McKinsey & Company

Advanced Industries

The coming shakeout in industrial distribution

And five keys to outperformance in the years ahead

April 2019

Authors
Alex Abdelnour
Associate Partner, Distribution Sector

Amna Hussein
Consultant, Advanced Industries Practice

Nick Malik
Senior Partner, Distribution Sector

Steve Reis
Senior Partner, NA leader, Distribution Sector

Nick Santhanam
Senior Partner, NA Leader, Industrial Practice

Sri Swaminathan
Associate Partner, Advanced Industries Practice

Introduction

Powerful trends that have disrupted industries around the world are now affecting industrial distributors. A few are quickly building scale, making 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 leave 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 the pressure may rise. 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 leaders are growing share and margin. Based on our research and experience serving clients across industries, we believe that distributors who move quickly can create deeper customer relationships and sustainable competitive advantages to outperform consistently in the years ahead.

In this brief article, we review the industry's major challenges and then outline the five strategies that we believe will help the winners outperform in the next decade.

The business is getting tougher

Based on our research, experience, and discussions with industry executives, we've identified a combination of market trends and internal challenges that threaten revenue growth and profitability in wholesale distribution.

Suppliers are aiming to build relationships directly with end customers

As manufacturers search for ways to increase margins, some are eyeing the profit pools of distributors. 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.

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.

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.

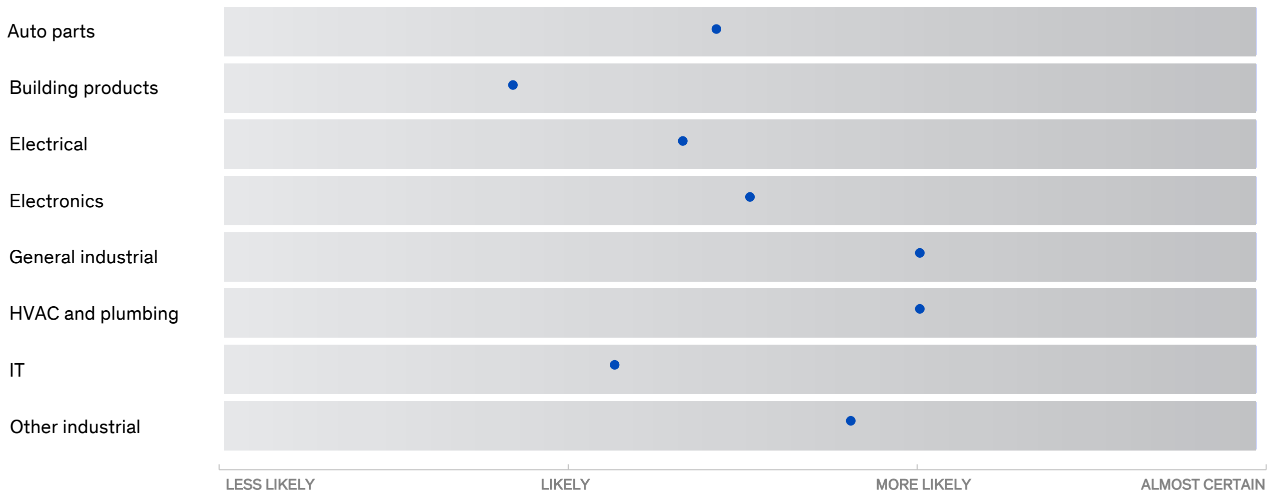
According to a senior leader at a midsize HVAC manufacturer, "Direct dialogue with customers is a more harmonious sales model." A department head at a midsize general industrial firm agreed. "We save money working directly with consumers," he explained, "so we'd like to take care of distribution ourselves."

These themes echo across segments (Exhibit 1). Manufacturers aiming for more direct end-customer sales say they are developing more end-customer relationships (40 percent of survey respondents), easing customer accessibility on the web (21 percent), and aiming to capture distributors' margins (14 percent).

Exhibit 1

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

Customer expectations are rising

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. Digital leaders with top-shelf talent and deep pockets, including Amazon and eBay, pose the greatest threats. By entering the B2B space, Amazon Business threatens to cut many distribution players out of the supply chain. Its integrated procurement system features multiuser accounts, flexible payment options, and enhanced invoicing capability. 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, Amazon Business could approach $20 billion in sales around 2020.

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 (Exhibit 2).

Exhibit 2

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

Electronics, general industrial, and auto parts may therefore face the largest disruption risk. 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.

All is not lost, however: distributors still have some advantages over other digital players. Customers tell us that distributors have the upper hand across several top selection criteria, for example. 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.

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.

Innovative technologies are disrupting traditional business models

New entrants are encroaching on distributors’ territory, disrupting the status quo and accelerating the competitive landscape. 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 driver’s pool. We want to use technology to optimize our need for labor, especially in a world where it is increasingly difficult to fill positions.”

Tomorrow's leaders are building five advantages today

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

1. 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 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.

Substantial rewards can come relatively quickly. 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.

The keys to the margin improvement included an engaged leadership team, well-resourced integration office and functional teams, a rigorous cadence, and careful performance management. Many acquisitions fall short of expectations, of course. 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 cultural and technological integration challenges.

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 in commercial and operational capabilities that they may have neglected as they scrambled to build share and integrate disparate pieces of the business.

2. Compete smarter

With countless customer-SKU 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 only single-digit EBITDA margins. Leaders must therefore improve relentlessly in sales-force effectiveness, pricing, category management, and fleet operations.

Some 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 discount providers, building best-in-class commercial organizations to strengthen customer pull and differentiate their products and services.

The best distributors equip sales staff to act as business partners who can identify customer pain points and co-create business solutions.[1] For example, a leading distributor launched an initiative to shift its customers to a higher-margin mix of products. To get the sales force on board and help them execute, the company trained them on best practices in selling solutions. It invested in routines, processes, and tools to support frontline sales managers: a comprehensive sales playbook, ongoing training, and a sophisticated customer-relationship management system that provides product and pricing recommendations directly to the sales force.

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.[2]

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.

3. 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: the annual reports of around 50 percent of the largest distributors mentioned the need to improve operational capabilities.[3]

---

[1] 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.

[2] 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.

[3] For more on operational excellence, see Bertil Chappuis and Brian Selby, "Looking beyond technology to drive sales operations," June 2016, McKinsey.com; 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.

Most distributors 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.

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.[4] 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).[5]

4. 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 high-end packaging solutions.

Many distribution leaders tell us that building differentiated value-added services that address customer pain points can help them fend off challenges from traditional and online competitors 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. Many distributors can use their superior product knowledge and technical expertise to provide clear customer value, maintain premium pricing, and create a moat against pure digital players.

[4] 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.

[5] For more on robotics and computing, see Frank Plaschke, Ishaan Seth, and Rob Whiteman, "Bots, algorithms, and the future of the finance function," January 2018, McKinsey.com.

5. 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,[6] 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.

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).

[6] For more on online sales, see *Digital sales and analytics: Driving above-market growth in B2B*, May 2018, 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.

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, genuine progress requires a structured and transformative approach that is clearly separate from business as usual, with exhaustive assessments and challenges to current assumptions. We believe proactive distributors have levers to adapt and win in the new landscape—but the clock is ticking.

Authors

Alex Abdelnour
Associate Partner, Distribution Sector

Amna Hussein
Consultant, Advanced Industries Practice

Nick Malik
Senior Partner, Distribution Sector

Steve Reis
Senior Partner, NA leader, Distribution Sector

Nick Santhanam
Senior Partner, NA Leader, Industrial Practice

Sri Swaminathan
Associate Partner, Advanced Industries Practice

Acknowledgments

We thank the many industry experts and leaders who graciously provided their insights, including the McKinsey experts whose guidance was critical to our work: Venkat Atluri, Pranav Chandra, Asutosh Padhi, Nick Santhanam, and Shekhar Varanasi. We are particularly indebted to our project team: Shruti Bhargava, Maggie Pan, Tim Schoen, and Haiyang Zhang, as well as Howard Tomb for editorial services.

April 2019

Designed by US Design Center

www.mckinsey.com

@McKinsey
@McKinsey

The coming shakeout in industrial distribution