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ALIGNING CULTURE AND STRATEGY AT A.P. NICHOLS

Ken Mark wrote this case under the supervision of Professors Jeffrey Gandz and Stewart Thornhill solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

"We need to change the way we go to market or risk being left behind by our competitors," said Roger Dufour, chief executive officer (CEO) of A.P. Nichols (Nichols), to John Klein, Nichols' newly hired VP of Sales. Nichols was a large Chicago-based distributor of industrial supplies, such as fasteners, bearings, abrasives and cleaning supplies, which were used by factories for maintenance, repairs and overhaul. It was a sunny day in August 2011, and both men had just finished lunch and were outside Nichols' head office, walking toward one of the warehouses. They had a lot of work ahead of them. "Unless we have more control over our sales funnel, we cannot achieve our goal to become one of the top 10 distributors in the U.S.," Dufour continued. "So we need you to rebuild our sales department to fit our new strategy."

THE MRO (MAINTENANCE, REPAIR, OVERHAUL) SUPPLY INDUSTRY

When factories needed parts to keep the lines running, they often turned to distributors to help them stock up on a variety of parts. Paying a markup of between 5 and 10 per cent for screws, tapes, inks, bushings or bearings was more efficient than trying to purchase them individually from upwards of 10,000 different domestic and international suppliers. Although the industry had thousands of distributors, the top 15 distributors controlled about half of the $60 billion market. Some of the larger distributors carried 500,000 different items in their regular line-up. A medium-sized distributor, such as Nichols, carried about 300,000 different stock keeping units and had 25 different offices around the United States.

Distributors earned a profit by purchasing products in bulk and then selling them via various tiers of sales agents who were their customers' point of contact when products were needed. At Nichols, small and medium-sized customers had the option of ordering by telephone, the Web or by fax. Customers would deal with one of 80 inside sales agents (ISAs) who were situated at one of Nichols' offices. The ISAs spent the majority of their time on the telephone and on email, coordinating the placement and delivery of orders. ISAs were a salaried group, with about 10 per cent of their compensation in the form of a bonus that was based on Nichols' annual results.

The increasing use of information technology in the distribution of industrial supplies had led to consolidation in the industry in the 1990s. Those distributors that had been able to invest in online ordering systems and in inventory management software and infrastructure had grown faster than the others. The availability of capital in the late 1990s had allowed some players to acquire smaller competitors. The top 20 largest distributors had taken a different tack, coupling their technology-enabled systems with significant investments in their sales forces.

For example, instead of requiring a customer's purchasing managers to initiate orders, distributors would assign client service representatives (CSRs) who understood customers' unique needs and sought to ensure that the correct assortment of parts was ordered and delivered. Some of these orders, for instance, could involve 2,000 or more different parts, six or more different delivery addresses and a strict delivery schedule. In addition to taking orders, CSRs were also trained (and compensated) to suggest better combinations of parts or substitute parts, some of which earned higher margins for distributors. CSRs were full-service, independent agents who earned 100 per cent of their targeted compensation as a direct percentage of sales, often 0.50 to 1.00 per cent. CSRs were required to share 50 per cent of these fee revenues with the distributor, to pay for sales infrastructure and support. For example, firms typically employed a CSR supervisor, who was also a CSR, to monitor the performance of up to 10 CSRs. High-performing CSRs could earn $300,000 a year or more, six or seven times the total compensation of a typical ISA.

While the largest distributors had added CSRs to their line-up in the 1990s, Nichols stuck with its technology-focused ordering systems, believing that customers were looking mainly for ease of ordering rather than increased levels of service. However, by 2003, Dufour was seeing his firm's growth rate slow while his rivals were growing at double-digit rates. When a few customers left Nichols for full-service distributors, Dufour started to take action. He hired some veteran CSRs from other organizations and by 2005 had built a team of 25 CSRs.

Nichols' CSR team was still smaller than the CSR teams at its major competitors, which had 50 to 100 CSRs per firm. At the top six firms, CSRs typically generated 60 to 70 per cent of all business despite having at least twice as many ISAs. Because of both the high level of service provided by CSRs and the long-term trend of cost cutting at factories, which had led to smaller purchasing team resources, many customers chose to remain with a particular CSR instead of switching distributors.

Nichols had built up its CSR team "one person at a time" by offering potential CSRs the opportunity to make more money. A typical offer to a potential CSR would include a fixed sign-on bonus for his or her book of business, provided he or she could convert it to Nichols within a reasonable time. Nichols' compensation offer to CSRs allowed them to earn the same 0.50 to 1.00 per cent of revenues in fee revenue but to keep 70 per cent of it. The intent higher revenue split for the CSRs (relative to the industry average of 50 per cent) was to allow CSRs to determine the level of sales support and information technology they needed. For example, many CSRs were on the road or worked from a home office and would self-fund their support and infrastructure needs in these areas.

Some CSRs came to Nichols because of its long-term vision: At Nichols, they were aligned to the business strategy and they played as a team. And while Nichols had a core group of CSRs who were the best in the industry, others joined the company only because of its 70/30 model, which magnified their entrepreneurial nature. While the CSRs acted professionally with respect to any health, safety and legal issues, they believed that the services provided to their clients were to be determined solely by them, how they managed their clients' accounts were to be decided by them, and so on.

THE SITUATION IN 2011

By late 2009, it was clear to Dufour that Nichols was sorely in need of a larger CSR arm to flesh out its corporate goal of becoming one of the larger distributors in the United States. The operations group within Nichols was firing on all cylinders and increasing cost savings by double-digit figures year after year. The ISA teams were becoming more effective at processing orders, leading to a 99 per cent on-time order fill rate, an industry-leading statistic. It was clear to everyone that, with the poor economic situation and the drying up of the capital markets, mergers were unlikely to occur. Yet the reliance on CSRs continued at other firms as customers' supply chains and specialized needs became more complex.

John Klein was hired in March 2011 as the new VP Sales with the mandate to integrate and "supercharge" the CSR team, as Dufour was preparing his firm's strategic goals for the next five years. Klein had already identified three key issues: 1) alignment of the CSR team to the strategy and the new model, 2) infrastructure and the need to make a commitment to invest in bringing the CSRs up to a best-in-class level and 3) building a critical mass in the CSR group.

Among the 25 CSRs employed as of August 2011, were some excellent individual contributors who had their clients' best interests at heart. However, a handful of CSRs had a culture of entitlement rather than of client service. Each CSR decided which clients to pursue, which products to steer them toward, how aggressively or passively to manage the accounts, what kinds of reports they would get and so on. A dozen CSRs carried their mission to the extreme; they thought nothing of poaching clients from the ISA teams and seldom made any SME referrals in return. They were entitled to use the Nichols' resources, the value of the franchise, referrals from the network and so on without contributing back other than from Nichols' share of their revenue split. But Klein could not just let these CSRs go as part of his reforms because they accounted for nearly half of Nichols' business.

Shannon Bilkes, who joined Nichols in mid-2008 as lead CSR, and now reported to Klein noted, "We had many fine people but there were a number who were working the organization and the system purely for their own benefit. The fringe had contaminated the core."

Discussions with the ISAs and the operations group had confirmed Klein's suspicions. Many of them did not know which CSRs were working in their geographical areas, and many did not want to know. Even within the Sales department itself, there were challenges. Said one ISA in a meeting:

> I have clients who are large enough and sophisticated enough to be served by a CSR but I dread the thought of referring them. Apart from the fact that I will lose them from my book of business, and won't get compensated for that loss, I just don't have the confidence that they will be looked after well by some of our CSRs.

"Nothing about this should have been surprising" said Bilkes.

> After all, these people had come from everywhere — they had all been in other organizations and had been attracted to Nichols as mercenaries. They had no common conception of a corporate strategy, no real sense about how the firm wanted business to be done. The fact that we pay them 70 basis points off of sales and then tell them that they control their own expenses in effect says: do whatever you want and do it your way! We can't tell them to undertake training when they have to pay for it. It's up to them! At least, that's how they see it.

The business environment in 2011 also posed numerous key challenges for Nichols. While the markets were recovering from the 2008 to 2009 financial crisis, customers continued to be cautious in ramping up production at their factories. The number of suppliers had increased by 30 per cent as new suppliers entered the market. And new distributors had also entered the market, mostly small players, who were competing aggressively on price. Even as customers' purchasing departments had been cut back, their superiors were demanding more from them. In return, customers were pressuring distributors such as Nichols to deliver better service at a lower cost. High service, in general, was still sought after: in the industry, CSRs continued to generate 70 per cent or more of all business while customer-initiated calls to ISAs generated the remaining 30 per cent of business.

An aggressive war was on for talented and proven CSRs. As a signing bonus, firms were offering to pay 100 to 125 per cent of a CSR's trailing 12 months' commissions or a combination of front-end and back-end bonuses (based on achievement of revenue targets). In addition, small independent start-up firms, such as JKB Supply, Walsh Pedersen Industrial Tools and McNeely Adams Limited, were actively competing for this talent. Major firms were attempting to counter the raiding by other firms by becoming more litigious, suing firms that offered inducements to CSRs to switch and bring their client accounts with them.

In this challenging environment, Nichols had a number of positive factors going for it. Customers were generally satisfied with Nichols' service and were recommending the firm to their sister companies who were having issues with their distributors. The efficient ISA network offered a huge source of referrals if it and the Nichols' CSRs could work well together in the interests of both customers and the firm. Nichols also had a nucleus of excellent CSRs whom Klein believed would be supportive of change if it were managed well.

OPTIONS FOR CHANGE

After a six-month intensive study of the business, including a huge amount of time spent in field offices with CSRs and talking to his colleagues in the firm, Klein had concluded that radical changes were needed if Nichols wanted to build a CSR team that was strategically aligned and culturally congruent with its strategy for building out its integrated operations. The status quo was now unacceptable, and a deep-seated change would be needed to facilitate the transition to a high-quality, integrated and aligned business model.

Klein knew instinctively that this change would not be an overnight, miraculous conversion. The existing CSRs were steeped in traditional ways of doing things, and he was, frankly, uncertain about how they would respond to change. Many, perhaps most of them, were good CSRs but they would only continue to be good if they adapted to a new way of thinking about their roles, as partners in the overall sales team, which, in turn, was a partner in the bigger group that was Nichols. The alternative to changing the approach and attitudes of the current CSR team was to develop a new CSR team from scratch. But such an effort would take time — years, perhaps — to reach critical mass. Thus, Nichols' — and Klein's — essential task was to find the appropriate zone in which culture, infrastructure, management experience, compensation and critical mass could be addressed.

By the fall of 2011, Klein had concluded that significant changes would be required in several key areas.

Communication

The CSRs would need clear communications that the future was not going to be business as usual. An all-hands-on-deck sales meeting was scheduled for August 25 at the local Hyatt Hotel, where Klein planned to unveil Nichols' new sales strategy. Nichols wanted to meet personally with the top producers to communicate the shift away from the 70/30 model to a new operating model that followed industry convention (i.e., a 50/50 revenue split with Nichols using its increased share to build infrastructure and support customer service activities). To add to the complexity, the top producers, who were the highest paid and most experienced in the network, had previously had their 70/30 compensation model grandfathered during a previous restructuring, while the remaining CSRs had been transitioned to a corporate model. Klein knew that some CSRs would not happy with this change and may have deliberately joined the firm because of the 70/30 model. Klein reinforced that he would honor a three-year transition package previously committed to them in the event of any change to the 70/30 compensation model and emphasized this change was irrevocable. Klein further asked the CSRs to take a moment to consider their future opportunity to be part of creating the best firm in the industry.

Compensation

It was a well-known fact that compensation could be used to direct behavior. This view had been generally true in the distribution industry, particularly around variable compensation packages. Any reduction to compensation was often a precipitous proposition.

Some senior CSRs felt that the 70/30 model was an appropriate way to be compensated for the entrepreneurial nature of their client acquisition skills. Any compensation changes might be regarded as "going corporate," starching the model or the effects of "corporate control creeping in," many of the factors that had caused them to leave their previous company for Nichols. What's more, numerous independent firms had been waiting for Nichols to move in this direction. These firms were prepared to move in on the top producers, offering them large amounts of money to desert Nichols and bring their clients with them. These upfront payments could be significant and, when other companies had tried similar shifts in compensation, the exercise had cost them good people — in some cases, whole sales teams had defected to the competition.

In fact, Klein's primary concern centered on the significant imbalance between compensation as a percentage of overall revenues and the lack of investment in overall support infrastructure. For example, Nichols' CSRs were supposed to invest in technology and support to service their customers: an office, administrative support, customer management software and record keeping software. Ironically, the extremely high variable compensation levels paid to Nichols' senior CSRs was starving the build out of essential infrastructure needed to properly service the CSR's clients appropriately. Other competitors' CSRs were provided with some of these services that were funded out of the 50 per cent they remitted to their firms.

Klein had also concluded that he did not want to wait until the 2011 conference to institute the change in the CSR compensation. He had concluded that this change must be implemented almost immediately despite the very real risks associated with doing so.

Control

If the CSRs were to uphold a high standard of customer care, then some controls were needed regarding how clients were dealt with by CSRs in such areas as account records, account reviews and the fit between certain types of product offerings. Klein knew that many of the CSRs would not take kindly to increased controls beyond those mandated by industry regulations. They were an independent-minded bunch and felt entitled to run things relatively autonomously. Again, choices needed to be made; Klein wanted more direct head-office control so that the CSRs would be better integrated with strategy, but he did not want to exercise this control at the expense of dampening the entrepreneurial flair expected of good CSRs.

Partnering with ISAs

The concept of an integrated firm required that all business units operated for the interests of clients and in a way that was both seamless and selfless. Thus, in sales, clients needed to be sought and serviced where it would be best for them. At some account levels, this servicing would be done by ISAs. In many cases, these clients would be first identified by ISA staff, and these referrals would be a critical source of new customers for the CSR group.

The history of relationships between the CSRs and the ISAs had been inconsistent. Klein, however, was determined that their relationship should become a real partnership, which would require both that the ISAs recognize when the client should be referred to an CSR and that a CSR be on hand and ready to respond to the client's needs. Within the ISA group, individuals would need to feel that a referral to a CSR would be a good experience for those clients whose unique and complex needs necessitated a transition.

Culling Those Who Would Not Fit

Initial assessments by Klein had indicated that some CSRs, including some very successful ones, would not or could not adapt to any new system that focused on close alignment to the firm's new strategy and on extensive teaming, partnering and reciprocity around the client model. Even in Klein's "getting to know you" tours of offices, he had witnessed people whose attitudes and behaviors were simply unacceptable.

Yet, Klein believed that people needed to be given a chance to understand the changes that were to be proposed, to consider their value and to determine whether they wanted to make the effort to fit into the new environment. Not everyone would want to and not everyone who wanted to would be able to do it. But Nichols employed many talented and ambitious people, and it had a business to be run as the organization was being rebuilt. As a result, Klein's bottom line was "Give them a chance," provided that doing so did not interfere with the goal of putting the client first.

Developing New CSRs through a "Rookie" Program

One key element that Klein considered essential was for Nichols to set up its own training program for new CSRs. Nichols needed to rethink the CSR role in light of the firm's strategy and translate the CSR role into a set of competencies, attitudes and values. While finding people who matched this profile might be impossible, experienced people were often accompanied by the wrong experiences — wrong at least from Nichols' perspective. What better way to realign the CSR role than to start from scratch by molding people to fit the new CSR profile and thereby attracting high-quality individuals with demonstrated success in their respective previous professions. But this process was going to involve breaking new ground, and Nichols would first need to establish the profile of competencies and other characteristics of this "new breed" of CSRs before embarking on any extensive recruitment and development program.

CSR Management

The CSR managers were quickly identified as occupying pivotal roles. While most successful ISAs eventually became successful CSRs, some CSR managers at competitors' departments had given up their own books and were dedicated full time to recruitment and management of CSRs. They were helped in this role if they had themselves been good CSRs, which gave them credibility; however, they also needed to be leaders and "talent breeders." High-quality managers were critical to recruiting, deploying, developing and retaining CSRs and ensuring that they were focused on the firm's strategy, embraced and acted consistently with the firm's values and built the distributor's franchise while also building their own books of business. Clearly the quality of the managers was uneven, which needed to be addressed. However, Klein was aware that some of the poorer managers had the allegiance of their own CSRs and that changes in these areas might be met by resistance or even the defection of CSRs with large books.

Rightsizing the CSR Network

One of the most difficult questions facing Klein was deciding how big the CSR group should be and by what date. This question was critical because Nichols was determined not to force-grow the operation using the type of hiring characterized during the growth in the 2003–2011 period, when the hiring of CSRs had been based on the candidate's track record in attracting new business and building the value of his or her existing book. Careful, values-congruent hiring and a good rookie program could not be suddenly ramped up in response to a sense of opportunity. Growth had to be strategically planned and executed carefully.

Klein understood that the transition of the CSR compensation model could lead to short-term attrition in excess of the industry average. The goal was to ensure that the nucleus of high-quality CSRs remained through the transition. The team committed to growing the number of CSRs by approximately 10 individuals per year net of attrition through judicious recruitment of veteran and new CSRs. The achievement of this objective should lead to Nichols becoming the fastest growing distributor in the United States.

Of course, if any changes hastened the exit of experienced CSRs far in excess of industry norms — especially those who were generally values-congruent and could be molded into the integrated sales team — then such a consequence would act against this capacity-building goal. Hence, Klein knew he needed to come up with aggressive strategies both for recruitment and retention. He also recognized that some of his internal partners and even his supervisor, Dufour, might not be happy with this pace of development, and he would need to handle this opposition well.

THE OPPORTUNITY

The challenges of rebuilding the CSR team up to competitive strength were significant. But as he thought about it, Klein was convinced that Nichols had much going for it that could serve as a basis for long-term development. He grouped these benefits under several key headings:

- Nichols' reputation was increasing significantly on the basis of its record of service, delivery standards and high levels of customer satisfaction.
- If the partnership with the ISA team could be strengthened, reciprocal referral opportunities would increase for CSRs.
- Although Nichols needed to move away from the 70/30 compensation system, compensation for the right people could be as good as or better than it had always been.
- The integrated sales approach — ensuring that all Nichols sales agents were jointly aligned and cooperating toward the collective goal of growing the total business — would be in the best interests of both customers and Nichols' owners.
- Properly funded, Nichols could develop and implement a best-in-class field system, national office and centralized support infrastructure to ensure that CSRs would be able to focus on what clients wanted them to do and what they wanted to do— give the best level of service to their customers!
- Even the relative smallness of the CSR could be positioned as an advantage because Nichols was often called upon to be part of a consortium of distributors for major infrastructure projects, such as large-scale city redevelopments.
- Finally, every industry expert in the distribution world agreed that the next decade or two would see the delivery of high levels of customized service as the major expansion opportunity for firms with the goal of double-digit, profitable growth for many years. Not to be ready to be a prime player in this field would be a major strategic shortfall.

THE IMMEDIATE CHALLENGE

As Klein saw it, the next few years would require shifting the capabilities of the CSR team members so they could function as part of an integrated Nichols strategy while building this capacity at an appropriate speed. The firm would face pressures to expand rapidly but the dangers of too-rapid an expansion were obvious from the situation that had developed through the 2000s. The challenge was to create a coherent capacity and capability building strategy for Nichols' CSR team and to execute it brilliantly.