

Understanding the Technology Distribution Business

A Guide to Optimizing Partnerships and Bottom-Line Value



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Based on Independent Research Conducted by VIA International

About this Report

Priming Your IT Distribution Business / Overview

The Global Technology Distribution Council (GTDC) commissioned the independent development of this guide to help all types of companies optimize business and partnership with IT distributors throughout the world. Whether you are interested in or already partnering with distributors, the content and analysis here can make a profound difference.

VIA International, a leading management consultancy exclusively focused on marketing, distribution and sales channels, objectively researched and produced all of the analysis and recommendations provided here. Their deep understanding of the technology channel business is based on 20 years of experience working closely with distributors, vendors and solution providers across all markets and product categories.

Although the authors and GTDC cannot assume responsibility for the outcome and impact of decisions made based on information within this guide, your distribution industry results will likely be far more successful when corresponding best practices are regularly and methodically leveraged or integrated as part of a comprehensive channel business strategy.

Learn More

For more information on VIA International or the GTDC – an industry consortium of IT distributors driving more than \$100 billion in annual worldwide sales – we encourage you to visit us online at: www.viaint.com and www.gtdc.org, or [click here](#) for detailed contact information.



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What are your perceptions? Are they changing – for better or worse? It's time to clear up any misconceptions. We give you the definitive view while helping you concentrate efforts on the core advantages that IT distributors enable.

Nine Things Vendors Do That Make No Sense to Distributors 40

Have you ever committed the same offenses – perhaps repeatedly, at least in the distributor's eyes? Avoid the pitfalls, and get to the bottom of what your distributors may view as incomprehensible actions that should change.



Introduction

Here's a complete perspective on who will most likely benefit the most – and how – from the deep analysis, best practices and other recommendations covered in this guide.

Primary Target Audiences

This “primer” is intended for anyone within a vendor organization whose role touches technology distributors. If your role and responsibilities involve determining the role of distribution in your channel mix, managing relationships with distributors or designing programs that involve distributors or indeed their value chain or ecosystem, then this booklet should be useful.

If you are a vendor partner account manager, partner business manager, channel manager, sales manager, or program manager, you need to understand the way your distributor's business works and to be able to demonstrate the commercial value of your relationships with distribution. In all cases, there is some aspect of your role which involves building business through distributors. Just as with any other channel partner, understanding the distributor business model is critical:

- It allows you to play an effective role as trusted business advisor to your partner
- It gives you insight into the levers available to you and how to connect your value proposition to those levers
- It provides a perspective on the model inside your partner:
 - Showing how the business model for your products/services looks inside their model
 - Allowing you to understand the role you as a vendor play within their business: are you a drag or an enabler?

Why this “Primer” was Developed

Members of the GTDC and leading edge suppliers into technology distribution saw the opportunity to broaden understanding of distribution – its role, benefits and business model – among the vendor community. This content is intended to provide everyone who interacts with distribution a common understanding of how the core distribution business model works. Obviously, there are many variations of the business, but the underlying model is common. The information will allow both supplying vendors and distributor personnel to master the detail of the business model and provide them a common language and understanding of how to work successfully together.



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The Role of the Distributor

Wherever you see a need or opportunity for IT distribution, it is critical to understand that most successful models are based on mutually beneficial partnerships. Build on a solid foundation that leverages what distributors do best.

For most major technology vendors, distribution is their principal route to market, typically representing as much as 80% of their revenues, with distributors playing a key role in providing extensive market reach and coverage. The value of this role grows exponentially in fragmented markets, even more so in emerging markets which may be new to vendors. Wherever the vendor sees a role for distribution, it is important to understand that the most successful model is one of partnership, whether optimizing joint supply chains in mature, consolidated markets, or sharing credit and business risk in more fragmented, emerging markets.

Role for Customers

Distributors serve a huge range of customers on behalf of vendors. These customers range in size from small, independent resellers to large multinational retailers, but all have the common requirement of a “one-stop shop,” where they can source products and services from the hundreds of suppliers whose products are part of their own offering to end customers.

It is more efficient for these “final-tier” players to be able to work with a limited number of distributors with whom they can establish trading relationships that meet most of their needs. And on the distributor side, there are a number of services they can offer which leverage their own economies of scale – either as part of their core offering or as optional services their customers can choose to use. *See the table at right.*

The distributor plays a critical role in selecting the right vendors and products to enable this **one-stop shopping** and to facilitate customers’ business growth. Core to this element is **availability**: the distributor’s ability to provide a significant proportion of products on demand, saving many of its customers the need to carry stock themselves. IT distribution is particularly strong in this domain, providing same-day shipping of thousands of SKUs to customers who are widely dispersed across geographies.

The second key role performed by distribution – for both customers and suppliers – is that of **breaking bulk**: in simple terms receiving truckloads and pallets of product and breaking them down into quantities that are closer to the requirements of end users, of resellers or of individual stores in a retailer’s portfolio. Effectively, many of the distributor’s customers are trading “back-to-back,” i.e., buying in the small quantities required by individual end customers, often shopping around on price and availability and placing their orders after trading off convenience, cost and credit.

The **provision of credit** is a core benefit from distribution, allowing customers to supply, configure and install products without having to finance their entire work-in-progress and receivables from the end customer. These are significant sums where products are incorporated into resource-intensive solution-based projects which cost many times more to deliver than the price of the products themselves. In the case of resellers, this working capital liquidity is often multiplied by sourcing from multiple distributors in order to

Key Distribution Facts and Figures (North America)

- 5 Billion+ of credit extended to the IT channel each year
- 5 Million+ inbound calls annually
- 2 Million+ configurations annually
- 50,000+ individual customers monthly
- 150 Million+ items shipped each year
- 100 Million+ software licenses managed annually

Source: North American GTDC Member Data

benefit from multiple credit lines. For retailers, on the other hand, distributor credit lines allow them to finance their inventories, which when combined with the cash payments from consumers leaves them with a cash-positive business.

The final “classic” role attributed to distribution is the provision of **delivery logistics**. With very few exceptions, most customers rely on the distributor to deliver their orders either to their own business premises or, in many cases, to their customers’ premises in the form of a “drop shipment” (which can also carry the reseller’s brand on labels and packing slips). Where products are out of stock or not carried as standard, the customer expects the distributor to order them from the vendor and ship them once they arrive. Gauging the right level of delivery charge to levy – recovering as much of the cost as possible while not alienating customers – is a key challenge for distributors. One mechanism which helps distributors manage this to the customer’s advantage is **order consolidation**, where delivery charges for all can be minimized by waiting until a complete order of products from different vendors is ready to ship. Additional services of this type take consolidation to the next level: for value-added resellers, for example, this might include managing the coordination of multiple suppliers, products and locations over the lifetime of a project.

For many resellers in most markets, distribution is also the main provider of pre-sale **technical support**, particularly

for the constant stream of innovative new products generated by the IT industry. Such support ranges from a simple “what is the difference between product X and Product Y, what are the specs and does it work with other components?” through to more complex configuration questions. Post-sale, this can take the form of troubleshooting or resolving mis-supply and configuration issues, or of more comprehensive post-sales support or technical training.

Linked to technical support is a range of what are effectively outsourced **product marketing** services, extending from the production of simple product marketing collateral – whether physical or virtual – through activities which allow the distributor to leverage their scale such as full catalogue production or website provision on behalf of their customers.

Finally, it is important to recognize the more strategic role played by distributors in providing customers with **market and business intelligence**, enabling their resellers to make smarter strategic decisions and facilitating the growth of their businesses.

Over time, as technology distribution has matured, more and more of the standard services have been built into the margin on the product, with frequent innovations by distribution to create augmented services and add new sources of profitability.

Typical Core Offering and Optional Services Distributors Provide to their *Customers*

Typical Core Offering

- One-stop shop – range and availability
- Bulk breaking
- Credit
- First level technical support (pre-sales)
- Logistics – delivery
- Order consolidation
- Product information collateral

Typical Optional Services

- Sourcing of products
- Back to back ordering
- Simplified supply logistics
- Consignment stocking
- Repackaging
- Extended credit, project finance
- Second-level technical support (post sales) – effectively acting as an outsourced provider of support
- Technical training
- Logistics – drop shipment to ultimate customer
- Project management – coordinating the supply of several suppliers and shipping to multiple locations
- Marketing services – effectively acting as an outsourced provider

Role for Vendors

Mirroring the roles distributors play for their customers are the roles they play for vendors. Ultimately, their role is as a route to market for vendors seeking to reach a specific segment of the market or an entire market. In broad terms, this role translates into activities in four main areas (See table):

Market Knowledge and Access – Distributors provide vendors with detailed knowledge about the specific markets in which they operate. Building a relationship with a distributor in a given market brings not just a set of relationships with resellers within that market, but also a wealth of insight into how to use those resellers to access the different parts of the end customer base. This role is usually backed up with reporting: sales out and inventory reporting, updated weekly or daily, provide a key window onto the marketplace for vendors. In addition, distributors may provide data on the state of the market, on the competitive environment, on lost sales, and similar.

Demand Generation & Outsourced Front Office – One main way in which distributors can leverage their market knowledge is in demand generation activity, working their existing network of resellers, recruiting new resellers, and actively driving awareness and sales capability amongst them in order to promote sales amongst end customers. For vendors, the market data, marketing tools and marketing resources a distributor can make available provide a highly efficient mechanism for generating demand for their products, and are therefore an attractive investment for market development funds. However, beyond these fundamental aspects of demand generation, distributors can also provide more extensive front office services, either supporting a local office in a new market or taking on the local agent/vendor representative role, providing channel development and account management services, running end-customer marketing or lead-generation/management programs, or administering channel programs and funds on behalf of the vendor.

Typical Core Offering and Optional Services Distributors Provide to *Vendors*

Typical Core Offering

- Market knowledge and access
 - Sales out reporting
 - Channel intelligence
- Demand generation
 - Channel recruitment
 - Channel accounts and database
 - Marketing fund deployment
 - Special pricing management
 - Teleweb outbound/inbound sales
 - Regular marketing mailings
 - "Spiff" sales promotions
 - Channel conferences
 - Channel training
 - Channel financing through credit provision
 - In-market product management
 - Front-line technical support
- Supply fulfillment
 - Bulk breaking
 - Outbound Logistics
 - Reverse logistics
 - Channel credit risk
- Outsourced services

Typical Specialized Services

- Market knowledge and access
 - Channel research
 - End-customer research
- Demand generation
 - Channel account management
 - Program management
 - Co-op fund management
 - Special channel financing and credit offerings
 - End-customer marketing and lead generation programs
 - Conference and exhibition services
- Supply fulfillment
 - Consignment stocking
 - Vendor managed inventories
 - Vendor stock warehousing
- Outsourced services
 - Warranty management
 - Break-fix operations
 - Second level and post-sales technical support
 - In-market representation
 - Trademark registration & protection

Supply Fulfillment & Outsourced Back Office –

Complementing the demand distributors can generate is a set of supply fulfillment activities they perform on behalf of vendors. With the extensive range of SKUs from most IT vendors, distributors perform a key role in stocking a complete or close-to-complete range of SKUs on the vendor's behalf, and assuring back-orders are handled promptly where SKUs are not in stock. With price volatility a common industry condition, the costs of holding this inventory can be high, in particular where vendor special pricing into the channel is not backed up by price protection.

The distributor's role for vendors regarding these SKUs mirrors that played for customers, i.e., breaking bulk, providing delivery logistics, and providing reverse logistics (e.g., taking back returned products), where required. In addition, they may provide additional services related to fulfillment, such as vendor stock warehousing, dedicated vendor inventories for major retail customers, or consignment stocking on behalf of vendors.

As highlighted in the section relating to customers, a second core fulfillment function of distribution is to take on and manage on the vendor's behalf the significant credit risk of thousands of reseller and retailer customers. This is a role which requires the application of all of the distributor's local market insight to a set of rigorous credit control processes to minimize credit exposure and the cost of bad debts. In addition to the costs saved by having a single, simple

credit function for the vendor, it is clear that there is real value in managing this credit exposure: the more risky the market or market segment, the greater value to the vendor.

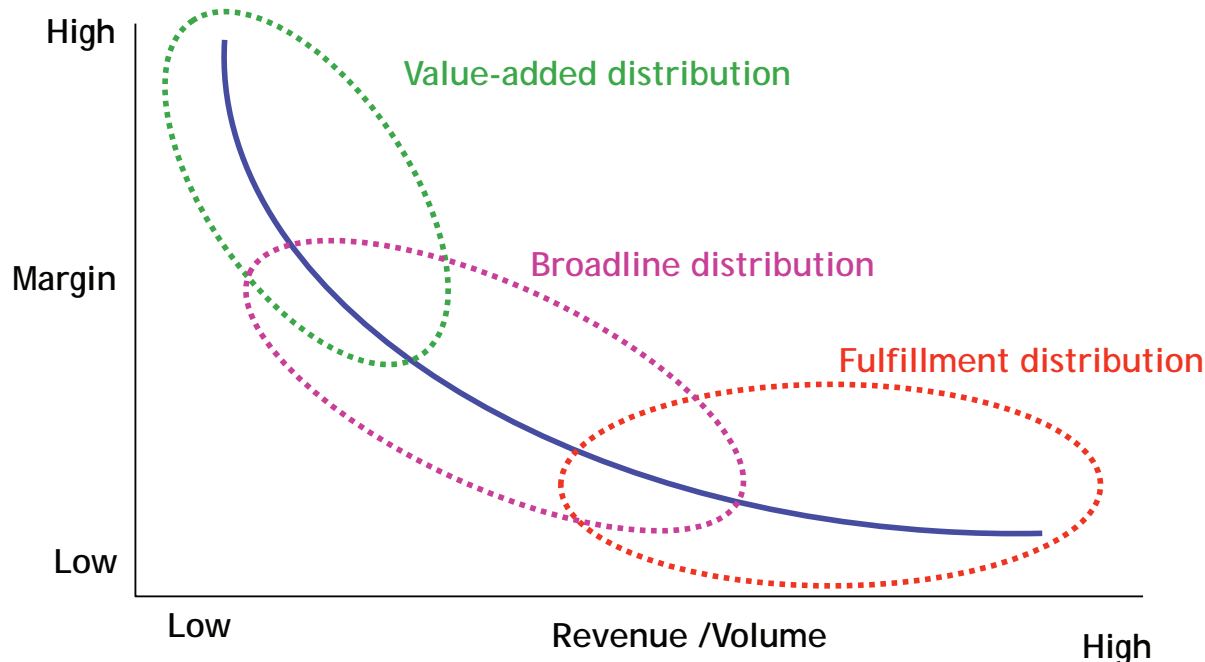
Additional back-office functions distributors perform beyond credit management include the running of debit notes, providing quotation support, and managing pass-through funds on vendors' behalf (often advancing funds).

Outsourced Services – Finally, there are other more specialized outsourced services which IT distributors provide, including warranty management, break-fix, post-sales support, or specialist legal services which leverage local knowledge, such as trademark registration and protection.

Different Business Models for Different Roles

Which of the sets of services above a distributor actually provides to a vendor – the exact nature of the distributor's "route to market" role – depends on a range of factors: the presence of the vendor in the marketplace, the segment of the market being addressed, the maturity of the product categories in question, the stage in the product lifecycle and the nature of the final-tier in the marketplace and distribution system. In simple terms, there is a spectrum of (overlapping) services a distributor may provide, ranging from Value-Added Services through Broadline Services to

Spectrum of Distributors Defined by Business Model



Fulfillment Services, which can be mapped by margin and volume, and which often relate to the position of the product category on the Technology Adoption LifeCycle (TALC).

Value Added Distribution Services – Typically focused on taking to market newer, higher-value technologies such as data centers, virtualization, secure networking and Open Source and supporting services delivered to larger and Enterprise-level customers, Value Added Distribution services involve recruiting, developing and supporting the specialist final-tier players who reach and service this end of the market, typically by planning and delivering complex IT projects. This, in turn, requires significant investments of time and resources in mastering products from a technical and marketing perspective, and in building infrastructure for services ranging from demand building, proactive sales, consultancy, extensive technical and sales training and certification, coupled with comprehensive pre- and post-sales technical support. With investments of this nature, significant numbers of highly-skilled, high-cost personnel, and an overall lower volume of sales, distributors providing Value Added Distribution services look to earn high margins and to receive compensation for the services they provide.

Broadline Distribution Services – Providing the mainstream market coverage to allow vendors to access and service dealers who address the vast SMB segment, distributors who provide Broadline Distribution Services need to cover most or all of the channels vendors need by establishing and supporting trading relationships with a full range of dealers within each segment. Market access is clearly core to the offering, along with the provision of proven marketing and communication tools such as catalogs, mailers and websites. With several providers of these services in each market, this marketplace is typically highly competitive, with prices and margins under greater pressure, meaning that process efficiency and cost control are essential, along with the volume discounts and rebates which reward scale. As a result, the additional costs of activities such as placement in marketing tools or sales promotions will typically be recovered from suppliers since they cannot be absorbed into the normal trading margin. In addition, given the scale of such a business, efficient management of working capital and cash is key, with the role of credit provider often extending beyond product into the domains of marketing and promotional funding. Scale is key, both for the distributor offering these services and for the supplying vendor.

Fulfillment Distribution Services – In markets where products are bought rather than sold, such as consumables, or where other players drive marketing and sales activity, such as retail, distribution performs the role of logistics engine on behalf of the vendor. With the vendor or final-tier retailer taking on most of the marketing activity, the core of this model is a high-volume, high-efficiency logistics operation, focused on stripping out any redundant cost in

order for margins to cover infrastructure and operating costs. In many respects, this model is comparable to that of a pure logistics provider such as FedEx or DHL, with two major differences: first, the distributor providing these services typically bears a stocking risk, leveraging their expertise in inventory management to balance demand and supply; second, the distributor also bears the credit risk. In this model, compensation can be either through trading margin as in other models or on a fee-per-transaction basis which reflects the fact that the distribution and handling costs are standardized and unrelated to the selling price.

Logistics and Special Service Distribution – The final, hybrid model, blends elements of all three models above into special service distribution. In domains such as telecoms, distribution may combine high-value configuration services with pack-out and branding services, repair and refurbishment with retail store fulfillment, category and shelf management.

Which of these roles your distribution partners play for you, and which services they provide, will determine the exact nature of their business model. This primer will not go into detail on how the business model varies for each type of role, although that may be the subject of future GTDC publications.

Future Roles, Evolution and the Cloud

As markets and technologies evolve, new roles for distribution are emerging and will continue to emerge. Although the core roles will remain, it is likely that disruptive technologies and discontinuous developments (such as cloud computing) will once again lay down the challenge for distributors and vendors of defining how the distribution role – and therefore business model and compensation model – will need to change.

What Does This Mean for the Vendor?

Each of the roles and services listed above has an impact on the distributor business model: the choice of whether it is provided or not, and to what degree, is determined by the specific role the vendor is looking for the distributor to play. As such, it is reflected in vendor contracts, in margin structures, in compensation schemes and in activity-based fees. The challenge for vendors is to be clear on what is required of distribution, which distributors are fulfilling the requirements and to what degree, and how that activity is to be compensated.

Ultimately, anyone in a vendor organization who needs to justify the use of or quantify the value of distribution, should work through these checklists – from a customer and a vendor perspective – and answer the question “Which of these activities do I need performing, which of them should my distribution partners perform for me, and what would it cost my own organization to provide these services?”

Five Myths of Distribution

1. I'm Giving Up Margin to the Distributor

Vendors often feel that by going to market through distribution they are giving away margin that they could have kept for themselves. However, this perspective completely ignores the fact that the vendor is also giving up the logistics and credit infrastructure that it would need to deploy to reach the resellers and retailers served by distribution. The recent cost study conducted among vendors by the GTDC shows that the economies of scale achieved by distributors means that the vendors are making cost savings which are considerably higher than the 3 to 5% average additional discount given to distributors

2. Distributors are Just Order Takers

There are very few products that have such strong brand strength and channel profile that the distributor's role can be restricted to simply taking orders for them. Most products need some level of pre- and post-sales technical support, depending on where they are in the technology adoption life cycle. Distribution plays a vital role in ensuring the resellers are fully informed as to the technical specs of products as well as advising on configuration issues and compatibilities. Without this role, many new technologies would move far more slowly through the adoption cycle and resellers would struggle to realize their business potential.

3. The Internet/Cloud has Removed the Need for Distributors

Distributors generate and respond to demand from thousands of resellers of all types, providing a one-stop-shop across hundreds of different vendors. While the migration of information to the Internet and the provision of services through the cloud make these transactions ever more efficient and lower cost, there is no substitute for the specialized skills and capabilities of distributors to drive the sales and fulfillment processes. With the exception of software, IT products require a physical logistical infrastructure, and all products need a credit infrastructure backed by the financial strength and credit insight of distributors to provide the liquidity needed by the channel at the lowest cost.

4. Retailers and Large Resellers Prefer to Deal Direct with Vendors

While it is certainly true that large retailers and resellers want to have a direct relationship with the key vendors, this does not automatically mean that they want the vendor to handle all aspects of the trading relationship. Most retailers have such demanding logistical requirements that they insist on distributors handling the supply chain and providing the related transaction processing infrastructure, including of course credit provision. Large accounts want the ability to connect with vendors at a strategic level backed up with day-to-day account management connections to be able to resolve issues with the right level of priority. In some instances the vendors will also deploy sales support that works directly alongside that of the resellers to develop end-customer relationships and win big or complex deals, but project management and fulfillment will go through distribution.

5. Distributors Move You One More Step Away from Market Signals

Although this might have been true twenty years ago, most vendors now have on-line visibility of "sell-out" data from their distributors through the integration of their IT systems, giving them at least weekly, if not daily or live visibility of market signals. This is to the benefit of both vendors and distributors, ensuring that the supply chain is as lean as possible while holding sufficient inventory to meet demand.



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How the Distributor Business Model Works

What are the primary levers and factors that come into play when establishing or growing your partnerships with IT distributors. Not all are created equal, but certain factors and considerations apply across all types of distribution models.

Characteristics of IT Distribution

Given the roles fulfilled by distributors for both customers and vendors, there are some key characteristics to be aware of in the distribution business model.

First, distribution is an inherently difficult business to get right. The fixed costs involved are typically long term, while the visibility of revenues is just the opposite. Distribution businesses are often critically dependent on a very few major relationships, which can change – and be changed – with relatively little notice. For example, a decision by a market-leading vendor to switch to supplying just one or two

major customers directly rather than through distribution can have a significant effect on its distribution partners, removing significant revenues – and the linked profits which were covering fixed costs. Clearly, distributors manage their exposure to such situations, and develop their 'next tier' customers, but there is still a short-term impact.

Second, distribution businesses are fast-moving businesses, consuming significant amounts of capital, or people, or both, and in many cases delivering – or perceived as delivering – relatively low returns on these investments. They are essentially product businesses, and as such they need to be managed in terms of both profitability and asset efficiency.

A Disti Co - Summary Financial Statements

Profit & Loss Account

	\$'000
Sales	19,316
Cost of sales	18,308
Gross profit	1,008
Overheads	952
Operating profit	56
Interest	12
Profit before taxation	44
Taxation	16
Profit after taxation	28

Balance Sheet

	\$'000
Fixed assets	423
Current assets	
Inventory	1,408
Accounts receivable	1,897
Cash	401
Total current assets	3,706
Current Liabilities	
Accounts payables	1,550
Other	764
Total Current liabilities	2,314
Net Current Assets	1,392
Long term liabilities	59
Net Assets	1,756
Shareholders funds	1,756



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Distribution Business Model

To understand this in more detail, it is worth looking at an example set of distributor financial statements (Profit & Loss Account or Income Statement, and Balance Sheet)

Focusing first on the **balance sheet** (a summary of the assets and liabilities of the business at any given point in time), it is important to note the importance of three numbers:

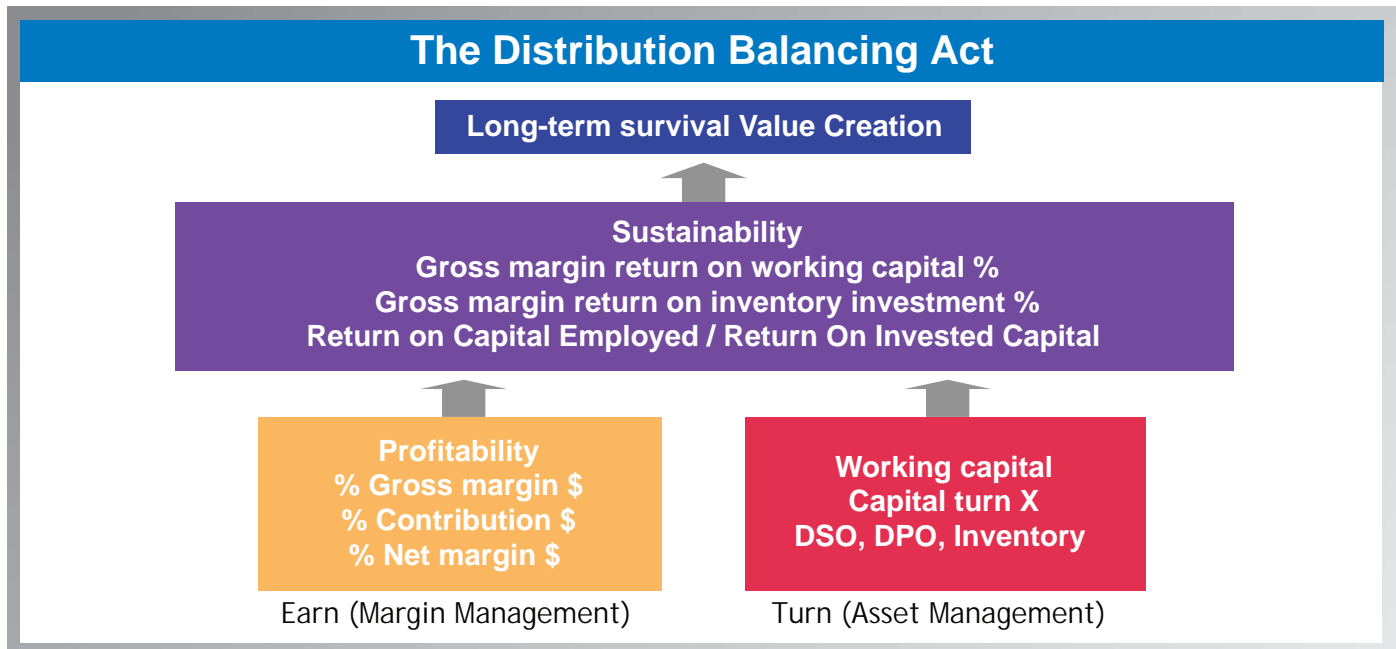
- **Inventory**
Products held for resale
- **Accounts Receivable**
Amounts due from customers for sales made on credit
- **Accounts Payable**
Amounts due to suppliers for products bought on credit

These three items make up the **working capital** required by the distributor, so called because it is the capital needed at any point in time to operate the business (as opposed to capital which may be required to finance the infrastructure). Working capital is calculated by adding inventory and accounts receivable and subtracting accounts payable. The other items in the balance sheet such as **fixed assets** (land, building, warehousing and sales systems, etc.) and **other** balances are relatively unimportant – it is working capital for the most part which determines how much capital a distributor needs to raise to finance its business. Managing working capital is a fine balancing act: too little and the distributor risks stock-outs (running out of inventory) or defaulting on payments to its suppliers while waiting for payments from customers; too much, and the cost of capital – especially the interest paid on any financing – damages the profitability of the business.

The **income statement** (a summary of the distributor's incomes and expenditures over a given period of time) – demonstrates how tight the margins can be in IT distribution. The **gross profit** margin is the difference between the price the distributor pays for its products (the **cost of sales**) and the price it receives for them from its customers (sales). In distribution this is typically a very small number between two very large ones, which explains why it is such an area of focus and the subject of so much negotiation. In addition, the distributor has to pay for all its **overheads** (or SG&A) out of this gross profit, leaving whatever is left over as an **operating profit**. But that is not the final cost to the distributor: as highlighted above, any capital borrowed to finance the business incurs an interest charge, which is also deducted from the margin, leaving a **net profit (or loss)** to the business. After tax is deducted (assuming this is a profit), whatever is left is available to be paid out as a dividend or retained in the balance sheet to finance the bigger working capital balance or additional assets required to grow in the next trading period.

Comparing the gross profits made in this example of \$1,008m with the working capital required to generate it of \$1,775m (\$1,408m + \$1,897m – \$1,550m) highlights the key challenge for distributors: our example company has tied up over \$1.75bn over the year in order to earn just over \$1bn in gross profit ... and only \$44m in net profit! A slim return for such a large outlay.

What's more, the slightest slip in managing this business (for example, overstocking leading to writing down the value of inventory, extending credit to bad- or non-paying customers or investing too soon in additional warehouse space) can wipe out that profit very quickly and turn it into a loss.



Managing Distribution is a Balancing Act

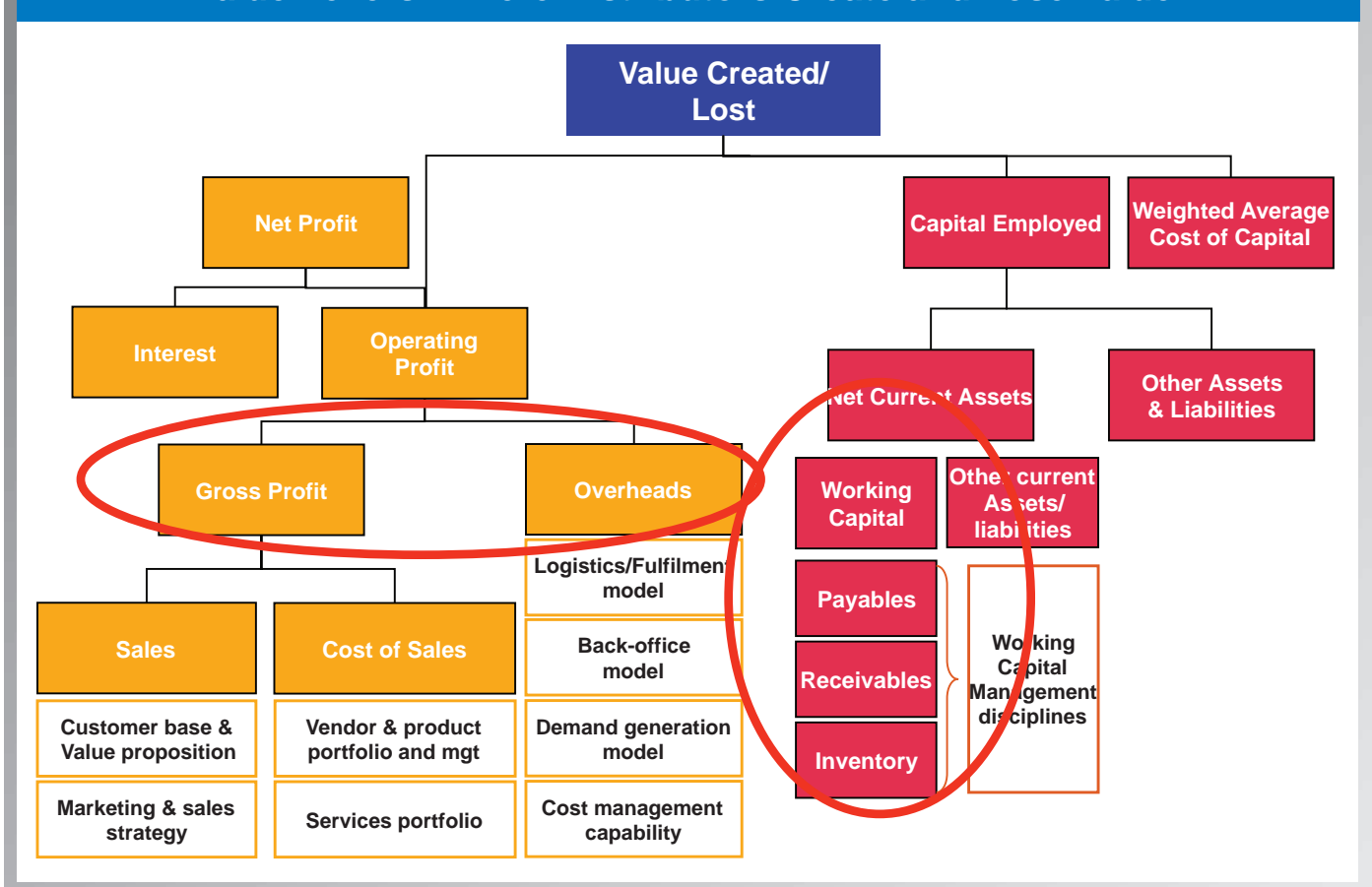
This balancing of profitability and working capital is the essence of the distributor business model. Ideally, each distributor will have a balance which is right in the context of its value proposition, its mix of the services we referred to earlier and its business model. Each will be pushing to maximize margins and minimize working capital, without affecting the range and availability of products they are offering to customers.

In their **margin management**, most astute distributors use a portfolio approach to blend fast-moving, low margin products with slower-moving but higher margin ones. Their challenge is to match their range and inventory levels with the demands of customers and vendors, all in ways which make sense financially. The 80:20 rule applies throughout the business, with 20% of their products making up 80% of the volumes ... but the probability is that a different 20% of products account for 80% of profits. Similarly, a small set of customers may drive the bulk of revenues, but it is vital for the distributor to know which 20% of customers drive the bulk of their profits.

Optimizing profitability also requires tight overhead control, with many of the distributor's costs being fixed in nature (i.e., not varying directly in line with sales). This means that growth often requires step changes in costs, where the challenge is to avoid pushing up the cost base before sales have grown to cover it – perhaps easier to do when adding new warehouse space (timeframe of months) than investing in new IT systems (timeframe of years). Conversely, in times of downturn, technology distribution has been forced to look at ways of making its cost base more variable by outsourcing elements of infrastructure such as warehouses, transport ... in some cases even call centers. Such decisions involve tough trade-offs between the advantages of greater cost flexibility and the risks of losing control and damaging customer satisfaction.

Managing working capital in distribution is all about managing a finite resource: money tied up in product A is not available to stock product B; cash expected from customer X is not available to extend credit to customer Y; vendor credit limits need to be paid off when reached, before more products can be ordered. In stable periods,

Value Levers: Where Distributors Create and Lose Value



this requires careful management. In times of growth, the additional working capital required presents the distributor with two blunt options: either increase the working capital to match increased trading volumes or improve the cash-to-cash cycle, i.e., the time it takes for money paid out to suppliers for products to convert from inventory into sales on credit to customers who eventually pay for the products.

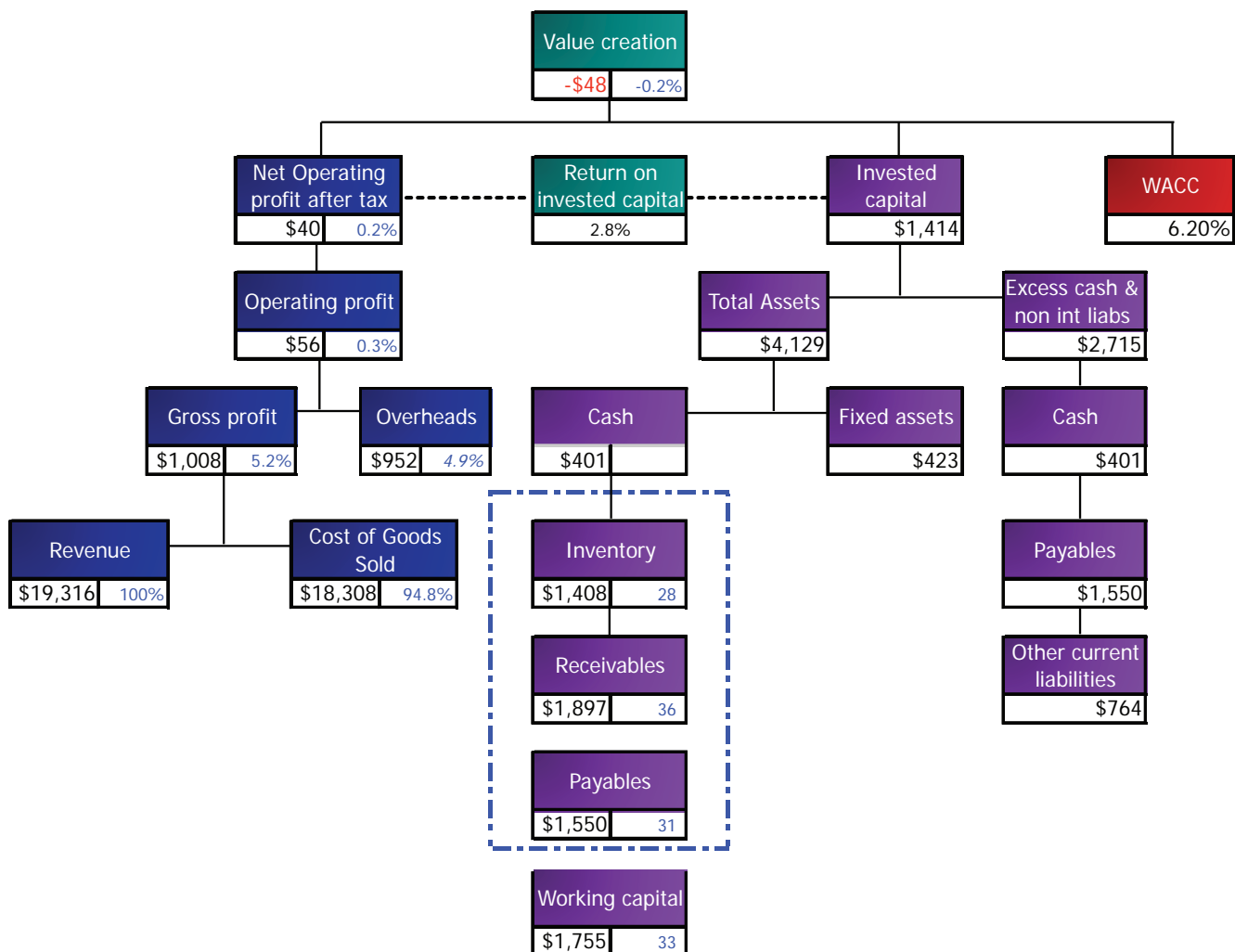
Taking the first option without careful planning can be extremely dangerous: even with sales and profits growing rapidly, the distributor risks “overtrading,” i.e., doing more business than their capital resources will allow, and ultimately running out of cash. This lack of liquidity has been the downfall of many IT distributors in industry growth periods.

The second option – accelerating the working capital cycle – presents its own challenges: tightening customer credit can lead to loss of sales short-term and customer relationships long-term; reducing inventory levels can result in poor availability, stockouts and incremental costs associated with managing and fulfilling back orders; and asking suppliers for extended credit terms or increased credit limits – can send the wrong message, quite apart from the risk of being met with a refusal.

The Measures that Matter and How to Manage with Them

The measures that matter in a distributor reflect the way the business model works, with tight management of margins, working capital and productivity metrics

Value Creation Tree for a Dist Co – Year 1



(combined margin and working capital) being key to the success – or even survival – of the business.

It can be helpful to view these numbers in the framework of a “tree” or pyramid, where the drivers of each side of the equation – Profitability and Asset efficiency – can be mapped in a way which shows their impact on the overall return on investment or the value created for shareholders.

This view of a distribution business highlights the fact that any change to the key drivers – however small – ultimately has an impact on the performance of the company. From a vendor perspective, it is essential to understand this picture, since every vendor action – adding SKUs, changing prices, offering a given set of T’s & C’s, running a promotion – will affect one or more of these drivers and therefore have an impact on the overall results-.

For our example distributor, A Disti Co, we can map the financial statements in a similar fashion, showing the principal metrics essential to the running of the business and how they relate to each other.

Ultimately, then, the distributor’s business must generate a Return on Capital. There are a number of key drivers: profitability, working capital and productivity. The next sections explore each of these three areas in turn, before going on to examine measures of longer-term sustainability and growth capacity.



Margins and Profitability

Think you know it all when it comes to such fundamental aspects of doing business with distributors? Take a closer look to potentially validate what you already assume – or shed new light on how distributors view margins and profitability.

Gross Margin %

$$\text{Gross margin \%} = \frac{\text{Sales} - \text{Cost of sales}}{\text{Sales}} \times 100$$

Gross Margin

Gross margin is the simplest measure of the value add of a distributor, since it measures the difference between the price obtained from customers and the price paid to suppliers.

For our example A Disti Co distributor, the gross margin is $\$1,008\text{m}/\$19,316\text{m} \times 100 = 5.22\%$. Note that gross margin is the gross profit expressed as a percentage of sales.

Despite this simplicity, there are a number of points to consider:

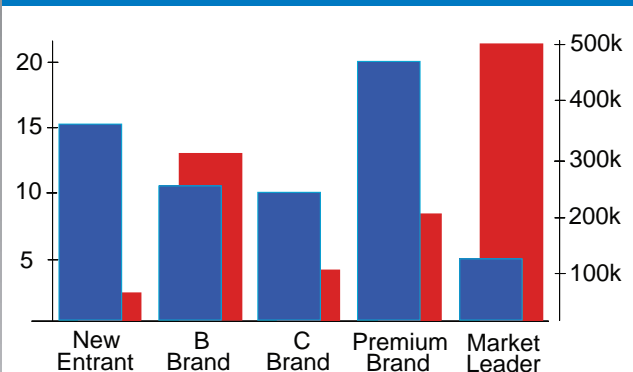
- Sales and cost of sales should exclude any sales taxes (e.g., VAT)
- Cost of sales should include all costs incurred getting the product for sale, e.g., inbound shipping
- Cost of sales should also include any work done on testing, configuration, assembly and packaging
- Discounts, rebates and other price reductions from the vendor reduce cost of sales (and consequently increase gross margins)
- Where there is a write-down of inventories for shrinkage, obsolescence, etc., the cost should be added to the cost of sales as soon as the loss is recognized
- Discounts given to customers reduce sales and therefore reduce gross margins
- Early payment discounts, in theory, should not be factored into sales or cost of sales. However, in some instances these are a significant portion of the profitability of the product and so are deducted to give a more accurate picture.

Margins – % Versus \$

Gross margin is important as a percentage of sales and as an absolute dollar amount. Percentages as a margin performance measure can be used and interpreted in misleading ways because they give no sense of the volumes of business done. For example, in the scenario below it would be easy to focus on the Gross Margin % achievable with the new entrant and to neglect the Market Leader.

However, the result would be to wipe out gross profits of \$500,000, profits which will be very difficult to replace with sales of the other brands, and which are essential in a distribution business to cover a set of relatively fixed overhead costs. The challenge for distribution is in finding the right balance between gross margin % and absolute dollar amount: running the business against gross margin % targets alone will leave the distributor in the same situation as one of the consumable distributors, who did precisely that and ended up turning down so much “unprofitable” business that they did not generate enough gross profit dollars to cover their overhead costs.

Comparison of Gross Margin % and Gross Margin \$ Earned on Different Brands



Margin Mix or Blended Margin

With a portfolio of vendors and products to manage, the margin performance of the distributor is driven by thousands of individual margins, both % and dollar. The overall gross margin is therefore an average, weighted by sales volume, and the key to successful margin management is understanding the make-up of this blended margin or margin mix.

In the example below, the blended margin is 7.6% (\$34,900/\$461,000). If our distributor is looking to improve this number, they have a number of options:

- Reducing sales of low-margin products D and E. However, even though these two products have lower percentage gross margins, they generate \$21,900 of gross profit or “money margin”
- Increase sales of products A, B and C, which would increase gross profits as well as improve the blended margin
- Add a new, higher margin product into the mix. As long as the gross margin is higher than 7.6%, this will increase the blended margin
- Increase sales prices or negotiate lower buy prices on any of the products in the mix

In practice, the lower-volume categories and products are likely to be less price-sensitive because they are not

price-referencing products. Consequently, some smart portfolio pricing – differential pricing within and across categories which shifts prices up on SKUs that are less price-sensitive – can allow the distributor to improve the blended margin. A classic example might be the opportunity in “attach” sales of accessories to high-volume products such as laptops: driving attach sales of high percentage margin items such as cases, mice and other accessories can add significant revenues and “money margin” to the sale, and will enhance the blended margin.

Another key driver of margin mix for distributors is their sales management policies. In most distributors the sales teams will have a set of discretionary discounts which can be applied based on order size, loyalty or customer spending power. The sales teams will fully use these to maximize sales, but potentially give away 1% or 2% discounts without being aware of the scale of impact those discounts can have: in a typical broadline distributor making net margins of close to 1% they are effectively giving away the total net profit!

From a vendor perspective what counts here is how you affect this blended margin. Does your portfolio of products improve or dilute the blended margin? Which products deliver most gross margin % and which deliver most “money margin?” Will the new products you are introducing improve the blended margin?

Example of Blended Margin Calculation

Product	Sales price	Cost price	Gross margin	Gross profit/unit	Volume	Sales revenue	Gross profit
A	\$500	\$450	10.0%	\$50	100	\$50,000	\$5,000
B	\$400	\$352	12.0%	\$48	50	\$20,000	\$2,400
C	\$350	\$322	8.0%	\$28	200	\$70,000	\$5,600
D	\$300	\$279	7.0%	\$21	500	\$150,000	\$10,500
E	\$180	\$168	7.0%	\$12	950	\$171,000	\$11,400
Total			7.6%			\$461,000	\$34,900

Contribution Margin %

$$\text{Contribution margin \%} = \frac{\text{Sales} - \text{Cost of sales} - \text{Variable costs}}{\text{Sales}} \times 100$$

Margins – From Gross to Contribution

Gross Margin is a very crude measure of performance, which does not take into account the range of marketing and selling activity required to sell different brands or products, or the funding and investment each vendor may provide into the distributor. Likewise, there are some costs for a distributor over which vendors have no influence and which would generate unfair/inaccurate comparisons at Net Margin level.

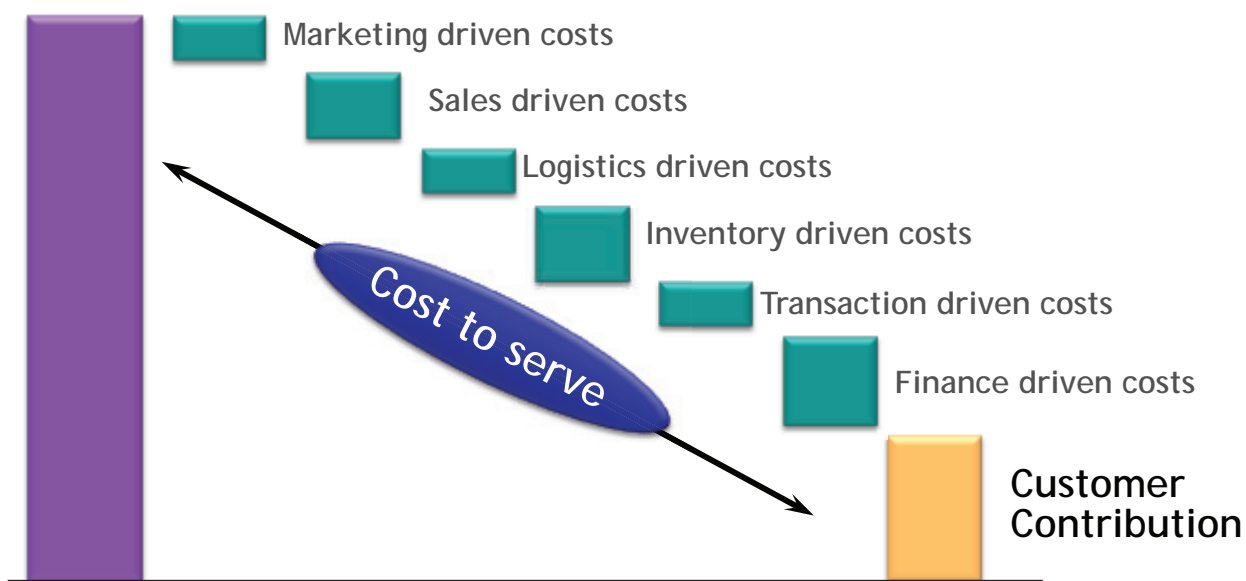
Consequently, it is important to quantify the “adjusted” or “contribution” margin/profit to get an accurate picture of the relative profitability of vendors, products and customers (see chart below).

All distributors will have different ways of calculating this Contribution Margin, and indeed some will strike series of Contribution Margins, working down the income statement to include additional factors, costs and savings (see example contribution statement on next page). For some, financing costs would be excluded from this calculation, although differences between vendor and customer T's & C's will clearly have an influence over financing costs.

This picture of contribution margin is essential for distributors' analysis of both vendor product portfolios and customer portfolios. Detailed analysis of customer contribution can completely change perspective on the business, as the example on the next page shows.

Contribution Margin %

Customer
Gross Margin



Some distributors will look to complete the picture by allocating all their costs to the vendor – both variable and fixed – to arrive at a Net Profit value for each vendor and/or customer (See example profitability analysis).

While this can be informative for the distributor, it is important to recognize that the results are entirely dependent on the basis for allocating fixed costs to vendors and customers. As such, this metric can be unhelpful to vendors, particularly as many of these fixed costs will lie outside the vendor's influence.

Example Contribution Statement

Turnover	175,149
- C.O.S I	166,651
=Gross Profit I	8,499
Customer bonus	184
Cust. Cash disc.	783
Int. on customers	979
- C.O.S. II	168,596
= Gross Profit II	6,553
- Int. on suppliers	- 1,512
- Stock depreciation	- 379
- C.O.S. III	166,705
= Gross profit III	8,444
Costs	
- Logistics	1,319
- Purchasing	890
- Production	1,473
= Contribution I	4,762
- Marketing	- 343
Marketing costs	705
Marketing income	- 1,048
= Contribution II	5,105
- Sales	1,657
- Bookkeeping	62
- Organisation	31
- EDP	152
- Personnel	170
- Internal admin	222
= Contribution III	2,811

Negative Contribution

One smaller national IT distributor was highly successful in sales terms but was struggling to make an operating profit, with cash flow sinking to the point that put the business at risk.

Analyzing contribution profit by customer showed that the distributor's largest customer – more than 25% of its sales – was making a negative contribution: effectively the distributor was paying for the privilege of serving the customer! Examining the cost drivers, the distributor team saw that a combination of extended credit terms, multiple ship-to points, and extensive pre-sales support were hitting contribution.

The customer was invited to modify its demands or accept that it should pay for them – a request that it refused. The management team took the tough decision to terminate the trading relationship, switching sales, management and other resources on building up more profitable customers and finding new ones. Within months, the profitability and cash situation improved.

Within six months, the terminated customer returned, requesting supply of a portfolio of products it had struggled to source elsewhere on new terms, eventually becoming one of the more profitable customers in the portfolio.

Example Customer Profitability Analysis

Turnover	156,115	
Cost of Goods Sold	145,194	
Gross Profit	10,921	7.0%
Transport costs	712	
Picking & packing	1,203	
Cost of financing receivable	1,013	
Rebates given	1,354	
Commissions paid	545	
Other variable costs	216	
Contribution Profit 1	5,878	3.8%
Direct cost allocation	1,613	
Contribution Profit 2	4,266	2.7%
Indirect costs allocation	1,955	
Net Profit	2,310	1.5%

Operating and Net Margins

Contribution margin takes account of the variable costs in the cost structure, leaving the fixed costs – the costs which do not vary directly with unit volume. Clearly these need to be less than the contribution profit if the business is to realize a net profit. Fixed costs tend to be related to infrastructure elements such as warehouses, storage racking, IT systems, call centers and payroll.

Distributors track both the total and the individual cost elements as a percentage of sales, with the expectation that this percentage will go down over time, as the business grows and achieves economies of scale. However, it is important to recognize that the rapid fall in ASPs (average selling prices) in the technology industry mean that to maintain or grow revenues technology distributors need to put significantly greater volumes of product through their businesses, which in turn put their infrastructure – and therefore cost structure – under pressure. More units will mean more orders, more picking and packing, more invoicing and administration, but for the same amount of revenue. Consequently two key measures your distributors will track are average order size and the

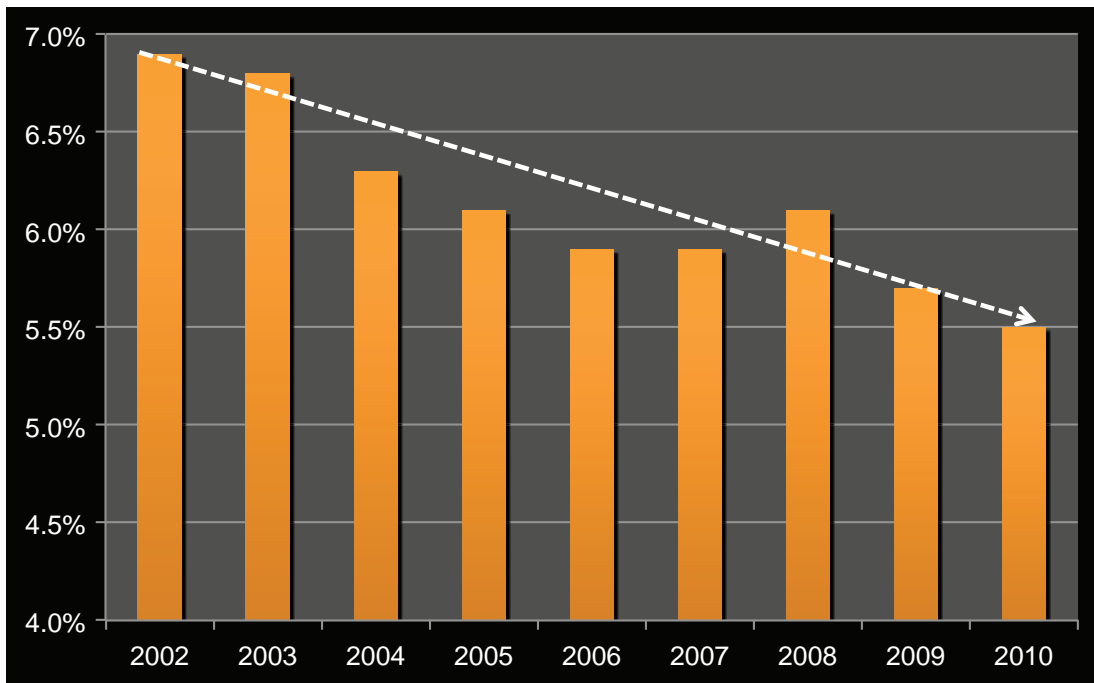
average cost of processing an order. Options to improve these measures include up-selling customers to bigger-ticket items and cross-selling additional products, in both cases generating higher revenues and gross profits from the same transaction ... and the same transaction cost.

The other approach to improving the cost efficiency of the distributor model is to invest in automation and to seek greater efficiency through scale. In both cases, there is a law of diminishing returns, where once major investments have been made and efficiencies secured, additional investments will often not generate sufficient additional efficiency relative to their cost.

Most of the leading IT distributors have already been through several cycles of investment in automation, and their cost structures are as efficient as distribution in any other industry – often more so. This investment has paid dividends for all parts of the industry over the recent downturn, as GTDC benchmarks demonstrate.

Once fixed costs are deducted, we are left with an indication of the overall level of profit made from the business. Even here, as with gross margins, it is important

Controlling SG&A



IT distributors successfully managed expenses during the downturn – reducing SG&A as a percent of sales by 20 basis points in 2010 and 140 from 2002.

Source: GTDC Research

to be clear on which net margin is being used: there are several profit lines struck in the income statement which can be used to calculate net margin (operating margin, net margin before tax, net margin after tax), quite apart from variations in terminology (profit, income, etc.).

In our A Disti Co example, the operating margin is \$56m / \$19,316m = 0.28% and the net margin is \$44m / \$19,316m = 0.23%.

This shows that A Disti Co is trading close to break-even, i.e., the volume passing through the business is generating just enough gross profit to cover the overheads – or, more accurately, just enough contribution margin to cover the fixed costs. Viewed in isolation, this is not good. The slightest problem in operations, or even a change in interest rates, can push the business into a loss. With

overheads in distribution relatively low, there is little scope for reducing them to increase profit, so the only real strategies are margin improvement and sales growth. Of course, with history we might consider that any profit for A Disti Co is good news, if the business has been losing money for years.

Typically internal management teams at your distributor will focus on operating margin since it excludes interest costs, driven by a capital structure to the business which is outside of their control. At an executive level, the focus may be more on pre-tax net margin, which allows performance comparison with competitors and industry benchmarks, and also, importantly, factors in changes in interest rates and in the cost of capital (for what is a capital-intensive business).

Operating Margin %

$$\text{Operating margin \%} = \frac{\text{Sales} - \text{Cost of sales} - \text{Overhead costs}}{\text{Sales}} \times 100$$

Net Margin %

$$\text{Operating margin \%} = \frac{\text{Sales} - \text{Cost of sales} - \text{Overhead costs} - \text{Interest}}{\text{Sales}} \times 100$$



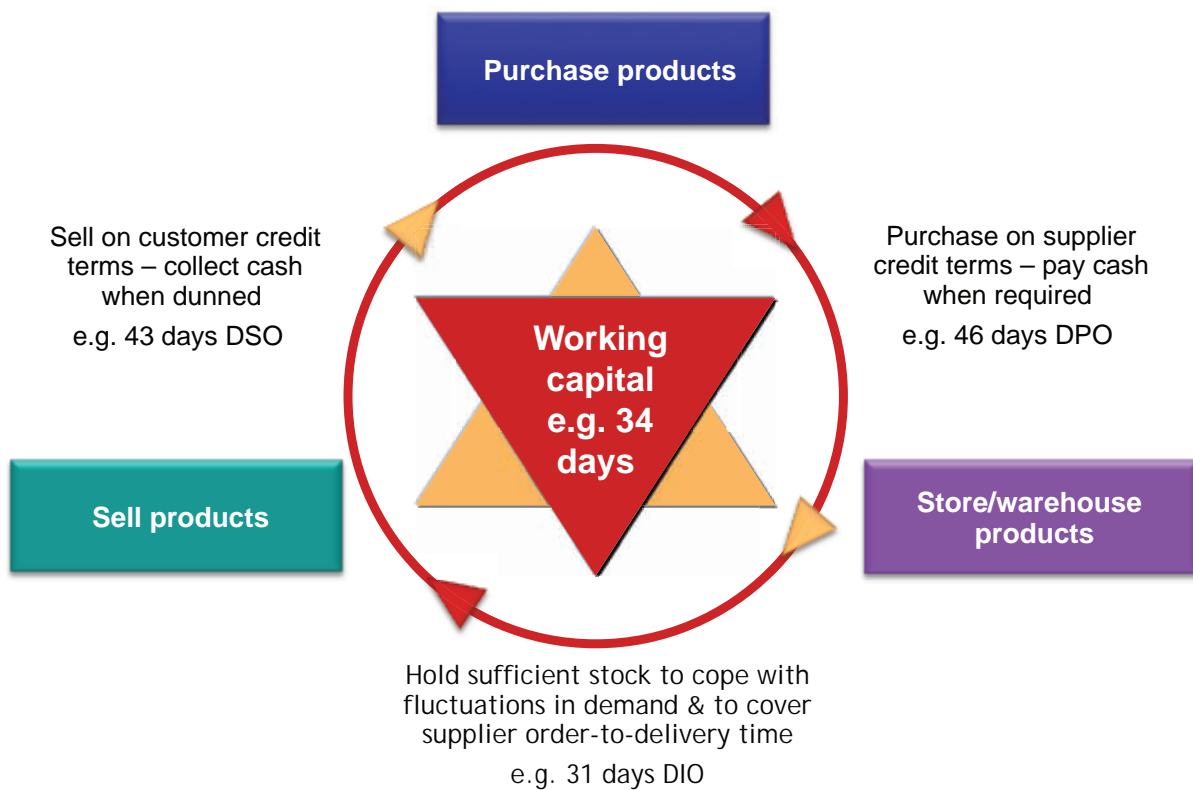
Working Capital

Managing the three components of working capital – inventory, receivables and payables – is of paramount importance to distributors. Do you operate with a full appreciation of these elements and how your business decisions impact them?

Working capital is the capital needed to fund the cash-to-cash cycle in your distributor, i.e., the time taken from the point cash leaves the business to purchase product from vendors to the point at which customers pay the invoice for the product after whatever period of credit they have been given. Managing the three components of working capital – inventory, receivables and payables – is of paramount importance to a distributor, and the whole emphasis is on velocity.

How quickly working capital can be converted back into cash determines how much capital is needed, so measurement in this area focuses on converting financial amounts into days: how many days the vendor allows the distributor before they pay for the products, how many days the products will be in inventory, and how many days the customers take to settle their debts. Putting all these elements together determines how long the distributor takes to cycle its cash through the business.

The Working Capital Cycle



Prompt Payment Discount

Many vendors will offer distributors incentives to pay early, with terms such as “2 percent 15, net 45” providing for an additional 2% discount if paid within 15 days. On the surface this looks attractive: 2% for paying 30 days early equates to an interest rate of 24.3% ($2\% \times 365/30$). However, distributors will also look at two other factors: the market and working capital.

In terms of the market, if all competitors are taking this discount and factoring it into their pricing, it may effectively be a trade discount: the distributor really has no choice if it is to remain competitive, and so takes the discount and factors it into its gross margin.

In terms of working capital, paying early sucks 30 days of working capital out of the business, which could have a much higher cost: the distributor is constraining sales in its business by 30 days worth of trading.

Assuming \$3.65m of sales with this supplier, the critical factor will be contribution margin:

At a 10% contribution margin, then 30 days sales is a contribution profit of \$30,000 ($\$3.65\text{m} \times 30/365 \times 10\%$). Compare this with the value of the prompt payment discount of \$65,700 ($\$3.65 \times 90\% \times 2\%$) and early payment makes sense

At a 20% contribution margin, 30 days lost sales is \$60,000 of contribution profit, versus prompt payment value of \$58,400 ($\$3.65\text{m} \times 80\% \times 2\%$), so the lost sales are worth more.

Vendor Credit

Taking each element in turn, the time taken to pay suppliers is termed days payable outstanding (DPO) or sometimes “supplier days” or “creditor days.” It shows the accounts payable as a proportion of cost of goods, then expressed as a fraction of the year.

For our example A Disti Co distributor, the DPO is $\$1,550\text{m}/\$18,308\text{m} \times 365 = 31$ days

What does this mean? It makes sense to answer the question by comparing this number with standard vendor terms, and with the number for previous periods. In the first case, it shows that DPO is pretty close to standard vendor payment terms, although we should bear in mind that this is a blended number across a range of vendors, some of which could be offering longer terms and other attractive prompt payment discounts. In addition, there may be regional and country variations in payment terms. In the second case, we do not have a previous value to assess trend, but if there were any sudden changes in DPO it would be important to understand the reasons.

Inventory

Once products are purchased, they go into the distributor's inventory waiting to be sold to customers. The time they spend in inventory is known as inventory days or days inventory outstanding (DIO), and is calculated in a similar way.

Note that Cost of Sales is used, since both inventory and cost of sales are valued at cost. For our example A Disti Co distributor, the inventory days value is $\$1,408\text{m}/\$18,308\text{m} \times 365 = 28$ days.

This means that, on average, the inventory is spending just less than a month in the warehouse. Is this good or bad?

First, it is important to remember that the distributor is holding the inventory to be able to offer availability when the customer requires it – if inventory days are too low they risk a “stockout” and either the cost of a back-order or a lost sale. If supply is stable and product can be obtained from suppliers within a few days of placing an order, the distributor only needs to carry enough inventory to cover sales in the period between order and delivery – plus a

Days Payable Outstanding (DPO)

$$\text{DPO} = \frac{\text{Accounts payable}}{\text{Costs of Sales}} \times 365 \text{ days}$$

Inventory Days (DIO)

$$\text{DIO} = \frac{\text{Inventory}}{\text{Costs of Sales}} \times 365 \text{ days}$$



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routes to market

safety buffer. However, since breaking bulk is also a key value for vendors, they will want to ship in bulk, which for slower-moving items will inflate the levels of inventory at their distributor. Clearly, too, inventory will be influenced by the nature and geography of the markets the distributor operates in, with distributors further from the vendor's own warehouses and in markets with less-developed infrastructure needing to factor in a longer – and possibly more volatile – supply chain.

Second, this value is an average, which can hide a wide range of different inventory levels. IT distributors use sophisticated systems to match inventory to volumes sold (“run rate/rate of sale”), fluctuations in demand, minimum order quantities and reliability of supply. They will also classify products into bands e.g., from A to E, where A denotes fast-moving products with frequent replenishment while E denotes items such as service parts and spares which are stocked as a service to customers. In the fast-moving IT industry, this clearly presents some major challenges in matching product lifecycles to bands and stocking levels. Once again in inventory Pareto's 80:20 rule applies, which can mean that most of the inventory is held in the 80% of products which account for 20% of sales, a situation encouraged by vendors offering full range stocking allowances.

Customer Credit

Once products are sold to customers they leave inventory. For a cash sale, that would be the end of the cycle, but since a key role of the IT distribution channel is the provision of credit most sales generate a receivable balance. The time customers take to pay this is called days sales outstanding (DSO) or “customer days” or “debtor days.” The calculation shows the average receivables balance as a proportion of sales, expressed as a fraction of the year.

In contrast with DPO and DIO, accounts receivable and sales are both valued at sales prices (not cost of sales). For A Disti Co, the DSO is \$1,897m/\$19,316m x 365 = 36 days.

On average then, A Disti Co's customers are taking just over 5 weeks to pay for their products. As with DPO, we can compare this number with the distributor's standard customer credit terms, with previous values, and benchmark against other (comparable) distributors in the marketplace. Once again, too, this value is an average,

Days Sales Outstanding (DSO)

$$\text{DSO} = \frac{\text{Accounts receivable}}{\text{Sales}} \times 365 \text{ days}$$

so it is important to understand how it is made up: different customers or sets of customers may have different terms.

It is also important here to recognize that when vendors request and incent distributors to develop specific markets and segments, this can have a major influence on DSO: different countries will have both different standard terms and different business cultures regarding adherence to terms; resellers who service the government and public sector will typically require longer terms since they themselves will be waiting longer to receive payment for projects; and any distributor who services the retail market will be able to share some of the horror stories around DSO!

Working Capital Cycle

Putting these three elements back together gives us the working capital days: DIO + DSO – DPO. In the case of A Disti Co, this means a working capital cycle of 28 + 26 – 31 = 33 days. In other words, it takes just over a month for A Disti Co to cycle its cash through working capital and back into cash. Another way of thinking of this is how frequently A Disti Co turns over its working capital in a year – its working capital turn.

The faster the working capital turns, the less cash is needed to finance the operation of the business. As the “Free cash!” example on the right shows, small improvements in each element of the working capital equation can lead to significant changes in the efficiency of the business, and reduce the cash needed to finance it.

In some cases – rare for IT distributors – working capital days can be negative e.g., DIO of 25 + DSO of 35 – DPO of 75 = working capital days of minus 15. The distributor may have focused on fast-moving products, avoided bad customers and negotiated extended terms with its vendors. What does this mean? It means that the distributor has 15 days' sales worth of cash in the business – a “cash float,” which can earn interest and, in turn, can boost profits or be factored into pricing to win more business.

More typically, however, there are additional elements which need to be factored into the distributor's working capital requirement and cycle: vendors may run promotions or marketing campaigns where the distributor is expected to advance funds on their behalf, before claiming them back later. Likewise, vendor rebates and debit notes also absorb further cash and slow down the cycle.

Working Capital Turn

$$\text{Working capital turn} = \frac{365 \text{ days}}{\text{Working capital days}}$$

Reductions in Working Capital Free Up Cash...

Free cash!

In this example, our distributor has sales of \$20m and a cost of sales of \$19m. By improving each element of working capital by 5 days we can reduce the cash required by nearly 40% (from \$3.25m to \$2.45m), freeing up \$0.8m of cash for reinvestment in purchasing product.

Working Capital Component Days		Starting Point		Improved profile		Improvements	
		Days	Value \$	Days	Value \$	Days	Value \$
Inventory	DIO	40	2.08m	35	1.82m	-5	0.26m
Receivables	DSO	45	2.47m	40	2.19m	-5	0.28m
Payables	DPO	-25	-1.30m	-30	-1.56m	-5	0.74m
WC Days		60	3.25m	45	2.45m	-15	0.8m
WC Turn		6 times a year		8 times a year			

Even more significant is that this cash can be run through the new, more efficient business eight times a year, meaning the potential for additional sales of $\$0.8m \times 8 = \$6.4m$, a growth rate of over 30%.

What Does This Mean for Vendors?

As we have seen, capital is vital to distributors, and its major operational element is working capital. Vendors must therefore understand the impact of their value proposition on the distributor's business, not just in terms of profitability but also in terms of each element of working capital. Quite apart from standard terms and business practices (prompt payment discounts, range stocking requirements, rebates, etc.), it is important to recognize that even within one vendor portfolio, the choice of focus

markets, categories and customers can create major differences in the business model. Asking a distributor to support you in a developing market with a long and unreliable supply chain by addressing resellers who service government projects incorporating complex product sets is likely to bring very different challenges – and a very different working capital profile – from asking them to support you in a mature market, close to your distribution hub, selling standard run-rate products through resellers who pay in line with agreed credit terms.



Productivity Measures

Are the odds “SKU’d” in your favor? Delve into the pluses and minuses on this front based on the portfolio of products you offer and where they fit from distribution point of view: Winners, Traffic Builders, Sleepers or Losers.

Margins – whether Gross, Contribution, Operating or Net – are all measures of Return on Sales. Given the capital-intensive nature of distribution, it is essential to understand how vendors contribute to the capital – and in particular working capital – dynamics of a distributor.

As a first step beyond profitability, it is important to understand how the inventory turn performance of a vendor’s products may complement its margins. The measure of GMROII (Gross Margin Return On Inventory Investment) includes both Gross Margin and Inventory turns, and so allows a comparison of products, which may have a range of margin and turn characteristics. Where

contribution margins are available, the contribution equivalent CMROII can factor in both vendor contributions to covering fixed costs and the turn rate of the vendor products.

GMROII/CMROII analysis can also be used to generate a portfolio view of the business or a part of the business: mapping the “Earn” dimension on one axis and the “Turn” dimension on the other provides a wealth of insight into how different vendors, categories and SKUs perform ... and how they drive overall performance. Products can be categorized and managed differentially to optimize overall performance. In the example, performance of each SKU is plotted on the grid, and the SKUs are categorized:

Gross Margin Return on Inventory Investment (GMROII)

$$\text{GMROII} = \frac{\text{Gross profit}}{\text{Inventory}} = \frac{\text{Gross profit}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Inventory}}$$

“Earn” X “Turn”

Contribution Margin Return on Inventory Investment (CMROII)

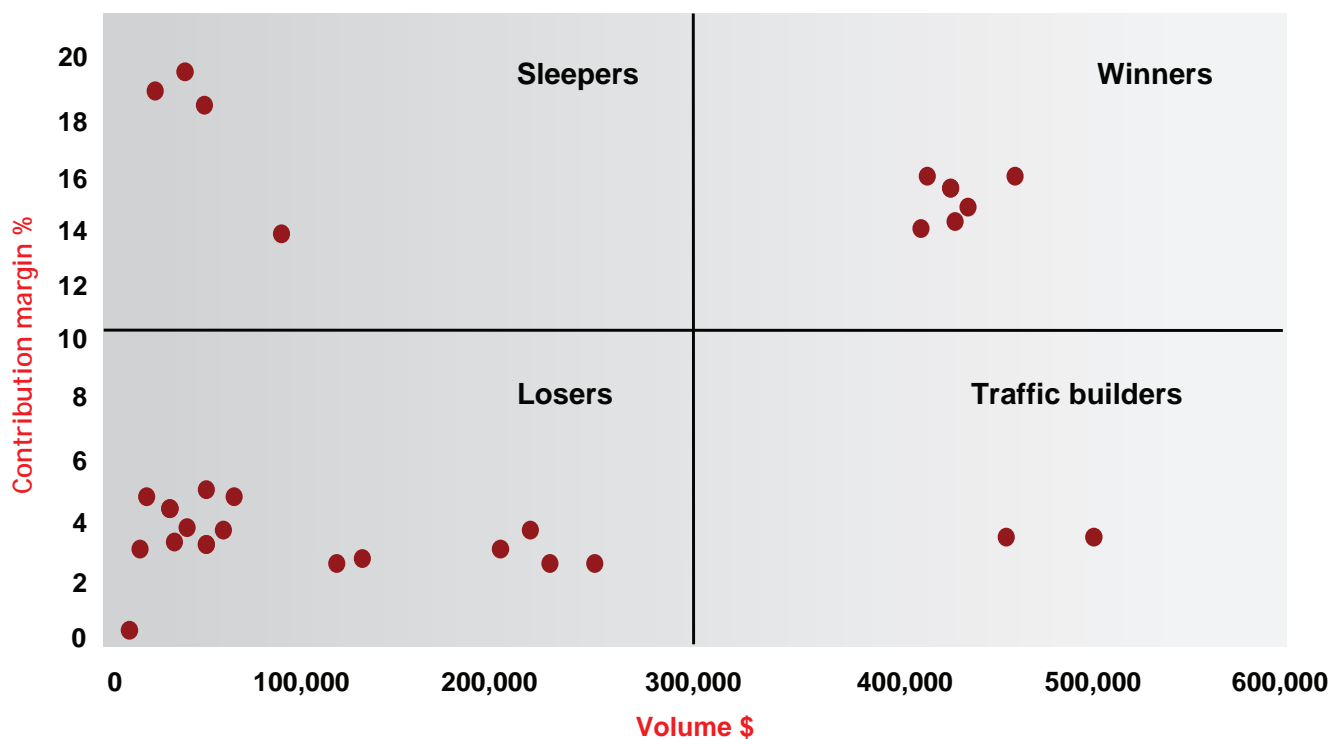
$$\text{CMROII} = \frac{\text{Contribution profit}}{\text{Inventory}} = \frac{\text{Contribution profit}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Inventory}}$$

“Earn” X “Turn”

- **Winners** are high-margin, high-turn SKUs. Focus is on establishing why they perform so well and on maintaining their performance.
- **Traffic builders** – products with high turn but low contribution – tend to be strong brands which customers buy in volumes, but which distributors need to price aggressively to establish price positioning and maintain their competitiveness.

- **Sleepers** are the most interesting products, since they have high contribution potential for small increments in sales. Some may be products early in the lifecycle, which will respond positively to sales stimulus. The greatest opportunities lie in connecting sleepers to traffic builders, and analysis of connect rates can show where these opportunities lie (and the value of additional connect).
- **Losers** are those SKUs which drag down contribution and turn slowly. These SKUs need to be reviewed regularly and action taken to address the poor performance.

Product Portfolio Profiled in Terms of “Earn” and “Turn” Characteristics



Adding into this equation the effect of a vendor's payment terms (and potentially even reflecting some better-quality customers who pay more promptly and who are brought in by the vendor) secures a view of GMROWC (Gross Margin Return on Working Capital), i.e., how many Gross Profit dollars are generated for each \$1 invested in working capital. This is the best overall measure for product and category managers since it is usually easily available and factors in most of the major economic elements.

Going one step further, using whatever level of contribution margin is available can allow you to measure Contribution Margin Return on Working Capital – probably the best guide as to product or vendor profitability as it builds in all dimensions of its economic performance.

Some distributors will work to take their vendor analysis still further – ultimately to Net Profit After Tax Return on Working Capital, since this also captures the extent to which the vendor is contributing to covering their fixed costs. As alluded to earlier, though, such analysis presents two major challenges:

- the **basis of allocation** – or “key” – for the fixed costs across vendors (or indeed customers). This key is tough to define: it varies by cost type, is tougher to agree on, and is always open to challenge.
- the **degree of control** a vendor has over drivers diminishes significantly once analysis goes beyond \ contribution: like all metrics, if we are looking for improvement it is always better to limit measurement to elements that the vendor can truly influence.

Gross Margin Return on Working Capital (GMROWC)

$$\text{GMROWC} = \frac{\text{Gross profit}}{\text{Working capital}} = \frac{\text{Gross profit}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Working Capital}}$$

Working capital = Inventory + Accounts receivable – Accounts payable

Contribution Margin Return on Working Capital (CMROWC)

$$\text{CMROWC} = \frac{\text{Contribution profit}}{\text{Working capital}} = \frac{\text{Contribution profit}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Working capital}}$$



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Sustainability Measures

Distributors use a number of top-level metrics to measure both their own business and the contribution of vendors to their performance. Where are you in the mix? Do you know the success formulas and how they can yield more ideal results?

Distributors use a number of top-level metrics to measure both their own business and the contribution of vendors to their business. The way they label these varies from distributor to distributor, which can be confusing, so it's essential to clarify how a given distributor is calculating a given ratio.

The key ratios you should be aware of are as follows:

RONA measures the return on the assets employed in the business, so it's useful when comparing distributor business units, subsidiaries or divisions.

ROCE measures the return on all the capital employed in the business, so is used by investors when comparing investment in the distributor with other opportunities.

ROIC is seen by some top distributors as a more precise measure for management targets and incentives. ROIC focuses on the operating components of the business model and relates them to the relevant portion of shareholders' funds. Note that the top line is Net Operating Profit After Tax, but should be without interest deducted.

Return on Net Assets (RONA)

$$\text{RONA} = \frac{\text{Operating profit}}{\text{Cash} + \text{Working Capital} + \text{Fixed Assets}}$$

Return on Capital Employed (ROCE)

$$\text{ROCE} = \frac{\text{Net profit after tax}}{\text{Total assets} - \text{Non-interest bearing liabilities}}$$

Return on Invested Capital (ROIC)

$$\begin{aligned} \text{ROIC} &= \frac{\text{Operating profit after tax}}{\text{Invested Capital}} \\ &= \frac{\text{Net profit after tax} + \text{interest}}{\text{Total assets} - \text{excess cash} - \text{non-interested bearing current liabilities}} \end{aligned}$$

Value Creation (VC)

$$VC = \text{Operating profit after tax} - (\text{Invested Capital} \times \text{WACC})$$

Value Creation – also labeled Economic Profit or Economic Value Add (EVA) – recognizes that management teams' task is not just to make a profit, but to make a profit in excess of the cost of the capital they used to make a profit.

By adding the cost of capital (technically the Weighted Average Cost of Capital or WACC) to the equation, it is possible to establish a dollar value, which is both more intuitive than a percentage and can reflect the scale of the business.

It is also possible to build a map of the business model of a distributor in the form of a VC "tree," showing how changes

to the business model have an impact further up the tree to impact Value Created or Lost. As an example, the chart on the next page shows the performance of our distributor – A Disti Co – with the lower figures for each metric showing Year 1 values, and the upper showing Year 2 values.

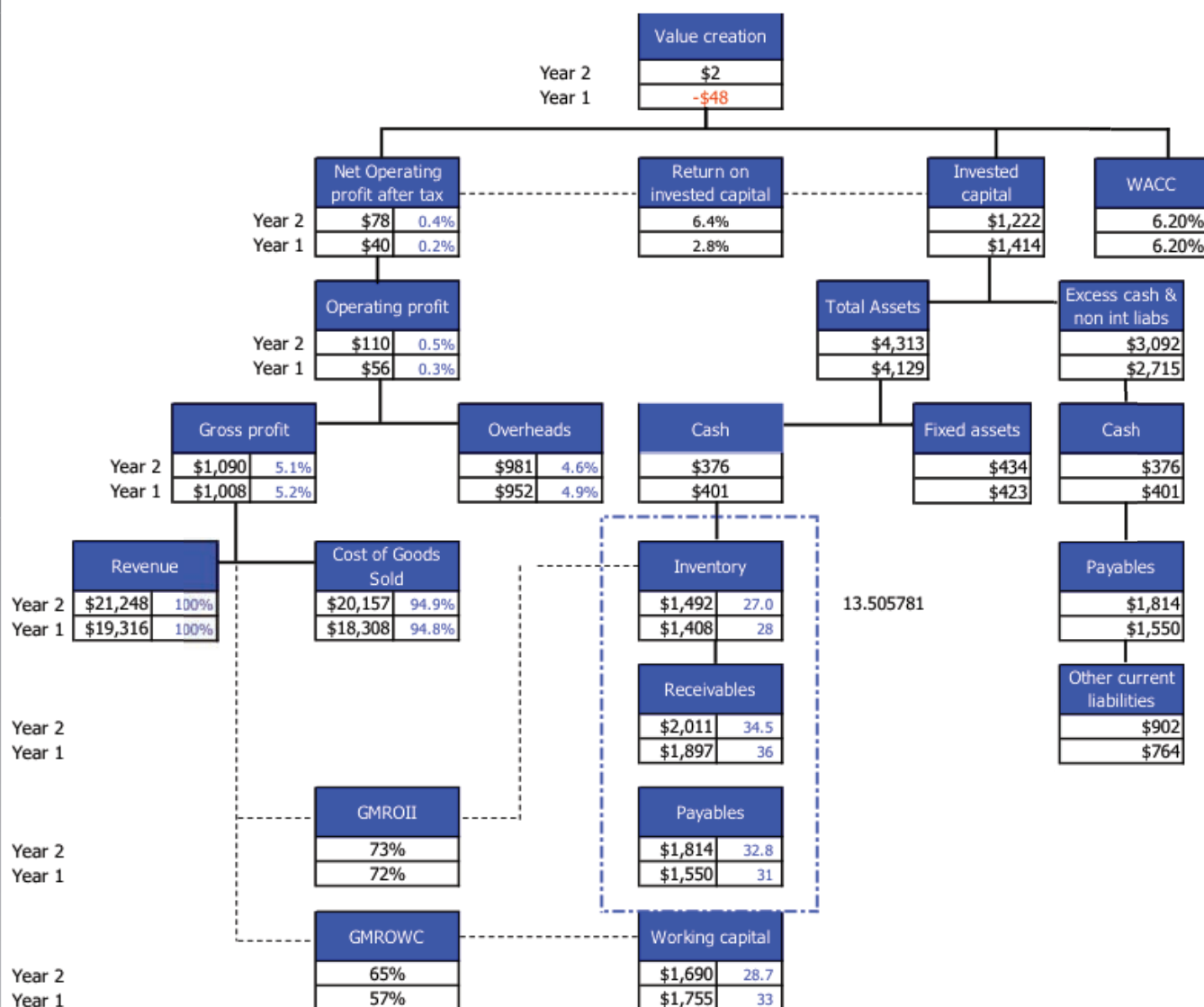
The last point to note with these more sophisticated measures is that a vendor only has an influence on a limited number of components within the distributor's business. In reality, a full analysis of CMROWC covers most of the tangible ways in which vendors can influence these metrics.

Different Measures for Different Stakeholders

Measure	Used for	Used by
Stock Price/ EPS	Valuing the business & evaluating future prospects	Current & prospective stockholders
Value Creation & ROCE	Assessing the performance of the business as an investment	Investors
RONA	Assessing the operational performance of a Business Unit, Subsidiary or Division (which has a discrete set of Assets)	Senior Management
ROIC	More precise measure for setting targets and incentives: focuses on the operating components of business model, and on relevant portion of shareholders' funds	Senior & Operational Management
CMROWC	When correctly scoped*, should include all aspects of performance which a vendor can influence in their contribution to the ROIC	Operational/ Product Managers; Vendors

*All metrics Are closely linked and can be calculated in different ways from those set out here. Should hold people accountable for the parts of the business model they can influence.

A Disti Co Example of How Business Model Changes Impact Value Creation





Managing Growth

It's a good problem to have – do you already have it or wish that you did? Zero-in on a simple way to quantify how the size, profitability and working capital efficiency of a business can determine how much growth a distributor can finance from its own resources.

Internal Financing of Growth

From a vendor perspective, it is important to understand how well the distributors in the channel can finance growth: whether to assess the capacity of the channel to grow the vendor's business, or to understand what the vendor could do to improve their contribution to the distributor's growth. There is a simple way to quantify how the size, profitability and working capital efficiency of a business can determine how much growth a distributor can finance from its own resources.

This potential growth capacity can be calculated as shown in the formula below.

Potential Growth Capacity %

$$\text{Potential growth capacity \%} = \text{Net margin after tax \%} \times \text{Working Capital turn}$$

In other words, the maximum growth achievable if a distributor applies all the profits it generates to funding increased working capital, which in turn supports increased sales.

Beyond this growth, the distributor – like any business – is obliged to seek other sources of capital: either its own (finite) cash and reserves or external capital (along with the associated constraints and scrutiny). The alternative is, of course, additional support from vendors: they should be looking for ways they can contribute to improved net profitability and/or improved working capital turn. An effective growth partnership is therefore based on a win-win approach, where incremental profits are shared between the partners.

Clearly, vendors who deliver better-than-average Contribution Margins and better-than-average Working Capital, are net contributors to the growth capacity, i.e., a “growth engine” relative to their competitors, and will be viewed more favorably.

Economies of Scale – Growth and Step Changes in Costs

The other dimension to growth is the economies of scale a distributor can secure through growth, which allow fixed costs to be spread over a larger volume of business. As highlighted in the margins section, many of a distributor's costs are fixed costs – which could be more accurately described as “stepped” costs: as investments in additional capacity are made, these costs increase in steps. The key to realizing economies of scale is to ensure that capacity is fully utilized before incurring costs in increasing it.

Compare the following two charts (on the next page), which – in a simplified picture of a real distributor's business – map steady volume increases and smooth contribution increases to stepped increases in fixed costs.

In the first chart, the distributor management team has a business that fluctuates above and below break-even: each time it moves into profit for a period, management invests in increased capacity, swinging the business back into a loss.

In the second chart, the management team operates a delayed investment strategy, waiting until after revenue growth has increased contribution before making further investments in capacity. The result is that the distributor remains in profit – although no doubt under considerable stress when running at maximum capacity!

Bear in mind that such systems investments can also have a significant impact on ROIC: sales systems can drive the productivity of sales teams, reseller-badged websites can attract new customers and drive sales with existing customers, automated warehousing and inventory management systems can drive inventory turns higher without risking stockouts, invoicing and credit collection automation can improve DSO, while payables systems can ensure that all credit notes are claimed, that DPO is optimized and that promotions are exploited to the full.

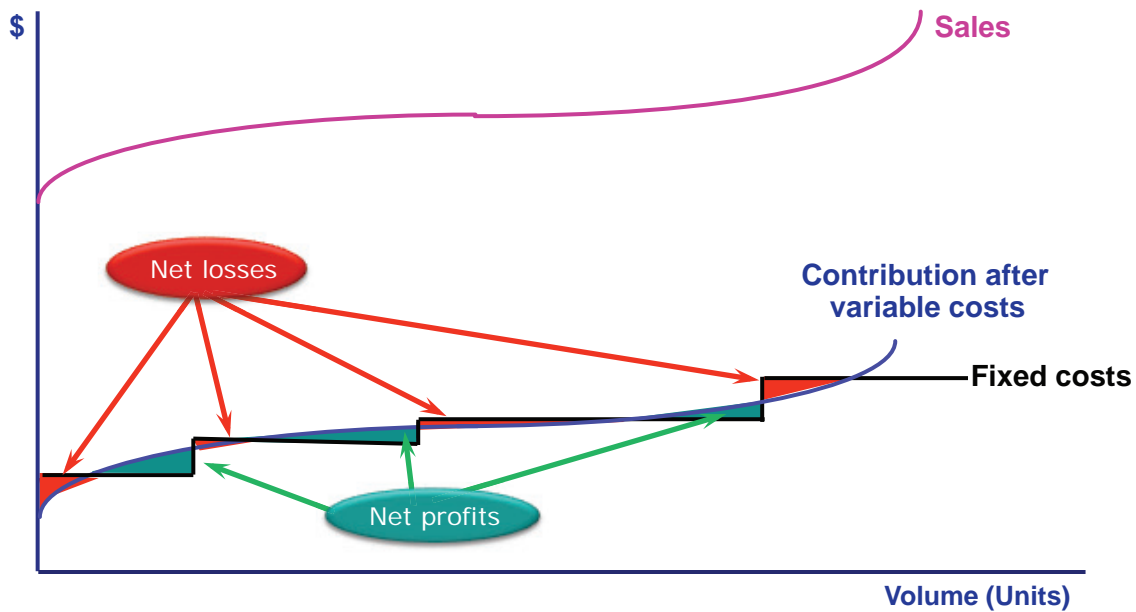
For the distributor's management team, therefore, getting the timing of such investments right can be the difference between major competitive advantage (delayed but right timing) and years-long disadvantage (investment delayed too long).



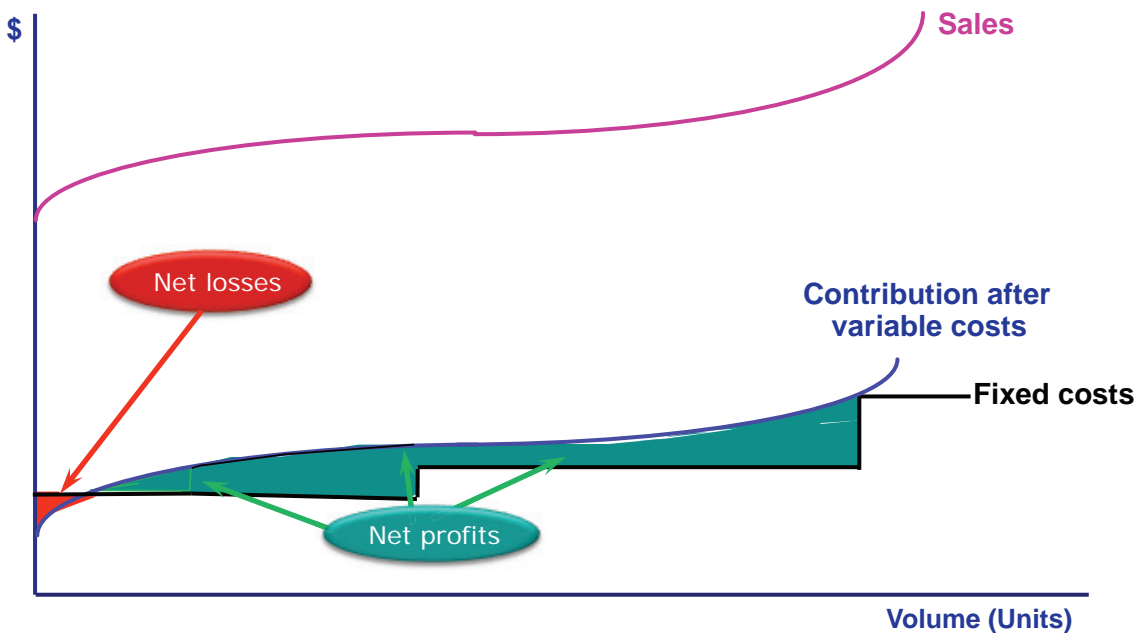
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Profile of How Contribution Margin and Fixed Costs Interact as Sales Increase



Profile of How Contribution Margin and Fixed Costs Interact with Delayed Investment





How to Sell to Distributors as a Vendor

Begin with knowing your distributor's strategy, value proposition and most important metrics they routinely evaluate. See definitive examples that can increase your company's value in distribution and vice versa.

This primer has looked at all aspects of the distributor business model, but from a vendor perspective the key question will be: "How does all this help me sell more to the distributor?"

First, in reality you are selling *through* the distributor, i.e., securing their agreement to list your products and to act as a route to market for you. You may want the distributor to perform some or all of the activities listed in Section 2 on your behalf. You will certainly want the distributor to focus on your products and actively promote their sale through whatever combination of market access, education, product management, marketing, promotion and competitive selling is required.

Second, the most successful sales operate through partnerships that deliver win-win results for both parties.

So how do you build the business case?

Understand Your Distributor's Strategy

Effective planning starts with your customer. Take time to understand their business objectives, their challenges, their pain points, their weaknesses and threats. Most distributors are happy to share their objectives and the strategy by which they plan to achieve them. Asking the right questions will highlight where there is mutual opportunity: customers switching business to competition, categories not delivering the promised growth, markets next on the priority list, and – particularly for publicly quoted partners – business metrics which are under pressure.

Make Your Value Proposition Relevant

We have established that the distributor's business is all about earning and turning, about Contribution Return on Working Capital, about Return On Invested Capital, Return On Capital Employed and Economic Profit. It is essential to understand how your value proposition fits into this picture. Your product features are only interesting if they drive higher end-customer demand and sales; your marketing spend on awareness and brand preference may only count when translated into lower sales costs as the product is bought rather than sold; you may be able to propose higher margins on your products through exclusivity or lower costs by funding resources in the distributor; you may have options for consignment stock and extended terms which completely change the working capital equation; the only part of your channel strategy which counts may be the fact that you do not have a direct sales force competing with the trade. All of these elements may need to be built into the value proposition you put forward.

Find Out Which Measures Matter... and to Whom

Throughout this guide we have seen how many variants there are on the measures that matter, the labels used for them, and the roles within your distribution partners who are focused and targeted on them. Different partners focus on different metrics: your task is to find out which specific measures are relevant to your partners and how they are calculated so that you can present your value proposition and business case to maximum advantage.

The example on the next page shows a simple distributor scorecard, illustrating the range of operational measures used.

	Ave for last 3 months		Plan this period		Actual this period		Variance	
High Level Profit and Loss		%		%		%		
Revenues	100,000		105,000		104,000		-1.0%	↔
Supplies	25,000	25%	26,250	25%	24,000	23%	-8.6%	
Other 1	66,667	67%	70,000	67%	70,000	67%	0.0%	
Gross Profit	2,459	2.46%	2,886	2.75%	2,841	2.73%	-1.6%	↔
Rebates	875	0.87%	918	0.87%	1,915	1.84%	108.5%	
Gross Profit +	3,334	3.33%	4,891	4.66%	4,756	4.57%	-2.8%	↓
Variable costs	-792	-0.79%	100	0.00%	-15	-0.01%	-	↔
Contribution Margin	4,126	-0.79%	100	0.00%	-15	-0.01%	-	↔
Allocated fixed costs	-792	-0.79%	100	0.00%	-15	-0.01%	-	↔
Net Margin	-792	-0.79%	100	0.00%	-15	-0.01%	-	↔
Working Capital								
Debtors at month-end	40,000		43,000		41,500		-3.5%	↓
Average debtor days in month	51		55		53		-3.6%	↓
Stock balance at month-end	20,000		19,000		21,000		-0.3%	↓
Average stock days in month	23		21		24		-0.3%	↓
Creditors at month-end	35,000		37,000		36,000		-2.7%	↓
Average creditor days in month	43		45		44		-2.2%	↓
Product Analysis								
Turnover on brand #1	50,000		52,500		52,000		-1.0%	↔
Turnover on brand #2	27,000		28,350		28,080		-1.0%	↔
GM on brand #1	4.2%		4.3%		4.3%		0.0%	
GM on brand #2	6.0%		5.9%		5.9%		0.0%	↓
Turnover on top 10 skus	50,000		52,500		52,000		-1.0%	
GM on top 10 skus	3.0%		2.90%				-100.0%	
Customer Analysis								
Turnover on top 10 customers	40,000		43,000		41,500		-3.5%	↓
GM on top 10 customers	51		55		53		-3.6%	↓
Amounts overdue	5,000		4,000		3,000		-25.0%	↑
Number of customers - overdue	79		50		40		-20.0%	↑
Productivity								
Sales per sales employee	2,128		2,234		2,213		-1.0%	↓
Sales per employee	1149		1207		1195		-1.0%	↓
Operations								
Number of orders	500		480		490		2.1%	↑
Average order size	200		219		212		-3.0%	↑
Number of active customers	800		810		790		-2.5%	↔
Value of back-orders	3,000		3,200		3,100		-3.1%	↓
Number of back-orders	230		230		200		-13.0%	↑
Value of queried orders	1500		1600		1550		-3.1%	↑
Number of queried ordered	100		90		95		5.6%	↓
Total value of credit notes	1000		500		400		-20.0%	↑
Number of credit notes	86		50		30		-40.0%	↑

Make the Business Case

Every business argument you make needs to be customized to your partners and to the business situation. However, it is possible to outline some simple rules-of-thumb to get you started:

If you are market share leader

- **Focus on gross profit dollars** that you as a market share leader, or your market-leading product, can generate from your high unit sales – even on a low gross margin %. Your distributor will recognize that these safe profit dollars are valuable in covering a significant proportion of fixed overheads. This can be illustrated graphically as shown in chart below.
- **Focus on contribution margins (% and \$)** rather than gross margins. The costs of selling your product should be lower than those for a lesser-known, less-promoted brand. Communicate and align your end-customer and second-tier marketing to your distributor so that the theoretical benefits of your market leadership are turned into real sales, reduced selling costs, and solid contribution profits.

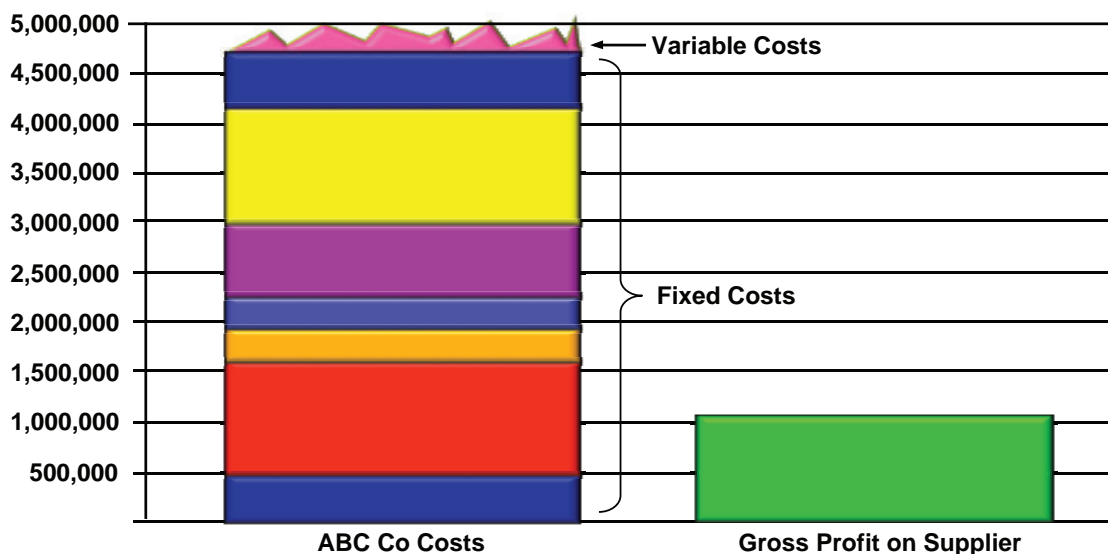
- **Shift the focus from return on sales (margins of all types) to return on assets/capital.** With high volumes, strong \$ profits and fast inventory turns, Return on Working Capital should be above average.

If You are a Smaller Vendor or a New Entrant in a Category

You will be challenged to secure senior management attention, so you need to show you can improve the operational measures for your product/category manager:

- **Focus on gross margin %**, and drive up GM% by putting some of your key, high-margin products in the spotlight, backed up by focused marketing dollars. Stress the impact on margin mix of incremental sales of your products and emphasize and demonstrate your products are just as low-cost to sell and support.
- **Emphasize growth, especially %** – which will be easier starting from a small base.
- **Highlight connect/attach opportunities** – show how your products can connect to the traffic-building products and build sales force and dealer incentives around this.

Illustration: Vendor Gross Profit Contribution to Covering a Distributor's Fixed Costs



Summary

In summary, if you are looking to engage effectively with distribution you need to develop a thorough understanding of your partner's strategy and recognize that you are selling a complete business model and channel value proposition. It has to be a model which creates positive forces on the distributor's economics, and to be a

successful vendor you will need to be able to analyze and explain where, how and by how much you can improve the distributor's business model.

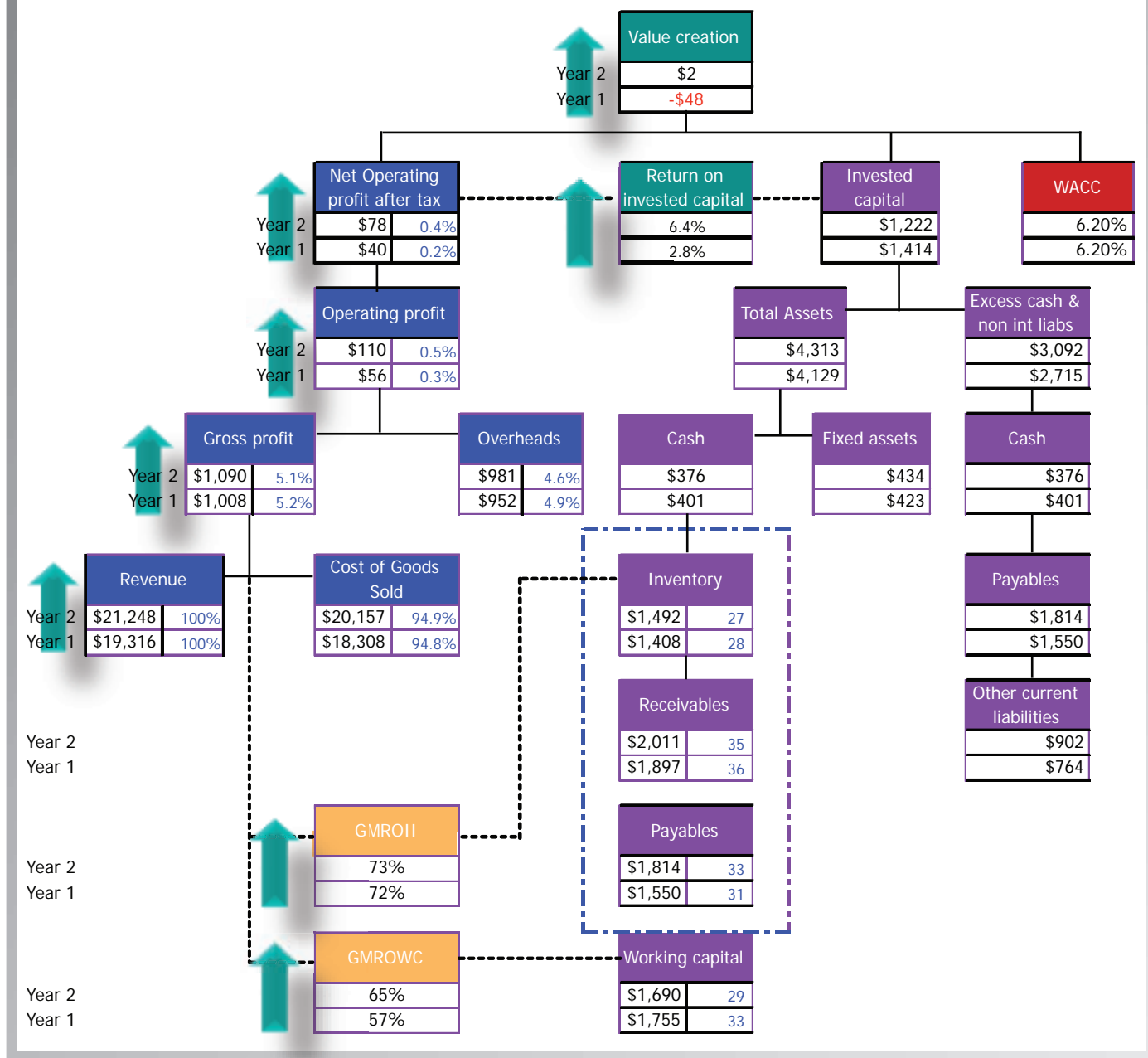
You can make use of the insights from this primer to articulate how your value proposition will drive forward your joint vendor-distributor businesses, highlighting where and how it improves the business model for your partner.

The distributor Value Creation/ Economic Profit tree serves as a very effective checklist in this domain, as can be seen in the example below.

The example shown illustrates how distributor Value Creation / Economic Profit tree can be used to highlight vendor impacts – here the effect for A Dist Co of adding an additional product line. Note that there are eight

measures which will be improved for the distributor in this example. Selecting the one or two which count for A Dist Co's management team is key to securing their attention. For example, a vendor who identifies Return On Invested Capital as a priority measure and who focuses on showing how adding their product line improves ROIC should secure a positive reaction.

Example Impact on a Distributor's Business Model of Adding an Additional Product Line





The Value of Distribution to a Vendor

Market access, reach, coverage, channel building...these are typically the key factors in the value equation for IT vendors. Get beneath the surface and tap the “new value” of IT distribution.

For many vendors, the logic of using distributors in their route to market strategy is so well understood that they never consider any alternative. However, it's well worth summarizing the key elements of a distributor's value to a vendor:

Market Access, Reach, Coverage, Channel Building

Distributors offer the ability to reach large parts of the market, or, for specialist distributors, large parts of target market segments. They have established trading relationships with very large numbers of partners in the market, and the right resources and processes to engage with partners of varying size and market importance. Many of these partners will not have the resources to work directly with vendors, especially if they are integrating across multiple vendors, and they look to the distributor to provide them with the product support and compatibility information they need. Distributors hold the information to filter partners against criteria for channel building and tiering exercises, and can provide valuable guidance as to which partners to work with in key deals or projects.

Speed to Market (for Brands & New Products)

Even today, after several rounds of consolidation, most markets comprise thousands of dealers, resellers, ISVs, etc. Vendors looking to access and service these partners find that it takes months or even years to research, select and appoint the right partners. A distributor can provide the right partners within days of being provided with the vendor's criteria, providing a huge time-to-market advantage.

Even where a new channel needs to be built through partner recruitment, distributors have the market knowledge, resources and processes to find, educate and sell potential partners on the value proposition. They can also help the vendor fine tune their proposition for the channel. For vendors new to a market segment, the distributor will add credibility and the confidence that partners will be able to access the account services they expect.

Economic Efficiency

The distributor is geared up to serve large numbers of

partners at very low cost because it can amortize the costs of its operations over the volumes of hundreds or thousands of vendors, including the very largest brands. These economies of scale simply cannot be replicated by one vendor, so the distributor can offer substantial benefits over in-house partner operations:

- **Lower cost to serve** – the costs of warehousing, order processing, inventory logistics, products support (pre and post sales), account management, warranty claims handling and so on are all reduced when outsourced to a distributor.
- **Variable cost, not fixed or capital investment** – by going through distributors, all the operating costs become directly related to unit volumes; in other words, they are fully variable. An in-house operation would require up-front capital investment in the physical assets of warehouses, logistics and related systems before a single product is shipped to a partner. These investments turn into fixed costs that would initially be extremely high and only reduce (per unit) as volumes increase – giving rise to the risk that the contribution from sales does not cover the fixed costs.
- **Balance sheet effectiveness, minimize working capital** - Each partner served requires a level of working capital to underpin the trading cycle (inventory and accounts receivable from credit sales). Depending on the product category, channel segment and local market practices, this can range from 30 to 120 days or more. Even at an average 60 days, that represents one sixth (17%) of the revenue generated tied up in working capital.

For example, for a \$10 million turnover, the vendor would need to tie up \$1.7m in working capital. By going through distribution, the vendor can reduce this to their standard trading terms, usually 30 days, and thus halve their investment in working capital. In our example, this would release almost \$850k of cash. This benefit ratchets up as the business grows, reducing the need to find additional investment. In our example, doubling the business would require another \$1.7m of cash if serviced direct, but only another \$850k with distribution. In other words, a vendor could handle double the business through distribution for the same amount of cash needed if it went direct.



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Risk Minimization

Distributors have established partner trading relationships, credit histories, knowledge of the people in the sector and understand the strengths and weaknesses of their partner base. They are also close to the ground when it comes to tracking trends, insights and developments among their partners (potential mergers, acquisitions, customer gains and losses, key people moving companies, trading problems and so on). All this insight enables them to avoid potential bad debts, inventory obsolescence, VAT carousels, frauds and other risks and prevent them from turning into costs and charges that would hit a vendor hard. On the upside, distributors are well positioned to capitalize on the opportunities in the market through ensuring that support and finance is extended to the right partners that are good bets for accelerated growth, major customer acquisitions or moves into new technologies or market segments.

Specialized Services Required by Different Channels

Each channel has different characteristics determined by their role in meeting the demand from different market segments. Distribution has done an excellent job over the last 10 to 15 years of identifying where there are economies of scale and effectively enabling partners to outsource these activities. Vendors looking to go to market through these channels directly would either need to provide these capabilities themselves or risk being uncompetitive in their channel value propositions. Working with distributors provides immediate access to these capabilities and provides instant credibility to the channels. Examples of these specialist capabilities include:

- **Logistics for retail** – Many retailers required sophisticated logistics capable of meeting slots timed to 15 minute intervals with financial penalties for missing the slot, or for

failing to fulfill orders precisely as specified. For retailers that don't operate their own distribution centers, they expect shipments of relatively small quantities to each of their many hundreds of outlets, all of which have specific restrictions on access, unloading facilities and times of operation. Distributors have all these issues logged and already sorted.

- **Configuration and drop shipment for dealers** – Many dealers have outsourced the complexities of configuring products for individual customers, ranging from simple software installation up to full imaging of bespoke in-house systems with security and access protocols. In addition dealers expect their distributors to handle the individual drop shipments to specific customers (even to the desk, not just the office), complete with paperwork that appears to be from the dealer.

Summary

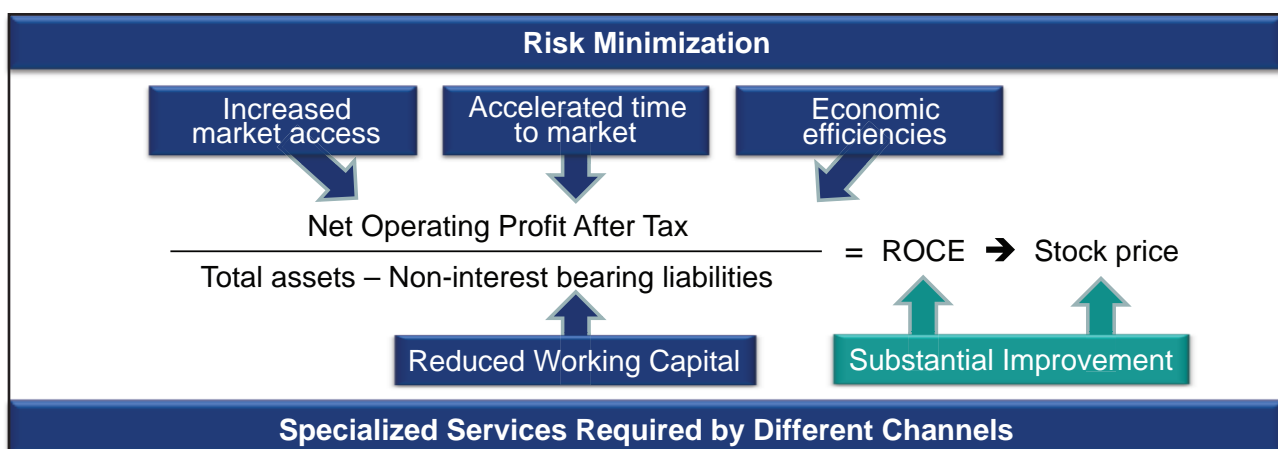
All the benefits of going to market through distribution can be quantified in hard economic terms, measured through improvements to the Return on Capital Employed (ROCE) of the vendor.

Accelerated market access and sales growth will drive top line benefits which are multiplied by the profit impact of economic efficiencies to increase the Return part of the vendor's ROCE equation. Leveraging the balance sheet of the distributor minimizes the vendor working capital employed in servicing the channel, reducing total Capital Employed.

The combined impact of both improving vendor returns on sales while reducing vendor capital employed delivers a substantial positive impact on the vendor's ROCE, limited only by the proportion of business it puts through distribution.

And over the long term, ROCE increases drive long term market value through stock price improvement.

How Distribution Drives Value for Vendors



Nine Things that Vendors Do that Make No Sense to Distributors

1. Variable Cost Discounts by Major Brands

These are discounts that are given per product, so the cost to the vendor varies according to the volume of product sold. However, this type of promotion costs the same per unit to the smallest brand as to the largest one. A large brand should be looking to leverage its brand power by making fixed-cost investments that can be spread over the larger number of units that it sells. Examples include investments in World Cup or Olympic sponsorships that can be harnessed through tie-in promotions.

2. Constantly Change the Personnel Managing the Relationships

The key word here is relationship and, often, no sooner has a vendor account manager built a relationship with all the key people inside a distributor than he or she is moved into a new role... and the process begins again. This is counter-productive, wastes everyone's time and hampers business building. And the problem is not limited to account managers, but everyone who is involved in the account-facing team.

3. Keep Fiddling with the Rules for "Pay-for-Results" Programs

"Pay-for-results" programs are attractive to vendors because they are self-financing and attractive to distributors because they reward effort and performance. However, these programs can be difficult to set up correctly so that they drive incremental sales by providing the right level of incentive. The result is that vendors are tempted to make adjustments to fine tune the program as they play out in practice (and find that some elements may be too generous). Each change has to be communicated, understood and then translated into changed promotional activity by the distributor, all of which ties up senior management and sales team time. Vendors should hesitate before making changes to these programs and limit them to only obvious design errors.

4. Set T's & C's for the Whole Business that Do Not Recognize the Different Business Models Involved in Reaching Consumers, SMB and Enterprise

As distributors have become larger and more sophisticated, so the degree of specialization required to service the very different types of channel partner involved in reaching the end-customer segments has increased. The different resources, processes and product-types represent different business models for the distributor, with different costs and financial dynamics. Yet, vendors will often set T's & C's that apply to the whole business. One solution seen is the adoption of Schedules to the main contract, providing for variations in the T's & C's with listings of the products and services that qualify for each.

5. SKU Proliferation

In some product categories, it has become common practice for vendors to add SKUs at a rate that the volumes sold just do not justify. A quick walk down the aisles of printers will demonstrate this point to good effect: just how many variations of features and specifications are really needed to serve the market? As so often in distribution, the 80:20 rule seems to apply, where 80% of unit sales will come from 20% of the SKUs. But this means that only 20% of the volume will be coming from the other 80% of the SKUs – an expensive and commercially unjustifiable model.

6. Set Pan-European T's & C's

Even after 54 years, the "Common Market" just isn't common ... and there are significant variations across Europe in the costs of the core activities of distributors – warehousing, logistics, payroll, credit, marketing and information technology and services. These variations relate to the underlying costs in different markets, market size and degree of market development. Vendors that look to set pan-European terms and conditions are ignoring the realities of the market and imposing artificial cross-subsidies between the individual markets, that both damages their business and undermines their routes to market.

Continued >



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Nine Things that Vendors Do that Make No Sense to Distributors (Cont.)

7. Appoint Too Many Distributors

Distribution efficiency and cost effectiveness are driven by economies of scale. These economies are undermined when vendors appoint too many distributors within a market. Of course, vendors want to ensure that they have a competitive discipline in their distribution model and the capacity in their channel to handle demand and growth. But the larger distributors now have the diversity of capability required to service different market segments and handle different product categories, without vendors needing to farm out the business to multiple distributors. Vendors should constantly check whether they can benefit from consolidating the number of their distributors.

8. Promote Too Many Deals

Perhaps it is the number of program managers employed by vendors, but there has been a trend towards an increase in the number of deals run in each quarter to stimulate demand. Each deal is a distortion of the business, affecting order linearity, often requiring a special SKU, sometimes special handling and always clearing out at the end of the deal period. They tend to be regarded within distribution as quick fixes to compensate for poor positioning or pricing. The alternative is to plan and execute proper systemic programs that are set up to achieve specific marketing and sales objectives.

9. Appoint Account Managers That Don't Understand the Distribution Business Model

To get the best out of a distributor-vendor relationship, account managers need to understand the financial dynamics at work in taking their products to market. This helps them to position their channel value proposition effectively to harness the resources available within the distributor and to articulate the benefits of their programs and plans. Yet, with a few notable exceptions, many vendors fail to invest in developing the commercial and financial skills of their account managers to be able to fulfil their role effectively.

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