

Distributor Profit Trends in 2011: Sales Growth But Profit Stagnation

Every year the Profit Planning Group reports on the key profit trends in distribution. The analysis is based upon results for forty different lines of trade. The report benchmarks the key drivers of profitability and how management has been able to blend them together for improved results.

Since distributions lines of trade vary widely in terms of their gross margin and expense structure, the report focuses on how results changed during the year. That is, did the gross margin percentage improve during 2011 or did it decline?

The analysis breaks distributors into three broad industry segments:

- 1) Industrial includes firms selling largely to the factory floor,
- 2) Construction represents firms selling a wide range of building materials and suppliers and
- 3) Consumer firms are those selling consumer products or products that are utilized by retailers of all sorts.

For each of the exhibits results are compared directly to the performance of FEDA members.

Al Bates, who prepared the materials presented here is author of ***Triple Your Profit! Stop Being a Profit Soldier and Start Being a Profit Winner***, available from both Amazon and Barnes & Noble. Signed copies are available at: www.tripleyourprofitbook.com.

Introduction

Prior to 2011, distribution firms followed a somewhat predictable pattern in relationship to the economy. As the economy entered a recession, sales and profits tumbled. Coming out of the recession, both sales and profits improved dramatically. This pattern changed in 2011 (the last year for which information is available). Sales increased sharply, but profits did not. To understand why, it is necessary to examine the key profit drivers—the factors that put profit on the bottom line the quickest.

The key profit drivers in distribution are:

- Sales – Increasing sales volume so that operating expenses can be spread across a broad base of sales.
- Operating Expenses – Reducing the level of expenses, especially overhead, without reducing the level of sales volume.
- Gross Margin – Increasing the gross margin dollars without necessarily having to increase sales volume.
- Inventory – Reducing the level of inventory investment without lowering sales.
- Accounts Receivable – Lowering the level of accounts receivable without a negative impact on sales.

The Trend in Return on Assets

Exhibit 1 tracks the Return on Assets performance for distributors over the last five years. Return on Assets (ROA) measures pre-tax profits as a percentage of the total assets invested in the firm. It is the most important overall measure of financial performance. For distributors ROA fell from 8.0% in 2007 to 5.8% in 2009. Most profitability analysts argue that a 5% return is the minimum required to allow the firm to make the new investments in technology, reinvest in physical facilities

and maintain a strong position with financial institutions. By 2009 distributors, in aggregate, were barely above the reinvestment line.

ROA improved in both 2010 and 2011, but at an incredibly slow rate. By 2011 ROA was only 6.2%. At the current rate of improvement it will take ten years to return to the ROA that was generated in 2007. To a certain extent, distributors are following the slow-recovery pattern demonstrated by the entire economy. However, for distributors the pattern is actually very different when the individual profit drivers are analyzed.

Sales Growth

Profit stagnation could not be attributed to a lack of sales growth. As can be seen in Exhibit 2, distributors experienced outstanding sales growth in 2011. The industrial sector lead the way for the second straight year with growth of 14.5%. Construction, which had almost no sales growth in 2010 recovered with 9.0% growth. The consumer segment lagged with 5.6% growth. Even that should have been enough to substantially improve ROA, though.

It should be noted that the sales growth numbers presented here are significantly higher than what is reported for overall growth in distribution. Individual firms enjoy growth when competitors cease business or when competitors are acquired. The total market does not grow as a result of either factor but the firm does.

Considering sales growth alone, there should have been a substantial increase in ROA rather than the almost imperceptible .2% increase in 2011. Clearly, other factors were offsetting sales growth.

Change in the Gross Margin Percentage

The primary culprit in the inability to increase ROA quickly was a deterioration in the gross margin percentage. Exhibit 3 indicates the decline was across all segments. The gross margin percentage fell slightly in 2010. The decline in 2011 was somewhat larger. Neither the decline in 2010 or 2011 is large enough to be of concern by itself. However, when viewed in the context of the large increases in sales it takes on a much larger significance.

The decline in the gross margin percentage reflects a very normal "volume at any price" mentality that tends to predominate during, and at the end, of difficult economic times. However, at this point in the recovery and with the sales increases demonstrated, the trend to sacrifice margin for sales should have vanished. It has not. The fear of a weak recovery may be impacting gross margin performance. Whatever the cause, it is the single most important issue that needs to be addressed by distributors.

Change in the Operating Expense Percentage

The growth in sales did have the impact of driving operating expenses down as a percent of sales. This pattern was also apparent in 2010. Combined, they allowed firms to offset the significant expense challenges of 2009. As shown in Exhibit 4 this decline was also experienced across all industry segments.

The decline in operating expenses was larger than the decline in the gross margin percentage across all industries. This allowed firms to increase their operating expense percentage. However, rapid sales growth lead to some significant increases in investment levels which was reflected in non-operating expenses, especially interest.

High investment levels and higher interest expenses muted the increase in operating expenses. The net result was that ROA increased only slightly in a period of recovery when things should have gotten appreciably better.

The decline in the operating expense percentage, while welcome, was not as significant as would be expected given the sales growth. A lot more work is needed in controlling operating expenses in the future. For almost every line of trade in distribution the key to expense control is control of payroll expenses.

The Change in Inventory Turnover

Exhibit 5 shows that inventory turnover rates experienced a mixed pattern in 2011. The turnover for construction suppliers improved, it fell for consumer-based firms for industrial distributors reflected no change. The reality is that the changes, both positive and negative, were close to miniscule. Without a strong improvement in inventory performance rapidly growing sales necessitates an equally increase in inventory investment.

Whether the lack of improvement in turnover is a problem depends upon the level of sales growth that firms will experience in the future. If the trend in mergers and firm closings continues, then sales growth will be strong, regardless of economic conditions. This creates a mandate for making enhancements to turnover. If the sales growth slackens, then turnover improvements will be only a minor issue.

The Change in the Average Collection Period

Accounts receivable collection days presented a slightly better pattern than inventory turnover. According to the results shown in Exhibit 6, two out of three segments were able to improve their Accounts Receivable Day. At the same time, while things got better, they did so at an incredibly slow rate. Again, the net result when viewed with strong sales growth was a need for a greater investment in accounts receivable.

Moving Forward

Management is continually challenged to plan for the future while looking over their shoulder at historical information. That rearview mirror suggest strong sales growth, a deterioration in the gross margin percentage, an improvement in the operating expense percentage and more or less treading water with regard to inventory and accounts receivable. The net result is an increase in ROA that is close to glacial.

The problem is that the key profit drivers are not being combined in a way that causes sales growth to translate directly into ROA growth. It's time to make some changes in the key profit drivers. Gross margin is clearly an area of concern. Without a reversal of the current trend, higher profit levels will be very difficult to achieve. In addition, firms need to continue to make strides with regard to operating expenses. The declines related to sales growth were somewhat disappointing.

Dr. Albert D. Bates is founder and president of Profit Planning Group. His latest book, ***Triple Your Profit!*** is available from Amazon and Barnes & Noble. It provides a guideline on how to drive higher profit. It also includes two Excel templates to help firms understand the profit patterns in their own business.

Exhibit 1
Return on Assets by Year

