



Floor Covering Industry White Paper

Indian River Consulting Group

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During the last decade, the floor-covering industry went through significant transitions. Just to refresh your memories:

- The retail landscape has changed since the beginning of the 1990s:
 - Sears and Color Tile were, by far, the two biggest flooring retailers.
 - Operating in only 12 states in the beginning of the decade, Home Depot had approximately 10% of its current number of stores.
 - By the second half of the decade, Home Depot positioned itself as the No. 1 floor-covering retailer fueled by approximately 900 new store openings during the 1990s and an increased emphasis on the flooring category.
 - Buying groups/affiliations were just beginning to surface in the industry.
- While the number of flooring retail outlets grew during the last decade, consolidation significantly impacted distributors and manufacturers.
 - In 1990, there were just fewer than 400 carpet mills with the three largest controlling less than 50% of the market. Today, there are 75 fewer companies and the top five mills control over 80% of the market. (Market Insights/Torcivia)
 - On the distributor side, over 40% of NAFCD members from 1990 are no longer in business today. However, strong market opportunities during the 1990s fueled growth in smaller distributors, particularly those that are specialty focused such as wood and ceramic.
- Changing economics sharply curtailed once common dual distribution of many brands of flooring.
 - Distributor consolidation is resulting in much larger organizations with greater efficiencies and scale. Based on 2000 estimates, the average sales of the top 25 independent distributors are \$111 million. In addition the top 25 distributors currently control roughly 40% of the flooring sold in the U.S. through distribution. This is an increase from 34% in 1995. (*Floor Covering Weekly's Top 25 Distributors*)

In 1995, the National Association of Floor Covering Distributors (NAFCD) sponsored a study that predicted the following transitions. Let's take a look back.

Transition #1: Distributor market share will decline.

Prediction: In 1995, approximately 27% of flooring products sold in the U.S. were going through wholesale distribution. The study predicted that wholesale distributors' share of the market would continue to decline before bottoming out at 20%-23%.

Reality: Approximately 29% of flooring products are currently going through distribution. (U.S. FLOORReport-2001, Market Insights/Torcivia)

Commentary:

- In the mid-1990s laminate flooring emerged. Suppliers needed independent distribution to help build the market and distributors needed the sales and gross margin dollars afforded by this new category.
- The growth in share of hard-surface products favored the independent distributor.
- For the past five years, the carpet mills have focused on consolidating and driving manufacturing and logistical efficiencies. Recently, they have moved on to focusing on putting hard-surface products through their logistical networks.

Transition #2: Manufacturers will continue to move to direct sales.

Prediction: Manufacturers will likely “move more product directly to the retailer/end user, thus bypassing distributors.”

Reality: Yes and no.

Commentary:

- Hard-surface products—at least at the time of this writing—have yet to be profitably moved directly from the manufacturer to the retailer/end user.
- While at first blush advances in logistical technology favor the direct selling model, this is challenged by the costly realities of small orders, job site deliveries, etc.
- The emergence of buying groups, and an increase in the power that retailers yield in the channel, changed the landscape by minimizing the role of the local distributor. Manufacturers now directly manage product selling (selection, pricing, terms, etc.) with the “national” groups of retailers. However, distributors are still touching the hard-surface product and/or the customer location (local inventory, displays, credit, etc.).
- The contractor/installer market remains comfortable buying from wholesale distribution and is difficult for the manufacturer to reach directly.
- New niche manufacturers and foreign suppliers have emerged to create a pool of new suppliers for distributors looking for growth opportunities. This proliferation of new products has also fostered the establishment and growth of new, smaller distributors.
- However, some smaller manufacturers and/or new market entrants lacking a distributor network have been forced to go directly to the market.

Transition #3: Buying groups/alliances will continue to attract members.

Reality: The majority of retailers now have some type of group membership/affiliation.

Commentary:

- CCA Global Partners (Carpet One) has emerged as the predominant player among the 30+ alliances/groups.
- Much of the uncertainty and positioning taking place in 1995 has now given way to established relationships and agreements.

Transition #4: Home centers' impact will continue to increase.

Prediction: The 1995 study estimated that warehouse home centers accounted for approximately 9% of floor-covering products sold at retail. The study predicted “that warehouse home centers’ share of the flooring market will continue to increase until hitting the 15%-18% level.”

Reality: Building materials and home centers controlled about 17.3% of retail floor-covering sales (excluding installation) in 2000. Home Depot and Lowe’s controlled all but one or two percentage points of that. (*FCW*, July 16, 2001)

Commentary:

- The DIY buyer has shifted his or her buying from Color Tile and a host of regional home centers to Lowe’s and Home Depot.
- Consumers are more educated about product options and appear to be less reliant on the full-service product knowledge offered by the floor-covering dealer.
- Both Lowe’s and Home Depot are developing programs that appeal to small contractors, property management firms and insurance replacement specialists. Although they have been unsuccessful in wooing the flooring contractor in the past, it is too early to tell whether these new programs will be successful.

Transition #5: Gross margins will continue to decrease.

Prediction: The 1993 median gross margin for NAFCD members was 22.6%. (This was the most recently available information at the time of the 1995 study.) 1993 performance represented a continuing decline from the late 1980s. The study predicted, “The decline in gross margins will continue for several years before stabilizing.”

Reality: NAFCD’s Chart Books indicate that its distributors have experienced essentially flat gross margins over the timeframe. NWFA’s average distributor has seen a decline in average gross margin from 22% in 1995 to 19.8% in the most recent Profit Report.

Commentary:

- For many full-line distributors, laminate and ceramic have contributed a boost to gross margin dollars in the face of declining resilient sales and margins. However, gross margin percentages for these two products have been on the decline for the last several years.

#1: Product category shifts are changing industry dynamics.**Reality:**

- Carpet's total share of market dollars (excluding area rugs) has declined to 54%.
- Resilient is 14% of the market dollars in 2000 compared to 16% in 1998. Rubber was/is the only growing product line in this category. (*FCW's Statistical Reports*)
- The laminate category is experiencing pressures on both volume and margin, creating uncertainty with regard to winners and losers.

Implications:

- The trend toward hard-surface products favors distributors' positions in terms of share of the total market, as carpet is the least likely surface to go through independent distribution.
- The resilient category is suffering significant pressure as consumers abandon higher-priced resilient products in favor of other hard surfaces.
- The laminate category continues to shake itself out.

#2: The top carpet mills are leveraging their supply chain efficiencies by expanding their product offerings to their captive customers.**Reality:**

- Carpet represents over 50% of a typical floor-covering dealer's purchases. By including hard-surface products in their offerings, Shaw, Mohawk and Beaulieu are determined to capture a larger share of purchases.
- Sizeable infrastructures are already in place: (*Hardwood Floors*, April/May 2001)
 - Shaw has 25 regional distribution warehouses and more than 1,000 trucks.
 - Mohawk has 54 distribution points and 700 trucks.

Implications:

- Carpet mills have enormous investments in their infrastructure and supply chain. To gain further economies, mills are expanding by:
 - Buying independent distributors (Beaulieu purchased Brinkman).
 - Adding brand name hard-surface products to their product offerings (e.g., Mohawk and Congoleum).
 - Building their own hard-surface manufacturing capacity (e.g., Shaw—laminate flooring).
- The end result is one or two new distributors/competitors in every market.

#3: Global trading trends are beginning to impact the U.S. flooring market.**Reality:**

- It is estimated that less than 35% of the world's floor covering manufacturing capacity is in the United States.

- Lower manufacturing costs and dramatically improved quality made foreign-made products viable. Imports accounted for approximately 17% of the total U.S. market in 2000, up from 13% in 1997.

Implications:

- Historically, price is the way to gain a toehold in an established market.
- Like laminates, overseas suppliers of ceramic and wood are looking to independent distributors to help guide them through the U.S.
- Opportunities exist for distributors with good market intuition and timing.
- Exchange rate movements, tariffs, etc., can swiftly change the competitiveness.

#4: Fewer manufacturers are driving the business.

Reality:

- The top four manufacturers—Shaw, Mohawk, Beaulieu and Armstrong—control the majority of the U.S. market supply (shipments plus imports). This is up from 41% in 1996.
- TriPac represents 42% of the domestic hardwood flooring market (*FCW*, April 16, 2001), not to mention the market-dominant position of its parent, Armstrong.

Implications:

- In almost every product category, there are a handful of players controlling $\geq 80\%$ of the business.
 - It is becoming increasingly important that distributors choose the right manufacturer partner.
- Given the current market dynamics, it is unlikely that the market can continue to support five major resilient lines.

#5: Floor-covering retailers/contractors are holding their own.

Reality:

- A large portion of DIY, and some BIY, has gone to Home Depot and Lowe's.
- Floor-covering stores (deriving more than 50% of income from flooring) have grown from 13,648 outlets in 1992 to an estimated 18,671 in 2000.

Implications:

- The majority of distributors' sales and profits will continue to come from their core customers, floor-covering retailers and contractors.
- Floor-covering retailers will continue to look over their shoulders to see if the home centers figure out a way to effectively compete in the professionally installed market.

FUTURE STATE

In this section, potential scenarios have been developed that will be useful and thought-provoking for the distributor executive to contemplate. Some of these trends are somewhat visible today while others may represent challenges and uncertainties for distributors. The benefit of looking at future scenarios is that it raises awareness about what may be. However, as you know, what actually occurs will be the result of both fate and action. The authors of this document remind the reader that the predictions and projections are made using the best information available in the summer of 2001, coupled with Indian River Consulting Group's experience and expertise in wholesale distribution.

#1: In 2005, U.S. floor covering sales will exceed \$24 billion (in wholesale dollars = shipments less exports and plus imports).

The soft economy in 2001 will result in a decline in sales. A rebound in 2002 is projected as well as continued growth through 2005.

- Ceramic tile will experience the greatest growth, with sales estimated to be up more than 50% over the next five years.
- Resilient is projected to be the hardest hit category with sales up only 6% in the projected five-year period.

U.S. Floor Covering Sales (in wholesale dollars) - IRCG's Projections

	1996	2000	% Of 2000 Market	2001	2005	% Of 2005 Market
Carpet	\$ 10,270,500,000	\$12,754,000,000	63%	\$ 12,180,070,000	\$ 14,383,334,000	60%
Wood	\$ 990,400,000	\$ 1,696,600,000	8%	\$ 1,730,532,000	\$ 2,331,359,000	10%
Ceramic	\$ 1,488,900,000	\$ 2,138,200,000	11%	\$ 2,223,728,000	\$ 3,375,228,000	14%
Resilient	\$ 1,824,300,000	\$ 1,906,600,000	10%	\$ 1,811,270,000	\$ 1,922,134,000	8%
Rubber	\$ 638,500,000	\$ 899,800,000	4%	\$ 890,802,000	\$ 1,082,775,000	4%
Laminate	\$ 240,000,000	\$ 737,000,000	4%	\$ 773,850,000	\$ 1,028,646,000	4%
Total	\$ 15,452,600,000	\$20,132,200,000	100%	\$ 19,610,252,000	\$ 24,123,476,000	100%

	Change From Prior Year (1999 to 2000)	Change From 1996 to 2000	Change From Prior Year (2000 to 2001)	Change From Prior Year (2004 to 2005)	Change From 2001 to 2005
Carpet	4%	24%	-5%	4%	18%
Wood	7%	71%	2%	8%	35%
Ceramic	6%	44%	4%	10%	52%
Resilient	3%	5%	-5%	2%	6%
Rubber	7%	41%	-1%	5%	22%
Laminate	17%	207%	5%	7%	33%
Total	5%	30%	-3%	5%	23%

#2: Horizontal integration will shake up the market dynamics.

Large carpet mills will build on their successes and financial advantages and put more hard-surface products through their logistical networks.

- Carpet mills will seek market and cost advantages either through unique supplier arrangements or owning their sources of supply.
- Carpet manufacturers will leverage their retail relationships by providing attractive incentives to push hard-surface purchases through their network.

The profile of wood-flooring manufacturers will change as more landowners and loggers move downstream while sawmills start making unfinished and prefinished flooring.

Laminate board producers will increasingly penetrate the U.S. laminate flooring market with lower-priced products.

#3: Manufacturing consolidation will continue and will be fueled by the emergence of low-cost producers in every category.

Value expectations by the consumer will create significant advantages for manufacturers that offer both low cost and high quality.

Supply chain efficiencies will determine many of the winning “partnerships” during the next five years. Increased cooperation and coordination will be required of both distributors and manufacturers, something that has not naturally occurred in the past.

#4: Distributors’ sales will increase 13% over the next five years. However, distributors will lose share of the overall market.

In 2005, distributor sales will be approximately \$9 billion, up from about \$8 billion in 2001. Wholesale distribution will continue to sell about a third of U.S. flooring.

The largest 50 distributors will capture the majority of the increased sales volume (70%-80%).

Overall efficiencies and the adoption of technology will result in productivity enhancements, yielding significantly more revenue per sales personnel. These advances will curtail the need to fuel this sales increase with historical levels of inside and field sales personnel.

Despite the sales increases, the total market share of independent distributors will decrease by approximately 3%-5% in the next five years.

- More ceramic will be moved through home centers.
- The carpet mills will be taking hard-surface volume through their own logistical networks.

#5: Fewer independent distributors will fight over a smaller pie and the survivors will clearly segment themselves based on size and offerings.

Over the next five years the distributor ranks will continue to thin with an estimated 20% reduction in the number of independent distributor companies in business. The distributor marketplace will have:

- The big and efficient:
 - The network of Armstrong’s approximately one dozen distributors.
 - A handful of other full-line distributors serving major metropolitan markets.
 - More than \$100 million in annual sales.
- The smaller players:
 - Less than \$25 million in annual sales.
 - May have a single focus:
 - By product such as ceramic or wood.
 - Accessory.
- Players in the middle will struggle:
 - Not quite big enough to enjoy the benefits of scale and efficiency.
 - May have outgrown their ability to consistently provide customer-intimate service levels.

#6: Independent floor-covering distributors will follow the path of many other industrial markets by adopting a “Bricks and Clicks” approach to the marketplace.

Distributors will continue to provide information and physical fulfillment for their customer base.

- “Clicks” essentially automates and streamlines the labor-intensive and costly communication and information flow through the supply chain.
 - To compete with the logistical efficiencies of the carpet mills, large independent distributors will transition most of their price-sensitive customers to online handling of ordering, product information and payment.
- Distributors will still be compensated by traditional gross margin as unbundling and fee-for-service structures will fail to gain acceptance in the less technical markets like floor covering.

With the exception of the large carpet mills, the other flooring manufacturers will stick with the traditional independent distributor as the best way to service local market needs.

#7: Distributors will place greater reliance on products and services other than flooring to bolster sales and margin dollars

The industry fixates on the sales of flooring, often ignoring the considerable value of accessory and other products in industry statistics and estimates.

- For example, many wood-flooring distributors generate approximately 20% of their sales from installation and accessory products.

Innovative products will be developed to ease the installation and care of flooring. Distributor sales of these ancillary products will increase and be profitable as consumers and installers welcome these items.

New and expanded services, such as design, installation and training, will prove to be a successful boost to profitability for some distributors.

Accessory distributors will find themselves threatened and/or acquired as the large, full-line distributors look for ways to expand their gross margin dollars.

#8: Alliances between top builders and large manufacturers will shift builder relationship power away from distributors and retailers.

Much like the buying group/affiliations, some of the large manufacturers will lock up the top builders' business.

- Retailers will handle the new homebuyer shopping for product.
- Distributors will provide local servicing at a predetermined and lower margin.

#9: Flooring will continue to be viewed by consumers as requiring "professional installation."

The role of the installer will continue to be vital. Anyone who comes up with a creative solution to the chronic shortage of quality installers will be a winner.

Barring any significant improvement to the installation process of flooring products, there is no major change anticipated in the percentage of product going DIY.

Distributors that maintain and cultivate relationships with installers will achieve advantages and alternate sales channels that will produce increasing sales and margins.

#10: The green movement will take a sizeable hold on the market.

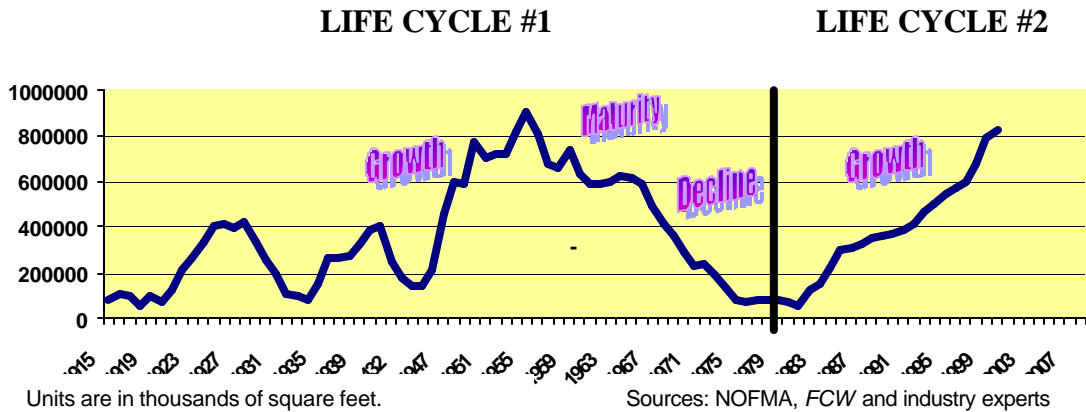
Certification, including chain of custody verification, will be the reality for portions of the wood flooring industry. The growth of wood flooring will begin to slow as these additional costs make wood flooring more expensive relative to ceramic and laminate.

This White Paper has reviewed the implications of a changing industry for floor-covering distribution in general. While this is critical in developing an industry overview, more specific information and commentary would be helpful to the wood-focused distributor.

This section is intentionally more narrative as it has been designed to discuss relevant issues in the historical, current and future context. While much that is written in this section may seem discouraging to wood-focused distributors, let this serve as a wake-up call to the challenges *and* opportunities ahead. There is a great deal of opportunity for all distributors who contemplate the evolving marketplace and create a compelling business plan and strategy. There is a great deal of market share and profit available to those distributors who have the discipline and diligence to implement and execute their plan.

#1: Wood-flooring growth fueled opportunities for specialty distribution.

Since 1980, wood-flooring sales have increased by over 750%. Fueled by product innovation and preference for all things natural, the wood-flooring market experienced a rarity—two distinctly different product life cycle experiences over 100 years.



Specialty distributors play a key role in the early phases of a product life cycle. To that end, wood-focused distributors have clearly benefited from the explosive growth of the product category during the last 20 years. As the maturity phase kicks in and products gain more acceptance and reach, full-line distributors will gain more category share.

Unlike other floor coverings such as resilient and carpet, wood has a greater reliance on the new home construction market. The majority of wood flooring manufactured is installed in new construction rather than as a replacement to an existing floor covering.

The wood specialty distributor was the primary supplier of unfinished strip (the dominant product until the later part of the 1990s) and the primary channel through which much of the wood flooring flowed from 1980 until 1995. It has only been within the last five years that most full-line distributors expanded their offerings, particularly in prefinished.

Another significant opportunity is the ongoing sanding and refinishing of the approximately 17 billion square feet of hardwood flooring installed in the U.S. If just 3% of the installed base is refinished every year the value of abrasives, finish and accessory products is about \$100 million at wholesale. In the U.S., an estimated 9,000 mechanics are involved exclusively in the sand and refinish business. Full-line distributors have failed to capture this contractor base currently served by the wood-focused distributor.

#2: Wood flooring market share is shifting toward the larger, broader distributor.

Wood distributors controlled about 60% of the wood flooring sold through distribution in 1996 dropping to an estimated 52% in 2000. This trend will likely continue as:

- Larger wood distributors will add additional floor-covering products and transition to full-line distributors.
- Wood-flooring manufacturers are growing larger through both internal expansion and acquisition. These larger organizations generally prefer to deal with fewer, larger and more sophisticated distributors.
- Product differentiation will become increasingly difficult requiring companies to gain competitive advantage through value-added activities. Larger distributors will invest in high-caliber people and services and therefore raise the service bar.
- The dominant home centers, sophisticated new home design centers and buying groups will continue to favor larger distributors. Larger and/or more sophisticated distributors have the logistical and technological infrastructure in place to support these demanding customers at the requisite lower margin.
- Retailers will likely seek fewer suppliers in the future as they consolidate their purchasing to achieve great efficiencies. Full-line distributors will benefit from this trend as they have broader product lines to offer.
- A greater percentage of wood flooring will continue to go into remodeling and redecorating projects. Consumers tend to shop floor-covering retailers for remodeling selections and these establishments favor the full-line distributor.

#3: Wood-flooring distributors have benefited from full-line distributors' lack of contractor understanding.

Generally speaking, most full-line distributors (wood sales <25% of overall business) lack an understanding and willingness to sell to wood-flooring contractors, the largest installation channel for wood. Today, many full-line flooring distributors view wood-flooring contractors as competitors to their "primary" customers—retail floor covering stores. Those that have tried to woo the wood-flooring contractor have found their needs to be very different from traditional retailers. Wood-flooring contractors require broader product lines, job site delivery, technical support and convenient will-call locations. As full-line distributors recognize the enormous potential of the wood-flooring contractor segment some may be willing to commit the resources to compete aggressively for that

business. A more likely alternative is that full-line distributors may acquire wood-flooring distributors to quickly gain the customer base and expertise needed to compete.

On the heels of a strong market, many wood-flooring contractors are growing and changing. A decade ago, few offered customers a display showroom or operated an office staffed with an office manager and salesperson. Today, many contractors have these offerings and are essentially wood-flooring “retailers.” As the lines become blurred between the mechanic/installer and the traditional floor-covering dealer, the challenge remains for distributors to meet the similar and distinct preference of these two segments.

#4: Solid flooring grew faster than engineered since 1996; that will change. Prefinished flooring is viewed as a better value to the consumer.

Many have predicted that engineered products would post rapid growth as consumer acceptance took hold. While this has been the case, solid sales growth of 41% has actually slightly outpaced the 38% growth demonstrated by engineered products since 1996. The pricing differential between solid and prefinished has, and will continue to, fluctuate. The wholesale price of engineered products has increased during this timeframe while the wholesale price of solid flooring is roughly the same as in 1996.

Over the next five years, solid and engineered wood sales will continue to grow. However, the changing economics in the hardwood lumber industry will favor the engineered category. Since full-line distributors control most of the major prefinished engineered brands, this will have significant implications on the balance between wood-only and full-line distributors—favoring the full line over time.

Prior to 1990, the marketplace viewed a professionally installed, sanded and finished hardwood floor to be superior to a factory-finished floor. Technology and investment—UV curing, milling and sanding improvements, etc.—during the last decade have changed that perception. Today, the quality of factory-finished flooring exceeds what a mechanic is capable of at the job site. When combined with the warranties and guarantees that prefinished manufacturers offer, the value of prefinished flooring to the consumer exceeds a job-site-finished floor. The typical NWFA wood-only distributor had a product profile that is still predominantly unfinished due to contractors’ preferences:

- Unfinished flooring 59.4%
- Prefinished flooring 18.1%
- Accessory products 22.5%

However, that is changing as some contractors are recognizing that their overall profitability will improve by doing more jobs each year using prefinished flooring *and* transferring the warranty responsibility to another party. As this trend intensifies, full-line distributors will benefit at the expense of wood-only distributors.

Message for Distributors

As you have been reading this document have you wondered: So what? What does this mean for my business? Based on feedback from distributors like yourselves, this is what they suggested should be taken away from this document:

- Don't be too negative about the future.
- There are a lot of good opportunities out there for distributors that are not hostage to the past and who listen to their customers.
- Improve your relationships with key manufacturers—it is one of the best ways for both parties to reduce costs.
- While technology advances are not yet prevalent in this industry, someone is going to figure it out because everyone keeps talking about it.
- Focus on your customers, where they are headed and map your future strategy accordingly.
- When looking at the retail landscape, it is essential to choose the winners and the losers.
- There is information here for everyone—now go do something with it!
- Make this available on the Web (it is).
- The hard part is now doing something with this information. Forward vision does not come with a "how-to" manual.
- Plenty to think about as you are formulating your company's strategy and action plans.
- Keep looking at your current and future business and don't overanalyze the past.
- Every product line carried needs to be scrutinized.
- Business sure isn't going to get any easier.
- Let dead weight go (vinyl?) and focus on high-value and profit categories.
- Time to enhance management skills and increase professionalism.

Do you have additional questions and/or comments? Feel free to contact Indian River Consulting Group at info@ircg.com or 321.956.8617.

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**The Joint Research Project
for both
NAFCD and NWFA**

J. Michael Marks has overall project management responsibility. Susan Hamar, Senior Associate, was mission lead on the White Paper and Rick Johnson, Managing Partner, was mission lead on the Roadmap and Tool Kit.

The collaboration and support provided by the trade association staff and the volunteer leadership was significant and highly valued by Indian River Consulting Group.

The Indian River Consulting Group (IRCG) is an experience driven practice that specializes only in the wholesale distribution industry. Within this specialty, we consult with distributors and manufacturers to make the changes necessary to maintain competitive advantage. We take pride in our ability to implement innovations that work. We often use an unconventional approach that helps clients break out of the box in their respective product sector, marketplace and arena of competition.

Our specialized knowledge, unique perspective and extensive contacts have, for nearly fifteen years, brought tangible results to clients who seek to change and enhance company performance, or to solve specific problems with our assistance.

Our “real world” experience fosters an understanding and empathy that makes our partnership invaluable when clients are facing challenges to improve. These include scenarios such as downsizing in a recession, changing major suppliers, escaping from venture capitalists, integrating an acquisition, divesting a subsidiary, changing out managers from “C” players to “A” players and helping a company stop the bleeding by creating a turn around to profitability.

IRCG participates in each phase of the consulting assignment with responsibility for the quality of the results. We stand shoulder to shoulder with our clients to make the changes work. Simply put, we spend more time with rolled-up sleeves working late nights to accomplish our goals than we spend making presentations.

This experience and dedication is the foundation of each of our core competencies, including Sales and Marketing, Compensation and Incentive Design, Channel Management, Operations, Mergers and Acquisitions, Organizational Development, E-/business Development, Supply Chain Management and Turn Around initiatives.

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