"I Can't Believe I Ate the Wholesale Thing!"

Digesting double digit EBITDA multiples in the Merchant Wholesaler Industry

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The authors contend that the recent EBITDA multiples of 10x and 12x, for distribution businesses, may be a way of the future. However, the buyers will need plenty of savoir-faire in cost reduction, pricing management and well planned human capital redeployment to make the numbers work. Changing the organizations to reflect the new realities will be difficult. Many will fail.

In the recent acquisition spree for Merchant-Wholesalers, valuation multiples have skyrocketed. Starting with the 10x EBITDA multiple paid by Sonepar for the Stuart Irby Company and followed by the 12x multiple paid by Home Depot Supply for Hughes Supply, the historic multiples of 6x to 8x, of the recent past, appear quaint.[1] With premiums of 30% or more being offered over historic, intra-industry deals, the seminal questions are: Does this increase make financial sense and how will buyers make the numbers work?

Our research and work in merchant wholesale markets finds that suitors with deep pockets may indeed make the math work on the historically high acquisition prices. However, they will need great skill and advanced knowledge in the areas of reducing solicitation costs, capturing value with better pricing, recruiting better leaders, and maintaining service quality with better organizational change techniques. We devote the rest of this paper to supporting our theories on the key ingredients needed to make the double digit multiples work.

It's an old business model with falling fundamentals and third generation managers

Wholesale distribution is a century old business that blossomed with the Industrial Revolution. Manufacturers needed an economic means of getting parts to market and distributors offered a place close to the market, extension of credit to industrial buyers, and a warehouse to store, break, and aggregate bulk products. As the business matured, the products commoditized, and capital returns began to fall precipitously. Starting in the 1970's, return on net worth declined from 20% to approximately 10% by the new millennium.[2] Industry specific acquisition began at a brisk pace in the 1980's and was, in part, due to the falling capital returns. Along with falling capital returns, we have found that productivity, as measured in sales per employee, has stalled for the last decade or more for merchant wholesalers in the durable goods sector.[3] Depending on the sector, many durable goods vertical markets had over 70% of their members fail to earn a market return of 11% on investment by 2004. [4]

As if the financial trends weren't worrisome enough, the generational ownership trends will, if parallel industries are any guide, cause nine out of ten businesses to sell out or implode as they near the third generation.[5] The majority of distribution businesses are in their third or late second generation. In addition, while many have been acquired, the vast majority of the slightly less than 300,000 distribution entities are family owned, small, and run by a second or third generation blood relative.

The synthesis of the financial and generation trends, on the surface, make an acquisitive strategy questionable. Unless the acquirer substantially changes operations, inclusive of reducing and leveraging costs, the acquisition into an industry with falling fundamentals and

leagues of third generation owners makes little sense. We have noted, on numerous occasions, that wholesale distribution is a notoriously difficult business to scale based on its conventional financial structure. The capital structure of distribution has perennially lower fixed costs than manufacturing and roughly two-thirds of all costs are for salaries and people who offer service to the customer. Outsiders, at the 40,000 foot level, cite that roll-ups will gain a competitive advantage as larger entities can leverage supplier relationships where cost of goods are 75% of the sales revenue. However, industry insiders counter that the vast majority of smaller wholesalers are members of co-op buying groups, leverage proprietary volume, and purchase at a comparable price to the large firms. Hence, with a low fixed cost base, our belief is that lasting cost advantage will take place primarily by **redefinition and streamlining of processes.**

Historically, intra-industry acquisitions have involved leveraging the rote services of purchasing, accounting, warehousing and shipping. These back door services, while important, are limited in their ability to offer cost concessions. At some point, the acquirer hurts customer service and asset management if these functions are stretched too thin. As the multiples rise, however, we believe front door costs will become the focus for leverage including sales. We also believe that the front door function of pricing, or capturing value, will become more controlled by marketing and operations, versus the largely cost plus pricing used by sellers. The table below depicts the various functions and the focus for financial improvement needed to support higher acquisition multiples.

Functional Leverage in Distribution Acquisitions				
Function	Door	Strategic Thrust	Constraints	Focus Priority
Purchasing	Back	Vendor reduction; supply chain leverage on key measurements of turns, GMROI, Buying Groups	Vendors are highly individualistic. Foreign unbranded vendor options.	Low
Warehouse Labor	Back	Automate and streamline. Key measures of picks and ships per hour. Continuous operation or two-shift operation. Hub and spoke branch layout.	Standardization of processes including vendors by geography.	Medium
Shipping	Back	Maximize route coverage with larger transactions. Send small transactions with outside vendor. Send special shipments with outside vendor	Reduction of sales led delivery options.	Medium
Accounting Labor	Back	Accuracy of transactions. Outsourcing of payables and careful negotiation of credit balances. Use lean processes to identify wasteful process steps and eliminate them.	Volume of transactions and accuracy is key. Software and outsourcing solutions. Timing of payables and receivables cycles.	Low
Inside Sales	Front	Match model with customer needs. CSR, Generalist, Tech Specialist, and personal account manager. Drive high transaction cost to catalog/fax or e-commerce.	Management of inside sales strategy is often non-existent	High
Outside Sales	Front	Reduce costs using new models and alignment measures. Eliminate negative activity accounts from territories and drive functional models to lower costs.	Existing sales management unfamiliar with new tools of alignment and modeling.	High

The acquisitive model, in short, will change from gaining leverage on back door functions to redefining and reducing costs on front-door functions. Some of the back door functions may be outsourced and the front door function of sales will be redefined using new models of deployment, alignment of sales with growth opportunities, and supplanting high cost of service sales with cataloging and e-commerce.

Redefining the sales culture and moving from selling to solicitation

Approximately 30% to 40% of distributor operating expenses are sales related. Typical costs for outside sales range from 3% to 5% of revenues and inside sales range from 2% to 4% of revenues. With operating expenses running 18% to 21% of sales, the sales cost component is the largest single bucket of operating expenses. Wholesaling is largely a sales culture. Sellers are familiar with products, their sources, and discreet customer needs. However, selling as it has been traditionally approached, is largely inefficient and in need of streamlining. In our 2006 release, Restructuring the Distribution Sales Effort, [6] we documented the following inefficiencies in distributor sales forces including:

- Margin dollar bonuses and commissions that reward sellers for any and all margin producing accounts including those that historically produce negative activity profits
- Geographic sales allocations that drive volume instead of profits and place the firm in questionable segments where they are at a competitive disadvantage
- Sales control of pricing where the seller “auction prices” with cost plus pricing behavior
- A service arms race where unique services are promised by sellers to differentiate commodity offerings with the result that the services raise operating expenses but are not included and priced in the cost of material goods.

These behaviors are ultimately profit destroying and are cause, in part, for the declining profit picture in much of durable goods distribution. In two separate surveys, we have questioned end customers on the financial value delivered by outside and inside sellers versus their costs. When the customer is offered a price decrease commensurate with sales costs, the majority elect to order via catalog and fax or e-commerce. While this type of service cost unbundling is radical thinking to existing distribution executives, it is not unnoticed by outside industry buyers who, from our experience, are investing in lower cost solicitation and transaction techniques including cataloging and e-commerce.

Based on our experience in restructuring sales efforts in distributed markets, it is not uncommon to take 20% to 30% out of sales functions by better territorial alignment and using queuing technology and process mapping for inside sales functions. Further cost reductions are possible if management uses newer sales models of enterprise, functional and segment sellers versus the geographic modeling that is inherently inefficient. Whether existing distributors will adopt new techniques of sales deployment is unknown. Most distribution is sales driven and sales dominated executives have a hard time understanding why sales costs and sales structures are inefficient. Outside buyers who are not steeped in the sales culture, have an advantage in that they don’t see sales forces as any more or less valuable than other functions. And, if they conclude that distribution selling is overstaffed and inefficient, they will seek ways to reduce their costs while maintaining service quality.

Pricing gains and sustaining the momentum

Pricing, as a potential for gain, was largely unexplored in distribution until the last decade. Our book, Pricing Management: Capturing Value for Distributors,[7] was the first of its kind in distribution six years ago. Today there are numerous pricing consultancies courting the distribution market with customized consulting and software solutions.

From our perspective, pricing has the potential, in sales driven distribution companies, to increase operating profits 30% or more without negatively impacting sales volume. Most distribution pricing is cost plus and highly reactive. Most sellers control pricing and suffer from behavioral pricing impediments including Prospect Theory and the Upper Limit Theorem. The old saw, if you want to price consistently in distribution, is the two- finger pricing rule. The first finger is cost plus 20% and the next finger is cost plus 15%. Pricing in distribution is, based on our research and recommendations, inherently complex and real pricing gain, with a chance of sustainability, takes a year or more to develop.

Price sensitivity can vary by type of transaction, segment, customer size, buying situation, and geography. For consistent and manageable pricing to take place, pricing modules, embedded in the ERP software require substantial change. Most pricing software is simplistic and captures limited marketing variables to help make the pricing decision. Many distributors try coaching and sensitivity training for sellers on pricing but these "inspection" systems have limited effect as they are mitigated by behavioral pricing factors. Distribution, by most accounts, is a decade away from widespread adoption of professional pricing practices. Progressive distributors have funded the discipline with pricing managers and divorced much of the cost plus pricing from the sales force. As in the need for sales cost streamlining, the sales culture often limits pricing gain. Pricing professionals, however, eschew sales driven pricing and, with support, can give their employer substantial operating profit increases. To secure pricing profits, the cultural change involves moving from a sales culture to a more balanced firm that engages marketing and operations with equal power to drive results. Outside the industry acquirers, as previously noted, don't come with cultural biases for sales driven pricing and are more likely to use professionals to develop the function.

Getting the right person for the job

Substantial change, through acquisitive companies, will require management and leadership skills that are not always available in the distribution field. Most distributor executives are family members and run the business at their own pace and often to their unique lifestyle. Finding an existing executive who will press the firm for quarterly earnings increases and who consistently meets analyst and investor expectations is difficult. The skills and know how to run the business in a big business mode with outside shareholders is, more often than not, brought in from the outside. Outside executive management, however, has a spotty record in distribution. Any number of vertical market roll-ups from the 1990's failed because outside managers failed to appreciate unique aspects of the distribution business including sales relationships with key customers, the inability of employees to adapt to a high rate of change, maintaining relationships with key vendors, and the intangible but powerful value of service quality.

We see two stumbling blocks to selecting the proper leadership to sustain high multiple acquisition strategies. They are educational attainment and salary expectations. Since distribution is a mature business, educational attainment has lagged other industries. Our research in educational attainment by broad industry sector finds that the wholesale industry, in workers aged 25 to 64 years of age, lags the U.S. industry educational attainment average.[8] For

instance, workers with master degrees are 8.33% of U.S. industry average but only 3.76% of wholesale industry workers have master's degrees. For professional and doctoral degrees the U.S. average is 3.54% of workers but in wholesale industries, the number is .74%.

When compared to industries in similar channels such as manufacturing, wholesaling still lags the average. Manufacturers have 4.84% of workers with master's degrees and 1.13% of employees with professional and doctoral degrees. In our view, it will be difficult for acquisitive companies to substantially change distribution culture without advanced degrees in managerial disciplines. The U.S. educational system produces tens of thousands of MBA graduates each year with 2005 placements and salaries averaging $106,000 with bonus. We are pressed, from an experience standpoint, to find the degree in managerial and executive positions in distribution. There are the occasional C level positions with advanced degrees but rarely do we find the degree in middle and upper level operations and sales and marketing positions in the distribution sector.

Leaders skilled in driving earnings performance with outside shareholders in a quarterly environment will be needed in merchant wholesaling. Unfortunately, existing pay scales may not be sufficient to hire needed talent. Using the 2004 NAW Employee Compensation Report[9] and counting for inflationary increases of the past two years, our salary comparison of key C and V level job titles for wholesalers versus U.S. industry averages[10] finds that distribution executive pay lags the U.S average by a range of 30% to 40%. We used reference points of distributors over 20 million and publicly owned distributors as our guidelines. The reason for the low executive pay in distribution is unknown. Part of the issue may be because of the low earnings, there is low pay. Part of the issue in low pay may also be the perspective of family members who define "salary" to include extra job perks and run the firm to minimize personal taxes and maximize long term earnings for a greater forward sell price.

However, for the superior financial performance needed to drive earnings to cover high multiples, we believe pay scale, education, and experience will need to be more in line with that of public companies. The likelihood that this will happen, for the private equity suitors, is unknown. The probability that the existing pool of distribution managers will be able to fill the slots in high performance environment is likely to be low. Many candidates will be brought in from the outside but they should have respect and prior knowledge of the modus operandi and nuances of distribution.

In this vein, the strategy of Home Depot Supply is commendable. The entity purchased "smaller" distributors of several hundred million in sales and carefully studied them over a course of years before investing in billion dollar sales entities. Private equity firms are encouraged to follow this strategy before hastily purchasing distributors and/or approaching roll up strategies. Again, many of the roll-ups and buying frenzies of distributors, of the past decade, failed miserably. Those failure modes should be learned and the unique qualities of distribution studied before the acquisitive process starts.

Making changes to the operations platform while maintaining service quality

Operations change, for acquisitive entities, will be substantial. Costs will come out of sales and back door positions. Distribution, as previously noted, is a slow to change industry. For the remaining employees, it will be necessary to adopt better organizational change practices without disruption to customer service.

Far too few organizations recognize the imperative to change long held beliefs and to challenge paradigms that have served them adequately. Those few that do and that recognize the need to confront Collins' Brutal Facts[11] find the challenge to be the biggest, most difficult, most important, and most prone to failure in the firm's history. The generally accepted maxim is that

some 70% of significant organizational change efforts fail.[12] We remark, above, on the need to find and attract executives with suitable management skills. Suitable change management skills are a scarcity. We argue they are more scarce in a century old business with below average compensation and educational levels. And these skill sets are sorely needed.

In the acquisitive picture painted above, buyers will have two distinct organizational change issues confronting them. Either one, alone, would be cause for concern. Together, (and they must be taken together to achieve desired financial returns) they are cause for genuine alarm. In the acquisitive scenario, the buyer must blend the two organizations with their disparate cultures, compensation programs, information systems, and management styles. Having done so, the buyer is then faced with making the strategic changes to the sales function if the hefty multiples are to be justified.

Hell hath no fury like a concurrent merger and a sales restructuring

Some 50% of mergers and acquisitions fail to live up to expectations[12], and therefore, to justify the price paid. While hard data is difficult to come by in the distribution industry due to private ownership and financial nondisclosure, the world of publicly held companies offers some interesting, if not disturbing examples. The Hewlett-Packard – Compaq acquisition is a recent example that culminated in the resignation of the CEO, Carly Fiorina. Earlier, the widely hailed merger between Pharmacia and Upjohn turned sour very quickly as culture clashes and integration problems raised integration costs from the original estimate of $100 million to $800 million and the planned cost reductions and touted synergies never materialized. [13] Our own work in distribution finds that post merger sales of the acquired entity decrease between 10% to 25% and can last for up to 3 years or more.

One may assume that, within these and other organizations with dismal integration track records, compensation was at market or above and there was no dearth of advanced degrees as well as managerial experience. Why then the disastrous results? Simply, there was a failure to understand the implications of merging disparate organizational cultures and the impact of employee resistance to change.

Assuming the buyer's new organization survives the initial stages of the merger, the management is still faced with implementing massive changes to the philosophy, objectives, structure, and, in all likelihood, compensation of both the internal and external sales forces. In the best of times, sales force restructuring is known to engender fierce resistance to change and foster employee distrust and demotivation. This is in addition to risking catastrophic reductions in customer service and satisfaction. Hard on the heels of an acquisition or merger in this tradition bound industry, we expect more trouble in changing the front door disciplines. A sales culture, like that of most industrial distributors, is widely acknowledged to range between stalwart and recalcitrant.

Merging and Acquiring – Avoiding Disaster

It is widely held that some one-third to one-half of all failed mergers and acquisitions do so as a result of the failure to address the issues of culture and the employees' resistance to change.[14] While intra-organizational change is, in general, stressful and subject to the adverse reactions of employees, the changes embodied in a merger or acquisition are fraught with greater peril. As a general rule, the degree of organizational commitment and the perception of leader and organizational competence vary across the management hierarchy. Senior leadership, almost invariably, perceives the organization as more competent and capable to absorb change than do lower level employees. For the acquired, a different paradigm applies. Rather than identifying

with others in their place in the hierarchy, individuals at all levels come together in a unified block of fearful, stressed, resentful, and often resistant employees. Managers in the newly merged or acquired organization will see this manifested as higher absenteeism, higher turnover, higher error rates, lack of commitment to the organization, occasional sabotage and, more importantly, declines in customer service.[15]

While the temptation to launch a program of restructuring to capture the "synergies" [read downsizing] will be great, particularly amongst the private equity buyers desperate to see immediate increases in EBITDA and valuation, we argue against haste. Real improvements will come, as we argue above, in the strategic realignment of the sales function. Haste in cutting heads as part of the integration process will only render the strategically important sales initiative more difficult. Patience here, coupled with a detailed plan supported by solid analysis and proactive employee communications and participation will pay dividends. It is better to spend time on an intensive, upfront analysis and plan coupled with participation from key employees than in using ham-handed heuristics in eliminating heads. Successive studies have shown that employees respond less favorably to downsizing driven by short term cost pressures and desired profit increases than to a well explicated plan. Of course job elimination is unpleasant for those who must leave, but a well crafted, participative and reasonable strategy goes further in maintaining a sense of justice and equity which is be critical to maintaining the commitment of those left behind namely, the survivors.[17] The survivors will outnumber the leavers and their commitment is critical to future success. A poorly managed integration will result in unwilling survivors, who are not engaged, committed or creative but who remain out of fear or force of circumstances. This, of course, will dampen performance and, eventually, the remaining initiators and doers hunker down as they mistrust management's ability to understand and reward organic change through innovative risk-taking. Too often, those with seniority and big pensions find ways to leave or retire early and "leave the mess" to those with limited change options.

Sales Force Restructuring

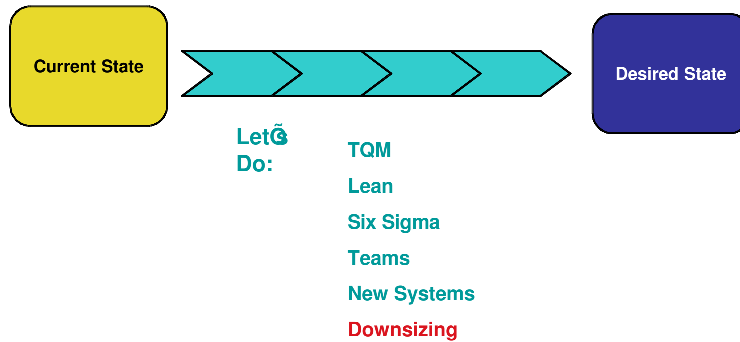
As before mentioned, the key to justifying today's high multiples, and to increasing the long-term profitability of Merchant – Wholesalers, is the strategic realignment of the sales function away from a geography to market based segments of interest. This event, alone, represents a significant change event in top management's understanding and philosophy. Following on the heels of an acquisition or merger, it represents a singular challenge.

Sahdev's[17] study of two downsizing organizations tells us first, that managers must resist the temptation to permit the downsizing imperative to drive the organizational redesign. This approach, in addition to being strategically unsound, smacks of a cost driven approach that will result in decreased organizational commitment and trust, increased hostility and the feeling, even among the survivors, that they will not be treated equitably by the organization. Rather, we argue, organizational redesign of the sales organization should be carried out with the maximum use of the three significant tools including analysis and planning, participation and communication. The involvement of as much of the affected organization as possible will lead to better decisions, more commitment born of trust, and to greater feelings of organizational justice on the part of the survivors.

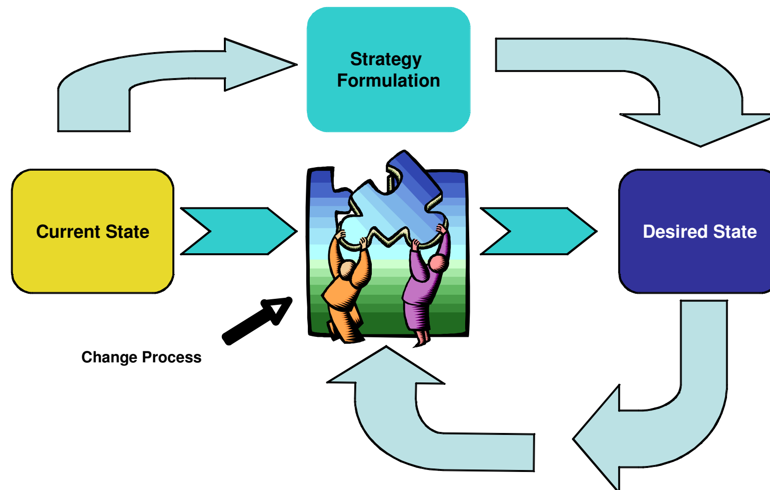
All too often, organizations leap at panaceas offered by the latest round of management gurus [easier to spell than Charlatan] before defining the current organizational deficiencies and the desired future state of the organization. We have seen distributors jump from Quality Circles, to TQM to Six Sigma to Lean in a headlong rush to "get better" without understanding the problem and how change will lead to greater customer value and higher profits. Similarly, in this situation, there will be a desire to rush headlong into downsizing before defining the deficiencies

in the current situation and envisioning the future, idealized organization. Only once this has been done, can the right tools, downsizing included, be employed. We conceptualize this approach in the figures below:

Typical Org. Change



Desired Organizational Change



In the model of desired organizational change, management and participants evaluate the desired organizational state, in this case, the state of the sales function and organization. They develop a strategy, use it to define the desired future state of the organization, then select the tools to employ during the change process. One of these tools is likely to be downsizing.

This approach has several advantages:

- It is likely to result in a more robust strategy.
- It clearly defines the end game and what the organization will look like.
- It encourages greater participation.
- It enables greater opportunities for senior management to communicate strategic visions and initiatives. Frequent, substantive communication has been repeatedly demonstrated to enhance the change process.
- It permits leadership to demonstrate competence.
- It builds confidence in the organization's ability to change.
- It builds confidence in the individual participant's ability to change.

These last three items are of particular significance. A variety of work in the area of sales force restructuring and change has demonstrated that sales manager and sales force readiness for change and acceptance of change is highly dependent on the perceived ability of the organization to change.[18] Participation by the current sales force in the sales strategy development builds confidence in the organization [organizational efficacy], the leadership [leader efficacy] and in the necessity and benefits of the changes [organizational valence] all three of which are critical to the acceptance of the changes.

Common Strategies

The reader will have noted several common themes in our discussion of the implementation of change. First, patience, as always is a virtue. A headlong rush into changes will result in increased resistance, disaffection, mistrust, and the defection of precisely those employees who must be retained and kept engaged and committed if customer relationships are to be maintained. Second, an explicit communication effort embarked upon immediately after an acquisition or merger is critical. It is essential that such an effort be completely forthright, sharing what is known and acknowledging what is not. Any hint of untruthfulness will simply reinforce issues of trust and commitment to the new organization. Thirdly, strategies developed with the greatest feasible amount of analysis and participation, inclusive of outside expertise as needed, should lead to a vision of the desired, future organization. This in turn, will lead to the appropriate actions as part of the change process. A well thought out strategy driving the actions will enhance confidence in the organization and its leaders, critical to the success of the changes, particularly in the sales force.

A Final Word

We are often asked about severance policies during organizational change events. We urge managers to think of severance and outplacement efforts as investments in the survivors rather than those who will be transitioning to new employment. Much of our advice concerning organizational change is intended to maintain an acceptable level of what is known as organizational justice – the belief among employees that the organization will treat them equitably. The communication, participation, and open strategy development efforts are all intended to bolster this. If those leaving the firm are treated with less consideration *than that which is perceived to be equitable by those that remain,* these efforts will be for naught. It is essential that management be able to look the survivors in the eye and assert that those who left did so as the result of a well formulated strategy, were not the victims of rash cost cutting, were treated fairly, with dignity, and with enough outplacement and financial assistance to ease their transition without significant hardship.

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