Executive Insights

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Industrial Distribution: Steering Clear of the "Danger Zones"

At first glance, all seems well within the industrial distribution space. An index measuring total shareholder returns for leading publicly listed distributors shows a 29% p.a. gain since 2009, three points higher than the S&P's XLI broader-market index through the same period (see Figure 1). Other indicators, including ISM's Manufacturing Purchasing Managers' Index (PMI) and New Orders Index, also reveal upward momentum.

Still, these figures obscure growing pressures within the industry that, if left unchecked, could constrict distributor profitability going forward. Companies face challenges ("danger zones") if they fail to differentiate with a clear product or service vision, lack sufficient scale, have failed to achieve a strong ecommerce presence or are subservient to manufacturers with broad downstream resources. In the following analysis, L.E.K. Consulting discusses strategies not only for insulating distributors from these growing risks, but also for using awareness of the trends as a way of accelerating growth.

Trouble in the middle

Generally speaking, industrial distribution customers fall into two main categories: those seeking a very broad product range in order to facilitate supplier consolidation and reduction of transaction costs (i.e., procurement through broadline distributors), and those requiring deep product assortment within focused categories along with strong customer service, technical support and product knowledge (i.e., purchasing through specialty distributors).

Distribution firms have found success at both ends of the spectrum. For example, broadline players like MSC and Grainger have profited by offering a wide range of products in categories that traditionally require less technical service and support. On the other hand, those firms that focused on specialty areas such as plumbing, electrical or HVAC (including the likes of Graybar, Wesco and Watsco) have performed well by meeting customer demand for deep product assortment along with strong technical service and support.

The important trends discussed in this *Executive Insights* are:

- Increasing bifurcation between broadline and specialty distributors
- Ongoing consolidation of industrial distributors
- Increasing role of the internet and mobile devices
- Manufacturers gaining power by establishing downstream leverage

Industrial Distribution: Steering Clear of the Danger Zones was written by **Chris Kenney, Robert Rourke** and **Darren Perry,** Managing Directors in L.E.K. Consulting's Industrials practice. **Brad Spicer,** a Senior Manager and **Kate Epstein,** a Consultant, also contributed to this article. Chris, Robert and Brad are based in Chicago, Darren is based in Boston and Kate is based in New York.

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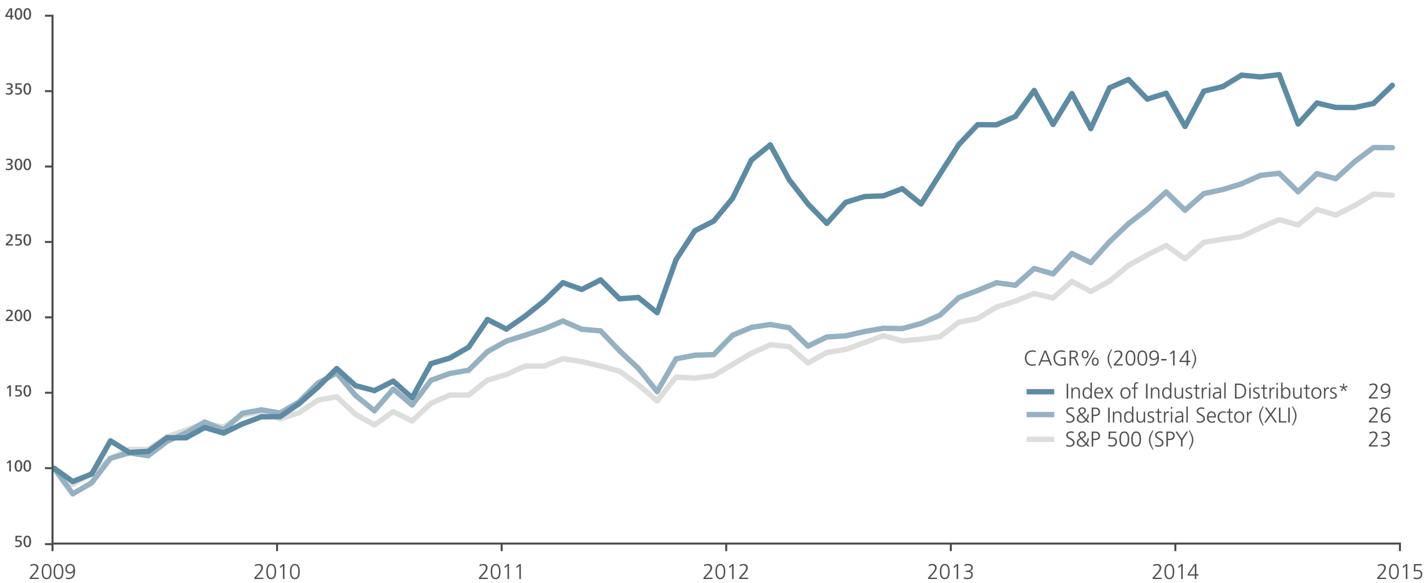
Figure 1
Total shareholder return (2009-14)



Note: Index=100 on Jan. 1, 2009. Data corresponding to each subsequent year beginning on Jan. 1 for that year. *Average of W.W. Grainger, Fastenal, MSC Industrial Direct, Watsco and WESCO International, weighted by market cap
Source: Bloomberg

A "danger zone" exists in the middle and includes distributors that lack either a clearly defined broadline or specialty value proposition. Such firms are typically sub-scale relative to broadline distributors and therefore struggle to compete on price. These firms are also not focused enough on specific categories to offer the strong service and technical support that customers require from bona fide specialty distributors. As a result, in recent years it has become increasingly difficult to operate profitably in this area. To stay in the game, these distributors must choose between broadening their range of product offerings and investing in a particular product or customer segment with a high-service offering.

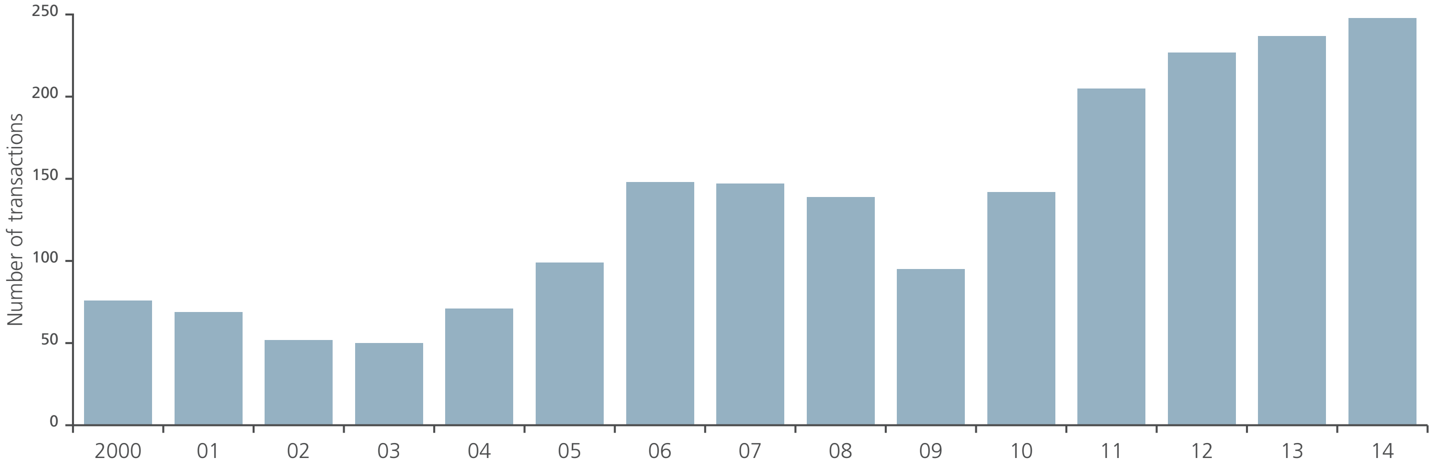
Acquire — or expire

The industrial distribution landscape continues to experience heavy consolidation — a trend that will likely continue well into the foreseeable future. M&A among industrial distributors has grown by 21% p.a. (see Figure 2) over the past five years, reaching a record high of 248 in 2014. Broadline distributors have primarily been motivated to acquire companies in adjacent product categories in order to expand their product breadth, as well as fully capture cross-selling opportunities and become a "one stop" supplier for customers.

In addition, relationships between distributors and their customers can often be sticky, so acquisitions are frequently required to fuel growth. Private equity firms have also been very active in this space, as they see opportunities to build consolidation platforms and roll-up distributors that have small shares of their addressable markets. Overall, this has pushed valuation multiples of industrial distributors to near historical highs, and the current environment offers strong exit opportunities for owners looking to maximize valuation in a sale.

In short, the forces that once sustained local or regional distributors are rapidly weakening. Current trends favor distributors with the scale to meet the complex supply chain needs of large national accounts such as managed inventory solutions, ERP integration and those with differentiated product expertise. This has created yet another "danger zone" for smaller distributors that typically do not have the capital and scale to invest in ecommerce, private label, technical sales staff, inventory management solutions and other growth initiatives. While the chances for survival without scale in the broadline segment appear slim, those on the specialty side may still find a way forward, particularly when offering a value proposition

Figure 2
Number of U.S. industrial distribution M&A transactions (2000-14)



Source: Capital IQ

differentiated enough to overcome their scale disadvantages (such as having strong technical expertise in product categories requiring a highly consultative sales approach).

Internet threat

Ecommerce is fast becoming an enormously important sales channel for industrial distributors. For example, web accounts already represent more than a third of Grainger's total business, with over 10% of web traffic derived from mobile users. Additionally, Grainger's online-only subsidiary, Zorotools.com, has been extremely successful at reaching a largely untapped segment of the market dominated by small businesses.

Still, ecommerce also poses a number of challenges, including the ability for newer, more disruptive players to compete. Such has been the case with AmazonSupply, the business/industrial offshoot of the mammoth online retailer, whose efficient delivery chain and lower margin requirements have helped the three-year-old enterprise gain a foothold within the distribution space.

The prospect for similar online activity represents a third "danger zone" for industrial distributors, with the greatest threat occurring in categories with minimal product selection or fulfillment support (since customers already know what they want before they buy). There is a silver lining, however: while anyone can purchase a lot of light bulbs unassisted, an electrician looking to replace a bad circuit breaker for an obsolete appliance may still require support when cross-referencing OEM/generic stock numbers, finding original parts schematics and more. These value-add services can help distributors differentiate themselves among the growing field of ecommerce newcomers who are less likely to offer such guidance.

Accordingly, distributors should focus on developing core capabilities in areas such as market-basket analytics and price optimization, while at the same time bolstering online product content and customer-support services. Fully integrating ecommerce into a true multichannel strategy is also essential. To better support its online offering, Grainger's local branches have been fortified with additional staff as well as worktables where associates can troubleshoot customer issues and offer other consultative services.

Downstream danger

Manufacturers often report difficulty convincing distributors to invest time and resources in their product offering using tailored education, training and customer support for end users. As a result, manufacturers have increasingly pooled their own downstream resources to generate pull-through demand (for example, many building products companies have begun to train and educate contractors to install their own products). By taking the distributor out of the loop, manufacturers are in effect able to boost their downstream leverage; some are even bypassing distributors altogether, typically using ecommerce to facilitate the strategy.

If customers can obtain the majority of their product knowledge and technical support directly from the manufacturer while using distributors for fulfillment only, distributor margins will be increasingly at risk. Worse, manufacturers with greater scale can invest even more resources in downstream activities, thereby increasing the ability to "own" the customer.

This too, has created a formidable distribution "danger zone," particularly in areas where manufacturers maintain higher-than-normal downstream leverage and control (such as roofing or other industries with a consolidated manufacturing base). To address this threat, distributors need to continually invest in selling resources — especially around major brands — in order to determine whether or not they are adding value to their brands by providing strong product education, training and technical support.

Conclusion

To remain competitive, it is paramount that industrial distributors work to steer clear of the various "danger zones" in their midst; those who do not respond or reposition themselves appropriately will likely see their profits squeezed and market share reduced. Given that, management must ensure they have a clear understanding of how their product assortment, scale and value proposition to customers is positioning their businesses relative to these growing risks, while at the same time take the necessary steps to boost their capabilities in online retailing, marketing and product support.

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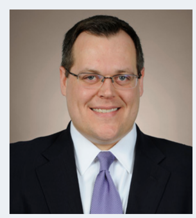

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