



Industry Editorial

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The Farr side of Emerson Electric

February 2010

Every now and then a business personality of some fame opens up and confirms what you thought about them or their company; either positive or negative. Such an event occurred recently when David Farr, CEO of Emerson Electric addressed an audience at a business outlook conference in Chicago. According to Mr. Farr, “Washington is doing everything in their manpower , capability, to destroy manufacturing...”ⁱ Mr. Farr was railing against excessive regulation, taxation, and general disincentives of doing business as a U.S. based corporation. His position is not unique as any number of companies are finding the current business environment difficult to manage. Small businesses, which create some three quarters of all net new jobs, are going under everyday as they can’t afford health insurance. What’s unique about Mr. Farr’s comments is that they were delivered in a stark, challenging manner. According to Mr. Farr, job creation will happen in Asia, especially China and India, “places where people want the products and where the governments welcome you to actually do something. ...What do you think I’m going to do? I’m not going to hire anybody in the United States. I’m moving. They are doing everything possible to destroy jobs.”

I read the commentary once, couldn’t quite believe it, walked away and came back to make sure I understood it in proper fashion. It seemed to me that Mr. Farr was directly challenging the governing bodies that set business policy. Inadvertently perhaps, he was insulting Americans who have worked in his plants, localities who had given his company various perks and tax breaks, and the legacy of numerous countrymen who developed infrastructure and upheld laws that allowed a 20 billion dollar in sales corporation to grow and succeed. The irony of his commentary is that it was delivered on November 11th.-Veterans’ Day, 2009. My bet is that Mr. Farr never connected his comments with the day on which they were delivered and never thought they might offend many of his countrymen and women who helped build the St. Louis behemoth. He probably never thought of recent history where the citizens’ funds were used and tax burdens increased to bail out Fortune Rated financial and insurance institutions, Wall St. types, and the automotive industry.

But this speech wasn’t about legacy, or any ongoing responsibility to a country or its people. There was no hint of loyalty or consciousness about what came before. The timing may have been poor and the speaker may very well be obtuse but the speech was about the now and the future. The cost of doing business for Emerson Electric was too high and it was time to move, hire more foreign workers, and go after sales in high growth, rapidly industrializing countries. So, when faced with the choices, he did what CEO’s in charge of Fortune Rated US corporations seem to do when faced with a choice of staying in the country in which his corporation had prospered and working to reform it from the inside or bailing . It didn’t matter if it was Veteran’s Day; he told his countrymen he wouldn’t offer them jobs and he was moving out.

The Rest of the Story

A generation ago, Paul Harvey, a radio personality in Chicago, would start off his airtime with "...The Rest of the Story." I have always felt there were many good sides to a story and since I know a little something about Emerson Electric from the inside, I decided to give this editorial another side of the story.

From early 1990 to late 1996, I worked for a premier division of Emerson Electric as a marketing manager. The immediate customers were a network of North American wholesalers serving the HVACR industry. The company was smart, planned well, made great products, and expected much from a newly minted MBA. I learned much from the company and was afforded much decision making and given a substantial budget to manage. As time went on, however, I realized that I was not philosophically in tune with the culture of the company. Emerson was a company committed to making its quarterly forecasts and had a long history of increased earnings and dividends. But this commitment to the short term, in my estimation, was overdone. In this environment, it was too easy to overlook long term issues and dismiss long term investments. The real genius was being able to balance short term earnings with long term strategies and the balance, to me, was out of whack. Ergo, after nearly seven years, I left to pursue another opportunity where the culture was more in line with my personal philosophy.

But my experience, among those I knew in large, public industrial firms, was not unusual. Emerson Electric made its fame and fortune by being a low cost manufacturer, driving quarterly performance, and paying increasing dividends all while under the guidance of long-time CEO Chuck Knight. There are few axioms in business but one is that the low cost producer of mature technologies wins in industrial and consumer durable markets. Chuck Knight knew this and created a colossus of best-in-class, low cost producers of quality products. Along with this mantra, he managed to create brands that were leaders in their field(s) including Emerson Motors, Rigid Tools, In-Sink-Erator, and Copeland Compressors. The company got cost out, drove new technology for better products, and had reliable engineering. It was a force to be reckoned with. But driving earnings and hammering out cost can blind the firm to new knowledge and new processes. Cost itself is a nebulous term and there are times when investment in the short run can reduce cost and create value in the long run. The Emerson I knew was a master of cost out strategies involving the manufacture of the product. They were also competent in creating value by producing product technologies that reduced life cycle cost. They were not so good, in my opinion, in understanding and investing in knowledge based technologies, outside the plant floor, that could reduce cost and enhance long term value. This was a long time ago and Emerson may have changed but, in my experience, successful companies really don't change that much and only tend to do so under severe duress.

When Mr. Knight retired in 2000, his successor, David Farr, was well-known as he had been at Emerson for some time. Mr. Farr was an employee starting way back in the early 1980's with degrees from Wake Forest and Vanderbilt. He has guided the firm for nearly a decade and made acquisitions and grown sales. The one nagging thing about Mr. Farr's performance is that during the period from early 2000 to late early 2010, the company's adjusted stock price went from \$21 to \$46.ⁱⁱ To be fair, I went back to 1997, when Chuck Knight was leading the company and looked at the price then versus today. This was, to me, a fair comparison over two CEO's and a long enough time period to work out peaks and troughs of business cycles. In January 1997, about the time I left Emerson, the stock was \$91. The stock split later that year with the price around \$46. The adjusted price during this time period was \$16 in early 1997 to \$46 in the current day. This means in the nearly thirteen years of history, through two CEO's and of which Mr. Farr has lead for seventy percent of the time, the company's stock has risen approximately at a 2.8 multiple. (\$46/\$16)

But one shouldn't compare stock prices in isolation. It's important to get perspective so I took a look at Emerson competitors and customers including United Technologies, Baldor Electric and WW Grainger. In early 1997, United Technologies (UTX) and parent of Carrier Corporation had an adjusted price of \$14 and by early 2010 the price was \$67. Similarly, Baldor Electric (BEZ) was \$29 in late 2010 versus \$13 in early 1997. Grainger is interesting as the company has been a long-time customer of Emerson Electric buying motors, compressors, and other products. Grainger's adjusted stock price (GWW) in early 1997 was \$31 and in early 2010 the most recent close is \$100. Of the group, Carrier's adjusted price appreciated at a multiple of 4.89, Baldor at 2.28 and Grainger at 3.22. Grainger's stock performance is interesting as the company is a distributor and not a manufacturer like Emerson, United Technologies and Baldor. Looking at Grainger versus Emerson from early 2000 to early 2010 finds the adjusted price of Emerson at \$21 in 2000 and \$46 in 2010 for a multiple of 2.19. Grainger was \$37 in early 2000 and \$100 in 2010 for a multiple of 2.70. In essence, Grainger appreciated significantly more than Emerson Electric and Baldor Electric during the period. Was there something underfoot here, something unseen that gives distribution, like Grainger, an upper hand?

Shift in Channel Power

Two years ago, I and co-author Steve Griffith released a book titled *Disruption in the Channel*. The book was written from an extensive survey we conducted with 200 executives of distribution companies across North America on the rising trend of distributors to source foreign "off-brand" products. We had witnessed that, as global manufacturing exploded, many high-quality "off-brands" began to show up on distributors' shelves. The theory of the flat world was in full force as distributors could check price and availability across the globe 7/24. And, with a little skullduggery, they could purchase the best of price and availability with manageable risk. We launched our research in early 2008 and, although it's taken two years, we have a steady audience for what is a tough message, especially for manufacturers of mature products. The message can be summed up in key findings from the research including:

- The price "off-brands" are 30% better in landed cost than domestic brands with an almost insignificant quality differential.
- End user preference was for a lower priced product and there was growing customer indifference of where on the globe the product was manufactured.
- Distributors who did not purchase "off-brands" showed an inability to compete against distributors who purchased foreign "off-brands."
- Over servicing of commodity products by domestic manufacturers was common with too many sellers, marketing programs, and too much redundant product application training.
- Exceedingly expensive corporate overhead including CEO's who earned 400 times what the average factory hand earned in a year and domestic engineers that were 60% or more costly than their counterparts overseas was a contributing factor for the uncompetitive price of domestic brands.
- There was an overreliance by domestic manufacturers on the value of the brand to maintain market share against low cost foreign competition.

It's also important to know that the research defined domestic brands as products having brand names created in North America but that could be manufactured anywhere on the globe. Since many brand name manufacturers were making products in Mexico or China, the 30% landed cost differential meant that "off-brand" manufacturers had a significantly better price than branded products even if they were manufactured in the same country.

In addition to the research, we conducted over 100 hours of confidential interviews with leaders of distributors across North America. What we found was truly astounding. There was a growing and well

established group of channel entrants including importers, short-line manufacturers, master distributors, and private buying groups who were ordering “off brands” for sale. The saturation rate of off-brands was around 20% and growing at 5% per year. Once the saturation rate got to 30% in any industry vertical, it was financially impossible for a distributor not to purchase “off brands.” Distributor leaders believed that many long-term domestic brands were in real trouble as they would lose out to “off-brand” competition.

Based on our research, we advised domestic manufacturers and their brands as follows: “It is imperative that manufacturers of products under attack by these (off-brand) competitors segment their businesses. Indeed, they must treat the standardized, commoditized portion of their operations as entirely separate businesses, free from culture, traditions, mindsets, and paradigms that have grow up... and now threaten to sink the firm...”ⁱⁱⁱ

The upshot of this research and its portent for domestic manufacturers of mature products is bracing. There has been, and will continue to be, a **shift in channel power that favors the distributor**. As distributors consolidate and grow, they become more sophisticated and able to take advantage of global supply chains where “off-brand” products are necessary for survival. And, this move toward foreign sourcing is driven not only by the maturation of products and explosion of low cost manufacturing but the communication afforded by the internet that allows instant information on the best sources of supply. The world is flat indeed.

In my interviews I found several distributors who were sourcing “off-brand” products in lieu of Emerson manufactured goods and/or those of similar manufacturers. I found a West Coast distributor buying electric motors from China at a 40% less cost than domestic branded motors. I found a mid-west distributor who was buying HVAC controls and accessories at a 30% to 40% less. If one doubts the ability of the world to supply Emerson like products, a simple search of Alibaba.com finds, for condenser fan motors, there are 1094 hits in Taiwan, 465 in China, and 18 in Singapore. If one searches electric garbage disposals, there are close to 500 hits in China. To be exact, many hits are from the same manufacturer for different models but, collapsing these models, there appears to be many legitimate manufacturers of these products and it appears relatively easy for distributors with international connections to source them.

WW Grainger is an interesting case because the company, as of several years ago, freely admitted that some twenty percent of branch sales were in private label products. And, a little more than a year ago, the company announced development of a Global Supply Chain function with the hiring of an executive to run the effort and mandate to staff it. The stock price increase of Grainger is no surprise. The company sits in an enviable position in the channel and can take full advantage of global supply chains. The observation, that not many manufacturers want to acknowledge, is that wholesalers, today, are both customer and competitor.

Finally, a little more than a year ago, I met with an executive of one of the nation’s leading industrial distributors. They are a big customer of Emerson products and many other domestic manufacturers. The meeting was precipitated by the purchase of multiple copies of our research. According to the executive, they were in the stages of developing a multi-year plan to source “off-brands”. The exec didn’t mention specific brands that were to be displaced only that many would be in for a shock.

The upshot of our research is not comforting for domestic brands selling through wholesale distribution channels. Are a growing number of distributors sourcing “off-brands” in lieu of buying Emerson products? I don’t know the answer specific to Emerson Electric but the signs for them, and similar manufacturers, are not good. And, our research says that foreign manufacturers aren’t encumbered with many of the historic costs of Domestic Brands. Expensive management, corporate edifices, and bundling of s,g,&a costs on mature product platforms are not an issue for many of the foreign “off-brand” companies.

Who Moves and When?

The pressure on Emerson to perform is real. David Farr is not alone in his opinions about the expense of running a global manufacturer from the U.S. The ability of distributors to purchase off-brands and supplant Emerson and similar manufacturers is real and growing. How much effect this has on Emerson's need to move to low cost countries is unknown. In the industrial history of America, a generation or so ago, agricultural products moved offshore as domestic employment plummeted and productivity soared. Brands such as Allis-Chalmers and International Harvester are lost to the globalization of the industry. Those who were out jobs were retrained and redeployed as the economy developed industries that were younger in their life cycle.

The movement of mature domestic products to foreign shores to get cost out is nothing new. As products mature, costs come out of labor, plant, and equipment. Eventually, costs come out of management and historic sales, general and administrative costs that are hopelessly intertwined over many products and divisions. What's different today is that distributors are large enough, sophisticated enough, and have instant information that allows them to bypass Domestic Brands in lieu of "off-brands" that are significantly less in price. Did Emerson's focus on the short term and foreign markets blind them to the shift in channel power in domestic markets and the rise of domestic distributor customers to set up direct relationships with foreign competitors?

It would appear that Mr. Farr, from his address, has made his choice and it is goodbye to St. Louis and scant chance that he will hire any more of his countrymen. Given the stock performance of the company, many investors would most likely welcome change. Other companies who compete in similar industries don't appear to have the same stock woes but they are not setting the world on fire either. Of course other options exist for Emerson including selling off the most mature product divisions and refocusing the company. Can a mature industrial products company compete while keeping their headquarters in the U.S.? Do concepts such as nationalism and patriotism matter in an industrializing world where costs of operation, regulation and taxation are much lower in fast growth economies?

As of the writing of this editorial, I've heard no announcements, similar to Mr. Farr's, from United Technologies, Baldor, WW Grainger or other companies who compete against them. Is Mr. Farr ahead of the pack on his position and will others follow? Is he part of the solution or part of the problem? Will he really move the corporation or will he be removed by the corporation's board? Only time will tell but I am betting the drama will unfold in near time.

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ⁱ See story at http://www.bloomberg.com/apps/news?pid=20601103&sid=a_EbBQyskKl0

ⁱⁱ Stock Prices from Yahoo Finance and closing prices are adjusted for dividends and splits.

ⁱⁱⁱ Benfield, S, Griffith, S. "Disruption in the Channel," page 117, Power Publishing, 2008, available at www.benfieldconsulting.com