



Original Research

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The Impact of Off-Brands on Financial Performance

Analysis of Financial Data for Electrical Wholesalers

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In the Spring of 2008, we released a White Paper entitled “Develop Your Long Distance Supply Chain.”¹ The paper reviewed research, conducted by us, on the importation of Off-Brands into North American markets by North American distributors. The research, conducted in late 2007, found a growing trend, across several dozen vertical markets, in the importing of foreign manufactured off-brands. Off-Brands are defined as products that have similar features and benefits of domestic brands but they are made offshore, are not part of original branded manufacturer offerings, and often have limited brand awareness. Off-Brands, however, had a significant price advantage over domestic brands of over 30% less. This is significant especially when one considers that domestic brands are increasingly made overseas.

In the paper, and based on the research, we advised distributors to move toward long distance supply chains and securing off-brands for future survival. Our reasoning was simple and supported by our research from some 200 distribution executives including:

- At the current cost advantages, pro-forma analyses showed that once off-brand purchases reach 30% of the product mix, it is very hard for a distributor not buying these products to compete.
- Off-Brand quality is on par with that of domestic products
- Off-Brand liability including product liability is manageable with distributors using a variety of insurers and coverage that has proven adequate

Distributor interest in the subject has been significant but covert. Most distributors know the cost advantage of off-brands but they are also cautious of disrupting relationships with domestic vendors. We were given a rare chance to compare distributors who purchased off-brands versus a Distributor that was adamant against such a policy. The

¹ Benfield, S., Griffith, S. “Develop Your Long Distance Supply Chain,” found at http://www.disruptioninthechannel.com/images/Long_Distance_Supply_Chains_and_Offbrands.pdf

distributors were all in the electrical industry and of similar size in sales. Those purchasing off-brands were identified as Grainger, Wesco International, and Anixter International. The company against stocking and selling off-brands was Graybar.

Is the Cost Advantage of Off-Brand Purchases Evident in the Financial Statements?

In our White Paper, we compared the operating profit, as a percent of sales, between these entities. In our thinking, if the thirty plus percent cost advantage was real, companies that purchased these products would have significantly better financial performance than companies that did not purchase them. The entities in the electrical industry gave us an excellent picture into the issue as Wesco and Anixter have international holdings and Grainger has publicly acknowledged over 20% of their branch sales are in private branded products. Looking at the year ending 2007 Statements of Income, we found that Anixter, Wesco, and Grainger had operating profits, as a percent of sales, of 7.5%, 6.5% and 10.4%, respectively. Graybar, during the same period, had a operating income of 3% of sales. Our position, given that the firms are heavily in the electrical and industrial supply markets, is that off-brands gave a significant cost and profit advantage to Wesco, Anixter and Grainger versus Graybar. In the February 2009 issue of Ted Magazine,² however, our research and conclusion was challenged. According to the article, Graybar outlays significant employee benefits in the form(s) of cash dividends and defined pension payments and, when accounted for, these cash items more than make up for the difference(s) in operating profit performance. The article, written by Joe Salimando, gave us reason to revisit our original research and shed light on whether or not the purchase of off-brands have a significant and visible positive effect on a firm's financial performance.

Revisiting the Numbers

The data we use for comparisons is public and part of the public domain. We used Google as our search engine and accessed the 10K's, annual reports, and available financial data for each company. As of the writing of this article (early 2009) not all of the year end financials were completed from calendar 2008. Hence, we will use the year ending 2007 reports for further analysis and comparatives.

In our original analysis, we looked at operating income since, to us, that is the primary metric for performance for the wholesale firm. However, the TED magazine article listed some 77.94 MM USD in "Cash Flow Items" that Graybar paid or set aside for employees in FY 2007. These included 12.44 MM USD in dividends, 28 MM USD in defined pension benefits, and 37.5 MM USD in a "planned add" to defined benefits. Graybar's claim is that without some 5800 employee owners who receive the listed payouts their profitability would be on par with Wesco International, Anixter International and Grainger. We found this a curious statement as Grainger, Wesco, and Anixter are public companies who pay dividends and set aside funds for pensions and 401-k match also. However, we are not necessarily arguing about bottom line profitability and employee compensation. We were trying to understand if the purchase of off-brands would show

² Salimando, J., "Graybar's reasons for being," TED Magazine, ppg. 22-23, Feb. 09.

up in the financial performance of the firm and, therefore, revisited the numbers in Exhibit 1 below.

In the exhibit, we see that sales for all companies are in the range of 5 to 6 billion per year. The cost of goods column is of interest as Graybar's cost of goods are 80.37% of sales as compared to Wesco at 79.64% of sales, Anixter at 75.85% of sales and Grainger at 59.43% of sales. Since cost of goods in most distributors reflects the direct cost of merchandise less any special discounts, it would appear that there is a significant difference between Graybar, Anixter and Grainger. Some of the difference may be in pricing but in mature markets it is difficult to understand how Anixter's cost of goods is

Financial Comparisons									
Graybar, Wesco International, Anixter International, Grainger									
2007 Year End Reports									
(000's)									
Company	Sales	Cost of Goods	Gross Margin	Gross Margin As Percent of Sales	Operating Expenses	Operating Income	Operating Income as Percent of Sales	Number of Employees at Year End 2007	Margin Dollars Per Employee
Graybar	5258301	4225983	1032318	19.63%	875044	161787	3.08%	8600	120036.98
Wesco International	6003500	4781400	1222100	20.36%	827900	394200	6.57%	7300	167410.96
Anixter International	5852900	4439600	1413300	24.15%	974200	439100	7.50%	7500	188440.00
Grainger	6418014	3814391	2603623	40.57%	1932970	670653	10.45%	18036	144357.01

nearly 5% less (75% vs. 80%) than Graybar's cost of goods. More striking is how Grainger's cost of goods as a percent of sales is nearly 21% less than Graybar's. This is significant as Grainger publicly stated in early 2008 that some twenty percent of branch sales came from private label products. Also in the fall of 2008, Grainger announced the establishment of a Global Supply Chain function under Senior Vice President, D.G. Macpherson.³ In essence, the establishment of a global supply function is important enough for Grainger to warrant starting and staffing the function to take advantage of the rise in global manufacturing and the cost advantage of these goods.

If a purchase cost advantage from off-brands is real, as our research indicates, it would likely show up in the metric of cost of goods as a percent of sales. The corresponding metrics of Anixter and especially Grainger versus Graybar gives an indication that there is an immediate and visible effect of off-brands on the profitability of the wholesale firm.

³ See "Grainger Promotes Michael Pulick to President Grainger Industrial Supply, <http://www.reuters.com/article/pressRelease/idUS262064+29-Oct-2008+PRN20081029>

There are product mix and served market variations that can and do influence which products can be sourced as off-brands. However, our research showed surprisingly narrow variations between industries as to the availability and cost advantage of off-brands. Most industries reported substantial availability in core products and an average range of cost advantage of 25% to 35%. In most distribution vertical markets, 60% to 80% of the products sold are commodities which, by definition, are differentiated by price.

Looking at the operating expenses also gives insight into the differences in the company strategies and how they achieve their profits. Operating expense as a percent of margin dollars for each company are: Graybar 84.7%, Wesco 67.7%, Anixter 68.9%, and Grainger 74.2%. It appears that Wesco has a low operating cost and this is further illustrated in the last two columns to the right of Exhibit 1. The columns take the number of employees at the end of 2007 and divide them into the margin dollars for the year. Not surprisingly, Wesco has 167,410 margin dollars per employee and Anixter has \$188,440. Grainger yields \$144,357 margin dollars per employee and Graybar has \$120,036 per employee.

In the Salimando article, CEO Robert Reynolds states that “if you’re reading one of our statements and look at ‘the bottom line’ it’s smaller because we distribute profits before they get down there.” The article goes on to illustrate the Cash Flow Items dedicated to employees for 2007 total 77.94 MM USD. Defined pension accounting is complex and it is difficult to know what part of the cited cash flow items are in operating expenses. However, if one takes the full amount cited by Reynolds and adds it back into Graybar’s 2007 operating income of 161.78 MM USD, the operating profit would be 239.72 MM USD which would make the firm’s operating profit 4.5% of sales which is still well below that of the other firms. Also, one must consider that Wesco, Anixter and Grainger would have significant distributions to 401-k or Pension Plans and Cash Dividends to shareholders to remain attractive to employees and investors.

Conclusions and Summation

It is difficult to know the full participation of a company in purchasing “off-brands” from reviewing the financial statements. The most telling metric is generated gross margin dollars which, for the 2007 calendar year, find Anixter and Grainger earning substantially more in Gross Margin Percent than Graybar or Wesco. Wesco’s earning performance appears to stem from low cost operations where operating expense as a percent of margin dollars is lower than the other companies. This is corroborated by high margin dollars per employee of \$167,410.

When considering other public information including Grainger’s admission of selling private label products and their development of a global supply chain function, there is strong circumstantial evidence that these trends plus the gross margin of 40.7% indicate the profit influence of foreign off-brands. Off-brands, according to our research, have a 30% cost advantage over domestic brands and our financial modeling shows that most distributors cannot compete without them when they reach an industry saturation level of 30% of total purchase volume.

The stance of Graybar’s executive management against private label and off-brand products is directly opposite the trend of globalization, world-wide manufacturing, and

research that finds distributors will source more of these goods. The financial information, when analyzed, does not support Graybar's position, as stated in the Salimando article, that the company is as profitable as the other similar competitors when considering cash flow items inclusive of dividends and defined pension benefits. And, the gross margin percent of Graybar is below that of the other companies. This could very well indicate a non-competitive position in purchases aided by the stance against off-brands.

Graybar is a large company that has done much for the industry and is held in high esteem. The company recently was voted most admired among Diversified Wholesalers in Fortune's poll of The World's Most Admired Companies.⁴ In our experience, Graybar executives are generous with their time and support many intra and inter-industry events. However, the financial performance of the firm is not up to par with industry competitors of similar size and who compete in similar vertical markets. From our research and experience, the company's stance against foreign off-brands is unfortunate and, most likely, impedes profits. And this position will likely erode Graybar's future financial performance as competitors increase their purchases of foreign off-brand goods and take the advantage to the marketplace. We recently talked to a sizable distributor who is rolling out a ten year strategy to source globally. Graybar should take heed. In our experience, in the mature and slow moving markets of business to business distribution, the low cost producer of an acceptable level of products and services usually wins.

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⁴ Lashinsky, A. "The World's Most Admired Companies, Fortune Magazine, March 16, 2009, pg 86.