

# Distributor's Impact on Contractor's Profitability

## PART II: THE CONTRACTORS

**T**HE AUGUST 2006 PRODUCTIVITY COLUMN investigated the impact of the changing market facing electrical contractors. With the current and continuing expansion of commercial and residential construction markets, the needs of contractors are dramatically changing.

Electrical distributors provide the essential connection between manufacturers and the owners and specialty contractors. While the position of an electrical distributor has not changed, its role must change from one of distribution to one of supply. Distributors arrange and facilitate the transfer of materials from the factory to the contractor. Suppliers support the customers by responding to their needs. All of these relationships impact an EC's profitability. Let's illustrate with a short story:

*The crew arrives at the job site at 6 a.m., preparing for the day's work. With the toolboxes unlocked, assignments given, coffee procured and donuts eaten, the crew attempts to locate its materials. Crew members find all they need except for the six additional boxes and 20 feet of cable ordered yesterday. The materials will be on the next delivery truck and were promised for first delivery.*

*The first truck of the day arrives. More material arrives but without a pallet jack. One crew stops to help carry it all to the sixth floor.*

*The next truck shows up, a different distributor. The general didn't leave instructions for this truck to have access to a restricted area. The foreman spends 15 minutes trying to locate the project manager (PM). The truck will have to come back tomorrow to try again.*

*Now the project foreman is on the cell phone with the PM trying to track down yet another order. The truck is en route but not expected to arrive until 10. The crew can do nothing but wait.*

*Finally, the truck arrives with 20 feet of cable and five boxes. The sixth box was backordered, but all six are needed. The five are stashed in storage. Maybe the distributor will get more in today, and someone can go pick it up.*

*A return is packed and waiting, ready to be picked up. The driver doesn't have the return authorization paperwork; the crew moves the material back to a safe place to wait until tomorrow.*

*Next comes a third-party shipper with a truck that doesn't fit inside the fence. The*

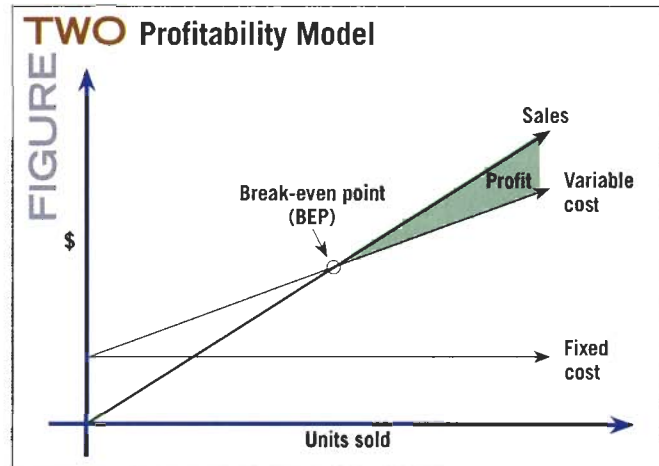
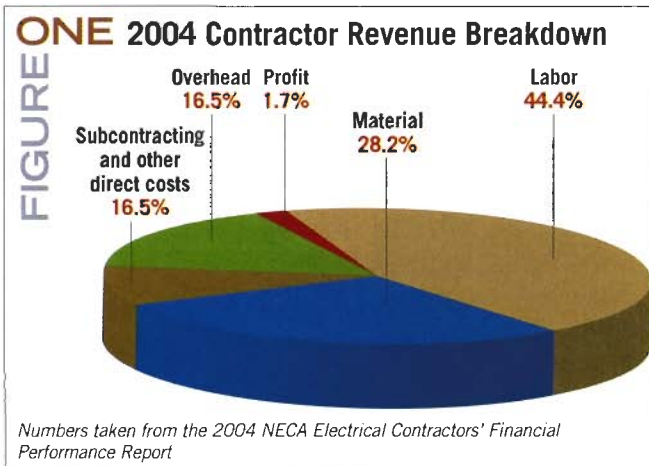
*electricians must unload 400 fixtures, only 50 of which will be installed this week.*

To the contractor, labor matters. Delivery matters. Even though the contractors constantly fight for the lowest price, in reality, price is secondary. Without the lowest prices, and often even with the lowest prices, contractors are unable to recover from the labor losses associated with handling materials instead of installing.

Distribution faces a paradox. This is the result of a shift in the entire electrical construction industry, away from the historical industrial work and toward a growing commercial and residential market. Historically, the industrial market was as good a fit for electrical distributors, with their focus on the manufacturers, as it was for contractors.

Over the past 30 years, the commercial and residential components expanded until now where they make up almost 60 percent of the electrical construction market. As the economy shifted, the needs of each side also shifted. ECs are facing new challenges, and as a result, electrical distributors are being forced to change their operating philosophies in order to meet their customers' needs.

To profitably respond, electrical distributors must understand the needs of



each player in the supply chain, from the manufacturers all the way through to the end-users, beginning with their financial models and cost drivers.

■ **Financial model:** A company's financial model is determined by its cost structure, which is the combination of its fixed and variable costs, profit and revenue bases and cost drivers. Electrical contractors' costs are primarily driven by variable costs. In fact, 85 to 90 percent of the operational costs of any specialty contractor, including electrical contractors, are typically allocated as variable costs, regardless of whether the contractor is a union or an open shop.

■ **Variable costs:** Variable costs are the costs associated with completing a project: labor, materials, rental expenses, etc. Variable costs increase as sales increase because of the costs required to complete a project. For example, an eight-story building with 200 fixtures on each floor requires twice as many fixtures as a four-story building with the same plans. The cost of the fixtures is a variable cost, as is the cost of installing each one.

■ **Fixed costs:** Fixed costs define the costs required to operate. Fixed costs typically remain constant throughout the year and include general and administrative costs, salaries, insurance, property taxes, carrying costs of inventory and other expenses.

■ **Profit:** The relationship between net profit, variable cost and fixed cost is shown in Figure 1. In order to recognize a profit, earned revenues must exceed both the variable costs and fixed costs.

The break-even point (BEP) is the point at which both variable and fixed costs are covered.

Contractors and distributors, just as every other business, achieve top performance by minimizing both their variable and fixed costs through error reduction, process improvement and customer awareness. However, the biggest return in terms of cost reduction comes from targeting the cost drivers, that is, the elements of a particular financial model that have the biggest impact on the end cost of providing any product. According to the National Electrical Contractors Association (NECA), a typical contractor in 2004 saw its revenues broken down as shown in Figure 2.

Profits, the money remaining after all costs are addressed, made up only 3 percent of the typical contractor's revenues in 2001. This dropped to a measly 1.7 percent in 2004. In other words, a \$1 million project returned only \$17,000 in profits to the electrical contractor.

The biggest cost driver for the electrical contractor is its labor, a true variable cost. The longer it takes to install materials, the higher the labor cost. As shown in Figure 3, by targeting its variable costs, a contractor can reduce its overall costs, achieve its break-even point much earlier and recoup the difference as profits.

Electrical contractors earn their money by installing electrical components. Recall from Figure 2 that labor costs typically require 44 percent of the typical contractor's revenues. Any reduction in the cost of labor goes straight to the contractor's bottom line. Industry research has shown that approximately 40 percent of labor's time is spent handling materials instead of installing. The

benefits from supplier services can help the electrical contractor significantly reduce the time currently spent on material handling, allowing this time to be applied instead to productive installation (Figure 4).

With the shift toward commercial and residential work, the needs of contractors are following suit. Commercial work is faster and less specialized, with materials and specs that vary widely from project to project. Contractors need suppliers who can help address the labor costs by providing the right materials in the right quantity, correctly packaged and delivered to the right place at the right time.

Using their labor for any purpose other than installation can turn a job from a potentially profitable, successful project into a money loser, even going so far as to turn it into a killer job that single-handedly wipes away all profits made by every other project in the company. By refocusing customers away from price and onto the labor savings that can be gained by correctly using the supplier to manage the materials, the situation can turn into a win-win for all involved.

However, to profitably make the shift from a distributor to a supplier, electrical distributors need to understand their own financial model as well. In the next article, we will investigate this model and then how the contractor's model and the distributor's model can be effectively used to reduce the costs on both sides. **EC**

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