

Apples & Oranges

Distribution

Klas Mellander

Acknowledgements

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Preface

In my book “Apples & Oranges – Everything you need to know to understand business finance,” I discuss the elements of business finance, using a manufacturing company as a model. Here I focus on the distribution system that makes merchandise available to consumers.

This book is relevant for everyone who is involved in moving goods from the producer to the consumer: manufacturing companies, transport firms, wholesalers and retailers (small shops, large self service chains, etc.). Here I also include businesses that voluntarily become members of specialty-store and franchise chains in order to gain access to the benefits of coordinated business concepts, product-selection policies, etc., while retaining local ownership.

Many retail businesses have succeeded by redefining themselves as movers, rather than sellers, of merchandise. This change in philosophy has demanded an integration of the entire distribution chain – from the production plant to the store shelf – based on up-to-the-minute information on what customers are buying. This new way of working has enabled retailers to streamline the distribution process by eliminating warehouses, etc., but without obliging them to trim their product assortment, which often consists of thousands of items.

What are the economic demands on retail businesses? Who do they compete with? How do different changes in policy affect profitability? How important is it to have an efficient flow of merchandise?

Here I try to answer questions like these, in order to provide an overview of the links that form the distribution chain between the producer and the consumer. I hope that this book will make it easier for people involved in distribution to understand the role that their individual efforts play in the overall merchandise flow.

Klas Mellander

“The model company”

As a model for the simulation and for several of the examples, I’ve chosen a large department store.

I could just as well have used a grocery store, a hardware store or a car dealership. All of these businesses constitute the last link in the distribution chain between the supplier and the consumer – or, if you prefer, the first link in the chain between the consumer and the supplier!

Merchandise for our retail chain flows from the supplier, to a warehouse, to a store stock room, and on to an individual department. The corresponding flow for a grocery store starts with the supplier, who delivers merchandise to the wholesaler for further distribution to store stock rooms. From there the merchandise is placed on the shelves.

The most important success factors for businesses of this kind are efficient merchandise flow, low costs, high service level – and, of course, good products.

To illustrate this more clearly, I’ve made the store responsible for “its part” of the stock at the warehouse.

The margin, i.e. the difference between what the customer pays for the merchandise and what the retailer pays the supplier, varies considerably with the type of business and the price profile. This margin (gross profit) can be anything from 5%-15% (for a car dealership or a discount store) to 20%-50% of the retail price.

In the model company I set the margin at 50%, mostly to simplify calculations, and to make it easier to handle the markers in the simulation. (Of course, we assume that the competitors have the same margin.)

Instead, I focus on how we can increase our **sales volume**, and on how we can use our gross profit.

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What does an empty shelf cost?

A customer leaves the store disappointed. The item she was looking for wasn't there, in spite of assurances that it would definitely arrive the day before.

We can ask ourselves how much **sales value** this customer represents when she leaves the store.

In this case we missed a sale – that's obvious.

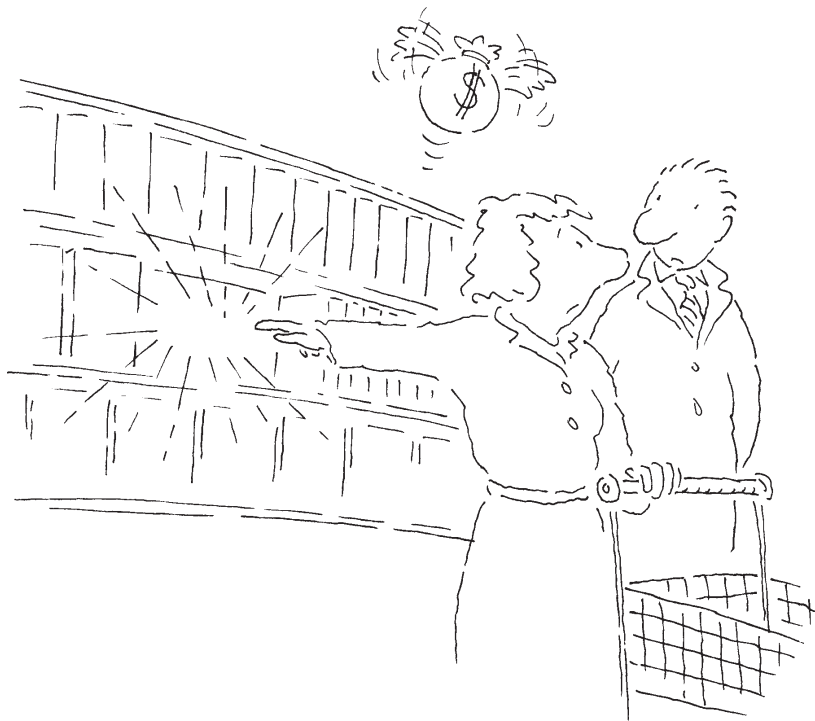
But we also lost her trust to some extent. Maybe she won't come back; maybe she'll go somewhere else next time. What does this mean in terms of sales value over a period of a few years? How much will it cost us in terms of extra marketing to replace this lost customer? What will it cost us in lost sales when she tells her friends and acquaintances what happened?

There are many ways to disappoint customers: with employees that are too busy doing other things to take care of them. With overburdened employees that make customers feel like a nuisance. With disheveled displays, tattered merchandise and outmoded products. With employees that run into customers with fully-loaded hand trucks at rush hour. With long lines at some checkout counters, while others are closed and the cashiers there are doing other work. And, as we said, with empty shelves.

Naturally, the **opposites of all of these things** are the things that make customers want to come back, to recommend the store to their friends and acquaintances, to buy more.

It's easy to say that all of this is a matter of employee attitude and service capacity, but if the basic requirements aren't fulfilled, there isn't much the employees can do other than display a friendly smile and agree with the customer that things aren't what they should be.

Here we'll take a closer look at these basic requirements.



What does an empty shelf cost?

Power to the customer!

The rules of the game in retailing have changed dramatically. Here are the views of Göran Lagerström (Lowe-Brindfors) on the democratization of the retail trade:

“When our parents and grandparents went to the grocery store, it was the grocer who decided what they should buy (*what* he would sell) and *how much* they should buy. (He knew what their economic situation was.)

When self-service stores were introduced on a large scale in the United States after the Second World War, the main objective was to lower costs by letting customers do the work. At the time, retailers didn’t realize that one of the reasons why people accepted this was that it gave them power: They could decide themselves what to buy. They didn’t have to tell anyone how much money they had in their pockets. They could choose the product quality they wanted, not the one that the grocer wanted to sell.

A fairly long time went by before other businesses followed suit. But when Erling Persson of Sweden’s Hennes & Mauritz discovered that he needed to cut costs, he hung some blouses on a round clothes rack where customers could pick them out themselves, instead of piling them up as usual on elegant shelves where a sales clerk had to rummage through them to show them to customers. He didn’t make any other changes, but he found that sales immediately rose by nearly 40%. That’s when retailers started to get an inkling of what they could gain by letting customers find what they were looking for on their own.

One line of business after another – furniture, household appliances, etc. – has introduced self-service, and there are even self-service stores for building contractors, dentists and many other groups.”

In retailing today, the customer makes the rules.



*The more stores there are to choose from, the greater the number of factors that determine where the customer will shop. So retailers have to be good at **everything** that influences the customer's choice.*

Maintaining a sharp profile

One of the most important rules of the game is that, at a minimum, the customer must find both the type and the quality of the merchandise that he or she expected to find. But atmosphere, customer treatment and quality of service are just as important. “*Well-stocked.*” “*Everything easy to find.*” “*Helpful employees.*” These are the things that customers value most.

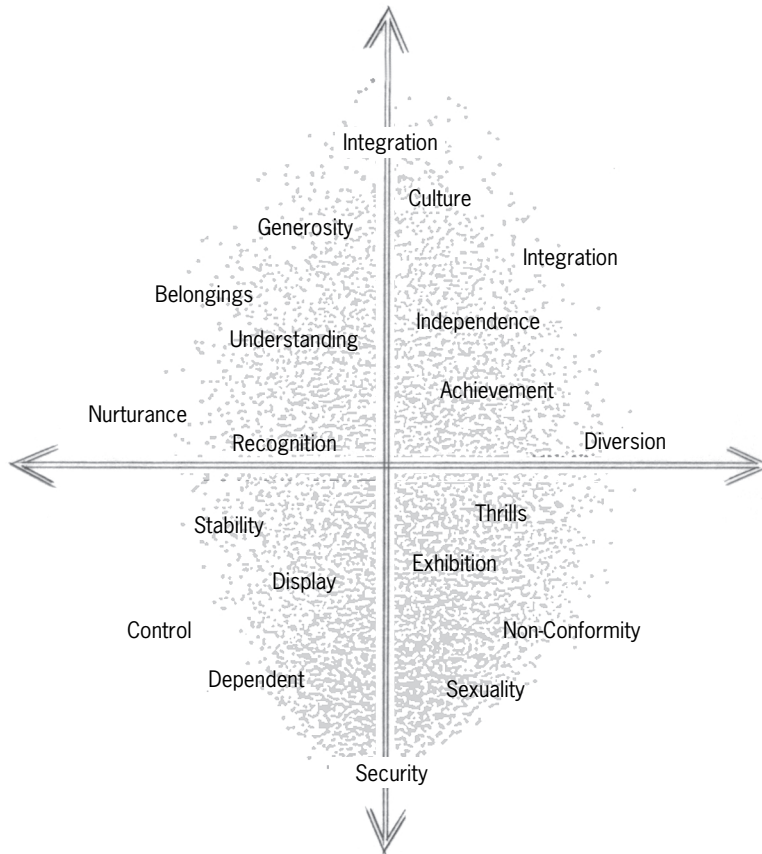
And there is something else that customers value: the store’s profile, its identity.

Before, retailers aimed for specific target groups: high-income earners, low-income earners, skilled workers, yuppies, etc. Income and social status were the deciding factors, and this was reflected in both the merchandise offered and in the store’s atmosphere. But gradually, retailers found that these classifications weren’t very relevant in terms of buying behavior.

Now it’s **shared values** that count, and retailers today base their market charts on values. The chart at the right shows how the general population can be classified in terms of basic beliefs and values. (Each point represents a certain percentage of the population.)

By carrying out customer surveys (profile surveys) at regular intervals, retailers try to ensure that their profile is uniform (the one that they desire), and that it continues to coincide with the characteristics of the target group or groups. In the same way, they determine where on the values chart their competitors appear to be positioned, in order to obtain data for modifications and campaigns.

Conclusion: We cannot be all things to all people, so we have to decide which customer groups we can (and want to) target – and then concentrate on these groups.



If we decide to concentrate on the customers whose values are shown in the lower part of the chart, for instance, then we have to make sure that these values are evident in everything in the store: in the products offered, advertising, displays, signs, general atmosphere, employee attitudes, etc. Departures from these values will create a feeling of uncertainty and alienation.

(Sources: SIFO Research and Ameriscan Consumer Motivations, RISC International Research Institute on Social Change)

In the eyes of the customer

The next task is to live up to customer expectations within the framework of the established profile. To do this, we must look at everything through the eyes of the customer:

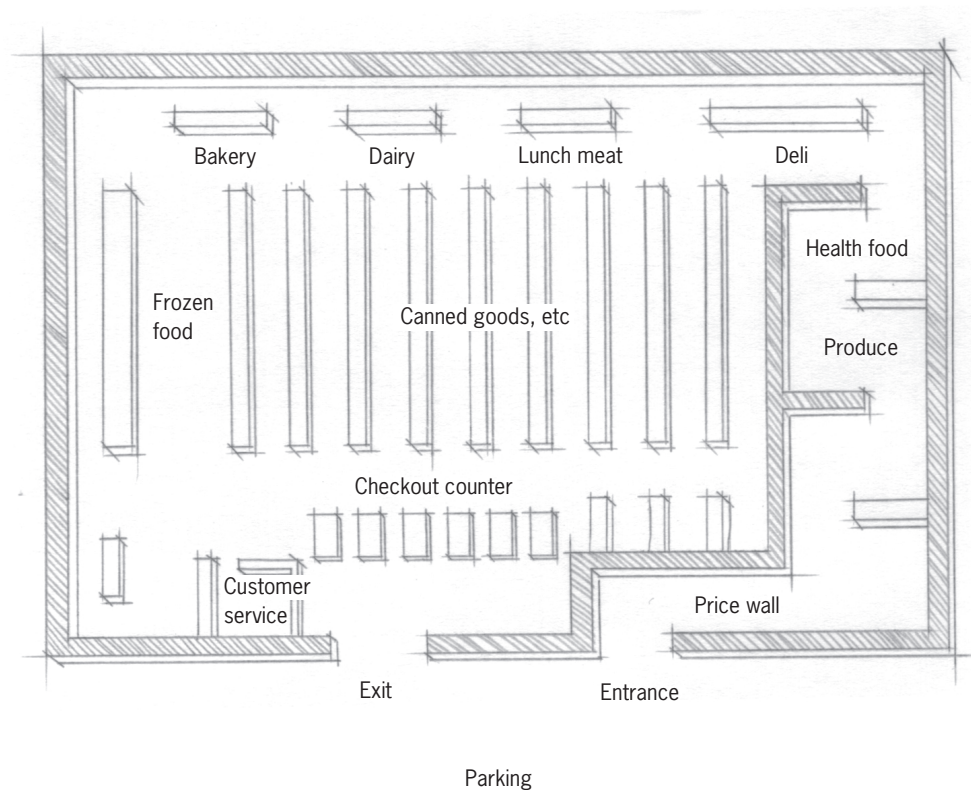
1. “It must be well-stocked.” As customers, we say that a store is well-stocked if we almost always find what we’re looking for. Thus, a store that carries a large number of items risks being viewed as less well-stocked precisely because we didn’t find what we went there to buy. The objective is to be (to be perceived as being) well-stocked, while minimizing the number of items in stock. To know what customers want is one thing. To decide in advance what customers *will want* is another. We all know how we occasionally react as customers: We suddenly say “*That’s what I want!*” without even knowing beforehand that we did want it.

2. “Things must be easy to find.” Regardless of whether the customer is after something in particular or just “looking around,” merchandise must be easy to find. Important factors here: how the merchandise is grouped, displayed, etc. A good store layout not only helps customers to find things and plan their route through the store, it also results in additional sales (additional purchases). See the illustration.

3. “The employees must be helpful.” Customers want the store to have a policy of good customer treatment of course, but just as important, they want to be able to consult a store employee when they need help, and they don’t want to wait in line too long at the checkout counters.

Most retailers continuously ask their customers to complete a simple questionnaire to find out what they really think. Without such surveys, we can easily become blind to what’s going on around us.

It makes no difference what we think our customers should think; it’s what they actually think that determines whether our business will be successful.



Rainbow, an American grocery chain. Profile: “Low, low prices but fresh and clean, with a high service ratio.” At the entrance is a “price wall,” where prices are so low that customers will forget their shopping lists and have their carts half-full by the time they reach the produce department, which exudes quality and offers a wide selection of fruits and vegetables. The store is easy to overview and has legible signs. The profile is reinforced by well-tended departments alternating with large displays of items on sale. The checkout counters give an impression of speed.

The challenge

A sample merchandise flow for a large retail chain is shown in the illustration. Thousands, perhaps tens of thousands, of different items in different amounts: on the way from suppliers, at warehouses, on the way to the stores, in the stores' own stock rooms, on the shelves. (Knowing out where a certain item is at a certain instant makes finding a needle in a haystack look like child's play.)

All of this costs money and thus affects prices – which influence customers – who prefer to shop where they can get the most for their money.

What is it that costs money?

In addition to what we pay suppliers, we have costs for transport, stock handling, stock maintenance, further transport, handling, stock maintenance, sales, etc.

We also have major costs for merchandise that is damaged, spoiled, obsolete or stolen.

Moreover, sizable amounts of capital are tied up throughout the merchandise flow. And capital costs money, regardless of whether it comes from the producer, the wholesaler or the store itself.

So the challenge is to minimize all of these costs, while giving customers, at the very least, the service they expect.

Someone put it this way: *“In that case, we can't have our employees spending half their time looking for merchandise that isn't there!”*

What this all boils down to is using resources where they do the most good.



Thousands, perhaps tens of thousands, of different items in different amounts: on the way from suppliers, at warehouses, on the way to the stores, in the stores' own stock rooms, on the shelves.

Using gross profit

In retailing, as in all businesses, the harder the competition, the more important it is to avoid costs that don't result in added value for the customer.

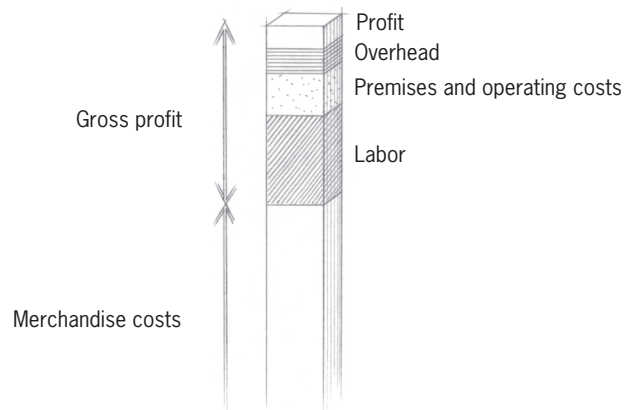
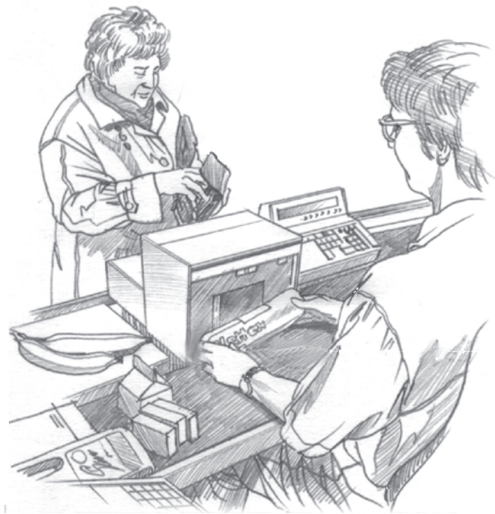
Merchandise costs – what we pay suppliers (or wholesalers) for merchandise, including shipping, insurance, etc. – are the largest cost item in the retail trade. The percentage of the sales price that merchandise costs account for varies from one line of business to another. How much retailers must pay their suppliers for merchandise depends on the degree of competition between these suppliers, etc.

Many retailers view merchandise costs as “money out, money in” – or even “money in, money out,” because in the grocery business and some other businesses, buyers normally don't have to pay for merchandise until they sell it and receive payment. (This means that retailers don't have to keep money tied up in merchandise, which is an apparent benefit, but the resulting capital costs for producers and/or wholesalers are obviously included in the price.)

What retailers earn money on is their **markup**. This is their gross profit. All costs must be paid from the gross profit – and, hopefully, there will be something left over for investments in the future, etc.

An overview of the major cost items in the retail trade is shown in the illustration at the right, although, as I said before, the percentages vary from one line of business to another.

So the question is: How can we use our costs to give our customers the greatest possible value?



It's remarkable how a combination of increased competition and declining demand have slashed costs in one line of business after another. (For example, we can ask ourselves what an American or European car would cost today if the Japanese hadn't thrown their hat into the ring.)

What about labor?

How should we use labor, the largest cost item after merchandise costs?

Here advances have been made at a rapid pace - and the trend continues.

That employees have always had to work hard is nothing new; the question is whether they've been doing the right things.

The illustrations at the right give some idea of what I mean:

The upper figure shows the number of customers in a store on a given day.

Now suppose that the employees' working hours and job duties are shown in the charts below. Here I've divided the job duties into **customer contact** and **donkey work** (price marking, stock handling, administration, etc.).

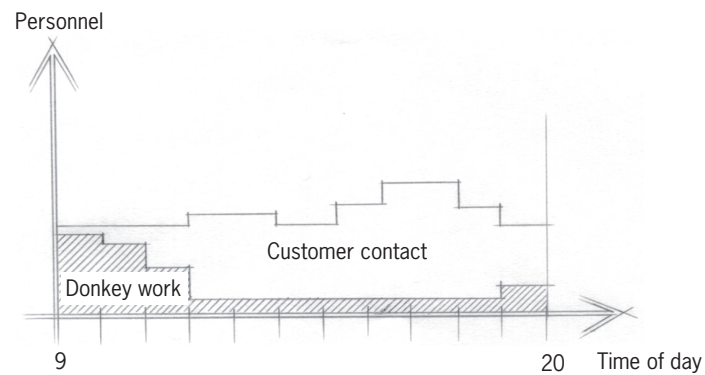
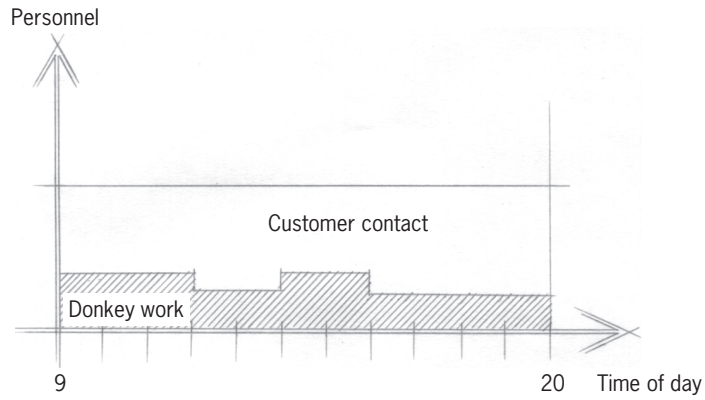
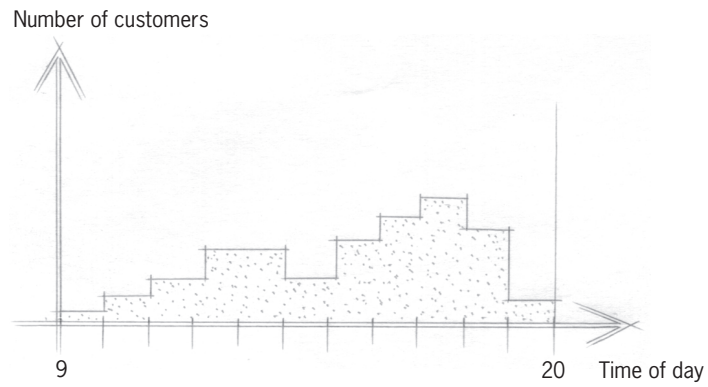
Many retailers have corrected this imbalance through two types of efforts:

1. Employee working hours have been modified to better meet customer needs.
2. Mechanization and automation have simplified and speeded up a large part of the donkey work, and more of this work is now carried out during the morning hours. The capacity thus freed can be used for sales work instead.

The results are shown in the lower illustration.

Customer needs vary over time (days, weeks, years), so employee work schedules must be flexible.

Otherwise, excess labor costs can nullify the effects of any attempts to strengthen the company's competitive edge.



Automating the donkey work

A great deal in the retail trade has been mechanized and automated through information technology, extensive cooperation at all stages from suppliers to retailers, etc.

Bar codes have had a profound impact in this regard. At the beginning of the distribution chain, the supplier marks each item with a bar code, and this simplifies the work at all subsequent stages. At modern stores all merchandise is marked with bar codes or identified in some other way to permit optical or electronic scanning. The bar code contains the supplier's name and the item number.

When the merchandise reaches the store, the labels are scanned in order to notify the computer system that the merchandise has arrived. A large part of the merchandise can be placed directly on the shelves. Labels attached to the edge of the shelf indicate the item number, the quantity of the item in stock (safety stock) and the "correct" amount to be ordered each time (optimum order quantity). With simple hand scanners, the employees can go out and check the shelves, and enter their **orders** into the system.

Bar codes also make the **cashier's** work easier, but even more important, they simplify the store's **administrative** work because all purchases can be entered into the system.

Every day the store managers receive detailed reports from the **checkout-counters**, so they can check the cash balance from each register. Moreover, they can monitor sales to determine what was sold and for how much.

This, together with the fact that the customers themselves do a large part of the work (see page 8), is what has made it possible to eliminate so much of the donkey work.

As we'll see, quick and simple registration (when properly used) offers other benefits that are at least as important for strengthening the retailer's competitive edge.



Simple reading and input of data. Modern scanners are cordless, and they communicate with the system via radio signals. The display indicates whether the merchandise is in the stock room, en route, etc.

Pulling instead of pushing

Large retail chains check every hour (!) to determine the exact location of each item in the pipeline from the supplier to the customer. How can they do this?

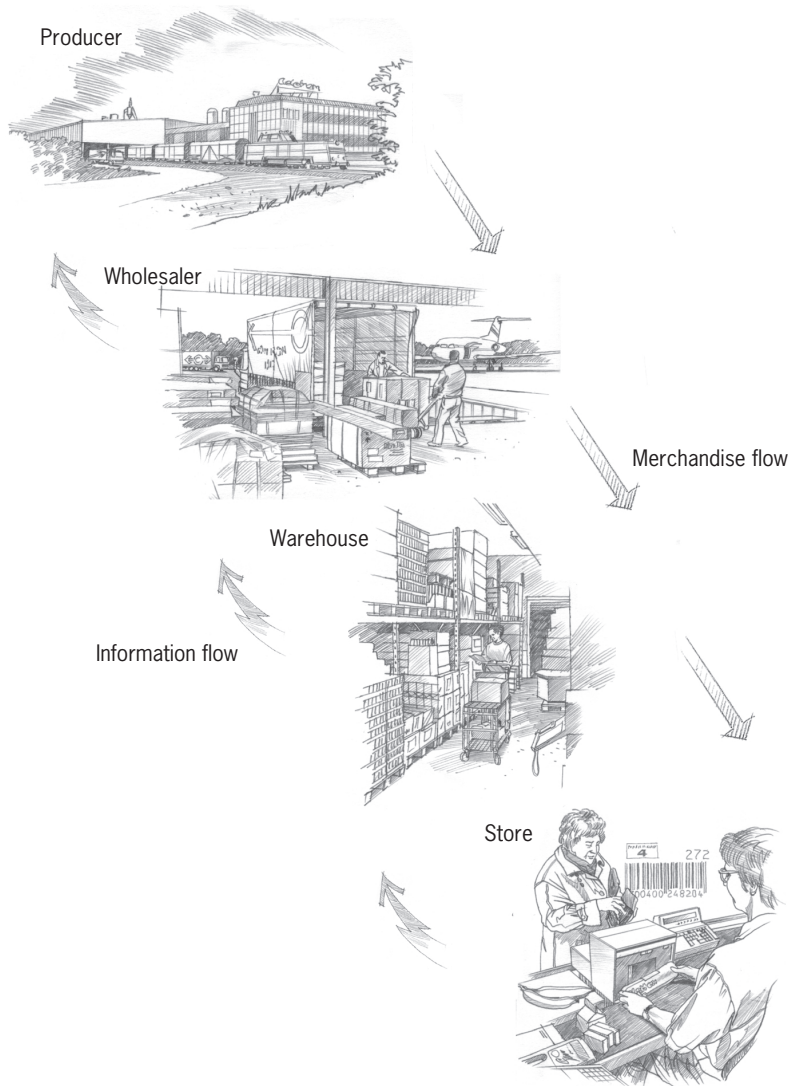
One of their secrets is that they employ advanced information technology. So the illustration at the right is not science fiction; it's quite real.

Study the illustration – and remember what I said about the needle in the haystack. Then try to answer the following questions about what this type of information system seems capable of doing.

- Can the store manager inform the system quickly and easily when he/she is about to run out of certain items?
- Can the people in charge of keeping the shelves full be notified easily when more stock is needed? Can they find out simultaneously whether the merchandise is in stock, or on its way and, if so, when it will arrive?
- Can wholesalers easily determine which merchandise moves fast and which moves more slowly? Can they find out how attractive different items are? Can they monitor trends in different stores' needs and simultaneously check suppliers' capacity to deliver certain merchandise? Can retailers experiment to see, for example, whether toy sales would increase if the toys were moved to the diaper department?
- Can suppliers' delivery capability be monitored? Can retailers monitor sales of different parts of the product assortment and quickly modify their orders and/or cut prices and implement campaigns in order to increase sales?

A large number of stores today can do many of these things, and the large, successful retail chains can do them all.

And all of your competitors are in the process of learning to do them – better and better and better.



With information technology, we can let our customers' buying behavior control the entire merchandise flow. Instead of "pushing" merchandise through the system (as we did in former times) we can let our customers "pull" it through.

“Tailor-made” ready-to-wear clothes

Information technology enables us to reduce the number of items in stock and increase our customers’ freedom of choice at the same time.

Henry Ford’s retort is a classic: *“They can have any color they want – as long as it’s black.”*

Compare that with Benetton’s policy: *“We knit our sweaters from undyed yarn. We don’t dye them until we receive an order from the retailer.”*

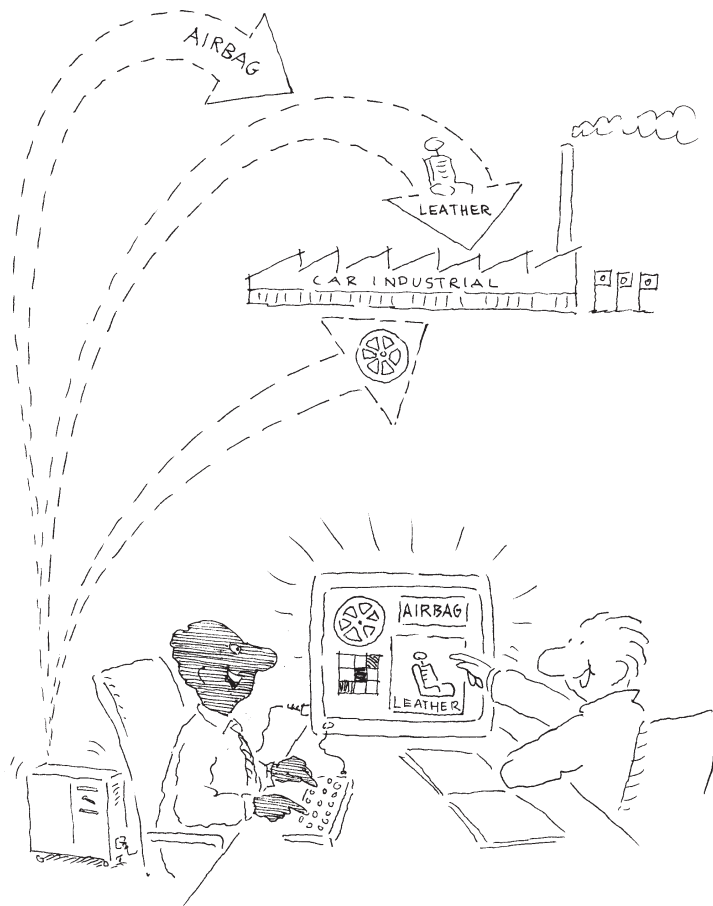
In the future, many consumer products will be manufactured (or at least assembled) to fill a direct order from the end user. Cars are a good example:

To satisfy everyone, each car model is available in a vast number of variants (with different engines, number of doors, wheels, upholstery types, colors, etc., etc.). Obviously, there’s no way a car dealer can keep all of these variants in stock. Instead, the dealer helps the customer to pick out the options he or she wants. When the customer’s order is entered into the system, it’s automatically converted into an assembly order and sent to the manufacturer, who automatically orders the necessary components from his suppliers. We see the same thing happening in many other areas of retailing.

Why should each furniture store in a chain stock all of the different sofas available in all of the different fabrics available? Would customers prefer to buy a sofa immediately, rent a truck and take it home themselves, or to have it delivered to their home a couple of days later, directly from the factory? Most would probably choose the second alternative. In this way, the furniture store can give its customers greater freedom of choice and more convenience, while reducing its own costs.

This is the same idea that I discussed on the previous spread:

The main objective isn’t to sell what you have, but to have what you can sell!



The customer's freedom of choice increases and the retailer's costs decrease at the same time. Perhaps in the future it won't be necessary to travel to a showroom at all to buy a car; we may be able to order the car we want without leaving home, by pressing buttons on a touch-tone phone.

Across all boundaries

Technology has been a necessary element in the trend toward lower costs, but technology alone isn't enough: **We must also be capable of cooperating across boundaries.** That's why we try to tear down the traditional barriers between different employee categories. The more versatile people we have, the easier it is for us to use our resources where they do the most good at any given time.

All people (regardless of where they are in the distribution chain) must also be given a chance to understand **what role their own job duties play in the overall operation:** If they aren't, it will be hard for them to set priorities. (There's an obvious difference in outlook between a worker who says "*I drive a truck,*" and one who says "*My jobs is to get merchandise to the place it's needed when it's needed.*")

Moreover, cooperation between different departments (such as purchasing and sales) has increased as the awareness of **common goals** increases and the traditional rigidity of organizational structures and working procedures is relaxed.

Suppliers' attitudes with regard to cooperation – their willingness to be a partner rather than an adversary – are particularly important. In such relations the parties together establish the guidelines for everything from delivery intervals, the handling of irregularities, invoicing, payment terms, etc., to how each of them can monitor the other's stock balance and delivery capability, respectively. Suppliers can also contribute by marking each shipment, for instance, to save a great deal of work for the consignee: at the warehouse, for example, merchandise can be transferred via conveyor directly from the arriving goods department to the trucks that will transport it to the various stores.

Results: faster and easier handling, lower costs and less chance of error.

THEN



NOW



Cooperation across boundaries: the key to increasing your competitive edge.

Economic aspects

The following reports bear witness to the fact that the actions I've described do make a difference when it comes to profitability.

Note that all of the sales increase for year 2 is a direct result of reducing the number of empty shelves in the store. We can see the same effect for year 3, but here combined with a 5% increase in demand. Note also how better utilization of labor and premises increased the operating profit for year 3.

Income statement

(in millions)		Yr 0	Yr 1	Yr 2	Yr 3
Revenue, full price	+	67	64	72	80
Revenue, 50% discount	+	5	5	3	0
Total revenue	=	72	69	75	80
Cost of goods sold, full price	+	33	32	36	40
Cost of goods sold, 50% disc	+	5	5	3	0
Loss	+	3	4	2	1
Total cost of goods sold	=	41	41	41	41
Contribution	=	31	28	34	39
Sales & administration	+	18	20	20	16
Depreciation (1/3)	+	6	4	4	3
Total common costs	=	24	24	24	19
Operating profit	=	7	4	10	20
Interest (10%)	-	4	4	4	2
Profit before taxes	=	3	0	6	18
Taxes (1/3)	-	1	0	2	6
Net profit/loss	=	2	0	4	12

Balance sheet

(in millions)		Yr 0	Yr 1	Yr 2	Yr 3
ASSETS					
Current assets					
Cash and cash equivalents	+	20	22	29	39
Accounts receivable	+	2	4	4	4
Total quick assets	=	22	26	33	43
Total inventory	+	53	52	51	39
Total current assets	=	75	78	84	82
Fixed assets					
Machinery and equipment	+	12	8	8	6
Real property	+	13	13	13	13
Total fixed assets	=	25	21	21	19
TOTAL ASSETS	=	100	99	105	101
LIABILITIES AND EQUITY					
Liabilities					
Loans	+	40	40	40	20
Tax due	+	1	0	2	6
Total liabilities	=	41	40	42	26
Equity					
Beginning balance	+	57	59	59	63
Profit/loss this year	+	2	0	4	12
Total equity	=	59	59	63	75
TOT. LIABILITIES & EQUITY	=	100	99	105	101

The figures have been taken from the simulation model. We should point out that the turnover rate for inventory capital, i.e. the ratio between annual turnover and the value of merchandise in stock, is considerably higher in real-life retailing. The difference is due primarily to the fact that we've included the value of the entire merchandise flow in our calculations, not only that of the goods on the store shelves and in the stock room. See the following page.

Key indicators – the challenge

In all lines of business we use financial indicators, i.e. figures that tell us how the business is doing in different respects. (See also “*Apples & Oranges – Everything you need to know to understand business finance*,” pages 86-95.)

Here are the questions that are asked most often in the retail trade:

1. How’s business?

A store’s **turnover** (sales) and **gross profit** can tell us a great deal if we compare the figures from successive years.

2. What about profitability?

We can also phrase the question like this: How much are we earning on each hundred dollars? This financial indicator is called the **profit margin**, i.e. the ratio between operating profit and turnover.

3. How efficiently are we using our employees?

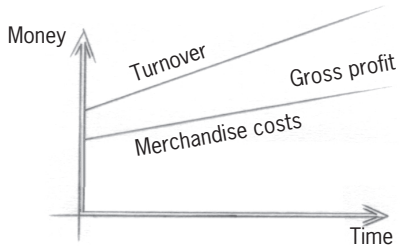
The ratio between labor costs and turnover answers this question, and the financial indicator can be called **labor intensity**. A variant of this is the **turnover per employee**.

4. How efficiently are we using other costs?

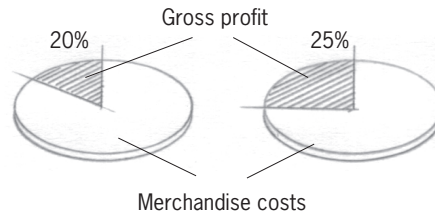
Similarly, we can look at fixed costs in relation to turnover. Cost-effectiveness is the name for this financial indicator.

5. How efficient is our merchandise flow?

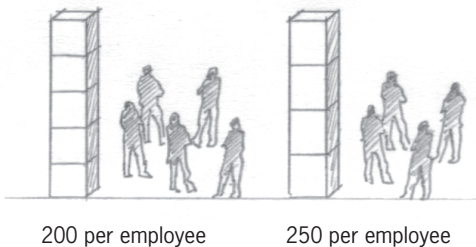
What we’re interested in here is the value of our **stocks of merchandise** in relation to annual turnover – in other words, the speed at which inventory capital flows through the circuit. The financial indicator is called the **inventory capital turnover rate**, and it shows the ratio between annual turnover and the value of the merchandise in stock. (See also “*Apples & Oranges – Everything you need to know to understand business finance*,” pages 66-67 and 90-91.)



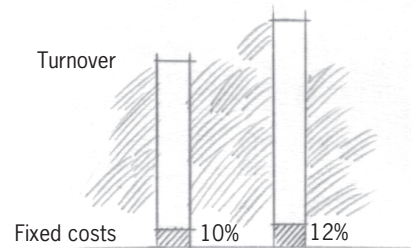
Either the retailer raised his/her prices or the suppliers lowered theirs – perhaps as a result of more rational distribution.



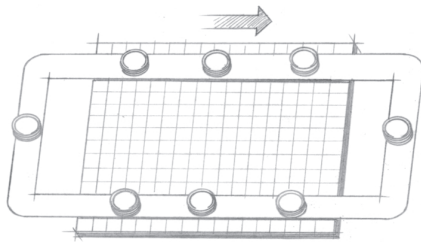
Higher prices and/or lower costs increase the profit margin, i.e. how much the retailer earns on each hundred dollars in sales.



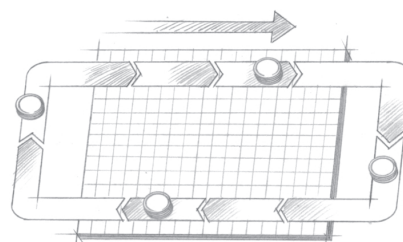
Increasing turnover per employee can be the result of the elimination of donkey work, and of greater employee flexibility.



Why are fixed costs increasing faster than turnover? Maybe it's time to review our fixed costs.



Before, grocery stores stocked enough merchandise for one to two months of sales (annual turnover rate: 5 to 10 times).



Today's stores stock enough for two to three weeks (annual turnover rate: 20 to 30 times). The result: more efficient use of resources.

Success factors

The illustration provides an overview of a merchandise flow, along with examples of the important success factors in each link of the distribution chain. After you study these points, it can be a good idea to think about them in the context of your own business:

What are your strong points and your weak points?

Don't hesitate to include other factors that you consider important. Mark your strong points with a +, for instance, and your weak points with a –.

Also: **What are your own ideas for improvement?** (See also “*Apples & Oranges – Everything you need to know to understand business finance,*” pages 102-103.)

Think about what we said in the introduction – here slightly modified:

A customer leaves the store satisfied. She found what she was looking for and then some. We can ask ourselves how much **sales value** this customer represents when she leaves the store.

In this case we made a sale – that's obvious. But we also gained her trust to some extent. She's sure to come back instead of going somewhere else next time. What does this mean in terms of sales value over a period of a few years? How much will we save in marketing costs by not having to replace a lost customer? What will we earn in extra sales when she tells her friends and acquaintances about us?

There are many ways to satisfy customers...



- ☐ High quality
- ☐ High delivery capability
- ☐ High flexibility
- ☐ Simple purchasing and payment routines
- ☐ Reliable transport
- ☐ Promptness
- ☐ Simple arrival inspections
- ☐ Simple storage
- ☐ Merchandise easy to find
- ☐ Quick retrieval and loading
- ☐ Coordinated deliveries to customers
- ☐ Simple handling and identification of arriving merchandise
- ☐ Effective monitoring of needs in individual departments
- ☐ Effective stock monitoring
- ☐ Minimized waste and obsolescence/spoilage
- ☐ Good communications with store employees
- ☐ Flexibility and expertise
- ☐ Rational working methods
- ☐ Suitable staffing
- ☐ Spirit of service
- ☐ Right product line
- ☐ Few slow-moving items
- ☐ Appealing overall atmosphere that stimulates customers to buy
- ☐ Helpful employees
- ☐ Quick checkout
- ☐ Simple administration
- ☐ Good knowledge of customers
- ☐ Good knowledge of competitors
- ☐ Effective cooperation between different employee categories.