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Advanced Industries

The coming shakeout in industrial distribution

And five keys to outperformance in the years ahead

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Introduction

Powerful trends that have disrupted industries around the world are now affecting industrial distributors. A few distributors are moving quickly to create more value by building scale, making dramatic advances in commercial and operational excellence, and digitizing to create the seamless, omnichannel experiences that customers now demand. But we expect slower-moving distributors to struggle—and some to go the way of Blockbuster and Borders.

We also expect the disruption to accelerate. Fast-moving digital players eyeing the industry's trillion-dollar revenue pools are offering best-in-class customer convenience and more price transparency. Sophisticated customers, armed with new data, are demanding deeper discounts and better promotions on more commoditized products. As manufacturers and customers gain leverage through consolidation, some are forging strong relationships that cut out the intermediaries—leaving distributors in the cold.

These and other challenges come at a difficult time for the industry, whose returns have lagged those of the overall industrials sector for 15 years. Margins have remained narrow even in the recent economic recovery and under increasing pressure. Indeed, we expect many industrial distributors to lose strong customer relationships in the next few years and become mere links in supply chains, rather than business partners who add value.

But while the overall picture may look bleak, we see opportunities across sectors. A handful of industry leaders are growing share and margin. Based on our research and experience serving clients across industries, we believe that industrial distributors who move quickly can create deeper customer relationships and sustainable competitive advantages to outperform consistently in the years ahead.

In this report, we present an overview of the industrial distribution industry, including performance across subsectors. We then describe some of the many challenges and opportunities we see on the horizon, and we conclude by outlining the five main advantages that we believe will distinguish outperformers in the decade ahead.

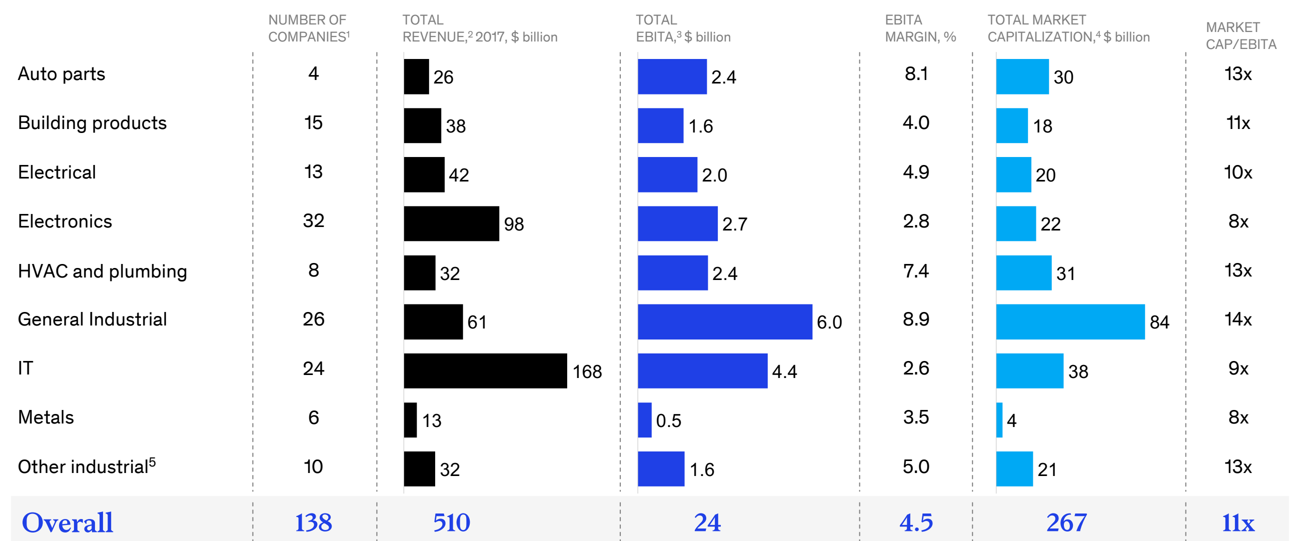
Understanding the industry's fragmentation and performance

Industrial distributors play huge and vital roles in the global economy. They generated about $2.5 trillion in revenue in the United States alone in 2017, and the industry has grown by about 1.2 percent annually since 2015, roughly in step with GDP. We analyzed the performance of more than 130 public global industrial distribution companies over the last 15 years in the nine industry sectors shown in Exhibit 1. Together, the companies we studied generate more than $500 billion in annual sales.

Despite variability in industry dynamics, including customer preferences, product differentiation, and localization, the industrial distribution market has been challenging, with margins below 10 percent and low double-digit multiples in every segment. On average, distributors generated only about half the economic profit per dollar of revenue reported by industrial companies overall, including manufacturers.[1] The economic profit per dollar ratio for distributors has remained flat, at about 0.8 percent, since 2012.

Exhibit 1

Financial performance varies widely across 138 public global distributors.



[1] Number of public companies in the sample. [2] Total 2017 revenue of the companies addressed in analysis. [3] Total earnings before interest, taxes, and amortization (EBITA) of the companies addressed in the analysis. [4] Total market capitalization of companies included in the analysis. [5] Includes packaging, industrial machinery, farm, lawn and garden supplies and janitorial/sanitary supplies.

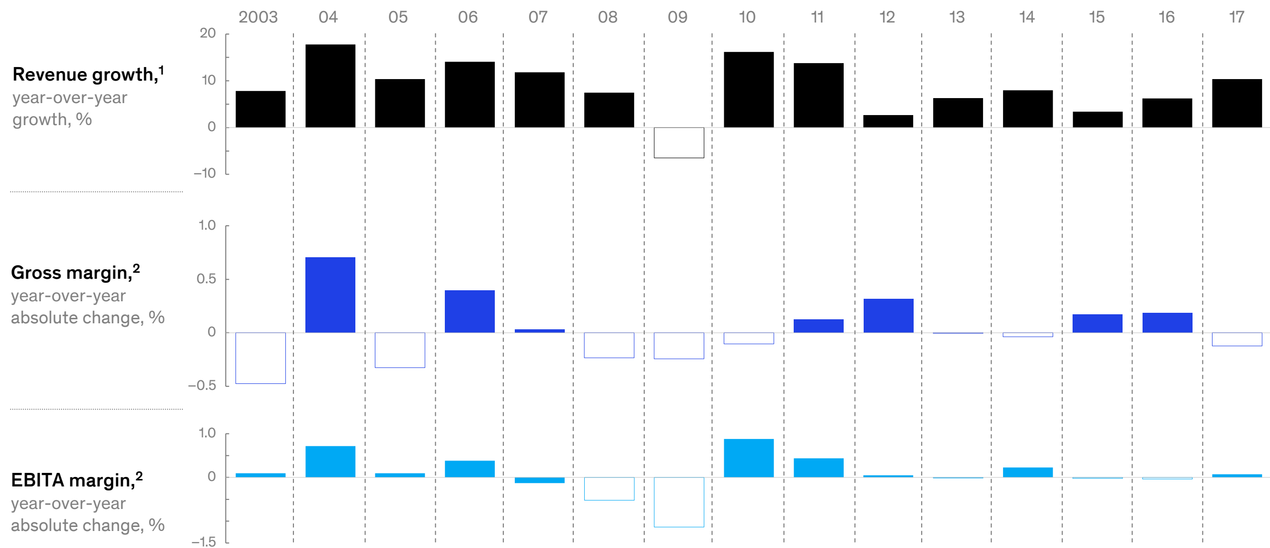
SOURCE: McKinsey CPAnalytics

[1] Economic profit is the surplus a company generates after accounting for the opportunity cost of the capital invested in the business—typically the fixed-asset stock and net working capital balance.

Distributors' weak profits and returns to shareholders since 2012 reflect a new reality. During the financial crisis, distribution's margins narrowed significantly as volumes declined, paralleling declines in other industries. But distribution margins have not improved during the recovery, as shown in Exhibit 2, even though revenues have grown steadily. Both gross margins and EBITA have been mostly flat.

Exhibit 2

Distributors have not regained margins during the recovery.



[1] Revenue growth calculated in local currencies and then weighted by average USD revenue over the time period. [2] Weighted by revenue in USD.

SOURCE: McKinsey CPAnalytics

In interviews, industry leaders told us that Amazon Business and other new digital entrants—many with vast financial resources and first-rate digital capabilities—are giving customers deeper insights into pricing and therefore more negotiating power. The executives added that as many manufacturers and customers consolidate, they are gaining new leverage in negotiating pricing with distributors.

Distributors have traditionally served as a primary go-to-market channel for manufacturers, held their products in inventory, broken up bulk, and helped them meet the varying needs of a widely distributed and fragmented customer base. Distributors' dedicated sales forces and technical experts still play important roles for many manufacturers, and some distributors serve as one-stop shops for customers who need a wide range of products. Many customers still expect a supply chain partner with a full range of products and access to credit and aftermarket services.

The distributors who thrive in the years ahead will be those who increase their scale and sophistication to keep pace with manufacturers, customers, and competitors.

Today, however, as manufacturers and customers gain scale, some are building their own distribution platforms or going direct with enhanced digital platforms. This trend threatens to relegate slow-moving industrial distributors to a narrower set of products and customers—or to commoditized warehousing, fulfillment, and transportation roles, where margins will be even lower.

Traditional services are becoming table stakes as customers look for more sophisticated partnerships and offerings. As customers grow nationally and internationally, for example, they will look for distributors with the scale and capabilities to provide a seamless experience across operations. Consolidated distributors who can serve these types of customers have a natural moat against local players and can unlock powerful efficiencies of scale.

Indeed, we believe that the distributors who thrive in the years ahead will be those who increase their scale strategically in markets where it matters, capturing the full synergy potential—and do so with sophistication to reach the next horizon of commercial and operational excellence. They will keep providing more value to manufacturers and customers while keeping pace with competitors, especially those with deep pockets who offer innovative services and convenience.

Marketplace fragmentation has important implications

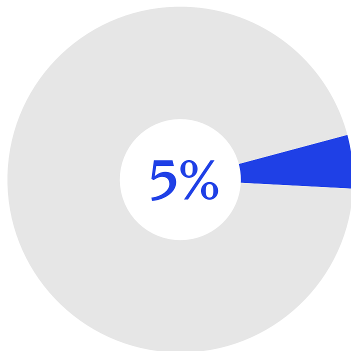
In each segment, from building products to electronics, the distribution landscape is highly fragmented. In IT, for example, one of the most consolidated sectors, the three largest public distributors account for less than 15 percent of the overall market.

Exhibit 3

The industry is fragmented with a few large players.

Share of US industrial distribution market, %

Top 12 publicly traded distribution companies that cover about 5% of the roughly $2.5 trillion US market



COMPANY NAME	US SALES, 2017, $ billion	SEGMENT
Ferguson	15.8	HVAC and plumbing
CDW	15.2[1]	IT
Tech Data	14.2	IT
GPC	13.3	Auto parts
Synnex	12.5	IT
Arrow	11.3	Electronics
Grainger	7.9	General industrial
Veritiv	7.5	Janitorial/packaging
Builders FirstSource	7.0	Building products
WESCO	5.8	Electrical
Anixter	5.8[2]	Electrical
LKQ Corporation	5.7	Auto parts

[1] Global revenue (individual countries not reported, but less than 10% of total revenues). [2] US and Canada revenue.

SOURCE: Company reports; Bureau of Economic Analysis; IBISWorld industry reports, 2018

We see similar fragmentation in the United States overall, as shown in Exhibit 3, where the top industrial distributor in almost every segment represents less than 6 percent of the overall market. The fragmentation has important implications. For example, customers with a wide array of choices among distributors may have stronger negotiating positions. Some local mom-and-pop distributors, who still constitute the majority of the market, may focus less on optimizing pricing than large, publicly owned distributors, who must generate higher returns on capital to satisfy shareholders.

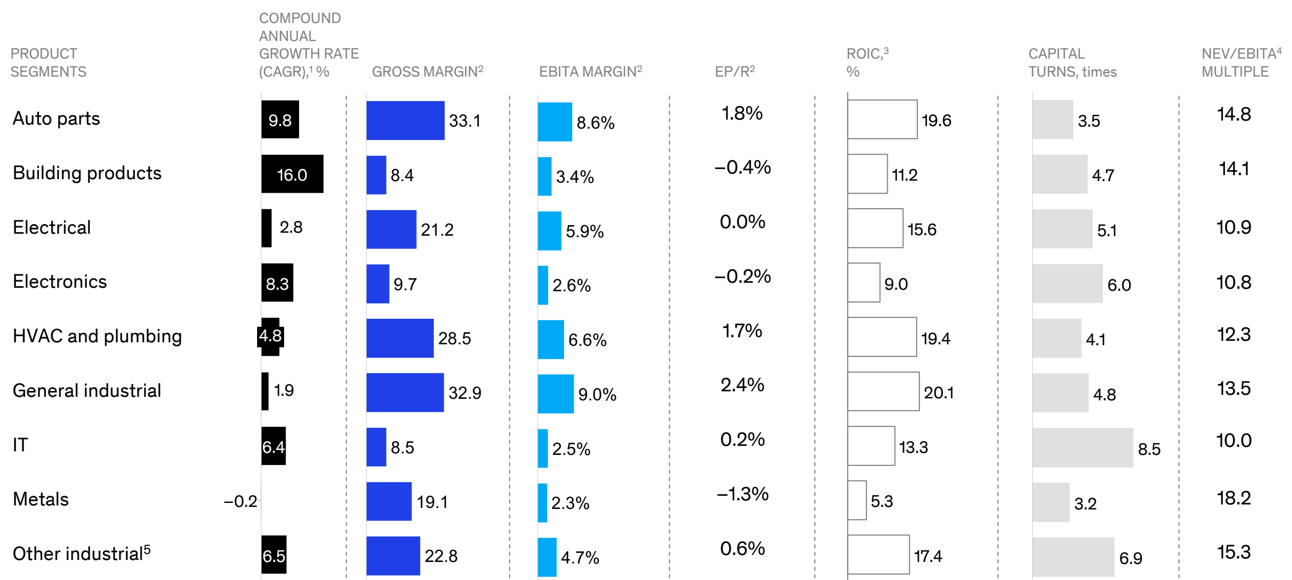
That said, each segment has its own challenges and opportunities, with wide variations in performance over the last five years, as shown in Exhibit 4. The subsectors with the highest returns on invested capital (ROIC) since 2012 have been auto parts, HVAC and plumbing, general industrial, and "other industrial," including packaging, industrial machinery, farm and garden, and janitorial and sanitary supplies.

Subsectors with lower margins, including electronics, metals, and building products, have generally struggled to generate ROIC, but there are exceptions. For example, IT delivered ROIC of 13 percent despite margins of only about 2.5 percent. The leading distributors here are focusing on capital efficiency to generate higher revenue per dollar of capital invested.

In general, the difference in ROIC between segments reflects the relative strength of distributors over customers and manufacturers in the segment, the penetration of private labels versus branded products, and overall margins in the industry.

Exhibit 4

Performance varies widely by segment.



[1] Revenue growth in local currencies; Weighted by average USD revenues in the time period. [2] Weighted by revenue. [3] Weighted by invested capital. [4] Weighted by adjusted EBITA. [5] Includes packaging, industrial machinery, farm, lawn and garden supplies and janitorial/sanitary supplies.

SOURCE: McKinsey CPAnalytics

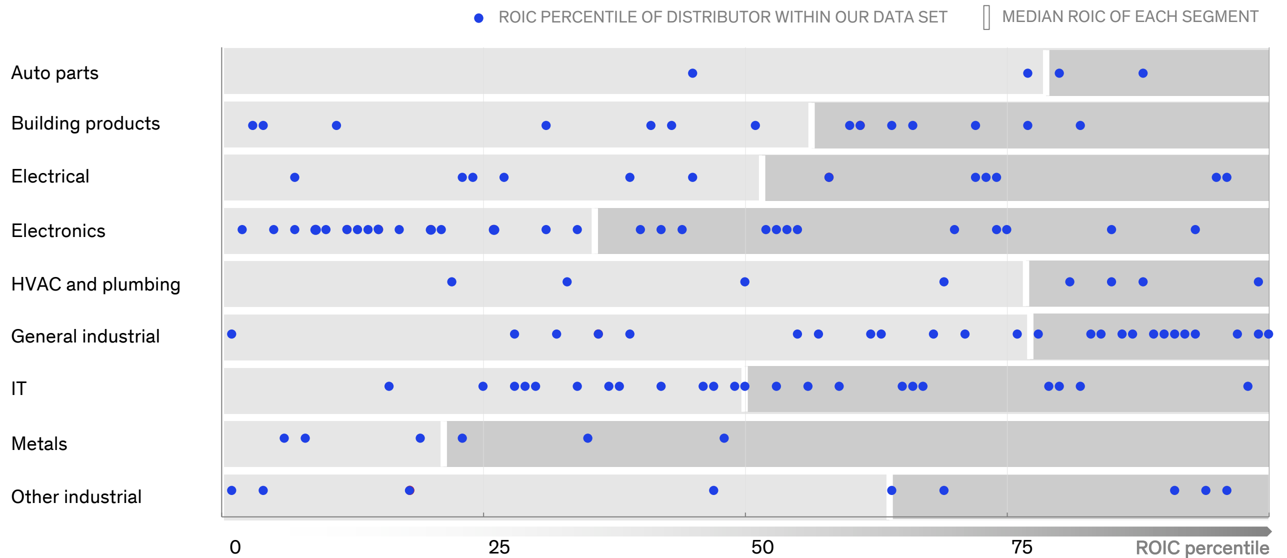
Winners play the game differently

Even in challenging sectors, some companies outperform the market by wide margins, as shown in Exhibit 5. In the electronics segment, for example, the median ROIC is well below the median for the industry as a whole, yet two players were able to deliver ROIC above the 80th percentile of the industry.

Exhibit 5

Corporate performance varies widely within segments.

Dispersion based on ROIC, 2017[1]

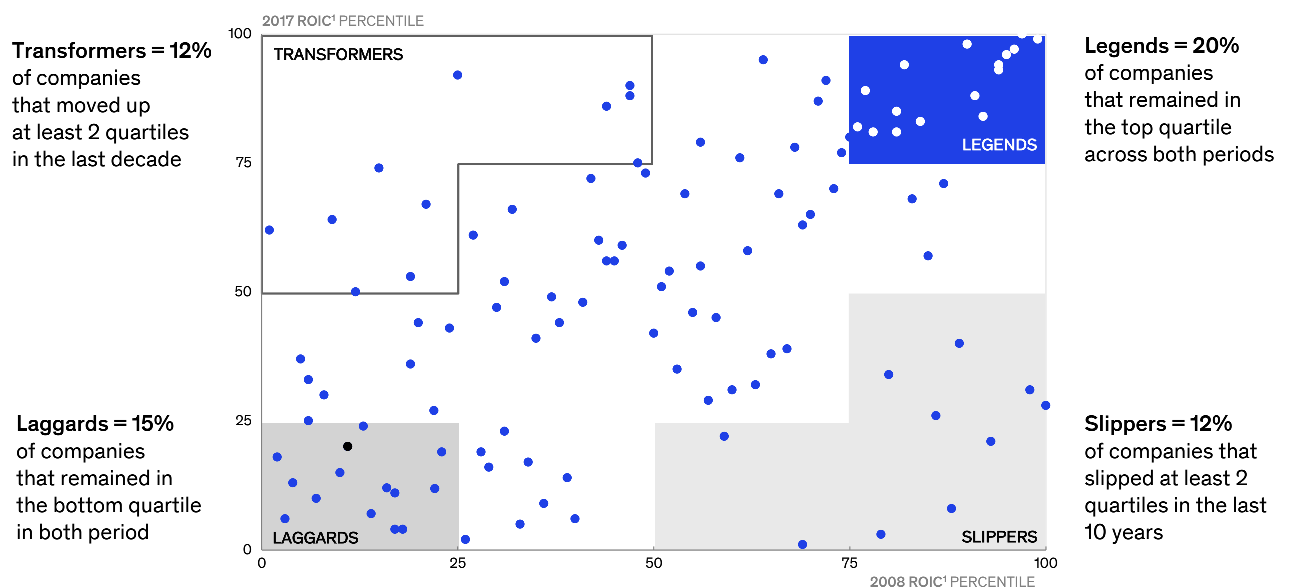


[1] Includes 108 companies with data available. Return on invested capital (ROIC) is calculated as an average of 2015, 2016, and 2017.
SOURCE: McKinsey CPAnalytics

What are the winners doing differently? To find out, we began by exploring changes in ROIC performance over the last ten years as the marketplace evolved. As shown in Exhibit 6, about 20 percent of the companies we studied delivered top-quartile ROIC throughout the decade—the "legends." About 12 percent, the "transformers," rose at least two quartiles, and 12 percent, whom we call the "slippers," fell back two quartiles. The "laggards," about 15 percent of the total, remained in the bottom quartile.

Exhibit 6

Some companies improved ROIC performance in the last decade.



[1] ROIC for 2017 is calculated as an average of 2015, 2016, and 2017. ROIC for 2008 is calculated as an average of 2006, 2007, and 2008. Includes companies with data available; n = 86.

SOURCE: McKinsey CPAnalytics

Some subsegments are inherently more attractive, with higher margins and ROIC. The legends include a disproportionate number of general industrial players, for example, while the laggard quadrant includes more electronics distributors. But individual company strategy also matters: legends and transformers include companies from eight of the nine subsectors.

We analyzed the financial performance of distributors across those four categories to find insights into how these companies supercharged their performance. Exhibit 7 summarizes our findings.

Exhibit 7

Transformers improved ROIC through profitable growth; slippers grew revenue at the expense of margin.

[1] Categorization based on 3-year average ROIC performance in 2008 and 2017. Includes companies with data available; n = 86. [2] Calculated as the average as of 2015, 2016, and 2017.
[3] Difference between 3-year averages of 2015-17 and 2006-08; averaged across all companies in category.

SOURCE: McKinsey CPAnalytics

In the last ten years, 17 legends maintained an impressive 30 percent ROIC average. They expanded gross margins and EBITA margins slightly—from an already high base—while keeping SG&A[2] essentially flat as a share of revenue.

The transformers raised ROIC from 7.3 to 18 percent by substantially improving gross margins with better pricing and/or sourcing. They slightly reduced SG&A spend as a share of revenue, suggesting operating leverage from top-line growth. As a result, almost all of their gross margin benefit dropped through into EBITA margin. Transformers also achieved an impressive 1.6x increase in capital turns (revenue produced per unit of invested capital)—some probably by reducing working capital or switching to asset-lighter models, such as by outsourcing logistics.

In contrast, the ten slippers saw a dramatic drop in ROIC from an average of 31.5 percent to 3.8 percent. They generated above-average annual revenue growth of 7.8 percent, possibly with heavy investments in SG&A, pricing low to win share (which meant losing 3 percentage points of gross margin), and increased inventory for an average decrease of 1.3x in capital turns. This fast growth clearly did not maximize value, however: overall operating margins plummeted 6.2 percentage points to just 1.0 percent.

[2] Selling, general, and administrative expense.

The 13 laggards treaded water for a decade, with no substantial changes in margin or capital turn profiles. We believe most of them failed to make big strategic moves, such as reallocating capital to new businesses or capabilities.[3]

Top performers share five main characteristics

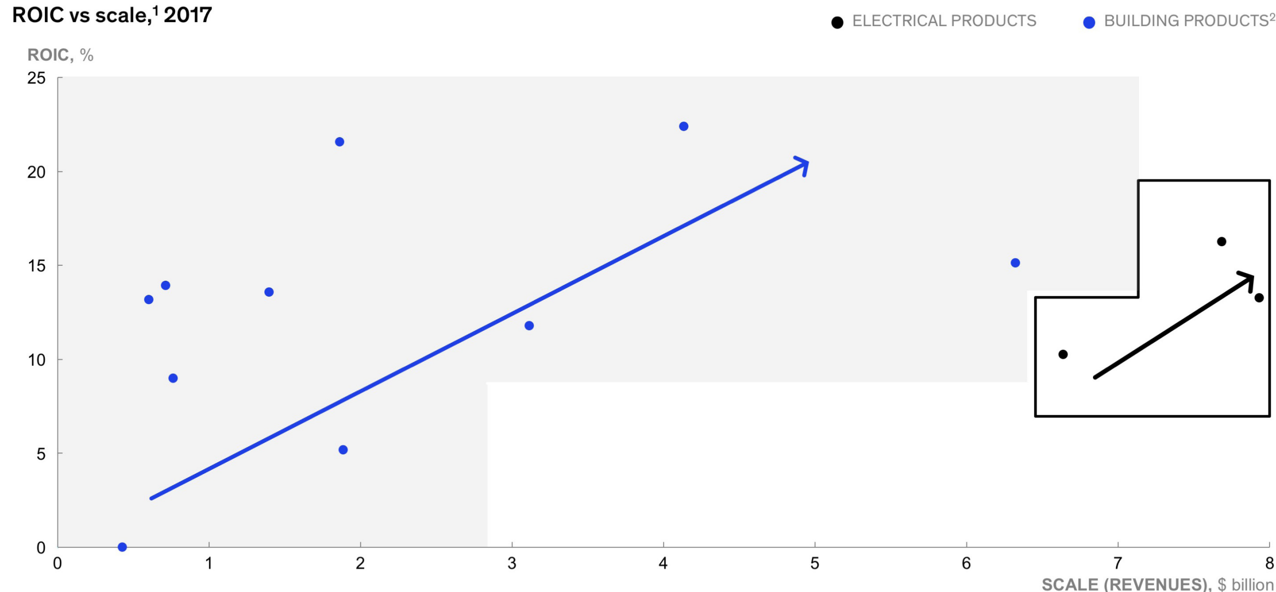
Making bold strategic moves is more difficult than ever in today's fast-changing marketplace; missteps can be costly. In our research, we found that industrial distributors with superior ROIC performance share five main characteristics: each is one of the largest companies in its segment, serves a favorable mix of customers, provides a broad range of product categories with a targeted assortment, offers value-added services, and invests in digital capabilities.

Operating at scale

As manufacturers and customers gain scale, leading distributors are keeping pace with their own aggressive and strategic consolidation. They use their scale to improve back-office efficiency, obtain better terms from manufacturers, and build deeper supply chain partnerships with customers. The largest players in each segment tend to have higher ROIC, as shown in Exhibit 8.

Exhibit 8

Strong correlation between scale and ROIC performance.



[1] While scale drives margin efficiency, other factors, such as customer landscape and manufacturer's power within the value chain, affect margin potential.
[2] 2015–2017 average for Huttig building products.

SOURCE: Publicly traded company financials

Serving a favorable mix of customers

Leading distributors continually optimize their mix of customers to capture high-growth and high-margin segments. By contrast, companies that focus on a single portion of the market risk being boxed in as competition intensifies and margin pressure increases.

Leaders also have a sophisticated understanding of the role each customer segment plays in overall economics and build a go-to-market approach that best serves each customer segment to maximize convenience and reduce cost to serve.

[3] For more on this topic, please see Sven Smit, Martin Hirt, and Chris Bradley, *Strategy Beyond the Hockey Stick: People, Probabilities and Big Moves to Beat the Odds* (Wiley, 2019).

A leading plumbing distributor, for example, built a third of its portfolio with large national customers despite their lower margin, since it helped the company cover fixed costs and enabled the sales force to focus keenly on more lucrative medium-size and small customers using a range of go-to-market channels from field sales to inside sales and e-commerce.

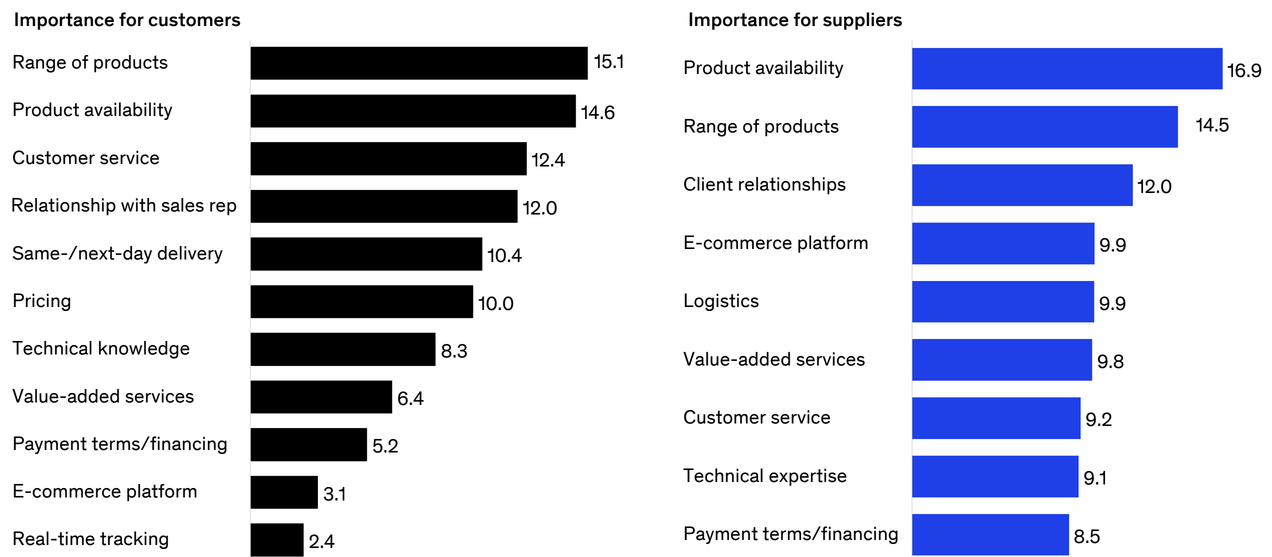
Providing a broad product assortment for convenience

Customers and manufacturers alike tell us that a broad range of available products is the most important value distributors can offer, as shown in Exhibit 9. Many customers look for convenient, one-stop shopping experiences, reporting that they aim to consolidate purchases with fewer businesses in the years ahead.

Exhibit 9

Product range and availability are vital to customers.

Importance of value added, by companies' role in supply chain,[1] average allocation of 100%



[1] Based on the survey question "Where do you think traditional distributors currently provide most value?"

SOURCE: 2018 McKinsey Distribution Service Line Customer Survey, n = 220; 2018 McKinsey Distribution Service Line Supplier Survey, n = 100

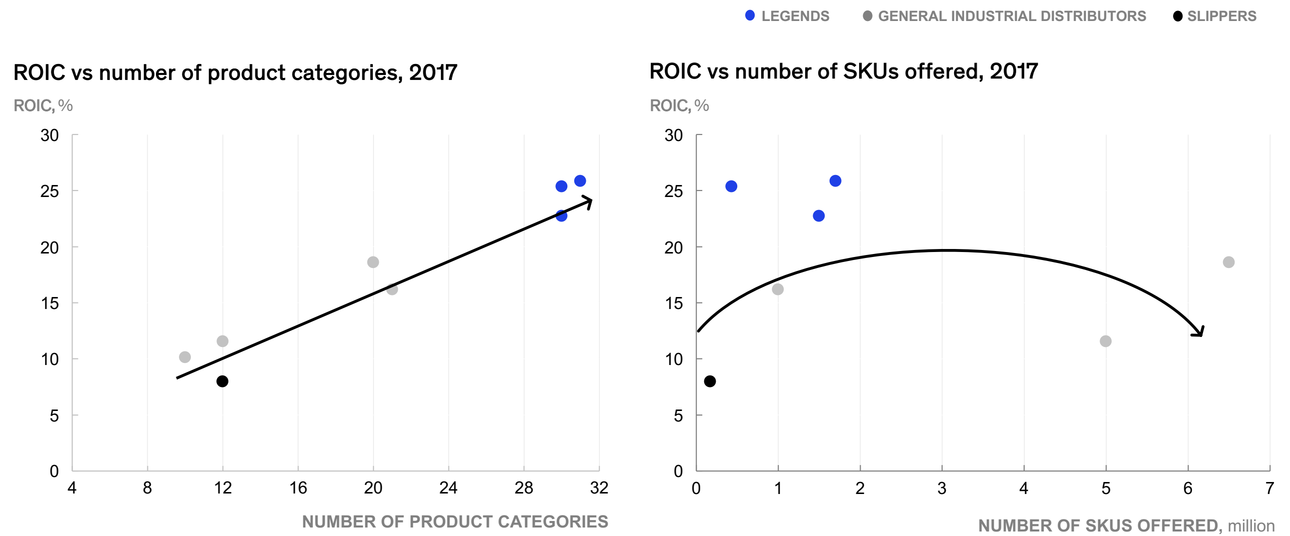
Our research also showed that performance tends to rise with the number of product categories a distributor offers, as shown in Exhibit 10. That said, building and maintaining an exhaustive inventory with a long tail of SKUs across categories can erode margins. In other words, most distributors should offer large but targeted assortments.

Offering more value-added services

Our research shows that companies that offer "visible" value-added services—those that customers demand and consider top-of-mind — tend to have higher ROIC. While product selection and convenience are crucial, many customers are looking for more, as shown in Exhibit 9. For example, a distributor of maintenance, repair, and operating supplies helps customers adopt green energy solutions and improve safety in the workplace, such as by offering emergency preparedness tools and training. These and other services improve the appeal of the company's product offerings and deepen relationships with customers.

Exhibit 10

Among general distributors, product range correlates strongly with performance.



SOURCE: Publicly traded company financials

Investing in digital capabilities to improve the customer experience

Digital giants like Amazon, Apple, and Google have raised the bar for everyone else. Customers now expect seamless 24/7 service, including simple, easy-to-navigate websites and mobile apps, and they have less patience for clunky catalogs and opaque order-tracking systems. Research suggests that only few customers who have bad experiences actually complain; most simply don't come back.

In industry after industry, companies that move quickly and decisively to transform and enhance their go-to-market approaches, processes, and culture through digitization and advanced analytics outperform competitors who neglect such investments.[4]

For distributors, critical capabilities such as e-commerce platforms, mobile tools, real-time product availability, and delivery tracking set the winners apart. Our analysis indicates that companies investing in digital capabilities already enjoy stronger margin performance than those earlier in their digital journeys. In the years ahead, we expect the gaps between the digital haves and have-nots in industrial distribution to get wider as customers increasingly expect fast, easy, omnichannel experiences.

[4] Venkat Atluri, Satya Rao, and Andrew J. Wong, "Why tech-enabled go-to-market innovation is critical for industrial companies—and what to do about it," November 2018, McKinsey.com.

The business is getting tougher

Powerful trends threaten revenue growth and profitability in wholesale distribution. Based on our research, experience, and discussions with industry executives, we've identified a combination of market trends and internal challenges that distributors need to manage to grow sales and margins.

Suppliers are aiming to build relationships directly with end customers

As manufacturers search for more ways to increase margins, some are eyeing the profit pools of distributors. Disintermediation has been a constant risk for distributors, but the rise of new digital technologies makes it easier than ever for manufacturers to pursue the idea at scale.

Some manufacturers are building their own distribution channels. For example, Bridgestone and Goodyear, two of the largest tire manufacturers, announced a joint distribution partnership in 2018. The new venture, TireHub, complements the companies' networks of third-party distributors and provides a fully integrated distribution, warehousing, sales, and delivery solution, competing directly with traditional tire distributors. Another example of captive distribution is United States Gypsum, which created and scaled its own distribution channel by acquiring small gypsum distributors and building its L&W division. USG then favored its captive distribution over other distributors it sold to, disintermediating them when possible. As the lower-margin distribution business became a drag on overall margins, USG sold L&W to ABC Supply in 2016.

Other manufacturers are selling directly to consumers on online platforms. For example, Dow Corning recaptured cost-sensitive customers by establishing Xiameter, a low-cost web-based brand. Within ten years of launch, online sales accounted for 40 percent of Dow Corning's revenues. Kohler, a major manufacturer of plumbing products, has invested in direct-to-consumer and builders' channels with a state-of-the art e-commerce platform and supporting organization structure despite an extensive network of distributors and retailers who sell its products. The list goes on: prominent manufacturers across industries are looking for ways to capture a larger share of the overall value chain on online platforms.

Disintermediation seems poised to accelerate. According to our 2018 survey of more than 100 senior manufacturing executives across the United States, manufacturers predict that the overall share of direct-to-customer sales will increase slightly in the coming years and that the share of products flowing via distributors and retailer channels will fall modestly.

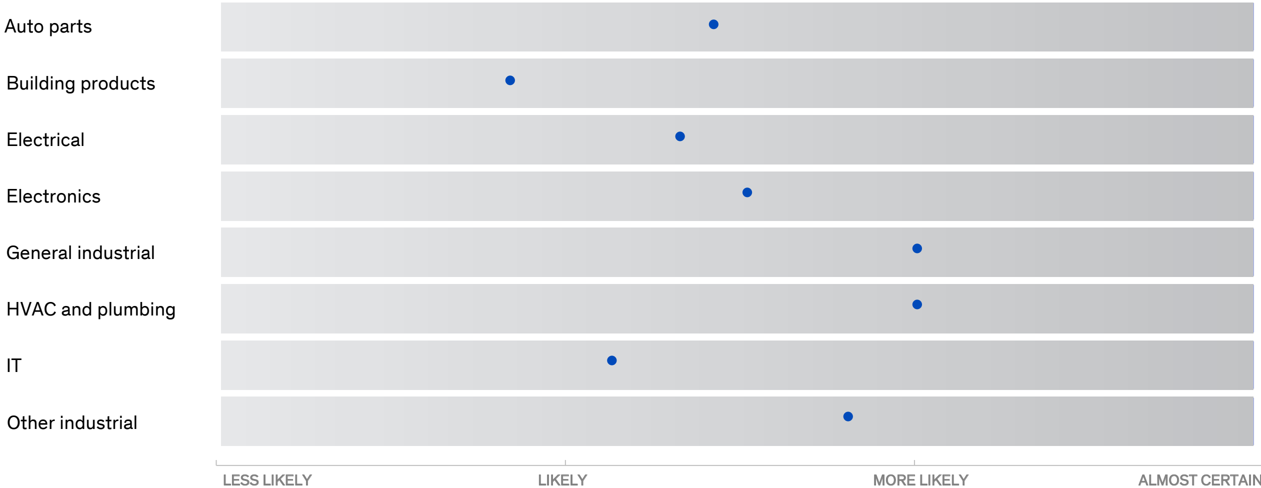
> **"Disruptions are no longer driven by historical industry leaders but by new entrants and game-changing technologies."**
>
> **CEO of a large industrial supplier**

The risk of disintermediation varies by segment. According to our survey, the likelihood of manufacturers trying to increase direct sales is highest for general industrial and for HVAC and plumbing, as shown in Exhibit 11.

Exhibit 11

Disintermediation varies by segment and is highest in general industrial and in HVAC and plumbing.

Likelihood to increase reach to end customers in next 2 years, average across respondents, by industry segment



SOURCE: 2018 McKinsey Industrial Distribution service line Manufacturer Survey, n = 100

According to a senior leader at a midsize HVAC manufacturer, "Direct dialogue with customers is a more harmonious sales model." A department head at a midsize general industrial firm agreed. "We save money working directly with consumers," he explained, "so we'd like to take care of distribution ourselves."

These themes echo across segments. Manufacturers aiming for more direct end-customer sales say they are developing more end-customer relationships (40 percent of respondents), easing customer accessibility on the web (21 percent), and aiming to capture distributors' margins (14 percent).

Customer expectations are rising

As noted, professional buyers who shop on Amazon now expect digitally enabled services such as customized reporting, multichannel ordering, and full visibility into distributors' inventory. Among customers who responded to our survey, 57 percent said omnichannel convenience was one of the top three improvements distributors should provide. Features they want include 24/7 customer service, a complete e-commerce website, order tracking, and real-time inventory management. Customers expect to make 30 percent more of their purchases from distributors via online means; those in the electrical segment expect a 50 percent increase.

Our interviews with industry players confirmed the vital importance of value-added services. "I'm really worried about the labor shortage and our inability to build houses fast enough to meet demand," said a local buyer at a national homebuilder. "A distributor who installs windows and doors will win my business day in and day out."

The chief of manufacturing engineering at a global auto parts manufacturer explained that his distributors "have always managed inventory for us—and that gives us peace of mind."

Disruptive new entrants are accelerating competition

New entrants are encroaching on distributors' territory, disrupting the status quo, and accelerating the competitive intensity. The biggest disruptors include digital leaders and big-box retailers looking to expand their share of the customer wallet.

Digital leaders with top-shelf talent and deep pockets, including Amazon and eBay, pose the greatest threats. By entering the B2B space, Amazon Business, previously known as Amazon Supply, threatens to cut many distribution players out of the supply chain.

According to our survey, customers expect the share of purchases made through digital players to rise by 50 percent (from a low base) over the next five years. About 65 percent of customer surveyed already procure a number of items from digital players. More than one in three do so on a recurring basis, and 15 percent and 19 percent use digital players as primary and secondary distributors, respectively.

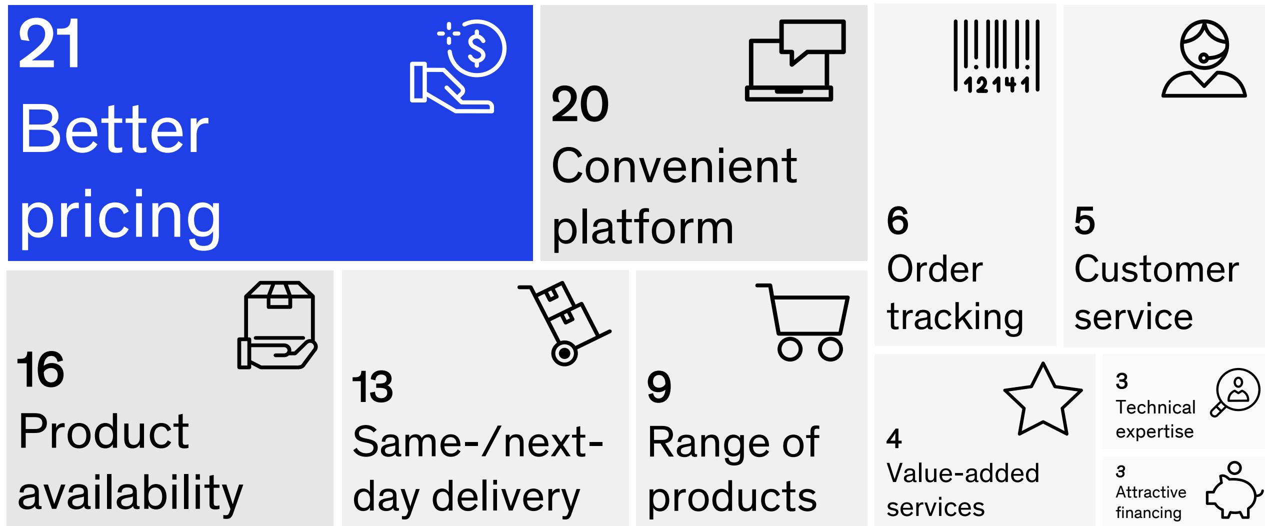
> **"People shop on Amazon at home. What we hear most often from business customers is, 'Can we have an Amazon shopping experience at work?'"**
>
> **Amazon Business leadership**

Many customers shop with digital players for better prices and convenience, as shown in Exhibit 12—especially those purchasing easy-to-ship products. The survey also revealed that around half of products that customers buy from digital players are small undifferentiated products such as toolboxes and wires and cables.

Exhibit 12

Customers turn to digital players mainly for price and convenience.

Importance of factors driving purchases from online players,[1] average allocation of 100% across respondents



[1] Based on the answers to the question "What are the reasons that drive your purchases from online only players (e.g., Amazon, Alibaba, eBay)?"
SOURCE: 2018 McKinsey Industrial Distribution Service Line Customer Survey, n = 220

According to the survey, 43 percent of customers who already use digital players mentioned better technical expertise as one of the top three improvements that would make them shift more volume. More than 80 percent of those who do not use digital players today cited product availability and range as the primary reasons holding them back.

The distributors at the greatest risk may be those in large segments with high margins, limited technical expertise, low value-added services, low customer purchasing power, and easy-to-ship products.

Amazon Business's integrated procurement system features multiuser accounts, flexible payment options, and enhanced invoicing capability. Barely a year after launch, the system has facilitated the sale of a billion dollars' worth of goods with 20 percent month-on-month growth. More than 100,000 business sellers now offer more than 400 million SKUs on the platform, serving a total of 300,000 business customers. If its growth continues at the same rate, Amazon Business could approach $20 billion in sales around 2020.

The potential for disruption is unprecedented. After Amazon acquired Whole Foods in June 2017, the value of shares in publicly traded food service distributors dropped by up to 5 percent. After the company's purchase of PillPack in June 2018, shares in publicly traded pharmaceutical distributors dropped by as much as 12 percent.

What does this mean for industrial distributors? There is no denying the obvious: digital disruptors like Amazon and eBay will disrupt the industrial distribution sectors. The question is when, not if. Experts tell us that in deciding whether to enter an industry, digital giants like Amazon consider how much they can improve customer experience with their current capabilities and infrastructure. The distributors at the greatest risk may therefore be those operating in large segments with high margins, limited technical expertise, low value-added services, low customer purchasing power, and easy-to-ship products.

Based on these assumptions, auto parts, electronics, and general industrial may face the largest disruption risk, as shown in Exhibit 13. Electronics, even with a low EBITA margin of 2.8 percent, is the largest target, with $354 billion in revenues in the United States alone. Commoditized products in electronics are small and easy to ship, and many transactions are made online. The general industrial segment has high margins at 7.4 percent, relatively easy-to-ship products, and mostly smaller buyers with knowledge and expertise.

Exhibit 13

Amazon may present the biggest risk to auto, electronics, and general industrial distribution.

Characteristics of companies at most risk of Amazon's entry

- Large market
- High margin potential
- Limited product technical expertise required
- Low supplementary value-added services
- Low customer purchasing power
- Easy to ship

SEGMENTS	U.S. REVENUE 2017, $ billion	EBITA MARGIN, 2017	DISRUPTION RISK HIGH	MEDIUM	LOW
Auto parts	241	8.1%	H	M	
Building products	113	4.0%		M	L
Electrical	171	4.9%		M	
Electronics	354	2.8%	H		
General industrial	99	7.4%	H		
HVAC and plumbing	263	8.9%		M	L
IT	307	2.6%		M	
Metals	208	3.5%			L

SOURCE: Expert interviews; IBISWorld industry reports, 2018

The metal and building products segments may face somewhat lower disruption risk because their products tend to be hard to ship, but experts we have interviewed mentioned that digital disruptors like Amazon are now partnering with third-party vendors to ship large, bulky products, such as refrigerators and lumber.

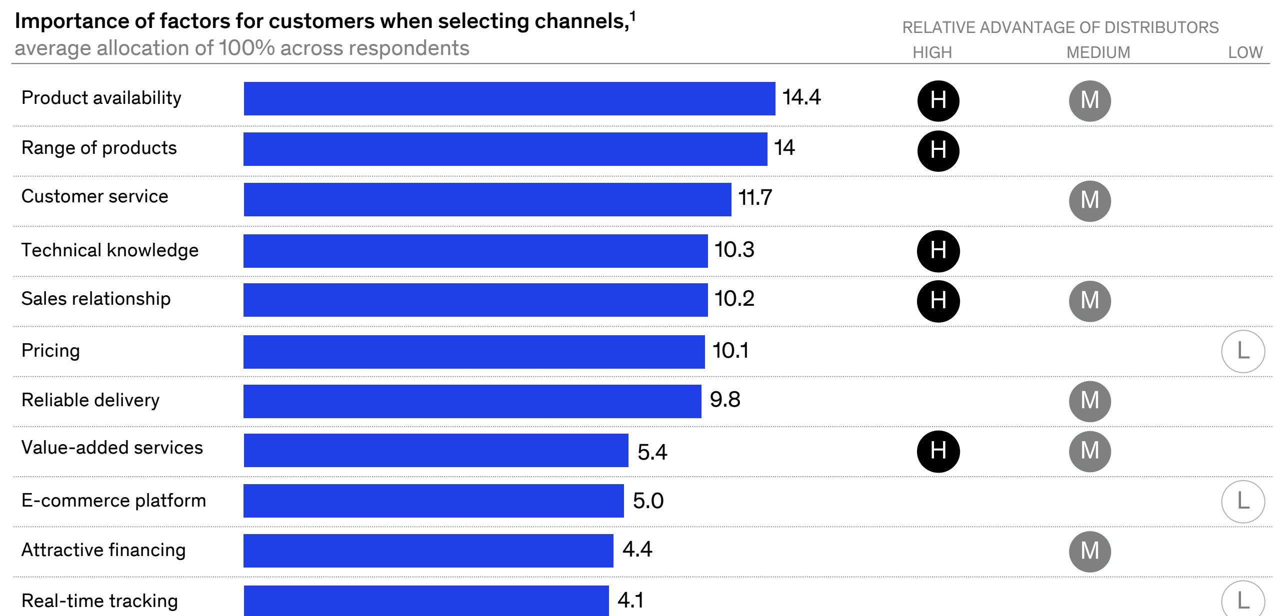
In short, it would be foolish to ignore the many “gorillas” in the marketplace. Every distributor, even those whose customer and supplier relationships seem invulnerable, should have a plan to compete with digital disruptors. The survey revealed that 48 percent of manufacturers are already considering partnering with Amazon, despite its reputation for squeezing manufacturers’ margins.

As one HVAC and plumbing manufacturer put it, “Amazon is the ideal partner. Cooperation will mean faster and more shipping opportunities and faster capital flow. It’s a win-win business model.” A general industrial manufacturer told us Amazon could help by providing a go-to-market channel that spans the whole country, calling it “a way to reach the final customer in a semi-direct way, with Amazon as a mediator.”

Despite this doomsday scenario, distributors have some advantages over Amazon and other digital players. Customers tell us that distributors have the upper hand across several top selection criteria, for example, as shown in Exhibit 14. And while many distributors rightly fear Amazon and other digital attackers, top distributors are aggressively expanding their “moats”—including deep product knowledge, technical expertise, service capabilities, and a long tail of products that pure digital players can’t match without big investments in technical talent and physical assets.

Exhibit 14

For now, some distributors have advantages over digital competitors.



[1] Based on the responses to the question “What are the characteristics of your primary and secondary distributors?”

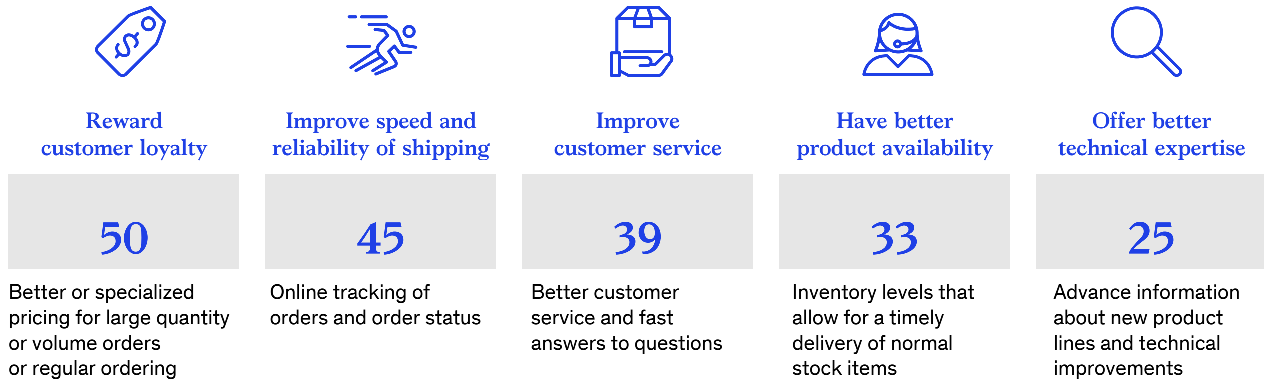
SOURCE: 2018 McKinsey Industrial Distribution service line Customer Survey, n = 220; 2018 McKinsey Industrial Distribution service line CxO interviews

When asked about improvements that could drive their volume to distributors, half of the customers surveyed said they wanted more value from their distribution partners, 45 percent want faster, more reliable shipping, and 39 percent want customer service improvements, as shown in Exhibit 15.

Exhibit 15

Customers want improvements from distribution partners.

Potential improvements that could drive volume to distributors,[1] % of respondents



[1] Based on the free-text responses to the question "Thinking about all of your interactions with distributors, what are 3 things a distributor could do to significantly improve your experience with them and make you want to order from them more often?"

SOURCE: 2018 McKinsey Industrial Distribution service line Customer Survey, n = 220; 2018 McKinsey Industrial Distribution service line CxO interviews

Competitive threats are not confined to digital entrants. Big-box retailers are also challenging traditional distributors, using their analytical prowess and customer insights to create tailored value propositions for contractors, for example, and using their large footprints to offer in-store convenience and extended hours.

The shares of Home Depot and Lowe's revenues generated by "pro" customers are now about 40 and 30 percent, respectively, after growing by 10 percent in each of the last five years. Big-box retailers have several advantages over industrial distributors. Most are open from dawn until late seven days a week, for example. Some have the capital to make major acquisitions. In 2015, Home Depot acquired Interline Brands, a leading national distributor and direct marketer of maintenance, repair, and operations products. Home Depot now promises two- and four-hour deliveries in some markets.

> **"Amazon is the ideal partner. Cooperation will mean faster and more shipping opportunities and faster capital flow. It's a win-win business model."**
>
> **HVAC and plumbing manufacturer**

Innovative technologies are disrupting traditional business models

New data and advances in computing power, data storage, analytics, and mobile platforms are turning industries as varied as music and healthcare upside down. Wholesale distribution is not immune, of course. Predictive and prescriptive analytics are helping the most sophisticated customers and manufacturers use dynamic pricing, predict churn, and optimize workforces and capital. For instance, UPS reports that its new navigation system saves its drivers about 100 million miles and 10 million gallons of fuel each year, reducing logistics costs by $300 million to $400 million.

Automated warehouses are speeding deliveries while cutting labor costs. Robots can now handle every step of the warehousing process, from unloading to quality control, reducing order-picking labor costs by as much as 80 percent and boosting operational efficiency in industries with razor-thin margins.

Autonomous vehicles are on the horizon—a potential boon to the distributors who can afford to put self-driving fleets on the road. Nearly every leading distributor tells us that transportation costs are affecting their margins. Flatbed trucking rates have risen 40 percent since 2016. Experienced drivers and high-quality warehouse workers are hard to find—and to keep.

A senior executive at a leading North American building products distributor put it plainly. "The labor issue keeps me up at night," he said. "We've paid millions in raises just to keep our people from accepting other jobs. This is especially true in our drivers pool. We want to use technology to optimize our need for labor, especially in a world where it is increasingly difficult to fill positions."

> **"We want to use technology to reduce the need for labor, especially in a world where it's increasingly difficult to fill positions."**

Leading North American building products distributor

Tomorrow's leaders are building five advantages today

Winning distributors are already transforming their operations to adapt to the major trends impacting the market. Based on our research and experience, we've identified five transformative actions that will distinguish the industry's outperformers across segments:

— *Build scale where it matters most.* Reap economies of scale by becoming one of the largest distributors in the sector and across markets where you play.

— *Compete smarter.* Invest in commercial excellence, from dynamically tailored pricing to sales-force training, to accelerating organic growth and expanding margins.[5]

— *Become leaner and execute flawlessly.* Improve operational excellence such as warehouse optimization, fleet maintenance, and demand forecasting, to reduce costs as a share of revenue and reallocate resources to pursue growth opportunities.

— *Move beyond product distribution.* Offer a suite of monetizable value-added services that customers want and need, and create an integrated offering of products and services that increases customer stickiness and spend.

— *Embrace the digital revolution.* Harness new digital tools and mountains of internal and external data to improve operations and the customer experience.

Build scale where it matters most

Scale will continue to be a key to margins. It helps distributors gain purchasing power, create denser delivery routes, optimize warehouse locations, increase coverage of products and sales, and reduce redundancies. These and other synergies can expand margins by a few percentage points and up to 3 to 4 percent return on sales in some mergers with significant overlap.

Top distributors have been pulling this lever for decades and are going after larger targets or merging with other top distributors. Since the bottom of the recession, M&A activity for the large publicly traded distributors has increased: 27 percent of top distributors have acquired at least one other distributor, up from 20 percent in the decade before the recession, and the average acquisition today is roughly 35 percent larger.

The rewards can be relatively quick and substantial. For example, a building product distributor nearly doubled its combined-entity earnings before interest, taxes, depreciation, and amortization (EBITDA) within two years of an acquisition by pursuing procurement synergies. It consolidated suppliers in key categories; eliminated redundancies in finance, IT, HR, and back-office support; consolidated overlapping locations; and designed denser routes with a new optimized footprint.

[5] For more on pricing, see Arnau Bages-Amat, Walter Baker, Nicolas Magnette, and Georg Winkler, "What really matters in B2B dynamic pricing," October 2018, McKinsey.com; Walter Baker, Dieter Kiewell, and Georg Winkler, "Using big data to make better pricing decisions," June 2014, McKinsey.com; and Walter Baker, Michael Marn, and Craig Zawada, *The Price Advantage*, 2nd edition (Wiley, 2010).

The keys to the margin improvement included a highly engaged leadership team, a well-resourced integration office and functional teams, a rigorous cadence, and careful performance management. Not every acquisition goes so well, however; many fall short of expectations. Some distributors have left tens of millions of dollars on the table because of poor planning, a lack of sales integration, limited leadership and resource commitment to the transformation, or underestimates of the cultural and technological integration challenges of integration.

Some companies also see diminishing returns as they keep building scale even after reaching number one or number two in a marketplace. For many large distributors, especially those who have reached the sweet spot of scale in their key markets, a better long-term bet is to invest aggressively in building commercial and operational capabilities that they may have neglected as they scrambled to build share and integrate disparate pieces of the business.

> **“Every distributor needs a sales organization that is a partner to the customer, providing technical expertise and solutions.”**
>
> **Senior executive at a leading European packaging distributor**

Compete smarter

With thousands of customer-SKU-transaction combinations and constant margin pressure from manufacturers on one end and customers on the other, distribution is ultimately a low-margin business. Even the most profitable sectors, such as general industrials and auto parts, achieve single-digit EBITDA margins. Leaders must therefore improve relentlessly in sales-force effectiveness, pricing, category management, and fleet operations.

As consolidation becomes more expensive, distribution leaders are looking beyond M&A, using new treasure troves of data and strides in advanced analytics to unlock commercial opportunities. They're shifting away from their traditional role of cost-plus or discounted-list-price product providers to develop unique customer value propositions. By building best-in-class commercial organizations, they're strengthening customer pull and differentiating their products and services from those of competitors and manufacturers.

The best distributors equip their sales staff to act as business partners who can identify customer pain points and co-create business solutions rather than just offer products.[6] For example, a leading distributor launched a major initiative to shift its customers to a higher-margin mix of products. To get the sales force on board and help them execute the initiative, the company trained them on best practices in selling solutions. It invested in routines, processes, and tools to empower and support frontline sales managers: a comprehensive sales playbook, ongoing training such as biweekly coaching sessions, and a sophisticated customer-relationship-management system that provides product and pricing recommendations directly to the sales force.

Another leading high-tech distributor dealing with a high volume of transactional orders, hundreds of thousands of SKUs, and thousands of customers realized the importance of arming the sales reps with tools and analytics to turn pricing from an art into a science. It invested in a dynamic pricing tool to segment customers and products into like clusters and provide sales reps with pricing recommendations tailored to each order. Pricing recommendations take into consideration order attributes such as geographical location, size of order, customer characteristics, end market, and suppliers—the main attributes that explain pricing and margin—thereby reducing human error to a minimum, tightening margin variability, and improving overall margins significantly.

Some distributors have not yet embraced the latest digital tools or dynamic pricing but have begun their journeys of commercial excellence. They are building pricing organizations to drive consistent pricing processes; crafting escalation and exception processes; implementing tight controls and best practices for contract setting, rebates, and payment terms; and building sales-force capabilities in value selling and negotiation. For most distributors, these changes represent a significant shift from traditional selling practices and oversight of highly entrepreneurial sales forces. But we are seeing that nearly every distributor who increases pricing discipline and sophistication has expanded margins and helped sales reps focus on what they do best: building and maintaining relationships with customers.[7]

We're not alone in seeing commercial excellence as a pillar of success in the industry, of course: 60 percent of leading publicly traded distributors mentioned it in their latest annual reports.

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[6] For more on building sales capabilities, see Bart Delmulle, Brett Grehan, and Vikas Sagar, "Building marketing and sales capabilities to beat the market," March 2015, McKinsey.com, and Homayoun Hatami, Kevin McLellan, Candace Lun Plotkin, and Patrick Schulze, "Six steps to transform your marketing and sales capabilities," March 2015, McKinsey.com.

[7] For more on sales-force effectiveness, see Bertil Chappuis, Steve Reis, Maria Valdivieso De Uster, and Michael Viertler, "Boosting your sales ROI: How digital and analytics can drive new performance and growth," February 2018, McKinsey.com; Charles Atkins, Maria Valdivieso De Uster, Mitra Mahdavian, and Lareina Yee, "Unlocking the power of data in sales," December 2016, McKinsey.com; Olivia Nottebohm, Tom Stephenson, and Jennifer Wickland, "Freeing up the sales force for selling," *McKinsey Quarterly*, July 2011, McKinsey.com; and Maryanne Hancock, Homayoun Hatami, and Sunil Rayan, "Using your sales force to jump-start growth," *McKinsey Quarterly*, April 2011, McKinsey.com.

Become leaner and execute flawlessly

Many large distributors still act like decentralized local businesses without consistent processes, routines, or performance management. The rapidly changing landscape is finally pushing many to reconsider investments in core operations to capture incremental efficiencies. Around 50 percent of the annual reports of the largest distributors mentioned the need to improve operational capabilities.[8]

Most can make significant progress in several areas. For example, smart, data-driven product purchasing and sourcing are helping leading distributors shape categories to optimize both their own and their customers' P&Ls. They undertake thorough category reviews to understand improvement opportunities, regularly refine and streamline their assortments based on customer and competitive insights, and conduct fact-based negotiations with manufacturers for volume discounts and better pricing. Many are now using data-driven purchasing and supply management—for example, by standardizing specifications and using clean-sheeting and other sophisticated purchasing techniques.

Many distributors are also pushing private-label products, which can improve margins for them and their customers. Others are addressing the never-ending concerns about transportation costs, refining routing practices to maximize output per driver while improving working conditions, such as by limiting miles driven, to attract and retain drivers.

Some are establishing more robust vehicle maintenance programs and making better replace-or-repair trade-offs based on total cost of ownership over an asset's life. Taken together, these improvements can reduce fleet-related costs by 10 percent or more, raise asset availability, and improve customer and employee satisfaction. A senior executive at a European packaging distributor, asked to describe a best-in-class distributor, talked about "tremendous cost management and flawless execution."

A final area of improvement involves streamlining administrative and overhead functions to reduce cost and improve effectiveness. While most distributors are already lean, we often see opportunities to consolidate functions such as accounts payable, purchasing, HR, and IT that have become widely dispersed throughout the organization as a result of continual M&A activity.[9] Some distributors are also adopting robotic process automation that can free resources now devoted to repetitive tasks such as invoice matching, processing expense approval requests, and auditing reported hours versus schedule (a common pain point in warehouse operations).[10]

[8] For more on operational excellence, see Bertil Chappuis and Brian Selby, "Looking beyond technology to drive sales operations," June 2016, McKinsey.com; Tomas Koch, Gernot Strube, and Khoon Tee Tan, "Unleashing long-term value through operations excellence," February 2013, McKinsey.com; and David Fine, Maia A. Hansen, and Stefan Roggenhofer, "From lean to lasting: Making operational improvements stick," *McKinsey Quarterly*, November 2008, McKinsey.com.

[9] For more on mergers and acquisitions, see *Leadership & Organization Blog*, "How to win at M&A," blog post by Oliver Engert and Emily O'Loughlin, May 28, 2018, McKinsey.com; Rebecca Doherty, Oliver Engert, and Andy West, "How the best acquirers excel at integration," January 2016, McKinsey.com; and Scott A. Christofferson, Robert S. McNish, and Diane L. Sias, "Where mergers go wrong," *McKinsey Quarterly*, May 2004, McKinsey.com.

[10] Frank Plaschke, Ishaan Seth, and Rob Whiteman, "Bots, algorithms, and the future of the finance function," January 2018, McKinsey.com.

We believe many distributors can leverage superior product knowledge and technical expertise to provide clear value, maintain premium pricing, and create a moat against pure digital players.

Move beyond product distribution

Most wholesale distributors who have reached scale do much more than product distribution: they're core value chain partners who provide customers with a suite of value-added services such as credit financing, inventory management, and product expertise. In surveys and interviews, customers tell us that these traditional value-added services are now becoming table stakes.

With that in mind, a few leading distributors are taking a customer-back view of their customers' challenges and pain points, partnering with them in new ways to raise satisfaction, such as by installing windows and doors for the many custom home builders struggling to find qualified labor. Some are improving customers' margins—for example, by offering international sourcing and providing "Silicon Valley–level" packaging design services and other high-end packaging solutions, such as for toxic-waste transport.

Distributors who provide customers with high-value services like these are capturing a larger share of wallet and significant increases in customer spend and loyalty. These value-added offerings create a differentiating edge to win new business.

Many distribution leaders tell us that building differentiated value-added services that address customer pain points can help them fend off challenges from traditional competitors and online players alike. An automotive distribution company is making significant investments in value-added services, for example, to provide incremental value to customers—especially those willing to pay a premium price relative to online players. We believe that many distributors can leverage their superior product knowledge and technical expertise to provide clear customer value, maintain premium pricing, and create a moat against pure digital players.

Embrace the digital revolution

As noted, digital advances are game changers in the distribution industry. But most distributors are still in the early innings of digital adoption and lag other logistics industries, despite customer demands for more convenient omnichannel experiences. In fact, our digital survey of more than 1,000 business purchasers found that over 90 percent of B2B buyers conduct research online before making a purchase, and 84 percent prefer to make repeat purchases through online channels,[11] given their convenience, cross-channel services, and features.

We believe every distributor needs a clear digital strategy. Digitizing the go-to-market model, the typical first step, means redesigning key customer journeys, offering a cohesive and integrated omnichannel experience (website, mobile app, in-store location, and social media), simple credit applications, paperwork integration software, and a coherent online portal to track orders. Developing a rich data ecosystem with robust analytical tools can give distributors and their sales teams a 360-degree view of customers, which can drive targeted product recommendations and service decisions.

Some distributors are building novel, customer-first digital flows that reimagine the typical "stock and flow" distribution model to better reflect how customers operate. For example, instead of requiring contractors to visit a location each morning to pick up supplies for that day's work, digital buy flows can ingest bills of material to help customers forecast purchases and consolidate a single weekly delivery. This saves restocking costs for the distributor and time and money for customers. Distributors with the talent and imagination to reengineer their business models will differentiate themselves from the competition and generate outsize value for customers and shareholders alike.[12]

Distributors investing in digital and e-commerce strategies are accelerating sales growth, expanding customer reach, and improving customer retention and loyalty. Grainger has led the pack, creating three e-commerce platforms—Gamut, Grainger, and Zoro—to reach different types of customers. The company's dedicated digital team has also built analytics-based personalization and real-time inventory updates. These investments have consolidated Grainger's spot as a leading distributor in digitally enabled operations, with e-commerce generating 51 percent of revenue in 2017 (up from 25 percent in 2012).

Home Depot understood the need for digitally enabled operations early. In 2012, it acquired BlackLocus, which helps retailers develop data-driven pricing models. Home Depot expanded its online presence and delivery capabilities by purchasing Interline Brands in 2015 and The Company Store in 2017. In 2018, the company announced that as part of its three-year, $11 billion strategic plan, it planned to hire about a thousand tech workers to upgrade their technology capabilities. The aim is simple: building a world-class, interconnected customer experience that almost no competitor can match, especially for pro customers, who want omnichannel convenience—and spend more.

[11] See *Digital sales and analytics: Driving above-market growth in B2B*, May 2018, McKinsey.com.
[12] For more on digital transformation, see Thomas Siebel, "Why digital transformation is now on the CEO's shoulders," *McKinsey Quarterly*, December 2017, McKinsey.com; Jacques Bughin, Laura LaBerge, and Anette Mellbye, "The case for digital reinvention," *McKinsey Quarterly*, February 2017, McKinsey.com; "Cracking the digital code," September 2015, McKinsey.com.

The first step

As times get tougher, many distributors are wondering if they can move fast enough in the right direction to fend off digital attackers. Indeed, we believe incremental improvements and wait-and-see attitudes could lead to ruin. That's why we're urging our distribution clients to set a bold strategy to reach the ultimate destination: a winning platform.

The race is on. We expect distribution as a whole to follow a version of the Amazon model, with just two or three winning platforms per segment. The laggards—perhaps the majority of distributors—will struggle. Many will become commodity distributors, low-margin logistics providers on someone else's platform.

Most of the winners will drive efficiency through analytically and technologically enabled commercial and operational best practices, and then reinvest a portion of the savings and profits to digitize and build more compelling customer portals to provide the most seamless, convenient, and high-value customer experiences in their segments. They will add value for manufacturers and customers, own the customer relationship, and maintain their essential role within the value chain.

The first step is to take a dispassionate, independent view of one's business to understand the full improvement potential, taking into account what leading players are doing. In our experience, incremental thinking is dangerous here; genuine progress requires a structured and transformative approach that is clearly separate from business as usual, instead performing exhaustive assessments and challenging current assumptions. Our experience suggests that proactive distributors have levers to adapt and win in the new landscape—but the clock is ticking.

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