How Changing Demographics Are Killing Profits

(and What Distributors are Doing About It)

The labor market is almost unrecognizable. Turnover is shockingly high even as wages have escalated beyond anything we've ever seen. Many executives are asking, "When is this going to get back to normal?"

The real answer is, "It isn't – this is just the beginning."

We distributors (along with all other industries that employ people without college degrees) are drawing from a rapidly-shrinking pool. This is not going to get better. (More about this below.)

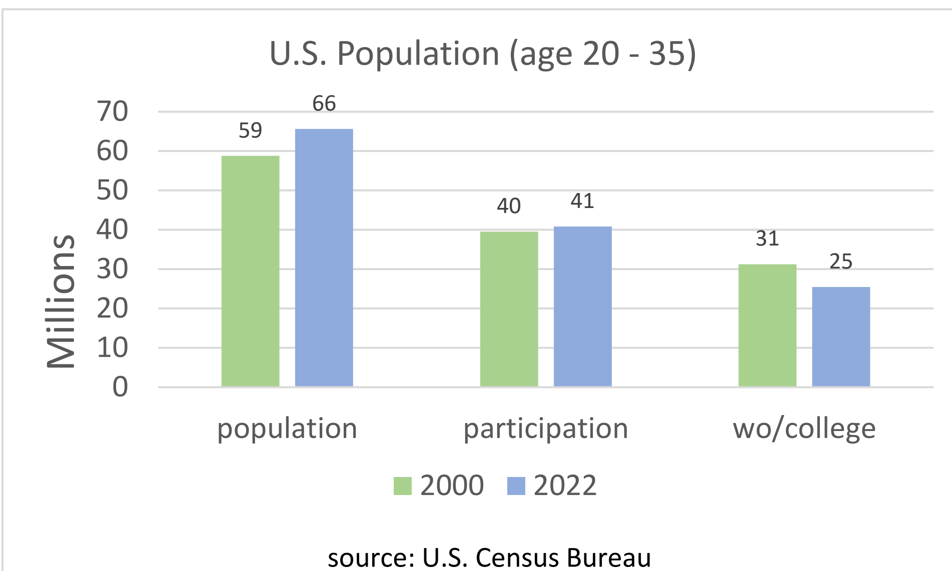
As always, market changes open new opportunities and will reshuffle the order of the players. The nimble companies will take leadership positions by recognizing and exploiting these changes.

In this first installment of a three-part series, I'll explore the nature of the challenge so you can begin to think of solutions that fit your situation. I'll also introduce a new online benchmark and analysis tool that sends an instant report, showing how you rank on the metrics affected by the labor situation. (See the DPA section at the end for more detail.)

In part 2, I'll share how forward-leaning companies are adapting their operations to the new environment, and how this creates a permanent competitive advantage. Part 3 discusses adjustments to sales models that exploit the operational improvements, and are already driving record returns.

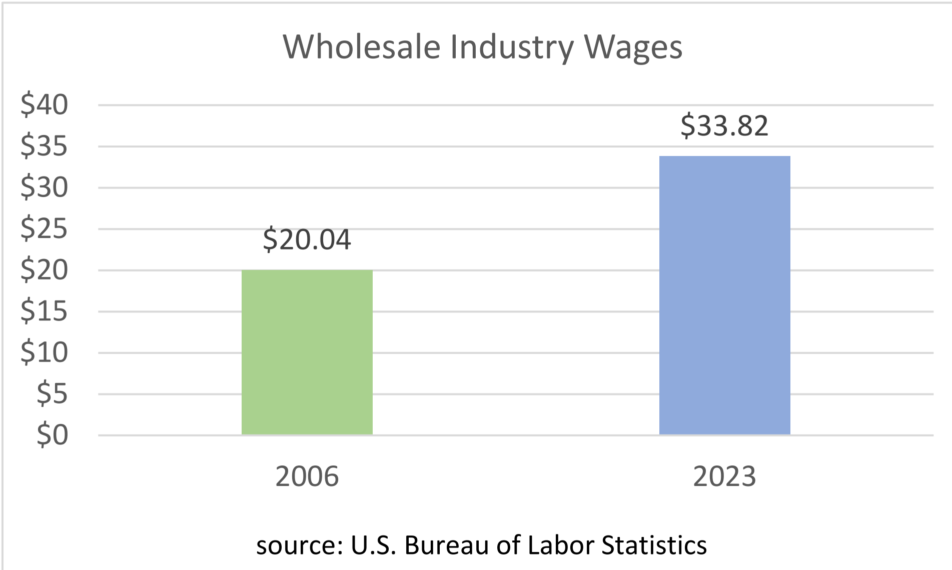
Demographics Are Killing Our Traditional Model

The hiring and retention challenges are due to a shrinking labor pool, and the causes aren't particularly obvious. The cultural changes that are driving this mean that the situation is both permanent, and moving in the wrong direction.



Using numbers from the U.S Census Bureau and the U.S. Bureau of Labor Statistics, let's look at our labor pool. For warehouse, delivery and administrative work, we're generally interested in people in the 20 – 35 age range, without college degrees.

From 2000 to 2022, the population grew 11.6%. This should be good news. However, in the same period, the labor participation rate dropped 5.1% and the percentage that did not have college degrees dropped 16.6%. This means the pool of available workers has gone from 31 million to only 25 million, down a whopping 18.5%.



This cadre is the source for distribution, hospitality, construction, manufacturing and all the rest of the market. Competition for these people has driven wages up from $20.04 in 2006 to $33.82 in 2023 – a 68.8% jump!

Product price inflation has been a natural consequence of this but it really means that, without change, our industry's traditional cost structures aren't sustainable.

Going forward, *companies simply must move more product value with less manpower*.

The new model for recovering your traditional profit rates requires changes to operational efficiency, and to your sales model. I'll cover each of these in the next articles in the series.

On the sales side, the good news is that we're already equipped with one of the most critical sources needed to fund higher costs – hidden profits.

Hidden Profits? Huh?

At WayPoint, we've created a sophisticated cost and profit analysis system as a companion for distributors' ERP systems. We and our clients can see precise profitability for every customer, territory, product, supplier, etc. For more than 15 years, we've been working with clients on profitability opportunities.

One of the things we've seen is that certain accounts in every distributor's customer base are exceedingly profitable. This is one part of the answer to the manpower challenge – the funding source needed to cover the higher costs.

Let me explain. In our work, we conceptualize the source of profits like this:

Every customer relationship converts revenue into profit at its own rate. If you're typical, the net of all customer accounts may come out to around, say, 5%. However, you will certainly have certain relationships producing profit rates of 20%, 25% and more! These high-leverage accounts are the key to providing more cash-flow and profits to fund your operations and make a growing bottom line.

From the sales side, you'll be working with customers to consolidate orders so more of them have enough gross profit to cover your operational costs. There also a number of important policy and incentive changes you'll make to shift business in this direction. (I'll detail some of the best in part 3 of this series.)

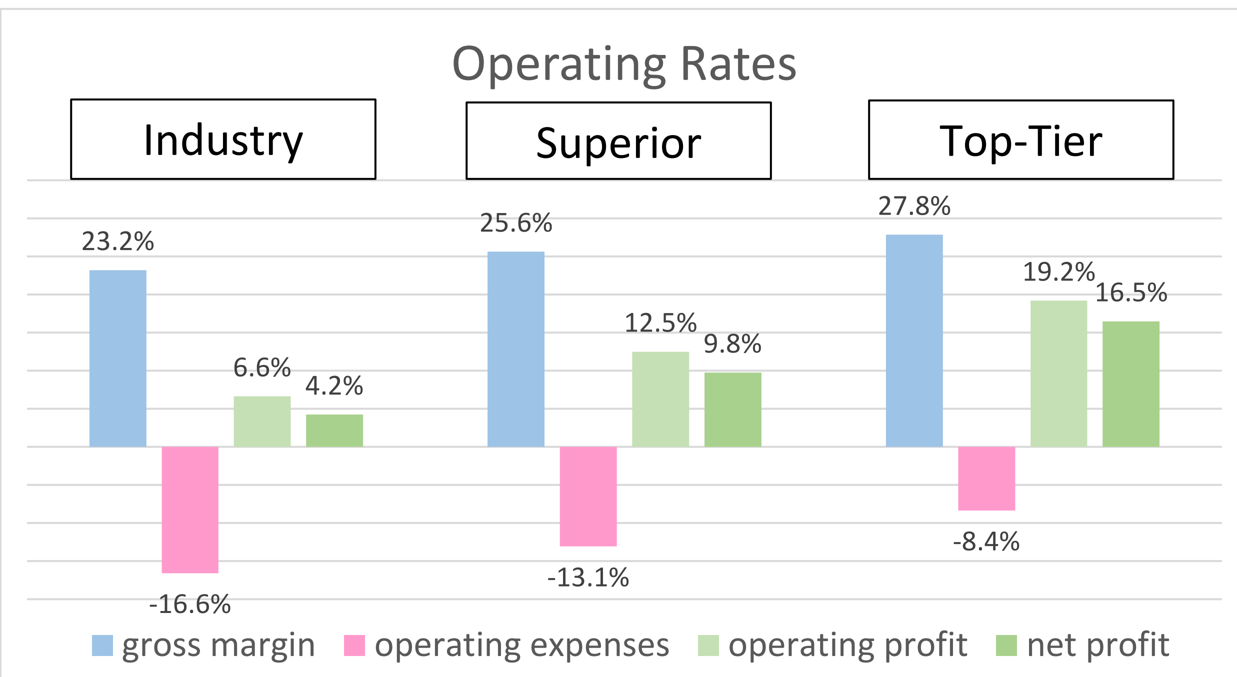
But What About the ~~Cost~~ Operations Side?

To be the superior company in the near future, your operations have to move more product value per man-hour or payroll dollar. Simply put, as manpower costs continue to escalate from the current very-high levels, you'll have to use manpower wisely.

Operationally, you'll need to reduce the time it takes to accomplish every step involved in gathering and preparing product. You'll automate where feasible, eliminate superfluous activities, and also small orders that cannot possibly be profitable.

For the future, increases in operational efficiency (moving more GP value per dollar spent) is the most critical action area. This will lower the threshold at which an order or customer becomes profitable, and also increases the profits generated on all orders. This magnifies the benefits of later sales improvements.

The leading companies have already structured to offload activities to customers and suppliers. Having certain small accounts pick their product and bring it to the counter, take it with them, and pay by check or credit card is one very effective strategy. (More on this in in part 2 of this series.)



So, what's realistically possible?

Pulling from more than $100B of industry data, we can see the operating averages of the wholesale Industry, of Superior companies using analytics and advanced techniques, and of the Top-Tier companies aggressively focused on best practices.

In the chart, you can see that bottom-line profit rates for the top-tier companies are close to 4 times industry averages (16.5% vs.4.2%). The bulk of this difference is due to reductions in per-unit operating expenses due to efficiency gains (operating expense rates are half of industry). Margins are also improved, largely through actively managing customer selection guided by profit conversion rates.

Almost any company can move into the Superior range, and those that roll up their sleeves can get to the Top-Tier.

For the Nimble, the Future is Bright

For nimble companies, market challenges are always opportunities, sidestepping issues that seriously harm competitors. The key is acting quickly to make advantageous changes before your rivals do.

I have the great fortune to see the on-going successes of leading companies who're doing just this, and their achievements are inspiring. We've seen resulting profit rates above 20%, and sometimes above 25%! That is, certain companies get 20-25% of their revenue to the bottom line. (Yeah, I thought it was impossible too.)

How is this?

Well, they're exploiting a number of dynamics that directly control profits:

- industry-wide 62% of invoices lose money, due to mismatch of gross profit levels and operating expenses – easily addressed when identified
- high-conversion customers represent a highly-leveraged opportunity to produce new profits through penetration selling programs – also easy if you have good customer profitability analysis
- increased operational efficiency lowers the gross profit threshold for profitable sales – this can be monitored and managed utilizing advanced measures like OpCash Ratios and ROX (explained below)
- warehousing and delivery efficiency gains reduce costs and ship times, increasing both sales and customer satisfaction

Notes:

- **OpCash Ratio** is Gross Profit / Operating Expenses and represents <u>profit opportunity</u> in a sale, customer or product
- **ROX** (Return on Expenditures) is Operating Profit / Operating Expenses and represents <u>actual profit</u> production per expense dollar

Get Guidance with the DPA Tool

So that distributors can get started, knowing where they are and what's possible, we've created an online evaluation tool – the Distributor Performance Assessment (DPA). This is how we can "give back", by helping companies grow.

The DPA analyzes a handful of your performance metrics and delivers your own confidential seven-page consultants' report, benchmarking your company against both industry standards and (so you can see what's realistically possible) that of the market leaders. The report will show your performance on critical success metrics like OpCash Ratio and ROX. It will also provide actionable suggestions to get you going.

There's no charge or obligation for getting a DPA, and your confidential report will arrive in your inbox just minutes after you enter some of your operating numbers. There's nothing to sign up for – this is a free service for qualified wholesalers. You can click to get a [confidential DPA report].

Conclusion

Demographic changes are certainly changing our priorities and our operational strategies. Recognizing the nature of the issue, and addressing it with a different focus and with refinements to operating priorities is the path to sustainable long-term profits and growth. It also represents the best opportunity to pull ahead of those that haven't yet got the memo…

Coming Next:

Part 2: Using Labor Wisely

Part 3: Covering Labor Costs with Sales

About the Author

Randy MacLean is President of WayPoint Analytics, the leading provider of cost and profit analysis software to the distribution industry. Since 2008, his firm has been focused on the dynamics that drive (or destroy) profitability, and he's created many of the advanced metrics companies use to monitor and manage their performance.

Coming from a career in sales, management and software engineering, he works with distribution leadership teams on their cost management and profitability initiatives. WayPoint clients produce profits at more than three times the industry standard.

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