



BARRY E COYLE

**DEALER ECONOMICS
& BEST PRACTICES**

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Introduction

Traditionally, a contract furniture dealer has been viewed as a sales entity, functioning as a classic point-of-sale organization in the marketplace. This may simplify the business of a dealer too much. A dealership today has a number of economic complexities that must be understood and managed to ensure success in the marketplace. With major corporations expecting every day deep discounts, with product being more commodity-like, and with services being touted as the new frontier for growth and margin, the dealership heading into the next century has much to consider in the financial management of their business.

This paper will attempt to describe the dealership as a relatively sophisticated financial entity, with a number of business and economic complexities that must be managed to ensure financial success.

Definition of a Dealership

A contract furniture dealer is a non-stocking, value-added, re-seller of interior furniture for a predominantly commercial office marketplace. The fact that it is a non-stocking re-seller differentiates it immediately from a classic retail sales operation. Additionally, the value-added concept means the dealer provides essential 'product' of it's own to go along with the goods it resells.

The 'product' of a dealership consists of the complex tasks and processes required to implement a contract furniture sale. Originally, implementing a sale was a fairly simple act and the dealer really did function as a local point-of-sale operation. Today, the wide spread acceptance of systems furniture combined with the increased standard of performance expected by clients has changed the nature of the value-added services provided by dealerships.

Systems/modular furniture has been a major contributor to the complexity of today's marketplace. A furniture manufacturer today has multiple lines, each with thousands of part/finish/fabric/option combinations. A single project can easily contain 3,000 to 30,000 individual parts. A dealership's clients expect 100% precision for the layout, ordering, receipt and assembly of those parts - with each part being application specific and requiring sequential assembly; placed to the inch and assembled within a fixed, immovable building; interconnected to the building's electrical/telecommunications services; all accomplished within a specific 'window' of a pre-set schedule; and coordinated with numerous other project parties, none of whom the dealership has authority over. To achieve all this requires not only contract furniture industry knowledge, but also sophisticated understanding of interior construction, architecture/interior design practice, building codes, electricity, data and voice cabling, project planning and control, logistics, etc.

It must be remembered that from a client's point of view they are purchasing assembled workstations, not truck loads of boxed parts that the manufacturer's ship. To purchase assembled workstations a client must also purchase:

Complex order preparation		Installation
Extensive order management	Factory interface	Project/technical management

These added-value services, by definition, are as much a part of the 'product' as the physical product pieces themselves. Given the complexity required today to perform those services, the function of a dealership has changed from being a fairly simple transaction processing organization to one that performs elaborate, and essential, value-added tasks.

This does not mean that the dealership no longer has a sales function. Rather it operates as a local point-of-sale entity for product lines that require value-added services to give the product full worth to the end user. Thus, the sales margin has changed from being the 'prize' of the past to being an attached 'fee' to

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cover the costs of those services. The dealership today is a hybrid sales/service organization and as a result the economics are much more complex than has traditionally been understood.

In addition to product sales, customers today have sophisticated expectations for servicing of their installed base. Dealerships have to be experts in producing and delivering competitive services, both as stand-alone sales to customers as well as part of furniture product/service packages. No longer can services be treated as just an adjunct to product.

To understand the economics of dealership, first must come an appreciation of how a dealer operates in today's marketplace. Three issues that impact the financial view of a dealer are:

- The dealership as a service organization
- The concept of workload management in a capacity constrained environment
- The customized nature of the dealer's sales and sale implementation

A Service Organization

As a non-stocking, value-added re-seller a dealership is a really a labor intensive organization where the cost of goods sold is more of a financing issue than an economic/operational one. The cost of goods sold is really a “pass-through” expense, where the dealership doesn't control the manufacturing cost of that product, only the margin on the sell (which is really the income of the dealership). A dealership does have direct control over their operational costs, though, and this becomes the dealership's real expenses.

Viewed this way, a dealer's expenditures are similar to other service organizations such as accounting firms, architectural firms, law businesses, etc. Labor, and labor related expenses, make up nearly 65% of total expenditures when the cost of physical goods are eliminated (the “pass-thru” product). The remaining 35% of total expenditures covers standard business operating costs - occupancy costs, communications, office equipment and supplies, insurance, etc. There is little significant capital investment and little or no purchased inputs (as would be found in a manufacturer for instance).

Labor is a dealer's major resource (and cost) and the key to dealer economics/operations is labor productivity. Whether it is getting the most volume from the sales staff or providing the required services to process a sale with the least staff, the more productive the dealer's personnel the more effective the operations. In many ways, running a dealership is a process of managing time (labor hours) against the tasks required for each sale.

Capacity Constraint & Workload Management

Another important fact about a dealership is that it is a capacity constrained business. Resources are relatively fixed (most labor is salaried and overhead is relatively fixed at any given size) so demand is the main variable in the day-to-day management of the business. Capacity is constrained to what the given labor and overhead can accommodate, with little ability for the dealership to add or shrink staff quickly.

If workload (from sales) allows for efficient utilization of the fixed staffing, then a dealership has a good chance of being in a profitable situation. If workload is light, and capacity is under-utilized, then there is a good chance the dealership is not functioning in the profit zone. On the other hand, if workload is heavy, the dealership staff will be stretched and the quality of work may suffer.

The ability to keep workload at a level that keeps capacity at a productive level is an important key to maintaining a profitable dealership. Today, most dealerships operate very lean, stretching their staff in peak workload periods, as the best way to ensure productivity and profit.

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Staying lean means a low core expense, a strong indicator of dealership profitability. Another factor in managing workload with a lean organization is the flexibility of the staff and the organizational structure—flexibility that comes from experienced, skilled labor that can accommodate changing workloads throughout the year, month, or week.

Managing demand is more than just steady sales, as types of business and different clients produce different workload demands. For instance, large projects are very productive for a dealership, but carry peaks of workload that can stretch the staff. Day-to-day business, on the other hand, is more workload steady, but decidedly less profitable. With margins varying $\pm 50\%$ (on a list point basis) from one sale to the next, workload to income (margin) can be a very complex management issue.

Value-Added Cost Management

Since sales margin is no longer the "prize" of the past, but a fee for services that has an associated cost, a key economic problem of a dealership is the management of those costs against their margin revenue. A classic point-of-sale operation is transaction oriented, a more or less standardized set of processes with a consistent relationship to sales volume. Today's contract furniture dealer, though, must account for the varied tasks and sale parameters surrounding each of its transactions.

Even with automated CAD/specification packages and automated business systems (Cadre, Hedberg, Team Design, ProSoft, etc.), few sales pass through a dealership routinely. Almost every sale requires some "contract furniture management," industry specific knowledge and skill that is not built into the internal transactional processes that a sale goes through from point of sale to customer sign-off.

Systems furniture has been the cause of much of this complexity, but the nature of a dealership's business is also an issue. A manufacturer has strong control over their manufacturing process—they manufacture their product in factories where the conditions are known and consistent—and produce products that are relatively standardized (the biggest complexities of furniture manufacturers come from multiple finishes and fabrics, although option choices do add to the problem). A dealership, though, sells a very custom product that is uniquely manufactured at the client's site, where the dealer rarely controls the site or project conditions. This means that few dealership sales happen automatically.

This issue of sales implementation is at the heart of the dealer performance effectiveness, with every dealer looking for a solution that combines the efficiency of transactional business with the necessary oversight that a contract furniture sale requires. In essence, no matter how much automation can be brought to the dealership, there will always be a necessity for highly experienced, trained and skilled employees to ensure sales are made and implemented effectively.

It is this attempt to strike a balance for structured work (which can be routine and highly productive) against the need for unstructured qualitative judgment and knowledge that causes much of the organizational diversity within different dealerships. How many project managers, what role the sales staff is responsible for in the implementation of sales, how strong the customer service group, and how many designers are needed to support the sales and sale implementation—all are issues of balancing routine, standardized processing of orders with the need for skilled personnel to oversee the job-shop uniqueness of so much of the dealership's work. This is even more true as dealers get deeper into the service business, where labor and labor management require sophisticated oversight.

Labor is a dealership's capital, and a dealership must invest in hiring the best personnel or in developing skilled staff on their own. The most successful dealerships have the most productive personnel, and not necessarily the lowest average wages per staff member.

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Core Expenses

As the physical product is not stocked, but acquired after the customer signs a sales order, that part of the dealership's sales can be viewed as pass-through cost to the customer. What really drives a dealership then is the operating expense and its relation to the value-added margin that is associated with the product or service sales. If that operating cost is less than the margin then the dealership makes money. If not, then the dealership will show a loss or breakeven.

Today, delivery and installation need to be seen as part of the service products that a dealership provides, services which have a cost, sale and margin just like the physical furniture product. Services have a unique margin contribution to the dealership, and as a "product" either produced internally by the dealership or by a local service vendor, require more attention to cost management than the standardized products purchased from the furniture manufacturers. This view also considers that a higher delivery and installation cost may be the result of selling more services, not the result of an inefficient service operation (which if treated as an operating cost, it may be seen as).

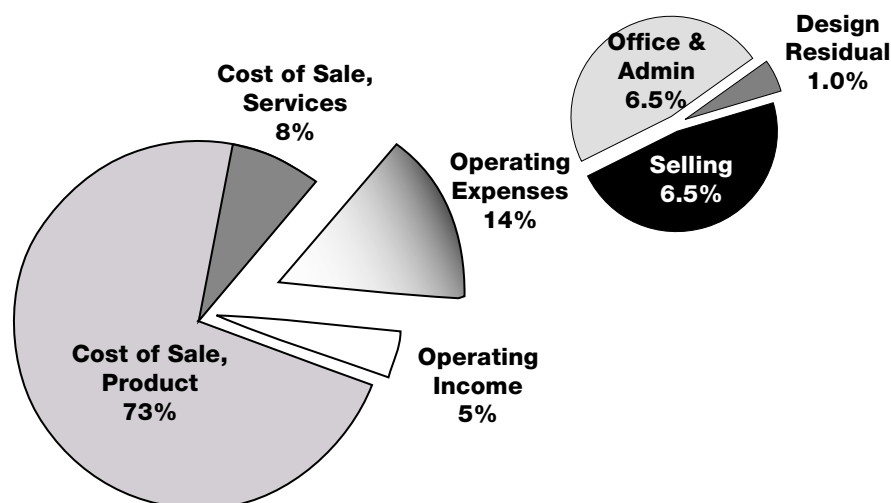
In the past (and still occurring today), many dealerships treated delivery and installation services as part of the general operating expense. This doesn't isolate the separate margin contribution of services, but blends it with the product margin. Even now, dealerships often show delivery and installation costs as both Cost of Sale expenses and general operating expenses. This comes from allocating a nominal internal cost for those in-house services to the cost of sale which doesn't fully account for the entire expense of delivery and installation, or design. So, some cost still remains in operations, some in cost of sale, a confusing duplicity when trying to manage the entire cost of a service.

If we move services out of operating cost to become part of the cost of sale, we now have two parts to the cost of sale:

- Cost of Sales, Product
- Cost of Sales, Service

Our operating cost now consists of only:

- Selling expenses
- Office and administration expenses, include office occupancy
- Design residual expenses (the cost remaining after a cost of sold design is excluded)



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Core Expenses

The core expense of a dealership then consists of:

- Office Expense
- Selling Expense
- Residual Design Expense

Office expense includes all office and administrative personnel, including owner/officers. Computer expenses and office occupancy are also part of this expense category, along with the traditional and expected expenses (professional services, office supplies, office equipment, insurance, etc.).

Selling expense includes all sales management, sales staff, account managers, marketing staff, and support staff (sales assistants/project coordinators/customer service, etc.). Order entry, acknowledgment verification and receiving verification may be in selling expenses (part of customer service) or in office expenses (under accounting). Project managers are also included in selling expense if they aren't a sold expense (sold to the customer on a per hour basis or as part of the estimated installation hours).

Residual design expense is the design expenses which are not associated with direct design sales. As an example, if direct design sales are costed at 70% of the selling price (the direct cost of design is 70% of the hourly sell price), then 70% of design sales is a cost of sale and the remainder of design expenses (after that 70% cost of sale is removed to COS) is residual design expense. This accounts for the fact that much of the design expense is a cost of doing business—systems furniture required layout and specification to even be able to quote to a customer.

Non-core expenses include all the costs of sold services, including all delivery and installation (and associated warehousing, inventory, and asset management services), as well as the portion of design and project management services that are sold (typically hourly) to customers.

Low core expenses are more indicative of a strong profit (an operating income of 4%-7%, for instance) than a high core margin. Typical low core expenses would be in the range of 12%-15% of sales with core margins of 18%-22%. Different dealer scenarios would look like this (all percentages are per total sales):

	A Successful Dlr	A Less Successful Dlr	A Low Margin Dlr
Selling Expenses	6.5%	8.5%	5.5%
Office & Admin Expenses	6.5%	9.5%	4.5%
Design Residual	<u>1.0%</u>	<u>1.0%</u>	<u>1.0%</u>
Total Core Expenses	14.0%	19.0%	11.0%
Margin	19.0%	19.0%	15.0%
Less Core Expenses	<u>-14.0%</u>	<u>-19.0%</u>	<u>-11.0%</u>
Operating Income	5.0%	0.0%	4.0%

Successful dealers typically have core expenses of 12%-15% with margins of 18%-21%. Less successful dealers have higher core expenses in the range of 17%-19% with margins of 17%-19% as well. Another picture is the dealer working with low product margins (near single digit) where the margin might be 15% and the core expense 11% for an operating income of 4%.

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Service Margin Contribution

Services are an essential part of the dealership margin make up. Services can provide up to 30%-33% margin versus a typical product margin (when delivery and installation is unbundled) of 16%-18%. To achieve 30%-33% service margins a dealership must seriously manage:

- Service costs and overhead
- Service labor efficiency
- Service marketing & sales

Assuming a dealer starts with product sales equaling 90% of total sales, with a margin of 18% with service sales making up the remaining 10% at a margin of 30% then as service volume increases the following occurs:

	<u>Services @ 10%</u> <u>Products @ 90%</u>	<u>Services @ 15%</u> <u>Products @ 85%</u>	<u>Services @ 20%</u> <u>Products @ 80%</u>
Pts to bottom line, service	0.8%	2.6%	4.6%
Pts to bottom line, product	4.2%	4.2%	4.2%
Total bottom line	5.0%	6.8%	8.8%
Service's contribution to the bottom line:	16%	38%	52%

A dealership where product margins average only 13% show an even more dramatic result from service margins:

	<u>Services @ 10%</u> <u>Products @ 90%</u>	<u>Services @ 15%</u> <u>Products @ 85%</u>	<u>Services @ 20%</u> <u>Products @ 80%</u>
Pts to bottom line, service	1.0%	2.8%	4.8%
Pts to bottom line, product	3.7%	3.7%	3.7%
Total bottom line	4.7%	6.5%	8.5%
Service's contribution to the bottom line:	21%	43%	56%

Achieving 30%-33% service margins requires strong management of service operations and aggressive marketing and selling of services for volume.

A dealership can match service costs of independent service businesses, even with the dealership's extra costs for benefits and sometimes higher wages. A key to cost management is volume, so that service overhead (not dealer core expenses) are distributed over a large number of service hours. This is one of the most effective ways to lower service cost. Good volume, combined with a service business run as a profit center, will provide costs that are very favorable to the dealership (often more favorable than from a subcontractor). A dealership selling installation labor for \$36 per hour can have a service cost, fully loaded, of \$24-\$25 per

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hour. Similarly, a dealership in the south selling labor for \$27.50 per hour can have service costs of \$19-\$20 per hour. Design services at \$50-\$55 per hour can also produce service margins of 30%-33% (so can project management at the same or slightly lower sell).

In summary, it is feasible to produce and sell services for margins that will average in the 30%-33% range, and if service volume can get into the 15%-20%+ range of sales, the impact on the dealer's bottom line will be significant. With products functioning more and more as commodities, services are the one area left for the dealer to pick up higher margins.

Five Key Operational Issues

There are five key operational issues that contribute heavily to the financial success of any dealership in today's market and economy:

Workload Management/Sustained Sales

Service Margin Exploitation

Cash Flow and Management

Low Core Expenses

Staff Productivity

As a capacity constrained organization, a dealership's success is dependent upon a workload that stretches the fixed resources without breaking them. To achieve this a dealership must have sustained sales volume, a result of a disciplined sales process, and skilled and experienced sales staff. The more the sales volume can be steady and sustained, the better chance to match workload to a lean staff. With too many ups and downs in sales, the staff will either be under-utilized or overworked to the breaking point.

As sales and workload tends to peak with major projects, the skillful management of workload during those periods is one key to dealer success. Managing sales volume (and the corresponding workload) is the most difficult financial and operational element a dealer has to master.

Product margin is just too lean for a dealership to rely on without the extra boost from service margins. Although some dealers can survive with a decent bottom line on a very low margin, the extra percentage that services allow is often the difference between a very weak bottom line and a strong one. Service margins can be as high as 30%-33% for a dealership, significantly better than the 16%-18% that product brings in. When sold and managed right, services can contribute from 20% to 50% of a dealers total bottom line.

As most dealerships rely on retained earnings for capitalization, strong cash flow and cash management is essential for a dealership. There can be a full point addition to the bottom line between a dealer who has to borrow and pay interest versus one that has the cash flow to take discounts.

There is a strong correlation between a low core expense (selling, office & admin, and residual design expenses) and a dealership's bottom line. This is a reflection of staff productivity, organizational efficiency, and a conservative approach to balancing a capacity constrained organization to an unpredictable workload. Organizational efficiency comes from a work process that is supported by an organizational structure populated by experienced, skilled and effective staff. Work doesn't just flow routinely in a dealership, but requires intelligent oversight by employees who are knowledgeable in contract furniture management.

Finally, staff productivity is a strong factor in dealer financial success. Those dealerships with high sales and high margin per core expense staff show a better bottom line than dealers with lower numbers. Given that a dealership is a labor intensive organization, labor productivity is a key to efficiency and profitability.

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Labor Productivity

Of these five key operational issues, only one—cash flow—isn't directly tied to labor productivity or labor effectiveness. There is no question that the single most important aspect to a dealership's operation is labor productivity. This comes from two areas:

Strong individual skills levels, knowledge and experience

An effective organizational structure that takes advantage of those skill levels to affect the dealership's contract furniture work processes

Labor productivity, though, isn't easy in the contract furniture industry. For a number of reasons the ability to recruit and/or develop productive staff is the most significant challenge a dealership encounters:

- There are no public education programs for the contract furniture industry (designers excepted)
- There are no self-study materials
- There are few, if any, industry training programs (most manufacturer training for dealership, if it exists, is either sales and marketing oriented or so simple to be ineffective)
- Contract furniture management is a localized job, not a national career, so there is little if any sharing of standards of performance or establishment of national criteria for positions or work processes

Not only is skill development very informal and haphazard (most training is OTJ—on the job training, where one learns as one does the work with little if any formal training), but establishing an effective organization structure is just as difficult. There are few, if any, models for a dealership to emulate and those that do exist (typically as part of a manufacturer's dealer development group) assume ill-defined skill sets for positions that may or may not exist with a given dealership's personnel (and can't be taught as there are no training or educational programs for customer service personnel, or account/project managers, or operations management personnel).

Additionally, the dealership's work process isn't necessarily straight forward, but one that supports different approaches for different sales as workload varies, projects come and go, and different internal groups support the customer's requests.

Service Cost of Sale

The concept of core expenses and a core margin means that most services (and particularly delivery and installation) are not part of operations expenses (typical dealer overhead), but are a distinct product with a cost, sell and margin. The key here is to treat service cost of sale as an expense with a supporting sell (and margin) forcing expense management that will ensure a strong service margin. When treated as just an operating cost, service expenses are blended into the overall margin and not given the attention necessary to meet the 30% (or more) margin potential (realized as much from cost management as from high service unit sales).

Inherent Inefficiencies

It is clear that there are certain inherent inefficiencies in the operations of a contract furniture dealership. The revenue obtained on sales won must subsidize these inefficiencies. There are at least three inherent inefficiencies: cost of lost sales, periods of under-capacity for staff workload and unprofitable individual transactions. While none of these three can be eliminated, their implication must be minimized to reduce the subsidy required from won sales.

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The cost of lost sales not only includes the direct and indirect costs supporting the sales personnel themselves, but also the costs of technical sales support required during the marketing process. The cost of under-capacity for staff workload arises from the fact that at a given size each dealership has the capability for a certain workload. This is not always realized because the 'random arrival' of projects/sales produces periods of over, and under, capacity from a staffing standpoint. The third inefficiency stems from the fact that certain individual sales cannot be implemented profitably. Sales of individual pieces of product produce a fixed amount of added-value revenue (although the margin percentage may be similar to other company sales) which is often less than the fixed cost of processing the transaction. In aggregate these sales may have value, but individually they may not be profitable.

Obviously, any effort to minimize these inherent inefficiencies will immediately impact the bottom line. The cost of lost sales could easily consume 5-10% of a dealership's total costs and all three together could constitute 15-25% of total costs, a not insubstantial amount. Efficient management of a contract furniture dealership requires minimizing these inefficiencies. To do this requires detailed cost accounting and activity tracking.