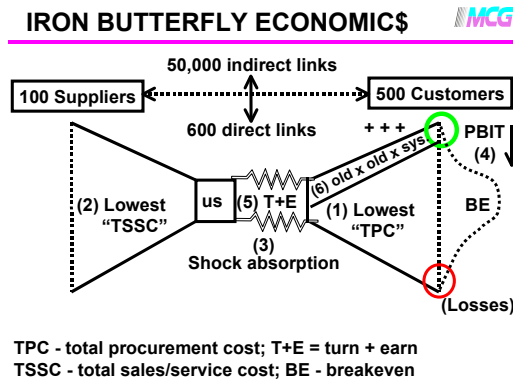


HUB OR BUTTERFLY ECONOMICS



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: $100 \times 500 = 50,000$. 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.¹
- 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

¹ For more on “TPC” go to www.merrifield.com, click on articles and check out articles #ed 4.2 and 4.3. 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).

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.

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 ECONOMICS

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?

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.