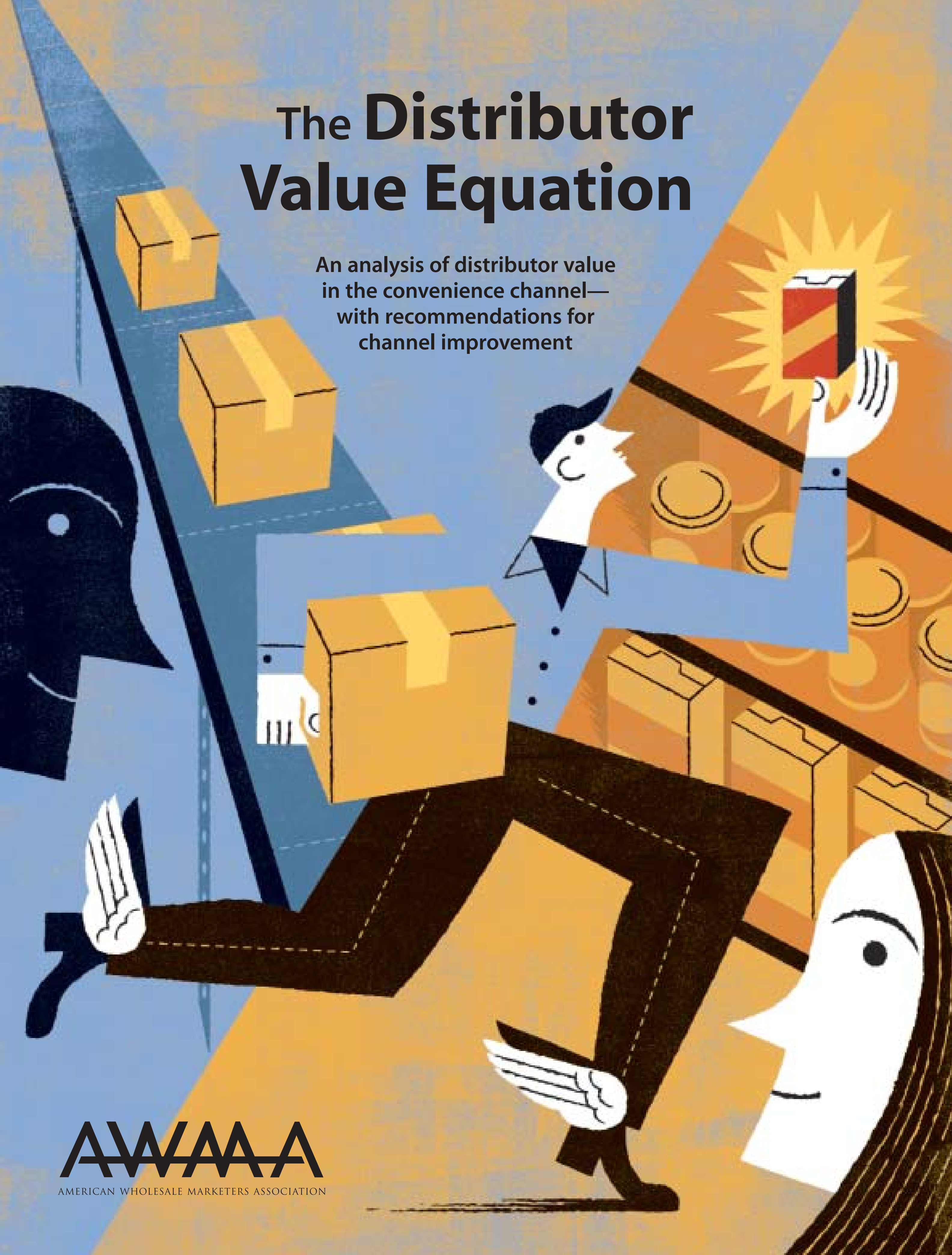
The Distributor Value Equation

An analysis of distributor value in the convenience channel— with recommendations for channel improvement



AWMA

AMERICAN WHOLESALE MARKETERS ASSOCIATION

The Distributor Value Equation

An analysis of distributor value in the convenience channel—with recommendations for channel improvement

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Preface

Many AWMA distributors are at a crossroads. They continue to experience declining and disappointing profits, returns on investment and assets, and yet they face the need to constantly do more to attract and hold their customers.

The services distributors provide to move manufacturers' products into more than 140,000 convenience stores across the nation are many and are complex. Manufacturers and retailers alike applaud those efforts and services by distributors and recognize how important they are to their own success.

Yet many AWMA distributors find it virtually impossible to receive compensation sufficient for long-term growth and viability. Why? What are the factors that influence today's Distributor Value Equation? What is the roadmap to change, improvement and long-term viability? Those are questions that are at the heart of the future for this important industry segment.

To address this issue, AWMA commissioned the team of Kit Dietz, a former distribution company CEO and now one of the industry's most respected business consultants, and Bob Gatty, a communications consultant, writer and editor who has specialized in the food industry for 25 years. Dietz is president of Dietz Consulting LLC, Huron, OH. Gatty is president of G-Net Communications Consulting, Poolesville, MD.

They were charged with quantifying the value that distributors provide to manufacturers and retailers and providing an analysis of the factors that contribute to the poor profit performance that typifies many c-store distribution companies today, as well as developing recommendations for change based on best practices they uncovered.

To accomplish this mission, AWMA's research team interviewed distributors representing all sizes and regions of the country, major manufacturers, and retailers asking a common set of questions for each segment designed to elicit the necessary information and data. Interviews were conducted by email, by telephone and in person. All participants were assured of confidentiality and are not identified.

AWMA wishes to thank the dozens of executives who took the time to share their thoughts, concerns and often proprietary information with our research team during the course of this work. Without their assistance, the insights provided in the following pages would not be possible.

What is the roadmap to change, improvement and long-term viability? Those are questions that are at the heart of the future for this important industry segment.

Executive Summary

"Our wholesaler is doing business in non-traditional ways and is willing to do whatever it takes to meet our company's needs."

Convenience store distributors are the essential link between the manufacturer and the retailer, enabling the supplier to efficiently and effectively provide distribution to more than 140,000 convenience stores nationwide. Thus, the services supplied by distributors are critical to the ultimate success and profitability of each of these trading partners.

Working in an increasingly complex and competitive marketplace, distributors provide scale and efficiency across a broad range of consumer products, while supplying important support services to customers in this high cost-to-serve channel of trade. All of that effort and all of those services translate to enormous value that enhances sales and profit for manufacturers and retailers alike.

But those services and that value do not come without cost. As competition intensifies in a changing industry, many convenience store distributors are developing new expertise, technology and capabilities to help serve their customers even more effectively and efficiently.

It is a remarkable story, and today's convenience store distributors are searching for ways to cope with the challenges with which they are faced so they can serve their customers even better.

Distributor Benefits Recognized

Across the industry, suppliers and retailers alike acknowledge the work of distributors and the contributions that they make to their bottom-line success. If distributors feel unappreciated on occasion, they need to listen to the words of executives of both suppliers and customers as they are asked to frankly discuss the value that distributors do—or do not—provide.

Ask manufacturers to describe the most important value provided by distributors and they usually will cite the distributor's ability to purchase, stock and distribute a variety of products every day at a competitive price.

Said one large national-brand manufacturer: *"They are our only gateway to get our products into the convenience channel. With the complexity of 140,000 c-stores, many of them individual mom-and-pop operations, the distribution network is our only source of supply in this channel."*

Another national-brand manufacturer put it this way: *"Their most important contribution? Without a doubt it is their ability to get our product to the stores in the right quantity at the right time. It is a very efficient system, and it's not one we want to take over. But there is room for improvement."*

Ask retailers and they will also credit distributors for their responsiveness and the many services that they perform. Said the owner of a regional c-store chain: *"Wholesalers have adapted to accommodate our changing needs. Our wholesaler is doing business in non-traditional ways and is willing to do whatever it takes to meet our company's needs."*

For distributors, the tasks of purchasing, stocking and distribution are the basics—the table stakes for being in business. To differentiate themselves from competitors and to meet the constantly evolving needs of retailers, many distributors large and small do much more, providing:

- Inventory management
- Category management
- New-item introductions and management

- Merchandising assistance
- Accrual tracking
- Store sets, resets and tagging
- Promotional planning and coordination with manufacturer
- Technology assistance
- Real-time access to information
- Marketing expertise
- Speed-to-market assistance for new products
- Extra deliveries
- A credit shield for manufacturers and credit services for retailers
- The handling of returns

But those services all come at a cost, and while manufacturers and retailers often understand and recognize the benefits of these value-added services, distributors large and small contend that many of their efforts go unrecognized and are simply assumed. Worse, many retail customers who do say they appreciate the distributor's efforts generally are unwilling to provide the compensation for them that is needed and justified. Often, history has told retailers that distributor requests for increased prices or fees will not be enforced, particularly if competitors enter the picture and offer lower prices.

Commented an executive of a large distribution company: *"We provide retailers with easy access to the right products and program and have better systems to deliver information than our competition, yet when it comes right down to it, they are so focused on the cost of goods, that our value-added services are only a tie breaker."*

In other words, all of those services are great, but if somebody with fewer add-ons comes along offering product a few pennies cheaper, that company may well get the business—no matter the efficiencies and added profit those "frills" would have provided. If two distributors come in at the same price, then perhaps some of those additional services will tip the scales in that distributor's favor.

It is no small feat that convenience store distributors perform as they receive, warehouse, deliver and merchandise thousands of products every day to convenience store chains large and small, and independent operators alike. Said one regional distributor: *"We keep our customers' stores filled with the products they need at a competitive price. The fundamentals of what we do involve incredible exercises on behalf of our customers. It is a big deal."*

It *is* a "big deal," and the sense of being taken for granted causes resentment that runs deep among some distributors, and no doubt interferes with the positive partnership relationships that are so important to manufacturers, distributors and retailers alike.

"Some manufacturers take us for granted and for fools," a distribution company CEO said during an interview. *"If we can get their product introduced for them, that's all we're good for. And when we reorder, it is going to be at their most profitable price."*

Said another: *"The manufacturer community has been slow to realize the value that the really sharp distributor brings to the marketplace."*

And a third company complained that all too often, after it helps retail customers find the right merchandising mix and shelf sets to maximize profit for their previously underperforming but now profitable stores, they take their business elsewhere.

"We're still held pretty close to the lowest bidder. People forget there are other companies who can do it but not as well," he said. *"It's 'What have you done for me lately?' that is important. So now*

"We keep our customers' stores filled with the products they need at a competitive price. The fundamentals of what we do involve incredible exercises on behalf of our customers. It is a big deal."

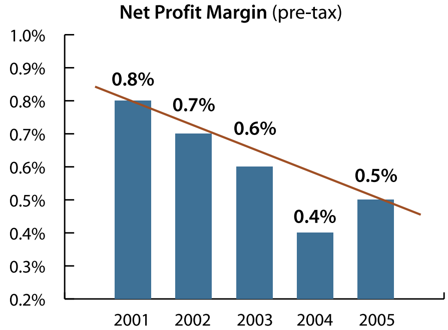
they say, 'I'm going to use your configuration and buy it from somebody else cheaper.' It's tough to look that guy in the eye and say 'I can't walk away from my price.' It's always a big risk with a sizable customer."

There always seems to be someone willing to offer a service at a lower cost, whether it makes good business sense or not, even to the point of giving away value-added services—such as extra deliveries.

The Profit Problem

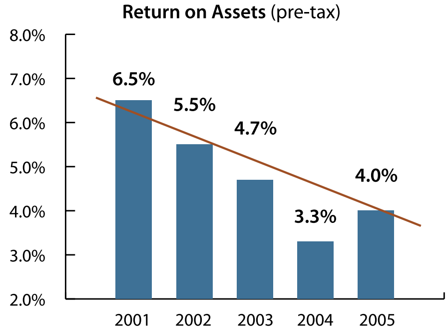
The most serious problem facing distributors comes down to dollars and cents—to profit. The 2006 Hershey Industry Performance Analysis (HIPA) report reiterates a long-standing problem for much of the industry: extremely poor profit and return on investment (ROA). The typical AWMA distributor produces a pre-tax profit margin of just 0.5% and an ROA of 4.0%.

AWMA Average Distributor Net Profit Margin (pre-tax)



Source: 2006 HIPA Study, The Profit Planning Group, Dietz Consulting LLC

AWMA Average Distributor Return on Assets (pre-tax)



Source: 2006 HIPA Study, The Profit Planning Group, Dietz Consulting LLC

The HIPA study, conducted by The Profit Planning Group, shows that the financial results of convenience store distributors rank 75th in a list of 75 industries examined. Thus, it is not surprising that in this study, the ability to turn a reasonable profit—and all that this represents—was ranked as the most important challenge by virtually every company that participated.

Distributors attribute this bleak profit picture to many factors, including:

- Excessive—and increasing—taxation of tobacco products
- Declining volume in the cigarette category, changes in the major cigarette manufacturer programs, advance payment requirements and terms reductions that negatively affect cash flow and gross margins
- Rising operational costs, including health and property insurance, energy, and investment in technology and equipment without offsetting margin gains
- Over-proliferation of SKUs in the warehouse
- Growth of high-weight/cube categories and products that do not cover basic costs to pick, pack and ship
- Unreasonable competitive challenges caused by distributors willing to provide added services at little or no cost
- Perceived discrimination against the c-store distributor class of trade by some manufacturers; i.e., retail customers can purchase some items from club stores at a price lower than what the distributor must pay

LOW-PROFIT CONTRIBUTORS

Competition within the channel appears to be responsible for part of the problem. There always seems to be someone willing to offer a service at a lower cost, whether it makes good business sense or not, even to the point of giving away value-added services—such as extra deliveries. That's a key factor, but it's been compounded by recent developments involving the all-important cigarette category, which has been the lifeblood of most c-store distributors for many years.

Some distributors complain that of all too many companies tend to perform to the lowest common denominator—to cut prices to the bone for retailers whose primary focus is on price rather than overall value. As a result, many distributors have come to the conclusion that *more* business is not always the answer. The answer really is the *right* business—working with customers who appreciate the value of the services they provide.

Competitive pressures have made it difficult for distributors to consistently apply cost-to-serve standards for all product categories, leading to under-pricing and low margins. Many distributors are finding that they need to delve more deeply into their own companies' balance sheets to truly understand the cost incurred in providing products and services to their customers.

Thus, distributors realize that they must break the trend of downward financial results and raise their own profit expectations to a reasonable level.

Clearly, the distribution business has evolved, and distributors either are changing, or must change, with the times. Despite competitive pressures, it is essential for distributors to understand their margins and the cost to serve their customers. One distributor put it like this: *"If we can get the industry to understand what's at stake, we can increase our margins. We've got to look at the cost side of the business—the cost-to-serve."*

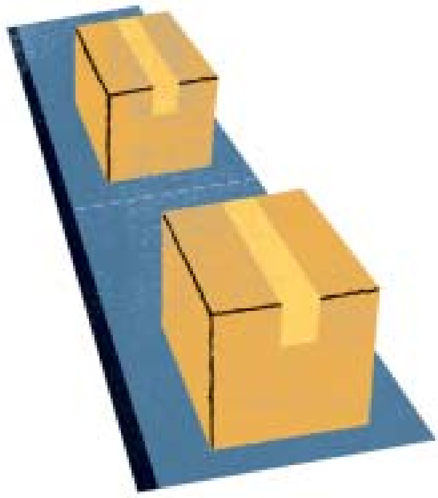
THE CIGARETTE FACTOR

Much of the current problem facing distributors stems from developments in the cigarette category, which accounts for 71.3% of the average distributor's sales while requiring only 9.7% of SKUs.

As cigarette manufacturers sought to satisfy shareholder expectations in a declining category, growing market share and brand equity and increasing prices over time was a successful formula from the early 1980s through 2002. Cigarette price increases were fairly predictable and, like commodities traders, distributors speculated on the timing of those price hikes by building inventories and achieving significant non-operating profits when prices went up.

But times have changed. The cigarette industry is now a mature declining business, and over the past eight years, a number of developments have negatively affected distributors. While overall cigarette volume declined, c-store distributors did not feel the pinch because cigarette sales volume in convenience stores dramatically increased. However, about 18 months ago, that trend changed and has begun to slightly decline—even as cigarette companies have imposed advance payment requirements and implemented share-based programs that are a challenge for some distributors to meet. At the same time, state excise taxes also have increased.

What did this really mean to distributors? For the first time in this industry, distributors were forced to raise prices to offset losses and still were unable retain their margin because of competitive pressures.



"If we can get the industry to understand what's at stake, we can increase our margins. We've got to look at the cost side of the business—the cost-to-serve."

Meanwhile, distributors are not sitting by idly waiting for a white knight to rescue them.

Today, distributors are investing more money in their cigarette inventory, and also paying faster for their goods. But it has proven very difficult to change *their* payment policies with *their* customers because of competitive concerns. Thus, they are collecting accounts receivables at a much slower pace than they are being paid, directly contributing to the declining ROAtrend that began in 2003.

Declining numbers, increasing costs and conflicting payment terms are not a formula for success, especially given the miniscule margins in other product categories.

Possible Solutions

Is further consolidation the answer? Would companies be stronger if there were fewer but larger competitors in the marketplace?

Many distributors as well as manufacturers expect that some consolidation is inevitable and say it would be a positive development. In fact, it may well be true that distributors either need to consider being the aggressor in the consolidation hunt, or they need to position themselves to be purchased.

DISTRIBUTOR ACTIONS

Meanwhile, distributors are not sitting by idly waiting for a white knight to rescue them. Many are taking concrete and aggressive action to improve their businesses and their outlooks for the future, and more such action is needed. Here are some examples of steps being taken by distributors to improve profits and ROA:

- Increasing the use of technology for warehouse management, inventory control and category management
- Reducing the number of SKUs carried in the warehouse to eliminate slow movers and duplicates
- Seeking new profit centers, such as foodservice, to compensate for reduced profits from other declining categories
- Imposing surcharges or minimum fees for handling low-profit, high-cube items
- Training sales personnel to focus on net margin provided by each customer
- Enforcing minimum purchasing requirements on customers and providing incentives to encourage exclusivity
- Carefully assessing "value" provided by customers and eliminating those customers that do not contribute to profit or cannot be profitable over time
- Increasing focus on logistics efficiency
- Taking advantage of multi-vendor snack units provided by AWMA
- Seeking increased compensation for more frequent deliveries
- Imposing restocking fees
- Seeking acquisitions where they make sense and are feasible
- Planning and implementing strategies for organic growth
- Seeking new opportunities outside the convenience channel that can increase utilization of plant and equipment

However, these actions by themselves are generally unilateral. For distributors to continue to offer the breadth of services they currently provide, there are a number of issues that must be addressed on a channel-wide basis by their trading partners at each end of the spectrum.

MANUFACTURER PRACTICE CHANGES NEEDED

What supplier procedures would distributors like to see changed if they could have their way? What modifications would help them achieve a more reasonable profit and ROA?

- **Cigarette issues.** Distributors are not pleased with many of the requirements and policies imposed by the major cigarette brand manufacturers, such as advance payment requirements, a no-return policy and share-based programs.

- **SKU proliferation.** Rein in proliferating product lines. Manufacturers agree this is a problem, and major brand executives say their firms are aggressively assessing their product mix and are reducing SKUs significantly. Nevertheless, SKU rationalization on the part of manufacturers would help distributors improve efficiency and reduce their costs.

- **New products.** While new products are recognized as the "lifeblood" of the industry, distributors want suppliers to establish clear exit strategies for non-performers as they are replaced by new offerings.

- **Class-of-trade discrimination.** Manufacturers should provide equitable pricing that acknowledges the value of the broad product mix offered by distributors, rather than placing distributors at a competitive disadvantage vs. club stores.

- **Use of information.** Manufacturers should recognize the value of purchasing data provided by distributors and use it to increase sales for the benefit of all trading partners.

- **Promotions.** Manufacturers should improve follow-through and coordination to make certain promoted product is available when and where it is needed.

Bottom line, distributors believe that manufacturers should help, not hinder, the very trading partners that are critical to their success in a channel that would otherwise be very difficult for them to reach. Policies and terms should be established with that understanding clearly in mind.

RETAILER RECOGNITION OF VALUE

It is also essential for retailers to have a clear understanding of the value of the services provided by their distributor. Retail customers need to recognize that technology-based services, category management assistance, planogram creation and implementation, and extra deliveries all come at a cost.

Certainly, by beating down prices during negotiations, retailers may achieve short-term savings. But it is unrealistic to expect that distributors can continue to provide such service over the long term without receiving fair compensation. If a distributor shows that he will move mountains to accommodate the retailer's needs, then that must be recognized, particularly when negotiations take place and terms are established.

By recognizing the contribution that full-service distributors make to their bottom lines, retailers can help ensure that such services not only continue but also will be improved. However, if that does not occur and distributors are forced to eliminate such services to control costs, then others will follow suit and the entire channel will suffer.

Bottom line, distributors believe that manufacturers should help, not hinder, the very trading partners that are critical to their success in a channel that would otherwise be very difficult for them to reach.

Distributors realize there are problems to be overcome, but many believe relationships with suppliers and customers are improving and can be further improved.

Thus, when retailers enter into a relationship with a distributor, they should take advantage of the value-added services that are offered, including those involving technology.

Retailers should recognize the value of the distributor's ability to meet their overall product needs and not give in to the temptation to cherry pick items at the club store because they can save a few pennies. That is not the way to encourage a positive long-term relationship that can pay much bigger dividends in the future.

Retailers should recognize the value of the distributor's relationship with their major suppliers—companies from which they may not be able to command individual attention, but with whom their distributor can work to resolve problems on their behalf.

TRADING PARTNER COMMUNICATION

Communication, coordination and execution involving new product introductions can be much improved. Manufacturers should accept responsibility for developing exit strategies for poor performers and communicate those strategies to distributors.

Currently, some distributors and manufacturers proactively create opportunities for trading partner communication and collaboration. These are positive developments and can benefit all involved. Suppliers, distributors and retailers need to work as closely together as possible, and the distributor plays a critical role in keeping these lines of communication open and working.

Conclusion

Convenience store distributors are faced with tight margins that typically allow little freedom for investment and building for the future. However, many of these companies have aggressive and dynamic leadership and are determined to find ways of thriving and continuing to grow and serve their customers. In fact, they are so bullish on the future that they are seeking ways to expand, whether organically or through acquisition. Bottom line, they are committed to long-term success.

Distributors realize there are problems to be overcome, but many believe relationships with suppliers and customers are improving and can be further improved.

As companies become better educated about the costs associated with product types, categories, customers and services, distributors hope that competition will be rational and based on the value of services provided. They also hope that manufacturers and retailers will appreciate the value distributors bring to *their* companies and recognize that for distributors to continue, they must be able to turn a fair profit.

As distributors continue to provide increasingly sophisticated value-added services to help improve the efficiency and profit of their customers, they believe sales will increase, translating to higher returns for every trading partner in the supply chain.

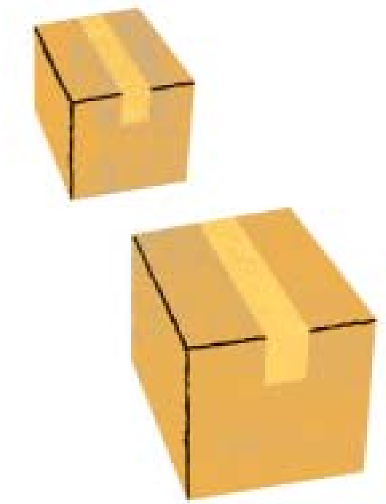
Manufacturers say they understand the distributor's profit and ROA predicament and are anxious to help, within the constraints of their own business paradigms. Ultimately, they know that the c-store distributor is an invaluable partner in their effort to penetrate the convenience store channel that is thriving and growing in importance to consumers every day.

For as one major supplier commented, *"There is a tremendous amount of efficiency in a complex channel. Distributors enable us to get our products on the shelf when we need them there. We couldn't do it without them."*

During the course of this study, one convenience store operator made this comment about his distributor: *"We have an excellent relationship with them. We've asked them to do a lot of things for us, and they always come through."*

That basic statement is the foundation upon which success for the future must be built, not upon the never-ending downward spiral of price competition.

There should be no underestimation of the value of sound business relationships in this channel. With manufacturers, distributors and retailers working together as a team, difficult issues can be overcome and success can be achieved.



"Distributors enable us to get our products on the shelf when we need them there. We couldn't do it without them."

Distributor Benefits Provided

"Distributors are our only gateway to get our products into the convenience channel."

Convenience store distributors are the essential link between the manufacturer and the retailer, enabling the supplier to efficiently and effectively provide distribution to more than 140,000 convenience stores nationwide. Thus, the services provided by distributors are critical to the ultimate success and profitability of each of these trading partners.

This complex and powerful system creates significant value for all manufacturers that rely upon c-store distributors to provide them with efficient and reliable access to this vast network of convenience stores, many of them individually operated in small towns and hard-to-reach locations across the country. The scale and efficiency provided by this single shared business process that encompasses one order and one delivery to the retailer, creates a lower cost competitive advantage for manufacturers vs. their direct-store-delivery competitors.

By supplying important support services in this high cost-to-serve channel of trade, distributors provide scale and efficiency across a broad range of consumer products—an enormous value to both manufacturers and retailers.

Distributor Benefits to Manufacturers

"Distributors are our only gateway to get our products into the convenience channel. With the complexity of 140,000 c-stores, many of them individual mom-and-pop operations, the distribution network is our only source of supply in this channel."

—Large national brand manufacturer

Manufacturers participating in this study concur that the overriding benefit provided to their companies by c-store distributors is their ability to purchase, stock and distribute a variety of products on a timely basis every day at a competitive price to a channel of trade that would be virtually impossible for them to otherwise reach.

1. LOGISTICS AND DISTRIBUTION

Some manufacturers recognize the vast number of distribution points that must be served and the ability of today's distributor to get products to the shelves in time to coordinate with specific marketing and promotional campaigns. Other manufacturers, in the view of some distributors, decidedly do not.

A national-brand manufacturer put it this way: *"Their most important contribution? Their ability to get our product to the stores in the right quantity at the right time. It is a very efficient system, and it's not one we want to take over. But there is room for improvement."*

However, when asked if manufacturers understand the benefit of the full-service distributor, one regional distributor executive replied: *"No. I don't think they have a clue how SKU proliferation, unforecasted demand and product issues drive us nuts when they can't deliver on it. Out-of-stocks are a big problem, but manufacturers have a difficult time dealing with supply and forecast issues."*

This, of course, is especially important when manufacturers release new products and execute their accompanying advertising and marketing plans. For manufacturers, distributors offer a means of placing those products, according to planogram, in stores in every corner of the nation on time. Distributor programs that advise customers of new products that are coming and when, or automatically ship new products when they hit the door, are valuable marketing benefits for those product manufacturers, as they help retailers to plan and, ultimately, to increase sales.

Manufacturers acknowledge that distributor product coverage in independent convenience stores is more difficult than in a national chain with central purchasing and distribution. But the ability of wholesale distributors to provide this channel-wide penetration is crucial to that new product's success for both manufacturer and retailer.

2. CREDIT INSULATOR

There is another benefit that many distributors believe they provide to manufacturers that often goes unrecognized: serving as a credit "insulator" with retail customers, since distributors accept all of the receivables risk. *"Manufacturers don't understand that we are a credit shield for thousands of retailers out there,"* commented a regional distributor from the Southwest.

Said another larger company: *"They [some manufacturers] don't seem to understand the value of credit rating. 'Am I going to get my money quickly?' It is surprising to me that credit rating and terms are so consistent. Certainly, manufacturers are driven by their concern to sustain value, and no value is given to the question of 'Is somebody going to pay me on time, and am I even going to get paid?'"* Of course, those are questions with which DSD manufacturers must concern themselves.

3. SALES CONTACTS

For national-brand manufacturers and local specialty product suppliers alike, convenience store distributors provide a sales force that has regular contact with stores and is able to make certain that products get to the store when they are supposed to at a low cost.

That is an especially valuable service for smaller retailers that do not have regular contact with manufacturers.

For lower volume c-store operations, the distributor sales force is generally the only touch point for manufacturer, whose own sales organizations must, out of necessity, focus on larger volume accounts.

4. CATEGORY MANAGEMENT

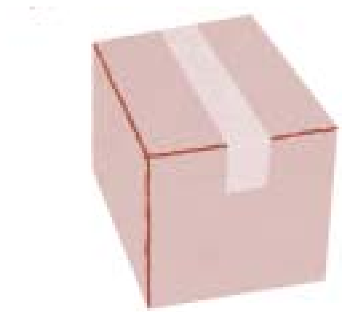
Some distributors have established performance-measured sales growth programs within their companies to help increase sales and ensure success.

Planogram management, often aided by sophisticated technology, is a service provided to retailers by distributors. But it is also valuable to suppliers, enabling them to obtain market penetration for their products and coveted space on convenience store shelves. With room for only 2,700 to 3,500 items, c-store shelf space is at a premium. Thus, the distributor's ability to generate and execute planograms, provide reset assistance and shelf tags are essential services from which product manufacturers benefit.

5. LOW-PROFIT ITEMS

Of course, many distributors carry as many as 12,000 or 15,000 SKUs—or more—to meet those individual stores' needs. And although some product categories are not profitable and are difficult to manage throughout the distribution chain, c-store distributors still provide them as a service to both suppliers and retailers.

These include high-cube, heavy, cumbersome products like bottled water and some soft drinks and sport drinks. Profit margins are slim, and there are unanticipated problems that sometimes occur involving such products. For example, if a bottle of water spills over other products causing damage, time and whatever profit exists are lost. If workers suffer back strain from lifting and moving



> "Manufacturers don't understand that we are a credit shield for thousands of retailers out there."

"Growth is a big deal. If you are growing a manufacturer's sales, and he is not giving value to that except to say, 'Just keep on going,' that just doesn't seem to be a really rational way to keep encouraging those to continue their efforts."

those items, workman's compensation expenses, and lost time on the job and lower productivity can result.

However, because c-store distributors understand those products are needed, they provide them for the benefit of the supplier, retailer and the consumer—who is unaware of, and does not care about, such problems, but simply wants to be able to purchase those items at the local convenience store.

Such low-profit categories also include low-cost, low-margin items that typically are found in convenience stores in small quantities simply for the convenience of consumer. *"How much do we make on a can of soup?"* one distributor said. *"Maybe a nickel. It doesn't even cover the cost of putting it in a tote."* Nevertheless, such items, even single pick items, are commonly provided by distributors for their customers, even though they contribute to the low profit margins that are commonplace.

6. INFORMATION & COMMUNICATION

Information is a major weapon in the sales and marketing arsenal of product manufacturers. Some c-store distributors provide their suppliers with detailed product sales information that can help them develop focused marketing initiatives for targeted retail operations.

Distributors can track what retailers purchase specific products and brands and what retailers do not and can make that information available to suppliers.

Distributors also provide an invaluable communications link between manufacturer and retailer, through sales contact, regular trade shows and meetings facilitated by the distributor between suppliers and retailers.

Commented one distributor executive: *"The key to any relationship is communications. We have events where we help the customer meet the manufacturer one-on-one so they can plan an annual advertising budget, for example. It's a way to connect the retailer and the manufacturer, and it works."*

Distributors want to be recognized by manufacturers for helping to build their presence in the marketing areas that they serve. One large distributor put it this way: *"Growth is a big deal. If you are growing a manufacturer's sales, and he is not giving value to that except to say, 'Just keep on going,' that just doesn't seem to be a really rational way to keep encouraging those to continue their efforts. The cigarette industry said, 'We need to make sure the manufacturers and distributors have a way to work together,' and we became hooked on that. But it drove cigarettes to a level they never would have otherwise achieved."*

7. CIGARETTE INDUSTRY BENEFITS

For cigarette manufacturers, many of the same distributor practices and services are important benefits just as they are to the CPG suppliers. However, in this mature and declining category, cigarette manufacturers rely heavily on consumer promotions to keep their brands viable and affordable for the consumer. Distributors, therefore, must manage an ongoing barrage of complex promotions and marketing approaches.

Cigarette manufacturers depend on distributors for successful implementation of their promotional strategies, which include: type of promotion, shipment date, appropriate quantity by SKU for each customer's retail locations, according to their promotional shipment lists.

Distributors also must handle the costly process of promotional product refusals by retail customers. Because the efficiency of the supply chain is in shipping product to retail, not bringing it back, distributors must constantly review promotional shipment lists with manufacturers to minimize product refusals. Product promotions require distributors to invest more money and carry more inventory than ever to accommodate the stamping and staging of these promotions for shipment.

Distributors are beginning to play an even greater role by helping retailers manage their cigarette inventories, a direct benefit to manufacturers, as this helps retailers keep their brands and packings in-stock for the consumer. One cigarette manufacturer stated: *"As excise taxes continue to escalate, which impacts the dollars invested in the cigarette category at retail, having the right assortment and proper inventory level is essential, and the distributor can play a valuable role in that process for the manufacturer and retailer."*

Distributor Benefits to Retailers

"It's incredible, all of the headaches and the deliveries and the agony that those people go through; really a partnership between us and the wholesaler is what's happening. And it needs to be two-sided. The wholesaler becomes a good friend and partner."

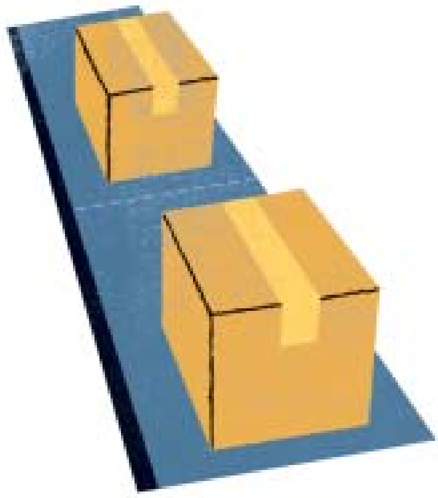
—130-store convenience store retailer in the Southeast

The tasks of purchasing, stocking and distribution are basic to convenience store distribution operations. They are, simply put, the table stakes for being in business. But for today's distribution companies, large and small, they are only a fraction of the overall services provided to retail customers. To differentiate themselves from competitors and to meet their customers' constantly evolving needs, many distributors large and small do much more, providing:

- Inventory management
- Category management
- Store sets, resets and tagging
- Extra deliveries
- Technology assistance
- New-item introductions and management
- Speed-to-market assistance for new products
- Merchandising assistance
- Marketing expertise
- Promotional planning and coordination with manufacturer
- Real-time access to information
- Accrual tracking
- Serving as a credit shield in cigarette inventory purchasing

Ask retailers, and they will credit distributors for their responsiveness and the services that they perform. Said the owner of one regional c-store chain in the Northeast: *"Wholesalers have adapted to accommodate our changing needs. Our wholesaler is doing business in non-traditional ways and is willing to do whatever it takes to meet our company's needs."*

Clearly, many retailers understand and recognize the benefits of these value-added services. Unfortunately, such efforts often go unrecognized and are simply assumed. Even worse, some distributors say many retail customers generally are unwilling to provide the compensation that is justified, although they understand those services are worthwhile and contribute to their own company's profit and success. Often, history has told them that distributor requests for increased prices or fees will not be



"It's incredible, all of the headaches and the deliveries and the agony that those people go through; really a partnership between us and the wholesaler is what's happening."

"We continually provide higher levels of services, including higher in-stock ratios and on-time deliveries, while driving costs out of the system and sharing the savings with our customers."

enforced, particularly if competitors enter the picture and offer lower prices for the same goods.

Commented a distribution company executive: *"We're still held pretty close to the lowest bidder. People forget there are other companies who can do it, but not as well. It's 'What have you done for me lately?' that is important. So now they say, 'I'm going to use your configuration and buy it from somebody else cheaper.' It's tough to look that guy in the eye and say 'I can't walk away from my price.' It's always a big risk with a sizable customer."*

Let's focus on specific services that distributors provide to retail customers that add value to their operations and businesses:

1. DISTRIBUTION EFFICIENCY

The ability to distribute a broad range of products efficiently and at a competitive price is the c-store distributor's core competency. Everything else flows from that basic, but complex—and increasingly expensive—task, the efficiency of which determines the ultimate success or failure of the convenience store distributor.

The test is the fill rate. How quickly and how efficiently does the distributor get the products ordered to the retail customer? It's true with everyday items and inventory, but it's especially important with new products that are needed to tie in with manufacturer promotions and advertising. As a result, many distributors are investing in systems and technology to help make logistics as efficient as possible, from every conceivable operation in the warehouse to truck transportation and delivery operations to in-store services at retail.

For large distributors with numerous regional distribution centers, internal warehouse efficiency becomes especially important as they seek to compete with local competitors with shorter routes and thus, lower costs. According to one large national distributor: *"The way we overcome that issue is with more efficiencies on the inside with our larger volume rack and buying, and with our handling technologies—all of the components that make the receiving, slotting, pick selection and loading more efficient."* In addition, such companies are adept at obtaining maximum utilization of their transportation equipment with backhauls and serving customers in other channels along the way.

But, it's not just the big national distribution companies that are being driven by efficiency to keep their prices down. Commented a regional distributor in the Midwest: *"Our internal efficiencies allow us to continually do more with less. We continually provide higher levels of services, including higher in-stock ratios and on-time deliveries, while driving costs out of the system and sharing the savings with our customers."*

Many distribution companies have a long history and are family operations that hold to established policies and procedures. Still, they are becoming increasingly sophisticated in their operations so they can deliver increased value to their customers. Automated product sortation is a common practice at some distribution centers. At one regional firm in the East, the distribution center now has a sorter in its loading area that splits into six lanes to move scanned product to the appropriate door. One lane is set aside for scanned items that are not properly read. By focusing attention there, the amount of product that is not read properly has declined by 90 percent, thus reducing costs and increasing service.

Distributors must focus on efficiency to keep prices competitive; they must also be cognizant of each retail customer's own specific needs. Some companies pride themselves on flexibility; their ability to meet customers' requests—for additional deliveries, for example—even though that reduces efficiency and increases costs.

All of that adds value above and beyond the basic services provided. One regional distributor has quantified the value to retail customers of 24-hour, next day deliveries for cigarettes vs. a competitor on a day-delayed delivery schedule. For the customer, it means less safety stock—as much as a 30% reduction in inventory as a result of the 24-hour delivery schedule and taking advantage of the company's system of automatic replenishment.

2. INVENTORY MANAGEMENT

By leveraging the advantages of technology, many distributors large and small give the retail customer tools to track product movement and inventory needs. Smart handheld devices are being used, and some distributors provide them to their customers at no cost. It's made the order process more efficient for the retailer, and it's reduced the number of store trips required by the distributor. Using technology, distributors can check the retailer's current inventory and create orders based on historical item movement.

Observed an executive of a large national distribution company: *"You only get what you order, you have to have the best ordering system that is the most time efficient in recognizing marketing trends and then use it in supply chain management. If a store is out of stock, it is a big problem for us. We only make money when they sell product, just like the retailer. If we didn't order it and we're out of stock, then shame on us. That was a stupid thing to do, and we need to be better. We invest and work to find a better way so it doesn't happen."*

Another distributor in the Southeast has developed its own Palm-based handheld unit that allows retailers without scanners or computers to track their inventory, orders and even manage their profit margins. The units were developed in-house five years ago, and upwards of 40% of upgrades since then have been the result of suggestions made by customers.

3. CATEGORY MANAGEMENT & MERCHANDISING

Distributors aggressively work with retail customers to help them maximize the profit of the limited shelf space in their stores. Optimum store sets are created using performance data and other information, including knowledge of the local marketplace.

Explained one smaller distributor in the South: *"We create a store set that is constantly evolving. It has modified items in it from what we set three months ago. If they buy from us on an ongoing basis and renew new items, we provide tags for permanent items. The evolution of items is subtle and it happens week-in and week-out."*

Distributors realize that they have a tremendous opportunity to increase their own efficiency and reduce costs if they effectively manage their own inventory. Many distributors interviewed for this study reported an on-going initiative to reduce warehouse SKUs significantly for this reason—some by 30% or more. One distributor reported that this action has made it possible to close one DC entirely, without reducing sales or profit.

"If a store is out of stock, it is a big problem for us. We only make money when they sell product, just like the retailer."

"Retailers have told us that where we have really made a difference is how we configured the store for them. If the retailer is selling 20% more, we're selling 20% more."

One reason that DCs are loaded to the rafters with more SKUs than may be necessary is that distributors often agree to carry specific brands or items for customers, especially new customers, even though they may well carry comparable or even identical products with another brand name.

However, distributors are attempting to rationalize their warehouse inventory mix to reduce duplication and cost. As they do this, the increasing use of technology to provide planograms that help retailers maximize profit is an especially important and valuable service. Some distributors provide category management professionals to work with their customers to develop the right approach for each store.

Getting that right can make a major difference in sales and profit for the store, the distributor and for the manufacturer. One distributor reported that its merchandising department tracks the effect of product sales before and after resets to determine the exact impact of this service that is designed to maximize sales on every foot of shelf, cooler and freezer space.

Explained a regional distributor in the East: *"There's a lot of science in store layout and location and we use it. Our experience is that good retailers are capable of measuring the impact that this has on store sales, and that number is significant. Retailers have told us that where we have really made a difference is how we configured the store for them. If the retailer is selling 20% more, we're selling 20% more."*

A Midwestern regional distributor has developed a suite of computer-based category management services that includes order replenishment for cigarettes. It also tracks every item purchased by the month and includes "what ifs" that can be used for category management, whether or not the retailer is capable of scanning. There is an Internet-based component that includes real-time information, such as inventory on hand and costs. It even allows customers to maintain their own retail accounting online. The customer also can authorize or de-authorize items themselves.

Another distributor reports that its category management team continually seeks new programs and ideas that will enhance their customers' profit. An example is a new Multi-Vendor End Unit (MVE) that allows customers to improve snack sales at margins exceeding those from snack products from direct store delivery (DSD) suppliers. The MVE program was developed by a special AWMA committee, and units are available to all member companies.

"Making sure we're getting what we've ordered when we need it, and then assisting in managing inventory and inventory turns, plus planogram assistance—those are valuable resources provided by our distributor."

—Mid-sized regional c-store operator

4. NEW-ITEM INTRODUCTIONS & MANAGEMENT

Distributors are given high marks by manufacturers for their ability to get new items into the convenience store channel on time. That, of course, is also a major benefit to retailers, who rely on new products to help draw customers into their stores and build sales and profit.

Many distributors have their own proprietary systems for notifying retail customers of new items and when they will be available. Some are Internet-based and offer real-time information; others are provided by more traditional means. One distributor creates a PDF form that is also e-mailed, showing all new items that are scheduled to arrive and when, and when they actually have arrived. Some small regional companies, particularly, provide insight from their buyers who use local marketplace knowledge to determine which new items will succeed in specific locations.

Distributors recognize that growth in every category is a result of new items, but managing them is a challenge—particularly when there is no exit strategy for the items that they are replacing. Best-of-class manufacturers are working to help distributors resolve this problem and are also reducing their own lines of duplicative products.

Commented one such supplier: *"If you are the category captain, you have to review the whole category. Then you are told that XYZ is coming out with new products, and you have to eliminate the slow sellers, whether it's your SKU or others. Then you have to come up with a program to help them reduce that inventory."*

The New Item MVE concept developed by the AWMA Warehouse-Delivered Snacks (WDS) Committee helps retailers increase candy and snacks sales by partnering with distributors. New items are responsible for the majority of growth in the confections category. The new item MVE provides a home for such items, building consumer awareness and allows retailers to synchronize the availability of new products with manufacturers' advertising and promotions. Retailers can use this MVE as their testing ground to determine if the sales performance of a new product merits a place in the planogram, replacing a slower moving SKU, or should be discontinued.

A distributor in the Southwest has developed two marketing vehicles to help sell and promote new products: a separate listing of new products in stock and ready for shipment, with full color graphics and product details, and a rack to launch new sales. Retailers automatically receive new products that are placed on the rack.

5. PROMOTIONAL PLANNING WITH MANUFACTURERS

Distributors use many means to help retailers develop meaningful plans for new products, and to prepare for marketing and advertising with their suppliers. A common tactic is to hold individual trade shows, where suppliers exhibit their products for the distribution company's retail customers.

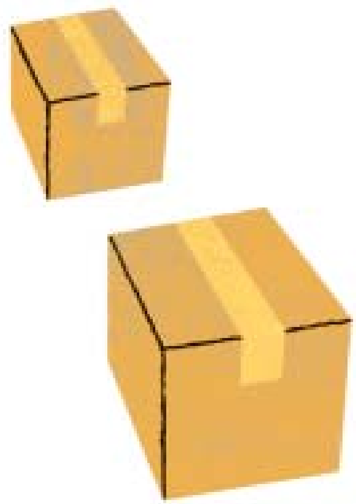
In addition, some distributors facilitate one-on-one meetings at the distribution company's offices between manufacturers and retailers, providing direct access that otherwise might be difficult for some of the smaller retail operators to obtain.

Often tactics used are fairly basic but effective nonetheless, such as providing a regular "deal sheet" outlining all available special buys.

"Before we grew to the size where it now pays suppliers to work with us directly, our distributor was an extremely important conduit of information," commented a 60-store c-store operator in the Western U.S.

6. ACCRUAL TRACKING FOR RETAILERS

A value-added service that some distribution companies provide to their retail customers involves keeping track of accruals—the marketing and promotional funds due to retailers from manufacturers for their product purchases. One distributor provides an online service allowing customers to track daily both accruals and results of promotions.



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Distributor Challenges

"Their problem is every manufacturer's problem. What needs to happen is to change the profit picture long-term."

The many outstanding services provided by distributors to their retail customers and the value that they represent do not come without cost. Unfortunately, without compensation to cover those increased costs, many distributors are facing intense pressure on already dismally low profit margins.

Intense competition in a changing industry is prompting many convenience store distributors to develop new expertise, technology and capabilities so they can serve their customers as effectively and efficiently as possible. However, those same competitive challenges make it difficult for many distributors to increase pricing and fees to their retail customers, so they must find ways to continue to provide great service while managing their expenses. Thus, as they make these commitments and investments, convenience store distributors are searching for ways to help address the challenges with which they are faced.

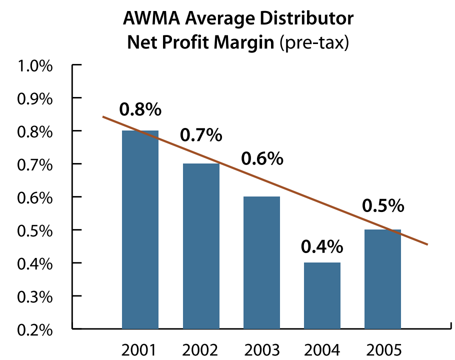
It is an inescapable fact that distributors cannot watch their financial performance continue to worsen and still hope to remain viable. Yet, distributors are bullish on the future and are determined to survive and prosper, and remain a viable force in the convenience store channel.

The Profit Problem

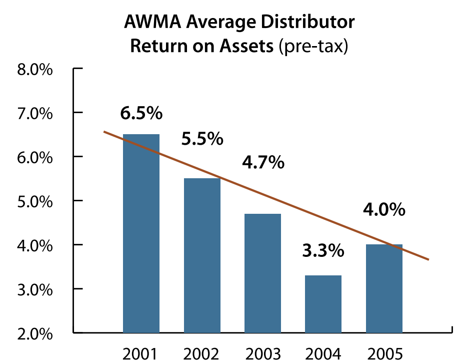
The 2006 Hershey Industry Performance Analysis (HIPA) report reiterates a long-standing problem for much of the industry: extremely poor profit and ROA. The typical AWMA distributor produces a pre-tax profit margin of just 0.5% and an ROA of 4.0%.

It is a serious problem, one that concerns not only distributors themselves but some manufacturers who rely upon c-store distributors to provide them access to an extremely important channel of business.

Commented one such supplier: *"Their problem is every manufacturer's problem. What needs to happen is to change the profit picture long-term. The situation exists, and it is dangerously important now. Manufacturers need to have a better understanding of the operations and the processes of the wholesaler. Where is he making money? Where are his expenses? Where are the opportunities for increasing profit?"*



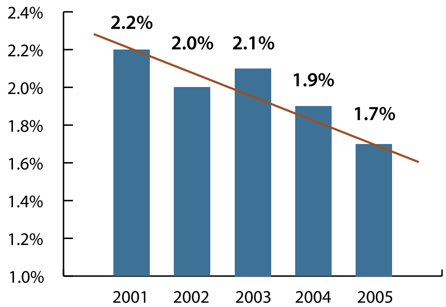
Source: 2006 HIPA Study, The Profit Planning Group, Dietz Consulting LLC



Source: 2006 HIPA Study, The Profit Planning Group, Dietz Consulting LLC

According to HIPA, the current ratio—the ability of AWMA members to pay short-term debt with current assets—has steadily declined from 2.2% in 2001 to 1.7% in 2005. Clearly, the trend is headed in the wrong direction.

AWMA Average Distributor Current Ratio



Source: 2006 HIPA Study, The Profit Planning Group, Dietz Consulting LLC

Also disheartening is the fact that the convenience store distribution industry is ranked last in overall financial performance compared to 75 distribution industries tracked by the widely respected Profit Planning Group in Boulder, CO.

Said one distributor interviewed for this study: *"Why is it that this industry is ranked dead last? That should be a wake-up call."*

Against that typical performance, it is not surprising that in this study, the ability to turn a reasonable profit—and all this represents—was ranked as the most important challenge by virtually every company that participated.

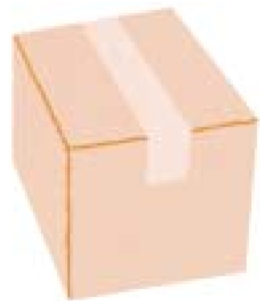
Distributors attribute this dismal profit picture to many factors, including:

- Excessive—and increasing—taxation of tobacco products
- Declining volume in the cigarette category, changes in the major cigarette manufacturer programs, advance payment requirements and terms reductions that have negatively affected cash flow and gross margins
- Rising operational costs with no offsetting margin gains, against unreasonable competitive challenges from distributors willing to provide added services at little or no cost
- Over-proliferation of SKUs in the warehouse
- Growth of low-profit high-weight/cube categories and products not covering basic costs to pick, pack and ship
- Perceived price discrimination against the c-store distributor class of trade by some manufacturers; i.e., retail customers can purchase some items from club stores at a price lower than what the distributor must pay

The Cigarette Squeeze

For many years, the convenience channel, including cigarette manufacturers, distributors and retailers, all benefited from year-over-year price increases on cigarettes. Over time, many distributors became comfortable with that steady source of profits and were willing to subsidize less profitable items without much concern, or perhaps, even much thought.

But times have changed. The cigarette industry is now a mature, declining business, and over the past eight years many developments have negatively affected distributors. Although overall cigarette volume declined, it was only just over a year



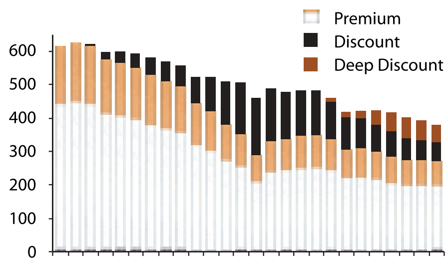
"Why is it that this industry is ranked dead last? That should be a wake-up call."

With a stroke of the pen, over the course of the next five years, distributors lost a revenue source that had contributed immensely to overhead.

ago that c-store distributors felt the pinch because until then cigarette volume was shifting to convenience stores. Now, however, that shifting has leveled out and even dropped somewhat—at the same time that state excise taxes have increased and cigarette companies have imposed requirements for advance payment for product and implemented share-based programs that are a challenge for some distributors to meet.

Cigarette industry total volume peaked in 1981 and since has steadily declined at a rate of about 1.5% to 2% per year. In total, from 1982 through 2005, total industry volume declined nearly 39%.

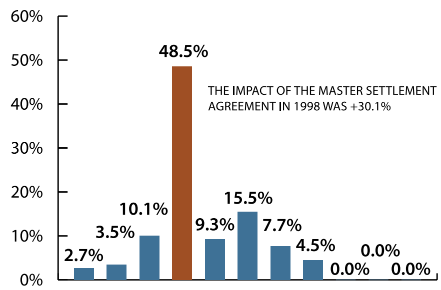
Total Cigarette Industry Volume In Units



Source: Industry Data, Merrill Lynch, Dietz Consulting LLC

As cigarette manufacturers sought to satisfy shareholder expectations in a declining category, growing market share and brand equity and increasing prices over time was a successful formula from the early 1980s through 2002. Cigarette price increases were fairly predictable and like commodities traders, distributors speculated on the timing of those price hikes by building inventories and achieving significant non-operating profits when prices went up.

Major Cigarette Manufacturer List Price Increases
(as a percentage of increase versus prior year)



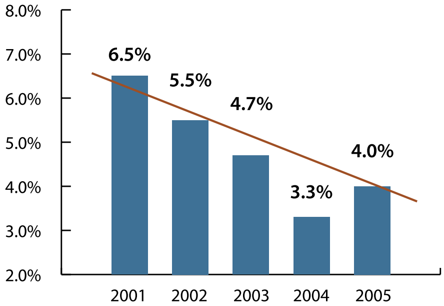
Source: Industry Data, Merrill Lynch, Dietz Consulting LLC

Theoretically, those industry price increases should have been a windfall for distributors. Instead, because they were so steady, distributors grew accustomed to them, and the resulting profits became part of normal operating income. Unfortunately, many of those dollars also found their way to retail customers as distributors fought for market share.

Then in 1998 came the Master Settlement Agreement, which added about $5 to the cost of a premium carton, ending that practice of steady price increases. With a stroke of the pen, over the course of the next five years, distributors lost a revenue source that had contributed immensely to overhead, a source that still has not been offset by other category pricing changes to retail customers.

It is instructive to compare the disappearance of these price increases with the decline in average distributor profits and ROA. That the downward trend line is the same is no accident.

AWMA Average Distributor Return on Assets (pre-tax)



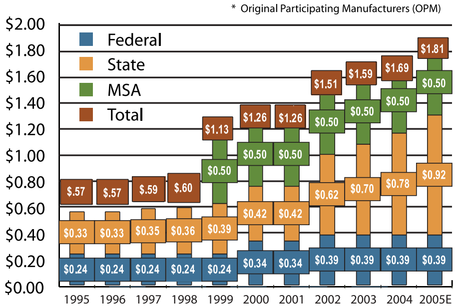
Source: 2006 HIPA Study, The Profit Planning Group, Dietz Consulting LLC

The Master Settlement Agreement created on opportunity for deep-discount manufacturers to surge into the market, challenging major manufacturers to manage the price gaps between the premium and discount brands in order to stem the influx of this low cost product. Suddenly this business model, which succeeded based on rising market share and prices over time, began to crumble.

To further compound the problem, the 9/11 tragedy and the subsequent economic slowdown left many states looking for ways to cover budget shortfalls. They found one easy politically safe solution: Raise excise taxes on cigarettes.

Average State, Federal Excise Tax & Estimated OPM MSA Assessment Per Pack

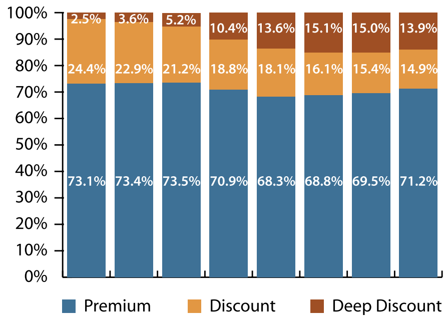
* Original Participating Manufacturers (OPM)



Source: Industry Data, Merrill Lynch, Dietz Consulting LLC

This combination of settlement costs and rapidly increasing taxes quickly sent the retail price of major brand cigarettes skyward and opened a significant price gap with the new deep-discount brands.

Share of Industry Volume By Price Segment



Source: Industry Data, Dietz Consulting LLC

The share of deep-discount brands grew rapidly; first at the expense of major manufacturer discount brands and eventually eroding share of their premium brands.

As a result, Philip Morris USA and RJ Reynolds Tobacco Co. substantially changed their go-to-market strategy to make their brands more affordable for consumers, resulting in dramatically increased promotional spending and a restructuring of retail and wholesale programs. They reduced their cash discount and established new variable terms based on the distributor's market share performance vs. established share targets.

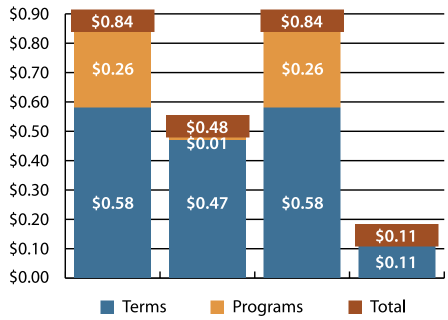
The new wholesale programs with the addition of a variable terms rate created a significant difference between distributors that were at or above the market share target and those who were below.

Suddenly this business model, which succeeded based on rising market share and prices over time, began to crumble.

The average loss of margin for distributors based on terms and program changes was about 43 cents per carton.

High/Low Wholesale Program Differential—Cost of Goods

PMUSA/RJRT PREMIUM BRAND CARTON COMPARISON



Source: Dietz Consulting LLC

What did this really mean to distributors? The average loss of margin for distributors based on terms and program changes was about 43 cents per carton. For the first time in this industry, distributors were forced to raise prices to offset losses. Still, they were unable to retain that entire margin because of competitive pressures.

When PMUSA instituted a three-day advance payment requirement for the purchase of their products, it meant that the distributor needed more capital to pay for his inventory, further exacerbating the cigarette squeeze.

To help us illustrate this, one distributor participant in this study shared an internal analysis of the capital investment caused by increasing prices and the advance payment requirements. For that company, it meant a 151% increase in required capital investment and a resulting financing gap of 148%.

The bottom line is this. Distributors are investing more money in their cigarette inventory, and they are paying faster. But they have not changed *their* payment policies with *their* customers because of competitive concerns and are collecting their accounts receivables at a much slower pace—directly contributing to the declining ROA trend that began in 2003.

Working Capital Investment & Available Borrowing Base

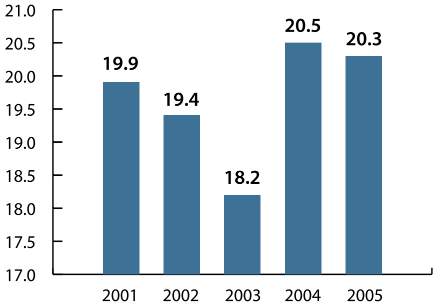
December 1996 vs. January 2003

	Dec - 1996		Jan - 2003
National List Price	$ 11.39		$ 27.64
Discount	3.75%		2.75%
Net	$ 10.96		$ 26.88
Taxes	$ 3.00		$ 8.00
Working Capital			
Inventory (a)	$ 2,792,000		$ 8,371,000
A/R (400,000 cartons)	$ 5,584,000		$ 13,592,000
Promotional A/R	$ 420,000		$ 650,000
A/P	$ (3,500,000)		$ (9,333,000)
Working Capital Investment	**$ 5,296,000**		**$ 13,280,000**
Additional Working Capital Needed		**$ 7,984,000**	
Borrowing Base			
Inventory (70%)	$ 1,954,000		$ 5,860,000
A/R (85%)	$ 4,746,000		$ 11,553,000
Less: Stamp Liability	$ (3,500,000)		$ (9,333,000)
Available Borrowing Base	**$ 3,200,000**		**$ 8,080,000**
Financing Gap	**$ 2,096,000**		**$ 5,200,000**
Increase in Financing Gap		**$ 3,104,000**	

(a) 200,000 cartons in 1996. In 2003, 240,000 cartons due to lead time increase.

Source: AWMA Distributor Value Study Participant, Dietz Consulting LLC

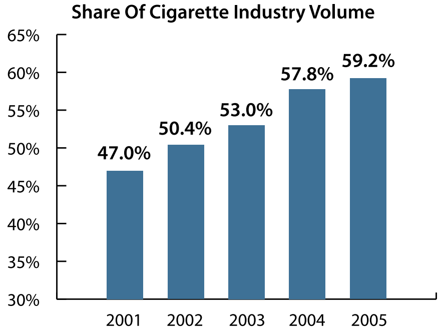
Accounts Receivable
Average Collection Period



Source: 2006 HIPA Study, The Profit Planning Group, Dietz Consulting LLC

On the bright side, convenience distributors and their retail customers have benefited from the channel shift that has occurred, as grocery stores' cigarette market share declined and c-stores' share increased. Getting a bigger piece of a shrinking pie is certainly positive, and from 2000 to 2005, c-stores' share of industry volume increased by 15.3%.

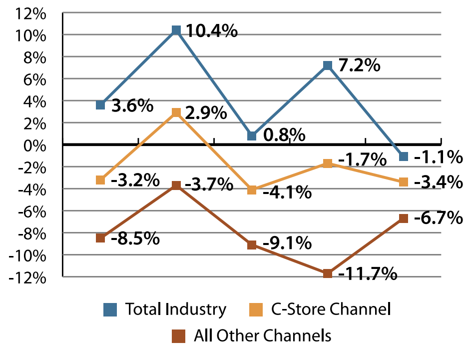
C-Store Channel
Share Of Cigarette Industry Volume



Source: Industry Data, Dietz Consulting LLC

However, trends now suggest that this phenomenon, which has outpaced the overall cigarette industry volume decline, may be coming to an end. Convenience store cigarette volume in 2005 was slightly less than in 2004, reversing a steady increase that began long before 2000, adding yet another challenge to distributors and emphasizing the need for corrective action. Declining numbers, increasing costs and conflicting payment terms are not a formula for success, especially given the miniscule margins in other product categories.

Cigarette Volume Change Versus Prior Year



Source: Industry Data, Dietz Consulting LLC

Even cigarette company executives themselves recognize the difficulty of the payment requirements being imposed on distributors. *"It is incomprehensible the money that they lay out for cigarettes and when they lay it out vs. when they get paid,"* one such executive commented. Moreover, he predicted that the situation would worsen as many states further tighten their payment requirements for stamps.

"It's almost like the channel needs to reinvent itself," he said.

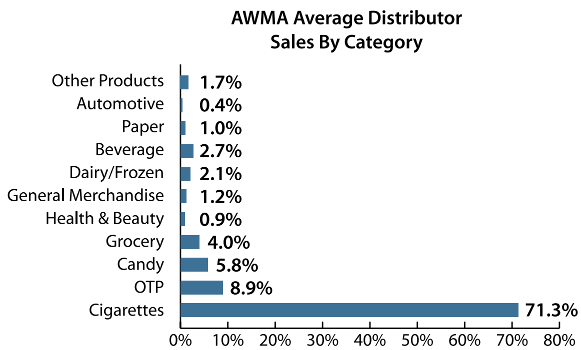
A mid-sized distributor put it this way: *"We're slowly bleeding down. If we were to take cigarettes off the table, I would question whether the convenience store industry could be serviced in the manner it is today because of the incremental costs of handling and delivering all of the other products."*

Distributors are investing more money in their cigarette inventory, and they are paying faster. But they have not changed their payment policies with *their* customers.

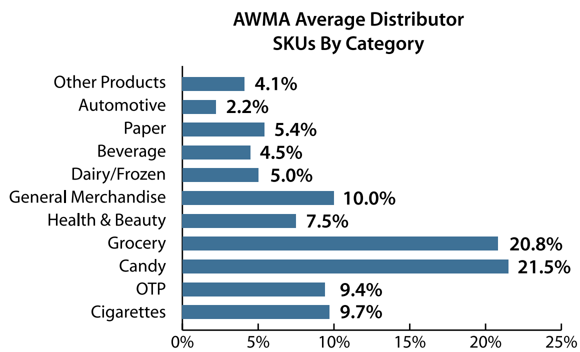
"Distributors need to look into the future with less dependence on tobacco over time. How can they have a long-term viable business?"

A large non-tobacco CPG company declared: *"Distributors need to look into the future with less dependence on tobacco over time. How can they have a long-term viable business? Manufacturers have to do what they can to help them so the distributor can continue to distribute their products to retailers."*

The 2006 HIPA report illustrates the depth of this problem, showing that the typical AWMA distributor counts on cigarettes for 71.3% of its sales with only 9.7% of its SKUs, while sales of all other categories were in the single digits against much higher SKU counts.



Source: 2006 HIPA Study, The Profit Planning Group, Dietz Consulting LLC



Source: 2006 HIPA Study, The Profit Planning Group, Dietz Consulting LLC

The HIPA study contained this advice: *"In developing an appropriate product mix, firms are torn between trying to build a reputation as a focused product specialist vs. building an image of supporting one-stop availability. In either case, the firm needs to ensure that every product category supports the overall merchandising strategy and justifies the investment level in that category."*

That commentary is directly applicable to the situation involving c-store distributors' dependency upon cigarettes. Today's convenience stores are increasingly becoming destination points for many consumers, who make stopping there regularly for gasoline, coffee, breakfast or lunch items, beverages, lottery tickets and more part of their regular routine.

Despite distributor resentment against some of the policies imposed by the cigarette brand manufacturers, there is a recognition among many that the deed is done and is unlikely to change, so let's stop complaining and move on.

Declared one distributor executive: *"We need to focus on what we can actually change, rather than things that get us emotionally charged, but that we can't do anything about. That is draining energy, wasting time and burning bridges. You do get emotional; after all, it is your family and your business. But you've got to take a deep breath and translate this to your customer base."*

RISING OPERATIONAL COSTS

It is no small feat what is performed by convenience store distributors as they receive, warehouse, deliver and merchandise thousands of products every day to convenience store chains and independent operators alike.

Said one regional distributor: *"As an industry, we don't do ourselves any favors if we don't link competitive pricing and fill rates—keeping our customers' stores filled with the product they need at a competitive price. It's not valued; it's just assumed. That is the biggest piece of the value equation, but the fundamentals of what we do involve incredible exercises on behalf of our customers. It is a big deal."*

The cost of providing these services continues to creep up as distributors face rising energy costs for their fleets, distribution centers and offices; increases in business insurances, particularly health care coverage for employees; and the need to invest in new technology for both logistics and warehouse operations and for services to their retail customers. At the same time, there is little in the way of counter-balancing returns to offset those expenses.

Ironically, one factor in the poor profit picture appears to be low profit expectations by distributors themselves. Bluntly put, some distributors simply set their goals far too low, and it is against that low threshold that strategies are established and decisions made. So it is no surprise that results do not exceed those expectations.

Commented one distribution company executive: *"We're profit expectation poor."*

Unfortunately, often all of this stems from a situation over which many distributors feel they have little control—competition that is willing to do about anything to land a customer without considering the cost of doing business. Such an approach has considerable impact on distributors that do set profit goals high enough to allow for growth and investment in the future.

A distributor put it like this: *"We provide retailers with easy access to the right products and programs and have better systems to deliver information than our competition, yet when it comes right down to it, they are so focused on the* ***cost*** *of goods, that our value-added services are only a tie breaker."*

In other words, all of those services are great, but if somebody with fewer add-ons comes along offering product a few pennies cheaper, that company may well get the business—no matter the efficiencies and added profit those "frills" would have provided.

Thus, some distributors believe there is a tendency on the part of all too many companies to perform to the lowest common denominator—to cut prices to the bone, just to get—or keep—the business, regardless of what it costs to provide those services.

Meanwhile, some c-store retailers question how they can be sure they are receiving a fair price. Unfortunately, there is no benchmark standard to use. The price is determined by numerous factors, including the size of the delivery, total volume, the category mix, services provided, delivery frequency and, of course, competitive forces of the marketplace.

OVER-PROLIFERATION OF SKUs

Faced with difficult competitive pressures and retailer resistance to higher prices needed to cover increased services, many distributors are determined to find ways of cutting costs. One widespread practice is to focus on duplicate and slow-selling SKUs carried in the warehouse, which is seen as an important factor in distributors' overall poor financial results.

Bluntly put, some distributors simply set their goals far too low, and it is against that low threshold that strategies are established and decisions made.

> "If you carry the right items, there is an opportunity to take cost out of the system."

Nearly every distribution company interviewed for this study reported an ongoing effort to reduce the number of warehouse SKUs dramatically, some by 20% to 30% or more. They recognize that all too often they have acceded to customers' requests for specific items or brands, even though they duplicate what is already on hand. However, they also realize that if they can manage their warehouse inventory more effectively, they can reduce costs significantly and that downward spiral of gross profits.

Said one regional distributor: *"My target is to get rid of between 2,000 and 3,000 SKUs by the end of the year. We probably have 10,000 now. We would like to go further than that."*

A larger company with a larger inventory is considering a reduction of from 7,000 to 8,000 SKUs, saying, *"If they are dead for us, they are dead for retailers."*

One regional distributor stressed the importance of having the right assortment, emphasizing the importance of category management. *"If you carry the right items, there is an opportunity to take cost out of the system,"* he said. *"We started out with over 10,000 items. We were very proud of that. But today, we are at 8,300 and our goal is 8,000. We freed up and closed an entire secondary warehouse over a period of 15 months. You've got to stay on top of it."*

A national cigarette brand manufacturer agreed that many retailers carry far too many SKUs, resulting in pressure on distributors to do the same. It is surprising, he said, how many retailers are over-stocked on slow-moving brands and under-stocked on those that fly out the door. That situation offers a significant opportunity for distributors who can help retailers do a better job of managing their cigarette inventory, he added, noting that when a convenience store is out of stock on popular brands, consumers simply go elsewhere. Not only is that sale lost and never recouped, but future sales—and a regular customer—may also be lost.

While his advice was directed toward cigarettes, it has application across the store and stands as testimony to the wisdom of rationalizing warehouse inventory to provide the most efficient and cost-effective mix of product possible to retail customers.

Other national brand manufacturers reported ongoing efforts to reduce the number of duplicate products and line extensions offered to increase their own efficiency.

"Everyone gets excited when a new product comes out, but sometimes that excitement exceeds where we want new items to take us," a supplier executive reported. *"So we've lost some core product distribution as a result. We're going to try to protect our core by enhancing productivity on those products, and in turn, we will pare down the number of SKUs across all channels. We understand the impact that having to deal with too many products has on distributors."*

But that manufacturer pointed out that many distributors carry the product the retail customer wants, regardless of what duplicate items are already offered. He said flatly, *"The distributor has to put forth a better effort of fighting back on having to stock a multitude of products because the retailer feels he has to have this specific item in his mix."*

The rapid rate of new-product introductions is an important contributor to the burgeoning number of SKUs carried by distributors and a cause for strained relationships between all three trading partners. How will the new product affect planograms already implemented? What is the manufacturer's exit plan for new products that don't succeed? If there is a plan, is it shared with the distributor so he can work with the retailer to coordinate scheduled events? What happens when promotions are in place, plans implemented, advertising running, and the new products don't arrive in time?

Commented one distributor: *"The outcome of that has been an over-proliferation of SKUs. It's common in the industry to redo planograms on a six-month or even yearly schedule, when new products come in at a huge rate every day."*

The result is often confusion, as well as a distribution center filled with old product being held just in case it's needed, causing a whiplash effect and higher costs all along the distribution system.

Many distributors say manufacturers commonly fail to communicate their exit plans for failing and slow-moving products, but they also admit to not insisting that such plans be provided. *"The communication doesn't occur,"* a distributor said, *"not even a yellow light that says this one's on the bubble. With the roar of advertising that exists for new products, it's with a whimper that old products make an exit."*

Another distributor pointed out that with today's technology, including handheld devices used in the c-store, products that should be eliminated can be identified, which he contended is essential for new products to succeed. *"Everybody expects that manufacturers should be willing to deal with their mistakes if retailers and distributors are willing to take the chance with their new products,"* he said.

Often, distributors say, the volume of new items exceeds the capacity of the new-item rack. While they understand that new items are a major contributor to growth in every category, the new-product glut puts the distributor in a difficult position between supplier and retailer—often resulting in the distributor being faced with unsold products for which they do not receive reimbursement.

Some major national brand manufacturers do understand this dilemma and contend they are seeking solutions. *"If you go to a buyer and you don't have an exit plan for whatever your new product will replace, how can they say, 'Yea, bring it in'? We have a tremendous number of SKUs that we sell, and have for years. We are taking a very hard look right now and will be eliminating SKUs."*

On the surface, the effort by distributors to reduce warehouse inventory may seem to fly in the face of the pride that many place on their full product lines and their ability to meet just about any retailer request. They consider that ability a major advantage for both their suppliers and retail customers. They also see it as a solid reason why suppliers should afford the best possible pricing to them and why retailers should be loyal and purchase all of their non-DSD items from them. They believe that a full product line is an effective selling point to those customers who might purchase some items from the club stores for a few cents savings. However, those same distributors have come to the realization that "full product line" does not have to mean duplication and unnecessary overhead.

"With the roar of advertising that exists for new products, it's with a whimper that old products make an exit."

"Don't be scared and try to hide the 50 cents. Be a man and tell them. It's nothing to be ashamed of. We're supposed to make money—we're in business."

LOW-PROFIT CATEGORIES

Many distributors complain about the cost of handling high-cube, cumbersome items like water and other beverages. Profit margins are slim, and the risks of damage to other products, in the case of spills, or to employees from back and muscle strains, is real. Workman's compensation cases, additional expenses and lost labor can result.

Some distributors impose, or have sought to impose, surcharges for such products—especially if orders do not meet certain minimums. Explained one distribution company executive: *"What are you really making on a $12 case of Gatorade? We've separated out our beverages from grocery and have a higher up-charge. And if we have a really cheap order, under $5 a case, we add 50 cents to it. Don't be scared and try to hide the 50 cents. Be a man and tell them. It's nothing to be ashamed of. We're supposed to make money—we're in business. And if we're asked to bring in special items for customers, and if turns aren't enough, there's an up-charge for that."*

Another distributor put it like this: *"Beverages? That's under water. It costs $1.50 to move a case and we get 70 cents. We get no help from manufacturers at all. We have to fight them to make that service requirement work for their benefit."*

Low-cost, low-volume items are also difficult for many c-store distributors to profitably carry, although most continue to do so for their customers. Often, distributors complain that single-pick items are profit losers, but few refuse to provide that service even though it often costs more put it in the tote than the margin gained.

One distributor considers this an opportunity to turn lemons into lemonade. He sees single-pick purchases as a challenge to increase sales. *"Shame on us if our expectation is to sell one per delivery cycle. It's like a stand with one hot dog in it. I don't think you'll ever see very sharp retailers just stocking one of anything. But they like the idea of dabbling and testing the water. But if their expectation is one, that doesn't even deserve a test. There are some customers who do only buy by the case. Our job is to serve, and we want to do what our customers want us to do in the way that is best, but you try to gently provide information that will help their decision-making."*

The goal, that distributor explained, is to realize the potential to take the next order to a higher volume, incrementally. *"If I sold five, I need to take it to 10,"* he said. *"If I have these items that showed no consumer interest, I need to replace them with others. That's the sort of service that is instrumental to success for retailers that is not valued very highly, but it does have value."*

PRICE DISCRIMINATION

Many distributors complain that too many of their customers can buy items that they need for their store inventory cheaper at club stores than even they, the distributor, can obtain them from their suppliers. The result, of course, is that business is lost to companies such as Sam's and Costco, even though they carry only a small percentage of the products needed by the convenience store operator.

The situation is viewed as price discrimination, if not in the legal sense, certainly in a practical one. However, some manufacturers counter that anyone—c-store distributors included—can obtain the same prices that clubs receive if they purchase sufficient volume. They also point out that some club store operators price their goods against a low profit margin because of their volume, and thus can offer low prices.

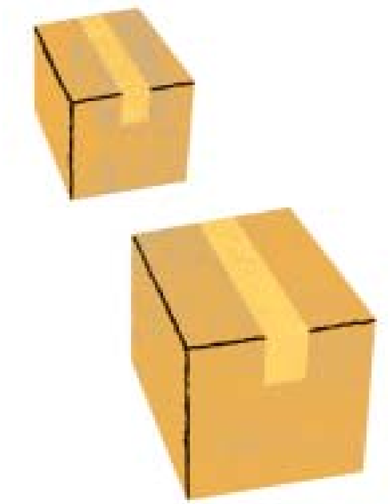
Declared one mid-sized distributor: *"It's discrimination against our class of trade. We have customers who can buy cheaper from the clubs than what we can acquire it from the manufacturer. But, of course, we handle the full line of products for them [the manufacturer], not just a few. That to me is the ultimate area where we are significantly hurt by the people who should be supporting us in getting the product out to their customers."*

Large manufacturers have varying policies, but some point out that they offer bracket pricing for volume purchases and that they are not interested in serving retailers whose volume is so small that they buy from club stores rather than from the distributor.

The issue arises frequently with regard to foodservice items, an area of convenience store growth and one that is seen by many distributors as an area of significant profit opportunity.

Distributors also contend that some manufacturers offer specific sizes or products to club stores that would sell well in convenience stores, but are not available to them. Once again, they consider this to be a discriminatory practice that hurts their bottom line, even as manufacturers acknowledge that distributors are their most important conduits into the convenience store channel of trade.

Commented a mid-sized distributor: *"Some manufacturers don't recognize who we are in the industry, and so we have to compete against both Sam's Club or a company like Sysco, depending on the customer. In the manufacturer's eye, we're a wholesaler, not a foodservice distributor, so we're not getting those allowances. The market has really blurred. Often times, they say, 'You just do convenience stores, you're not a foodservice supplier.'"*



"It's discrimination against our class of trade. We have customers who can buy cheaper from the clubs than what we can acquire it from the manufacturer."

Conclusion

“There is a tremendous amount of efficiency in a complex channel. Distributors enable us to get our products on the shelf when we need them there. We couldn’t do it without them.”

Convenience store distributors are faced with tight margins that typically allow little freedom for investment and building for the future. However, many of these companies have aggressive and dynamic leadership and are determined to find ways of thriving and continuing to grow and serve their customers. In fact, they are so bullish on the future that they are seeking ways to expand, whether organically or through acquisition. Bottom line, they are committed to long-term success.

Distributors believe there are problems to be overcome, but many believe relationships with suppliers and customers are improving and can be further improved.

As companies become better educated about the costs associated with specific product types, categories, customers and services, distributors hope that competition will be rational and based on the value of services provided. They also hope that manufacturers and retailers will appreciate the value that distributors bring to *their* companies and recognize that for them to continue, they must be able to turn a fair profit.

As distributors continue to provide increasingly sophisticated value-added services to help improve the efficiency, performance and profit of their customers, they believe sales will increase, translating to higher returns for every trading partner in the supply chain.

Manufacturers say they understand the distributor’s profit and ROA predicament and are anxious to help, within the constraints of their own business paradigms. Ultimately, they know that the c-store distributor is an invaluable partner in their effort to penetrate the convenience store channel.

For as one major supplier commented: *“There is a tremendous amount of efficiency in a complex channel. Distributors enable us to get our products on the shelf when we need them there. We couldn’t do it without them.”*

During the course of this study, one convenience store operator made this comment about his distributor: *“We have an excellent relationship with them. We’ve asked them to do a lot of things for us, and they always come through.”*

That basic statement is the foundation upon which success for the future must be built, not upon the never-ending downward spiral of price competition.

Needed Changes in Manufacturer Practices

There is much manufacturers can do to ensure that distribution of their product into the c-store channel is preserved.

There is room for improvement with regard to communication, coordination and execution of new products. Exit strategies for poor performers are needed, and manufacturers should accept the responsibility of developing them and communicating them to their distributors.

If there are pricing practices that put distributors at a disadvantage against other channels, they need to be recognized and remedied. If there are misunderstandings regarding this issue, they need to be candidly addressed by both parties.

A major manufacturer made this point that every supplier should consider: *“We depend on the distribution network to get our products to the marketplace. We need to understand their profits, and* *we have to look at what it might look like without distributors. That has to open up lines of communications, bringing in the retailer. And people have to understand that they can't keep killing each other with these low margins."*

What supplier procedures or policies would distributors like to see changed? What modifications would help them achieve a more reasonable profit and ROA?

- **Cigarette issues.** Distributors are not pleased with many of the requirements and policies imposed by the major cigarette brand manufacturers, such as advance payment requirements, a no-return policy and share-based programs.

- **SKU proliferation.** Rein in proliferating product lines. Manufacturers agree this is a problem, and major brand executives say their firms are aggressively assessing their product mix and are reducing SKUs significantly. Nevertheless, SKU rationalization on the part of manufacturers would help distributors improve efficiency and reduce their costs.

- **New products.** While new products are recognized as the "lifeblood" of the industry, distributors want suppliers to establish clear exit strategies for non-performers as they are replaced by new offerings.

- **Class-of-trade discrimination.** Manufacturers should provide equitable pricing that acknowledges the value of the broad product mix offered by distributors, rather than placing distributors at a competitive disadvantage vs. club stores.

- **Use of information.** Manufacturers should recognize the value of purchasing data provided by distributors and use it to increase sales for the benefit of all trading partners.

- **Promotions.** Manufacturers should improve follow-through and coordination to make certain promoted product is available when and where it is needed.

Bottom line, distributors believe that manufacturers should help, not hinder, the very trading partners that are critical to their success in a channel that would otherwise be very difficult for them to reach. Policies and terms should be established with that understanding clearly in mind.

Retailers' Role

Certainly, there may be short-term advantage to the tactic of pitting one distributor against another for the purpose of beating down pricing. But that is not the path that will lead a strong partnership, mutual respect and understanding, and ultimately, successful businesses.

A distributor put it like this: *"It is not recognized as well as it should be that our role is so joined at the hip. When the retailer wants a product, there is nothing we want to do more than to provide it so we can enjoy the sales. There is a huge amount of symbiotic relationships among the supply chain. Manufacturers want to sell, distributors want to sell, and retailers want to sell. Somehow, there is often an adversarial rather than a collaborative approach. In our discussion with many retailers, there seems to be a little confusion and finger pointing, when it is a question of all three parties working together so we can all make more money."*

"Manufacturers want to sell, distributors want to sell, and retailers want to sell. Somehow, there is often an adversarial rather than a collaborative approach."

Thus, when retailers enter into a relationship with a distributor, they should take advantage of the value-added services that are offered, including those involving technology, and recognize the contribution that these services make to their ultimate success.

Retailers should recognize the value of the distributor's ability to meet their overall product needs and not give into the temptation to cherry pick specific items at the club store because they can save a few pennies.

That is not the way to encourage a positive long-term relationship that can pay much bigger dividends in the future.

Retailers should recognize the value of the distributor's relationship with major suppliers—companies from which they may not be able to command individual attention, but with whom their distributor can work to resolve problems on their behalf.

There should be no underestimation of the value of sound business relationships in this channel. With manufacturers, distributors and retailers working together as a team, difficult issues can be overcome and success can be achieved.

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