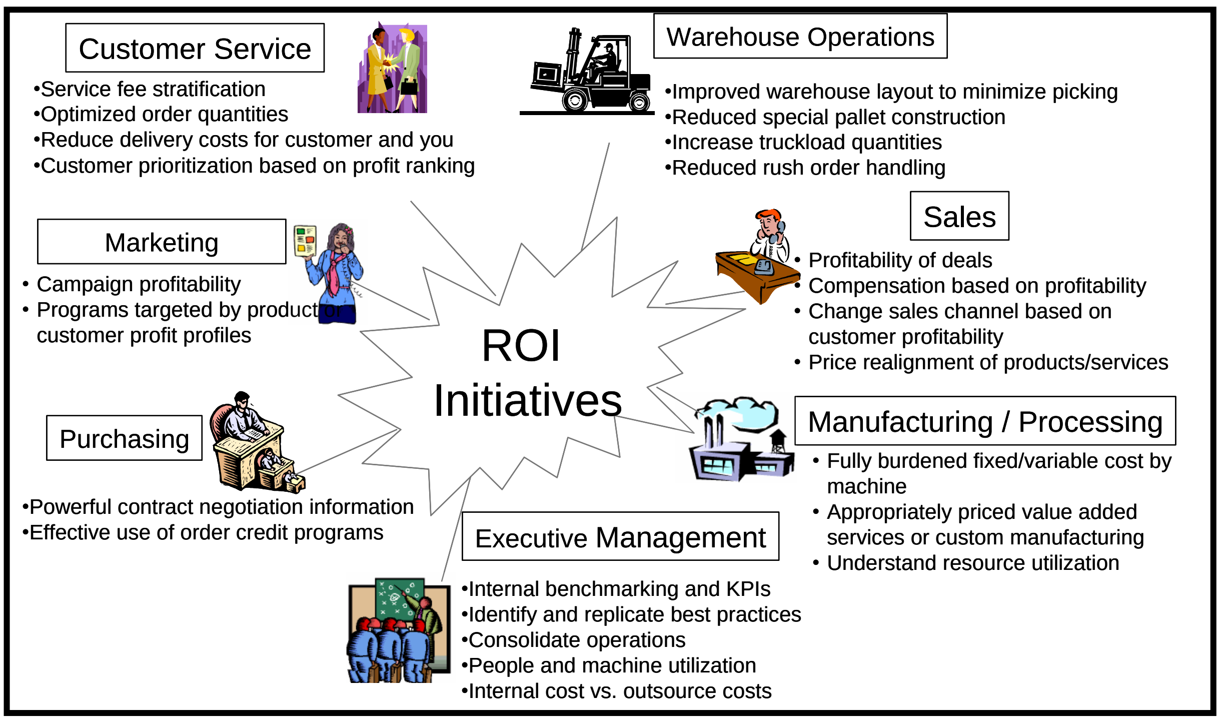
1. <u>Programs that improve efficiency or boost customer satisfaction can have a long term impact on profitability, but this effect is indirect.</u> For example, a grocery distribution client boasted about how a state-of-the-art conveyor system increased the number of cases picked per hour. However, if the number of pickers does not decrease and the volume sold does not increase, then how does this efficiency improve the bottom line? We want to provide you with approaches that will directly generate the largest immediate return. In this example, reducing headcount.
2. <u>Identifying opportunities does not equate to impact</u>. We call the former value identification, and the latter value capture. Both are necessary. The former can be completed by a stand-alone ABC team. In 1995, I was on a consulting engagement with a large petrochemical company. Our ABC team had identified $30 million of cost reduction opportunities. We considered it a great success. However, years later I ran into a member from our client team. I asked if they were still receiving benefits. He regretted to inform me that the project was canceled as a result of NO gains to the bottom line. Identifying opportunity only gets you half way there. You have to complete the mission and act to capture most, if not all of the value.
3. <u>The effectiveness of profit improvement initiatives (value capture) is highly correlated with the confidence of the participant</u>. This is best achieved when the

information being used or shared is accurate (e.g., reconciles with actual financials), provides visibility to root causes, quantifies impact of a proposed change, and involves the individuals who are closest to the opportunity (e.g. front-line employees). These all help generate organizational buy-in.

4. Not all opportunities translate into equal profit impact. For example, a one dollar increase in revenue may only translate into an incremental increase in operating profit. On the other hand, a one dollar reduction in operating expense may translate into a one dollar increase in pre-tax profit. Management should focus on growing the bottom-line, not necessarily the top-line.

The list of actions used to achieve the above strategies is endless. Exhibit 2 provides a few examples within major departments of any company.

Exhibit 2: Sample Profit Improvement Initiatives



As discussed earlier, the profit improvement process is standardized. It should answer these questions:

- What is the scope of the profit improvement effort (short term, long term)?
- What is the timing?
- Who are the departmental champions?
- What training is required?

- What are the $ targets?
- How will success be measured?
- How can this process be institutionalized?

Implementing Profit Improvement

We recommend the reader follow the approach of many of Acorn's clients. We call this the Four Ps of Profit Improvement.

Step One: Identify Profit Improvement Opportunities

Identify where profit improvement opportunities exist. As we saw at Stateside, the core team, with representatives from finance, IT, sales, and operations, performs analysis (e.g. ABC, EVA, Lean Management) to identify and quantify specific opportunities. These findings are presented to management for buy-in. This first step typically takes six to eight weeks, but it can be fast tracked. The Hawkeye Foods ABC team completed this

Exhibit 3: Profit Improvement (Value Capture) Process

	Prepare... Get the right information and insights	**Plan**... Schedule the right actions	**Perform**... Do the right things	**Post**... Take the right measurements, communicate success
	Month 1	*Month 2*		*Month 3*
Purpose	Identify **highest potential opportunities**	Develop **game plans to capture value**	**Execute game plans**	**Institutionalize process** by documenting and communicating success and executing roll-out
Actions	• Form dual Cient / Acorn value capture (VC) team • Review and validate #s from latest 6 months with operational mgmt • Synthesize and quantify opportunities • Prepare Value ID presentation • Educate senior mgmt on value capture process and key findings	• Prioritize opportunities with senior management • Develop core VC process and roll-out plan • Focus on top 5 opportunities • Identify key champions and opportunity teams • VC education • Develop with champion tactical strategy (including internal fixes) • Quantify win-win • Schedule actions	• Educate target on process and findings • Propose changes and present opportunity for win-win • Provide range of options • Document changes	• Monitor and document success of value capture • Communicate performance to internal team and mgmt • Revise roll-out plan as necessary • Establish formal VC program system (including monitoring system) • Execute roll-out

first phase in less than one month. The team for Countryside Foods completed the step in two weeks. To identify these opportunities, distributors have found most useful reports that track the profitability of customers, vendors, sales representatives, and products. Regardless of how many initiatives they can realistically pursue, we recommend teams expand the scope of their analysis in this phase to verify where opportunities really exist. For example, the initial intent for ABC at Stateside was to analyze the true cost of different processes. However, to identify opportunities the ABC model generated invaluable insights into customer profitability, product / service profitability, facility profitability, process benchmarks, and KPI's.

Step Two: Prepare the Plans

Create game plans for improving profits (capturing value). Now that we have a robust list of opportunities and have prioritized them, the team can begin to document proposed next steps. For each initiative, a champion should be identified who will help prepare the plan, confirm the expected impact, and establish timing. Exhibit 4 is an expanded and modified version of Exhibit 3, and highlights the detailed steps of this planning phase. It walks us through the methodology that Acorn shares with clients to help educate their personnel about value capture. This framework combines steps 3 and 4 of Exhibit 3. Notice how critical the plan and execute phase steps are with respect to the overall success of the project.

Exhibit 4: Profit Improvement Process

		Confidence / Buy in	Prepared with Details	Gameplan / Prioritized	Ownership / Accountibility	Measurement
Prep	Training	X				
	Validation	X				
	Client Case Study	X				
	Pre-VC Prep Meeting	X	X			
	Client Brainstorms	X			X	
	"Fox" Involved	X	X	X	X	
Plan	Quantify Gains		X	X		X
	Be Specific		X	X		X
	Formalized Internal Plan		X	X	X	X
	Define Respective Roles			X	X	
	Top 5 List			X		X
	Communicate the Goal			X	X	
Post	Follow-up / Remind Top 5			X	X	X
	Acorn / Client Teamwork				X	
	Need to follow. in contract				X	
	Consultant rewarded on ROI				X	X

The columns of Exhibit 4 represent the goals for steps, which appear in the rows. As we mentioned earlier, the first step in identifying profit improvement opportunities does not include creating execution plans and capturing value. Nor does it establish ownership. This is the goal of the second step. One word of caution: companies can be overwhelmed by the number of opportunities and have difficulty knowing what to do first. In step two, we recommend teams establish a rating system to further evaluate and prioritize the opportunities. Listed below are sample metrics. Estimating these up front will help the team assess where the greatest return is, and what they have sufficient resources for:

- Immediate (< 90 days) profit enhancement

- Long term, annual profit enhancement
- Implementation, sunk costs
- Number of employees required to implement
- Estimated amount of time (hours) to implement
- Alignment with corporate mission (Yes/No)
- Level of risk

We recommend listing the top 10 initiatives in a spreadsheet (with the above metrics if possible) to help prioritize the opportunity. The team should work with the assigned champion to prepare a game plan for each initiative.

Step 3: Perform / Execute

This phase covers the execution of initiatives. As discussed earlier, frontline personnel are typically responsible for these actions. It is important that these employees are educated about the goals of the program, how the analysis was completed, and the findings. They will probably want to understand the assumptions made along the way, and the source of the data.

In the case of a large Midwest-based dairy company, the VP of Operations was actively involved in implementing a few of the initiatives (e.g., shifting partial cases to full cases). He knew that his involvement would encourage greater organizational buy-in from the sales group as well as operations.

Actions will probably require the involvement of more than one department, and it is important that your company has the infrastructure and culture to encourage such team work. For example, at a grocery distributor, the transportation director worked with IT and sales management to set up and enforce the new policy of not picking up returns.

Each initiative should have a responsible party and a due date. It should also have management approval and oversight, ensuring actions are completed.

Step Four: Post / Measure Results / Communicate Success

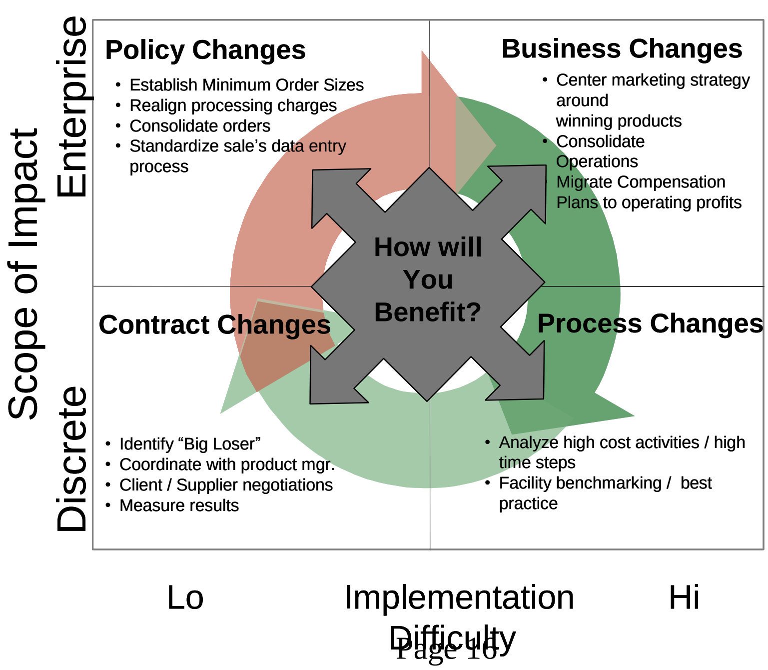
This phase includes measuring results of the profit improvement initiatives (value capture) and communicating success. It is important to communicate the success of the actions taken. As we saw at Stateside, there were many reasons for low morale. Value capture success can help keep employees excited and committed. Ideally, reporting on each initiative is automated. An ERP system can easily show the reduction in small orders, or the increase in surcharge revenue (e.g. from small orders). However, these changes should be linked back to actual profitability. Tracking surrogates (e.g., number of cases) may be easy to do, but have no impact on the cost of the process (e.g. delivery). This is where ERP systems and many corporate programs (e.g., Lean Management, Six Sigma, CRM) have fallen short. In contrast, activity-based costing studies can provide those answers, but need to be tightly integrated with the transaction data sources. For example, reports were generated at a dairy company on their Time-Driven ABC system to display capacity utilization of key processes, how it changed over time (e.g. post-downsizing), and cost/profit impact. At Stateside, Tom's team diligently tracked the success of different initiatives (e.g. consolidating processes, raising minimum order size) and reported it back to the rest of the organization.

It is also important to define targets for each initiative so the organization can track performance over time. This takes advantage of what consultants call "the Hawthorne Effect." It is a behavioral phenomenon they have observed with their clients when personnel are given a target. Recently, we saw this at an industrial distributor where we set a target of raising the average order size. The goal was communicated across one division, and within a matter of months, the target was hit. Of course, it helped that they established the link between order size and profitability and measured both. Profitability skyrocketed. The division went from losing money to becoming the largest profit source in the company.

Value Capture Matrix

Most companies either lack the experience or resources to tackle all initiatives at once. In 2001, Acorn worked with a multi-billion dollar electronics distributor to assist them in the value capture process. We realized that there was a logical categorization of value capture actions, and a natural flow. We call this the Value Capture Matrix (Exhibit 5). The actions in each quadrant can be differentiated by the level of effort (time and cost) needed and the scope of the impact. The latter can represent both the size of the gain and risk.

Exhibit 5: Value Capture Matrix



Contract Changes - We recommend starting in the lower left quadrant – contract changes. These actions are easy to implement, and while the gain may be limited (e.g. one customer), so is the risk. If it fails, you are not jeopardizing your entire customer base. An example is renegotiating with a "big loser" customer. The four step value capture process is followed, and hopefully success is reported. A company can stay in this box forever.

Policy Changes - For a bolder company that has identified a pattern of unprofitable customers, policy changes may be a good fit. However, we do not advise unveiling a policy change without the experience gained from contract negotiations. Changing a corporate policy has sweeping impact across the company. It is generally easy to implement. The new rule needs to be communicated internally to affected employees and externally to affected partners (e.g. customers). There will probably be changes to corporate collateral and possibly IT systems.

Business Changes - These changes require more thought. For example, the findings from Phase 1 analysis may suggest that the company is losing a lot of money within one of its core divisions. A packaging distributor discovered that its industrial business, while having higher gross margins, was burdened with high overhead expense. It was far less profitable than the commercial business. To complicate matters, the company had been growing its industrial business through a series of acquisitions. The new findings suggested that their efforts were destroying shareholder value. They decided to transform the business and shift product from industrial to commercial markets. This also resulted in a change in M&A activity, and strategic market exits.

Process Changes – These changes, the most difficult to implement and with the lowest return, are where most companies have focused their profit improvement efforts over the last two decades. Why do they have the lowest return? Efficiency improvements do not necessarily increase profits. An electrical distributor in the Midwest routinely presented at industry conferences and boasted about their usage of ABC to create a best-practice collections process. They had identified significant process waste, and through new procedures, were able to streamline the process. I spoke to their President and asked about the impact on collections. There was none. I asked how could there be any real profit improvements without corresponding cost reduction. The department only had one employee. Apparently, the rule of one will always be alive and well within this company. Perhaps they should have started with a higher cost department and process.

Building Your Profit Improvement Strategy

To determine what profit improvement strategy is best for your company, it helps to understand what the winners are doing. We can leverage what we have learned from Acorn clients. As we glance down the list of over one hundred distribution clients, we can apply what we learned from the Stateside example. Exhibit 6 summarizes the findings with fifteen of those companies, representing five industry segments. They have all been successful in their profit improvement efforts. We should note here that this matrix is based on our preliminary analysis.

In particular, we are interested in understanding whether there is a correlation between the internal capabilities of a company (the strength of their leadership and organization; **Org** column in matrix), the quality of their information (ERP system, breadth of their ABC analysis; **Info** column), the industry dynamics (the power of the distributor over its clients; **Mkt** column), the profit improvement strategy they chose to implement (**Strategy** column), and the ultimate success of their efforts (**Impact** column). For confidentiality, we have disguised the names and particulars. We will leverage Acorn experience within each of these segments to assess whether the company is low(L), medium(M) or high (H) performing compared to other distribution companies in general, not just with their segment peers.

Info Scores: This is a qualitative measure of how accurate, accessible, and valuable the information is. The hypothesis is that better information results in better decisions[2].

- Good: integrated ERP system, combined IT group
- Poor: company without a system (e.g., manual data collection on spreadsheets), or one where the data is unreliable and/or difficult to extract.

Org Scores: A qualitative measure of how aligned and prepared the organization is (both management and front line employees) to affect change. Companies with experience using timely information to execute change are at an advantage.

- Strong: capable and aligned management team, with clear vision and experience leveraging good information (e.g., ABC data) to lead change. Strong organizational buy-in.
- Weak: company lacks individuals to lead effort, and will require outside help

Mkt Power Score: A qualitative measure of the company's strength in the marketplace. This is influenced by the intensity of competition, the concentration[3] of customers, and the ability of the company to influence its customers and suppliers.

[2] An interesting corollary: over the past ten years, Acorn has discovered that the performance of a company is more influenced by the quality of the information than the quality of the executive's resume. This is the opposite of what many private equity and headhunting firms argue.

[3] Customer concentration is a qualitative measure that describes how much of the business is driven by the large customers.

- High: clear leader within their market. High customer concentration. Experience getting customers to support changes.
- Low: follower in marketplace. Intense competition results in customers having more power. Very few large customers.

There are some important qualifiers. First, this list of factors is not complete. There are nuances within each company and each industry that are impossible to reflect in a matrix that only tracks three core factors. The factors we chose seemed to have a very real impact and were also easy to track. Second, these qualifications are subject to change over time. Third, the difference between scores does not necessarily correlate directly with outcome. In other words, a high score does not necessarily translate into high impact.

Exhibit 6: Capturing Profit Improvement in Distribution

Company	Segment	Info	Org	Mkt	Strategy	Impact
Steel Distributor #1	Steel Service Center	**H**	H	H	• Regionalized value capture • **Comprehensive**	Saved company from bankruptcy
Steel Distributor #2	Steel Service Center	**M**	M	H	• Focus on **3-4 big loser customers**	Doubled income in less than 12 months
Steel Distributor #3	Steel Service Center	M	M	M	• **Tested** with specific facilities and products	50% increase in profits
Food Distributor #1	Foodservice	M	H	H	• After pilot, **comprehensive** rolled-out to entire company • Renegotiated with **vendors**	Doubled income in two years
Food Distributor #2	Foodservice	H	H	H	• **Comprehensive** (customers, vendors, policies, pricing)	Not available
Food Distributor #3	Foodservice	H	M	L	• Renegotiated with **key vendors** on rebate dollars and prices	Doubled income
Food Distributor #4	Grocery	M	M	M	• Focused on **internal changes**	150% increase in profits
Industrial Distributor #1	Industrial	M	M	L	• Renegotiate with **vendors** to realign price discounts	Not available (but at minimum, a 10% increase in profits)
Industrial Distributor #2	Controls	M	H	H	• Pilot led to enterprise roll-out	Doubled profits in less than one year Led to successful industry roll-up
Industrial Distributor #3	Industrial	M	M	H	• Lengthy pilot, which then led to **Comprehensive** solution	Over doubled profits
Chemical Distributor #1	Chemical	M	L	M	• Renegotiated with **vendors** to get support for price increases	Doubled income
Chemical Distributor #2	Paint & Coatings	M	H	H	• **Comprehensive**: charges for restocking, increased SKUs, price changes, renegotiations	"Significant improvement to bottom line"
Chemical Distributor #3	Chemical / Lab	H	H	H	• Customer ship-to and SKU profitability	Not available. Now a division of Thermoelectron
Packaging Distributor #1	Packaging	M	M	H	• **Pilot**, and then slow roll-out • Focus on policies and vendors	Doubled profits at pilot location.
Packaging Distributor #2	Packaged goods	H	H	M	• Comprehensive (customer, vendor, policies)	Captured immediate returns.
Packaging Distributor #3	Janitorial	M	M	M	• Internal fixes, renegotiate with vendors and customers	Not available

One of the findings from the analysis of the matrix is that **companies with lower scores tend to pursue and do better with more moderate, conservative strategies**. For example, the third steel company tested the approach with different facilities. Instead of moving from pilot to roll-out, they continued to perform a series of pilots. The scope of analysis was also more specific and targeted. The first chemical company did not attack unprofitable customers. Rather, they focused on unprofitable vendors and products. According to a subsequent conversation I had with their CFO, their market presence and organizational support was not strong enough to ask customers to change to reduce the company's cost of serving them.

Contrast this to high performers in the matrix like 1) the first steel distributor (Stateside Metals); 2) the first food distributor; and 3) the second chemical distributor, and second packaging distributor. These companies can pursue comprehensive[4] change efforts. With better information and experienced teams, the companies were able to launch parallel efforts. For example, the food distributor had the VP of Sales distributing customer P&Ls to strategize changes. Meanwhile, the VP of Purchasing worked with the CFO to renegotiate with key vendors. Another example is the third industrial distributor. When the project started they had a medium score because of data issues. They had difficulty getting reliable data. And once the numbers were fed into the ABC system, they had difficulties reconciling financially. Finally, the roll-out to 25 other locations was being driven by only two individuals. But during their extended pilot of three locations, the company upgraded their information system. With higher scores and greater confidence, the company launched a comprehensive value capture effort and generated great results. So great that in 2006, they acquired a large competitor, which doubled their revenue and number of locations.

To assist distributors in determining which profit improvement strategy may be best, we have created a new framework, **The Profit Improvement Roadmap (Exhibits 7a, 7b))**. This tool will help you assess your company's Info, Org, and Mkt scores. The framework points you in the general direction of the path that may work best for your company.

Assess the capabilities of your company within the matrix (Exhibit 7a), and then follow the sequence of steps dictated by 7b. For example, both High Performes and Pioneers would start with Contact Changes.

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[4] Comprehensive denotes that the solution is being used for client / vendor negotiations, pricing decisions, process changes, SKU rationalization, and headcount reduction

Exhibit 7a: Profit Improvement Roadmap: Where is Your Organization?

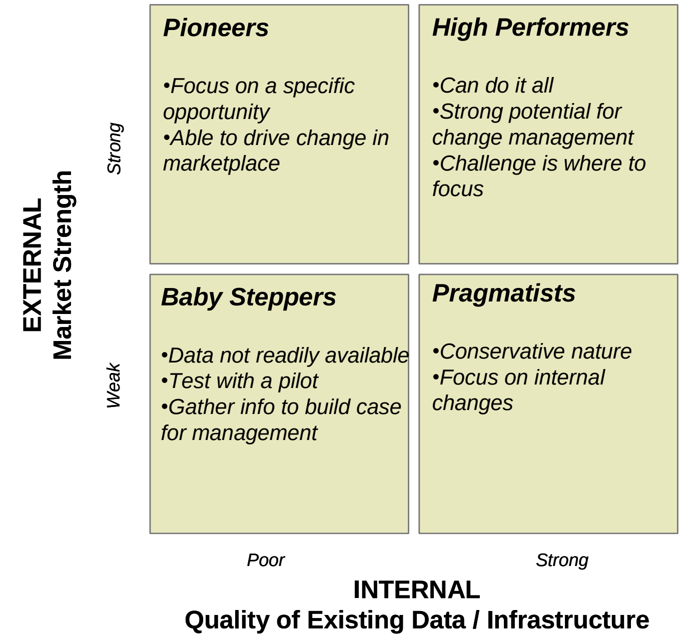


Exhibit 7b: Profit Improvement Roadmap: What Strategy is Best?

	Pilot?	Contract Changes	Policy Changes	Business Changes	Process Changes	Winning Strategies
High Performers *Comprehensive Approach*	N	1st	2nd	3rd	4th	• Client / vendor negotiations • Strategic price increases • Policy Changes
Pragmatists *Internal Approach*	Y	2nd	3rd	4th	1st	• Headcount reductions • Facility consolidation • Right-size service levels • Educate key customers
Pioneers *External Approach*	N	1st	2nd	4th	3rd	• Renegotiate with key 1-2 customers / vendors • Change 1-2 policies to gain internal support • Educate organization
Baby Steppers *Gradual Approach*	Y	2nd	3rd	N	1st	• Test with a pilot • Select 1-2 minor process changes • Work with one customer • Improve data • Educate

Applying the Profit Improvement Methodology to Countryside Foods

To illustrate the profit improvement methodology, let's walk through the process at Countryside Foods (food distributor #4 in the matrix), a medium-sized grocery distributor in the Midwest. In the summer of 2006, they agreed to sell the company to a buyer who was eager to apply activity-based costing to identify and capture profit improvement opportunities.

Before we begin, let's use the Profit Improvement Roadmap (Exhibit 7) to asses what profit improvement strategy is best for the company. The acquisition team gave Countryside this score:

- Info: Good. They had reliable data from the ERP
- Org: Strong. The new management team had significant experience implementing ABC and value capture
- Market: Weak. Under new ownership, Countryside would have difficulties exerting control.

The conclusion: Proceed as a Pragmatist. Focus on internal changes first.

Next, let's use the Profit Improvement Process.

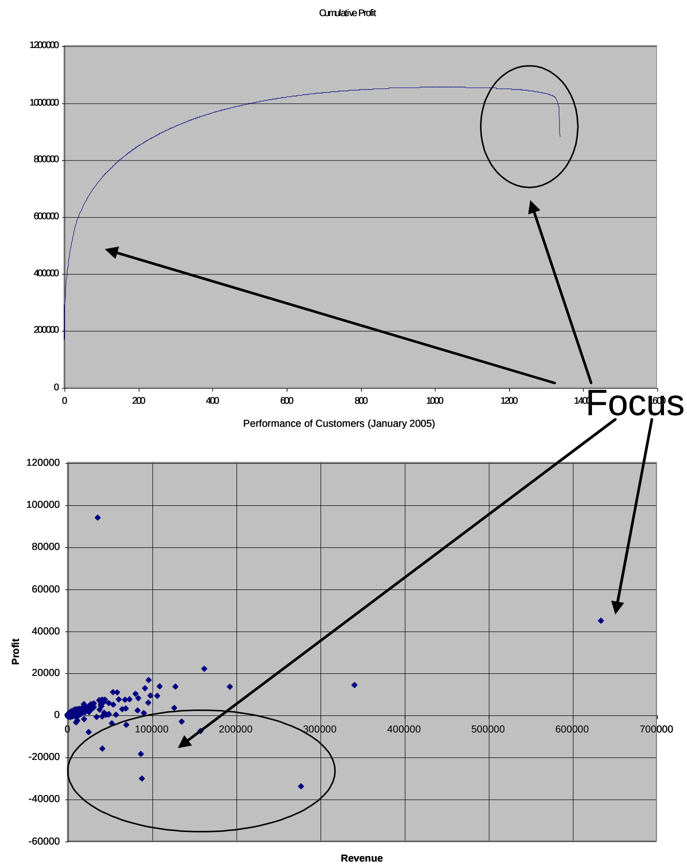
Step One: Identify Profit Improvement Opportunities

Over the course of two weeks, two people on the new acquisition team built a Time-Driven ABC model. The team presented a **comprehensive** report on the findings, which included:

- Customer profitability
- Product profitability
- Sales territory profitability
- Route profitability
- Vendor profitability
- Break even order analysis
- KPI
- Capacity utilization for each department and process

The overall opportunity was significant. The team reviewed the profitability analysis of the 22,000 customers. They were impressed by the concentration of their business in a handful of large customers. A few generated huge profits and needed to be protected. A half dozen others (see right side of whalebone) needed contract adjustments. The analysis of products and vendors were equally revealing. The team had identified a way to triple profits.

Exhibit 8: Sample Profitability Analysis

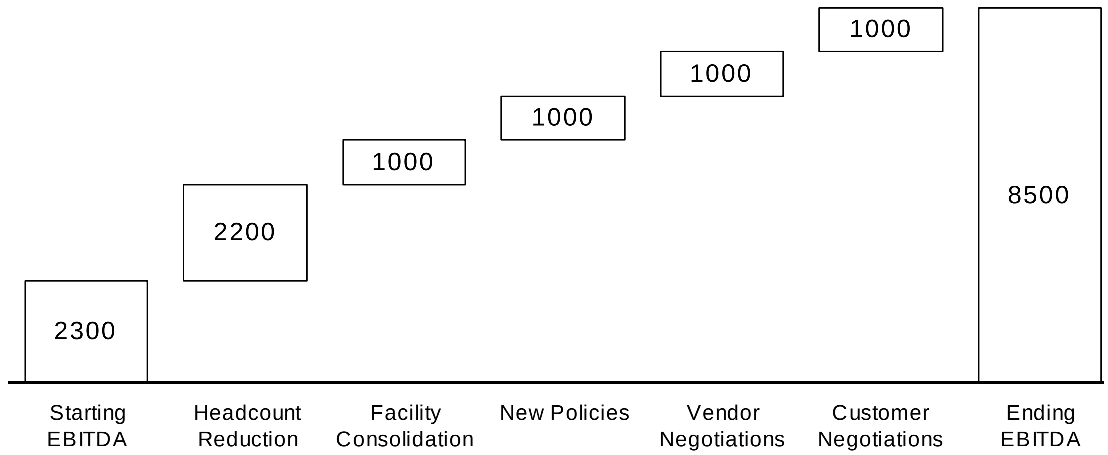


Step Two: Plan

As a pragmatist, Countryside's strategy was to focus on internal changes and minimize the number of initiatives. Exhibit 9 shows the series of actions the management team planned and the expected impact. They decided that downsizing was a good step to accomplish up front because it would help the company to compete more effectively by reducing expense by as much as $150,000 per month. The second plan was to consolidate facilities, but this was given a lower score because of expected transition costs. Finally, the team planned to enforce minimum order size through close monitoring and penalties. However, since this could jeopardize customer goodwill, the risk was too high.

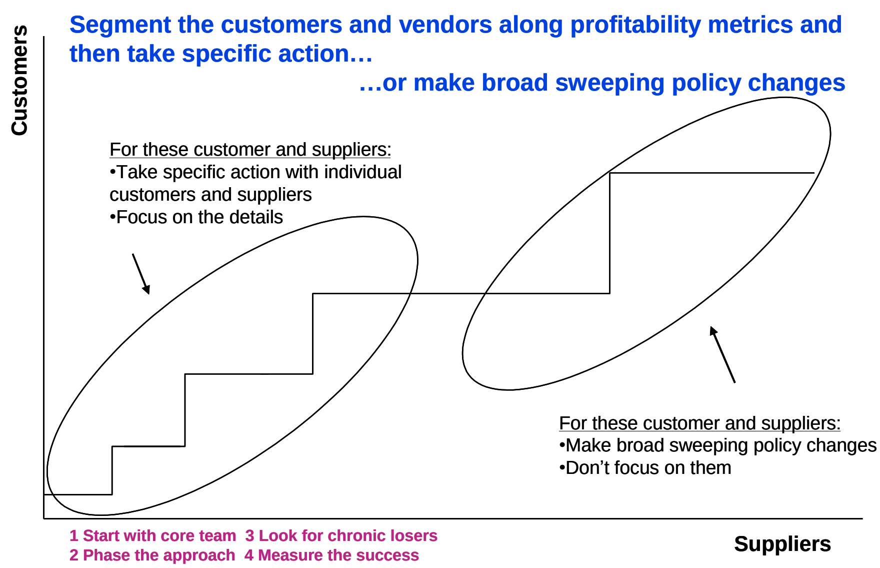
Management was not comfortable with unleashing this information to the sales force and purchasing group for fear that defections may result in competition getting this information. Working with the sales force to renegotiate customer contracts was moved out to 2008.

Exhibit 9: Opportunities Identified at Countryside Foods ($K, over first 30 months)



At the same time, they were staring at a multi-million dollar opportunity. Given the number of customers, products, vendors, and sales representatives touched by this analysis, the management team decided to pursue an approach followed by many of Acorn's distribution clients – an escalating roll-out (see Exhibit 10). Working with management, the ABC Team identified the two to three highest potential clients and/or vendors. They worked with the sales representatives and/or buyers to forge a game plan (Step Two). They then executed those plans (Step Three). After documenting success (Step Four), they communicated it internally to a slightly wider audience of sales representatives and buyers. This new group is targeting five to eight high potential clients or vendors.

Exhibit 10: Scaled Approach



Step Three: Execute

There is not much to report on the actions taken to date. As of the writing of this paper, downsizing is the only major effort completed. Thirty people have been let go, and there are eight more that may soon be let go. However, actions have been taken to not renew three leases. Truck routes are also being consolidated to eliminate at least 10 trucks.

Step Four: Post / Measure Results / Communicate Success

To date, the company has reported $1.7 million in EBITDA improvements. This has resulted in an annual increase from 2.2 to 3.3% operating margin. This strong gain is being well received by management and the new owners.

Summary

As distributors contemplate how to achieve the greatest impact from their perennial profit improvement efforts, we believe using the methodology discussed in this paper can help them focus their efforts. The prescribed approach:

> **First:** Use the Profit Improvement Roadmap (Exhibits 7a and 7b) to determine what profit improvement strategy is best for your company. Do you have good data and strong organizational buy-in, and can you affect change within their market? How aggressive can you be? What are your next steps?
>
> **Second:** Implement the four-step Profit Improvement Process (see Exhibit 3). This will help synthesize and prioritize your findings. How many initiatives are you prepared to tackle? What is their expected impact on the bottom line? You can leverage the roadmap to help you determine which quadrants of the Value Capture Matrix (Exhibit 7) to focus on.

You have just embarked on what will hopefully be a very profitable journey. Like most distributors we have worked with, you will have gains along the way, but will also hit potholes. We recommend that you keep two things in mind. First, there is an endgame – higher profitability. Second, there is no finish line – the profit improvement process is an ongoing effort that needs to be woven into the fabric of your company. In other words, profit improvement must be a key component of your culture. It is what ultimately aligns your entire organization.

About the author…

Steven Anderson is the Founder of both Acorn Systems and Oak Forest Ventures. The first was a software company founded in 1996 with offices in Houston and Philadelphia that specializes in activity based costing and other decision automation software tools that help boost the operating profits of their clients. The second is a solutions company founded in 1998 that specializes in capturing value through its proprietary methodology and solution. Mr. Anderson is an alumnus of Harvard Business School and McKinsey & Company. He also holds an engineering degree from Princeton University, and an accounting post-baccalaureate from University of Houston. He can be reached for advice at (484) 437-0953, or by e-mail at sanderson@oakforestventures.com. For additional information on this subject, visit Oak Forest at www.oakforestventures.com.