FINANCIAL TRENDS IN DISTRIBUTION

BY ALBERT D. BATES, PH. D

INTRODUCTION

THE ACCOMPANYING SET OF EXHIBITS provides an overview of financial trends in distribution between 2003 and 2007. It places special emphasis on the changes between 2006 and 2007.

The analysis covers 40 different lines of trade in distribution. In developing such a macro-view of distribution, it is not possible to compare most financial ratios directly. For example, some industries have a high gross margin and accompanying high expenses, while others have a low gross margin and low expenses.

What is possible is to compare the direction and magnitude of change. The emphasis is on how much performance changed during the time period covered.

In most of the exhibits, results for all of distribution are divided into three subgroups:

- Industrial—Industries that primarily serve the factory floor.
- Construction—Industries that primarily serve the construction trades.
- Consumer—Industries that sell consumer products, or service businesses that sell to consumers.

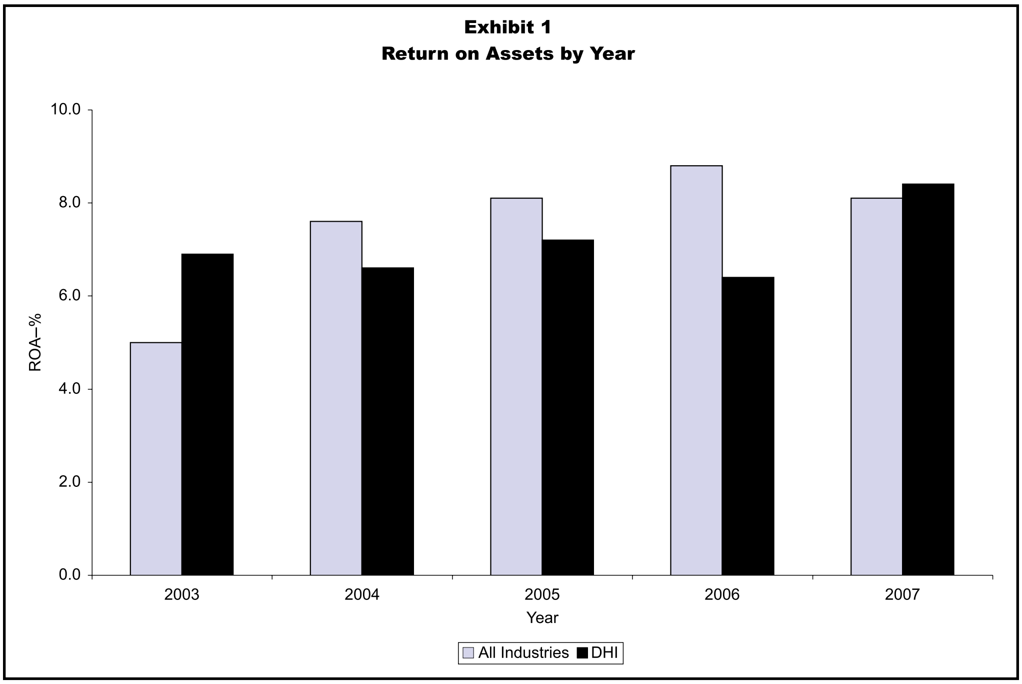


EXHIBIT 1: THE TREND IN RETURN ON ASSETS

PROFITABILITY RESULTS FOR 2007 demonstrated the beginning of an inevitable “up and over” pattern. ROA remained strong for most distributors in 2007, but began to slip. The easiest way to think of 2007 is that it was three-fourths of a very good year and a final one-fourth of a mediocre year.

Return on assets (ROA) is the best overall measure of financial performance in distribution. The ratio is net profit before taxes (but after all expenses) expressed as a percentage of total assets. Total assets represents the total investment in the business.

For an individual line of trade, a median ROA of 5.0% is considered the absolute minimum level of performance. If ROA falls below that level, firms begin to give serious consideration to liquidation in order to re-deploy assets into higher-returning areas. In contrast, a median ROA of 10.0% in an individual line of trade is an indication of a strong, vibrant industry.

EXHIBIT 2: SALES GROWTH BY SEGMENT

SINCE THE ECONOMIC CHALLENGES began in the home mortgage arena, distributors in the construction segment of the economy served as the proverbial canary in the coal mine. Even in construction, though, there was still some very modest growth in 2007.

A significant part of the growth in the industrial sector was due to the rapid escalation in commodity prices, especially for steel and copper. Across all forty lines of trade, though, there was a significant increase in the level of business activity over and above any price increases.

Finally, consumer markets continued to serve as the engine of growth during 2007. Growth remained strong in that segment during almost the entire year.

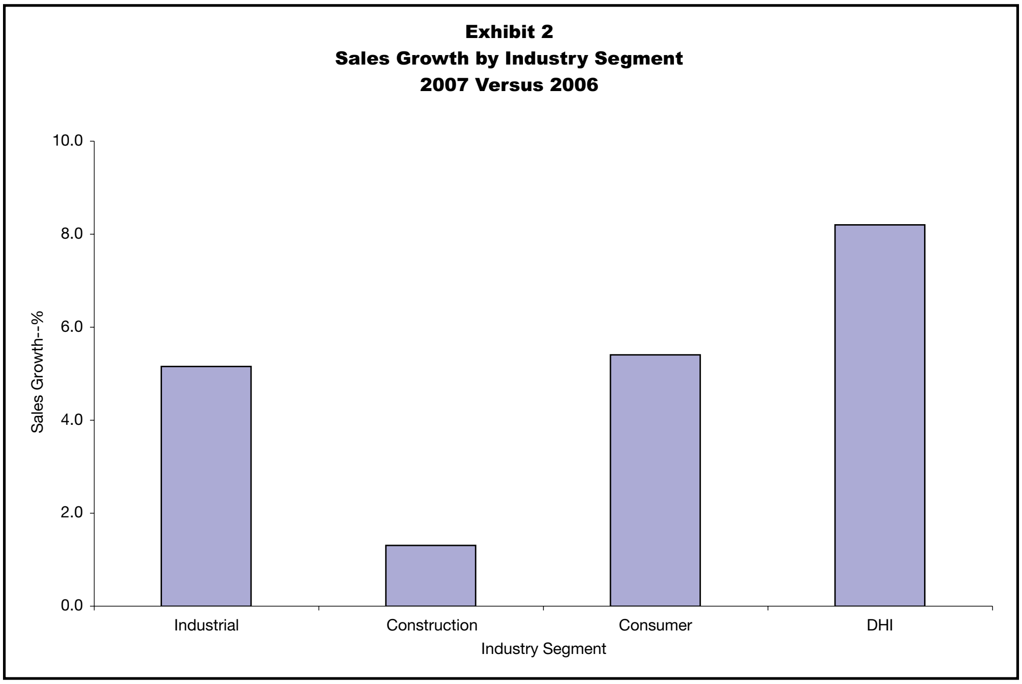
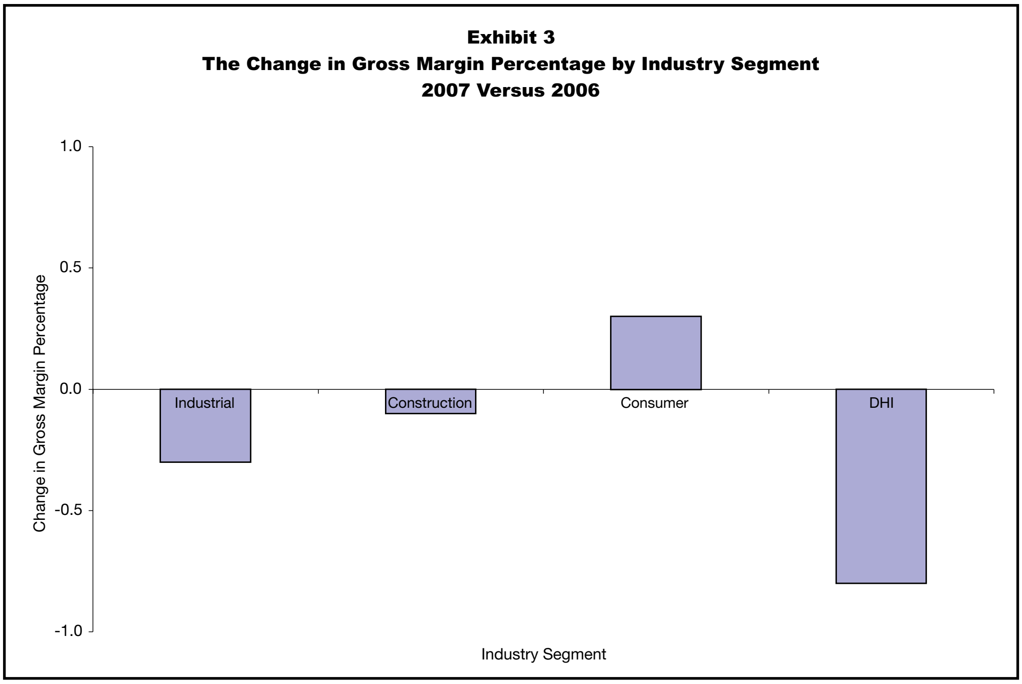


EXHIBIT 3: THE CHANGE IN GROSS MARGIN PERCENTAGE

IN PRIOR YEARS, MOST segments of distribution were able to increase their gross margin percentages. In 2007, the wheels came off of the trolley in a major way.



A significant portion of the problem was associated with the price increases that helped drive growth. Price increases from suppliers sometimes become difficult to pass along to customers. In the classic scenario, a five percent price increase from suppliers is partially absorbed and only three percent is passed along to customers. While sales and gross margin dollars rise, the gross margin percentage falls. This has very significant long-term profit implications.

Exhibit 4
The Change in the Operating Expense Percentage by Industry Segment
2007 Versus 2006

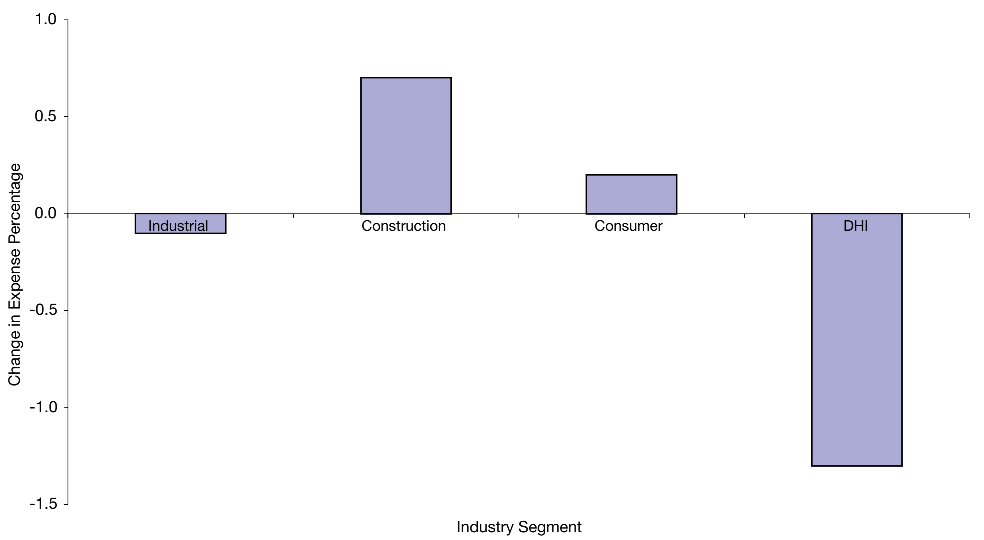


Exhibit 5
The Change in Inventory Turnover by Industry Segment
2007 Versus 2006

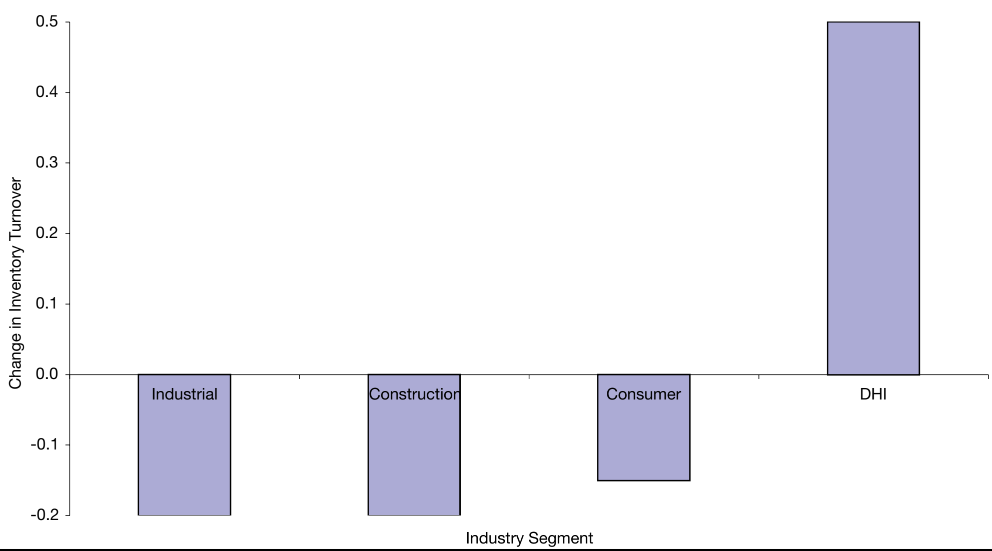


EXHIBIT 4: THE CHANGE IN OPERATING EXPENSE PERCENTAGES

ANY TIME SALES growth is diminished, operating expenses as a percent of sales tend to increase. This was the classic pattern followed by the construction segment of distribution. The pattern was also duplicated in the consumer segment where sales continued to grow, but not at the spectacular rates seen in previous years.

Industrial was the only segment where the operating expense percentage actually fell. In large part, this was due to price increases increasing sales to somewhat artificially high levels.

EXHIBIT 5: THE CHANGE IN INVENTORY TURNOVER

IN 2007, INVENTORY turnover fell in every industry group, for the first time in the five years this report has been prepared. It seems likely that the slow down in economic activity in the fourth quarter caught many firms off guard. Sales growth moderated while inventory buildups were still taking place.

Inventory turnover plays only a minor role in driving profitability. However, it is a huge issue with regard to cash flow. The decline in turnover, even though somewhat modest, is a concern, particularly for highly leveraged firms.

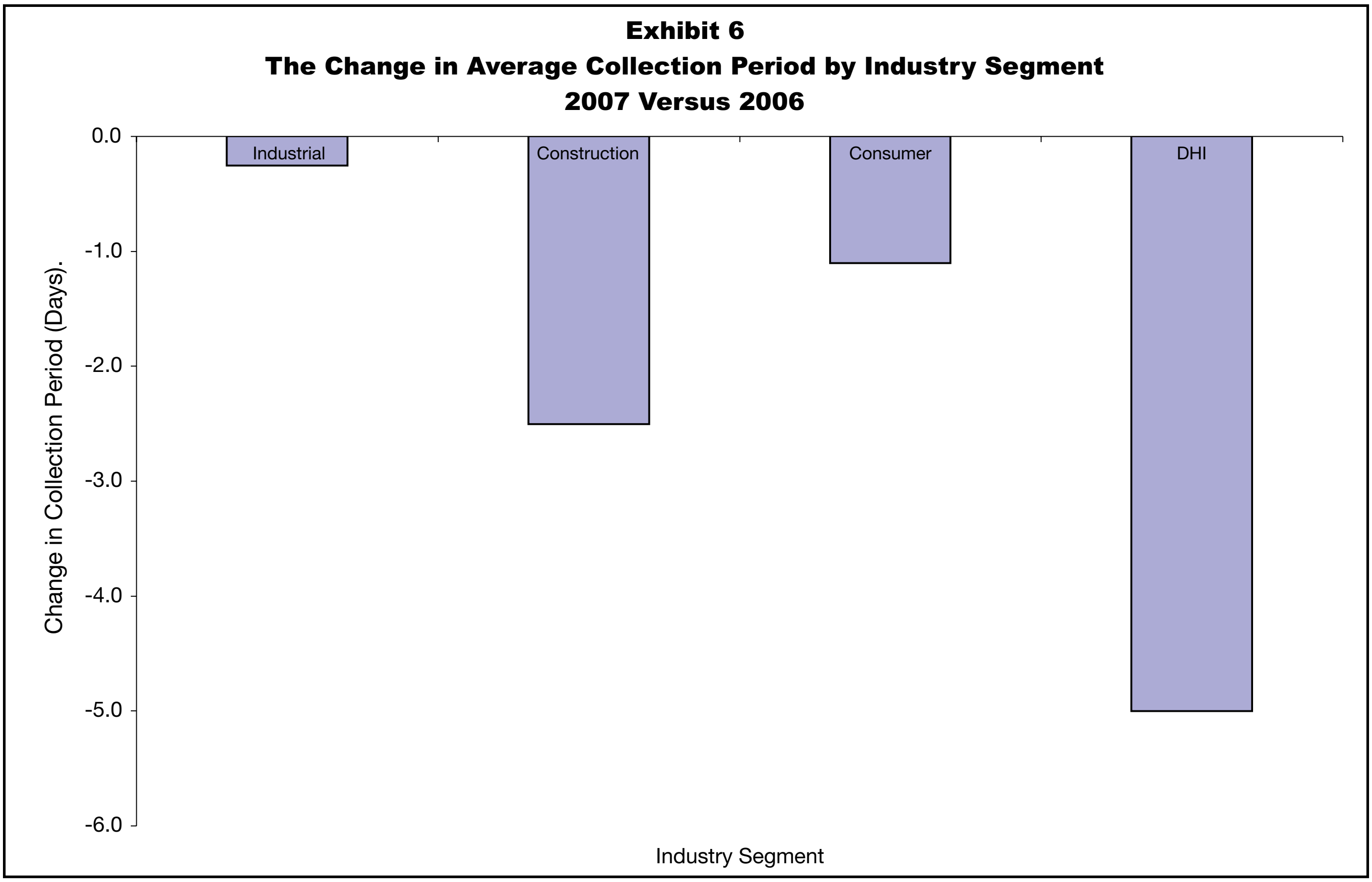


EXHIBIT 6: THE CHANGE IN THE AVERAGE COLLECTION PERIOD

THE COLLECTION PERIOD DECLINED in all three segments. This is an unprecedented collective movement, just as was the decline in turnover. The fact that the collection period was improving in light of slower growth is somewhat surprising, though.

Typically, as sales growth lessens the collection period increases as customers take advantage of opportunities to delay payment. It is possible that given the somewhat sudden reduction in sales growth that firms responded by tightening credit and collection policies. Responses in accounts receivable can be made much quicker and much easier than can responses in inventory. Faced with some cash flow challenges, cutting receivables may have been the only available course of action. dh

About the Author: *Albert D. Bates, Ph.d President, Profit Planning Group www.profit planning group.com*

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For more information contact:
Door and Hardware Institute
14150 Newbrook Drive, Suite 200
Chantilly, VA 20151-2223
Phone (703) 222-2010, Fax (703)222-2410
www.dhi.org
www.lifesafetyandsecurity.org