The distributor challenge

About the Author

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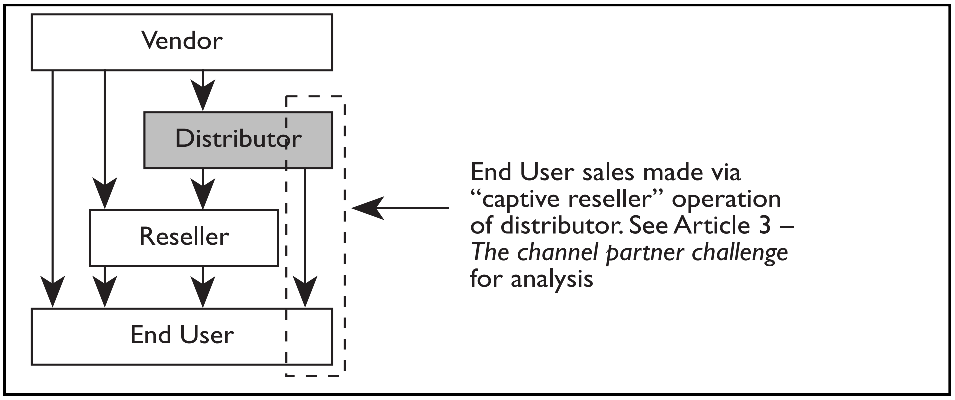
The challenge for distributors in tough economic times is different than the challenges for channel partners. The impact of deflation and currency devaluation takes a little longer to impact distributors. The effects of economic turbulence filters through the end user, through the channel partner and finally into the businesses of the distributors (Figure 1).

The objective of this article is to outline the impacts that a deflationary economy has on distributors and their businesses. The chapter also outlines what actions distributor managers should be encouraged to take in the face of the current economic pressure. Many distributor account managers need business-focused training such as ChannelCorp's *Advanced Channels Workshop* or *Channel Management: the business dynamic* in order to cope. As many distributors in the Asian market also sell product to end users via "captive channel partners", this article should be combined with the material presented in the previous article. The analysis contained in this article pertains only to the "two tier" component of a distribution business whereby product is purchased from vendors and then resold to channel partners by distributors. There are two sections in the article:

impacts

action

Figure 1 – Channel map – impact takes longer



Source: ChannelCorp Management Consultants Inc.

Impacts

The impacts or shocks to the businesses of distributors is the region may lag the shocks that hit the end users and the channel partners, but they will hit. And when they do, they will hit revenues, expenses, cash flow, assets and liabilities.

Distributor ***revenue*** levels and unit volume levels fall as the ability of channel partners to close deals drops. Imported products, with pricing driven by the cost of U.S. dollars, are particularly susceptible to rapid unit volume and revenue drops as prices in domestic currencies rise dramatically. Some channel partners will be forced to return products that they can't pay for causing some previously booked revenues to have to be reversed off the books. Revenue that does continue is focused on the products of the major and influential vendors that can afford to continue to invest in demand generation, brand development, end user financing assistance, and/or consignment inventory programs for distributors. The traditional sales distribution of 20% of products generating 80% of revenues will in some cases go to 10% of products generating 90% of revenues. Fewer vendors will have a bigger and bigger impact on the market Turnover levels plummet for some products as run rates tumble. Distributors endure simultaneous overstocks of slow moving items and stockouts of fast moving items as cash will be unavailable to replenish stocks. Fill rates and channel partner satisfaction levels drop.

Expense levels in distributors are impacted by increases in domestic interest rates, increases in Cost of Goods Sold (COGS) and increases in write-offs associated with bad debts from failed channel partners. As domestic currencies devalue and domestic interest rates increase, the costs associated with holding inventory paid for with borrowed money increase dramatically. Cost of Goods Sold, especially for products driven by U.S.$ pricing, rises causing a corresponding reduction in Gross Margins. Bad debt expense rises as accounts receivable owed by troubled channel partners become uncollectable due to severe cash flow problems in channel partners. In some cases of channel partners, bankruptcy results in accounts receivable write-offs of 100% of the amount owed.

As with the channel partners, the combination of Revenue and Expense impacts result in lower profitability for distributors. This in turn reduces cash flow from operations and the ability to finance growth internally.

Six shocks hit ***cash flow*** simultaneously:

1 *reduced operating profits*
2 *increased investment in A/R due to slow payment by channel partners*
3 *write-offs of bad debts due to bankruptcy of channel partners*
4 *reduced ability to borrow from banks or vendors due to lending restrictions*
5 *demands by related companies for cash to keep other businesses going*
6 *demands by vendors for COD for products*

Reductions in operating profits reduce the amount of cash generated by the distribution business. Without alternate sources of cash, most likely provided by the major vendors, only the top 25% of distributors survive.

More and more cash is tied up in A/R investments as channel partners take longer and longer to pay their bills. Many distributors act as banks for their channel partners. As "banks", up to 25% of the loan portfolio of distributors could be non-performing with 5–10% of channel partners never paying their bills at all.

Banks curtail or reduce their lending to companies in the distribution business as the poorer ones go out of business in spectacular fashion. Vendors of computer hardware, software and telecommunications (at least some of them) reduce the amount of credit available to distributors, in spite of the fact that product that is out-of-stock doesn't sell. As noted earlier, the smart vendors see the provision of credit as a key component of their business proposition.

Some distributors endure the uncomfortable fate of being cannibalized by their own owners. These distributors, owned by diversified family-controlled conglomerates in cash flow trouble, find themselves forced to loan or dividend out cash to keep other parts of the empires alive. Instead of restructuring, unloading unproductive assets in poor performing businesses and/or focusing on core businesses, the centrally-controlled conglomerates strip any distributors that they own of any surplus cash.

As has happened before in countries where market growth has slowed down, vendors that have inexperienced channel business managers get nervous. Reduced credit availability will not be the only impact on cash flow that the vendors will drive. Some vendors, on orders from their regional controllers and Head Office finance people, put distributors on COD. This means that distributors will be forced to pay for product 30–60 days prior to when the distributor will be paid by the channel partner – a problem of survival for many distributors.

Inventory, cash, and accounts receivable are the key ***assets*** that will be impacted by the devaluation and deflation.

Inventory investment levels change in inverse relation to domestic interest rate levels and in direct relation to credit availability. As interest rates rise, inventory levels will fall. As credit availability falls, inventory levels fall. Falling purchases by channel partners require less inventory investment. Worst hit will be the 80% of products in the distributor's inventory that generate the 10–20% of sales.

Slow selling products will be delisted in favor of those products that do sell. Once again, strong and/or smart vendors find ways to solve distributor problems. Some vendors even find ways to put products into distributors on a consignment basis in order to capture any sales that do come by.

Levels of cash and near-cash (non-utilized lines of credit from banks and/or vendors) fall in the short term and remain reduced for some time. In some cases, A/R that would have been converted to cash in early 2002 will be shown on the books as A/R for months only to be eventually written off.

Liability levels increase for the good quality distributors and fall for poor quality distributors. The age-old problem of obtaining credit from banks will be magnified. Those that don't need cash can borrow all they want; those that need cash can't find any; and the more you need cash the fewer number of people will even talk to you.

Figure 2 provides a summary of the impacts that deflation and devaluation have on the various components of the average "stricken" distributor business.

Figure 2 – Distributor impact summary

Revenue
– revenue levels and unit volumes ↓
– product returns ↑
– concentration on key products ↑
– inventory turnover levels ↓
– overstocks *and* stockouts ↑

Expenses
– inventory holding costs ↑
– COGS ↑
– bad debt expense ↑

Cash Flow
– operating profits ↓
– A/R investment ↑
– A/R turnover ↓
– write-offs of bad debts ↑
– ability to borrow money from banks/vendors ↓
– demands from affiliates for cash ↑
–demands from vendors for COD ↑

Debt Levels
– supply available to good businesses ↑
– supply available for poor quality businesses ↓

Source: ChannelCorp Management Consultants Inc.

Action

What action should the owners and managers of distributors take in light of the economic and market prospects in economies stricken by economic slow down? What actions should managers of vendors and channel partners encourage their distributor partners to take? Once again, history tells us that distributors that take swift decisive action have a better chance of surviving during challenging economic times than those that deny problems exist. In addition, those distributors whose people understand the businesses and economics of their partners have a better opportunity to succeed.

Managers of distributors should take the following steps:

Step 1 – Portfolio audit

Step 2 – Account management plan

Step 3 – Credit management plan

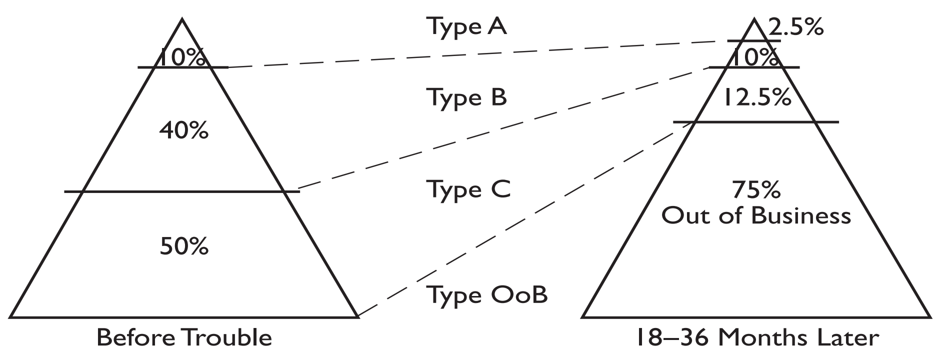
Step 4 – Staffing plan

Step 5 – Business development plan

Step 6 – Growth plan

Distributor management should immediately conduct ***Step 1*** – portfolio audits to determine which of the channel partners that they sell to are going to be worth working with, and which channel partners should be put on credit hold and allowed to fend for themselves. This decision is one of "economic triage"; who to save through continued support, and who not to save. It is a decision with long term ramifications; channel partners will remember which distributors supported them and which didn't in 1997–99. It is a decision that could cost tremendous amounts of money if not made correctly. However, the following chart outlines the change in business quality that will take place (Figure 3).

Figure 3 – Change in business quality



Type A: 10% or more of last year's revenue in cash or near cash [will go from 10% of channel partner portfolio to less than 3% of portfolio]

Type B: not insolvent but chronically cash short and late paying bills [will go from 40% of channel partner portfolio to 10% of channel partner's portfolio – most will slip into Type C]

Type C: technically insolvent – unable to meet current liabilities as they come due – always cash short, always late paying bills – significant bankruptcy risk [will go from 50% of channel partner portfolio to 12.5% of channel partner's portfolio]

Type OoB: out of business – businesses that will fail if economic trouble lasts 18–36 months

Distributor management must rapidly decide which components of their portfolio they plan to invest in with hopes of saving or building channel partners for the future. Obviously the future is based on working with the Type A and Type B channel partners while reducing exposure to Type C and OoB channel partners.

Step 2 – Account management plans require management to focus programs and people on the businesses that in Step 1 were designated as the channel partners to work with. Because the selected channel partners (Type A) are quality businesses with quality people and quality plans, any account management plans that are developed must be a joint plan of channel partner and distributor management.

The third step **(*Step 3*)** is to develop a credit management plan for the entire portfolio of channel partners that you plan to focus on. Some distributors will tighten and cut credit across the board. It is critical ***not*** to do this. Credit should be tightened for the bottom 75–85% of your portfolio. However, expanding credit to the top 15–25% of your channel partners will allow them to grow their businesses and provide a competitive advantage in the marketplace.

The staffing plan is the fourth step **(*Step 4*)** for distributor management. Many distributors will cut employees in a mad dash to get SG&A down. The distributors that will prosper will resist the temptation to be free of their people. They will instead pull their people off the bottom 75–85% of their channel partner portfolio and refocus them on helping the top 15–25% get all the business that they can. Special attention and special focus will be put on the top 5% of the distributor's channel partner portfolio.

Step 5 for distributor management is to create a business development plan for the business. Domestic demand will not disappear; it will simply shrink. Sales will be made. Systems will be purchased. The storm will come, but it will go away. Distributor management must focus all channel partner programs on three key issues:

1 *channel partner revenue enhancement/sales generation*
2 *channel partner expense reduction/cost suppression*
3 *channel partner asset investment reduction or suppression*

The final element (***Step 6***) of the distributor plan is the creation of a growth plan. Tough times are an excellent opportunity to develop relationships with those channel partners who may not have shown any "red" in their plans. Distributors that target vertical markets, horizontal markets and geographic markets that are in need of coverage and actively recruit to fill holes will prosper. Figure 4 indicates how partners can be recruited (A–F) to fill holes in market coverage (M_1–M_6).

Figure 4 – Market focus

Channel Partners in Portfolio

Horizontal Markets & Vertical Markets

	A	B	C	D	E	F
M_1						
M_2						
M_3						
M_4						
M_5						
M_6						

Any programs that don't deliver one or more of the above issues should be fixed (so that they do) or eliminated. Business development will result from fewer, better programs properly executed by dedicated channel partners.

Article summary

During times of economic pressure, distributors are squeezed from both the vendor and channel partner components of the business. In the short term, distributors fight to survive as traditional functionality, like providing credit, becomes impossible. Channel partners can't pay bills – vendors want their money. The strong, aided by their vendors, survive. The rest go out of business or are bought up.

The next article outlines the challenges faced by vendors as they try to operate in economically challenged markets.