Profitability Patterns in a Year of Strong Growth

The latest annual analysis of distributor profitability has just been completed by the Profit Planning Group. It examines aggregate financial performance for thirty different lines of trade.

During 2012 (the last year for which complete information is available), distributors, as a group, enjoyed strong sales growth. However, that sales growth did not translate directly into higher profit. While profit was up slightly, the results were disappointing given the sales activity.

The following paragraphs review the key findings from the analysis. It must be kept in mind that on some factors comparisons across industries can be made easily. Sales growth, for example, can be compared directly. If one industry grows and another does not, it is a directly measurable factor.

On most of the factors that influence profitability, though, direct comparisons are not possible. Some distribution industries, for example, have high gross margin percentages while others have low percentages. For factors such as gross margin the key is the degree of change. If the gross margin percentage is declining for a specific industry while the rest of distribution is increasing, it is a clear indicator that attention is needed.

Exhibit 1—Return on Assets (ROA) is the best overall measure of distributor profitability. It is profit before taxes expressed as a percent of the total asset investment in the business.

ROA followed a slow downward path from 2008 through 2010 then recovered in 2011 and 2012 as the economy slowly moved ahead. Individual industries, deviated from this direct pattern due to conditions unique to a single line of trade. However, in general distribution followed a pattern of slow decline and modest recovery.

What is important to note is that the term "modest" with regard to the recovery in ROA really does mean modest. ROA advanced from 6.1% to 7.0%. While an increase is an increase, the size of the improvement was disappointing given the level of sales growth that will be discussed in the next exhibit. All distributors were able to do was return back to about where the were five years earlier.

Exhibit 2—The most important factor taking place in 2012, as mentioned twice previously, was strong sales growth. This was true across all three sectors analyzed—distributors selling largely in the industrial market, distributors selling into the construction market and distributors selling directly to consumers or to retailers ultimately selling to consumers.

Ideally, sales growth in excess of 5.0% should lead to increase profitability. Since all three segments were above the 5.0% level, the modest change in ROA noted in Exhibit 1 does not reflect the full potential that firms could have achieved. Clearly, other factors were at work.

Exhibit 3—The primary profit culprit was a decline in the gross margin percentage. Both the industrial and consumer segments experienced measurable declines, while construction was up, but only by an insignificant .1%.

Gross margin is the single most important driver of profitability. Often, strong sales growth causes firms to take their eye off the pricing ball. The decline in the gross margin percentage is an issue that needs to be addressed by all distributors.

Exhibit 4—The one thing that sales growth should do is help drive down operating expense percentages. In reality, the operating expense percentage rose slightly in all three segments. While the changes were modest, they should be an area of concern going forward.

This negative change may reflect a period of reinvestment in infrastructure in anticipation of continued future sales growth. If the increase in operating expense percentages continues in the future, it will cause all of the sales growth to be little more than wasted effort.

A great question emerges from Exhibits 3 and 4 "If the gross margin percentage is down and the expense percentage is up, how did ROA go up?" The reality is that virtually all of the improvement came from non-operating expense control. In essence distribution is generating all of its improvement off of "other income." It is a pattern that can't continue.

Exhibit 5—Inventory turnover rates fell in two out of three industries. This is not at all surprising in a period of strong growth. Firms rush to maintain in-stock positions which almost always lead to a short-term decline in turnover. Ultimately, this issue is self-correcting.

Exhibit 6—The average collection period (or Days Sales Outstanding) also increased slightly. Again, this is a somewhat normal pattern when sales growth is strong.

In aggregate the figures reflect a distribution base that is enjoying the pattern of sales growth, but not yet adjusting to the challenges that such growth brings. In the future, attention must be devoted to bringing the gross margin percentage and the operating expense percentage back into line.

Exhibit 1
Return on Assets by Year

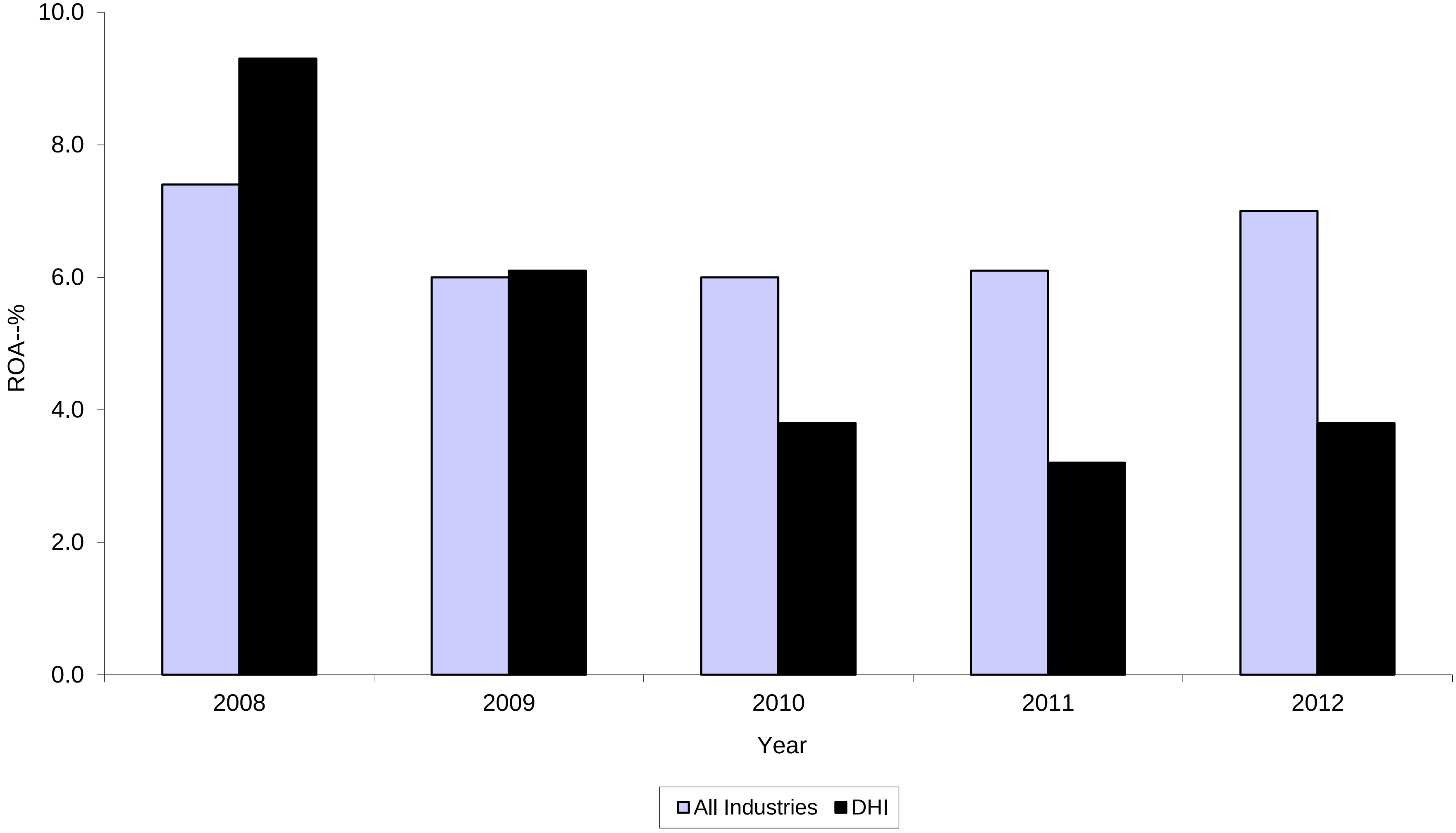

Exhibit 2
Sales Growth by Industry Segment
2012 Versus 2011

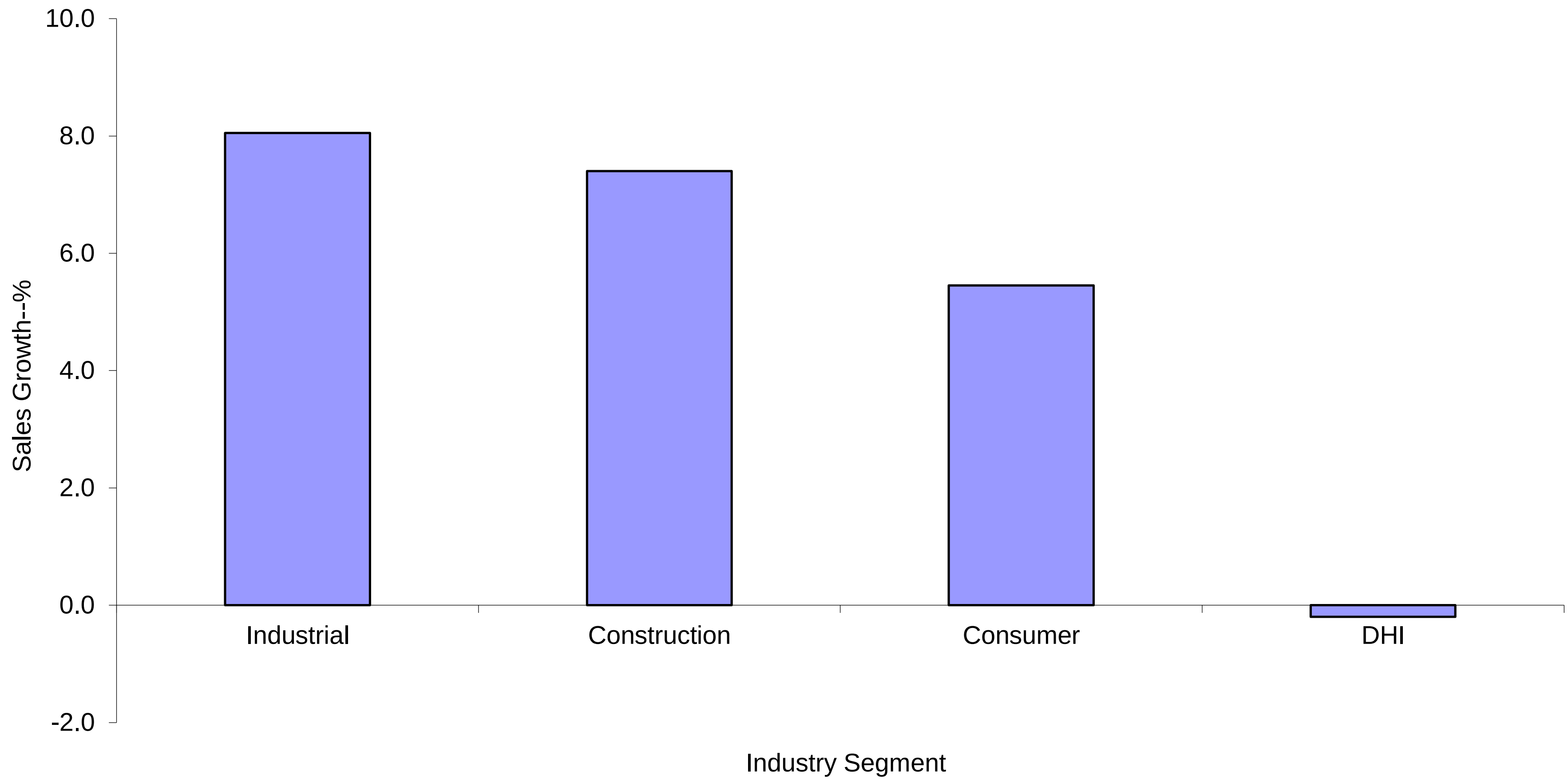

Exhibit 3
The Change in Gross Margin Percentage by Industry Segment
2012 Versus 2011

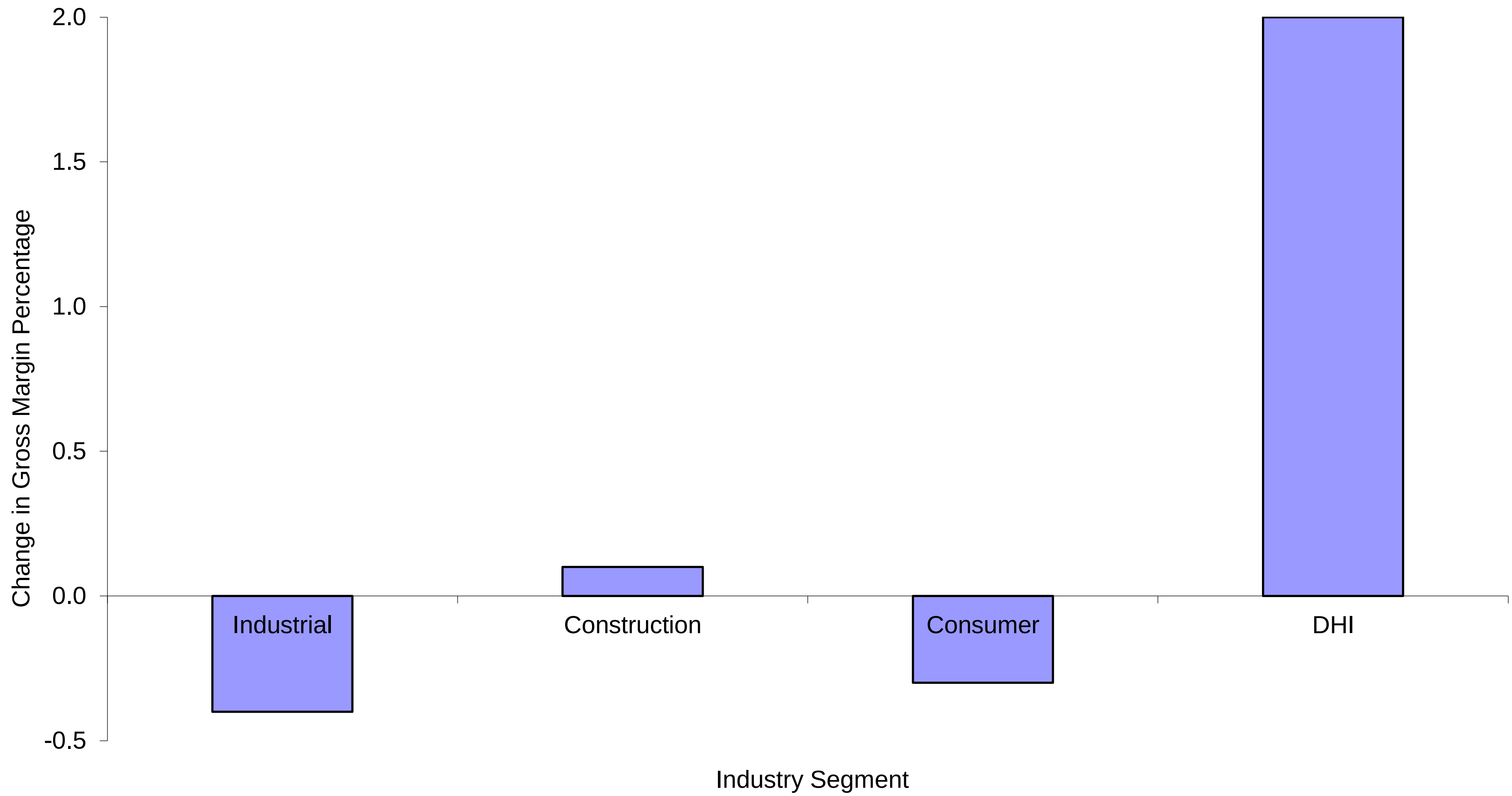

Exhibit 4
The Change in the Operating Expense Percentage by Industry Segment
2012 Versus 2011

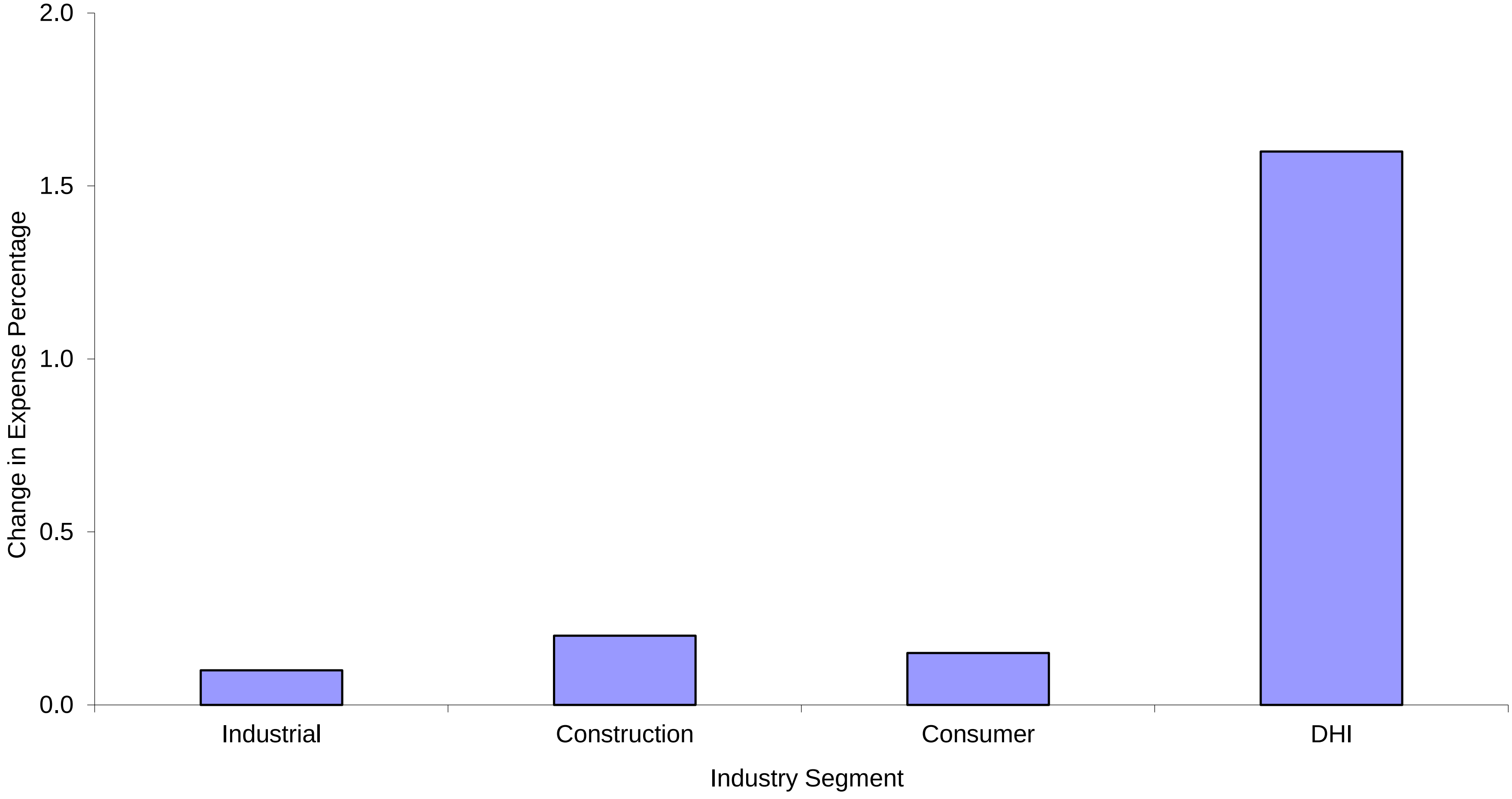

Exhibit 5
The Change in Inventory Turnover by Industry Segment
2012 Versus 2011

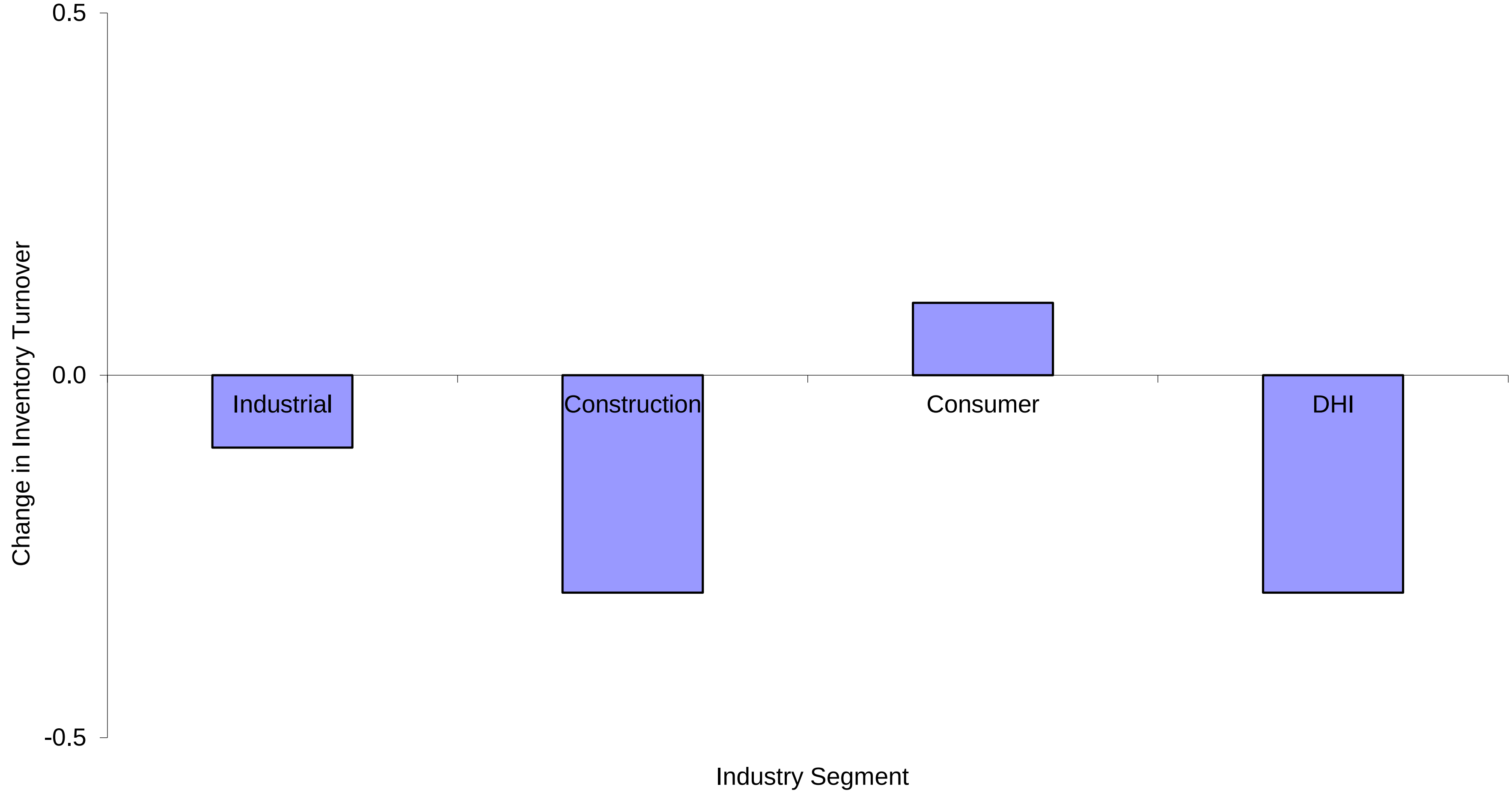

Exhibit 6
The Change in Average Collection Period by Industry Segment
2012 Versus 2011