INTRODUCTORY COMMENTS TO CHAPTER 1 DRAFT OF REINVENTING DISTRIBUTOR PROFITABILITY:

Greetings:

This document is a draft of the first chapter of my forthcoming book, Reinventing Distributor Profitability. We encourage you to:

- Tell as many people about it and where to find it (www.merrifield.com) as possible.
- Although it is copyrighted, we grant you permission to copy and circulate it widely.
- Give us feedback. Be editors on all matters. We have already made many changes to Chapter 1 because of feedback from readers. Send critiques and questions to bruce@merrifield.com

We expect the book to be available in paperback in the late fall. Before then, the book will have it's own web site at which we will post outlines of the remaining chapters along with other related features.

Progress on the book will also be reported in our "Distribution Channel Commentary" (DCC) weekly series. For the entire series of DCCs, look in the upper right hand corner of our home page. The series has been and will continue to be on a sporadic summer vacation until mid-September. For those of you who would like an automatic mailing of any new DCCs which normally go out on Wednesdays in an attached "word document" format, please send your e-mail address to karen@merifield.com.

Here's hoping that Chapter 1 will pique your interest and start you on a path towards reinventing your strategy and way of business to grow faster than your industry and increase your financial returns several times.

Sincerely,
Bruce Merrifield
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SUMMARY OF CHAPTER ONE:

The first section of this chapter points out that by being product, volume and cost driven, 95% of distributors have competed their way down to a return on capital on which they can't survive longer-term. They need to overhaul their strategic thinking.

To that end the chapter then reviews six "strategy maps". Most distributors will be familiar with some of the wisdom in some of the maps, but 100% understanding of all of them put together is necessary for each distribution location to find its best starting point for "reinventing distributor profitability". This book is a process book that is aimed at helping every distributor find their unique, elemental value-paths to pursue in a continuously innovating and differentiating way.

The chapter has a disguised case study on "ABC Distribution Company" that is actually a composite of two different durable goods distribution firms that have applied the strategy maps. Because this chapter is conceptually heavy, some readers might do well to skim through the included slides and underlined statements. Then, read the case study towards the end on ABC Distribution. And finally, go back and read through the strategy map in detail.

CHAPTER ONE

RETHINKING STRATEGY

Chapter Brief:

Productivity is the essence, of profitability, of competitive advantage and therefore of survival. But increased productivity goes far beyond cutting costs. Profitable distributors, (and there are some) operate targeted strategies. As a result, the top 10% of all distributors, even in 2001 a recession year, averaged pretax returns on total assets (ROTA) of 15.4%! The bottom 90% of distributors averaged 5.4%, about the same as risk-free bonds.

The point that these data make is that being driven only by product, volume and cost, in a hyper-competitive environment, is a recipe for extinction, with the dumbest, most desperate distributor determining the bottom price for 90% of the distributors who follow this terminal strategy. By contrast, the top 10% have developed specific strategies which maximize "value" to both the consumer and to the distributor. Moreover "value" varies not only from niche to customer niche, but also even for each customer within a niche.

This chapter identifies five critical procedures for (1) defining profitable niches; (2) for measuring the value and composition of each niche; (3) for developing a service formula for effective selling into a profitable niche; (4) for managing lowest cost niche-focused economics; and (5) for deploying resources now spent on losing accounts. There is no magic here, just solid planning and execution, which a determined CEO can manage in a reasonable time. Remember: 40% of all accounts generate 155% of the profits before income tax (PBIT), but the other 60^ of all accounts lose 55% of PBIT.

Sustained distributor growth and profitability is feasible even in economic down turns, but a concerted and well-guided effort is required. Reinventing Distributor Profitability provides the guidance.

Map 1

A DISTRIBUTOR CUSTOMER PROFIT RANKING

% of Customers		What % of "PBIT"
Top	10%	95%
Top	20	145%
Top	40	155%
Other	10	Breakeven
Bottom	20	(55%)
	100%	100%

A FINANCIAL PROBLEM FOR DISTRIBUTORS

We are currently at a crisis point within independent distribution channels in the US. Over 90% of wholesale distributors have a "strategy" that isn't making enough profits to survive the slow-to-no growth, no-pricing-power future that will persist for the foreseeable future. Is their financial pain great enough to consider reinventing their "strategy" and operational ways? Time will tell.

To measure the unfolding crisis, I stay in touch with my old friend and professional colleague of 20+ years, Al Bates, the founder and Chairman of The Profit Planning Group in Boulder, Colorado. Al runs comparative financial surveys for over 40 different distribution channel groups. He has amassed a 10+ year database of financial history for about 4000 companies with over 12,000 distribution locations. These firms vary in size from the smallest to the largest.[1]

Al's database reveals troubling profitability trends for distributors. The one best comparative ratio to use for all distributors is pre-tax return on total assets (ROTA)[2] for which the trend is not good. The ROTA averages for the entire database trended to a bottom in 2001 and appear to be, depending upon the channel, sliding a bit further or holding steady for year 2002 numbers that are starting to be published. In '01, **the bottom 90%** of all distributors in the database averaged a measly **5.4% ROTA,** while the **top 10% averaged 15.4%**. With clever use of debt leverage, the top 10% can make 4 to 6 times the after-tax return on shareholder's investment (ROI) that the bottom 90% did in 2001, and they have been growing faster. Good comparative performance in tough times is possible with the right strategy!

THE ROOT CAUSE PROBLEM: GETTING PAID FOR SERVICE VALUE

Poor ROTA numbers are symptoms of what root cause problems? Many distributors are quick to portray themselves as victims of a truly poor economic environment. Supply exceeds demand and is still growing. There is, at least, a 25% domestic, excess capacity to make and perhaps distribute tangible goods in all channels. Meanwhile, less expensive capacity to manufacture most tangible goods is and will continue to grow much faster than global demand for a number of reasons.[3]

Many smaller, domestic manufacturers are now starting to shift production to China before big distributors beat them to it with their own private label brands from the same Chinese factories. I have seen equally excellent products from China that have had landed costs of 10 to 15% of what domestic manufacturers have been charging (for how much longer?). Moving manufacturing to China is taking on a still-accelerating, gold-rush mentality.

Because of the both the China production factor and hard pressed end-users shopping more aggressively, pricing power will not exist for the foreseeable future, and the margin erosion game will continue. The game often goes like this:

- A good customer of yours puts business out for bid.
- A "dumb competitor" using marginal cost thinking bids lower;
- You get a chance to meet the low bid and do to keep the business using marginal math.
- Having lost margin dollars needed to pay the bills, you go after some new business with marginal cost thinking and get to play the "dumb competitor" role to some other entrenched distributor.
- The result is a downward spiral "started by the other guy" with the "dumbest, most desperate competitor" determining the bottom price for 90%+ of distributors who are price takers.

What happened to getting paid for "service value"? Put to a test, how many of us can specifically and confidently define "service value" in way that is both meaningful to the customer and profitable to the

[1] Al Bates authored a big study on 10 year trends entitled "Improving Distributor Profitability" available from www.nawpubs.org.

[2] Productivity is output (profit before interest and taxes) of a system (firm) divided by input (total dollars of assets invested). The capital invested doesn't care about sales, margin %, expenses – just give it a high enough return and it will stay. Too low and it will convert back into cash and seek a higher return somewhere else.

[3] To understand how the "dollar standard" global economy over-stimulates third world manufacturing capacity headed for the US, check out: The Dollar Crisis by Richard Duncan. Wiley, 2003.

distributor. The definition of "value" will vary generally by customer niche and then more specifically by each customer within a target niche. Most distributors could do a much better job of:

- Defining their most profitable customer niche(s)
- Defining their total service value offering and service metrics for those niche(s)
- Measuring, achieving and selling that service formula better than anyone else
- Executing at the lowest cost, because of better customer niche-focused economics
- Financing the improvement of their better, focused service by re-deploying resources spent on, heretofore, losing accounts that are in other niches for which the distributor has no chance of dominating locally.

Having a current strategy of "good service"- in a general, well-meaning sense for too many different kinds of customers - isn't providing the competitive edge needed to avoid becoming a price-taker. Hoping to be a survivor amidst too many me-too sellers doesn't look promising.

If any readers have been blaming the economy for their weak numbers and think they compete effectively with the general statement of "good service", then your temperature may now be rising. I apologize, and encourage you to relax, because you are in good company. All of us, even the top 10%, are guilty of the same shortcomings to some degree. Instead, take a deep breath, and skim through the "customer IQ quiz" at the end of this chapter. Perhaps 1% of all distributors would pass the quiz, the rest of us have lots of upside opportunity if we should choose to determine the right answers.

WHAT IS A GOOD ROTA TARGET?

Isn't a 5.4% ROTA average for the bottom 90% at least survival? For now, yes; long term no. The return isn't enough to give shareholders a minimum return on their investment considering the risk that they are incurring for being in a typically private, illiquid investment. Good capitalistic stewardship demands that shareholders should sell, exit, liquidate or fix the bottom 90% of distributors as soon as possible. (How's that for a thoughtful shareholder challenge, especially in a family business?)

If the shareholders don't do something, then the best employees, customers and suppliers will leave for greener pastures (like the top 10% of distributors) as soon as they can. A 5.4% ROTA will not generate enough re-invested profits to finance even a mediocre improvement path for these other stakeholder groups.

The top performing distributors, in the meantime, are not only making and reinvesting more money with the same tough economy, they are growing faster than their industry average as they slowly take from the bottom 90% on a profitable basis. How? I would assume that: they have a more precise definition of a best strategy for their firm; and that, they have been doing more innovating and investing in a more strategically focused way than the bottom 90%. If the bottom 90% don't stop waiting for the economy to get better and settling for being survivors, then most share the risk of frogs sitting in a pot of slowly heated water: being unable to jump before being boiled.[4]

What is a minimum average ROTA that a distributor needs to keep all of his stakeholders – employees, customers, suppliers and shareholders – satisfied (although not the company of choice for the best quality stakeholders) for the long run? In our current total investment environment, I would guess about **a 10% average ROTA**, which isn't easy to achieve when you are trying to survive a tough economy.

[4] Biological phenomenon: when frogs are placed in a room temperature pot of water that is slowly heated, the warmer water makes the frogs groggy and unable to jump before the rising heat finally boils them to death.

Besides a lack of strategic focus and clarity, there are two other factors that could be holding distribution CEO's back from orchestrating successful turnarounds: past commitments and lack of extra resources. Distributor CEOs/principals are, generally speaking, a conservative, hard-working, upright and conscientious group who have all made past commitments to stakeholders during better times. When wage cuts have had to be done over the past few years, CEOs have often taken the first and biggest reductions. They then have been the ones to lead by example by putting in more hours to shoulder more tasks that used to be done by those who are now gone.

Most executives that I have visited with also know how to run their businesses a lot better than they are doing, but they don't have or feel that they can afford the up-front investment in resources – time, talent and treasure – during these tough times. When we are underwater breathing through a bent reed it is tough to rethink how we might get to high ROTA land. We, instead, tend to reflexively just hunker down, do what we know how to do harder, faster, more cost effectively in an effort to survive while waiting for a recovering economy to provide some relief and flexibility as it always has since WW2.

THE LONG-AWAITED ECONOMIC RECOVERY MAY NOT HELP

Hunkering down and waiting for economic recovery relief hasn't worked so far in the "post-bubble" period since there hasn't been a strong recovery! (Distributors of MRO goods to manufacturing plants have weathered 36 straight months of manufacturing layoffs and counting). According to the "normal recovery" pattern since WW2, our current economy was supposed to respond to each of three rounds of economic stimulus – lower interest rates, more money supply and tax cuts – in each of the past three years. However, for the first time since 1929, three rounds of medicine have not worked.

As I write this (08/03), economists are still hoping that their consensus forecast for a "second half recovery" will happen the third time around. After three straight quarters of anemic activity around the globe (except for China) plus massive stimulus in the US, Europe and Japan, we are due for some sort of a bounce. But, any bounce will run into the following headwinds:

- Rising factory unemployment due to still accelerating Asian import growth to the US;
- Our growing, collective debt mountain - $38T of interest bearing debt supported by a $10T economy. Debt is currently growing five times faster than the economy; can we borrow and consume our way to prosperity and a sustainable recovery? Will consumers spend or save their tax rebates? Is there any pent up demand left for autos and houses? The two industries that normally pull us out of recessions never went into one.
- 25% + excess plant capacity. Why spend on capital expenditures when revenue forecasts are flat with excess capacity on hand?

Modest recovery or not, the global excess capacity for physical products coupled with slow growth, at best, guarantees **no pricing power for sometime**. Instead of using hope for a strategy, perhaps it is time to systematically re-think our company strategy using some different lens or "strategy maps". Most every distribution location has hidden upside potential and a best affordable, do-able path out of the swamp to a higher ROTA point in the marketplace, if we could just see it with the help of some new perspectives.

For generating new strategic perspectives, we will do, in this chapter, an overview of six "strategy maps" with more in-depth detail in subsequent chapters. Many readers may know much of the theory behind most of the maps, at least in an intuitive way, but that is not sufficient for either gaining breakthrough insights or for convincing ALL employees to support a general reweaving of corporate capabilities. We have to be able to teach all employees the why's and how's of what these maps suggest in a comprehensive, integrated, understandable and believable way, so they can be part of the solution instead of part of the problem.

“STRATEGY MAPS”

After reviewing the six “strategy maps” that follow, we will systematically apply them against our “traditional thinking and practices” in Chapters 2 and 3. This exercise will help us to name and claim the ineffective assumptions and cultural habits that have been holding us back from being more successful at doing more of what we know we should. Then, with hopefully more open minds, we will be able to revisit and apply strategy map wisdom in far greater detail in later chapters.

MAP #1: CUSTOMER PROFITABILITY RANKING REPORTS (“PBIT/CUSTOMER”[5])

Here’s an assumption followed by a related question:

Assumption: “Our strategy is where or how we make our sustainable profits.”

Question: “Where do you make your profits; from your products or from your customers?

If we had to choose one of the two as the primary creator or driver of profits, most distributors today would say “customers”, because their products are commodities that all other competitors already do buy. Exclusive supplier franchises that will grow both sales and profits if we just do what the manufacturers tells us to do, generally don’t exist for most distributors any longer.

As for the profitability of customers, most distributors know that not all customers are profitable and that the profitable ones vary in degree. Few would know of or believe the “150/20 rule” which states that: on average 20% of a distributor’s customers will generate 150% of their profit before interest and tax (PBIT).[6] This pattern was confirmed by the results of a customer profitability analysis that I did (figures below) before launching a turn-around for a distribution company in the early ‘80’s.

Map 1

[5] PBIT = profit before interest and taxes. It is a synonym for “earnings before interest and tax” (EBIT) and “operating income”. I will use “PBIT” and “PBIT/Customer” continuously throughout the book.
[6] From, Angel Customers and Demon Customers by Selden and Colvin. Portfolio Press, 2003. P. 56

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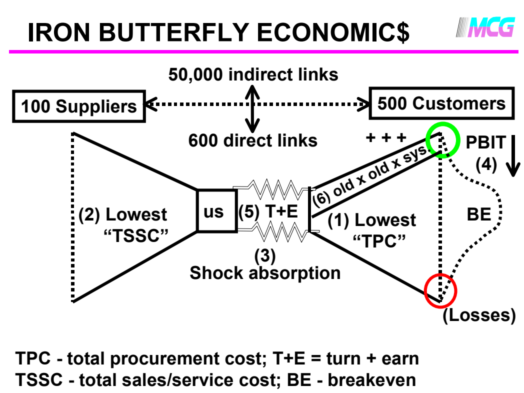
Every distributor's top 10, most profitable customers are unique to them. The distributor and its top 10 accounts have, perhaps unknowingly, trained each other to match up inventory breadth and depth fill-rate capability with customer needs. This needs-service match is a unique, local-stocking, service value proposition that no other distributor happens to have at the moment. And, once defined this service capability can be easily improved to support fast, incremental and very profitable growth.

These 10 accounts will be key guides for helping any distributor to better define and penetrate what their historic, perhaps somewhat hidden, best strategic niche has been. Customer profitability, ranking reports generate a number of different plays that will be covered in detail in Chapter 4. These plays will help every distributor to reweave their culture around being "customer profitability centric". The "PBIT/customer strategy map" may be the single most important map for new insights.
Ah! I can hear the "Yes, but" questions popping up in your mind already. Most of them will be answered in Chapter 4's in-depth discussion of the how's and why's of customer profitability analysis. For now, lets move on with the overview so we can use the maps to surface our cultural thinking habits in Chapters 2 and 3.

MAP #2: "IRON BUTTERFLY ECONOMIC$"[7]

Map 2



[7] "Iron Butterfly Economics"(IBE) may confuse you for two reasons: the "Iron Butterfly" is a heavy metal rock group that released its first album in '67. In July of '68, the released a second one with their biggest hit, ***In-A-Gadda-Da-Vida.*** Then, there is a book entitled "Butterfly Economics" which is on chaos theory. My hope is that I can give new, unforgettable meaning to "IBE" for use in teaching channel partners how to work better together.

Don't be scared by this slide's complexity, it explains a number of foundational concepts for distribution from which all distributor strategy must be built. First, here is an explanation for the phrase. I choose "iron" to connote reflect the fact that physical goods distribution is an irreplaceable function in the channel. The "butterfly" (or some may prefer "bow-tie") comes from the general appearance of the diagram. And, the "economic$" has to do with the transactional cost consolidation benefits of a "hub" or in this case distribution location.

HUB ECONOMICS

What are the hub economics? There are a number of elements to the answer. On a big picture basis, there are two scenarios for connecting suppliers with (end-user) customers. First, imagine that the box in the middle of the diagram is a distributor that buys from 100 suppliers on the left in large, skid or truckload, quantities that come into a warehouse that has perhaps 10,000 Stock Keeping Units (SKUs). Then, 500 active accounts on the right order items in small quantities. The number of direct lines it would take to connect the 100 suppliers directly to the 500 customers would be: 100 x 500 = 50,000. If, alternatively, each supplier sells into a distributor that in turn sells out to 500 customers, the number of direct lines becomes: 100 + 500 = 600. Can you intuitively appreciate that the huge consolidation of lines from direct selling to indirect selling saves both suppliers and customers a lot of transactional costs?

To dig deeper into exactly what these transactional savings are and what they are worth, we should look at:

- The 11 elements of "total procurement cost" (TPC) for customers.[8]
- The elements of "total sales and service costs" (TSSC) for suppliers.

These costs will vary for every channel partner relationship. But, generally speaking for now: end-users pay a higher price per unit when buying from the distributor than if they bought in larger quantities directly from the supplier. But, when they buy from a distributor, the other 10 elements of their TPC will go down more than their price will go up. End-users receive a better total economic value or lower TPC at a higher price than direct buying.

On the flip side of the equation, suppliers could sell direct in smaller quantities to many more customers at a higher price per unit than what they sell to distributors in bulk. But, the suppliers' total costs for selling and servicing 500X more customers and orders will rise much more than their incremental mark-up margin, so they will make less profit. Suppliers can reach more customers, sell more total volume and make more money by going through distributors.

SHOCK ABSORPTION SERVICES/FEES

Another hub economic element is the value of "shock absorption" services (#3 in the diagram) provided by distributors for both sets of channel partners. Inventory buffer value is most important to those manufacturers with the longest, most variable lead times and/or the most unpredictability in the local demand for their products. The buffer value is most important for customers that have the most frequent, random, emergency needs in both variety and quantity of goods.

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[8] For more on "TPC" go to www.merrifield.com, click on articles and check out articles #ed 4.2 and 4.3. "Selling the lowest TPC" will be covered in detail in chapter__. The definition of and selling TPC are also the topics in modules 4.11-13 in the Merrifield video, "High Performance.." The 11 elements fall into two sub-categories: buying costs (price, shopping time, paperwork, expediting, mistake curing, receiving) and holding costs (storage space, inventory financing, control, shrinkage, taxes/insurance).

At the other extreme, manufacturers of consumables (e.g. disposable diapers) that have steady, predictable, high-volume, local demand may ship directly to a retailers store or distribution center in big quantities and the stores still get high turns. In such cases, the independent distributor has seemingly been eliminated or by-passed. The reality, though, is that both the manufacturer and the big retailer have both absorbed the costs of doing the irreplaceable distribution function into their own operating budgets.

Another common shock absorption service by distributors for customers is to "solve my uncertain or odd product need". Like an experienced hotel concierge asked to find seemingly odd items at the spur of the moment, the experienced distributor does solve most special problems quickly, because they have done them all before for other channel partners. A rare problem for one channel partner is a perhaps even a routine one for the intermediary that serves as an out-sourced, economy-of-solution provider.

Because out of sight is often out of mind, channel partners will often take these shock absorption services for granted and free, if distributors don't measure true, extra costs and values and market them to earn special fees to insure making a profit. Distributors assume they will cover these costs and then some with their markup on their regular product sales to the customers, but according to PBIT/customer analysis they usually don't. 80% of the typical distributor's customers are currently at break even or profit losers.

MAXIMIZING BUTTERFLY ECONOMIC$

Perhaps the biggest insight that can come from the butterfly slide is the result of combining points 4, 5 and 6 on the slide. The # 4 is located at the "high, positive PBIT" end of the bell-shaped curve for customer profitability that has been drawn down the right hand side of the slide. What dynamics account for why our most profitable customers are that way? There are two inter-related causes. These customers buy a lot of the same, (#5) high-turn x high-earn SKUs from us on an (#6) (semi) automated, larger-than-average order size basis with predictable, annual volume. Another phrase for this type of purchasing activity is that "old"(good volume) customers are buying "old"(good selling) products on a "systematic" basis. On the slide, the shorthand for this pattern is: "old x old x sys".

The more line items a customer can buy from us per order, the more TPC value we are delivering to them. If we, for our part, have all of the right items in stock and execute without error, then we do fulfillment at the lowest total sales service cost. The difference between their maximum TPC value and our minimum TSSC is a distributor's primary source of structural, sustainable profit power for warehouse sales.

A competitor can offer lower prices on one big volume item that a core customer may buy, but the incremental cost to the customer of having two suppliers with two sets of transactional costs will exceed their price savings. For a competitor to be a real threat to us, they would have to stock ALL of the same, right items, in the right stocking quantities at the right location with consistent fulfillment execution AND then offer a lower price. But, could they then get enough other similar customers buying a common basket of items to get even more turns to offset the lower earn they will have from their price cutting? Not if we dominate the niche of customers that buy the common basket of items!

A summary set of math relationships for butterfly service economics is:

Customer service/TPC value > our price > our cost => structural, sustainable PBIT POWER

Big Question: How can we further maximize butterfly economic$ by selling yet more "old items to more old (common niche need) customers and do so on a more systematic, routinized, automated basis?

- Identify a common group of customers that all buy the same basket of common items.
- Selectively, strategically round out that special sub-group of one-stop-shop items and beef up our investment in them to have the highest, local, competitive fill-rate capability.

- Team-sell the 5 to 10 most important customers on TPC system possibilities.
- Go for a high share, 50 to 85%, of the most profitable customer volume within the target niche, so that their collective demand will give us a high turn-earn for the investment in the common basket of items.

There will be more on butterfly economic$ throughout the book. For now, the first two maps explain a paradoxical promise of the book. Strategy by definition is what makes your business different by having a unique, valued offering that produces profits. You can only achieve a competitive edge, by not following and matching the herd. How can a book's one recipe for reinventing distributor profitability give all distributors different strategic outcomes? By applying the maps for PBIT/customer and butterfly economic$, most every distribution location will find their own unique strongholds from which to begin value improvement and customer niche penetration paths.

Here is an analogy. Most distributors have been spraying too many product (promotion) offerings at too many customers for a long time just like spraying spaghetti at a wide wall hoping some will profitably stick. For accidental and mysterious reasons some clumps have profitably stuck better than most. The PBIT/customer drill reveals a unique starting point for any distributor, and butterfly economic$ applications will help any distributor to figure out:

- Why the profitable accounts that they dominate are that way, and,
- What unique common item baskets can be sold more thoroughly to what unique, local niche of customers on a high-value, low-cost basis?

This book is a process book that is aimed at helping every distributor find their unique, elemental value-paths to pursue in a continuously innovating and differentiating way.

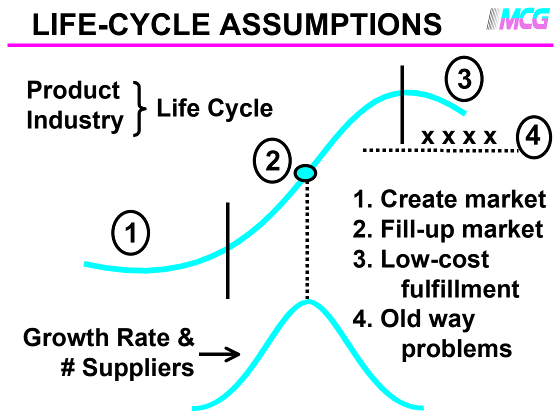
MAP #3: CORPORATE LIFE-CYCLE CURVE

Most of you have seen the s-shaped life cycle curve below. It can be applied to the growth rates and stages of maturation for products and industries. The diagram below has some additional features.

The bell shaped curve underneath the s-curve illustrates how an industry's year-to-year growth rate will continue to accelerate to an inflection point in the S-curve (2), then decelerate to some mature replacement grow rate (3). The bell curve also reflects the growth rate for the number of individual competitors that jump into an exploding market opportunity before they then consolidate or exit as the economic competition intensifies during the maturing stage. By example, imports for manufactured goods from China increased 34% in the first quarter of '03 over Q1 '02. This was the highest y-o-y growth rate yet on an ever, bigger base number. The Chinese assault on our manufacturing base is still accelerating; it hasn't yet hit point #2 on the curve. When will it? Who knows? The curve isn't a forecasting tool, as much as a general trend discussion tool.

Most distribution channels –manufacturers, distributors and end-users - are all at point 3 on the s-curve experiencing: consolidation, eroding margins, and a customer needs shift to buying established commodities in a "lowest-cost, demand (pull) fulfillment" (or total procurement cost: TPC). But, most channels persist in giving end-users far more product push/promotional activity than they want.

Map 3



As we look at this slide, a big question is how much does our corporate – culture and capabilities – lag behind what our customers really want and will pay for? Most companies in mature industries lag customer needs by varying degrees. Successful change or innovation is often a matter of minimizing the gap better than the competition. The bottom 90% of the performers in a mature industry are typically more mired in the past than the high performers that have lagged less.

LIFE CYCLE LAGGARDS- CASE EXAMPLES

Lagging the life-cycle curve is the biggest reason that many of yesterday's star companies have become today's losers. Sears once was the Wal-Mart of America. Corner grocers once controlled the industry with their intimate, trust relationships with their customers, but eventually lost out to bigger, impersonal stores at the edge of town. The corner guys held fast in their beliefs that customers would not want to drive to a store where no one knew their name, etc. On balance, however, the customers had new cars to use and liked the wider, better selections and lower prices. Over ninety percent of the corner grocers disappeared. Many may have died in permanent denial. But, many probably realized that they had to change with the times or die, but just couldn't act to reinvent themselves. Their corporate capabilities were frozen.

A star-to-loser story is happening as I write this chapter. The still top selling book, Good to Great by Jim Collins, focused on 11 star companies including Circuit City (CC) which had the best stock performance of them all. Since the book's research confirmed CC's greatness 3+ years ago, CC's results and stock price have been blown away by both a surging Best Buy and Wal-Mart. One day last February ('03), CC fired ALL of their commissioned sales people. They are now trying to reinvent themselves by mimicking Best Buy's formula of bigger stores, more inventory, help yourself to lower every day prices with hourly employee assistance. CC salespeople were vital in selling $1000 VHS or Beta-Max machines in 1980, but apparently half the floor personnel, costing half as much in a store twice as large is sufficient for customer's buying electronics today.

(Sears, corner grocers and Circuit City are all retail case studies to which most readers should be able to readily relate. But, for a number of reasons retailers can't reinvent themselves as easily as most distributors can, so don't despair, keep the faith and read on.)

WHY CAN'T WE CHANGE WITH THE CURVE?

A great strategy is potentially a two-edged sword. Yesterday's heroes had the best-defined strategic capabilities for the times. This allowed them to grow faster with better execution. Their employees who executed and fine-tuned the strategy the best were promoted to top management to become the guardians of the culture (how we do things here). Even if these culture creatures do see how yesterday's business model is falling short of today's competitive environment (the accumulating "X's" on the shelf at point 4 in the slide), how do they pull it off? They weren't promoted, because they were good at transformational change. While they fret, the most common default response is to just keep doing what the organization knows and responds to, but do ever better and financially tougher. This most commonly results in corporate wheel spinning instead of traditional forward traction.

We will spend a lot of time in later chapters on "change management" that among other things always involves filling gaps for:

- new information reporting needs to measure and manage new strategic intent,
- re-educating everyone on how to realign to pursue new measurable "north stars", and
- dealing with the huge political resistance that always arises.

But, first we have to define just how far we are behind life-cycle curve realities and why which is what we will attempt to do in Chapters 2 and 3.

My guess is that 99% of all distributors could benefit from re-synching, more or less, their corporate capabilities with life-cycle curve realities, especially those that still rely primarily on commissioned, outsides sales reps working geographic territories. This type of selling culture especially locks in the past and militates against all strategic marketing changes. Imagine, for example, a sales force's reaction to a PBIT ranking report that reveals that more than half of their assigned accounts lose money.(?)

MAP #4: PURSUING "SERVICE RETENTION THEORY (ECONOMICS)

If we are in a mature industry with commodities for products and customers wanting to significantly reduce total procurement costs, then "service retention" is the name of the game. More specifically:

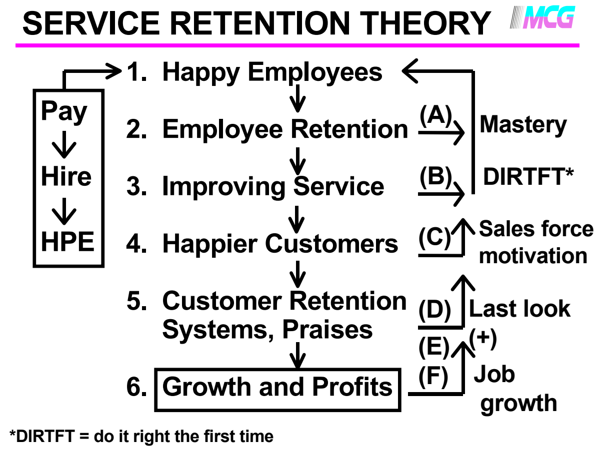
IF:

- A big percent of our sales (80 to 99%) are on established items for which competitors have the same or equally excellent lines.
- A big percent of our sales are on price-sensitive items to seemingly price sensitive customers.
- A big percent of our sales (80 to 99%) of our sales are to the same customers we sold a year ago, but that base of customers is consolidating.
- About 5% of the customers we serve in any given segment are growing both faster and more profitably than their competitors from whom they are taking market share. This organic consolidation by the most effective 5% makes the least effective 50% of a customer segment fade away; they are the living dead or extinction in motion.

THEN wouldn't it be smart to:

- Marry the best customers and serve them so well and valuably that they would stay with us and grow us? (Why would they marry us? For what unique product or total service value proposition?)
- Deliver the most consistent, error-proof (low cost, high morale, high value way to go) service so we don't give customers any reason to defect to the competition?
- Not alienate as many good customers into switching to the competitors as they alienate and send to us; couldn't we grow faster than the industry by having fewer service fumbles?

Map 4



Slide #4 above outlines how we could have less service fumbles than our competitors, so they drive more of their customers to us than we do to them for a higher net "retention rate" for existing, competitive, service-sensitive business. The chronological sequence of steps is:

- if we <u>get and keep the right people (1, 2)</u> then
- we can <u>achieve best service (3)</u> that will in turn
- <u>retain (right, most profitable) customers at a better rate than the competition (4)</u>
- <u>with whom we can then grow systems (butterfly economic$) (5) which will then grow profits and sales faster than the industry average (6).</u>
- Feedback loops A – F can all be positive, virtuous, self-refueling factors. Or, if we pay "fair" wages to get "average" turnover and service, then all loops can become negative, vicious deteriorating factors.[9]

This slide/theory does not tell us, however:

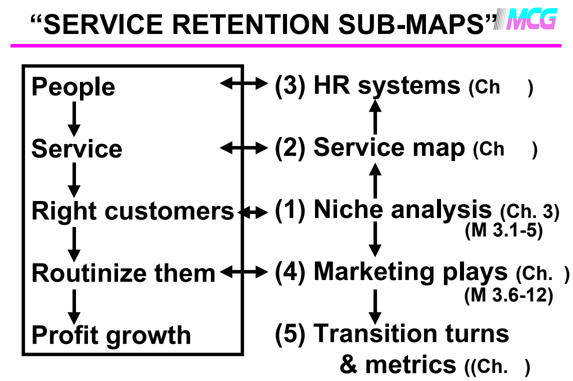
- How to attract and select the best aptitude, attitude employees.
- What a distribution location's best, historical customer niche(s) is.
- Who are the most profitable and fastest growing customers in the niche around which to re-tune "perfect service" and extra attention.
- What the exact, best total service formula is for each niche and strata within that niche assuming we can do lots more for super-profitable customers and something quite different with ones that are currently generating losses to convert most to profitability.
- How to measure, improve and sell those service formula metrics.
- Orchestrate a big service transformational change most effectively

The PBIT/customer and butterfly maps will help us to answer some of these questions. The other question points will require the "strategy sub-maps" touched on in the slide below that will be covered in subsequent chapters. For now just remember FedEx's motto summation: <u>"People, service, profits".</u>

[9] For more on the service retention map and specifically feedback loops A-F, see our article on the subject at http://min.isisit.com/merrifield/articles/3_7.asp.

MAP #4.1 SUB-MAPS FOR SERVICE RETENTION

Map 4.1

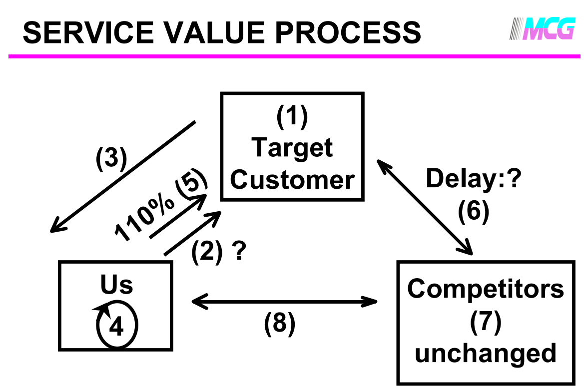


Because the service retention map is the tip of several icebergs, the slide above identifies "sub-maps" and their chapters on the right hand side. There will be no subsequent chapter dedicated to just the "service retention theory" map.

MAP #5: THE SERVICE VALUE IMPROVEMENT PROCESS (SVIP)

Using our PBIT/customer ranking reports to identify the top 10 customers, we can then, with some artistry, begin to identify niches of customers that have homogeneous needs for both products and services. <u>We must next visit a handful of the most profitable, progressive, demanding and/or untapped customers</u> within that niche to elicit their help for going through the <u>8-step service value improvement process</u> outlined by the slide below:

Map 5



The steps are:

- Identify the most profitable/important customers in our #1 historic niche to..
- (2) ask them what we do that bothers them and how we can work together to lower their total procurement cost (TPC) to..
- (3) Get new insights for service process improvement to take back to share with the team.
- (4) Re-engineer our total service offering(s) for those customers to then…
- (5) Give them 110% of what they requested with icing; to then patiently let service retention dynamics win 50 to 80% of the most profitable share of the target customer niche.

- After a surprisingly long delay or perhaps never, (6) the competitor that losses the most niche volume may visit some formerly good accounts to find out what happened. Upon hearing about our next level, service innovations and execution, they will vow to match us.
- With a frozen culture mired in the past, (7) they can't match our services ("unchanged"), so they cut the price.
- (8) We get last look +, because we have co-measured our unique ability to deliver the lowest TPC offering with the customer. We also have the lowest TSSC, because we have maximized butterfly economic$. The competition exits the niche or may die altogether.

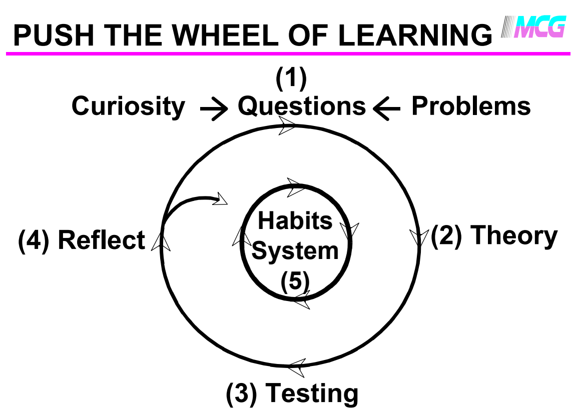
Point 8 hints at a big shift in how many people think about distribution economics. Instead of seeking a big share of product sales for a marketplace to bet some hoped for economy of scale (buy it better), we should pursue a big share of each customer niche (50 to 85%) that we target. This gives us an economy of scale and service performance for and within a tight scope of customers. The only way to have both a high, turn-earn factor and fill-rate level for a niche's common-need, basket of items is to dominate the sales for the niche. This concept will be revisited.

SUPPORT SLIDE FOR MAP #5: PUSHING THE "WHEEL OF LEARNING" #5.1

When we take new service improvement ideas in-house (map #5; step 4), we have to re-invent our processes and skills to deliver new service offerings. Trying new stuff with a few customers on a co-learning, experimental basis is the right first step. Succeeding with experiments does not guarantee that we will be able to easily scale the new service capabilities for many customers on a long-term basis at all locations. Employees will do new, extra things for a short time, but don't ignore the power of longer-term, collective passive resistance to kill any significant change effort.

To succeed even at the experimental stage will involve: confronting (unforeseen) problems; making honest, hopefully good mistakes; and more generally, pushing the "wheel of learning". These learning challenges are covered by the three support slides below (5.1-5.3).

Map 5.1



The steps of the wheel are as follows:

1. Exploring opportunities raises questions (in this case for customer service improvement)

2. Theories for how we could work better together to grow the customers' profits emerge. These new service solutions might require us to re-tune basics or add extras (perhaps un-bundled for a fee), but the customer might want to see a prototype, a free trial or sampling.

3. Together we do a cheap, prototype test or experiment to learn by doing, to fail forward, to find the bugs, over-sights, etc.

4. We reflect on the experiment's results, we either move to new general questions #1 and start around again; or,

5. If the experiment is a partial, promising success, we move towards pushing the wheel (inside) for refinement. This would include:
    - Documenting measurable value
    - Proving good profitability for us
    - Productizing the offering to be able to offer it to others in the niche with initial customer(s) testimonials
    - Having new corporate systems, language and habits as a final result

SUPPORT SLIDE FOR MAP 5: NEW PROBLEMS TO SOLVE #5.2

Map 5.2

NEW PROBLEMS TO SOLVE

Problems	**Solutions**
1. Known	**Known**
2. Known	**Not sure**
3. (Unknown surprises; opportunities)	

Whenever we go down a new, innovative path, we will run into three types of problems with three types of solutions that are listed above. It is the third group – total surprises – which can be either the most traumatic or fruitful depending upon how we want to look at them. If we are trying new stuff that has been directed and surfaced by the first four strategy maps, then the bigger the unforeseen problems, the bigger the eventual value possibilities and competitive barriers we will create if we can solve them.

The biggest problem with both pushing the wheel of learning and dealing with new problems is the fear that most people in a company will have with failing forward at new things. Most mature companies reward and promote people for:

- Fine-tuning the past
- Knowing all of the answers to the old questions and problems, and
- Keeping costs low by not trying anything new that might fail and cost more; experimentation resources and failures are not in the budget!

We will have to free up some slack time, talent and treasure; teach everyone why and how to make "good" mistakes; and, publicly praise (and even reward) those who do make good mistakes failing forward towards the new value creation goals. Tough tasks! Innovative activity led by "intrapreneurs" who are guided by effective strategies and the right strategic metrics all have to be present.[10]

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[10] Learn about intrapreneurs and take a survey to see how innovatively capable you are at http://www.intrapreneur.com/

SUPPORT SLIDE FOR MAP # 5: MAKING GOOD MISTAKES #5.3[11]

Map 5.3

MAKE GOOD MISTAKES MCG

1. **Plan it:** **Certify the benefits**
   Max. upside; Min. downside
   Design a good experiment
2. **Do it:** **Cheaply, carefully if possible**
3. **Learn**
4. **Try again** **Smarter**
5. **Teach and role model** **"Good Mistakes"**

This slide offers a full definition and cyclical process for making good mistakes and it can all be nestled into step 3 in the wheel of learning labeled "testing". A good mistake starts with:

- (1) Plan it. A good mistake should be the result of controlled, affordable (our worst-case scenario costs) experiment that is driven by a theory from the wheel of learning. The underlying theory should, in turn, be guided by questions about areas of opportunities surfaced by our strategic maps. We will get a lot more "lucky" if we fish (experiment) in the right strategic spots.
- (2) Do it. Cheaply and sooner rather than later to more quickly learn-by-doing and failing forward. Experiments should be done by can-do, open-minded, out-of-the-box-thinking intrapreneurs. Administrative, control-freak veterans who have to be right, on-time and on-budget won't have the spontaneity to see the surprise opportunities that emerge while messing around in the experimentation stage.
- (3) Learn from it. This is the one part of the full definition that every defender of the past will get right when asked to "define what a good mistake is". The answer is not good enough for reinventing an organization.
- (4) Try again smarter. Go back to the wheel of learning step for reflecting and then start the cycle over again.
- (5) Teach and role model both good and bad mistakes to encourage others to start to participate in step 1 with the right learning how to learn spirit.

MAP #6: STRATEGY FIRST, "ONE GOOD IDEA" LATER: THE KINETIC CHAIN

The maps we have covered so far are collectively a lot more complicated to think through and apply, then going to industry meetings to find "the one good idea that will pay for the trip".

I don't want to knock "the one good idea", but rather encourage you to strategically re-shape good ideas before implementing them. Continue to go to industry meetings. It's important and fun to: absorb channel

[11] For more on "good mistakes": see this article: http://min.isisit.com/merrifield/articles/5_4.asp; see our "High Performance.." video module # 5.8. For "how to praise publicly" see this article: http://min.isisit.com/merrifield/articles/6_3.asp; or video module #5.2

news, grouse about channel problems with trusted, non-competing distributor friends and exchange ideas for dealing with daily pains. Pool problems and solutions; no one is as smart as all of us put together.

Here, however, are the problems with most "good ideas".

- If we do the same quick fixes as everyone else, aren't we surviving by only matching everyone else's reactive, cost efficiencies on the surface of our vaguely defined "good service" strategy? We are still not creating a unique value proposition that will support sustainable profit power.

- If these ideas do work, they are apt to deliver small, incremental efficiencies to a still generally ineffective strategy. By illustration, a new way to arrange the furniture on one of the decks of the Titanic might have enabled more passengers to enjoy prime time sun during the voyage. But, the ship's architecture and strategic route were still headed for disaster.

Our last strategic map in this chapter, "the kinetic chain for profit power", is a self-invented tool for putting new ideas to work in an integrated, well-aligned way to increase the odds for getting results.

Map 6

KINETIC CHAIN OF PROFIT POWER

→ **Sustainable Profit Power**

7. Incentives
6. Tools
5. Education (→ Skills)
4. Great People (apt. for "growing to")
3. Systems (simple, flex., friendly)
2. Strategy (vision, values, UMP, SCA)
1. Leadership (People)/Mgt. (Science)

UMP - unique marketing proposition
SCA - sustainable competitive advantage

I borrowed the term "kinetic chain" from sports motion theory. Pitching, tennis serving, golf club swinging, etc.; all involve a kinetic chain motion. To succeed with any business change, we have to make sure that, regardless of which of the seven step(s) we are trying inject something new, the idea is reshaped and re-balanced to be compatible with the steps below and above. Otherwise, everyone will try to make the new idea work for about two weeks, but then the strain from poor internal integration amongst all of the steps will force everyone to go back to business as usual while perhaps still telling management that "it's working OK".

Here's a brief explanation of the 7 steps for now.[12] From the minds of (step 1) manger/leaders comes an effective (2) strategy (influenced by this chapter's maps?). The strategies then force us to rethink all of our (3) systems[13] before we populate them with (4) best people. ("Systems make it possible, people make it happen")

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[12] We will visit many different aspects of the kinetic chain in later chapters. For a detailed article, check out #2.1 at www.merrifield.com. It is also the subject of module #5.10 in my "High Performance" video.
[13] For more on rethinking systems see http://min.isisit.com/merrifield/exhibits/processx.asp and module 5.11 in our "High Performance" video.

If our personnel systems are re-designed to help us hire and keep the right employees, then our (step 5) educational investments, governed by steps 1-3, will improve the skills of our able people (4). Skilled, strategically minded employees can then get maximum value out of strategically selected and evolved (6) tools. Tools are anything the company can buy with cash as can any other competitor including buildings, inventory and infotech products.

"Incentives" (step 7), surprisingly to many, come last. If one of the first 6 steps is missing or out of alignment, then any incentive plan will generate excitement for about two weeks (as long as the average New Year's resolution) before normal activity resumes with residual lip service to the greatness of the plan. Most mis-aligned incentives will also force people to due dumb things that are at cross-purposes with what is best for all in the long run (more on this in chapter 2).

If the first six steps are aligned and effective, then things will happen with the only incentives being above average – wages, job security, pride and growth satisfaction. Additional incentives might well still be used as a back up spark plug or as a "fair gain share" distribution mechanism for premium profitability.

The kinetic chain model can be used several ways:

- It can be used as an implementation tool for integrating a "new", good idea into your business. Pinpoint first the one or more steps the idea is focused on. Then, chose the second of two theoretical choices. Don't plug the idea into the corporate body like any donated organ and watch it be eventually rejected. Instead, rethink the idea to be totally in tune with the steps below and above it on the kinetic chain. Sometimes when using canned software (a step 6 tool) we will have to re-adjust all of the steps underneath to mesh with the software.

- The kinetic chain can be a corporate reinvention tool. This book is aimed at helping the collective leadership (step 1) of the company to agree on how to rethink and act upon new strategic thought (2). There will be more on systems (3), people (4,5) and "strategic profit power reporting" tools (6) throughout. If it sounds complicated and stressful, it can be. If, however, everyone buys into the new strategic guidelines and management metrics, then steps 3 through 7 start to re-organize substantially on their own. We may stumble over new terrain, but as long as we are all believing in and following the same (new) North Star metrics we will reweave the corporate fabric with great, bottom-up involvement.

- The kinetic chain can help to define the differences between three levels of change: (individual or departmental) efficiencies, (strategic or process) effectiveness or transformation. Most "good ideas" tend to be aimed at steps 4 through 7, which, if they work, might help an individual(s) or a department become more efficient at what they have already been doing with less cost, a bit faster or a bit more accurately. As with re-arranging deck chairs on the Titanic, our vague strategy might still be a loser.

- Effectiveness results from re-thinking steps 1 – 3 and then letting steps 4-7 reweave themselves in light of better-defined strategic intent and new, North Star metrics. The six strategy maps we have reviewed are aimed at helping distribution companies become more effective.

- Transformation suggests radical change like crossing the country in a jet instead of a Conestoga wagon. Sometimes improving the effectiveness at a company can lead to a ripple of changes that adds up to a company-wide, supply chain or industry wide transformation.

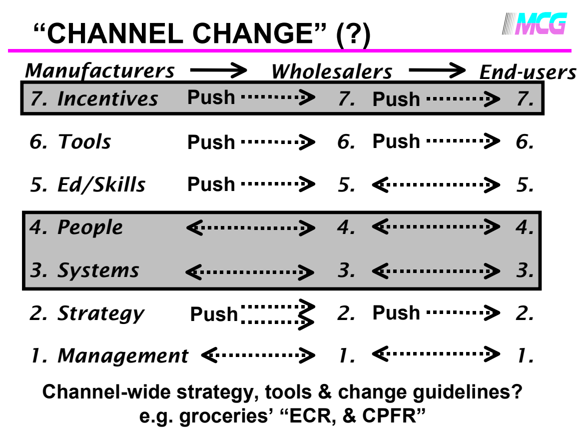
Toyota's just-in-time manufacturing system started with one change in 1952. They succeeded in reducing the setup time on a 1,000-ton press from six hours to three minutes. Then, like dominoes, they re-engineered their entire plant based on what they learned from that first step. The "Toyota Production System" was the final emergent result over the next 10 years. Then, from '62 on, Toyota imposed their JIT production systems and new process metrics on their in-bound supply chain. The development of "lean manufacturing" transformed Toyota and eventually much of the manufacturing world.

- The kinetic chain can shed light on why both companies and channels resist change. Early in Chapter Three we will review the case of how Wal-Mart put "quick response" to work first in the mass-merchant channel starting in '83 and then in the grocery channel in '90 while most of the other competitors just dithered and withered. They just couldn't get their firms to use channel-wide strategy maps (step 2) and tools (step 6) like industry standards for barcodes, EDI and data warehouses.

INTER-COMPANY, CROSS-LINKS RESIST TOP-DOWN CHANGE

Each channel player's kinetic chain is in a cross-linked, dynamic equilibrium with their most important channel partners' kinetic chain steps. In map 6.1 below, the horizontal, dotted arrows between the channel partners' respective 7 steps suggest how they not only influence one another, but lock one another in from changing.

Map 6.1



The slide above is trying to depict the following points:

- Friendship commitments between management (step 1) and operational people (step 3) will resist adaptive environmental changes if those changes might strain the friendships by going against past promises or even relationship rituals.

- The shaded boxes are areas where the most inter-dependent connections will resist change the most. By example, systems (step 3) and people (4) involved in on-going replenishment of large product flow between partners could be big resisters to any type of product promotion or supply chain changes that management (1) might announce.

- Some influences are still overwhelmingly unidirectional. Manufacturers' product marketing strategy (step 2), educational offerings (step 5) and merchandising tools (5) are all pushed through the channel often with big incentives (7) or subsidies for all downstream players. Wholesalers that grew up on exclusive franchise support have continued to push these influences on to end-users even though the franchise power has disappeared and big customers primarily want low-cost, demand fulfillment solutions rather than channel loading deals or new product pitches.

CONCLUSIONS FOR THE KINETIC CHAIN

The kinetic chain is a powerful and versatile tool; we will revisit it often throughout the rest of the book. I know many people think that it is "too complicated", and yet it is still only a crude model for the dynamic complexity and inter-activity that goes on within companies within distribution channels.

Perhaps some best closing advice for using this model is to first focus just on steps 1 and 2. Does management (step 1) really want to reinvent their strategy effectiveness (step 2)? If so, then when the new strategy's new metrics are figured out, publish those metrics as the new North Star(s) along with the education of all the employees as to why the new strategy is in their long-term, best interest. Then, sign them all up to be part of the solution for reweaving steps 3 through 7 of the kinetic chain so that the company can move toward the North Star. Perfection and rapid progress isn't necessary; the company just has to move towards the new strategic ideals better and faster than the other competitors.

CASE STUDY: APPLYING THE SIX MAPS TO "ABC DISTRIBUTION"

To improve our fluency with and ability to apply our six maps, let's see how the six strategy maps were applied in a sequential and integrated way in a disguised case study.

ABC Distribution has for years pushed an expanding array of supplier lines and SKUs to diminishing return limits of its geography and active account base. A few years ago, ABC's management found that they were working harder to have less fun and no profits. Their statistical profile at that point was: $10MM in sales, 1000 active accounts, 250 suppliers, 10,000+ stock keeping units (SKUs), 8 outside sales reps and 34 total employees. There financial profile and performance stats included: no debt, break-even profits, 3 turns on inventory, a 25% gross margin, 39 days outstanding on receivables and 73.5K in gross margins (or value added dollars) per employee.

They started their strategic reinvention process with a customer profitability ranking report (map 1) to discover that:

- the top 10 accounts generated $64,000 in profits at an average of 8% PBIT margin;
- the bottom 20 accounts lost $80,000 and included some big name, "good" accounts;
- 5 of the top 10 were all large firms that could be grouped into a certain segment of customers that probably bought a common-basket of items that another 50 A and B sized accounts in the same niche would probably also buy.

To do some quantitative analysis on the underlying butterfly economic$ (map 2) for the 5 similar, super winners, ABC did a common purchased item analysis. They discovered that all 5 customers in the niche bought 100 of the same items, another 100 items were being bought by at least 4 of the 5 and 200 items were being bought by at least 3, etc.

The two reports above changed management's thinking about their source of profits. Fifty years ago, the company had a number of supply lines on an exclusive territory basis for which they did product promotional efforts to expand market sales. High turn x earn products sold in good volume were believed to be the source of profit power.

Management realized that somewhere along the way, the company had lost all of their meaningful exclusive product power and had unknowingly started to add items and sometimes suppliers to accommodate demanding, "best" customers. As a result of the common item analysis for their number one niche of customers, management concluded that at least within their #1 niche, they had a critical mass of similar customers buying a common-basket of items that made all of those items seem profitable. How much more opportunity was there to sell more of these common items to more of the top 50 customers in the niche? What was the best way to practice "retention theory" (map 4) with best accounts?

To both leverage butterfly economic$ and retain/grow accounts in their number one niche, management reviewed their target fill-rate strategy for SKUs. They reasoned that fill rates for a one-stop-shop assortment of items is the cornerstone of good service, because on-time delivery, zero errors, etc. can't happen if goods are out of stock. They also questioned why they were trying to hit a 92% fill rate for inventory across ALL items, A's to D's. Why not invest in the top 500 common items for niche #1 to hit 98%+? They did the math and decided to beef up the "strategic niche's common items".

The higher fill rates had some interesting benefits:

- The average order size of shipments increased immediately while the number of small, extra orders for stocked out balances from elsewhere decreased. Productivity for order fulfillment personnel measured by gross margin/employee went up 15% in one month!
- Sales to the entire target niche climbed immediately due to the increased fill rates. Fewer stock outs was apparently increasing retention/penetration and decreasing defections. If two, local competitors going after the same niche have average fill rates of 99% and 92% respectively, what will happen to retention and defection rates over a period of time?
- Order fulfillment personnel morale climbed. They had to say "I'm sorry, we don't have it" to core customers less often. They were saying, "yes, we have it" to non-core customers in the same niche who were grateful. Less work, better numbers, better service pride and less stress all helped. They were the beneficiaries of working strategically smarter, instead of harder due to an unfocused strategy.

To better understand the needs of the niche that contained the 5 similar, profitable customers, management visited them and 5 others most like them for whom ABC was not the #1 supplier. The managers went through the value creation/improvement process (map 5) and identified a few service improvement wrinkles in addition to the fill-rate improvement strategy that would lower common customer frustrations and improve the customers TPC as stage 4 of the life-cycle map (#3) suggested.

One of the wrinkles was determined to be an "extra service" that would be free to the top 5 profitable accounts, because they were already averaging an 8% PBIT rate when 5% would have historically been a dream. As an experiment, they decided to offer the extra service to 3 of the 5 most important target accounts in the niche on a limited free trial basis as an account-cracking tool. The other 2 prospects were dropped, because they had revealed an emotional commitment to another supplier. All other accounts in the target niche were initially projected to pay a fee for the service if they should eventually want it.

After the service improvements were co-created using the "push the wheel of learning" model (map 5.1), ABC had to change some service process systems and do some cross-training of personnel to fully support the new services and higher basic service standards that were to be hit. The PBIT/customer strategy had begun to change the processes in both the department and individual activities in the order that map #6 had predicted. Some employees grumbled, at first, about the changes and were slow to understand and believe that they along with everyone else could be better off in the long-run with these efforts. But, good critical mass leadership and enthusiasm throughout the company helped to push the rest along.

All 8 accounts that were interviewed and still targeted were team sold for one year. The 5 most profitable accounts grew by 30% even though the sales reps assigned to these accounts had initially felt that "we are already getting all of the business". The 3 target accounts grew an average of 50% from a small base, but they kept on growing rapidly for the next two to three years until ABC had become their dominant supplier. The sales reps sold the next 20+ most promising customers in the niche the new service value story with heavy marketing support help to get strong, new penetration growth.

About 18 months after the service re-invention process had begun at ABC, a competitor's management team visited with the now lost 3 target accounts to find out why they had switched (Map 5; step 6). When the targets told them about the higher, guaranteed service standards and the new extras they were getting from ABC, the competitors vowed to meet and beat the service, but they never did. They offered, instead, more aggressive contract prices (Map 5; step 7). ABC got last look and kept the business without lowering the price, because they were still offering a lower TPC supply system in the minds of the customer (Map 5; step 7).

ABC's FINANCIAL RESULTS

ABC's numbers started to improve immediately for a number of reasons.

- Sales started to grow faster than the industry due to service retention benefits.
- Profits grew much faster than sales because of the flow-through of incremental margin dollars from selling more old items to both old and new customers on a systematic, larger average order size.
- There were other, bigger, faster profit improvements that came from ABC addressing both the biggest losing accounts and the small order, small account opportunities, but those are other stories covered in later chapters.

CHAPTER CONCLUSIONS

Most distributors are currently suffering from poor financial results, because of both a tough economy and dated, un-spoken strategies that are too far behind the life-cycle curve (Map 3). Learning how to carefully apply the six, strategy maps in this chapter will put many distributors on their own unique value creation path towards dominating one niche of customers at a time.

The competitors to the map users don't have to suffer. They too can focus on their most profitable customers who are apt to be in a different niche, because two players can't both be getting all of the business from the same, few best customers. Think of most product-defined distributors as decathaletes trying to be excellent in 10 different customer niches or events. If they all focused on their one best event at a time, 10 distributors with poor financial returns might become 7 with outstanding returns delivering much improved tailored service value to their respective targeted niches (events).

Three or so out of every ten distributors today would implode, because they currently are not #1 or #2 best service providers or market share owners in any of the customer niches that they serve. And/or, they will not be able to change, even though they may intellectually know what they should do. Their demise would be healthy for the industry, however, because there is too much excess distribution capacity in most channels.

With an overview of the strategy maps, we could jump right into more how-to measures for supporting our new strategies. But, many distributors would fail at their implementation efforts, because there are too many old, unspoken and conflicting emotions and assumptions carried by too many employees. Most employees might say that they understand and believe the new thinking, but their body language and their on-going cultural, habitual actions will support the old ways.

If we can't name, claim and defuse the deeply embedded habits that are holding us back, then we can not be receptive, intellectually or operationally, to the ideas in the rest of the book. If you work for a company that has tried change programs in the past unsuccessfully and generally knows how to be a lot better than you are doing, skim through Chapters 2 and 3. These chapters are dedicated to trying to systematically uncover those deeply embedded, un-spoken assumptions that worked so well 20 to even 100 years ago. If you find some themes that still exist in your business, write them down and start having some "dialogue" sessions with the still believers.[14] This process will evoke some negative emotions from some, but it will also allow big change for big gain to happen.

[14] For more on "dialogue" sessions check out: http://min.isisit.com/merrifield/exhibits/Dialogue_Exhibit.pdf

CUSTOMER IQ QUIZ

1. **Do your profits come from your products or from your customers?**

   (If you are an exclusive distributor for a powerful manufacturer that assures that you are profitable, even after selling lots of customers at a loss, the rest of this survey is still important. But, don't expect much luck with fighting the supplier about selling all customers on a profitable basis in order to sell, eventually, more total volume to fewer accounts while losing customers leave to sink competitors.)

2. **Who are your "best" accounts? How do you define them? How do your customers?**

   a. Do you have economic boundaries for deciding which mode of selling they should currently be with? Outside sales, tele-sales, house/catalog/direct mail, or "whole-tail" cash-n-carry? (Levels "A-D" respectively)

   b. Do you sub-divide them by how much estimated operating profit you currently earn from them? Within the largest sub-group there will most likely be very profitable and very unprofitable customers; do all employees treat them the same or differently?

   c. Do you sub-divide customer segments and strata into why they buy (e.g. emotional loyalty, best total value, or pure price)?

   d. Do you give any weighting of importance to how fast a customer has been growing and how fast they are likely to grow over the next 5 years?

3. **Do you agree or disagree with the following statements? Why or why not? How do you know?**

   a. The top 20 % of our most profitable customers could generate somewhere between 120 to 150% of our profits; the middle 60% may be breakeven; and the bottom 20% may costs us about 20 to 50% of our profits.

   b. The number of customers that are both high profit and high growth are very few, but they should make an enormous difference to us over the next 5 years if we can retain and further penetrate them.

   c. Two competing distributors in the same geographic area have the same sales volume. Both have about 20% of the total, product-volume, share of market from the view of their common pool of suppliers. Distributor A only has a third as many active accounts, but has an 80% share of their "number one niche of customers" that they have targeted (3x sales/customer). Distributor B, meanwhile, has promoted products to a more diverse, larger group of customers. Who might be more profitable? Why?

   d. If you agree with a and b, what is your company doing for the big winners, growers and losers?

4. **How do you define, measure and act on customer knowledge?**

   a. Do you measure retention and defection rates for your existing customer base?

   b. What are you doing to improve the retention rate of the right types of customers?

c. What are you doing to make losing customers either profitable or voluntarily leave for another supplier? Do you have a minimum profitability goal or level per customer per niche (strata)? How long do you allow for a customer's lack of profitability to be cured one way or the other?

d. How do you continually research, strategize and cover as a team:
   - target accounts
   - most profitable accounts
   - biggest losing accounts?

e. Who are the 1 or 2% of the customers in your number one niche that are the most innovative, demanding customers that will do experiments with you on new, service value ideas ("learning relationships", "co-created value")? What are the experiments that you currently have underway? What is the process for how you scale the winning experiments to more customers with similar need opportunities?

f. Are there other types of either outsourced service providers or miscellaneous goods suppliers that are common to two or more of your most profitable, progressive customers? Can you:
   - strike a marketing alliance with those suppliers for your shared customer bases
   - buy them and introduce them to the rest of your similar customers
   - or, replace them with your own in-house capability?

g. There are two ways to estimate what your share of a customer's total volume is. How do you estimate:
   - share of traditional products sold?
   - share of expanded supplier spend? (see "f" for a broader definition of customer spend)?

h. Do you offer special considerations for smaller, profitable accounts who are totally loyal and cooperative with you?

i. Who are your major competitors for your target niche(s)? What competitive edges do they have over you on a niche by niche basis? You over them?

j. What are the top 3 specific attributes of your total service proposition to your most profitable, #1 niche customers that differentiate you from your toughest competitor according to your customers' assessment? How big an edge do you have for these attributes? How sustainable are these edges?

k. What 40% of your total marketing support expenditures deliver only 10% or less of your target customers' perceived value benefit? How are you rethinking these poorly focused expenditures?

l. Do you guesstimate what your total market share of each customer niche is? Why? Why not?

m. Do you make simple, approximate lifetime profit stream valuations for key accounts?

n. Who is the customer niche manager whose full time responsibility is to answer and solve all of the questions in item #3? Does this person have profit and loss responsibility for improving the niche's total performance?

o. What would happen to the profitability and sales revenue levels of one of your target niches if you raised your prices 1% on average across the niche?

5. **For getting all employees to be part of the total service value improvement solution ("alignment"), do they know the answers to these questions:**

    a. Describe in detail our number one target niche of customers?

    b. Who are the five most profitable customers within that niche (by memory!)?

    c. What are the exact service metric goals to be achieved to become the best "total value" supplier to that niche?

    d. Define what "lowest total procurement cost (TPC) value" is? How can we offer the lowest TPC if our price is higher than a competitor's?

    e. How do distributors lower the end-users "total procurement cost" if our price to the end-user is higher than a direct purchase? And, how do distributors lower the "total sales and service costs" for suppliers so that they shouldn't want to sell direct?

    f. Why is the answer "yes" to whatever a most profitable or target account may request of you? How have you been trained and empowered to see and hear opportunities to help do extra effort, delightful acts for these customers?

    g. How are high pay for your job niche and long-term career security and growth paid for by high service value productivity for which you are part of the solution?

6. **To support the company's effort to marry the right, growing customers within a common-needs, target niche of customers, what is top management doing to**:

    a. Have information systems that measure customer profitability and service metric scores that:
        - force top management discussion about changing traditional mindsets and practices to reinvest the company's resources into more profitable practices?
        - (when eventually shared with all employees) will help everyone to re-align on a daily disciplined basis and create sustainable customer service value and profit power?
        - will allow the company to truly put profitable customers at the center of the business instead of just continuing to talk about it?

    b. Help traditional managers "comfort-zone" and have "dialogue" about switching from a product/sales/geographic volume driven, promotion culture (and metrics and incentives) to one that is re-organized around retaining and better targeting profitable customers within one niche at a time?

    c. Educate all employees about the inter-related opportunities of:
        - customer profitability insights
        - better customer segmentation
        - better definition of "service value" for the right customers
        - how to achieve higher productivity through better strategic value creation and marketing to reward all stakeholders ever better

d. Resist putting in supplier product line extensions that aren't needed by your target customers in order to sell more total volume of the supplier's line on the fewer, but needed items for your target customers?
e. Add new incremental suppliers and items to more perfectly tune one-stop-shop, highest fill rate service performance for your target niche(s)?

f. Resist all supplier channel-loading, product pushing promotions that involve offering buy-now (and more) discounts to end-users, because that message is antithetical to selling customers the lowest, every-day, total procurement cost system solution?

g. Have fewer outside sales people calling only on (soon-to-be) profitable customers with a minimum level of $400 in gross margin per month average purchase rate and spending the great majority of their time selling, installing and documenting savings in total procurement cost reduction purchasing systems?

h. Boost company capability to serve A-D customers within one target niche on a different, profitable basis allowing customers to migrate from level to level as they wish and deserve based on their volume?