RSM McGladrey

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2008 RSM McGladrey Industry Report
Distribution

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In the spring of 2008, RSM McGladrey conducted its third annual Manufacturing and Wholesale Distribution National Survey. The survey asked industry executives to provide their perspectives on the current state of their companies and industry and the strategies they are employing to sustain – and in some instances grow – profitability in the coming year. More than 960 participants responded to questions pertaining to current business conditions, domestic and global business strategies, cost structure, technology initiatives, operations, risk management and more.

Among the responses were 303 executives representing 284 distribution companies.[1] This special report summarizes the responses and provides unique insights into what distribution industry executives are thinking, doing and planning in 2008.

Of the 284 distribution companies that participated in RSM McGladrey's 2008 Manufacturing and Wholesale Distribution National Survey:

- Respondents represent companies in 29 states
- Annual revenues range from less than $25 million to more than $500 million: More than 70 percent have annual revenues of less than $100 million, 25 percent fall into the $100-$499.9 million range and 3 percent have more than $500 million in revenues
- 45 percent have fewer than 100 employees, 44 percent have 100–499 employees and 11 percent have more than 500 employees

Distributors in the fields of industrial equipment, food and allied products and building materials each represent between 12 and 14 percent of the respondents. Other industries represented include electronics, metal fabrication, chemicals and allied products, printing and publishing, transportation equipment, plastics, medical devices and others.

[1] In cases where multiple surveys were received from one company, responses were averaged. All companies are weighted equally in this final report.

Contents

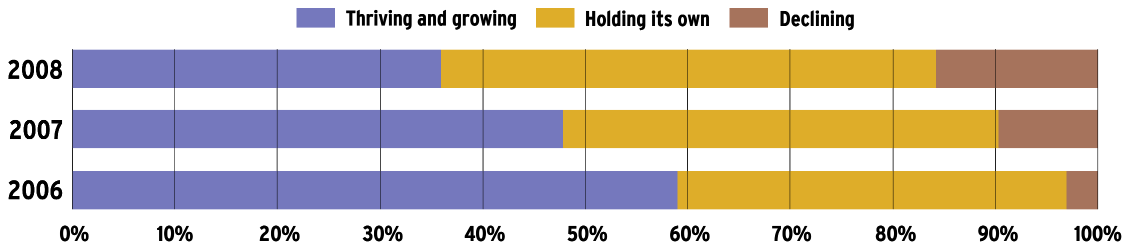
Business conditions

Current financial market conditions are significantly impacting all companies, including distributors, especially when it comes to credit availability. Prior to the financial market meltdown, access to capital was beginning to be limited, whether debt or equity based. Larger distributors were impacted first and smaller distribution companies are just starting to feel the affects.

The slowdown in the building materials industry segment, due to the deflating residential housing market, was felt by lumber, electrical and plumbing distributors. A slowdown in commercial projects placed additional stress on distributors along the supply chain. In combination with major reductions in automotive industry production levels, the optimism of distributors has continued to trend downward.

Chart 1 illustrates how business conditions have changed for distributors in the United States since 2006.

Chart 1
Business conditions in distributing

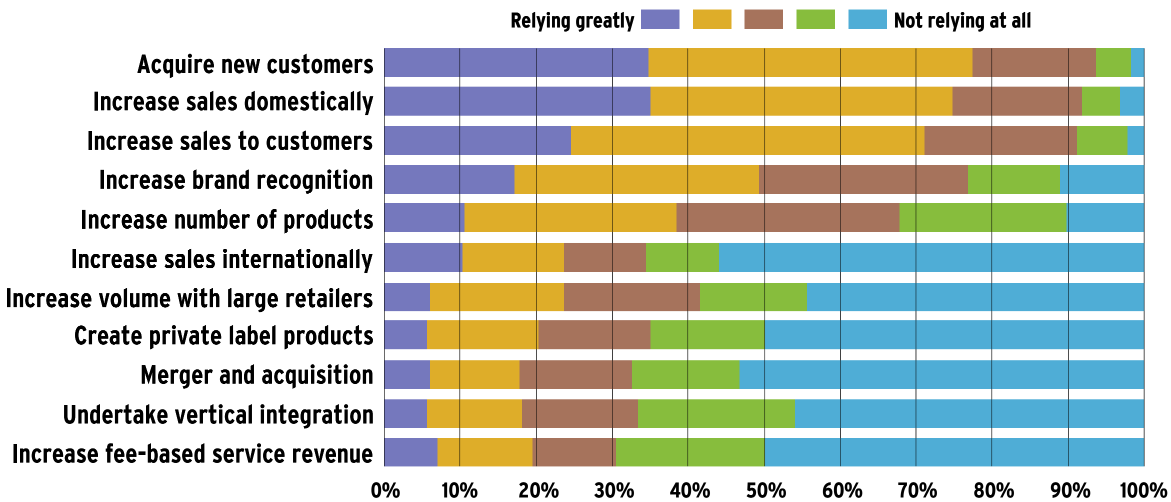


In 2006, 59 percent of companies in the survey described their businesses as "thriving and growing." In 2007, only 38 percent used "thriving and growing" as a description of their business conditions while 45 percent described their business as "holding its own." A total of 83 percent of respondents in 2008 describe their distribution business as either "thriving and growing" or "holding its own."

Growth strategies

Chart 2 illustrates the growth strategies distribution companies are relying on in 2008 to grow their business.

Chart 2
Reliance on specific growth strategies



Seventy-seven percent of respondents say they will rely on new customers for growth and 72 percent say they will rely on current customers. This may be a reflection of the challenging business conditions, since finding new customers is an expensive process compared to growing with current customers. One can expect growing with current customers to take on more relative importance only under conditions where current customers are, themselves, growing.

Another alternative for generating growth is expanding the depth of product offerings among existing customers. As customers reduce the number of suppliers to improve supply chain efficiency, the ability to offer a broader range of product may be a competitive advantage that generates growth.

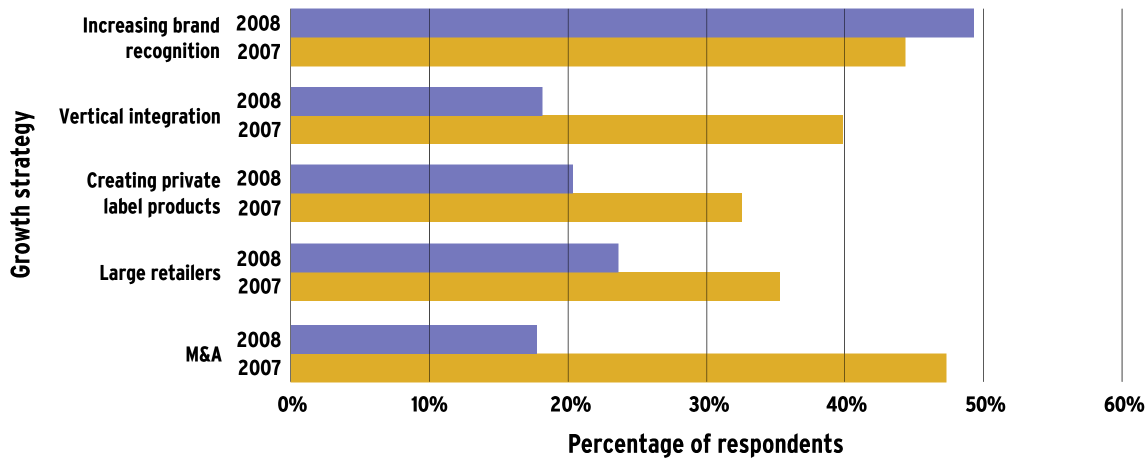
Distributing is primarily a domestic business. Seventy-four percent of companies in the survey report that growing their domestic business is important to them, whereas only 23 percent of respondents find a similar importance in growing their international business. Many distributors are one-house distributors for major OEMs and their territories are often limited by the manufacturer. Currently, transportation costs are limiting the ability to expand beyond local geographies.

Four of five growth strategies have dropped significantly from 2007 to 2008:

- Merger or acquisition
- Vertical integration
- Growing with large retailers
- Creating private label products

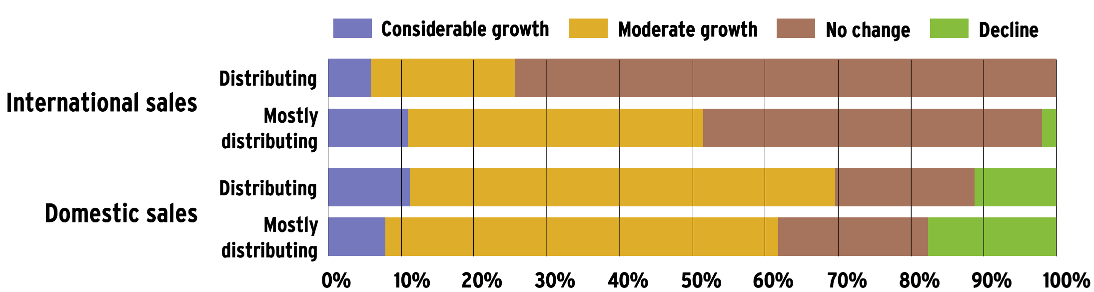
Chart 3 shows how preferences for strategies have changed between the two survey years.

Chart 3
Reliance on specific growth strategies in 2007 and 2008



Increasing brand recognition is the only strategy that maintained its viability as a growth strategy for distributors in 2008. The major decline of mergers and acquisitions is in direct response to the tightening of the North American capital markets. The current credit market not only impacts funding for mergers and acquisitions, but for all lending purposes. Lenders are now adhering to tighter underwriting, are being highly selective on the use of capital, have an increased focus on returns and margins and are concerned over the impact of industry consolidation.

Chart 4
Anticipated growth in international and domestic markets

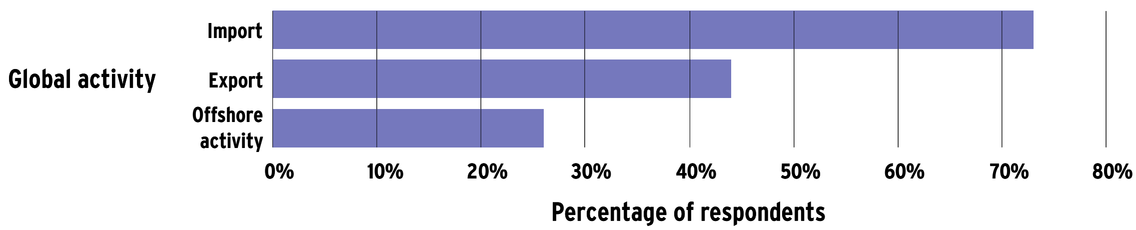


As noted above, distributing is primarily a domestic business. Adding just a slight amount of manufacturing to the business mix can have an effect on increasing international opportunities, as shown in Chart 4. Fifty-two percent of companies describing themselves as "mostly distributing some manufacturing" say they expect moderate to considerable growth internationally in 2008; only 25 percent of "distributing" companies say the same.

Global distributing

Businesses can participate in the global economy by importing, exporting or moving services or production offshore. Chart 5 shows what percentages of distributing companies in the 2008 survey participate in each process.

Chart 5
Percentage of respondents who engage in various global activities



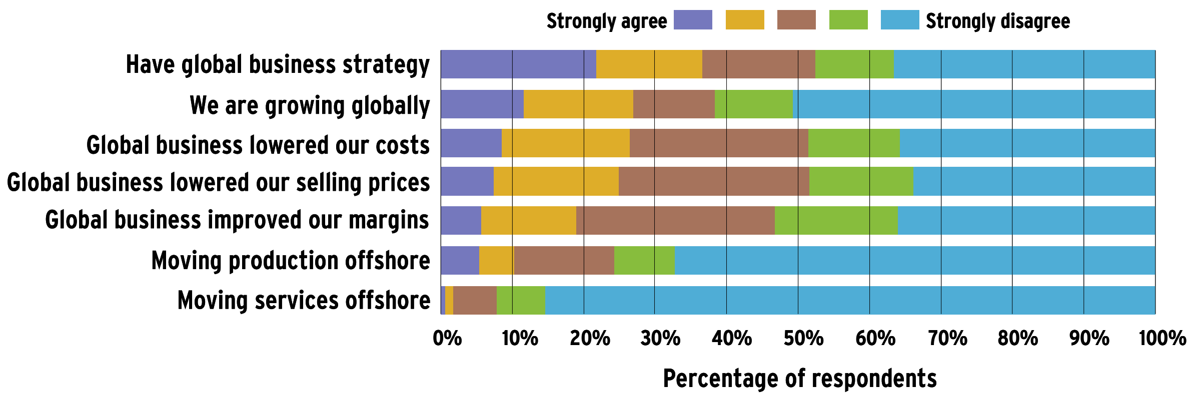
Distributors who export are more likely to export to Canada, Mexico and Western Europe.

The degree to which distributors have invested in importing and exporting varies.

- Importers – Half import less than 24 percent of the supplies they need; one-third import more than half of the supplies they need.
- Exporters – 73 percent of all exporters sell 85 percent of their product domestically; less than 2 percent depend on exporting for half or more of their revenue.

Less than a quarter of distributors have or will move production or services offshore. Forty-two percent of those who have moved some production or services offshore report moving less than one-quarter of their business; 46 percent are doing it with more than 55 percent of their business.

Chart 6
Global business practices in 2008

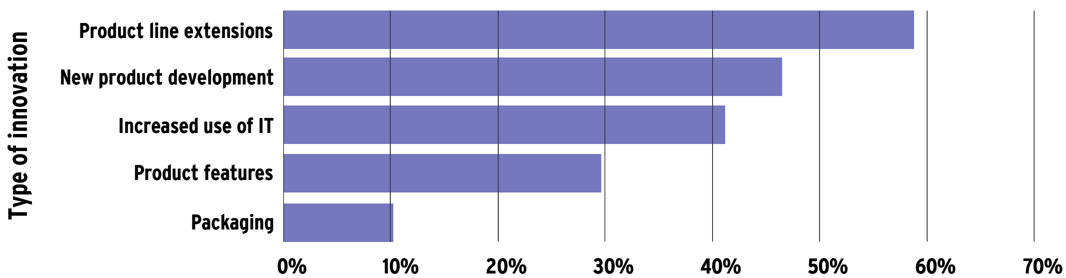


Of 284 distribution companies in the 2008 survey, 26 percent say they have a global business strategy in place. Companies with a global strategy report higher gross margins than those without. The survey indicated distributors are less engaged globally than manufacturers. With only one quarter of distributors reporting such a strategy, the opportunity exists for distributors to become internationally active and capitalize on the potential improved revenue growth and profitability.

Innovation

Chart 7 shows how distributors in the survey are using their innovation resources.

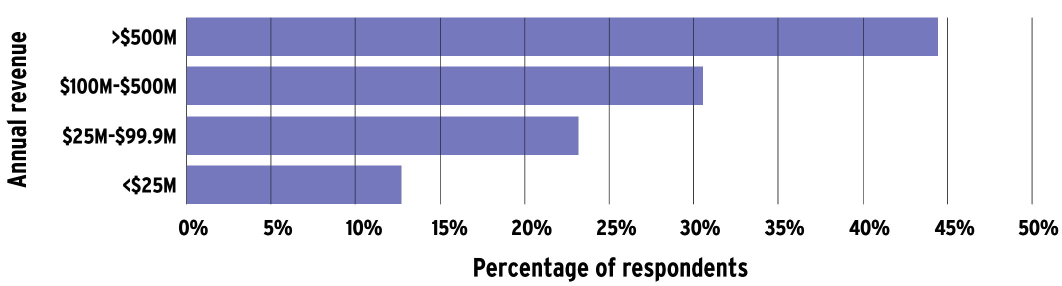
Chart 7
Utilization of resources for innovation



Compatible with the growth strategy of increasing the number of products in their portfolios, 58 percent of distributor survey respondents report the leading innovation strategy favored is investing in extending product lines. Close behind is the development of new products (46 percent). Increasing innovative use of information technology is an investment being made by 42 percent of companies responding to the survey.

Chart 8 shows that almost half of the largest distributors responding to the survey are being asked by their customers to invest in green initiatives.

Chart 8
Requested by customers to engage in green initiatives



Large companies are being urged to "green up" more frequently than smaller companies, although the survey reveals a growing green trend among many companies in the $100 million to $500 million revenue range. Green initiatives include recycling of waste, efficiencies in operations to consume less water and electricity and utilization of environmentally friendly supplies.

Only 10 percent of companies say they are beginning to use alternative sources of energy. Government incentives may provide an opportunity for distributors to invest in technologies that will ultimately reduce energy costs.

Operating effectively

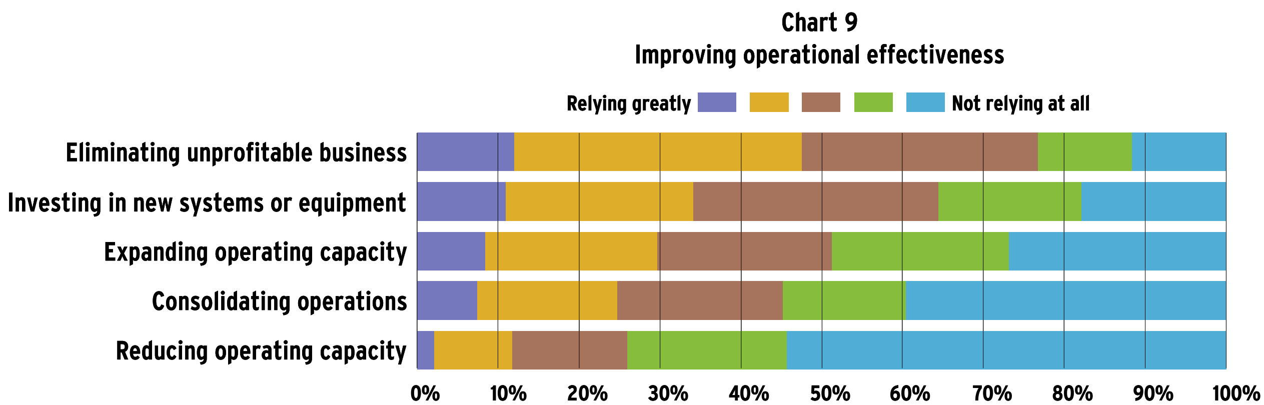


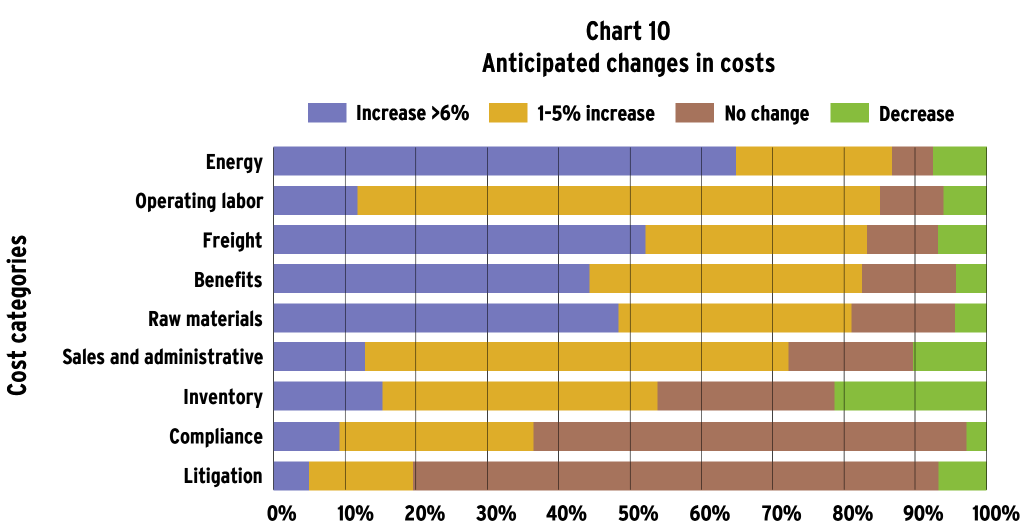
Chart 9 explains what distributing companies are doing to make their operations more effective. Forty-seven percent of companies indicate they are eliminating unprofitable business lines, products or markets. This is approximately the same rate as in 2007.

In 2007, the most frequently reported method of improving operational effectiveness was investing in new machinery or equipment. Sixty percent of distributors in the 2007 survey said they would make new machinery or equipment investments. In 2008, the percentage falls to 34 percent.

The biggest change from 2007 is in the proportion of respondents relying on reductions in capacity. In 2007, 33 percent of respondents said they were relying on reducing capacity to improve operational effectiveness; in 2008, only 12 percent say the same thing.

Managing costs

Chart 10 shows what proportion of respondents expect costs to decrease or to increase – and, if expected to increase, by approximately how much. This may explain some of the decreased equipment and machinery investments.



For distributors, increased costs come primarily from two sources – energy and personnel. Most respondents say energy is increasing the most, followed by rising costs in operating labor and moving freight.

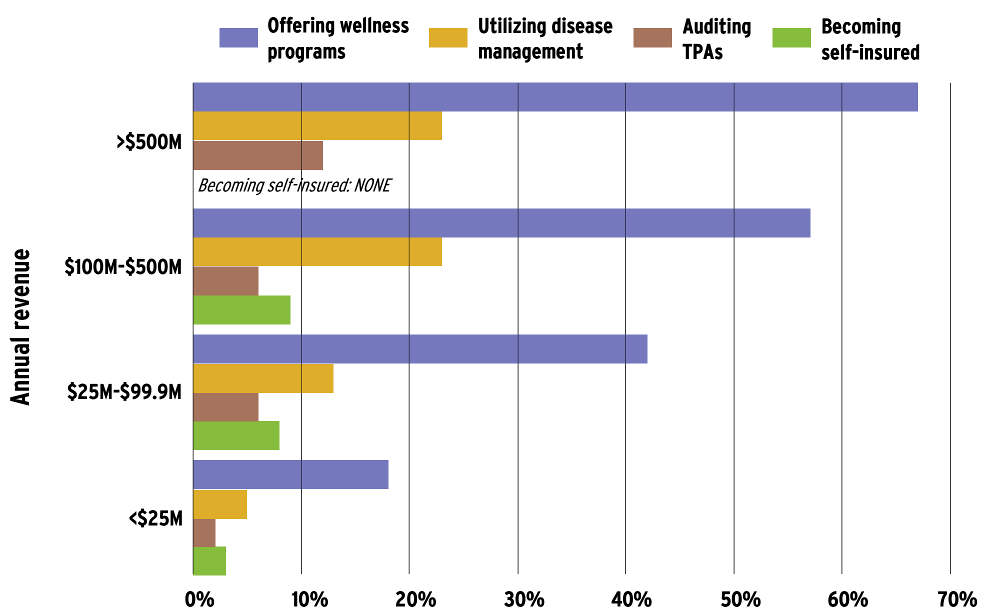
Eighty-eight percent of respondents expect operating labor to increase by 5 percent or less, but that is accompanied by increases in the cost of benefits, which 44 percent of respondents expect to exceed 6 percent.

Other cost increases expected to affect over half of the survey respondents are raw materials, sales and administrative costs and the cost of carrying inventory. At the same time, over 20 percent of respondents are projecting a decrease in inventory carrying costs. Of these respondents, 67 percent say they have formal plans to reduce their inventory.

As Chart 10 indicates, there are two aspects to employee costs – operating labor (i.e., wages, salaries), and benefits. Both are rising, but the chart shows that a significant proportion of what might otherwise go into wages or salaries is being swallowed up by a rise in the cost of benefits due predominantly to health care.

What strategies do respondents use to manage these increases? Chart 11 shows large companies have more accessibility to health care management strategies than small companies. Additionally, they have the ability to leverage their employee numbers to negotiate volume pricing.

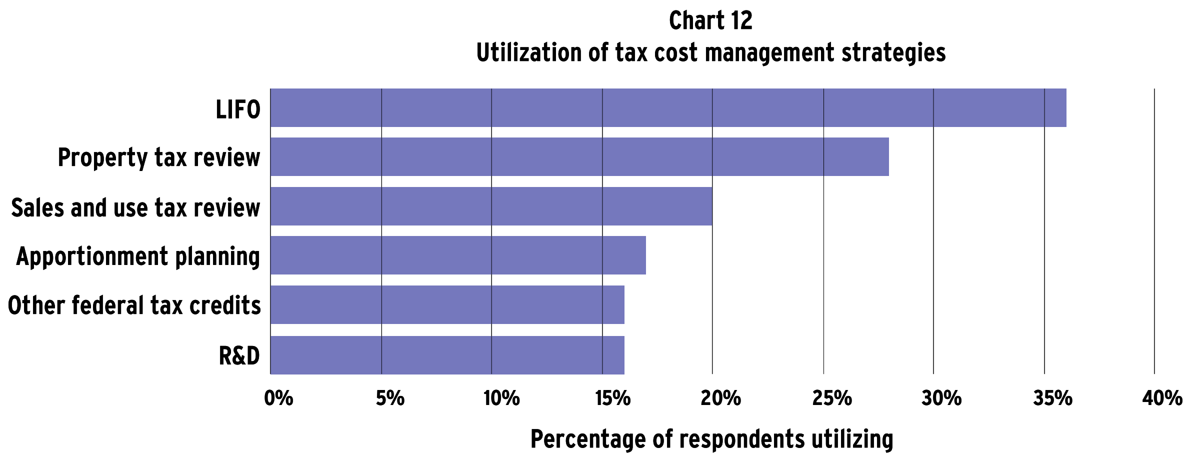
Chart 11
Managing cost of health care



The most common strategy to manage the cost of health care is to offer wellness programs. Over 60 percent of distribution companies with more than $500 million in annual revenue do this, but only 18 percent of companies with less than $25 million in annual revenue utilize the same cost management strategy. Wellness programs are a long-term strategy for distribution companies that may result in an overall reduction in health care costs if the company is self-insured. For fully insured companies, wellness programs allow the organization to negotiate lower premium rates as a way to reduce costs.

Other health care cost management strategies include utilizing disease management programs and, if the company is self-insured, auditing third-party administrators. Again, both of these strategies show higher utilization among larger companies.

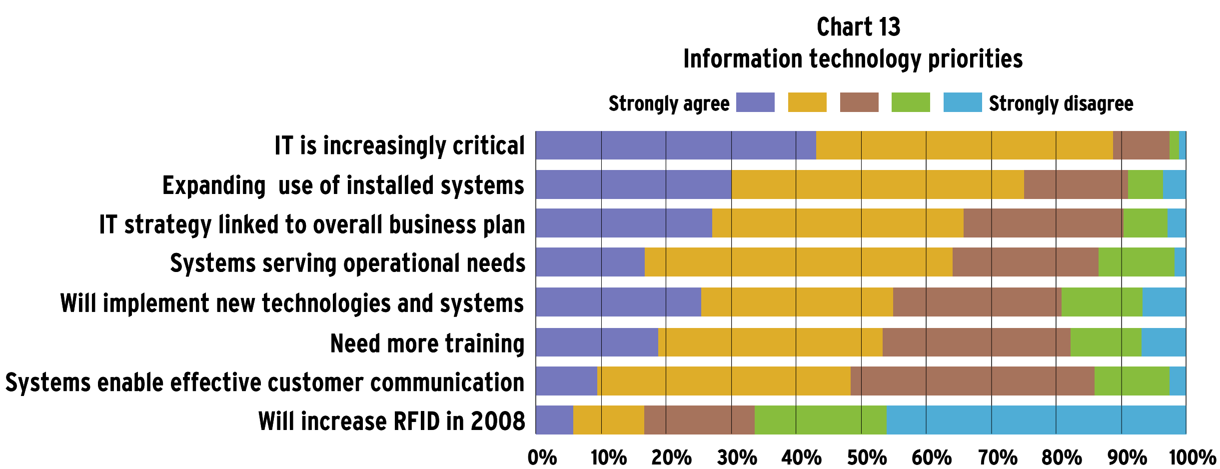
Tax management strategies also help companies manage costs. These strategies are typically under-utilized either due to lack of awareness or the difficulty in implementation versus the perceived benefit. Eighty-six percent of survey respondents say they are using a pass-through strategy (i.e., Sub S, LLC or partnership) to manage their tax costs. Chart 12 shows the next six common tax management strategies used by distributors. The pass-through strategies are available to companies depending on how they are incorporated or otherwise



organized. The other three most commonly used strategies – last-in, first-out (LIFO) inventory valuation, property tax reviews and sales/use tax reviews – are available to most companies.

Information technology

Chart 13 shows priorities in information technology (IT). Eighty-eight percent of distributors report IT is increasingly critical to their business, but only 66 percent report that their IT strategy is tied to the company's business plan.



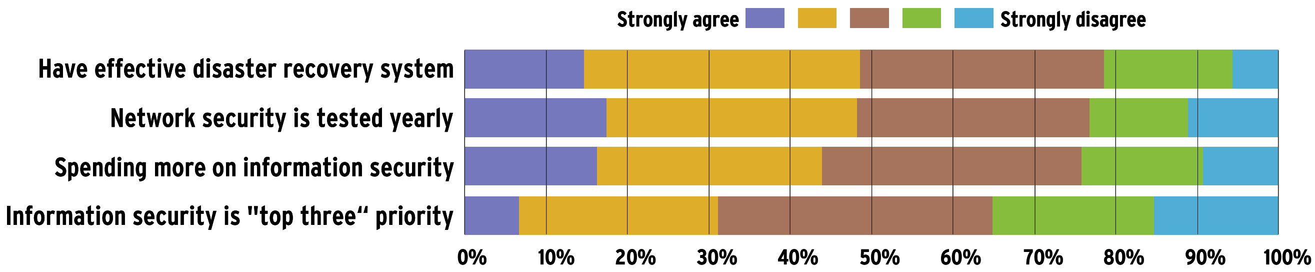
IT requirements distributors perceive as most important are:

- Expanding the functionality of already installed systems (75 percent)
- Aligning IT strategy with overall business plans (66 percent)
- Implementing new technologies or systems (55 percent)
- Training employees to use current IT systems more effectively (53 percent)
- Using IT to communicate with customers more effectively (48 percent)

More companies are coming to realize that training is the key to extracting full value from current systems. To complete the bridge between wasted and fully realized functionality, companies need to ensure follow-on training is provided.

Information security is an area in which much has been done, although the survey data indicate a surprising number of companies may still have significant needs. Chart 14 shows how respondents answered four items regarding priorities on IT security.

Chart 14
Information security priorities

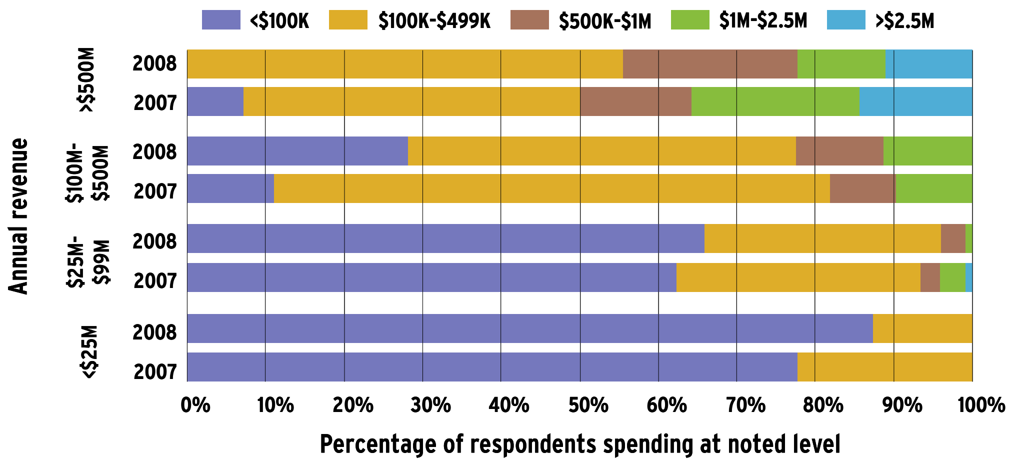


This data shows almost a quarter of respondents may lack effective disaster recovery systems, do not test their network security at least once a year or expect to increase their spending on information security.

Even though advances in system reliability are contributing to risk mitigation, the diminished focus on technology risk management is surprising given the level of reliance on IT for continuing operations – especially in light of recent, well-publicized disruptions such as security breaches, a series of poundings delivered by Mother Nature and the ever-looming threat of terrorism.

What can be expected in IT spending? Chart 15 indicates that regardless of the size of the company, spending on IT is decreasing slightly in 2008 — especially at the top end of the IT spectrum. Unless all credit sources are shut off in the current crisis, this may still remain a fairly realistic level of spending due to the level of priority and the fact that much of it is already budgeted.

Chart 15
IT spending by size of company

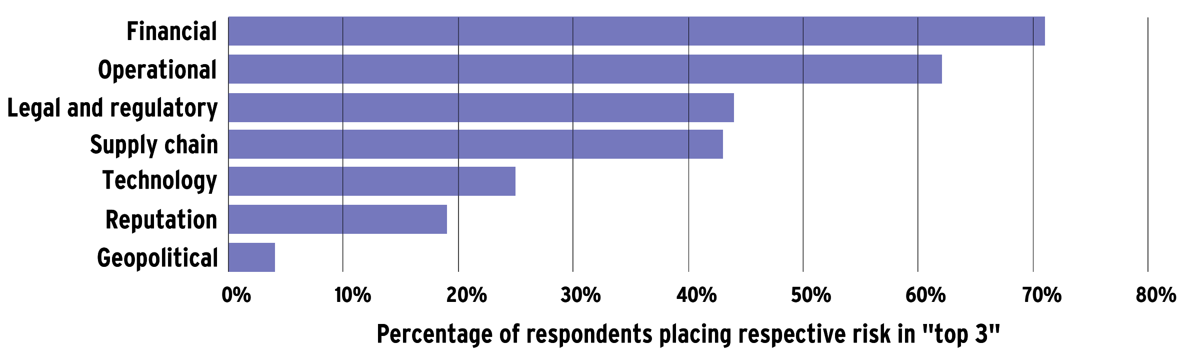


Among distributors with more than $500 million in annual revenue, 47 percent in the 2007 survey said they would spend more than $1 million on IT expansion. In the 2008 survey, only 22 percent of companies that size say they will spend the same amount. Among all other companies, the proportion of respondents who say they will spend less than $100,000 increases slightly over the prior year.

Risk management

Chart 16 shows respondents' priorities in risk management.

Chart 16
Most critical risks to manage



There are two areas of risk which over half of the respondents perceive as critical — financial and operational. Legal and regulatory risks, as well as risks in the supply chain, are also significant concerns among many of the respondents.

Companies concerned with risk management should:

- Implement a process to perform a risk assessment and prioritize risk areas,
- Develop a function to establish internal controls for risk and routinely audit compliance to those controls
- Put in place an independent resource to oversee the risk management process.

Table 1 shows the prevalence of each of these components among the 284 survey companies broken out by company size.

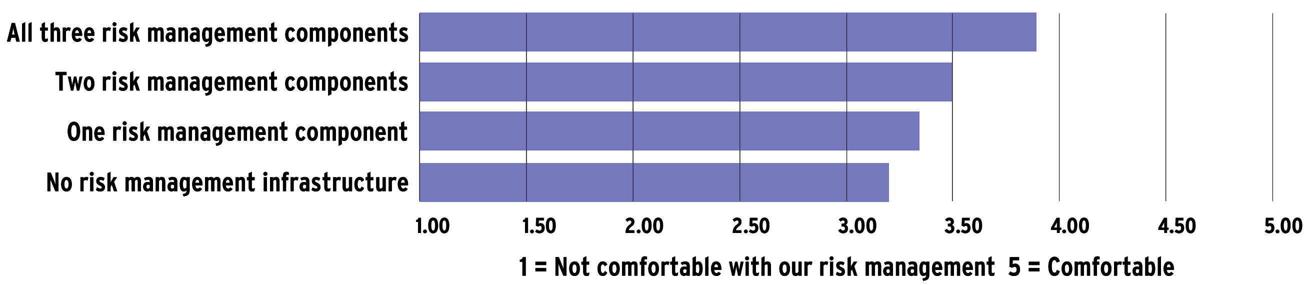
Table 1
Prevalence of risk management infrastructure components

	<$25M	$25M-$99.9M	$100M-$500M	>$500M
Identified high-priority risk areas	31%	40%	46%	33%
Have an internal audit function	31%	35%	31%	78%
Have an independent risk oversight committee	25%	31%	21%	67%

Large companies are more likely to have the administrative risk management infrastructure in place – that is, the presence of the function and an independent oversight committee.

Respondents were asked to report their comfort with their risk management on a 5-point scale with '1' equaling "Not comfortable" and '5' equaling "Comfortable." Chart 17 shows that the more risk management infrastructure a distributor has in place, the higher the comfort level.

Chart 17
Comfort with risk management on five-point scale

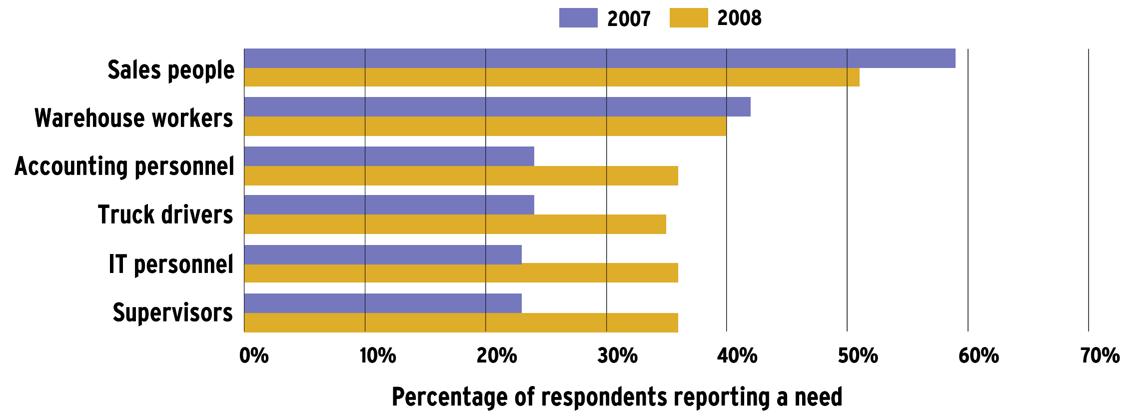


Comfort with risk management is highest among distribution companies that have both a risk audit function and an independent oversight committee, and have used them to identify and set their risk management priorities. Surprisingly, companies with no risk management structure seem fairly comfortable. Only 20 percent are more confident when all three components are in place. The question becomes, are those companies aware of the risk? If so, what steps are they taking to mitigate risk, if any?

Workforce

Chart 18 shows how distributors expected to change their workforces in 2007 compared to how they expect to change their workforces in 2008. The greatest need, by over half of the respondents in the survey, is for sales people. Forty percent of the survey respondents say they have a need for warehouse personnel. No other need is reported by more than a quarter of survey respondents.

Chart 18
Workforce needs, 2007 compared to 2008



Changes in workforce needs from 2007 to 2008 are indicated in Chart 18. The chart shows:

- Greatly reduced need for quality control personnel, engineers and entry-level workers.
- Reduced need for supervisors, IT personnel, truck drivers and accounting personnel
- Almost no change in the need for warehouse personnel
- Slightly increased need for sales people.

Finding and keeping qualified workers is the key workforce challenge facing distributors. Distributors have been focused on reducing overtime among personnel and aligning resources to where they are needed. It is also an opportunity to hold more training sessions on systems, products and customer service, as well as preparing mid-level managers for more responsibilities.

Summary

Optimism has been trending downward since the 2006 survey. In combination with the recent financial and credit market events, access to capital for operations and growth has become limited whether debt or equity based.

Distribution remains primarily a domestic business, but distributors that perform some manufacturing expect to see moderate to considerable growth internationally in 2008, which indicates an opportunity for distributors to access global opportunities.

With an uncertain economic future, cost management has become more and more important as increases in petroleum, natural gas and commodity pricing are rippling through the economy. Adopting conservation efforts is crucial for distributors in order to try and minimize the financial impact.

The 2008 survey indicates information technology (IT) has become increasingly critical for 88 percent of survey respondents. At the same time, information security doesn't appear to be a high priority. Given the high reliance on IT within the operations environment, it appears the risk associated with system disruptions and security threats may not be mitigated.

Finding and keeping qualified workers continues to be a challenge for distributors. To minimize layoffs, distributors have focused on reducing overtime and aligning resources where they are needed. Distributors have opted to hold various training sessions to prepare their current workforce to assume more responsibilities.

With the current economic storm, this coming year poses a series of challenges for distributors. It is important that strategic planning and allocation of resources are put in place now to ensure the industry continues to thrive and grow in the future.

RSM McGladrey is a leading professional services firm providing accounting, tax and business consulting. RSM McGladrey operates in an alternative practice structure with McGladrey & Pullen LLP, a partner-owned CPA firm that delivers audit and attest services. Though separate and independent legal entities, they work together to serve clients' business needs. Together, the companies rank as the fifth largest U.S. provider of accounting, tax and business consulting services (source: *Accounting Today*), with 8,000 professionals and associates in nearly 100 offices.

RSM McGladrey and McGladrey & Pullen serve more than 8,000 midsized manufacturers and wholesale distributors. Our heaviest concentration of clients is in food processing and distribution, metal fabrication, chemical products, rubber and plastic products, printing and publishing, transportation equipment, industrial and commercial machinery, and electronic and electrical equipment.

RSM McGladrey and McGladrey & Pullen serve clients' global business needs through their membership in RSM International, the seventh largest worldwide organization of independent accounting and consulting firms (source: *International Accounting Bulletin*), with 600 offices and 25,000 professionals in 64 countries. As the largest member of RSM International, we help companies establish and enhance global operations and distribution channels. Among our internationally active clients, 80 percent are manufacturers and wholesale distributors.

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