

# How top wholesalers succeed: secrets of a brutal business

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Until recently, conventional wisdom held that wholesale distributors had little future in the Internet era. The widespread trend of disintermediation, the process of cutting out the middleman and going directly to the source of supply, seemed to put the future of wholesale distributors in jeopardy. It was a brutal business even before the Internet era: only 20 percent of all wholesale distributors managed to beat the S&P 500 over the last five years, while more than 50 percent consistently destroyed shareholder value (Exhibit 1).

Yet a few wholesale distributors have surprising success stories to tell. To understand what drove a 1,000 percent difference in returns between the best and worst distribution performer, we interviewed the managers of those firms that have consistently outperformed the market. One counterintuitive insight we gained from these conversations – distribution must focus on local business. Local, not national, market share drives profitability. In the interviews we also learned the ingenious tactics the most successful companies have adopted to capture higher gross margins than their competitors, and how these leading companies have reduced operating expenses. Indeed the best distributors share a three-legged strategy: focus investments to gain local market share, select their service offering carefully to pump up gross margins and slice operating expenses to the bone. The contrasting fortunes of two food distributors, Sysco and AmeriServe, illustrate what can happen when you either employ or ignore this multi-faceted strategy. Sysco successfully implemented all three legs of the strategy and generated exceptional shareholder returns, while AmeriServe exclusively pursued national market share, with disastrous results (see sidebar 1). Our model of this strategy is called the "Bain Path to Profitability Framework."

## **The Sysco story**

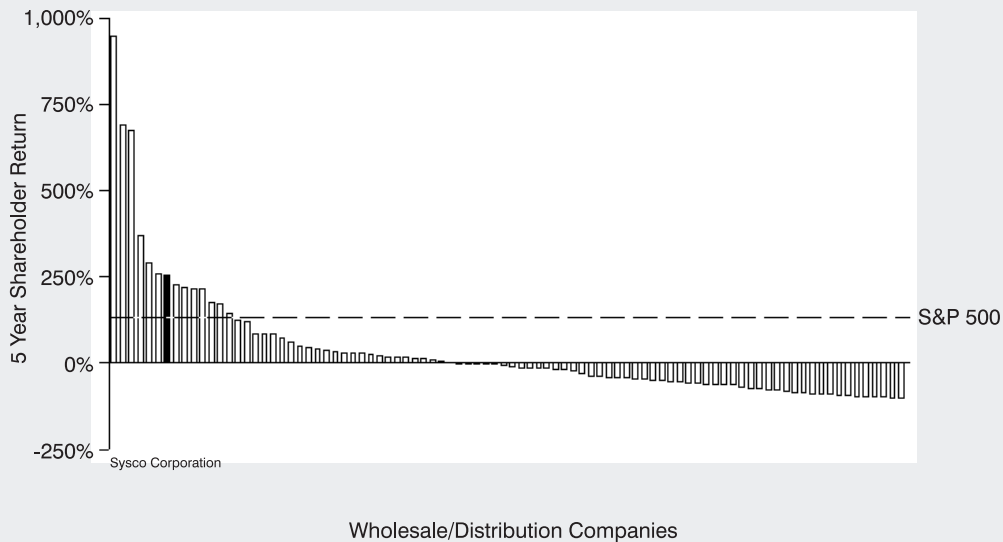
In 1969, Sysco was a \$116 million regional wholesale food distributor operating in a highly fragmented segment. Today, the company is the leader in its segment, with \$20 billion of revenues. How has Sysco posted 18 percent annual average revenue growth in a segment with only 3 percent end market growth? It accomplished all aspects of the three-pronged strategy – it gained high local market share, reduced operating expenses and increased gross margin.

The components of Sysco's strategy, when taken individually, are not unique. However, their combination, and their tactics, drove the company's remarkable success. Sysco's tactics included aggressively acquiring companies to gain high local market share in attractive regions, building a huge private label business to increase gross margin, and maintaining P&L responsibility at the distribution center level to secure tight inventory and operating expense management. Exhibit 2 provides additional detail on Sysco's successful strategy and tactics, which generated exceptional shareholder returns. The company posted a five-year total shareholder return of 252 percent, more than twice the S&P 500. Even more impressive, Sysco's shareholder return is almost 4.3 times greater than the food distribution segment average.



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## Exhibit 1



### The rise and fall of AmeriServe

In early 1999, AmeriServe appeared to be the quintessential distribution success story. In just three years, the company had transformed itself from a \$400 million regional, chain restaurant foodservice distributor to one of the nation's largest distributors with sales almost \$7.5 billion. At the time, AmeriServe was serving more than 36,000 restaurant locations, and its client list included leading chains like Burger King, KFC, Taco Bell, and Dairy Queen. Less than a year later, AmeriServe filed for bankruptcy and shocked the foodservice distribution industry.

How did AmeriServe fall from greatness so quickly? It believed incorrectly that national (not local) market share and scale economies were the keys to distribution success. Pursuing this strategy, AmeriServe made several large acquisitions to gain national presence, with a disastrous effect on profitability.

For example, as AmeriServe grew, its gross margin actually dropped by 10 percent. Unlike Sysco, which focused on smaller customers, AmeriServe focused on large restaurant chains, the most competitive segment of the industry. As a result, AmeriServe faced continual pricing pressure. To make matters worse, AmeriServe's operating expense (as a percent of sales) increased due to its flawed distribution center strategy. AmeriServe's customers required it have a national distribution center presence. As a result, it built a national presence but did not focus on local market share. This resulted in an underutilized network of distribution centers. Case in point, AmeriServe's average revenues per distribution center totaled only \$122 million, versus \$229 million for Sysco, a comparable food wholesaler. The operation of subscale distribution centers put it at a cost disadvantage, particularly relative to competitors with higher local market share. Why? Distribution scale economies exist at the distribution center level, not at the national level.

In a last ditch attempt to improve its cost position, AmeriServe reduced its number of distribution centers by over 50 percent. However, as the company consolidated its network, many customers fell outside its radius of effective service. Soon after, AmeriServe faced widespread customer dissatisfaction and lost the Burger King account, which accounted for one third of its total revenues.

In every industry, benefits to scale exist (e.g. purchasing discounts). However, in the distribution industry, local, not national, market share drives shareholder returns. Growth is important, but not if an investment in a local geographic strategy fails to improve local market share. In the end, distribution is and will remain a fundamentally local business.

### The path to profitability

The three tenets of Sysco's strategy are common to other successful distributors. Combined, they chart a "path to profitability" for wholesale distributors.

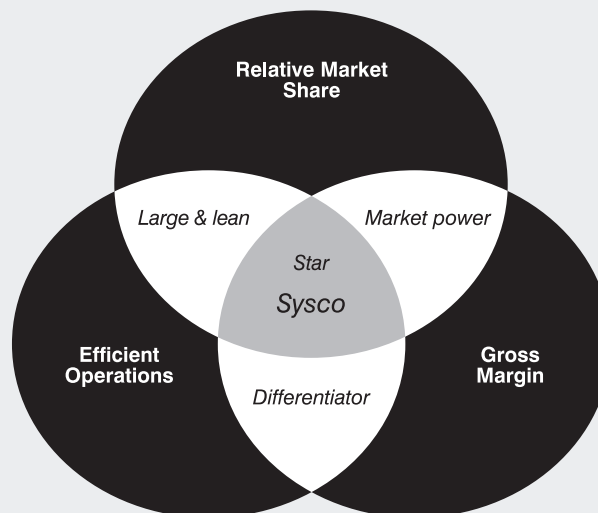
The Sysco story underscores why it is difficult to win in the distribution space – companies must execute simultaneously multiple facets of strategy in order to be successful. Unlike other industries, a stand-alone

customer strategy or cost strategy won't do. On the path to profitability framework (Exhibit 3), even companies leading in one of the three key components (shaded black) still post average shareholder returns below the mean for their industry segment. By contrast, companies that succeed at two or three dimensions (shaded white and grey) realized average returns above the mean for their industry segment.

## Exhibit 2 — Sysco's strategy

Sysco's Strategy Components	Definitions	Sysco's Tactics
<b>Relative Market Share</b>	Gaining high market share relative to competitors, with share measured at the <b>local level</b> (i.e., your sales in a local geographic market vs. the market leader, or #2)	Acquisitions used to gain highest local market share in most attractive food geographies; company is now two times the size of its largest competitor
<b>Efficient Operations</b>	Managing assets (inventory, routes, distribution centers, sales force, etc.) more effectively than your competitors	P&L responsibility retained by local managers; scale enabled investment in technology to increase efficiency
<b>Gross Margin</b>	Providing a service offering that yields a high gross margin relative to your competitors (requires you to perform a service more cost-effectively or efficiently than your suppliers and customers)	Purchased higher-margin food distributors (also extending product breadth); built private label business (46% of sales vs. 36% industry average); gained purchasing synergies through size

## Exhibit 3 — Sysco's position on the path to profitability framework



### Prescription for success

You could not miss CEO Robert Funari as he pulled his 720 horse power Shelby Cobra into the Syncor parking lot. Like his car, the company he manages is firing on all cylinders. Syncor, a \$630 million pharmaceutical distributor, has managed to generate a 950 percent five-year return to shareholders, versus 275 percent for its industry segment.

How did Syncor generate such differential returns for its shareholders? Quite simply, it formed a symbiotic relationship with DuPont, one of its key suppliers, for the distribution of its heart-imaging agent, Cardiolite.

To win preferential distribution rights to this exciting class of drugs – radio pharmaceuticals, or nuclear medicines, the company had to invest heavily in a sales and distribution

infrastructure. Product exclusivity, along with strong drug demand and limited product substitutes, largely explains why Syncor has achieved a gross margin of nearly 36 percent, which is over 5.0 times greater than the segment average, despite being a fraction of the size of the largest drug distributors. “We play a more important role than that of the traditional distributor,” explains Funari. “Our local market presence and unique service model not only facilitates greater product demand but also is critical when dealing with a product that is very expensive and can degrade in a matter of hours.” To meet this competitive condition, in most parts of the country Syncor can deliver a dosage-ready medicine kit directly to a patient’s bedside in under an hour. Moreover, its dosage error rate is statically zero, compared with as high as 5 percent in a hospital and 2 percent at retail.

While exclusive manufacturer-distributor arrangements of this sort are rare, Syncor did not come to occupy the “market power” space in the path to profitability framework through luck (see Exhibit 4). Rather, the company systematically built the capabilities that made it the distributor of choice for a manufacturer looking to quickly build a market for its radio pharmaceutical product. “Relative market share is the quintessential issue,” says Syncor’s CEO, “since all healthcare is about local market economics. While not a perfect analogy, it is like being in the ice business in Texas in the summer. That is our business model. The closer you are to where the ice cube goes into the glass, the better.” Richard U. De Schutter, DuPont’s pharmaceutical chief, echoed the importance of the Syncor business model. “Syncor’s service network, with its extensive nationwide reach, has played an important role in the success of Cardiolite.” Today, Syncor’s pharmacies process 93 percent of all nuclear medicine procedures in the country.

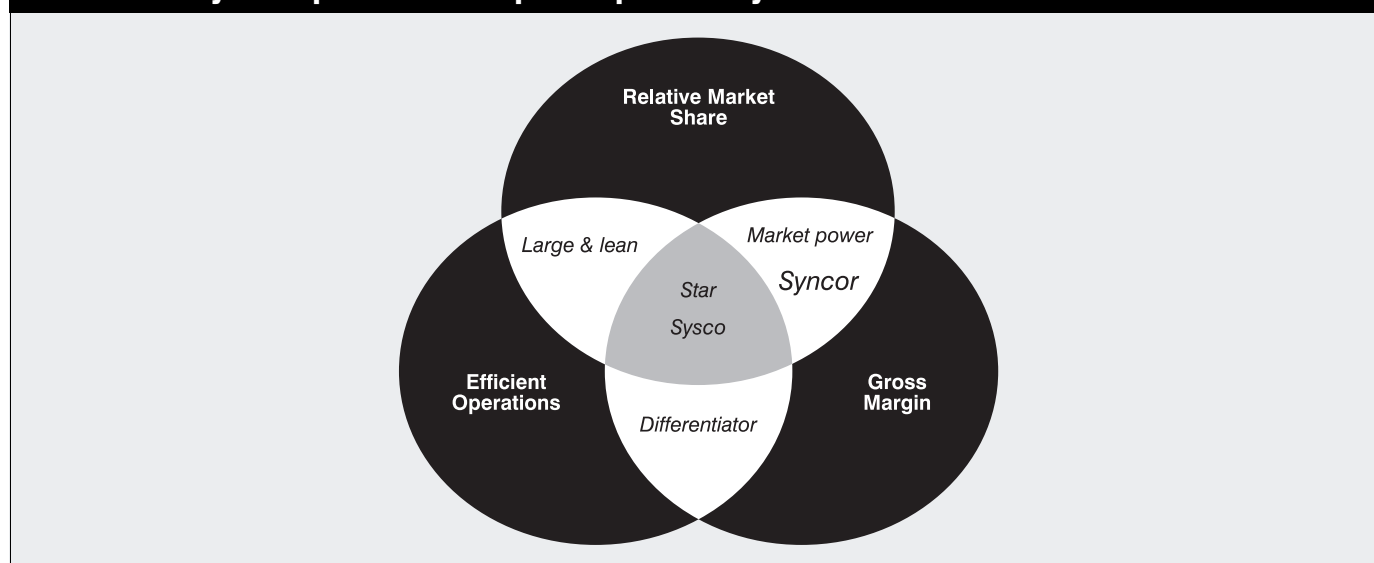
What about efficient operations? The path to profitability framework also highlights a key trade-off made by Syncor. To attain the contracts that would generate high gross margin and high radio pharmaceutical market share, the company sacrificed cost-leadership. Yet, nailing two out of the three stepping-stones to profitability was enough. In exchange for its ability to penetrate local markets and build product demand in a way that DuPont could not, it received compensation in the form of product exclusivity that drove the striking run-up in its share price. The Syncor story proves that manufacturer/distributor interactions do not always have to be zero-sum. Rather, when both parties are willing to invest in a relationship, the sum can be greater than the parts.

### How the Gibraltar ROCK got on a roll

Six years ago when its stock price began to slip, Gibraltar Steel was caught between a ROCK (its ticker symbol) and a hard place. It won praise throughout its industry for its efficient operations, but its slimming gross margin and less than robust share price were worrisome. This left Gibraltar with just three choices: it could do nothing, pursue local market share, or attempt to increase gross margin. The steel distributor vigorously pursued a strategy of increasing gross margin, and since that decision, it has been on a roll.

How does a small player in the steel segment differentiate itself? Quite simply, by investing in new processes and product lines that transformed it from a lower-margin steel warehousing company to a higher-margin steel processing company. At first glance, these tactics seem similar to those of many other steel companies that seek higher margins for their products. However, Gibraltar realized that its strategy would only be successful if it could perform value-added services at a lower cost than its suppliers or customers

**Exhibit 4 — Syncor’s position on the path to profitability framework**



(Exhibit 5). “We have found product differentiation to be critical, but we also had to perform these value-added types of services in a cost-effective manner,” said Brian Lipke, Gibraltar’s Chairman and CEO. “While it is difficult to differentiate in the steel industry, doing so drives higher margins and also has a diversifying effect, since the finished product from one business segment becomes the raw material for another.” Case in point, over the last five years the company acquired downstream processors and heat-treaters of metal. The former enabled Gibraltar to deliver finished steel products directly to end-users in the construction market, while the latter was a complementary process that enabled its customers to reduce the time and expense associated with heat-treating metal, with no incremental inventory investment. Impressive results followed. Products sold in finished form increased from 14 percent to 46 percent of revenues, which drove a 33 percent increase in gross margin. Today, Gibraltar is one of only two steel distributors in our research study to have generated a positive five-year shareholder return. As important, Gibraltar is thinking about the final piece of the puzzle, high local relative market share, as it continues to make acquisitions. For example, it has just built the largest heat-treating operation in the Southeast. While still a small component of total revenues, it is a near perfect example of a high relative-market-share strategy.

### Stationers of the world, United

If that pen on your desk came from your company’s supply room, chances are that United Stationers distributed it. United Stationers, the nation’s largest office supply distribution company with \$3.9 billion of revenues, is a perfect example of a company that fits into our framework.

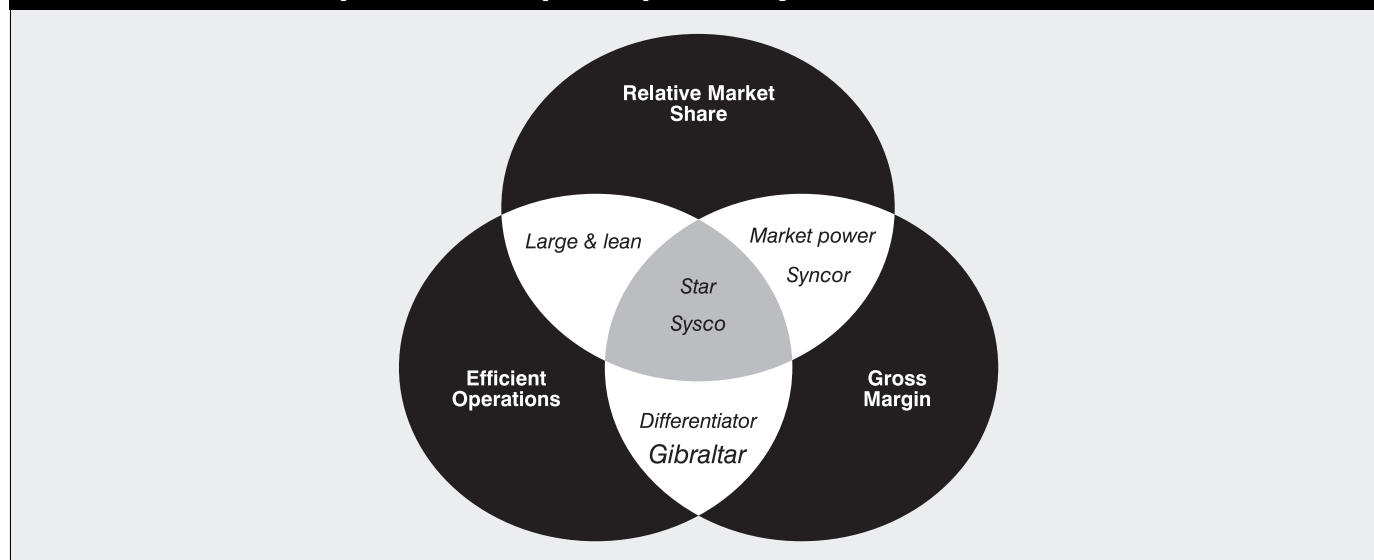
In 1994, United Stationers was a small, regional distributor of only average profitability. As competition intensified and the company’s largest customers began to request distributors with local presence to serve them nationally, United Stationers vowed to get big, broaden its product offering, and become brutally efficient (Exhibit 6). “We decided to focus both on size and efficiency,” said Randall W. Larrimore, the President and CEO of the company. “Scale and technology gave us the product breadth, turnaround times and order accuracy required to convince our customers to de-stock most of their inventories, which increased their ROA and took costs out of the entire value chain.”

Acquisitions were used to build a local presence across the country; with Stationers aggressively integrating new distribution centers to improve service levels and inventory efficiency, and to leverage purchasing scale. The result? The company can now provide one-day service to over 20,000 customers, with fill rates and order accuracy in excess of 99 percent. Financially, United Stationers’ strategic initiatives have transformed the company, driving a 50 percent decline in SG&A expense (as a percentage of sales) and a 120 percent five-year shareholder return. Today, United Stationers is large and lean, and 3.0 times the size of its nearest competitor.

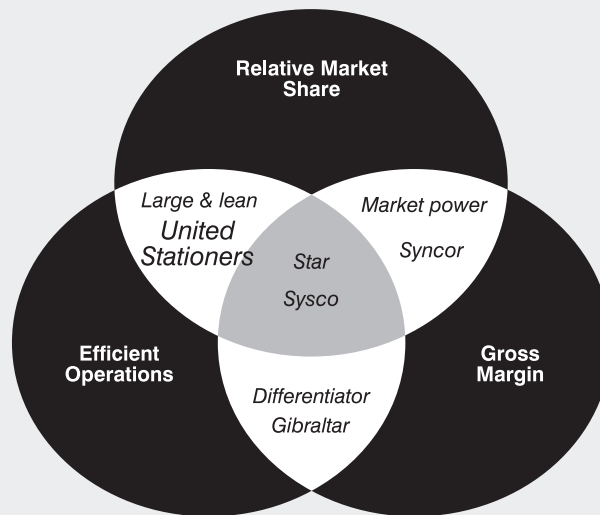
### Where are you?

While the success stories profiled above focused on food, drug, steel and office supply distribution, the strategies and tactics apply to all segments of the distribution industry. As important, once you chart your “path to profitability,” the tactics that you choose to get there will determine your success.

**Exhibit 5 — Gibraltar’s position on the path to profitability framework**



## Exhibit 6 — United Stationers position on the path to profitability framework



A star like Sysco, which excelled on all three dimensions of the strategy, had the highest return relative to its peer group. But Sysco is the exception. Most companies need only excel across two dimensions in order to begin to generate exceptional returns. That means CEOs pursuing a single focused strategy are just one step away from real success.

### Customer-focused culture

No matter what their path to profitability, each of the chief executives we interviewed for this article was quick to stress that a culture of top-notch customer service – important for any business – is critical in the distribution sector.

Here is how Robert Funari, CEO of pharmaceuticals distributor Syncor, explains it: “Customer intimacy and responsiveness are critical to moving customers away from a relationship where money issues are top of mind, and towards a relationship that is focused on how we can help them enhance their customer service. Everyone in the organization must foster a sense of intimacy with the customer.” Funari ensures that Syncor managers screen

for such characteristics when hiring and apply customer-service metrics when running employees’ performance reviews.

Training opens another avenue for building a customer-service culture. At office-supplies wholesaler United Stationers, CEO Randall Larrimore describes his firm’s “United University” this way: “Our salespeople are trained to be consultants who can assist customers with planning and finance issues.” United University goes further: over the last three years, it has developed training programs for staff members who do not directly face the customer. Says Larrimore: “In our distribution centers, we have what we call ‘Delta Teams’ that educate trainees on how each person plays a critical role in delighting the customer.”

And at distributor Gibraltar Steel, chief executive Brian Lipke literally puts a price on sturdy customer relationships. When reviewing an acquisition candidate, he gauges the strength of the candidate’s coziness with its customers and factors the result into what he’ll pay for the business. ■