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McCormick Center
Chicago, IL
Oct. 5, 2006

Fill Rate Economics Leads To New Business Models

This is a 25 minute presentation that will be given at 12:30PM in the McCormick Center at the back of the main floor in the “education theatre” for the ISSA Interclean Show. It has a revolutionary message for many manufacturers and distributors that do too much LTL business, as well as full truck load line buys that have big hidden fill-rate costs on the slower moving items in those lines.

This slide show and the presentation are made possible by the support of the Sanitary Supply Wholesale Association; Executive Director, Donna Frendt. Contact her at dfrendt@sswa.com

THE HOOK FOR DISTRIBUTORS

- Grow sales by 10% overnight
- See inventory drop 20 – 50%
- 50% of Δ GP$ to profits
- Free 20% (+) of management time
- Better 1-stop-shop programs for accounts
- Retain customers better

If distributors partnered with the right master distributor ("wholesaler"), then very quickly they would achieve the economic improvement benefits in this slide. Sales would grow 10% simply because of higher everyday fill-rates for having the exact items in the right quantities that customers want.

Inventory investment would drop by 20 to 50%, because of every night replenishment from the wholesaler's facility.

Because average order size would also increase due to higher fill-rates, 50% of the incremental margin in the extra 10% of sales would fall to the bottom line because the fixed cost of the paperwork and delivery costs in the transaction are fixed. On the other hand, when a distributor ships partial orders, split orders and backorders because of not having higher fill-rates on the items that a customer wants to buy, profitable orders become transactional cost losers.

THE PATH TO THESE RICHES?

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<u>Think deeply about fill-rates</u>

a) 1-stop-shop, in stock = foundation of

- **Basic service brilliance**
- **Retention (+) order-size economics**

b) Different stockout costs

- **Lost: order, data, customer**
- **Substitutions' delayed costs**
- **Split-ship costs vs. larger order $s**

Most channel players don't measure the costs of not having higher fill-rates than they have. Some do measure fill-rates and try to improve them in traditional ways. But, most are too focused on margin percentages. If we think about the hidden costs involved in:

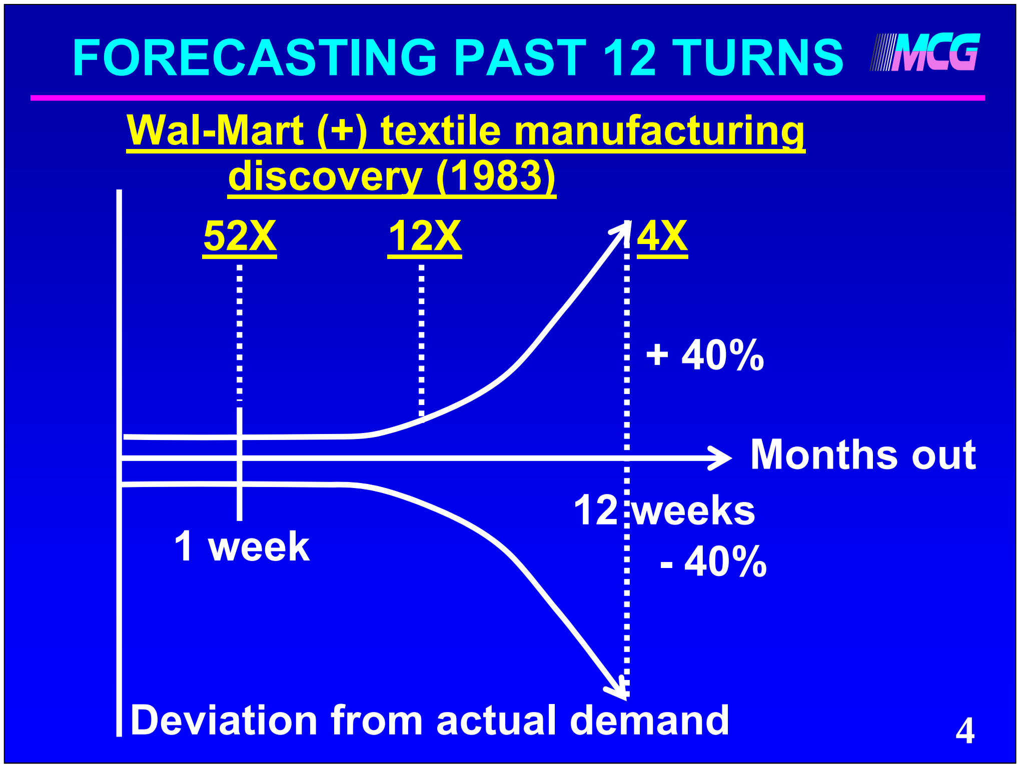
• lost orders

• split shipment orders

• substitutions with incorrect demand forecasting data captured

• overall customer satisfaction retention economics

then we can start to look for breakthrough solutions to improve fill-rates or reduce stockout costs.



This graph illustrates that we are pretty good at forecasting what we might sell of a given item over the next week. But, once we have to guesstimate at what we will sell for a given item past one month we start missing the actual amount by accelerating amounts to the high or low end. According to average statistics, an item that turns 4 times per year, or every 3 months, has a good chance of being stocked out way before we have a chance to reorder it again or, we still have way to much of it when it comes time to reorder. The message of the slide is that unless every item in a given supplier line turns more than 12 times per year, we will have fill-rate problems with the items that turn less than 12 times per year. Of course, if we are ordering cases and even skids as needed from a wholesaler everyday on an automatic replenishment basis, the turns and the fill-rates go way up.

WAL-MART QR BENEFITS

1. Reduce inventory 50%; double turns
2. Fillrates 90% → 99.6% $\boxed{+ 9.6\%}$
3. Added SKUs 20,000→ 40,000→ 100k
4. Same store sales ‘85 to ‘90 $\boxed{+73\%}$
5. Reduce operational costs -5%
6. Cross-docking in DC’s

This slide explains what Wal-Mart’s shocking discoveries were about fill-rates and total cost reduction by routing all big volume items through master distribution centers using their automatic replenishment solution that they called “quick response”. K-mart was, at the time, taking direct store delivery of full truckloads of the biggest consumer product items and didn’t wake up to this breakthrough disadvantage until the late ‘80s.

GP TRUCKLOAD LINE BUY?

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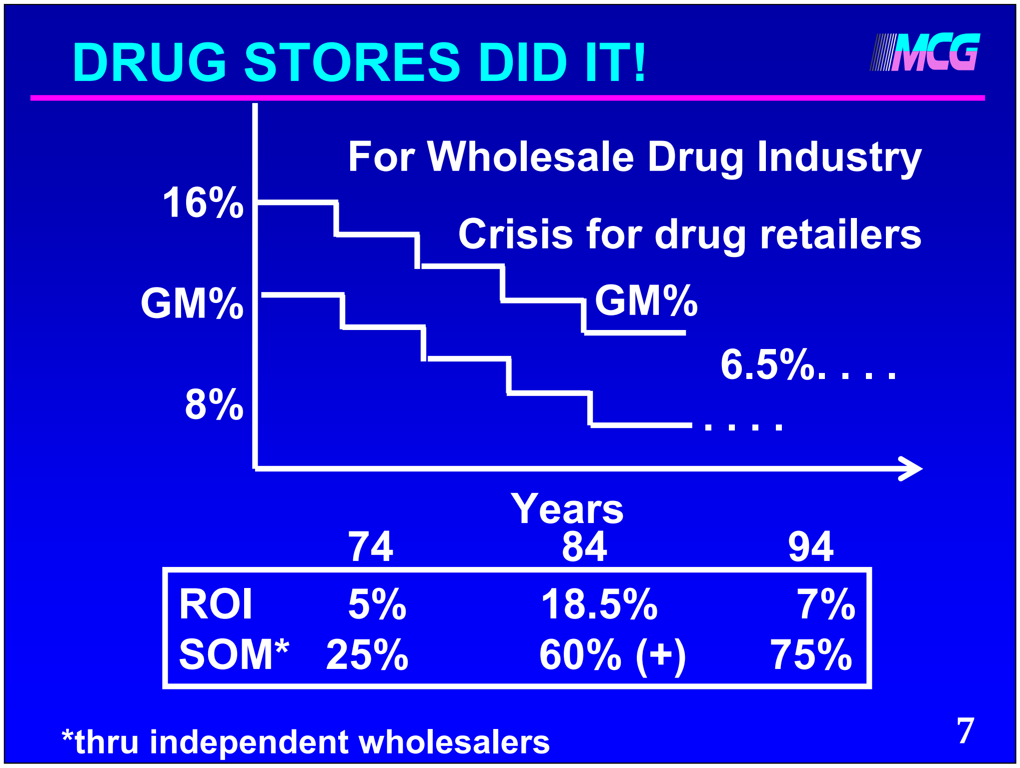
- 30+ SKU's
- 20% (6) → 80% sales?
- 24+ items are - excess/stockout; substitution (+) - problems

6

This is a simple case study from an industrial paper distributor that was buying truckloads of GP paper products direct. When they stocked out of the 24 items that turned slower than 12 times they would start to substitute other GP items and competitive brand SKUs. But, they didn't handle demand replenishment data correctly. As they bought emergency amounts of cases from a wholesaler it undermined their ability to re-buy the right SKUs in the right quantities on the next truckload. There was more systematic pain that evolved from this that we won't go into here.



Back in the early ‘70s regional drug store chains were trying to buy evermore products direct into their own distribution centers. But, they weren’t good enough on the slow moving items and all of the pharmaceuticals, so the trend reversed itself. The chains started to outsource the central distribution activity back to the traditional wholesalers on a 100%-let’s-get-married system basis. This allowed the wholesaler’s traditional margins to drop but profits rose because the order size economics, the automated replenishment savings, and the volume benefits exceeded the margin erosion. The share of product that flowed through wholesalers stopped dropping and soared. Why do industrial paper and Jan-San manufacturers and distributors not see this potential business model that leverages wholesalers existence? The foodservice channel has switched volume through Dot Foods to keep it growing at 20% a year compounded annually for over 40 years. Sysco was doing so much with Dot Foods, it decided to get into the master distribution center business. They plan to spend $1B on eventually 9 centers. If you want to know more about Sysco’s progress email Jason Whitmer, the best fundamental investment analyst on Sysco at jwhitmer@cleveland-research.com.

MARRY MASTER WHOLESALER(s)?! MCG

1. Sell today; replenish overnight
2. Cross-dock for next day delivery/pick-up
3. Whole-tail store sells 9K + SKU's virtually via web kiosk(s)
4. LTL shipments $\downarrow$ > overnight stops $\uparrow$
5. Forecast 1 – 2 weeks for skid-buy items
6. Entire new business model possibilities

The big idea of this slide is that whatever a distributor might sell out of their location during the day could be picked on the swing shift by a wholesaler and delivered on the grave yard shift to a lock up area. This would allow items to be cross-docked first thing in the morning, either for local delivery or pick up at a storefront. If a distributor stocks 1000+ items, but the wholesaler stocks 10,000, then the extra non-stocked items can be sold during the day for next day delivery or pick up.

BUT! QUESTIONS (WITH ANSWERS)

1. Don’t power players buy STL direct?

2. Some mfg’rs sell LTL for same price/less?
   - Permanently?
   - If turns less than 12X; both lose ?

3. Local rep will work less for me?

4. Special pricing, bill-back rebates?

5. Wholesalers overcharge? Sneak price up?

STL = straight truck loads

Self explanatory (?) If not, contact me for more information.

HOW DO YOU PICK A PARTNER; IMPLEMENT?

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1. Most SKU's; best fill-rates; nightly delivery?
2. VMI, barcoding, web site marketing?
3. Pass-through EDLP; open-book assurances
4. Speed of implementation; financing?
5. How fast to get there? (drug-10 years)
6. Others?

VMI – vendor managed inventory
EDLP – everyday low pricing

Self explanatory (?) If not, contact me for more information.

WILL MFG'RS EXIT L..T.L. BUSINESS?

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1. History says "yes"
   - Wal-Mart; drug; foodservice (slower)
   - CoLinx* manufacturer utility model
2. If all players look at total economics, then, first-movers will go . . ., then. . .

The Jan-San Channel Will Shift

*Colinx.com

Self explanatory (?) If not, contact me for more information.

This presentation may be taped to some degree and available over the web, we'll keep you posted on this.

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