Dear Readers:

This is a second draft posting of “Chapter Three” from our forthcoming book. In addition to making substantial revisions to the first five pages, which is a case study on Wal-Mart and why all of their competitors were so slow to change, we have added another 12 page sub-section. This new section entitled: “Controlling Producer Promotion Pressure” includes four case studies on distributors. The cases are designed to surface the channel culture rules that freeze us into past practices and keep many of us from doing what we know we should be doing.

This entire chapter is a bit of a risk because it is aimed at the heart of the “knowing-doing gap”. I promise that a lot of readers are going to feel very uncomfortable reading about sacred “rules” that they do practice followed by commentary on why these rules need to be overhauled.

If you have any good or bad responses to this 12-page section, I would greatly appreciate your feedback and will use it in the re-writing process.

Thanks! I hope you enjoy and benefit from the material.

Sincerely,

Bruce Merrifield

CHAPTER THREE

CONTROL THE CHANNEL’S PRODUCT- PUSH CULTURE

INTRODUCTION

Chapters One and Two dealt with logical ways for thinking about attempting big changes for big gain. In Chapter One, we used strategy maps to identify unique, value-creation, starting point opportunities and guidelines for each distribution location. In Chapter Two, we did a systematic check for unspoken, financial management logic themes that can unknowingly undermine our profit power health and constrain our ability to innovate forward. We also highlighted the need for developing a parallel and complementary set of profit power management metrics to go with traditional financial reporting.

For some readers, the first two chapters may compel you to jump to the how-to material that starts in Chapter Four. But, both historical business cases and my personal, turnaround experiences tell me that most business execs are frozen from doing a lot of what they know they should do by unspoken, flawed assumptions and channel cultural rules. If these assumptions are not thoroughly identified, accepted and then re-balanced to be in tune with current marketplace realities for all involved employees and channel partners, then the “political pushback” from most everyone affected will stall out any change initiative.

To surface channel culture rules that resist change, I will use general case histories as well as disguised distributor case studies. We will start off with an historical case study that stars a channel re-engineering strategy that continues to teach us many lessons, but especially the importance of creating and selling the lowest “total procurement cost” (TPC) as defined by each customer niche we pursue.

CASE STUDY 3.1: WHY WAS "QUICK RESPONSE" IGNORED BY ALL EXCEPT WAL-MART?

The single greatest example of a channel, rule-breaking change winning big for one player, while other, bigger-at-the-time competitors just watched and dithered, is Wal-Mart's implementation of "quick response" replenishment to achieve the lowest TPC for eventually all retail consumables.

The original, "quick response"(QR) experiments were spearheaded by the US textile manufacturers starting in 1983. The big idea was that if the domestic apparel industry could manufacture and replenish mass merchants based on real-time, point of sale data, then the domestic supply chain could be 30% higher priced than the imported sources, but still be the best total value supply chain.

The simple pilot tests involved three selected mass-merchants: K-Mart, J.C. Penney and a much smaller, but dynamic, southern chain called Wal-Mart that was pushing towards $3B in sales (They did $245B in sales in '02!) In 1983, JC Penney was doing a bit more than $11B in sales, while K-Mart was close to $17B.

The simple experiment proved to have enormous economic benefits. Wal-Mart boldly plunged ahead while the other two were distracted by other big expansion plans. K-Mart was buying into other big box retail concepts, Builder's Square, Borders Books, Office Max, etc. And, Penney was kicking off a $1B national department store renovation, upgrade effort. The rest is history.

By '86 Wal-Mart had made quick response work with the US textile industry and kicked off their "Buy American" (textile apparels that employ our small southern town store customers). Realizing what a breakthrough logistical platform they had developed, thoughts probably ran to what was possible if they could marry QR to the world's largest producer of price-sensitive, consumer staples, Procter and Gamble (P&G). Wal-Mart pitched P&G on plugging into the QR capability around 1986, and the two new partners had it working in 1988.

Meanwhile, K-Mart talked about QR as a concept worth doing someday, but didn't act. When they did seriously start to try to implement QR in '90, because Wal-Mart was starting to eat them alive, K-Mart played habitual hardball with all the suppliers on the cost-benefit sharing. The suppliers shifted all of their proactive development resources to continued progress with Wal-Mart. In March '93, K-Mart had a "we're sorry, let's try again" meeting with suppliers. It was too late, their trip towards bankruptcy had already been started.[1]

After a few years of experimenting, Wal-Mart decided QR could be applied to the grocery business and plunged into the industry in 1990 with their "SuperCenter" format that was a knock-off of Carrefour's Hyper-Markets.

In 1992, the grocery channel responded with its own visionary study and QR solution which they called "efficient consumer response" (ECR). Kurt Salmon Associates who had already been working for several years with Wal-Mart and its targeted suppliers did the study. I thought it was curious that nowhere in the report was there any mention of "quick response, Wal-Mart or supercenter" either as an example of how it does work or why the grocery channel should want to respond to a competitive threat.

Where these omissions acts of denial and pride? The grocery channel was proud that they had pioneered the use of bar code scanning in the '70s to speed up the check out process. Perhaps they didn't want to admit that Wal-Mart had taken bar code checking data and used it to transform the supply chain for mass

[1]"Electronic Commerce for Distribution Channels by Bruce Merrifield. Pub, NAW/DREF '99. Pp. 14-16.

merchandise then applied it against them to make them appear to be such laggards. We can't let pride and denial keep us from being fast followers to someone stealing our business with innovative service value methods.

By 2001, Wal-Mart had gone from zero to the largest grocer in the US with a 19% national share on their way to a projected 35% share by 2007 by opening another 1000 Super-Centers. As of late, for every new SuperCenter that is opened, 2 traditional grocery stores in the same area are closing. Since 1990 roughly 13,000 grocery store locations have been shut down due to SuperCenter competition.

The grocery channel players did not, on average, embrace ECR practices quickly. About 5% of the players had experiments up and going by 1994, perhaps another 5% got going by 1996. But, according to annual industry surveys, the average player didn't really fully understand ECR and act until about 1998. There was an interesting channel episode that highlighted this slow ECR-mindset, adoption rate that occurred in 1995-96 involving a big Procter and Gamble (P&G) initiative.

By the end of 1995, I suspect that P&G had learned a number of things from their Wal-Mart QR relationship. Some might be:

- Due to QR, Wal-Mart was growing faster and more profitably than any of P&G's retail customers. The shared total supply chain cost savings allowed P&G to offer lowest prices with even lower costs for a bigger income margin. (Marry the customers who outperform their industry due to perpetual innovation. They are about 3% of the total customer base. But, why would they marry us?)
- Wal-Mart's value proposition to us was outperforming the high/low pricing promotional deals and coupons that had dominated the channel. Their lowest total procurement cost proposition included: 1) one-stop-shopping on ever more (60,000+) items in our consumptive world; 2) a 99%+ fill-rate average; 3) everyday low prices that average 2-4% lower than the other discounters, 5% lower than grocery stores and 14% lower than specialty stores; and, 4) no wasted time due to coupons, shopping multiple stores for deals, finding stock outs on promoted specials, etc.
- Wal-Mart didn't want to use "high-low" special deal pricing to get people into the stores, because it upset the continuous forecast-able flow of products and steady, high fill-rates. They would rather have the money spent by the suppliers on creating and executing the programs put to lower prices. This allowed customers to once again become loyal to familiar brands (like P&G's) that were always in stock instead of buying whatever brand happened to be at a promotional price or that was a second choice substitute to a stock out first choice.
- Wal-Mart did not accept slotting allowance money, which the rest of the grocery channel was addicted to, because the practice compromised Wal-Mart's mission of having the lowest every day prices on the items that customers wanted to buy in stock.
- These last two points suited P&G. They were incurring huge costs for creating and orchestrating channel loading programs with big peaks and valleys of sales that weren't generating any sustainable, incremental market share gains. And, their deals just encouraged competitors to counter with bigger deals fueling a vicious cycle that taught customers to shop for whatever brand was on sale.
- There was enormous cross-subsidization between the best movers and the slowest movers in P&G's over-extended lines. For each product to make money on its own, the A+ items could be priced much lower while the slowest items would have to be priced so high that people would buy plain vanilla instead. AND, if P&G didn't offer the true value price on the A+ item, Wal-Mart would have the item knocked-off and put "Sam's Soap" right next to the A+ item for a lot less. (Since '95, Wal-Mart has developed many store-brand knock-offs for overpriced A+ items. I recently priced a 2 liter Coke at the Wal-Mart nearest me at $3.28

while Sam's Cola, which is made by Cott using the same lab tested formula as Coke, was priced at 58 cents! Another side by side comparison: 50 ounce Listerine $4.88, Wal-Mart's "Equate" brand is $1.77. This tactic is busting all cross-subsidized pricing models for "full-line" manufacturers.

P&G may have assumed that by 1995 the grocery channel would be generally ready to abandon the channel loading, forward-buying grocery channel practices because it was antithetical to making ECR work and meeting the Wal-Mart threat. For whatever underlying reasons, P&G announced a huge transformational program to their customer base. They consolidated redundant lines, trimmed slow moving items, consolidated plants and reduced channel promotional activity by over 75%. Their goal was to become the world's low-cost producer of best value products, and to that end they lowered their prices, on average, by 5% across the board while chopping costs by 7%+. Their last quarter sales tanked as they stopped their year-end channel loading programs, but within 6 months into '96 P&G had recovered their "lost market share" and then some with lower everyday pricing and a higher PBIT rate!

How do you think the grocery channel took the news? There was resistance of varying degrees from over 75% of the retail customer base. In a survey, about two-thirds grumbled, but were resigned to go along with the change, because they had to stock P&G products. About 10% attempted to start the mother of all channel holy wars with Stop-n-Shop as their leader. The hard core resisters had special, over-flow warehouses to stock huge amounts of goods bought at deal prices and marketing people to roll out economy of scale, regional advertising promotions to their retail customers. They were convinced that consumers all shopped on price and that retailers really made their profits on the buy side of the business.

Do you think the grocery distributors were happy? Distributor sales forces and independent rep agencies had warped their ways around pushing product deals through the channel. What were they going to talk about now? In 1996, most had not had time to bother to understand ECR or QR or TPC concepts, let alone how to be part of the new solution. They had been too busy doing the normal triage on what deals to strategically push, because there were more deals being offered from their suppliers than they had time to promote.

CONCLUSIONS FROM THE WAL-MART STORY

What can we conclude from Wal-Mart's success?

- Wal-Mart is an exceptional, perpetual innovator. But, their roaring success was also enabled by the slow to non-response of their much bigger competitors, first in mass-merchandise from '83 to '90 and then again in the grocery channel from '90 to the present. Competitors who pull away from the pack in mature industries do so because they are less frozen in the past and more in tune with what present day customers really want.
- Fear is a bigger motivational force than greed. Wal-Mart did not conceive of new things. Sam Walton reverse engineered his first Wal-Mart store by adapting K-Mart's new, big city format to small towns and used his same two-step distribution center that he had been using for Ben Franklin discount stores to replenish the new Wal-Mart stores. In 1983, the QR experiment was the domestic textile apparel industry's idea, but textile mill employees were the single biggest group of shoppers at Wal-Mart's small southern town stores in 1983. Do you think Wal-Mart was fearful about high unemployment amongst their best customer segment? Their "Buy American" campaign made a lot of local, self-serving sense when it was kicked off 1985. Wal-Mart clearly had a lot more fear and greed to make QR work than their other bigger rivals did. What is our current perceived (and heightened?) fear and greed to reinvent distribution profitability?

- Since 1962 Wal-Mart's TPC proposition has been the biggest retail format winner of all with the masses. Sounds like a trend! How many distributors have defined, measured, achieved and sold the lowest TPC solution to one niche of customers at a time? Very few! There is lots of upside opportunity for creating and selling niche-specific TPC to distribution customers in mature industries that are buying mostly commodities.
- While it may be tough to change organizational habits and unspoken mental models, it is even tougher to change inter-organizational relationships. Entire channels don't change. Pairs of progressive companies do change by pushing the wheel of learning together.
- If a few, progressive CEO's see new opportunities to work together that involve inter-organizational process re-engineering, how can they anticipate and defuse all of the natural resistance that will come from interpersonal relationships and invisible systems that exist between their companies? Even if there is a clear intellectual case for change, the troops don't want to see significant, old-job duties liquidated. Even if they all understand and believe that there will be new roles for them to play on the other side of the transition with no downside risk in compensation, they will be fearful of failing forward towards those new roles. For most people, any type of fear is a far greater motivator than greed for new upside potential. "Change has no constituents."
- If and when a company implements a new policy change for a wider group of customers (for example; new, higher minimum orders and special charges for small customers that order small, money-losing orders), anticipate that there will be a vocal 10% who will fight back. Of this 10% there will be a self-appointed spokesperson or leader (like Stop-n-Shop vs. Wal-Mart). However, if the change makes proven economic sense, the vast majority of the customers will grumble and then change. Don't let the vocal minority stop necessary changes. (P.S. Stop-n-Shop still buys P&G goods.)
- Could our traditional marketing structure, skills and incentive plans accommodate an ambitious customer's request to re-engineer our historic relationship? The P&G, Wal-Mart case is an extreme example that suggests not. P&G put a senior executive champion on the partnership project who moved to Bentonville, Arkansas along with an eventual special project team that grew to over 70 people. The initial re-engineering changes that P&G had to do were huge and are still evolving today. The old salespeople, skills, incentives and relationships were totally replaced by new ones. Perhaps some of the old P&G people who were historically on the Wal-Mart account found places on the team. Most distributors will have to develop some hybrid, team-selling system that involves: honcho-to-honcho concept selling, buying and co-creation planning; special service support; AND, a re-trained, best traditional sales rep on a new type of incentive plan. Existing sales reps and incentive plans will generally not transform the important accounts to win-win lowest, TPC replenishment systems.
- What does Wal-Mart's product knock-off success for the biggest selling commodities tell us about the cross-subsidy problems and opportunities that exist within a typical distributor's portfolio of products? If the bottom 50% of our items generate 1% of our sales, then the top 5% of our items must be obscenely over-priced and ripe for Chinese knock-offs to hit. Do we need the perfect Chinese made knock-off, private-label items to sell at initially 50% less with still great margins sooner or later? If we don't stock and sell such items, what will happen if our competitor starts switching our customers to the knock-offs first? At the other end of the spectrum, our existing micro-niche, dead-stock items should tell us that we can't afford to sell them on a local stocked basis through our traditional, high-cost, push, sales force. Centrally located items with web-based marketing that generates leads from a far wider base of self-selected customers will have to be developed.

WHAT ARE THE BIG, CHANNEL-CULTURE CHANGE OPPORTUNITIES IN MOST CHANNELS?

With the Wal-Mart story in mind, let's look at channel culture change opportunities that exist within many independent distribution channels through the use of case studies. These opportunities will be highlighted by case studies that fall into three sub-topic areas:

- Controlling Producer Promotion Pressure
- Marketing to Each Customer's Evolving Notion of TPC
- Re-thinking Sales Force Skills, Activities and Compensation

CONTROLLING PRODUCER PROMOTION PRESSURE

WHAT ARE YOUR CHANNEL'S RULES?

With the life-cycle curve in mind, most of us could construct a rough history of our channel by answering these questions:

- What invention or change in history started the channel?
- What supplier(s) was the first big line to have? (For example, Thomas Edison started a company in 1879 that was re-named General Electric in 1982. As GE cranked out new products to wire up America, it needed factory reps, then regional stocking reps, then full-line independent distributors, etc.)
- When did the industry trade associations start up and what standards did they first work on in the name of "growth and fairness" (Up until 1926, the number one concern was pricing that was "fair" and fixed).
- Where did "list pricing" – that everyone still publishes, but no one really uses – come from?
- When did the suppliers start appointing "product managers" and broadening their lines to accommodate even niche needs that didn't exist? When did some start trimming lines back like P&G did in 1996? (A common motive for line trimming has been the arrival of successful knock-offs of the best selling items produced by focused manufacturers and sold first by discount-oriented distributors. Then, full-line firms can no longer overprice the A's to cross subsidize the D's)
- When was the transition period in which distributors' product mix went from specialty push items selectively distributed at decent margins to 90% commodities sold by all making both internal and inter-company cost reduction the big themes?
- Is there still an annual calendar rhythm to some suppliers' promotions?
- How many executives of big (and little) suppliers, distributors and end-users have known each other for a long time and wouldn't want to upset them too much with big changes?
- How many distributor sales people are over 50 years old and have spent their entire lives in the channel? Do they have customers that they have called on for a long time? Do they and their buy side buddies really want to change with the times? How big a drag can long-term channel friendships be to big change initiatives?
- Are their big end-users in your channel that are going to "supply chain management" strategies that involve: new VP's with centralized mandates and software tools; consolidating suppliers; standardizing products; etc? Who will get their way, central purchasing or our local alliance with local purchasing influences? Because there will be local service failures due to new purchasing strategies, what will the final synthesized solution look like? What distributors will eventually make good money on next-level, TPC replenishment contracts, whatever they may look like, in your particular channel?

- If there is TPC, "supply chain management" fever with some of the biggest buyers in your channel, could it spread to the hard-pressed, owner-operator firms in which the owner also plays a purchasing role?

The answers and even best guesses to all of these questions will help us to understand how things are done in the channel and how we all get along. There is a culture that threads through the suppliers to the distributors to the end-users, and it always lags the living edge of change within the channel and outside the channel. (Recall the thought exercise in Chapter One under the kinetic chain? We imagined that three kinetic chains for each step in the channel were all cross-linked on a dotted, invisible line basis. Those links add up to enormous resistance to change.)

Because distributors are in the middle trying to respond to both big suppliers and big customers, they are rarely the channel-leader, especially for initiating cultural changes. In fact, because they are so operationally oriented and close to all end-users and Purchasing Agents, they will generally lag behind the proactive thinking of the most progressive (top 3% or so) manufacturers and end-users.

To reinvent our profits we will have to see the living edge for what end-users want and get there sooner and better than most of the competitors. But, getting there will require breaking the old rules which will require knowing what they are and why they hold us back.

There have been plenty of times when I have urged distribution clients to pursue my strategic map theories only to receive evasive answers and no follow through. By listening between the lines in these mini-cases, we can guess at the cultural laws of the channel that tend to bind us. Here are some paraphrased, case-study dialogues followed by some commentary.

CASE STUDY #3.2: WHY NO FOLLOW THROUGH ON CUSTOMER PROFIT REPORTS

Two, huge, durable goods distributors in different channels that I have worked with have great customer profitability analysis software and a ranking report showing big-name companies at the bottom with losses in excess of $100,000 per year. (Note: the biggest losers for any distributor are typically big name, big potential customers that are buying nothing but small orders that create huge transactional costs/losses for both players.)

BRUCE: "Wow, you've done the analysis; great work! What have you done so far with the most profitable and biggest losing accounts?"

PARAPRHASINGS FOR BOTH CEOs: "Well, actually not much."

BRUCE: "For the biggest losers, you could offer to do a 'TPC Audit' followed by recommendations on how they can buy on a modified basis, so that you both can save huge transactional costs. My experience has been that 80% of these "lead to gold" customers will work with you to make things win-win. A swing from a $100,000 loss on one customer to a few thousand dollars of profit would be terrific for any branch involved! For the bottom 5% of your biggest losers across your chain, we are looking at millions in PBIT turn around in a short period of time!"

CEO(s): "Well, yeah, OK, sure. I told my regional managers to do something with these reports, but I guess they haven't so far?"

BRUCE: "Why do you think they didn't follow up on it? Should we review this opportunity with them again? What other opportunity offers as big an immediate turn around opportunity in the company than turning lead accounts into gold?"

CEO(s): (The evasive stall) "Well I don't really know; maybe we should look into it again."

Comment: One client did not look into it again as far as I know. The other procrastinated for 18 months until a high level discussion broke out between big, outside shareholders who wanted to pursue the opportunity, but the CEO and a senior marketing exec "still weren't sure." Here is what they said:

CEO: "One account, for sure, will not budge, they don't care if we are losing money. If we walk away from the account, though, it would immediately get all over the industry which would be bad PR."

Comment: <u>Should we let the one bully that we are guessing will walk stop us from converting the rest?</u> What about the 80% of the losers that will work with us, because it is in both parties best interest? Isn't it interesting that the reflex response focused on the one account that would (probably) not change.

If the big contract were to be terminated, why would it be bad PR? Is this an emotional pride issue akin to who dropped who in a high school dating case? If any one asks or cares, <u>can't we just tell them our win-win guidelines?</u> Although we try to be creatively accommodating, if we accept losing deals then all of our other customers must pay more or lose a supplier when we go broke. Most customers and suppliers don't want to subsidize our losing customers.

Sr. Marketing Exec: "If we did the entire shape up or out program for all of our losing customers, our profits might increase, but the lost margins from <u>having 10 to 20% less in sales</u> would be a hit. In the long run, it would <u>not be a good thing for our relations with our suppliers</u> or for <u>our reputation with customers that we are being high-handed by raising prices</u> and tightening terms and services. We currently have a huge industry share and a great reputation; maybe we don't make as much as we could, but we are doing all right. <u>Why take any big risks?"</u>

Comment: <u>Note the imprecise, data assumptions</u> that profits might go up and sales down 10 to 20%. What if <u>the actual math</u> suggested that we could double profits and lose only 2 to 3% of our old sales volume? What would be the net sales level if we went gradually from the easiest loser-to-winner conversions to the bigger volume, no-change ones? At the same time, couldn't we pursue "more to the core" initiatives like ABC Distribution did in Chapter One. <u>Don't assume the better profits, for less volume trade-off is a given. We can grow both profits and sales. (ABC Distribution in Chapter One did!)</u>

As far as reputation and image, if we define, measure, achieve and sell the lowest TPC solutions that may or may not involve a higher price what's wrong with a "best value in the industry" reputation?

Between the lines, what are both Execs saying besides the universal: "<u>Gee, we have never done this before, how do we know it might not work. Our fear of the unknown is greater than our desire to change the status quo."</u>

CASE 3.2'S HIDDEN CHANNEL RULES?

What channel cultural laws am I bumping into in this case? I'm guessing:

<u>Rule One</u>: <u>Don't ever lose any volume</u> share of market. Since the beginning of the industry everyone has been oriented that way by the suppliers. You don't want to go against their volume wishes, <u>because you might lose the line</u> or see other distributors granted the line for the same region. This was a big deal when most distributors didn't have more lines then they really needed. And, manufacturers granted exclusive franchises that included unique products that could truly win new profitable business.

Comment: ABC Distribution in Chapter One discovered that all of the profit power had gone out of their franchise game that they had played so hard up through the late '70's. Most lines were now excessively distributed and other equally excellent lines seemed available.

ABC also reasoned that the following promotional efforts seemed like wheel spinning.

- Trying to sell customers the same (equivalent) thing for less;
- Trying to sell customers unusual items that they really didn't need;
- Selling some of the items a niche of customers needed without the rest of the one-stop-shop offering.

If ABC did have, however, an exceptional, valuable, exclusive supplier franchise that could grow them and their profits, they could then make exceptions to keep the supplier happy.

Rule Two: All Executive and Sales Ego's need volume for vanity and orders from all as acceptance. Ever since Alexander the Great went into a depression at 32 years old back in 324 b.c.e., because there was nothing left to conquer for adding to his empire, publicly visible scale has been more emotionally important to most than invisible profitability and long-term viability.[2] "Volume is vanity" wins over "profit is sanity", especially for extroverted sales types who also equate self-esteem with getting any order from every customer. Is Rule Two in effect when one exec is worried that losing an account would be bad PR, and the other is happy to be bigger and make less? How do we learn to accept that:

- We can't be all things to all customers; there are strategically not appropriate customers.
- Not all customers are wired to buy the value proposition that we are selling.
- If we waste resources and lose money on some customers, we can't pursue the very best customers in the very best total-team way to actually be bigger, more profitable and more popular with fewer customers.

Rule Three: Don't give up any small customers today. They could grow into winners in the future. (Acorns grow into oak trees wisdom) If we upset them today with extra economic demands to make them profitable, then if and when they grow big, they will refuse to do business with us for historical reasons. That would hurt future volume (see Rule #1).

Comment: In new, fast growth industries acorns do grow up. Once industry growth rates slow and consolidation begins, the odds of acorns growing drop dramatically. In nature, the odds of an acorn growing into a mature oak in a mature forest are 1 in over 100,000, and those acorns are happenstance winners. Companies can use selection criteria to bet on a few per hundred in the "living dead, growing nowhere" group of accounts, but the rest need to be re-priced, re-termed and re-serviced to make a profit or let them go elsewhere. (More on this in Chapter Four under the "small order program.")

Rule Four: This is a tight industry, we all steal each other's employees. If you upset someone today at one account, you don't know if they won't then go to another really good account and work against you. Make no channel enemies, get along with everyone.

Comment: Stealing each other's employees is common during the growth stage of the industry life-cycle. Once the industry matures and consolidates it sheds more employees than it hires. Upsetting an unprofitable customer by changing their terms and assuming they will – a) grow big someday when they have not in the past 5 years; or, b) the person will go to an important account and keep their anger – are

[2] Note the academically correct use of "b.c.e."(before the common era) instead of the traditional b.c.

both bad expected lifetime profit-flow assumptions. A bigger problem that we will see below is how to thin the ranks of veterans to make room for some new, young, "intrapreneurial" energy.[3]

Rule Five: A bird in the hand is worth two in the bush. "What's wrong with being bigger and making less if being smaller and making more has unknown risks involved?" (The Sr. Executive who said this had no stock in the company and was making a huge salary after climbing through the ranks for 30+ years.) "Don't rock **MY** boat" may be the operative phrase for a majority of executives who aren't concerned about creating a sustainable profit power commonwealth that will outlive their tenure and personal needs.

Comments: According to Chapter One analysis, making a terminally low pre-tax ROTA is risking the long-term health of the company, the horse with too little oats will die. ABC Distribution case illustrates that making more and growing through strategic, organic improvement methods can happen. The "volume **or** profits" trade-off can become "volume **and** profits".

Many mature distribution companies have gotten top heavy in age and compensation and too light in intrapreneurial ability. A common pattern for a company life-cycle is for an entrepreneur or next-generation buy-out team to work hard in the early years. They take out lower pay from the company in order to plough necessary retained profits into financing the company's growth. They hire people in their own image who may be 4 to 10 years younger than the top manager(s). They all grow up together, get raises every year (eventually as an entitlement) until the company has too many top people in their 50's or older. The energy and risk-taking levels drop, what worked on the way up is now still promoted and guarded. The company has too big a payroll and is too top-heavy to be able to afford and keep next generation intrapreneurs. The old guard needs to be bought out on a systematic, planned basis in order to continue to clear space for new intrapreneurial talent needed to champion the changes required to catch up to marketplace realities.

One solution for top-heavy firms is to sell out to a consolidator or bring in a turn-around artist who will solve the problem. But, it is never too late to confront the facts and the lack of change and implement a buy-out system and set of rules to abide by. Most sustainable legal and investment banking partnerships have these systems. And if you are a sports buff, draw inspiration from a management system that Branch Rickey, the General Manager of the Brooklyn Dodgers, had in the '40's. He was committed to having a starting rookie in the line up every year. This meant:

- One of the current year's starting 9 players wouldn't be starting next year, so they all worked harder not to be the one weeded.
- The team wouldn't get old and collapse together (like the Chicago Bulls after Jordan's second retirement)
- There would be rookie energy, spirit, humor and fan interest every season

What can we do to systematically maintain our change management, intrapreneurial capability at an optimum level within both our management and sales teams?

Rule Six: You have to be price competitive. Remember the marketing chap's quote, "it would not be a good thing for our relations with our suppliers or for our reputation with customers that we are being high-handed by raising prices and tightening terms and services." Is rule six the flip side of this statement? Does he, and therefore, his entire sales organization, believe that no distributor can raise prices for better service value? Are they afraid that if they do raise prices, modify services and terms on some types of losing customers, they will then lose volume which would violate Rule One?

[3] For definition and lots more on intrapreneurs who are needed to champion big changes within mature companies go to www.intrapreneur.com

Comment: If we have always worked for a "good service" firm and competed against other "good service" firms, then our reality is to be happy with last-look, meet-the-price loyalty. It's hard for the bottom 97% of a service industry's players to believe that the top 1 to 3% of the competitors are growing faster and charging more. It's also hard for 95% of sales reps to realize that 5% of the reps don't blink when offered last-look, but insist on a bit more just for their own incremental value added and get it!

In our personal lives, don't we all patronize and admire Starbucks, DisneyWorld, FedEx overnight service, and other premium priced, service leaders. Why can't we be such a leader for one customer niche at a time? And, if customers balk at a higher price, we can give them a lower one IF they want to work with us to co-create a replenishment system that lowers our costs to serve more than our prices to them to make a better PBIT rate.

Half of why we might be able to achieve distinctive service to dominate one niche of customers at a time is that we could price away a lot of customers who don't fit into our niche and/or can't be profitable. This frees company resources to do a better job in a focused way for the niches and the customers within those niches that really matter.

CASE STUDY #3.3: IGNORING SUPPLIER CHANNEL-LOADING PROMOTIONS (?)

With one client I had reviewed the process for how they might improve service value for a target customer niche[4]. I pointed out that selling better, lower TPC system solutions to the target accounts (butterfly map) was vital instead of selling channel-loading, price promotional deals for the commodities. Here's the conversation that ensued:

CEO: "Bruce, we can't ignore supplier channel loading deals, we have to play. If we don't our competition with the same lines will be in at all of our accounts offering them the extra 5% off that we aren't. We will look like crooks, and we will lose business too."

"Besides, some of the big promotions always come in the last quarter, which is when we are also usually in the money for growth rebates, so we have two levels of incentives at stake. And, our suppliers and sales force would both be very upset."

BRUCE: "Remember, we are talking about a chronological process. Wait until you have a total service offering that delivers the lowest TPC to a niche, then sell it ad nauseam before, during and after channel deals. Forewarn customers that deals may come and go, but beware of "bargain price, huge supply" in which the real price savings are more than consumed by the longer term carrying costs of the load up quantity. Remind them that they can't have everyday, good contract prices with smooth, regular replenishment flow (like Wal-Mart!) if they sporadically load up. The ones who want 'the best value' will be receptive to your marketing message that teaches them specifically what TPC is and how to work with a supplier to achieve it."

CEO: "Well maybe that might work for a few of our customers. But, there will still be others that will get wind of the program and want at least the extra 5% off their regular prices for whatever quantity they might normally buy from a promoting supplier during the promotion. They see any extras that we might get as theirs on a pass through basis."

BRUCE: "If they ask for it, give it to them. If they don't, don't offer. Many will not ask for it, if you have truly achieved and sold the lowest TPC replenishment system for the account.

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[4] See strategy map #5 in Chapter One.

There may be others that can't help themselves and will nibble at deal prices from competitors. Then, when the deal is over, they will come right back to the lowest TPC deal from you, because it is the best value. If we do the math for the margin dollars that are won and lost by not selling every customer every item, I think there will be a big positive trade-off to the bottom line. Let's do some actual math scenarios.

Most importantly, though, we don't want to sell deal-savings as a source of sustainable profit power for our customers. We want to sell lowest TPC system savings as the profit power solution. We don't want to sell two conflicting messages: load up on deals AND buy everyday, on-hand, system value and productivity."

CEO: "Well, we might still lose some volume by year-end that will cost us rebate dollars, and I don't think our sales force is going to like this whole shift at all. They like the program spiffs and having something to tell the customer about when they make calls."

BRUCE: "Let's not assume that the rebate trade-off math will be bad, let's do the math for several different scenarios. I think if we keep an open-mind and don't see any issue as an all or nothing proposition, then we will find that for every rebate dollar we lose in the future we may gain 2 or more times the incremental PBIT now. The key is to sell steady, best value and not "sell low" to everyone on every deal.

As for sales reps liking both spiffs and pushing instant gratification price deals to customers, channel loading bribe addictions, like cigarettes and coffee, are tough to give up. But, in the long run, if it makes big economic sense for the sales rep and the entire company to sell sole supplier, lowest TPC systems, then what are we going to do? Sell price today for fun, no profits and no future; or, create and sell TPC value to create premium commonwealth economics for all of your stakeholders for the long-term?"

CASE #2's HIDDEN CHANNEL RULES

(adding to the six rules from Case #1)

Rule Seven: All general channel loading programs must be passed through to preserve volume (Rule 1).

Comment: We have seen how rule seven has hurt the consumer channel players who persisted in high/low pricing promotions while Wal-Mart pressed on with its everyday lowest TPC strategy. Distributors have the luxury of targeting many different customer niches within a generally limited geographic area due to freight and time sensitivity factors. If we can better define customer niches and their respective service metrics, then measurably deliver them, we can get last look and something more. Then, we can convert service reliability into win-win TPC and "total sales-service cost" (TSSC) reduction systems that are generally impervious to channel deals.

Rule Eight: Growth rebates are our profits, pursue them with incremental cost thinking at year-end once the bonus sales target has been exceeded.

Comment: We used to assume that "profits" came from margin dollars gained from pushing more new products to new customers and into new markets during our industry's early life-cycle stage. In mature industry settings, however, those assumptions are dated. ABC Distribution discovered that profits come from dominating a niche of customers. As for fixed and incremental cost thinking, we learned in Chapter Two why "fixed costs" aren't so fixed. The path to profit power is not dumping products on a price basis in the last quarter.

Rule Nine: Sales reps like to meet prices, "sell" deals and earn spiffs (not create and sell value and hang tough on last-look + pricing). We should accommodate them, because…? (They control the accounts and may take them to a competitor as they might have in the 70's and 80's?)

Comment: When many channels and the US were both growing rapidly from 1950 to 1980, distributors aggressively opened up new locations in new cities and stole sales reps from competitors with the expectation that the reps would switch their loyal customers' volume. But, what happens when channel growth slows, consolidation begins and overlapping distribution locations are merged down in numbers? Don't the reps' opportunities for switching to other companies consolidate too?

But, more importantly the rep's role in creating and maintaining customer relationships has changed. In a new industry, most of the new product knowledge story was delivered by the rep. What happens when 90% or more of what the customers buy are commodities for which they are looking for the lowest total procurement cost replenishment system? Alternative product information delivery systems have emerged to let the customer find out what they want 24 x 7. Inside reps are sitting on increasing amounts of the total universe of information and regularly prove that the best search engine on the planet is talking to the right knowledgeable person between you and the on-line universe. Or, customers can go to increasingly sophisticated distributor web sites or in a pinch google.com on a 24 x 7 x 365 basis.

Try this experiment at google.com: type in a product name and number within quotation marks, then a space, then a plus sign followed by another space and then "price" to see what happens. If you get too many hits, add another space, plus sign and type in "China". The speed and quality of finding a specific product, all the information you would like, plus availability and comparative prices will only improve in quality and quantity.

The rep's role as extra allocation agent has disappeared. In 1974 a printer in St. Louis told me that he was loyal to my printing paper company's rep. He had been giving us the lion's share of his paper needs at a higher price than what competitors were offering for 30 years. The reason was that our 60+ year old sales rep, who had been calling on him for those 30 years, had gotten the printer "extra allotments" of paper during paper shortages after WW2, during the Korean War and sporadically up to 1974. His protection payments to our rep and company served him well in the months to come. We had one last shortage of most commodity goods in the second half of '74 into '75 before a huge glut occurred. How many customers today pay premium margins to distributors as insurance for getting allocated goods during the next shortage? In a consolidating world awash with excess capacity with new redundant capacity being added globally, it doesn't look like a big loyalty factor for the rep.

The relationships with any distributor's big-volume, important accounts have generally gotten more complicated, specialized and integrated. A team of people can be involved in selling, installing and maintaining buy-sell replenishment systems involving special: stock, services and paper flow. The switching costs for our few, high PBIT customers that have more customized replenishment relationships with us has and should be growing. And, because of distribution consolidation, the switching options for our customers has dropped. If the few important, truly profitable accounts per sales territory are team-sold, then the accounts will have the most loyalty to the company's team and the TPC service system value that they uniquely deliver. But, having a competent sales rep who can both maintain an account relationship and champion successful TPC solutions is still vital!

The power and loyalty story today is not about what the manufacturers or the sales force want. It is, rather, about what the biggest, most progressive, most inherently profitable customers in our #1 niche want. Getting spiffs for pushing product price deals to too many customers to get them to buy 8 weeks supply today isn't helping customers to lower costs due to our unique service offerings.

TIME OUT! Here is some emotional first aid for those executives who were and may still be super-star sellers and who will always believe in the sacrosanct rep-customer relationship. You and they can be more relevant and valuable than ever, IF you can reinvent your skill sets and work on salary plus gain-sharing bonuses tied into PBIT/customer improvement targets.

From an historical perspective of surveys conducted since about 1990, "big buyers" have consistently rated 10% of sales reps worth seeing. So, for starters, define what a top 10%-ile performer is and become that. If anyone doubts the 10% figure, do a quick survey of your own people rating the supplier reps that call on your distribution firm. Make a list of what the best and the worst do to set themselves apart from the middle. Then, do the same exercise with 5 or more best PBIT customers in your number one niche.

From a forward-looking perspective, the top 10% won't be messengers delivering the latest channel-loading promotional deals, but will, instead, be the best profit building consultants starting with business process re-engineering solutions to reduce customers' TPC. Then, they will stay on the living, changing, adapting edge of those systems.

For customer niches comprised of small, independent businesses, if the top 10% have systematically locked up the business, then they may next help the customers to more effectively market to their historic, best niche of customers to sell more, high flow-through margin business. This will help best customers grow both themselves and their supplier faster and more profitably than the industry.

WHAT DID THE DISTRIBUTORS IN CASE #1 AND #2 DO?

With their unspoken, cultural instincts still in control, the managers in the two case studies above didn't do anything differently right away. They kept doing what they had been doing, although obviously with more insight into what they could be doing if things got bad enough. Perhaps their inaction is analogous to most people trying to reweave good health habits into their daily lives. As we get older and our health fades, we keep learning about what we should do, but don't act until forced, if ever?

Sometimes distributors will take new insights and try to tack them on to old practices or to be a bit more strategically targeted with the old practices by "tinkering around the edges". The case study that follows stars a roll-up chain that tried to be strategic with their product promotions. Instead of letting the suppliers pitch them with the same programs being offered to all other distributors in the channel, this chain chose "strategic suppliers" and then co-created their own customized promotion. On the surface it looked and sounded good, but it doesn't have a happy ending.

CASE #3.4: TRYING TO MODIFY CHANNEL CULTURE RULES AT ROLL-UPS-B-US

A distributor, whom I've known for almost 30 years, sold his firm to a big consolidator in his channel, fortunately for cash, in the mid-90's. Because he had a "consulting contract", he hung around for a few more years to become privy to the chain's national, promotional deals with suppliers.

He was, at first, impressed with how strategically selective and proactive the chain was with their product promotions. MBA marketing types from Headquarters would put together sophisticated programs. They generally focused on big brand name commodities and got great supplier deals in exchange for their marketing clout with approx.1000 sales reps; 200+ locations; 200,000+ active accounts. They would position the promotion as being part of their more general effort to go after key customer types. They would offer researched case studies from the locations that were already doing the most business with the selected line sold into the most promising types of customers. They would top it off with slick incentive plans for the field sales force with real-time, tracking systems (probably now available via the internet 24 x 7!). And, they would sell a lot of "additional" volume during the promotional periods.

The chain, however, wasn't growing core earnings. As long as they could keep buying earnings growth through deals and then hide additional profit enhancement moves within the accounting for the deals, things looked good to Wall Street. The image was that this company was being run by real pros who could make real, financial synergies and economies of scale work.

However, at the branch level things were doing a slow fade as far as my friend could tell. How could we reconcile the superficial success of the HQ-driven promotions with the branches' slowly fading year to year growth rate in both sales and profit power? Do you think the marketing managers at HQ would like to be confronted with the following questions:

- What were the long-term effects of promotional deals that might just be loading up the old customers and selling unprofitable cherry pickers? Is anyone measuring these effects?
- Are there returns after the spiff points totaled for the reps? Any gaming of the programs?
- Are these promotions just moving future volume forward to existing accounts at a discounted price?
- Is selling "great price" deals consistent with selling everyday best-value service at steady, good margins?
- Is the chain really getting new penetration with the right (PBIT+) old or new accounts?
- Is there more to the historical stories of why the best branches have done good jobs with the featured line and certain target customer segments? Is promoting one line going to provide a longer-term, best fill-rate, one-stop-shop basket of common items that the target customer segments want to buy along with perhaps some other special, local service capabilities?
- Did the historically successful locations benefit from an unusual concentration of heavy using customers and/or competitors that were historically very weak in the target customer segment?
- What are the chances that one monolithic program is the right program for all locations, especially considering the diversity amongst locations due to growth by acquisition?

It's easy to be critical of companies after they fizzle, but how about some praise and fresh ideas for those HQ MBAs at distribution chains. I know I was once of those guys. I tried a lot of new stuff which was initially just improving the existing the model, nothing revolutionary, and I certainly didn't bat 1000% with all of my intrapreneurial acts.

If top-down, monolithic promotions for all branches to execute didn't work so well at RollUps-B-Us, what kind of centralized, economies of profit power solutions could they develop? First, they might rethink the metrics that they publish to their branches. If, for example, every branch received a monthly, one page summary report on the PBIT retention, growth progress of 15 accounts sub-divided into three categories – most historically profitable, most important target accounts, and biggest losers that need to be converted into winners – what would happen?

Experience tells me that not much would happen for the first 3 to 6 months, but then branch and regional management would start to proactively focus on those accounts to preserve, build, crack and convert them. It takes a few months for manager's selective perception to shift from fire-fighting and fine-tuning the familiar to noticing how much activities are wasted on the reminder list of losers and what isn't being done for the winners and the super-targets. If their incentive plans are tied into PBIT improvement, they will eventually start making things happen for the 15 accounts.

Second, chains might develop some consulting capability to help branches do strategy map analysis in order to pursue improvements like ABC Distribution did in Chapter One. If the branches are lacking in

project-champion, local intrapreneurial talent, then they could rent the talent from HQ at a much better cost/benefit rate than they could theoretically hire from the outside.

And finally, HQ could achieve an economy of scale for training all sales and marketing personnel on how to create, market, sell, install, measure, improve and maintain TPC value and reduction services for all customers. Every segment of customer and every customer within a segment will have their own particular notion of and ambition for pursuing lowest TPC. All locations and sales personnel just need to know how to determine what it is and let the customer know that we are ready to take their replenishment process to their own next level whenever they are ready.

WHAT FINALLY HAPPENED TO ROLLUPS-B-US?

Roll ups, in general, fell out of favor with the stock market. The deal rate for Roll-Up, Inc. dropped, sliding core earnings became apparent and the stock price tanked into oblivion. The company was merged into someone else, then spun out again to another private investor group. The company is now being run by the third wave of outside professional managers in the past 10 years. Perhaps the chain was and still is suffering from many of the financial management pitfalls covered in Chapter Two, but I hope our improved strategy map wisdom from Chapter One would also find weaknesses in their strategic product promotion process.

CASE # 3. 5: "BUT, ISN'T SELLING NEW ITEMS AND NEW CUSTOMERS VITAL?!"

A client had had his fill of my advice to "sell more to the core by '04" via TPC and TSSC systems selling. Because, as he finally blurted out, he already had a comprehensive sales incentive plan that included bonus points and bucks for new accounts opened and sold as well as for new sales on new products.

"But, what if 1 to 20% of our sales come from new products we have added in the past few years to ideally not just old, but new customers? Isn't **selling new stuff to new customers the living edge of our business? Don't we have to replace the old, dying and profitless products and customers**? 3M (one of his big, industrial tape suppliers) has had a long time policy of trying to get 30% of their sales from products introduced in the last 4 years. They are a great company, shouldn't we try to imitate that form of growth?"

The short answer is "sure", **IF:**

- We are high performers at doing our core business activity. But, Chapter One pointed out that 90%+ of distributors don't qualify, and the case on ABC Distribution illustrated the benefits and upside "new" growth by refocusing on the core elements of the business in a way that that 95% of distributors haven't done with discipline.
- We can learn our lessons from the bottom 50% of our stocking items that generate about 1% of our sales and are grossly overstated in value on our balance sheet. We should try to promote far fewer new items that are far more strategically selected, then promoted more persistently and written-off faster if they don't fly. Big, fast write-offs each year before you pay bonuses will quickly get managers' attention concerning how to sell new products more wisely.

The long answer is: "Sure, after you take care of top value creation and PBIT-growing priorities within your historic core business". To explain this conclusion in more depth, let's digress for a few paragraphs of Socratic questioning.

Because all distributors and their suppliers started out by selling only "new" items to new customers, isn't that how they and the rest of the channel have evolved their corporate capabilities *and mindsets* for a long

time? Wouldn't it make sense to evolve an internally consistent (kinetic chain) set of marketing systems for both the company and supplier-distributor efforts for launching: new supplier lines; new line-extension products; and, follow-up demand-creation promotions? In many cases, don't distributors expect key suppliers to have product-centric marketing initiatives at the same time every year (e.g. big trade show launches and announcements) whether the supplier has any viable new items to sell or not?

PRODUCT PROMOTION THOUGHTS

Doing product promotions is not, of course, totally evil. There will be suppliers and products that we might preferentially promote. But, how should we allocate our marketing resources between product push promotions of all types and TPC service creation and selling to best accounts in our target customer niches? Should the ratio be, for example, 90/10 for products or 10/90 for TPC solutions to target niches? Should we be pushing products to our entire, active account base, or maximizing butterfly economic$ for both parties at the 10 accounts at each location that have the most (lifetime) profitability promise in our best niche?

Are we aware of how our channel culture reinforces pushing products to too many customers everyday? Consider the allocations for printed marketing material and educational training. The manufacturers' printed materials dominate what distributors pass along to customers. Those product stories are not about unique value propositions available only from a given distributor. Where is the material that educates the customer as to why the distributor has the uniquely, best TPC solution for them?

Most of the education that goes on at distributor facilities is product knowledge training underwritten more or less by manufacturers in a strategic vacuum as far as total solutions for customer niches is concerned. RollUp-B-Us, Inc took the incremental step of choosing which suppliers got air time in front of the inside and outside sales force, which in turn depended upon how much the suppliers contributed in total buying concessions and marketing support for the good, turn-earn lines. They offered only superficial, incomplete thinking about what customer segments were big users of the promoted products; the total selling solution needed to sell a niche successfully and profitably wasn't even mentioned.

ABC Distribution, on the other hand, discovered (in Chapter One) that products didn't drive PBIT in a mature industry setting. The big PBIT driver was capturing a big share of a niche of customers that bought a common basket of items that came from a lot of different suppliers.

Where is the education for ALL employees to be part of the solutions that are covered in this book? Distributors have talked (not walked) for years about sales reps becoming "consultants". Perhaps many of them now do a better job with product application consulting with the end-user, but how many are doing inter-business process re-engineering consulting, etc. to lower TPC for the 90%+ of the purchases for which the customer knows how to use the product? If selling TPC solutions to the right customers in the right niches helps us grow faster and more profitably, don't you think the suppliers that would see their sales grow proportionately might want to subsidize a different type of training that gives them a better ROI? It's a change that will have to be sold, but if it makes sense, it can happen.

Selling new products that suppliers would like to add to our warehouses is OK, IF, we learn how to better screen and promote items that would fit into a common item basket for a profitable target customer niche. Don't just write off dead stock as fast as the new, future, dead items sneak into your warehouse, figure out how to prevent new dead stock from developing at a much lower rate than in the past.

And, a final thought on product promotions is distributors should not try to imitate 3M. 3M is a technology/manufacturing company, akin to pharmaceutical firms. 3M invests huge amounts into R and D to come up with patent-protected products that can be sold for huge margins. Distributors are

operational, transactional, service businesses. They win by executing targeted service to one niche of customers at a time better than competitors.

If 3M or any “innovative” manufacturer that is cranking out a lot of products tries to get a distributor to adopt their strategy, it is self-serving. Distributors can actually best serve their suppliers by growing faster than their competitors and paying their bills on time. This requires making good profits to reinvest back into the business to finance growth and working capital.

DEFINING OUR CUSTOMERS’ TPC NEEDS (To be continued; this will be posted soon!)