

**Proprietary Product Lines and Their Benefits to Distributors**

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**Distributors Build Brand Awareness for Manufacturers**

Distribution can be defined as the marketing and merchandising of another company's products. Manufacturers consider distribution to be a key component of their marketing and sales strategies because distributors help create brand awareness through the sale of manufacturers' product lines to retailers and consumers. The difficulty for distributors is that they have limited rights and control over manufacturers' product lines or brands even after the distributors have helped to create retail and consumer demand.

**An Overview of the Standard Distribution Agreement**

Manufacturers' distribution agreements are a unilateral partnership that is controlled by the manufacturer and provides the distributor with limited rights related to product lines and brands. Distribution agreements often focus on what the distributor is required to do to be allowed to continue distributing the manufacturer's product lines and brands. Distribution agreements usually have a fixed term from one to five years. Distribution agreements generally contain various clauses, covenants, and criteria to measure the distributor's performance. Distribution performance clauses can relate to, but are not limited to, sales quotas, exclusive sales areas, and marketing support by the distributor for carrying the manufacturer's product lines and brands. Distribution agreements with exclusive sales areas may require the distributor to sell only the manufacturer's product lines and brands. Also, distribution agreements provide the distributor with limited rights and recourse against the manufacturer when they discontinue product lines or brands. Distribution agreements may have clauses related to the renewal of the agreement and the ability to assign the agreement to a third party. Control over the ability to be able to assign a distribution agreement means that when the distributor wants to sell its business to a third party, the manufacturer has direct influence over to whom the distributor can sell the business. The result of all this: The distributor ends up working for the manufacturer to help market and merchandise the manufacturer's products, while assuming most of the business risks, and while having limited control over the manufacturer's product lines and brands.

### **Reasons Manufacturers Cancel Distribution Agreements**

Manufacturers cancel distribution agreements with distributors for various reasons, including, but not limited to, lack of sales performance, poor customer service, distributor financial instability, sales channel conflicts, and a desire on the part of the manufacturer to improve gross margins. One of the most common reasons for the cancellation of a distribution agreement is lack of sales performance by the distributor. Remember, manufacturers use distributors to help market, sell, and support their product lines and brands. Questionable customer service, real or perceived, is another reason why manufacturers pull product lines and brands from distributors. The financial stability of the distributor is of key importance to the manufacturer. The manufacturer needs to be confident that they will be paid, and that their product lines and brands will always be available through distribution sales channels.

Manufacturers also cancel agreements because of sales channel conflicts between the manufacturer's customers and the distributor's customers. Sales channel conflicts generally revolve around the distributor offering steeper discounts to their customers than the manufacturer does to its customers.

Astonishingly, when a distributor is selling high volumes of a manufacturer's product lines and brands, the manufacturer often determines that it is in its best interest to start selling directly to the distributor's customers in an effort to increase the manufacturer's gross margins and bottom line. When a high volume manufacturer's proprietary product lines or brands are pulled from a distributor, it can be financially devastating to the distributor. The distributor has most likely scaled their business operations, employee levels, and business finances to accommodate the added sales volume and profit produced by the manufacturer's proprietary product lines and brands. Though some of a distributor's costs may be variable and can be reduced quickly, such as employee levels and marketing expenses, these types of cost reduction are always disruptive to business operations. Additionally, there are frequently fixed costs that cannot be reduced quickly, such as warehouse and other facility expenses, and the cost of capital equipment leased or purchased to support the higher sales volumes. When distribution agreements are cancelled for exceeding performance goals, distributors are painfully reminded of the substantial risks and limited control inherent in the standard distribution model.

### **The Standard Distribution Model**

The standard distribution model is a low profit margin model, and therefore contains a fundamentally high level of financial risk. This financial risk manifests itself in a couple of ways. First, the distributor has financial exposure relating to product margins when the manufacturer increases the cost of the products to the distributor. The distributor may be unable to pass on all, or even a portion, of such cost increases to its customers. Second, competitive pricing pressures can have a negative effect on the distributor's gross product margins. Pricing pressures can increase when other distributors selling the same product line cut their prices in an effort to increase market share, or when competitors' product lines compete on price in the market. New product lines or brands may also enter the market causing additional competitive pricing pressures.

The standard distribution model is financially risky for several other reasons as well. First, the distributor does not control the rights to the manufactured product lines and brands. This lack of ownership rights leaves the distributor with no power to effectively control the manufacturer's product line and branding strategies. Second, the distributor assumes a host of ancillary product liability risks including customer returns, spoilage, slow moving inventory, and obsolescence resulting from such things as product packaging, formula, or technology changes. Third, the distributor also carries the risk that new government regulations may affect sales volumes and cause additional returns. Finally, the standard distribution model has a long cash flow cycle that starts when the distributor buys and pays for products from the manufacturer and ends when the final customer pays the distributor for the purchased products.

### **A Modified Distribution Model**

Distributors seeking to limit their risk can use a modified distribution model, based on the standard distribution model, but with proprietary product lines and brands owned by the distributor. In such a model the distributor's propriety product lines and brands have a lower cost of goods resulting in higher gross margins. This model is a lower risk because the distributor owns the proprietary product lines and brands. Ownership of the product lines and brands provides the distributor with direct control of the sales channel, product quality, and brand image. Control over proprietary product lines and brands also allows for increased control over gross margin by allowing the distributor to more easily pass price increases on to its customers. Distributors with proprietary product lines and brands also have improved inventory management through better control of product obsolescence due to packaging, formula, or technology changes. In general, distributors that have developed their own proprietary product lines and brands can react more quickly to market needs and changes. The cash requirement for starting a proprietary product line and brand, including creating packaging and paying in advance for large initial production runs, can use a large portion of a company's cash resources. The start-up cost of a proprietary product line can be equated to the cash requirements that a distributor has when they start carrying new manufacturer's product line and make their initial stocking purchases. While the upfront costs may be greater, the distributor with its own proprietary product lines and brands will, over time, have a stronger cash flow cycle due to better gross margins on their proprietary products.

### **How Proprietary Product Lines and Brands Help a Distributor**

Proprietary product lines and brands provide a distributor with complete ownership and control over their product lines and brands. The distributor controls the product's price, quality, branding, and image. With proprietary product lines and brands the distributor's sales and marketing strategies are developed specifically to build brand awareness for its own products. Proprietary product lines and brands provide increased gross margins and improved profitability for the distributor. Distributors are able to utilize their established sales and marketing channels with limited additional effort and expense to sell their proprietary products to new and existing customers. Leveraging existing sales personnel, catalogs, websites, and advertising to support proprietary products and brands helps cover fixed and variable overhead costs, which improves profitability. In addition, the distributor with specialized proprietary product lines and brands is more insulated from the competition. As the distributor is the sole source for the specialized products, which other distributors cannot provide, the distributor is allowed the opportunity to sell its commodity products to the customer too. The distributor that has proprietary product lines and brands realizes higher gross margins, higher pretax net operating income, and ultimately, a higher value for the business.

### **Proprietary Product Lines Increase the Value of a Distribution Business**

Proprietary product lines and brands add great value to distribution businesses. The ownership of the proprietary product lines and brands provides enhanced control of the distributor's customer base. Proprietary product lines and brands provide a distribution business with increased gross margin, profitability and improved cash flow over time. The superior financial characteristics of proprietary product lines and brands positively impacts cash, accounts receivable, inventory, and debt on the balance sheet. This in turn provides the company with better liquidity. The combination of all these benefits directly increases the valuation and sales price of a distribution company.

If you would like to learn more about how to create and manage proprietary product lines and brands that will increase the value of your distribution business.

The Siburg Company, LLC is a boutique consulting firm specializing in the areas of financial and operational consulting, business development, and mergers and acquisitions.

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Dan is the Managing Director of The Siburg Company, LLC and has experience as both a President and Chief Financial Officer. He provides mergers and acquisitions services to clients. The Siburg Company, LLC helped companies to improve operational functions and organization to manage costs and increase revenue streams, while implementing strategic policies and procedures that focus companies on profitability. He is a CVA (certified valuation analyst) as well as a CPA.

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