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Why Are Wholesalers Protecting High Returns?

Profit margins and returns on capital are important, but growth is the most important driver of shareholder value in the wholesale industry.

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As the Internet emerged and e-commerce took off during the 1990s, futurists foresaw the evolution of a more direct connection between those who make things and those who buy them. It became quite trendy to envisage a new economic order in which the middlemen of supply chains would no longer take their cuts and ultimately be replaced by technology.

Fast forward to 2012. Technology certainly has dramatically changed the product distribution process. But we still have the wholesalers: companies that act as intermediaries between producers and consumers. And they are generally performing quite well.

In fact, for the last 12 months, the largest 65 wholesalers produced over $700 billion in revenue and earned $26.7 billion of earnings before interest, tax, depreciation and amortization (EBITDA). From 2009 through 2011, the median industry participant delivered a total shareholder return (TSR) of 98%, about twice that of the S&P 500. (TSR is the sum of dividends and share-price appreciation.)

Wholesalers operate in a range of industries, including health care, food, manufacturing, and construction. These companies add value to their customers by aggregating products into a single purchasing experience. They also provide value-added knowledge and service to increase the efficiency and effectiveness for the buyer.

This is a high-volume low-margin business. The median wholesaler's EBITDA margin over the last three years was just 6%, which pales in comparison to the median S&P 500 industrial company figure of 21%. To earn attractive returns on capital,

wholesalers must generate substantial revenue with each dollar invested in their asset bases.

Over the last three years, the median wholesale company has generated enough volume to earn a respectable, but not outstanding, 9.3% return on capital. (ROC is defined as net operating profit after tax [NOPAT] divided by average capital. Capital is defined as debt + equity + minority interest.)

Given such thin margins and moderate return on capital, which strategies have created the most value for shareholders? It's no surprise that the companies that grow faster, expand margins, and improve their return on capital deliver higher TSR than their peers.

But what should management do when it faces hard choices about the trade-off among those key value drivers? Is it best to accelerate growth at the expense of margins and/or return on capital? Or should they focus solely on cost and efficiency gains?

Grouping companies based on their compound annual sales growth rates over the last three years shows that the fastest growing wholesalers created significantly more value for shareholders than the companies that grew more slowly. The fastest growing companies delivered annualized sales growth of 10.6% and total shareholder return of 136%.

In comparison, the companies in the middle group grew at 3.8% and delivered TSR of 76%. The slowest growing companies saw revenue fall by a median of 1% and realized only 60% total shareholder returns as a result.

A closer look at the companies that delivered the fastest top-line growth shows that these companies also earned attractive and improving levels of efficiency. The fastest growing group earned a median return on capital of 9.9% and improved return on capital over the last three years by a median of 80 basis points. EBITDA margins improved by a median of 10 basis points. Top-line growth seems to drive bottom-line efficiency, perhaps because economies of scale help to absorb fixed costs.

The improvement in efficiency of the fastest growing group, to be sure, was less than that delivered by the middle-growth group. The latter delivered higher return on capital (12.6%), greater improvement in return on capital of (90 basis points), and

greater expansion of EBITDA margins (40 basis points) than the fastest growing companies over the last three years.

Nevertheless, the stronger efficiency gains from companies that did not grow as fast were not sufficient to create superior value for shareholders. It would appear that investors understand that growth requires investments – either in capital or in costs – and within a reasonable level, are willing to allow a slower pace of efficiency gains than other companies in exchange for growth. This is a trade-off that often needs to be made, and our findings seem to suggest that a relentless focus on efficiency may be insufficient to maximize value.

Perhaps our most important insight is that many of the higher return-on-capital wholesalers may be missing a significant opportunity to maximize value creation for shareholders by not investing enough in future growth. For such companies, their higher returns on capital are often a result of some competitive advantage, and they may have an opportunity to invest more of their capital than they are currently doing. Too often we hear the argument that investment follows growth, but we believe that managers can take an action – i.e. invest – to spur growth more often.

When we group the companies based on the last three-year return on capital, we find that the median return on capital in the highest group is nearly 500 basis points higher (14.0% vs. 9.3%) than the middle group. Despite much higher efficiency, however, the highest return on capital group earns slightly lower TSR, at 104%, versus 110% for the middle return-on-capital group.

That lower TSR may be explained by the fact that companies with the highest return on capital invest less of their cash earnings, or EBITDA less taxes, back into the business than the median wholesaler. Their reinvestment rate, or the percentage of cash earnings invested in capital expenditures, acquisitions, and working capital, was only 39% over the last three years, compared to the overall median of 57% for all wholesalers.

In the near term, investments in capex and R&D often lower the measured ROC because the payback is frequently realized over longer periods. So companies that are overly fixated on improving ROC will tend to defer such investments for fear of diluting near-term returns. (Long-term, the investments do tend to drive future ROC.)

To maximize value for shareholders, it's not only the level of ROC but also the ability to reinvest and grow the business which creates a sustainable value-creation model.

Such a model implies a trade-off between investments in high ROC and in growth. When a company has high returns, taking a portion of the cash and reinvesting it in the high-return business creates more value for investors than simply returning the cash generated.

But reinvestment involves risk and involves potentially diluting near-term ROC, which some companies have a tendency to try to avoid. We often find that high ROC often becomes a barrier to investment for many companies. That's because they keep using current returns as the implicit benchmark for evaluating new opportunities.

What did the wholesalers with highest return on capital do with the cash flow that they weren't investing back into the business? Among other things, these highest ROC companies returned just over 13% of their cash earnings to investors through dividends and share repurchases. In comparison, the median company returned 8%. Was that the best use of capital for the companies with the highest returns in the industry?

For executives in the wholesale industry, our findings make clear that a renewed focus on investing in growth may be warranted in order to continue driving value for shareholders.

In fact, for those companies with competitive advantages and above-average return on capital, finding ways to proactively invest in the business to fund growth will often be the right choice for value maximization over the long-term.

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