The Private Equity Investor Framework

A collection of articles
encouraging distributors
to think like investors

By Stuart Mechlin

In the first half of 2013, we published a series of blog posts on mdm.com from Stuart Mechlin, who encouraged distributors to think differently about growth and profitability by using a private equity investor framework. Mechlin is a partner with Real Results Marketing and has more than 18 years experience in the wholesale distribution industry, including the role of senior vice president of Affiliated Distributors' Industrial Supply Division. He is a member of several wholesale distribution company boards of directors.

This MDM Premium Extra provides all of Mechlin's articles in one report, making it easy for you to print, share and discuss these ideas.

The Value of Thinking Like an Investor

One of the most important recent trends is the accelerated interest and involvement of private equity investors in distribution and related manufacturing businesses. Your opinion of this trend, your involvement with or lack thereof is not as important as whether you take lessons from these investors to further your own business's success.

In this series, I will discuss a useful approach, the Private Equity Investor Framework, which will help you think like an investor to improve and grow your business. You don't have to be a trained financial professional to use and apply it.

As a distributor, we are successful because of our singular focus on our products and services. Sometimes, however, we are too focused. We are just too close to it. But when added to the other factors we use to analyze, run and make decisions about our businesses, this model provides another dimension to our decision-making process and may give us a competitive advantage in the marketplace.

So what exactly is the Private Equity Investor Framework, or PEIF? Private equity investors are all about using best-practice, proven roadmaps to build success. Why? They want to sell the investment and cash out at some point down the road.

This framework is a way of thinking, a discipline and a decision-making tool based on the following major elements (including but not limited to):

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- Additional Value Creation, or AVC. It is about more than just improving profitability.
- Thinking of your company as an "investment portfolio."
- Trend analysis: The trend is your friend.
- The thoughtful, bold move.
- Impact, and not just making noise.
- Diversity: Mitigating risk and realizing the potential of core competencies.
- EBITDA multiple expansion as a key performance measure.

You may be reading this saying: "This doesn't apply to me," or "I'm not selling my business anytime soon." Or you may be thinking: "I get numerous calls from PE firms, and most have not impressed me much."

I submit that the Private Equity Investor Framework is every bit as relevant as anything else you do if:

1. You are committed to profitable growth.
2. You are committed to taking market share away from your competitors.
3. You are committed to executing and achieving top-tier performance results.

You have more in common with investors than you may think. Both you and the private equity investor are about making successful business decisions in an environment fraught with volatile dynamics and uncertainty. And both of you know having more options is better when it comes to your business' growth.

This model is about way more than just selling a business.

Below are some of the growth strategies you might be reviewing right now:

- Acquisitions, including smaller local opportunities to access new channels
- Succession planning and execution
- Organic growth, taking advantage of unrealized opportunities
- ESOP ownership
- Selling parts of the business
- Entering new channels and making convergence work for you
- Joint Ventures, product franchises and other collaboration opportunities
- Selling more services
- Website upgrades
- Vending
- Supplier relationship innovations

The future of your business will be determined by the actions you choose, but also how you respond to new technology, economic up- or downturns, new or aggressive competitors, nontraditional market entrants and changes in your company's makeup.

Thinking like a private equity investor gives you the ability to generate more options for growth. And having more options is the one certainty that enables you to gain an edge despite uncertain conditions.

Additional Value Creation: The Real Bottom-Line Drivers in Distribution

Many independent distribution companies wonder why their gross margin, net profit and attendant multiples are inferior to their $2 billion-plus sales, national-market, publicly held competitors. These competitors may have many structural advantages:

- They can raise capital in public markets.
- They have enormous scalability because of their size.
- They can afford and attract smart, experienced managers.
- They can source private label products.

- They can negotiate better purchasing prices.

I would argue that one of the primary advantages of larger competitors is their management focus and discipline on thinking and acting like an investor. This factor may be another, somewhat less obvious part of their success as the reasons listed above.

Our larger competitors run similar businesses. Their management decisions, like yours, are driven by marketing, product and operational considerations.

However, they add, with equal importance, looking at the business as an investment that should be generating superior returns, or the Private Equity Investor Framework. One way to accomplish that view is to focus on Additional Value Creation (AVC). AVC is a way of thinking about the disparate drivers of net profitability: What really contributes to your bottom line? How can you add value to your business by building margins more effectively and more sustainably? How do you add growth volume to your existing profitable business model?

This installment of my blog will examine the Additional Value Creation dimension of the Private Equity Investor Framework discussed in my previous blog.

I have selected some of the most important drivers of Additional Value Creation that private equity investors consider:

1. Growth with existing customers.
2. Growth with new customers.
3. Pricing strategy & elasticity, aka strategic pricing.
4. Granular analytics of customer and/or product line profitability. An example is The Islands of Profit in a Sea of Red Ink approach from Jonathan Byrnes.
5. Granular analytics of marketing strategy and execution.
6. Buying smarter by using master distributors, maximizing rebates, purchasing negotiation and other distributors.
7. Reducing non-core expenses/costs. Examples include using cloud IT, self-insurance, outsourcing and EDI.
8. Inventory: turns, turns and turns.
9. New market/product alliances and JVs, including collaboration, franchises and services.
10. Acquisitions: arbitraging other firms' less favorable performance.

Note that only a few of these drivers are product-centric. We are a product-centric channel, but there are more ways than product to add value and grow net profitability.

Distributors should think about net profits rather than gross profits when considering Additional Value Creation. Why? Gross margins give disproportionate weight to the impact of products. Looking at value creation with an eye on net profits broadens your viewpoint; it allows you to determine what might have the biggest impact on your bottom line.

No avenue to improved profitability is more valid than another. The Private Equity Investor Framework-driven manager considers every profitability improvement activity on its own merits.

Here's an example of thinking beyond product in Additional Value Creation:

Many companies' inventory turns are far from what they should be. Too many of us see our warehouses as long-term parking lots rather than switching yards. There are many valid reasons for low inventory turns, but for many of us it is because we are just too wedded to our physical product.

Think instead of your warehouse as stacks of dollar bills that should be creating additional value, rather than as boxes of product. Excess product that sits for eight months because you got free freight is not creating value. Staff time keeping track of items that don't move, over and over again, does not create value.

How many distribution managers spend an inordinate amount of time beating up suppliers for better pricing because of the real or perceived attendant gross margin improvement, where investing equal or even less time and effort in strategic pricing would have a significantly higher net margin impact?

That's what a Private Equity Investor Framework-driven manager does, and it's how your largest competitors think and execute. And that is how you – regardless of where you are – from working on your exit plan, making your own acquisition or preparing the next generation for leadership—should act

– like the investor that you are!

Think of Your Company as a Portfolio

From Benjamin Graham (The Intelligent Investor) to John C. Bogle (The Clash of the Cultures: Investment vs. Speculation), looking at investments through a portfolio lens has been a guiding principle for superior long-term returns and the mitigation of risk. The best private equity investors and fund managers view their private equity funds as portfolios.

The portfolio concept can help you better analyze the segments of your business, wherever you have assets deployed.

You are familiar with the portfolio concept if you own any kind of equity, bond, real estate or other investment fund. If you're familiar with the major investment companies – such as Charles Schwab, Vanguard, Fidelity, BlackRock – you are familiar with portfolio strategies. You know it works because you count on the development and execution of the strategies to deliver superior returns and manageable risk, for our personal finances, over time.

However, you may argue that your company's underperforming Segment A allows us to execute on Segment B, which is over-performing. Or you may argue that it's easy to reallocate a portfolio, when you have a market in which you can buy and sell assets, but that doesn't work in the company I'm running.

It's true we're not running private equity investment funds. We are running basic industrial distribution firms. But all too often we fall back into our comfort zone of how we've always done business without even realizing it and without recognizing that there are equally valid, proven models that can deliver better decisions.

Here's how the portfolio concept can be applied to wholesale distribution businesses:

Diversification: This concept can be applied to all aspects of your company – business segments; customer concentration; receivables management; suppliers; geographies – as a way to even out your peaks and valleys. An example of this in end-markets is a traditional industrial distributor investing in countercyclical markets such as health care. Another example in marketing is employing both direct sales and Web-based selling, the latter of which delivers revenue from a broader customer base at a lower cost-to-serve than traditional business.

Risk management: You must be a risk manager in the best traditions of an insurance actuary, a corporate safety officer or a fireman (like my son). Like them, you have to be constantly reviewing and reevaluating objective facts from multiple sources. Like them you have to be assessing assumptions with a healthy skepticism. The risks of an end-user switching contracts, a competitor delivering service more cost effectively or ERP system chaos can never be eliminated. However risk can be mitigated and reduced.

Asset allocation: Assets should be generating, or have the potential to generate returns, so keep to a minimum or avoid the consequences of choosing the wrong allocations. For example, assets should be used on a specific, granular level with attendant specific current or expected return. Disciplining your thinking this way will produce better decisions than just saying: "We are going to grow in XYZ geography" or "We're going to roll out vending machines." Don't lump the assets needed to do both and the expected returns in with everything else.

Rebalancing and tactical asset allocation: Sell or reduce your investment in overvalued assets and rotate those into undervalued assets that can generate greater return.

Let's go deeper into rebalancing and tactical asset allocation. Think about the words in this definition. "Rebalancing" implies trade-offs and coming back to stasis. "Tactical" implies a bias toward ongoing, immediate action. "Allocation" implies making decisions.

It's important to frequently assess your business and adjust your decision-making based on that assessment. For example, you may decide that a potential long-term return, as yet unrealized, may be a better use of new assets than something that we do because we have always done it.

Or you may want to reduce the assets applied to customers that have lower returns and redeploy that asset value to customers that are or can generating commensurate and/or superior returns.

As management guru Peter Drucker says: "What managers decide to stop doing is often more important than what they decide to do."

The portfolio concept with its siblings, Additional Value Creation and Trends Analysis (which I will cover in a future blog post) are the main engines that power the Private Equity Investor Framework.

The Private Equity Investor Framework and, with it, the portfolio concept may be uncomfortable and awkward to us at first blush. However, these are by and large mainstream concepts that fit in nicely with what most of us consider good short- and long-song distribution management practice. This concept is not a radical change but merely an extension of what we do. And the best of us – of all geographies, verticals and sizes – are already there, executing for competitive advantage and profitability.

The 3 Elements of Building a Profit-Driven Management Team

Ask the best private equity investors, or for that matter, any acquiring company such as chains, vertical convergers or platform investors – even independent distribution acquirers – and they will tell you that human capital – leadership and management – is a key factor to consider in any investment opportunity.

The private equity investor is looking at management as:

1. a resource for growth;
2. a resource that can be matched up with external resources such as additional capital, economies of scale and outside management expertise; and
3. a fertile field for improving performance discipline.

When combined, these three elements lead to superior returns beyond what either element can deliver by itself.

In this installment of my blog I will look at management using the Private Equity Investor Framework, which I first introduced in my post, The Value of Thinking Like an Investor.

Let's examine the three elements I outlined above:

First, investors are looking for human capital resources for growth that they do not possess. Most private equity investors are generalists – they don't know our business nor are they experts in any other business that they may invest in. The same can be said of any acquirer adding different vertical distributors to their portfolio.

They don't have information about suppliers and end-users, markets, technical expertise or industry relationships, just to name a few. They also don't have the reputation these management teams have in the market. These items are expensive and time-consuming to duplicate. They are distinctive to the respective business vertical. Investors know they need good leaders and managers as a knowledge platform if they are to have any chance of generating superior returns and growth.

Second, private equity views management as a resource that can be matched with external resources that management may not be exposed to currently. For example, an owner or management team is terrific in most things they do, but may be risk-adverse, less skilled in raising capital or reluctant to actively manage capital. The answer may be for the capital-raising pros to match that skill with the resource to fuel the engine of growth.

Another example: We may think that information management, backroom operations, certain services, IT, logistics, HR and other non-core, generic aspects of the business are unique to individual companies. Unfortunately, economies of scale are hard to achieve either because we think this way or because we just don't have the critical mass needed to operate at the level of our larger competitors. An investor may have a portfolio of companies to spread these resources over, benefiting all.

No matter your size, you can achieve some economies of scale by taking advantage of outside resources. However, you may resist taking advantage of significant net profitability improvement through economies of scale for non-core activities because you don't own it, manage it or control it. That attitude can limit growth. Let management focus on what is core to growth and outsource the rest if opportunities to use economies of scale present themselves.

The final element is a receptive management platform that will accept and respond to improved performance discipline. The three elements of this are:

- A focus on the right metrics for growth: In particular, management should focus on EBIDTA improvement, multiple improvement, new market growth, net profit improvement and risk reduction.
- Proper and meaningful incentive alignment: Future and ongoing rewards have to get people's attention and fit the culture of the organization. There should be fewer layers between cause and effect.
- Accountability: This includes an easy-to-read scorecard, ongoing communication, and nimble and flexible midcourse corrections.

The private equity investor demands management that uses all these elements to be additional value creators (AVC). They motivate managers to de-emphasize activities that do not take full advantage of a distinct core competency, are either non-core or that others can do better cheaper and faster. They motivate managers to operate with a new performance discipline.

I suspect that many companies' owners and senior managers believe their management resources are much more aligned than they really are. Again the objective is not to change how you do business or how you run your company. The objective is to align what you do best with performance that creates additional value, net profit and larger multiples.

Here are just a few questions you can ask to uncover how well your practices align with some of the best practices outlined above:

- Are your salespeople spending too much time protecting their customers rather than discussing pricing initiatives?
- Is your senior purchasing manager is spending too much time on the 300-400 minor suppliers that generate 20 percent of your business and maybe impact your net by .001 percent? Why?
- Is your IT staff worried more about protecting its turf and not enough on the impact of solutions such as the cloud on overall bottom-line profitability? Does IT management view its job strategically?
- Does your accounting staff prepare "inside baseball" reports rather than outward-looking growth and profitability reports?
- Are your bonuses structured to reward ill-defined goals? Consider what you're incentivizing.

As with every element we've discussed, the goal is to use the Private Equity Investor Framework to supplement your own management practices and principles to create additional value.

Take an objective look at ways you can improve the management of your business by combining best practices in alignment and compensation and removing non-core competencies from the job description.

Why the Trend is Your Friend

A number of years ago I spent two weeks on the foreign-exchange desk of a major money center bank. It was a period of sovereign debt crisis overseas, high inflation (1000 percent+) countries (and you think we have problems?), and new untested domestic and international global financial instruments. It was a high-risk, high-reward environment and a fertile learning ground.

Among the many lessons learned during this period, my favorite and most useful was: "The trend is your friend." Also useful was the lesson of "trading ranges" – the spread between the highs and lows of any data points over a period of time. These are familiar phrases to anyone who has had experience in financial or commodity markets. A trend in this instance is defined as something that breaks out of the norm or trading range, indicating a solid shift.

Data points in time indicate a real trend either up or down less than half of the time. By tracking trends, we can do a better job matching our expenses and cost-to-serve with the business, without fuss or emotions. We don't kid ourselves that what we want to be a trend really isn't and, conversely, what are real trends that demand additional resources or consideration.

Recent year-end sales reports for distributors were a good example of looking beyond just a point in time. The sales volatility caused by uncertainty at the end of 2012 caused sales to drop in December, but they were still within a trading range – which subsequent months have proven out. But some distributors looked at the drop and instead of tracking the broader trend,may have hit the panic button and started initiatives that they have since undone as sales have climbed again.

The concepts of trading range and tracking trends feed analysis that investors use to manage and produce superior returns. And it is an additional decision-making tool that owner-operators and managers of distribution companies should be learning and using for additional value creation. It is one of the important data-centric tools that act as a counterweight to the dominant product- and sales-centric approaches, all too common in distribution.

Most managers look at numbers at a discrete point in time. There may be comparisons to prior periods, whether that is week-over-week or year-over year. You may also be doing projections about the future – primarily in the form of budgets – and tracking whether they were met, missed or surpassed.

But thinking in terms of trends requires tools that encourage engagement, rather thanprimarily working off of tools of record for decisions.

The idea that the trend is your friend is not about the trend going the way you want it to go, or confirming your forecast. Rather, like a good friend, trends tell you what you need to hear and not just what you want to hear. Tracking trends gives us an added dimension beyond the point-in-time snapshot.

When we track trends and trading ranges, we can adjust quicker. We can start moves earlier and delay moves that prove to be unwarranted.

One of the most respected economic trend analysis firms in distribution is ITR Economics, led by brothers Alan and Brian Beaulieu, who are frequently featured at distribution industry events. Every graph and chart they provide shows trends and trading ranges, as well as rolling averages. Every subject or slide shows what that particular trend subject means for you. Most of us attend these presentations and read their reports with rapt attention. On a macroeconomic level we discover how the world has worked, how it is working and what the prognosis is – and most importantly how we should respond for the best chances of success.

Use the ITR economic trends reports as comparisons and background for your own business metrics and segments. Are you leading or following? Why? You should also use the MDM distribution trend articles and recent webcast, Top 10 Trends in Distribution in 2013. If one of the trends applies to you, ask the same question: Where do you stand?

Unfortunately, it's rare to see this idea applied on the operating level of a distribution company. When distributors bring this idea down to the firm level, it can reward them with competitive advantage by creating additional value.

Here are some examples:

1. With new business segments develop a trading range for the year as opposed to a snapshot approach. (Brent Grover's new book on strategic planning, published by MDM, has some excellent best-, base-, and worst-case (anothername for trading range) techniques to do just this.)
2. Choose some key internal business metrics and develop a trading range both in the previous 12 months, as well as the next 12 months.
3. Develop a net profit trading range for your top customers. Track closely and note any improvement or erosion of this range into a trend. What action or even inaction will this dynamic metric, as opposed to the static snapshot, tell us to take?
4. Develop trigger points for action or corresponding inaction based on where periodic data (daily, weekly, and monthly, quarterly) falls on the trading range for the above.
5. Consider trends when you make cost-to-serve decisions, acquisition decisions, geographic decisions and other growth and profit decisions. The main purpose of a growth initiative is to create a trend out of a trading range. Set your expected performance before you make an investment. To motivate employees, incentivize real trends – and not just performance that could be considered part of your average trading ranges.

This process is not about having four computer screens on your desk connected to a real-time Bloomberg newswire.

Your controllers and CFOs can track trends and develop trading ranges. Whether from their financial peers and colleagues or from public, Internet sources there are excellent how-tos – simple to complicated – to develop a dashboard that works for your situation.

In fact I suspect that your financial staff would welcome the challenge to create additional tools of engagement rather than always working on tools of record.

Regardless of what best practice example you learn from, it's a matter of applying an already invented wheel to your operating discipline. It's about starting with and tracking trends for a few metrics, learning what works and building from there.

The 6 Cs of Unifying Your Employees Under One Message

Some of the best distribution companies have unified the diverse voices that make up a business into one message, both internally and externally. I call this Many Voices, One Message. The idea is a staple of the B-to-C world.

Most distributors understand the concept of projecting their value message as one voice to customers and suppliers.

But its greatest power is in its application to internal messaging. It is used extensively today in distribution by private equity investors and acquirers with newly acquired businesses. (Read about the Value of Thinking Like an Investor.)

As I mentioned in a recent blog, investors value distribution management as a platform for growth. Many Voices, One Message recognizes and even encourages the distinct culture and personalities in a business. Any private equity investor will tell you that this distinctiveness is attractive and must be cultivated. However, the voices must be delivering one message. In other words, employees must be in alignment on the end goal, even if their ideas for reaching that goal are different.

Many Voices, Many Messages is a recipe for less than optimal results.

Take an internal decision to increase inventory turns as part of message to improve net income percentage. If a salesperson instead holds some product in inventory just in case a customer needs it six months down the road that does not contribute to reaching that goal. Many Voices, One Message instead encourages alignment with the primary goal but freedom to be creative in reaching it.

Here are the 6 Cs of the Many Voices, One Message discipline:

- **Choose**: You must decide what your key performance measurements are for everyone and keep those to a small number. (Read The Trend is Your Friend to learn more about the value of tracking data over time.)
- **Clear and Concise**: This is not about a single-spaced, full-page mission statement. It is about one sentence, with few words, that gets your message across quickly but effectively.
- **Consistent Communication**: You must be disciplined. This internal communication task is your most important sales job.
- **Criteria**: Put your goal in writing. Develop your message scorecard (remember, fewer items) with a quantitative component. For example, we want to increase net profit by X percent each year.
- **Consequences**: Executing this is as important to your business as any traditionally more weighty subjects such as tax compliance or safety. Your company is not the place for folks who don't take your message seriously or don't think it applies to them.
- **Celebrate**: Your "many voices" are your trump card. You must work at framing the importance of having many voices carry one message and the resulting success. Encourage the team to buy-in and to be stewards of that message while rewarding their contributions to ways that message can be fulfilled.

Here are examples of the importance of Many Voices, One Message.

Many of you are acquiring smaller companies in your market areas who have presented you with an opportunity to arbitrage their poor performance. By and large this phenomenon is under the radar screen and not reported as extensively as the M&A activities of the larger distributors.

You are a regional distributor who knows the marketplace; knows the competitive environment; and is close by. Former Speaker of the House Tip O'Neil's famous quote "All politics is local" has been used by many as an acquisition framework.

What usually happens in these situations is that the seller remains in place. The potential for a "many voices, many messages" is huge. After all, these sellers are used to running their own show.

But to be successful, the seller and acquirer must have adopted and implemented a deep, public, internal management practice of Many Voices, One Message – preserving the distinct voice of the seller under the new owner's message.

Here's another example.

We have a number of distribution companies that are employee-owned, or ESOPs. By definition, in this structure, everyone is an owner. At first blush, this environment is rife for a Many Voices, Many Messages approach to the business that may portend stiffer odds for success.

On the contrary, some of our most successful firms are ESOPs. While the reasons for success are many, one glaring reason is that they have mastered the art and science of Many Voices, One Message and utilize many of the 6 Cs above.

They also view themselves more as investors. Their multi-faceted business finds ample expression in their many voices, in celebration of the success that accompanies the one message.

You can, too.

I know about the importance of the value of the qualitative side of our business. It is an integral part of our value to us, our stakeholders and investors, current and future. Having lived and breathed it, I can state categorically that it's a big part of what makes distributors tick.

However, these values must be accompanied by financial strength to realize their full promise and potential. This is not a zero-sum game. This is not about either/or. In fact a combined quantitative and qualitative message is the holy grail of this process. You should have both within the guidelines of the 6 Cs.

Want to Grow? Stop Being Complacent

One of the ways that private equity investors create additional value is by planning, developing and executing thoughtful bold moves.

In this article I will discuss this powerful approach and encourage every distributor owner-operator to think like a private equity investor and increase their use of the thoughtful bold move.

Let's define the thoughtful bold move:

Thoughtful: You have to think about where you are going next. But don't get caught up in every detail – don't get "analysis paralysis." You need to do enough thinking to mitigate risk but not any more than that. You need to do enough thinking to get rid of what "seems like a good idea at the time." You have to swing at strikes to get home runs. The goal is not perfection or no risk. As Andrew Groves of Intel said: "Perfection is the enemy of the good."

Bold: It's another word for audacity – one of the favorite words of the famous General Patton. However for distributor operators, audacity must be tempered with thought (see above). It must be tempered with risk mitigation. It is tempered with looking everywhere – inside and outside the organization – for ideas, best practices, success stories and opportunities to create value. It is the opposite of complacency. It is the opposite of the "no good if not invented here" philosophy. And it applies to both grand strategy and street tactics. There is as much boldness in taking routine business to a new level of net profitability as there is in buying a company.

Move: The word move implies action, doing something different or doing it in a different way. And doing it with metrics, execution and accountability. A good definition is advancing the base runner, base by base, to get home.

You want to foster a culture of the thoughtful bold move in your organization. You want to include as many team members as you can. Any move you make must be tracked and incentivized. And it must be celebrated – both the successes and the failures. Encouraging the thoughtful bold move must be tempered with "no harm no foul" for trying.

Here are the important reasons why you should be developing more thoughtful bold moves:

1. Nothing screams diversification more than a mix of bold moves in various stages of execution and development, attention to the ongoing day-to-day business and diminishing resources applied to unprofitable activities.
2. Thoughtful bold moves have the potential to turn into real trends – see The Trend is Your Friend – as opposed to just operating in a trading range.
3. By design or by accident, your competitive environment is dynamic, bold and always changing. Your competition is not waiting on your schedule. At the very least, you have to keep up to stay in the game. At best, you create money-making value that wins against the competition.
4. Thoughtful bold moves will distinguish you with your future managers, customers, suppliers and your own team. Additional value creation is all about building a sustainable, growing company that will appeal to and retain future decision-makers.

So what are some thoughtful bold moves that can add value to your distribution business? The following examples are from real distributors (many from the pages of Modern Distribution Management) operating in similar environments, with one important difference. They are thinking like investors. They understand the need to view at least a portion of their business as a bold undertaking if added value creation is the goal.

These examples are a mix of thinking boldly with the day-to-day business, as well as brand new initiatives:

1. Granular customer profitability analysis and the resulting actions. This is boldness applied to routine ongoing business.
2. Divesting or diminishing resources applied to lower-return segments of the business.
3. Using analytics to grow your marketing program. Get serious about marketing as an equal partner to your predominantly salesperson-centric activities and culture and enjoy profitable new growth in the process.
4. Acquisitions, including taking advantage of channel convergence opportunities; arbitraging a smaller poor-performing competitor; or consolidating a core competency.
5. Strategic pricing initiatives. Be bold about realizing net profit opportunities.
6. Significantly improving inventory turns through the use of other distributors, master distributors and 3PLs.
7. Exploring and signing up for collaborative sales opportunities with other distributors and suppliers that extend your reach in your core areas of expertise.
8. Figure out how to use the reach of Amazon and eBay (and others) to your incremental sales advantage.

So why is the private equity investor able to assist their distributors to make both qualitatively and quantitatively better moves? Three reasons: First management has more time, freed up from non-core activities, to look at, test, reject and develop thoughtful bold moves.

Second, management now has better access to outside advisors who have a vested, monetary interested in your success. Management can use outsides advisors to test and share best practices. Captain Kirk and the crew of the Enterprise may "boldly go where no one has gone before," but you need to boldly go where you can mine best practices and knowledge that will promote success but keep you out of trouble.

Finally, the private equity investor has additional resources from freeing management from non-core activities or through accessing economies of scale.

These can be duplicated by any leader if they are taking thinking like an investor seriously.

Why Manufacturers Should Care About Distributors' Financial Health

There is one big reason manufacturers should care about how their distributors run their businesses: The supplier does not want to wind up with just three to five large distribution customers.

The supplier doesn't want to operate in a quasi "dedicated supplier" system with high risk and low profitability. They want to continue to enjoy a healthy portfolio of strong and diverse distribution partners.

National, larger distribution companies are growing. We still operate in a fragmented channel, but the trend is toward fewer, national players who continue to gain scale not only in the U.S. but worldwide.

Smart suppliers want a lot of distribution partners – independents, regionals, nontraditional entrants and so on. They also want their distributors to be growing (as many are) and financially strong and that their distributor partners are profitable and creating additional "distributor" value.

Therefore suppliers need to care about distributors using the best financial tools to do just that – one of the best being the private equity investor framework I've been discussing in my blog posts over the past few months on mdm.com. Only then can they continue to reap the rewards and benefits of a portfolio.

Here's why the portfolio concept is important to manufacturers, as well:

1. **Diversification**: More distributors means more diverse geographies and end-users, and in turn greater annual sales volume.
2. **Profitability**: Only with a mix of geographies and end-users can a supplier achieve desired levels of profitability. Negotiating with a small group of larger customers (ie distributors) is not a reliable path to profitability. Negotiating leverage is better when you have more options.
3. **Mitigating risk**: Economic and marketplace volatility is only going to increase in the future. That's one trend that is not your friend. Risk management is all about minimizing the impact – negative or positive – of any one customer.
4. I**nnovation of products and processes**: Large-volume, national, bureaucratic distributors can be innovative. But even better is benefiting from a wider swath of innovation from the talented diverse group of players that our industry enjoys.
5. **Growth**: In this slow-growth market share battle that we are in and will be in for the foreseeable future, suppliers need every strong growth vehicle they can partner with.
6. **More fun**: The relationship side of our business has proven itself time and time again as one of the reasons we are who we are, and why we enjoy what we do.

Suppliers may ask: What's the matter with having three to five large distributors for the bulk of your business? They are confident that like Clint Eastwood's Gunny Highway character in the film Heartbreak Ridge, they can "improvise, adapt and overcome" no matter what the ever-changing environment throws their way. They may not see their roles as getting involved with distributor finances or financial structure, strategy or tactics. They have enough problems of their own.

Or they now have good relationships with the main players, even with the growth of private label brand sales.

All the above are valid. And if a supplier is good, it's not a bad strategy.

However I know something about dedicated or quasi-dedicated suppliers and purchasing systems from my experience with a previous best practice company. I know something about what makes a dedicated supplier environment sing. I know how much work is involved. I know about the roles, obligations and responsibilities of both sides.

And I have to tell you our environment isn't it. We are getting better. Most of us are improving our knowledge, experience and execution especially when it comes to mitigating risk and maintaining profitability in this environment.

For most suppliers across verticals, a better bet is to operate with many strong distributors of varying size, ownership structure and end-users. But they should all share a common thread – a focus on Additional Value Creation. The channel may be more complicated, but it will reap larger rewards.

Here are some examples of what suppliers can do to improve their partnership with distributors:

Make your skills and knowledge of markets and operations available to distributors. Suppliers are huge repositories of knowledge in areas where critical mass gives them an advantage – such as IT, marketing, lean manufacturing and finances. With a little creativity suppliers can share resources and do it within legal and ethical guidelines.

Make process and technology innovation initiatives equal partners to product innovation. Distributor-supplier process improvements will increase profitability for both sides. Suppliers may be pleasantly surprised with the number of distributor owner-operators who want to have that discussion. Suppliers are great about talking about products, end-user marketing strategy and how they can both sell more. But suppliers and distributors are not so good about discussing the operational side. Discussions with channel partners need to go beyond rebates and pricing; you may find both sides will reap bigger rewards when they use imagination and boldness. For example, how can you use the Web to improve the market share of your best distributors?

Refocus existing relationship vehicles. Across verticals, distributors enjoy excellent buying/marketing groups, industry associations committees and boards, supplier and distributor advisory councils, and individual company boards. They're made up of distributors and suppliers of different sizes, products and approaches to market. But they are all too often way less productive than they should be. Rather than spending time on low-impact activities such as reward/recognition, communication duplication and training that could be done on the Web, members of these forums should primarily be focused on growth, profitability and risk mitigation.

Caring about distributors' businesses is not just for big suppliers. Any manufacturer can contribute to distributors' initiatives to strengthen their futures. And they have. Leadership among suppliers is all around us – look for it, adopt it, encourage it and imitate it.

The rewards will be big for both partners.

How to Make Collaborations Work

One of the great lessons from private equity investors is the portfolio approach to the business and by extension the use and understanding of collaboration. They know that you don't have to own it, control it or manage it (in the traditional sense) to make additional dollars and add value.

Distributor owner-operators who think like private equity investors should plan to collaborate more. In this article I will explore collaboration, how it works and why you should consider it.

First, what's in it for you? Collaboration allows you to:

- Compete more effectively against powerful, resource-rich competitors;
- Risk less – can try new ideas out without betting the ranch;
- Use resources that otherwise are unavailable or too costly to access;
- Create additional value and growth opportunities;
- Take advantage of the benefits of economies of scale;
- Enter new markets that may be inaccessible with your current resources;
- And further support the portfolio concept.

I have had many years of experience working in collaborative efforts, including international joint ventures and franchisee systems. No matter how the ownership structure was set up – whether it be 50/50, 40/60 or 30/70 – we acted and operated like a collaborator.

Collaboration can be defined as people working together to create value whether you're at the same organization, a complementary one or competitor.

Some folks use the term "win-win." A good term and if it helps you structure your thinking and approach, great! But here's how I have seen the best and most successful "collaborators" view the world.

They believe that the best collaboration happen when two entities with selfish motives, get together by aligning those motives. There is nothing wrong with being selfish and aligning with other selfish players. These best practice folks have found that if you can align selfish motives, you'll move mountains –

and make a few bucks in the process.

First, you have to be aware of three things:

1. You have to know your own selfish motivations.
2. You have to know theirs, as best you can.
3. Then you have to focus – many voices, one message.

Second, there are some of the critical management skills necessary for successful collaboration. You've got to manage this relationship. Not in the traditional sense but in the collaborative sense. Here are some tips:

- Let the less important things go.
- Enhance and protect your brand.
- Know your legal, moral and ethical issues up front.
- Trust but verify.
- Accelerate your decision-making – be nimble. If it doesn't look like it's going to work, don't start. If you do start, and it doesn't look good after 30 days get out. You may hate to admit it but most time it never gets any better. On the flip side if it looks better than it did at first, step it up.
- Give 110 percent every day, with no promise that it will last.

Collaboration may have a limited time frame and may not succeed. Everyone (including you) operates with two motivations: making the collaboration successful as well as selflessly enhancing their company's resume to help get the next gig.

Examples of collaboration among distributors include using equipment franchisee opportunities; following customers to Mexico or China; working with distributors in other verticals to present "one face" to the end-user; and using eBay and Amazon as supplemental sales channels.

However, there are many examples of what we are not seeing and should be.

Our industry has many distributors who have developed extremely profitable end-user value-add offerings, as well as best-in-class cutting edge operating models. These may include vending or vendor managed inventory programs, mobile power generation, contractor trailers and catalog and web marketing programs, to name just a few.

These competencies lend themselves readily to collaborative efforts with other distributors outside your market area. There are proprietary skills, products or services that could be made available to other companies in a franchise or collaborative growth arrangement.

And yet these and other equally worthy potential money-makers and service offering extenders are conspicuous by their absence in the distribution universe.

If you are still having difficulty in getting your arms around this potential tool, think about the business model that has given all of us great joy, passion, inspiration, ideas and entertainment: films, books, TV, music – the entertainment business. The industry is based on collaboration. A project may involve several companies, and while each of those companies may not own the project, per se, they have to collaborate for everyone to succeed.

They know there are no guarantees, but they work together to produce a result that is better than any one person could produce. Each collaborator has a chance to make additional money that otherwise would be unavailable on their own.

I don't know about you, but on these pages MSC, Fastenal, Grainger, Ferguson, HD Supply, Motion Industries, Wesco and Sonepar are often featured doing the latest and greatest, and what they are doing is interesting and important, but they are not the only game in town. The industry's pool of talent, experience and execution is deeper than just those companies.

How can you use collaboration to differentiate and add value to your company, and your current and future markets?

Why Every Distributor Needs a Board of Directors

Corporate governance using advisory boards or boards of directors is a critical aspect of any private equity investor approach with their investments. These investors know that a board comprised of at least half outsiders brings measurable, qualitative impact to any investment they may participate in.

The combination of owner, senior executive team and outside board members has been proven time and time again to be an advantage that creates additional value in the investment and subsequent higher returns.

I have been fortunate to be a participant in, leader of and executive reporting to some exceptional boards and leadership committees. Well-run boards have an impact!

There are many reasons why across verticals, geography, size and ownership type, many distributors are either reluctant to set up advisory boards or they hold onto mediocre ones:

1. Fear of giving up control.
2. Not comfortable with heightened accountability.
3. The additional expense.
4. More work: It's another management job – assessing and selecting candidates; preparing and debriefing meetings; and other responsibilities.
5. Owners are very skilled in so many things they do, but running boards is not usually one of them. They want to stick to what they do best.
6. Redundancies. I have a network from my industry association, my marketing group, regional executive forum and my family. Aren't I getting everything I need from these groups?

The above are all valid objections.

But there is one reason to have a well-run board: Consistently better decision-making that yieldsadditional value creation and more options for growth.

A significant number of our best-run distributors and of course those involved with private equity investments have seen these benefits in action. Investors in public companies also have great examples of the impact of well-run boards. And you have seen many good, successful firms not realize their full potential – in both growth and profitability – because they omit this very productive tool.

Well-run boards are like Rocky Balboa's sparring partner Apollo Creed. Like Apollo, a seasoned professional in his own right, boards give you a workout – probing, jabbing, trying out new moves, validating current moves, showing things you may have missed – so the "champ" (that's you) can win in the ring. (Winning defined: Create additional value and outcompete.)

Here's how boards can help distributors make better decisions:

An outside point-of-view: Outside perspectives are critical. Owners should be told what they need to hear not what they want to hear. Include term limits to keep perspectives fresh.

Limited baggage: For your outsider members, their careers are not dependent on what they say on the board. For your inside members, the board forum is a higher and different calling than their internal day jobs. For family members, with some ownership and/or working in the firm, the board provides an unemotional sounding board.

You can't hide: The best board members care about the company they are associated with. They are professionals, and they are getting paid. On the other hand, they have other day jobs. This is true independence: They can walk out any time.

Additional expertise: These are invaluable resources for any firm that can complement the skills you already have, including strategic planning, finance, accounting, IT, industry knowledge, suppliers, acquisition expertise and more. They all bring rich gifts. Boards also bring a network of other experts that they know and have used that you may be able to rely on in the future.

Improved external stature: Whether it's your bank, your end-user customer, suppliers or your buying and marketing group, outside groups will see you in a different light when they know you rely on a board.

Improved internal stature: Nothing ups the game of your staff from senior executives to the warehouse floor than your employees knowing that you have a board and periodically having selected folks present to the board about their activities. A board also encourages the many voices, one message approach.

"Nose in, hands off" philosophy. The best boards are not there to run the business, they are there to generate and confirm good decision-making or to question poor choices. They provide oversight and counsel without disenfranchising the management team.

Confidential networking: In today's competitive environment, strategy has to be kept confidential. But that can limit getting the critical information you need to make good decisions. Board members are extremely useful in filling the gaps.

Accountability: Socrates said first and best: "The unexamined life is not worth living." A well-run board is the mirror of truth that the best of us all strive for but don't always achieve by ourselves.

OK, you say, I get the benefits. Again you will argue that you get all that from the extensive best practice networking you have in associations, marketing groups, regional executive committees, supplier relationships and so on. I have great accountants and lawyers to help me. I have experienced family members.

But here's the difference: You are more isolated than you think. If you are a distributor owner-operator or senior executive you are paying attention to your business every minute of the day. And rightly so. Unfortunately it's a recipe for isolation and insulation that can be remedied to a large extent by relying on a board.

What's more, networks in any form are not compensated. Professionals who are paid a fee are good, but it's not the same. There is something about being compensated for independent advice and input – representing respect for the time and resources of that individual – that makes board advice, both in quality and quantity, better than anything else you can get.

Private equity investors know this. That's why they almost never operate without a board.

There are a lot of resources out there on how to form an advisory board for your business.

Understand the benefits and potential impact, as well as what an effective board looks like – whether contemplating forming a new board or upgrading an existing one – and good execution will follow.

Readers Respond: Thinking Like an Investor

Over the past two months I've had the privilege of sharing and discovering with you a valuable tool: looking at your business from a private equity investor's framework.

The interest and response from MDM's readers has been positive.

For the last blog in this series, I wanted to share with you many of the comments from your fellow MDM readers. These comments are anecdotal and unscientific but not a bad gauge of our distributor and supplier communities' thinking. I have taken the liberty of paraphrasing the collective comments under each topic below.

What resonated the most: The "business as a portfolio" concept, the "trend is your friend" concept and the "many voices, one message" approach were by far the most popular. I have been particularly pleased with comments about how these concepts will be used by distributor and supplier managers as a framework for subsequent planning and action.

Kudos from top operators: Distributor owners and managers who are among the most successful operators in our industry have been complimentary. In particular, many of these leaders have told me that they are currently engaged in inspiring, motivating and teaching their employees at all levels to think like investors. In fact I had numerous requests asking if it was OK to distribute the blogs (of course!) to their respective employees.

Readers liked the structure: Many operators were already experiencing and thinking about the pros and cons of these and other best practice concepts, but were finding it difficult to communicate them to their team. Helping to put these thoughts and best practices on paper, to be used by managers to improve team and individual performance, was an unanticipated benefit of our efforts.

Comments from private equity investors: Many practicing private equity investors felt that my series of blogs reinforced many of the concepts that they present to prospective and existing customers about private equity. Similar comments came from experienced distribution practitioners and those who currently operate with private equity investors.

Comments about private equity from distributors: From comments from both distributors and private equity principals it was also clear that the misperception, miscommunication and reluctance to engage by both sides were palpable. From speaking with a broad spectrum of folks on both sides I would argue that many private equity investors assume that their target audiences understand the "what's in it for them."

Not all private equity investors spend time getting into the heads of distributor owner-operators, which the best investors realize is critical to not only doing a deal but the successful long-term value creation of a deal. On the distributor side, way too many distributor owners and senior managers erect obstacles to even preliminary discussions with investors. In fact, one of the great rewards of writing this blog has been using it as a way to bridge some of their respective perception gaps.

Financial understanding: Comments range from "Thanks for making the connection from what I understand with my personal investments to my business" to "I'm not a financial wiz and it's just not that important to me." The blog was not intended to be a financial textbook – far better brains than mine have produced material for that. However I was gratified to hear on many occasions that folks understood that financial considerations have to be a part of their thinking and especially their senior management team's thinking, and if possible the thinking of the folks on the warehouse floor.

Supplier reaction: The blog about why suppliers should care was my most popular blog in this series. I suspect that most readers were distributors. While there are many suppliers who work at trying to understand their distributors, the lack of response, comments and other feedback from suppliers was surprising. I believe it is just a reflection of what many of us have observed in our daily operations, that suppliers' understanding of the distribution business can be greatly improved. For good or bad, many don't see it as a top concern.

But our best minds on these pages believe the future will be driven by suppliers and distributors who create innovative ways to work together on growth and profitability processes, and not just products. This is only possible with a better understanding of each group's respective financial drivers.

Long-term vs. short-term: I received many comments about not spending more time focusing on the differences of long-term and short-term thinking of owner-operators and the private equity investor. In my career was I've spent time with many distributors who have been in business for over 25, 50 or even 100 years., serving their customers and employees. I think that maybe the secret to their success is always being engaged in creating additional value no matter how the environment shifts.

Finally, thanks to the MDM staff and MDM readers for this opportunity to continue to contribute to the future growth and profitability of the one of the most dynamic disciplines – wholesale distribution – on the planet!