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MDM Special Report:

Wholesale Distribution Disrupted

How to navigate the distribution industry's inflection point

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Deloitte Consulting LLP

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Wholesale Distribution Disrupted

How to navigate the distribution industry's inflection point

Disruptive forces may have a big impact on the future performance of distributors. This article, the first in a three-part series, will identify some of the critical disrupters and their effect on distribution.

After years of evolutionary change, the wholesale distribution industry faces major disruption and a true inflection point. The disruptive forces impacting distributors across all lines of trade provide ample qualitative evidence for this. And quantitative evidence can be found in the erosion of the industry's financial performance. The current inflection point will likely produce a marked division in future performance between visionary distributors willing and able to chart a new course for their business and those too constrained by orthodoxies to keep their business from declining.

In recognition of these dynamics, 22 executives from nine leading distributors recently gathered at Deloitte's Greenhouse for a full-day workshop to examine the industry's financial performance and disruptive forces, and then explore a framework for navigating the inflection point. In this three-part series, we will share some of the insights and perspectives from this workshop.

Financial Performance

Each quarter, Deloitte analyzes the financial performance of distributors with publicly available financial statements. For an extended period of time across a number of key metrics and indicators, performance has been deteriorating. The umbrella metric Deloitte considers is return on operating capital (ROC), defined as:

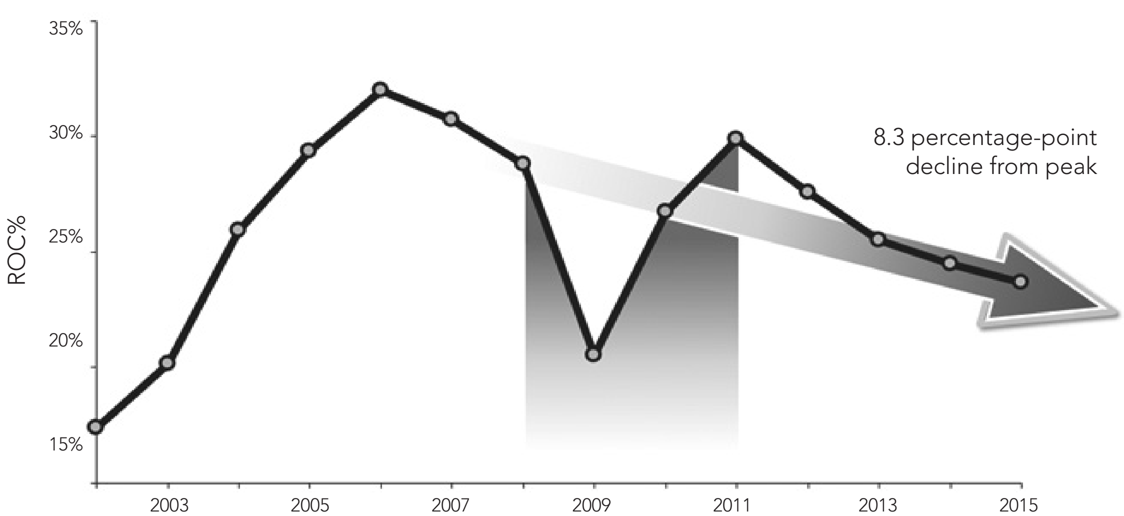
$$\frac{\text{Earnings before Interest \& Taxes}}{\text{Net Fixed Assets + Net Working Capital}}$$

This formula reveals how effectively a company is turning capital into profit.

Figure 1 displays average ROC since 2002 for the distributors included in Deloitte's analysis. While some cyclicality is evident during the financial crisis, the chart shows a persistent negative trend over the past 10 years. The 8.3-percentage-point decline since 2006 represents a fundamental shift in industry performance that exposes and constrains weaker players, while also creating a breakaway opportunity for leaders.

Driving the decline from an income state-

Figure 1: Average Return on Operating Capital (2002-2015)



Source: Deloitte Consulting LLP Analysis; S&P Capital IQ Database.

ment perspective is:

- **Uninspiring year-over-year revenue growth**, which has slipped from 16 percent in 2006 to 3 percent CAGR in more recent years, with a negative trend.
- **A 40-basis-point erosion in gross margins** due in part to the inability of distributors to get customers to compensate them for incremental services, inventory management, self-service capabilities and value added services.
- **Flat SG&A productivity**, reflecting ongoing investments in e-commerce, mobile, self-service, a better trained and informed sales force and other value added services without offsetting efficiencies in more traditional expense areas such as inside/outside sales.

When taken together the revenue, gross margin and SG&A factors have depressed distributor EBIT margins by a full percentage point since 2006. This is the primary reason industry ROC has declined 8 percentage points since 2006.

The industry's financial performance represents a serious call to action for distribution executives. But navigating the industry inflection point and avoiding the fate of Kodak, Blockbuster, Lucent and Borders – among countless others that failed to navigate their own inflection points – requires a deep understanding of the forces in play and new thinking.

Orthodoxies

In distribution, orthodoxies are powerful forces that can and do have a detrimental effect on decision-making. Concerted effort and decisive action will be needed by executives to overcome their own organization's orthodoxies. Here are some common "truths" about distribution to consider – and challenge:

- We are a low-margin business.
- We need a large sales force.
- We are an asset-intensive business.

At the workshop, Deloitte engaged participants in a structured exercise to both acknowledge and challenge their orthodoxies.

The emergence of new competitors is one powerful sign that an industry has reached an inflection point. For distribution, this can be seen in AmazonSupply's (now Amazon Business) 2012 launch and its rapid growth to $1 billion in revenues by 2016. Amazon is unbounded by orthodoxies; they simply don't exist in the same reality of most distribution businesses.

Reflecting on your orthodoxies and understanding how they impact your decision-making can create new perspectives and open your eyes to new opportunities.

Disruptive Forces

The sheer number, as well as the magnitude, of the factors impacting the industry presents a daunting, shifting landscape for distributors to navigate. Most distributors are not accustomed to the rapid emergence of new competitors leveraging completely new business models, swift advances in new technologies or seismic shifts in how customers want to interact and transact. Some perspective on these disruptions can help navigate the new market realities.

Accelerating digitization

What makes digital a truly disruptive force is not the enabling technology, but the transformational shift in value creation that it is driving. Digitization is not only empowering distributors to make more informed decisions about what inventory to stock, how much and where to store it, but also what value proposition will resonate with each customer segment, what price to charge, which markets are growing, which segments value private label, which customers prefer face-to-face sales vs. self-service and which customers offer the strongest growth potential.

Digital is also driving greater transparency. Some distributors have thrived in market niches with a certain level of pricing and availability opaqueness. However, digital is enabling customers to more efficiently shop for items from various suppliers and for distributors to offer an endless aisle of products. As e-commerce, online marketplaces and other digital tools gain further acceptance and capabilities, they will further drive transparency, increase pressure on gross margins and commoditize some specialty products.

Expanding competition

Distribution has always been highly competitive, but the number and variety of competitors has reached new heights. This increased competition includes traditional distributors expanding the breadth and depth of their offerings. For example, a growing number of foodservice distributors now also offer foodservice equipment, smallwares, safety products and technology solutions.

Beyond traditional competitors, B2C retailers are showing interest in B2B, particularly in building supplies and tool markets. These competitors can effectively leverage their purchasing power, store network and B2C experience to present a formidable source of competition for distributors.

Digital is exerting a massive influence on the competitive landscape, as well, enabling companies to launch specialty models that focus on a particular customer segment or product category. Examples include Zoro Tools, Enco Tools, AtlantaLightBulbs.com, BuildDirect.com, WebstaurantStore and Supplies on the Fly.

Capturing new customer demand

Inflection points can have positive or negative effects. Potential positive implications are seen in the new industries being spawned by technology and business disruptions. Consider the private space business where newly formed companies, such as SpaceX, Blue Origin and Virgin Galactic, each represent significant potential for a wide range of distributor products and services such as industrial MRO, electrical switches, wire and gear, electronic components and a wide range of chemicals. In foodservice, new go-to-market models are creating potential new customers (e.g., Blue Apron, Freshly) and expansion of food service offerings in convenience stores and the growth of food trucks. Additive manufacturing also represents an opportunity; one chemical distributor already announced it carries filament refills.

These examples are truly disruptive in that these industries simply didn't exist a few years ago. They bring different business models and economics to traditional segments and exhibit rapid growth. Distributors of the future will likely need an ecosystem of connections to stay aware of developments and stay ahead of their competition.

Product innovation

An array of product innovations are reshaping distributor value chains, while at the same time creating unanticipated opportunities and challenges. For many electrical supplies distributors, the rapid adoption of LED lighting has created a paradigm shift in the sales discussion, from sockets and bulbs to total cost of ownership, compatibility and integration. In the process, LED technology has created an entirely new set of suppliers, a different go-to-market channel and is rapidly eroding the recurring revenue stream associated with replacement bulbs. In the foodservice line of trade, growing consumer interest in locally sourced and organic produce and concerns about GMO have created challenges and opportunities.

Another innovation with the power to completely disrupt many lines of trade is additive manufacturing, or 3-D printing. The full suite of technologies involved in 3-D printing is complex and compelling. Materials such as metals, ceramics and even food ingredients can be used to create parts and products as diverse as electrical circuits, shoes, jet engine parts, personalized housewares and even steaks!

A market is growing for the supply of additive manufacturing machinery and equipment, the raw material inputs into production and the ongoing MRO needs associated with their use. AmazonSupply was an early entrant into this market, featuring 3-D printers and supplies on its site before evolving into Amazon Business.

Continuing disintermediation

According to a UPS study from 2015, 64 percent of industrial buyers say that they already buy direct from manufacturers (DFM) and 88 percent indicate they are likely to increase their DFM purchases. However, unlike the past when disintermediation was a gradually evolving and less important threat, today it is rapidly evolving and exerting significant pressure on many distributors, forcing them to higher levels of due diligence and introspection about their value proposition and go-to-market channels.

Today's disintermediation threat is playing out in different ways across lines of trade. Some examples:

- In medical supplies, customers such as integrated health networks and integrated delivery networks are building scale and capacity to self-distribute, completely removing the distributor from the value chain.
- In LED lighting, manufacturers such as Cree Lighting are not only selling direct to end customers but also providing design services, financing and installation.
- In foodservice, the continuing growth of group purchasing organizations is reducing the distributor's role, sometimes to drayage only. Overall GPO penetration in foodservice grew from 16 percent in 2009 to 21 percent in 2014, according to research from The Hale Group. Even more troubling is the growth in the street segment where many make their money.

Whether the distributor is completely removed from the transaction or just the price negotiation, the implications on performance are dramatic. Digital tools are in many cases accelerating this disruption, and demographic shifts indicate it will likely increase further. Distributors should develop long-term responses that leverage their capabilities and reflect their line of trade dynamics, according to the UPS study.

Consumerization of expectations

Distributors often emphasize that B2B commerce is very different from B2C. Figure 2 highlights some examples of these common differences.

Figure 2: B2B vs. B2C Priorities

B2B	B2C
I need...	I want...
Complex, negotiated pricing	Simple, standard pricing
Ongoing	Transactional
Purchase approval workflow	No purchase approval
Rebates	Coupons
Relation centric	Product centric
Products configured	Products standard

However, expectations in B2B commerce are increasingly informed by developments and experiences in B2C. Expectations common in B2C, such as transparent pricing, a rich, tailored user experience and communities/social connections are rapidly permeating to B2B. B2B e-commerce customers now expect:

- Intuitive, easy-to-navigate ordering platforms, including mobile, that have high quality product images, in-stock information, measurements and specifications, faceted search and the ability to buy online with a variety of fulfillment options
- Transparent pricing with the ability to quickly compare price and availability using digital tools. Amazon enables B2B buyers to compare their negotiated price for specific items with that of other Amazon sellers, giving them the option buy at a price below their negotiated price.
- A consistent and persistent experience across channels and platforms. (For example, "Inside sales knows I've been on the website.")
- Ratings, reviews and social network access via Twitter and YouTube. Already a handful of leading distributors survey customers about their willingness to recommend them to peers. The resulting Net Promoter Score and trends inform distributor marketing, promotion, sales and customer service decisions.

Distributors that cling to outdated perspectives on B2B engagement and experience will likely forego opportunities for fostering customer loyalty and miss incremental revenue growth. At a time when top-line revenue growth comes at a premium, this dynamic is not sustainable.

Engage to Combat Disruption

Future success requires a strategic framework to act on opportunity

Disruptive forces may have a big impact on the future performance of distributors. This article, the second in a three-part series, introduces a framework for harnessing these disruptive forces and identifies the capabilities distributors need to develop to successfully navigate the inflection point.

Successful distributors of the future will be those that appreciate the magnitude and import of the disruptive forces they currently face and have the courage and conviction to act decisively. These distributors will embrace a framework to effectively assess opportunities, develop plans and act with purpose.

Unlike in retail, where disruption led to the rapid disappearance of some leading players (e.g., Circuit City, Borders, KB Toys, Blockbuster), the wholesale distribution inflection point will see a bifurcation in financial performance. Driving this inflection point are six disruptive forces, which were identified and expanded upon in the first article of this series:

- Accelerating digitization
- Expanding competition
- Emerging customer demand
- Product innovation
- Continuing disintermediation, and
- Consumerization of expectations

In this second article we introduce a framework for harnessing these disruptives forces and the capabilities distributors will need to develop to successfully navigate the inflection point. This accessible "E" framework (see **Figure 1**) has three complementary elements 1) engage the customer, 2) execute the value chain and 3) energize the business.

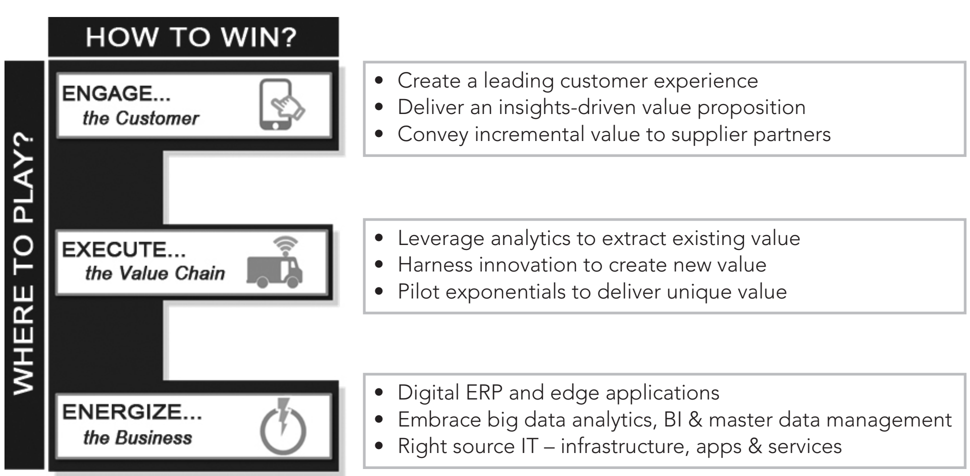
Breaking down the "E" framework

Future success for distributors will center, much as it does today, on engaging the customer. Despite numerous forces disrupting the industry and many of its orthodoxies, "customer first" retains its critical position. But for it to maintain its power, distributors will need to transform their thinking from simply meeting customer needs to anticipating and shaping them and proactively delivering solutions to problems that customers may not even know they have. This encompasses a reimagining and realigning of e-commerce, customer service, sales, marketing and other go-to-market capabilities leveraging analytics.

Distributors of the future will also understand that engaging customers can't be limited to updated e-commerce and a reimagined customer facing organization. It requires executing the value chain. This means applying analytics, process improvement and technology to

Figure 1: Framework for navigating the industry inflection point

Effective distributors will be those that transform the traditional wholesale value proposition to a relentless focus on Engaging the Customer, Executing the Value Chain and Energizing the Business.



inventory, logistics, pricing, rebates and network optimization to drive efficiencies and free capital that can be invested in other innovative technologies such as internet of things, robotics, drones and augmented reality.

Distributors will also need to more effectively harness the power of IT to energize the business. This includes establishing a modern, efficient platform for the core transactional needs of the business and leveraging other advances to deliver functionality.

Consideration of the three elements of the framework feeds directly into a distributor's strategic planning. Strategy can best be expressed as a series of interdependent and self-reinforcing choices starting with Where to Play and How to Win. Once distributors have defined their Winning Aspiration and Where to Play (i.e., their vision, objectives and target customers), consideration of the three limbs of the "E" helps develop responses to the next strategic question of How to Win (i.e., the assets and capabilities they will deploy to create competitive advantage).

Engage the customer

A profound shift is underway in wholesale distribution as it relates to customer interactions, from simply meeting customer needs to anticipating and shaping them – and proactively delivering solutions to problems that customers may not even know they have.

Two examples from other industries epitomize this shift to anticipating customer needs:

Uber gained traction and a multibillion-dollar valuation by challenging the orthodoxies of a taxi trip, fundamentally changing the way in which available capacity is matched with passenger demand, the way destination information is conveyed and how payment is transacted. It has also extended its model to develop solutions to better match trucking capacity with customer demand, to mitigate the shortage of drivers and to fulfill other delivery demand.

Amazon disrupted many industries and interactions, including the homeowner's task of reordering various products, such as laundry detergent, toilet paper, batteries and pet food via its Dash buttons. It, too, has extended its model by integrating the functionality into products themselves (i.e., washing machines) and buttons you can program for any product reorder.

The distribution industry's customer-centricity and the premium placed on face-to-face interactions will need to transform to better align insights, interactions and channels with shifting expectations. Face-to-face interactions will likely become fewer in number but more relevant in terms of content. Instead of reactively meeting customer needs, leading distributors will proactively engage the customer. They will sense and shape demand, deliver a superior experience, capture and leverage insights, and realize incremental value.

These changes are more than semantics. They are being driven by advances in technology, shifts in demographics, increases in competition and heightened expectations. A new demographic of B2B customers is assuming a position of responsibility. These customers are increasingly willing and able to research products, assess vendors, check availability and compare prices before engaging with the distributor.

A recent Forrester Research survey highlighted that B2B buyers would prefer to self-educate about products and services vs. talk to a sales representative by a 3-to-1 margin. The report went on to note that 75 percent of B2B buyers prefer to buy online vs. through a sales representative. In this disruptive environment, incremental changes will not suffice, yet 49 percent of B2B companies still do not have a mobile strategy.

With the emergence of such an informed, empowered and independent B2B customer, the onus is shifting to engaging the customer in new ways, at numerous different touchpoints and at a whole new level. This means, for example, that sales reps must consult with customers to identify pain points they aren't even aware they have and deliver solutions, not just recap additions to the line card. Distributors should capture mindshare and value before, during and after the purchase transaction occurs. This dynamic continues to reshape the retail industry offering some lessons for distributors, but ultimately the experience assumes a different manifestation for B2B than it does in B2C retail.

Create a leading experience

The primacy of customer experience over customer service represents a deep fundamental change in thinking for many distributors. Ever-pragmatic distributors have not traditionally focused on the somewhat amorphous notion of an experience, believing instead it was sufficient to meet the more tangible and immediate customer needs. This mindset manifested in a relentless focus on broad and deep inventories (we have what you need), competitive pricing (we are the low-cost choice), superior fulfillment (we will get it to you overnight) and responsive customer service (if you have a problem, we are here).

Those foundational capabilities retain a high level of importance, but the future distributor's value proposition will be driven by a suite of digitally enabled capabilities, such as content marketing, search engine marketing and mobile, that are refined and targeted to deliver a compelling B2B experience. Nearly three-quarters (72 percent) of industrial buyers report a likelihood of increasing spend to a distributor with a user-friendly website. And from our discussions with distributors in other lines of trade, these dynamics are not unique.

As they consider this shift it would also be wise for distributors to research trends and capabilities from the B2C. Traditional drivers of the B2C customer experience include informed store associates, enticing in-store merchandising and compelling brand storytelling. More recently these have been augmented with innovations such as robust omnichannel capabilities (e.g., seamless shopping across mobile apps, retail store, phone and e-commerce) and IoT-enabled fixtures (e.g., hangers with sensors that activate targeted promotions when an item is returned to the rack). Distributors of the future will study and learn from the retail transformation journey and apply B2B-relevant lessons to their own business and customer interactions.

The select group of distributors already considered leaders in delivering a superior customer experience typically began with comprehensive and multidimensional customer segmentation (e.g., profitability, cost to serve, share of wallet and lifetime value). The insights drove decisions about customer engagement, digital capabilities and the portfolio of relevant value-added services.

Because of the increasing importance of this capability, some distributors have invested in the creation of a true marketing function and a chief marketing officer. This investment helps drive a stronger focus on developing market insights, customer segmentations, branding and a compelling value proposition. What these distributors understand is that delivering a superior customer experience is a highly quantitative exercise around capturing and assessing a diverse set of metrics (such as net promoter score, average order value, conversion rate, abandoned cart rate, retention and first-call issue resolution) and applying analytics to deliver the desired and required experience.

Another dimension of the B2C experience that has great relevance to distribution is omnichannel, the relevance of which is growing as customer expectations increase and go-to-market channels proliferate Leading examples of the omnichannel experience include: ordering both stocked items and special orders via the distributor's onsite vending machine portal; placing items in a mobile commerce shopping cart while at a job site; linking to a specific project or work order, using workflow for approval, then picking up the items 24x7 at the distributor's nearby branch; and placing a single order via the distributor's mobile app for partial pick-up next morning at the branch with delivery of the balance to a job site two days hence.

This focus on the omnichannel experience isn't just for the benefit of the customers. In a 2015 study from Forrester Research, 60 percent of B2B sellers report that the more channels customers use for purchasing, the more they actually spend overall.

Deliver an insight-driven value proposition

In an effort to better serve the evolving needs of customers, most distributors have added to their line card and product catalog, expanded and upgraded their service offerings, entered new market segments, and increased business complexity through acquisitions and geographic expansion. Yet only a select few distributors effectively apply insights to capture the potential value from this intentional complexity.

To navigate the inflection point, distributors should deliver an insight-driven value proposition, one that encompasses a tailored customer experience as well as analytically driven cross-sell and upsell opportunities. They should master the art and science of gathering disparate primary and secondary data, converting it into actionable insights and leveraging those with customers, suppliers and influencers. One electrical supplies distributor delivers this value proposition in a simple but valuable way by kitting products together for a residential building contractor. The bundle combines precut, labeled sections of wire, wire nuts, electrical boxes, receptacles, faces plates and light fixtures, providing the electrician with exactly what they need for each room in the house. Other distributors leverage insights to tailor delivery times, product put-away, packaging, palletizing, labeling, replenishment, product selection and invoicing decisions. These and other insight-driven value propositions will create sustainable differentiation for distributors.

Convey incremental value to partners

For most distributors, the primary perceived value of customer and market insights is through leveraging them to refine product and service offerings and to develop value propositions that will resonate with specific customer and supplier segments. But distributors looking to position themselves as "the preferred route to market for suppliers" (mitigating the impact of disruptive disintermediation) are waking up to the realization that being a preferred route means more than saturating the market with branches, inventory and sales reps. Increasingly distributors are investing to capture a wider array of data and information, applying an array of analytic tools to extract insights from that data and collaborating with suppliers on its application in the market.

This data-driven approach is evident in the growing adoption of end-to-end category management approaches, investment in sales and operations planning, greater amounts of time spent reviewing results with suppliers and an ongoing search for ways to enrich the insights with macroeconomic, regulatory and weather data. For example, one HVAC distributor is modeling market potential for replacement units based on compliance with regulations requiring conversion to new refrigerants and technologies, changing weather patterns and usage profiles. These and other insights offer great value to the distributor, but can also represent a source of great value with suppliers.

Engaging customers, suppliers and influencers on this higher level will be a critical part of a distributor's future success.

Building a Distributor of the Future

Future success requires better execution and an energized business

Disruptive forces will likely have a transformative effect on wholesale distribution. In our previous two articles, we assessed the financial performance of the wholesale distribution industry and an array of disruptive forces already impacting participants. We also introduced a framework for harnessing these disruptions and the capabilities distributors will need to develop to successfully navigate the current industry inflection point. In this article, the third in the series, we discuss the final two parts of the framework: executing the value chain and energizing the business.

Many distributors have struggled to drive top-line growth, resorting to a steady stream of tuck-in/fill-in acquisitions. However, the additional physical infrastructure, IT systems and headcount when post-merger integration is not completed strains company earnings. Indeed many acquisitions fail to realize their potential as branches, DCs, customers, suppliers, delivery routes, product lines and inventory accumulate and calcify.

As they look to engage customers and deliver the expected experience, distributors of the future will have to extract the value stranded in their value chains and reinvest proceeds for sustainable differentiation. For inspiration, they should look outside distribution to examples such as Fast Radius' creation of an automated, distributed manufacturing hub that leverages 3-D printing technology on the UPS Supply Chain Campus in Louisville, KY. These and many other truly innovative technology and business model innovations are reshaping the end-to-end distribution value chains.

Execute the value chain

Distributors of the future who execute the value chain will continue to offer high fill rates on A, B and C items and on-time delivery; they will harness a broad ecosystem and invest in new capabilities. But their journey starts with extracting stranded value.

There are multiple, analytically driven approaches that distributors can leverage to help extract stranded value (see **Figure 1**). Proceeds from these foundational initiatives can be used to help fund investments in more forward-looking, transformational opportunities. Explicitly linking the initiatives at the inception helps build organizational excitement and maintain focus on long-term value creation.

Figure 1: Improvement Initiatives for Extracting Stranded Value

Gross Margin

Pricing

Distributor pricing practices and the application of analytics tools lag other industries.

Transaction complexity creates significant opportunities for value capture.

SKU management

Broad and deep inventory has long been viewed as a source of competitive advantage for distributors.

Analytics can identify SKU reduction opportunities without impacting revenues and creating cost savings.

Rebates

Distributor EBIT margins average ~6 percent and rebates 5-10 percent of revenues.

Distributors can realize substantial benefits by managing rebates as a business.

Cross-sell

Expansions of product catalogs and additional service offerings multiply the potential for cross-sell/upsell.

Distributors must overcome compensation, organization, analytics and other challenges.

Operating Expenses

Sales effectiveness

Sales are typically high cost, autonomous organizations with often limited alignment to corporate priorities.

Account coverage, sales segmentations and incentive structures can be aligned for heightened effectiveness.

Shared services / outsourcing

Most distributors lag in capitalizing on the available benefits of shared services and outsourcing.

Finance, project management and customer service are frequently duplicated across branches and DCs.

Working Capital

Network rationalization

Few distributors – if given the chance – would redraw their supply network as it currently exists.

Too often DCs, branches and delivery routes accumulate via acquisition and are not rationalized.

Inventory

Distributors can leverage established strategies from other industries to bump up the performance curve with regard to inventory performance without sacrificing customer service.

A relatively quick assessment of current performance vs. leading practices and benchmarks can assist distributors in prioritizing investments in these areas for maximum benefit. Here is some additional perspective on four of the improvement areas.

Rebates

A significant source of distributor gross margin leakage can be found in their management of vendor rebates, chargebacks and deviated pricing. Based on research from Deloitte Consulting, typical distributor EBIT margins are around 6 percent and rebates range from 5 percent to 10 percent. As such, it is no exaggeration to say that effective rebate management can make or break a distribution business. There are many potential sources of rebate leakage, including: new items added with incorrect rebate amounts, poor tracking of vendor agreements that include marketing incentives or rebate tiers and not updating systems to pass along vendor freight charge increases.

Quick-hit areas for benefits include shifting spend to maximize incentives across manufacturers, reducing rogue spend, tracking compliance, and empowering the organization with insights (i.e., true net/net cost comparisons) to negotiate more effectively with suppliers.

SKU management

Distribution businesses tend to be very good at adding to their portfolio and touting the number of items in stock, but they can struggle to rationalize their portfolios. The application of SKU management analytics can reveal duplicate items and significant hidden, non-value-added cost. Variant tree analysis of the nitrile glove assortment at one MRO distributor revealed 73 different SKUs (color, thickness, manufacturer, powdered, powder-free, pack size, etc.), but just eight of those SKUs generated 55 percent of unit volume at a higher margin than other SKUs – and customers were completely indifferent about many of the attributes driving the SKU count higher.

Network optimization

If given a clean sheet of paper, most distributors would likely position DCs and branches, stock inventory and route deliveries very differently than their existing network. Too often distributors have grown via acquisitions and accumulated a disjointed, duplicative network. As a consequence, much of the value they expected to realize from the transactions is left – metaphorically speaking – on the shelves of the DC. A network optimization that assesses both product flows and operating footprint can surface opportunities.

Inventory

A growing number of distributors are applying advanced analytics to their most sacred of assets – their inventory – and more effectively managing the trade-off between service levels and stock levels/locations. Traditional thinking is that distributors must manage a direct relationship between service levels and inventory levels. Graphically this relationship takes the shape of a curve, and by changing performance, distributors can move up and down this curve. However, application of proven analytics and supply chain process improvements can shift the curve, allowing for reduced inventory levels and improved service levels.

In other instances, distributors engage directly with customers to validate service-level requirements: Are current service levels higher than customers actually need to efficiently run their business? It may be that distributors could reduce inventory levels without impacting customer satisfaction. Questions distributors might ask include: Do you really need items delivered overnight or is two-day fulfillment acceptable? Would you rather receive a single bundled order than multiple orders each week?

Harness innovation to create new value

Executing the value chain effectively also requires that distributors harness innovation. Distributors looking to create "moats" and sustainable differentiation may want to assess the internet of things for their business.

Many underlying IoT technologies, such as tags and sensors, have already passed the pilot stage creating near-term opportunities for distributors to create new sources of information that they can monetize. For example, a waste-to-energy cogeneration facility may place great value in knowing the timing and composition of inbound loads, as well as projected energy needs of its service area. If enough high-energy coefficient materials are inbound, a utility can avoid purchasing fuel, improving profitability.

The true power of IoT isn't the technology but the business model innovations it enables. Construction companies that previously relied on a fluid power or bearing distributor for their MRO needs as parts failed can contract for predictive maintenance that leverages sensors and tags embedded in equipment. In foodservice, increased information about cold chain integrity and humidity conditions during storage and transport can help operators reduce spoilage of meats, fruits and vegetables. Applying IoT to an existing business process in a small scale pilot can be a low cost, low risk starting point.

Other innovations include exponential technologies, such as drones, additive manufacturing, driverless vehicles and robotics. Innovations in this domain occur in fits and starts and often move in unpredictable directions, but leaders are already experimenting. At least one distributor Deloitte Consulting has examined has explored leveraging drones to assess the condition of utility power lines and towers following a storm. While widespread adoption of these technologies may be several years down the road, distributors should consider potential applications of these technologies.

Energize the business

Too many distributors continue to view IT as a cost to be managed or minimized. Few distributors operationalize aggressive use of IT for real action and incremental investment. To effectively energize the business (versus just enabling it), distributors need to leverage digital ERP and edge applications, embrace big data and analytics, and right-source IT infrastructure, apps and services business.

Distribution is among the last industries to make the transition to packaged ERP solutions and the expanding universe of edge applications. Perceived implementation risks, competing priorities and a false sense of security about the ability of legacy systems to support changing business needs have kept distribution lagging.

Advances in technology and implementation can be applied to reduce risk, even as the risks of not embracing a modern ERP grow. Some factors to consider include:

- Variety of sales channels supported (e.g., vending, consignment, VMI, CMI and digital)
- Product portfolio expansions and customized, configured, complex and bundled offerings
- Ability to accurately cost and price value-added services
- Efficiency and effectiveness in areas such as pricing, rebates and other variable drivers of profitability
- Complexity and timeliness of customer cost-to-serve calculations

Today's leading ERP packages leverage flexible and modular core architectures, extensive middleware and in-memory databases and they leverage partners' agile implementation approaches to mitigate risk, accelerate implementation speed and reduce cost. Agile bolt-on applications and extensions further enhance the flexibility and scalability of the solution. ERP implementations create opportunities to transform your business with streamlined processes, centralized back-office functions, new service offerings and a better understanding of business profitability.

Many distributors believe that their business and processes are unique and a source of differentiation. The truth: Most processes are standard, repeatable or otherwise handled by out-of-the-box ERP solutions. Finding the right balance between standard application and needed customizations requires 100 percent engagement from affected business functions and knowledgeable implementation partners who can introduce best practices and challenge where necessary.

Embrace big data analytics, BI and master data management

Few industries are as awash in complexity and underused data as distribution. Without efficient means to capture, store, analyze and act on this data, wholesale distributors large and small are likely missing opportunities and losing competitive value. Data is the fuel for transforming the customer experience (e.g., what cross-sell offer will resonate), executing the value chain (How many nitrile gloves should I stock?) and improving financial performance (What gross margin will I realize with a 1 percent price increase?).

One of the primary innovations with great potential for distributors of the future is in-memory computing. The ability to conduct on-the-fly, what-if analyses in real-time will be a game changer for those with the vision to transform the way work is done as a result of these innovations. It facilitates asking questions about how my business would look if:

- Sales reps could model the cost-to-serve and profitability impact of different service-model scenarios in real-time with customers
- Real-time allocation decisions regarding scarce inventory could be made based on customer lifetime value and competitive

analysis
- CFOs could close the books in hours – not days, monitor the performance of the business in near-real-time and conduct extensive what-if scenarios

Competitors like Amazon already apply big data analytics to continuously improve every facet of the customer experience.

Right source IT infrastructure, apps & services

But what about the cost of all these investments? How can a distribution business with 1 percent to 3 percent net margins possibly fund all the required infrastructure, application and service investments and organization?

While advances in technology and their adoption create a compelling need for the outlined capabilities, they also help reduce the cost, complexity and potential risk of the investments. These innovations – which we put under the umbrella of right-sourced IT – include cloud technology, in-memory computing, software as a service, web applications and other hosted/outsourced models for application development and maintenance.

The flexibility of dynamic cloud and SaaS also creates a new competitive dynamic in the industry (small distributors are able to harness technology innovations) and fundamentally rebalances the risk and cost. Cloud-based innovations offer financial flexibility by creating a more variable cost structure and providing greater transparency into IT costs and usage. They also offer more rapid deployment and scalability, an unparalleled ability to access upgrades and innovations, and leading security and resilience capabilities.

New vs. old complexity

Distributors of the future will have as a core competency the ability to chart a capability road map that puts energy behind the aspirations of the business to assess myriad options. Implicit in this road map-building exercise is a well-developed ability to assess available and emerging options, quantify benefits and costs, and mitigate change management considerations.

Effectively harnessing these innovations and aligning the organization behind them involves a visionary CIO who can work hand-in-hand with the business, as well as third-party suppliers and service providers. More distributors are waking up to the reality of industry disruptions and the inflection point – and looking to technology to energize their businesses.

Beyond functional leadership, distributors of the future will also transform their IT organizations in terms of structure and skills. Factors influencing these decisions will include corporate culture (e.g., highly decentralized decision making), geographic scope of the business, customer segmentation, branding and digital aspiration.

While the distribution industry faces a true inflection point and the decisions and investments appear daunting, leaders are building the capabilities to position them for the next phase of the industry's evolution. Winners will emerge and deliver the financial performance that allows them to create further differentiation.