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**Winning at the wholesale
distribution inflection point**

The wholesale distribution (WD) industry faces a true inflection point similar to decisive moments that other industries, such as retail, health care, and automotive, have faced. A wave of disruptive forces—amplified and accelerated by digital technologies—is poised to transform an industry unaccustomed to rapid, unpredictable changes. Indeed, the competitive moats that preserved distributor business models and value propositions for many years no longer offer the same protections. As a consequence, the strategic choices you make will likely determine whether you win at the inflection point, or are disadvantaged and disrupted.

After years of being insulated from the disruptive forces reshaping other industries, wholesale distribution is now feeling the seismic impact. As a case in point, until Amazon bought Whole Foods in June 2017, many food and food-service distributors felt relatively secure in the belief that factors such as stringent customer and regulatory requirements for the storage and shipment of perishable items in the cold chain created a near insurmountable barrier to outside competition. However, that acquisition and Amazon's subsequent moves into pharmaceuticals and grocery have increased palpably the perceived sense of threat in distributor C-suites across most every line of trade. Indeed, it is now common for executives to ponder the likelihood and potential implications of Amazon buying the No. 1 or No. 2 player in their line of trade.

Wholesale distributors may need to think more broadly about their competitive positioning and develop strategies to navigate the increasingly dynamic landscape. Winning at the inflection point will likely require distributors to make choices about where to play and how to win, with an emphasis on sharpening value propositions and business models, embracing innovation, and gaining scale in targeted segments.

An inflection point... and a winning strategy

Disruptive forces are creating a true inflection point in wholesale distribution—driving the need to develop and execute a robust strategy

Summary

For much of its history, wholesale distribution has avoided the impact of disruption and the need for transformation. As a consequence, distributors have tended to focus on traditional forces and on the near term, rarely developing plans or forecasts beyond a 12-to-24-month time horizon. This approach is likely no longer viable, as the industry faces an inflection point that may be relentless and ruthless in separating winners and losers.

Two years ago, at an event Deloitte hosted with more than 20 senior executives from leading wholesalers across various lines of trade, we introduced our assessment that the industry faces such an inflection

point. While most attendees were somewhat skeptical at that time, many doubters have now become believers and many now drive real change with an acute sense of urgency at their companies. Events such as Grainger very publicly cutting prices on one-third of its products; a decision by two of the top tire manufacturers to cut their business with a distributor in favor of their own networks; Amazon's purchase of Whole Foods; and the continued growth of digital commerce across B2B helped drive this conversion.¹ The cumulative effect of these events and the continued emergence of disruptive forces have further sharpened the inflection point.

Given these dynamics, distributors should consider a robust strategy to guide their activities and investments and a relentless focus on driving execution against that strategy (see figure 1).

Figure 1. Wholesale distribution industry dynamics

Traditional and disruptive forces are creating an industry inflection point—to win, distributors will need to develop and execute a robust strategy.

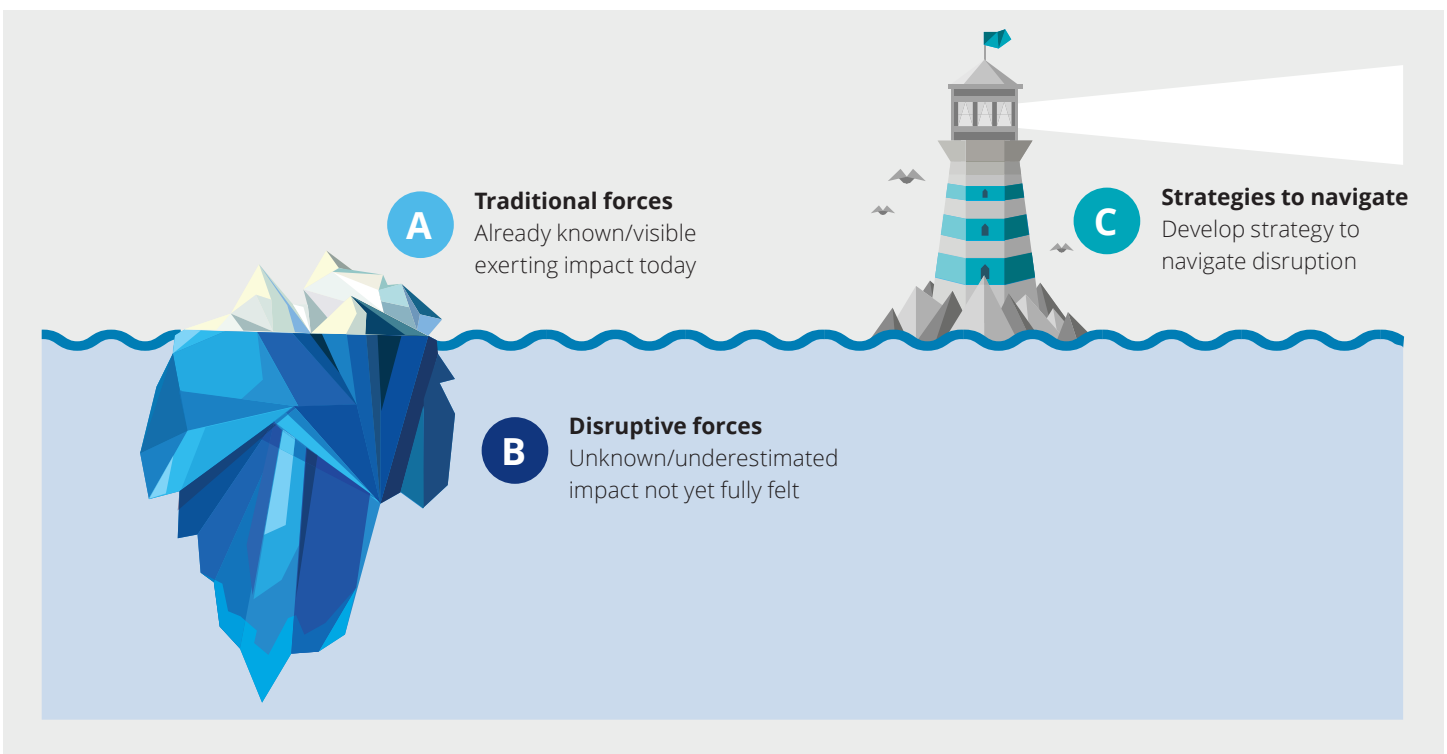
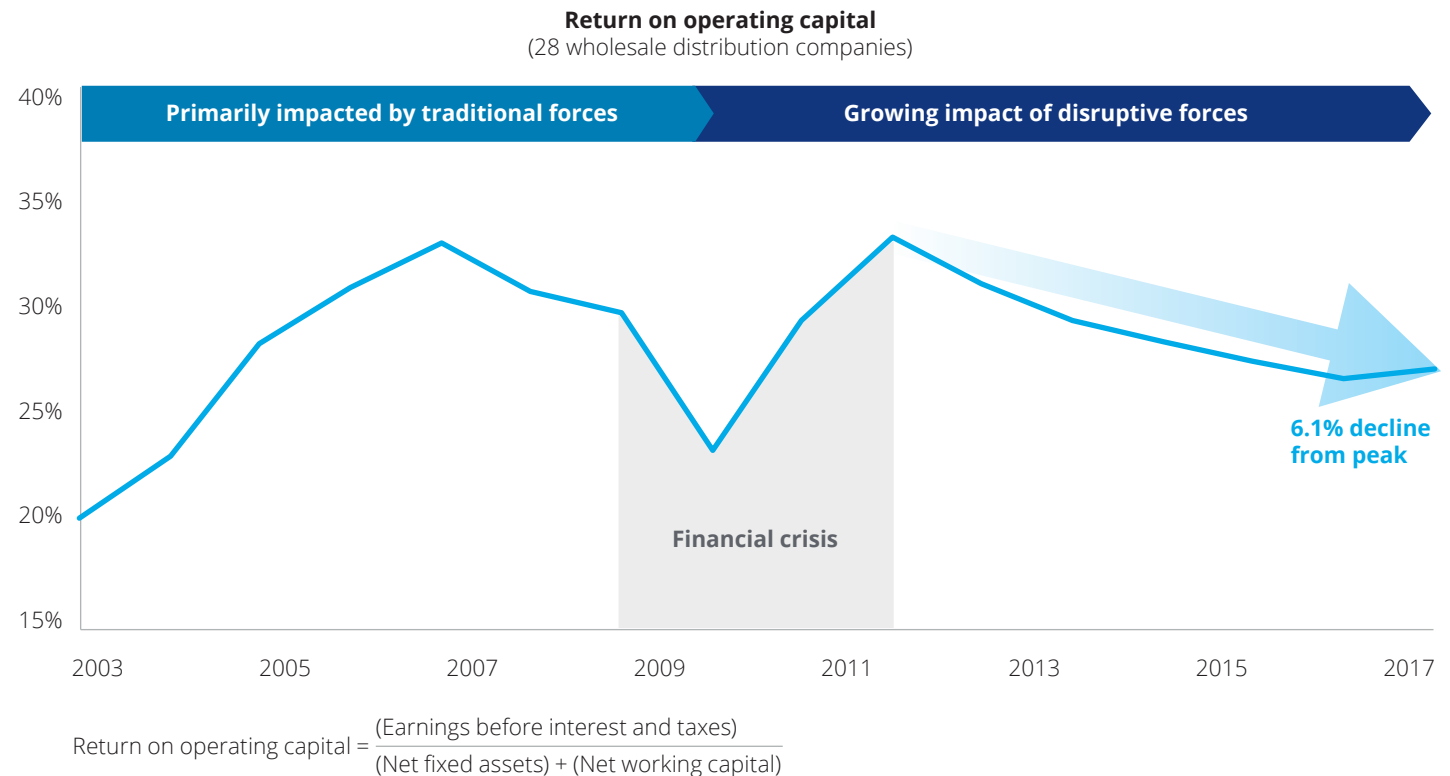


Figure 2. Wholesale distribution financial performance

The industry's financial performance suggests a change in its fundamentals.



Source: Deloitte Consulting analysis; S&P Capital IQ database.

Inflection point

The financial performance of the wholesale distribution industry—as measured by return on operating capital—has been under pressure for several years, with return on operating capital dropping more than 600 basis points since 2011 (see figure 2). Underlying this drop are weak organic growth in revenues, compressed gross margins and stubborn levels of selling, and general and administrative expenses, all of which have contributed to weaker earnings before taxes and interest (EBIT) margins. We believe that the current inflection point will prove decisive and dramatic. The coming years will divide the industry between the winners and losers. Those distributors who chart a new course and embrace new business and operating models will likely see their performance outpace that of their peers who are unable to pivot in the face of the inexorable disruptions. Although the changes in fundamentals of the industry cut across all lines of trade, the pace of change and points of emphasis will vary.

Ultimately, we believe the winners will be those who are capable of looking beyond the next quarter's results, who consider the impact of choices three to five years from now, and who are asking themselves the strategic questions: what is my aspiration, where will I play, and how will I win to realize that aspiration? The victors will be those who most effectively assess their businesses, resources, and markets, and who learn from leaders in other industries how to harness digital and disruption for sustainable competitive advantage.

Traditional forces

The traditional forces impacting wholesale distribution are primarily macroeconomic and include consumer and wholesale inflation, individual commodity price trends (e.g., oil, copper, and lumber), labor costs, interest rates, changes in the regulatory environment (e.g., labor, safety and environmental regulation), and federal, state, and local government legislation. Other traditional forces, such as residential construction activity, are also critical but exert greater influence over some lines of trade than others.

What the diverse, traditional forces share is that they are familiar to wholesale distributors: There are numerous existing sources of information, data, and forecasts for these forces, and their impact on individual lines of trade and companies is reasonably well understood. For example, rising lumber prices drive up the cost of residential construction and can curtail home-building activity. Historically, these forces and their associated trends have been the focal point of distributor business planning and investment decisions (e.g., reducing inventories and expenses during recessions).

These forces remain important, but more recently disruptive forces have exerted an outsize influence over business performance. Unfortunately, many wholesale distributors have yet to factor the new dynamics into their strategy.



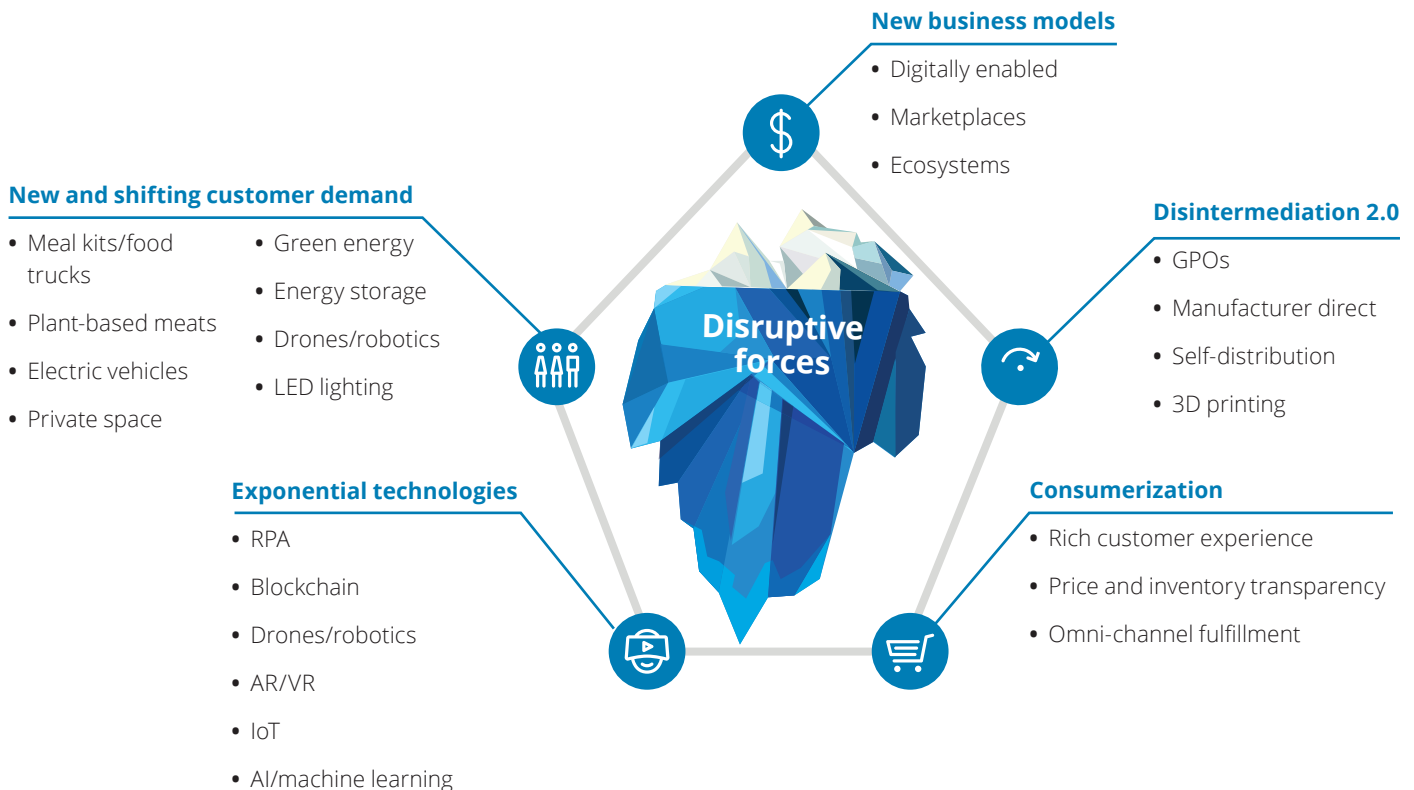
Disruptive forces

In contrast to traditional forces, disruptive forces are, by definition, unpredictable and not well understood—and consequently more likely to be underappreciated. The primary disruptive forces impacting wholesale distribution can be grouped under five broad categories (see figure 3). Some of the forces are not new, but digital is helping amplify their effect and accelerating their impact. For example, the threat of disintermediation has existed since the birth of wholesale distribution, but digital tools are making it easier and cheaper for suppliers and customers to bypass a distributor to connect and transact directly. Whereas in the past a supplier looking to sell direct needed a costly field sales force and supporting customer service organization, today that same company can market, sell, and service customers using one or more digital commerce platforms, a self-service portal, and centralized resources.

Further magnifying the impact of these forces is their propensity to rapidly evolve and interact, which amplifies uncertainty. For example, companies like Grubhub, DoorDash, and Uber Eats that started as online meal order and delivery platforms are now supporting a virtual restaurant business model that can quickly respond to shifting customer demands for what, how, and where meals are ordered and consumed, and in the process upend the dynamics in the value chain.²

Figure 3. Wholesale distribution industry disruptions

Disruptive forces are reshaping the distribution landscape in dramatic and somewhat unpredictable ways.



Source: Deloitte Consulting analysis.

New competitors and business models

The rapid advance of digital technologies has impacted each of the five disruptive forces—but nowhere more dramatically than in the formation of new competitors and business models.

Developments in digital have significantly helped lower the barriers to entry for new competitors—in particular the need to own inventory or other physical assets—and reduced the need for a face-to-face sales force. Indeed, many new competitors are online-only virtual companies. Digital has also enabled new ways for distributors to charge for products and services, aided the extension of traditional business models (e.g., digital marketplaces for an endless aisle of products and services), and facilitated new value propositions (e.g., ecosystems of service providers offering tailored solutions to customer pain points).

Historically much of a distributor's value proposition was tied to it owning a broad and deep inventory, stocked close to customers, executed through a focused logistics capability, and augmented with a knowledgeable sales and customer service organization. It could be summarized as: We have what you need, can help you find what you need if you aren't sure, have it close at hand, are price competitive, and can get it to you as and when you need it.

Now, however, agile competitors are able to provide a similar or even differentiated suite of capabilities through a network of specialist service providers (e.g., 3PL/4PL or common carrier for fulfillment, outsourced customer service), or completely digitize them (e.g., EDI, e-commerce and marketplace to replace field sales). Examples of new, digitally enabled business models for distributors to assess and understand include Airbnb, Uber, and Instacart. Many of the new business models necessarily leverage disintermediation, consumerization, and new customer-demand disruptive forces

also. These dynamics represent a stark threat to many wholesale distributors in part because agile competitors can target high-profit niche segments of the business without incurring legacy infrastructure costs. And for many distributors a key challenge is figuring out how to maintain that legacy business, even as they broaden their capabilities and try to build the new business. It is clear that many distributors would love to capitalize on new business models but fear cannibalizing their legacy business.

A distributor sales and marketing executive recounted an industry conference keynote where the founder of a disruptive startup implored the audience of distributor executives to “manage their businesses as if they had nothing to lose” ... An unseen audience member responded, “The problem we have is...we do have something to lose.”



Disintermediation 2.0

Disintermediation as a potential threat to wholesale distribution is certainly not new. Indeed, manufacturers in many lines of trade have periodically sold direct to end customers when the value of distribution came into question or as a means to capture incremental value for themselves. We already referenced (in the *Summary* section on page 3) the move by two of the top tire manufacturers to sharply cut their sales through distribution and instead sell direct to auto-repair shops and customers. Additionally, customers are candidates for disintermediating wholesale distribution in a quest for value and control. As a case in point, Dollar General in early 2019 announced that it would self-distribute fresh and frozen foods out of a company-owned distribution center in Pennsylvania, disintermediating regional distributors that had previously served this need.³

Continued innovation with the application of digital technologies can further transform the disintermediation threat from something dismissed as a passing trend to an existential threat to the distributor's business and profitability. This threat can also assume new forms as trading partners negotiate commercial terms directly and only look to the distributor for fulfillment, sometimes relegating the role to drayage.

Some examples of the digitally enabled disintermediation 2.0 are:

- **Group purchasing organizations (GPOs):** Long viewed as a source of gross margin pressure in certain categories and lines of trade, such as medical supplies and food service, GPOs have morphed their operations by leveraging digital to expand their impact and to negotiate commercial terms on behalf of a much broader customer base. They have also expanded their service offerings, extended their reach into new segments, and leveraged digital tools such as self-service portals, robust e-commerce, and punch-out to lower the cost of both onboarding and managing suppliers and acquiring and serving a diverse set of customers.
- **Manufacturer direct:** A growing number of manufacturers—in aerospace and other high-value equipment—are recapturing lucrative areas of lifetime customer value by increasingly selling replacement parts and related services direct to end customers. This market has long been a source of revenue and profit for industrial; electrical; and maintenance, repair, and operations (MRO) distributors who have invested heavily in infrastructure, inventory, and product knowledge to support this market. However, digital tools sharply lower the cost for the manufacturer to expose their parts catalog and also make it easier for customers to find and buy the items they need. The danger lies in manufacturers taking the growth-oriented and most profitable customers to a direct model, leaving distributors with the rest.
- **Self-distribution:** Customers (see Dollar General reference above) are building scale and the capacity to self-distribute, thus removing the distributor from the value chain completely. In some lines of trade this threat is an outgrowth of the buying and marketing groups that initially served to level the playing field for small, independent distributors vs. their larger national peers.
- **3D printing:** Additive manufacturing (one form of which is 3D printing) represents a new, emerging challenge to the distributor's traditional role and value proposition. By combining the various technologies that comprise additive manufacturing with digital, customers can now acquire the designs and license to product parts and products that they traditionally may have purchased through distribution. The expanding scope of this threat now encompasses products as diverse as electrical MRO supplies to jet engine parts to industrial fasteners. As the cost and speed of additive manufacturing continues to decline, while precision, structural integrity, and range of materials continues to expand, the threat of disintermediation will likely grow. A compelling manifestation of this disruption can be seen in the 2016 announcement by UPS that it partnered with parts manufacturer, Fast Radius, to create a fully distributed manufacturing platform. The platform connects with UPS store locations, each equipped with a 3D printer, and augments the Fast Radius main operation on the UPS Supply Chain Campus in Louisville, KY. Need a spare part? Fast Radius can either print it for you and ship it via UPS, or print it at your local UPS store for pickup.⁴ What is the value of inventory in this scenario?⁵

Consumerization

It has become somewhat of a cliché but is also true and so worth exploring that many B2B buyers, spoiled by the conveniences and experiences they receive in their B2C worlds, are demanding that their B2B partners better anticipate and respond to their needs. They want a partner who can not only deliver the product they need, but also a much higher level of convenience and overall improved experience across the digital and physical journey.

To be more specific, in light of the consumerization disruptive force, many B2B customers increasingly expect:

- **Rich online customer experience:** Make it easy for me to log on, regardless of device—see my orders, my history, my curated catalog—to reorder and find information.
- **Price and inventory transparency:** Enable full price and inventory transparency, including if an item is out of stock and will require back order punch-out to the supplier's ERP, and let me know when I can expect it. This price transparency also increasingly extends to visibility to available promotions, applicable manufacturer rebates, and other special deals.
- **Seamless omnichannel capabilities with dynamic fulfillment:** Let me, as the customer, buy online and pick up in store (BOPIS), buy online and return in store (BORIS), buy online and take delivery from store (BODFS), or buy online and take delivery at a specific location on a job site/plant floor... and increasingly this extends to providing real-time visibility to the location and status of a delivery truck and/or package.
- **Rich self-service functionality:** Allow me to see and search my transaction and order history, review invoices, change my preferences, change a delivery or order, or arrange for a return.
- **Communities, deep product content, tools, and ratings:** Provide a highly curated content library to help with product and service search and selection and a range of other digital options for users and buyers to gain relevant insights and perspectives.

The disruption in consumerization is the erosion of traditional sources of the distributor's profitability and differentiation. In the New competitors and business models section (page 7), we discussed some of these sources (e.g., I have the item in stock), but if product availability can be determined immediately and with precision online my deep inventory stocked close to you becomes less relevant and less valuable... at least for a wide range of noncritical items. Similarly, if I can network with other buyers and learn from their experiences via an online community, the differentiating value of the distributor's highly knowledgeable but also somewhat biased sales rep is reduced.



Exponential technologies

The *Deloitte 2014 Tech Trends* report differed from prior years in that, in collaboration with leading researchers at Singularity University, it added a section on “exponential” technologies. The report explored five exponentials with wide-ranging impact across geographies and industries: artificial intelligence, robotics, cybersecurity, additive manufacturing, and advanced computing.⁶ For purposes of this paper we consider exponential technologies to be those that a distributor can apply to their own business to improve efficiency or effectiveness and/or to offer new services.

Exponentials encompass a diverse group of rapidly changing innovations such as blockchain, robotics, robotic process automation (RPA), augmented reality (AR), virtual reality (VR), artificial intelligence (AI), machine learning, and the Internet of Things (IoT). The challenge for distributors is to stay abreast of developments and applications of these innovations and to explore options for their application in their own business. To fully realize the potential value of these technologies the exploration should consider applications beyond the current business and ways of working. Augmenting or automating an existing process with an exponential technology will likely deliver only incremental benefits. Indeed, distributors should further understand that traditional approaches to measuring return on investment (ROI) may be insufficient and traditional payback periods too limiting. Unlike many other technology investments, with exponential technologies distributors should be willing to invest in small-scale, tightly scoped pilots and to fail fast, learn, and apply the lessons learned to the next pilot/project.

In addition, it should be noted that some of these technologies are creating new markets for distributors requiring a separate assessment of the opportunity and investment ROI. For example, a distributor’s business case for investing in robotics in its distribution centers is very different to the multifunctional assessment that would evaluate the ROI of selling electrical supplies and components to robotics manufacturers.

Noteworthy from wholesale distribution

Augmented and virtual reality can be used on a job site or in a manufacturing plant to precisely locate a machine, device or component and to overlay instructions on how to repair or operate that item. These technologies can also be applied to accelerate training of new employees, to deliver updated processes to existing employees or to guide the activities of workers in complex, dynamic environments. Rapidly growing, fast-casual concept restaurant operator Honeygrow is leveraging virtual reality to more rapidly and effectively onboard employees to its chain of green restaurants.⁷

Blockchain is already deployed to drive efficiency in the supply chain by enhancing traceability, lowering losses from counterfeits/gray market goods, improving visibility and compliance, and reducing paperwork and administrative costs. Bumble Bee has partnered with SAP to leverage blockchain to establish the provenance of its tuna product.⁸

New and shifting customer demand

As the economy moves from a product-based system to one emphasizing solutions, services, and experiences, new sources of customer demand and shifting customer expectations are creating opportunities for distributors. New sectors and industries are being born, enabled by innovative technologies such as those pioneered in the private space industry, electric vehicles, green energy, and market opportunities such as meal kits. To capture and capitalize on these opportunities, distributors may need new go-to market models, business models, and/or other capabilities such as the ability to partner, finance, and joint venture with startups. Some of the emerging opportunities include:



Food trucks/meal kits/ghost kitchens



Plant-based meats



Electric vehicles



Private space



Green energy



Energy storage



Drones/robotics



LED lighting

Three strategies for navigating disruption

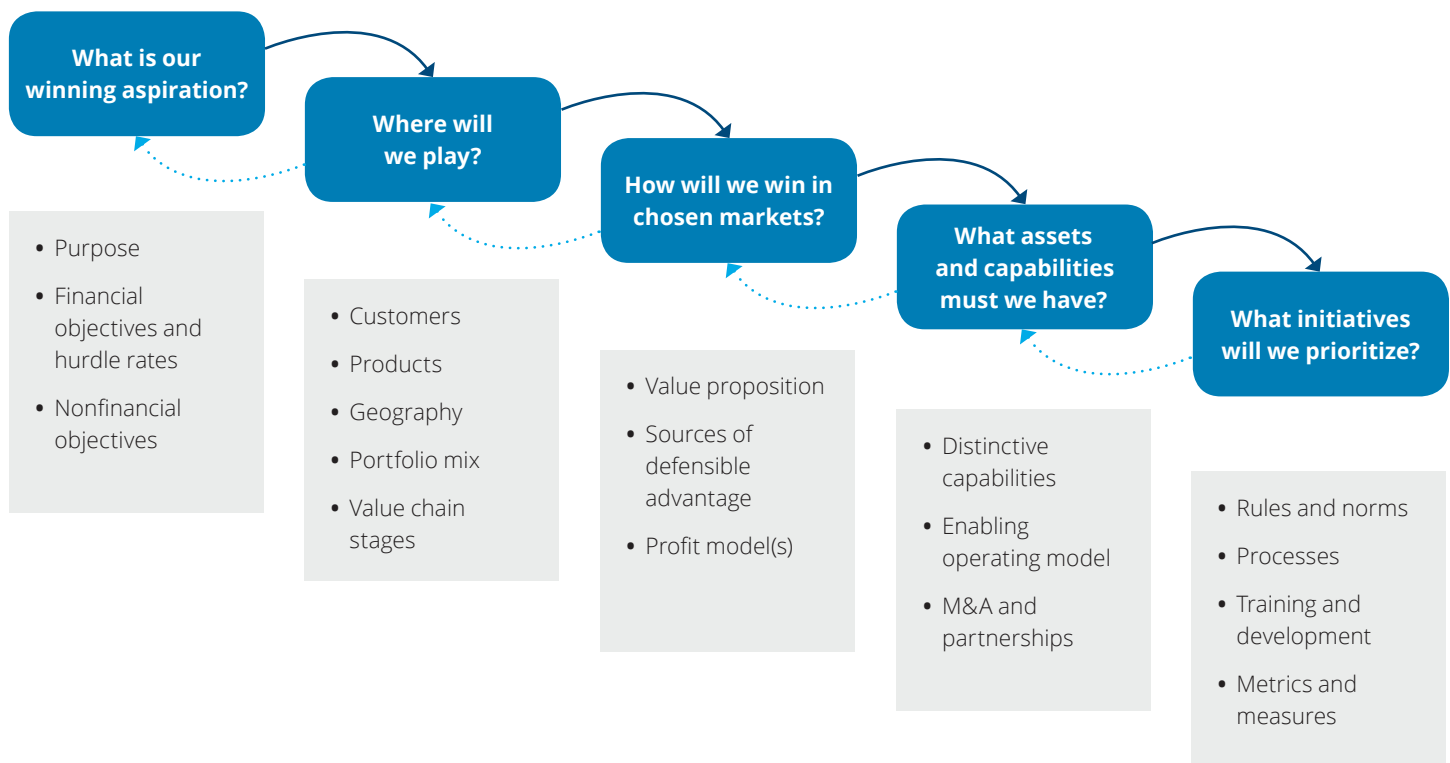
The magnitude and pace of change impacting the industry—and the expectation that it will increase—heightens the importance of distributors developing and executing a robust strategy. To do that, distributor executives should align on their responses to five key questions: What is our winning aspiration? Where will we as a company play (and just as importantly, where will we not play)? How will we win? What capabilities must we have to execute the strategy? And what initiatives will we prioritize? The process for developing the answers to these questions is iterative in nature (see figure 4) with answers to subsequent questions driving reflection on and consideration of earlier answers.⁹ For example, the cost of acquiring new capabilities may force reconsideration of an earlier answer to where we will play.

What is our winning aspiration? Responses to this question should be considered across quantitative and qualitative dimensions with an emphasis on the notion of winning. The quantitative dimensions might include sales, share, margin, and/or working capital targets. Qualitative dimensions might include being perceived as the go-to resource for industrial automation solutions with deep technical resources and leading online tools.

Where will we as a company play? What customer segments, product segments, categories, and geographies will we serve? And the flipside of that question: Where will we not play? And how do those decisions about positioning affect our achieving our goals? If we stay out of markets, then we may not be able to achieve our financial goals. But if we choose to compete everywhere and in every category, we may wind up constraining our internal resources.

Figure 4. Strategic choices cascade

Strategy is about making choices. It is as important to determine what you won't do as it is to define what you will do.



Source: Roger L. Martin, "Strategic choices need to be made simultaneously, not sequentially," *Harvard Business Review*, April 3, 2017, <https://hbr.org/2017/04/strategic-choices-need-to-be-made-simultaneously-not-sequentially>.

How will we win? Will we drive efficiencies to become the lowest-cost distributor? Will we be the high-touch expert? Will we have the biggest sales team or will we service exclusively online?

What capabilities do we need? To execute on their strategy, distributors should understand the capabilities that will be needed, both in terms of existing capabilities that may need to be repurposed and new capabilities that need to be acquired/developed.

What initiatives will we prioritize? A portfolio of specific initiatives—along with owners—underpins the strategy. Collectively these initiatives should deliver on the aspiration.

In formulating answers to the above questions distributors should consider from the following three options for potential application to all or parts of their business (see figure 5).

- **Retrench and focus**
- **Drive cost advantage**
- **Innovate to thrive**

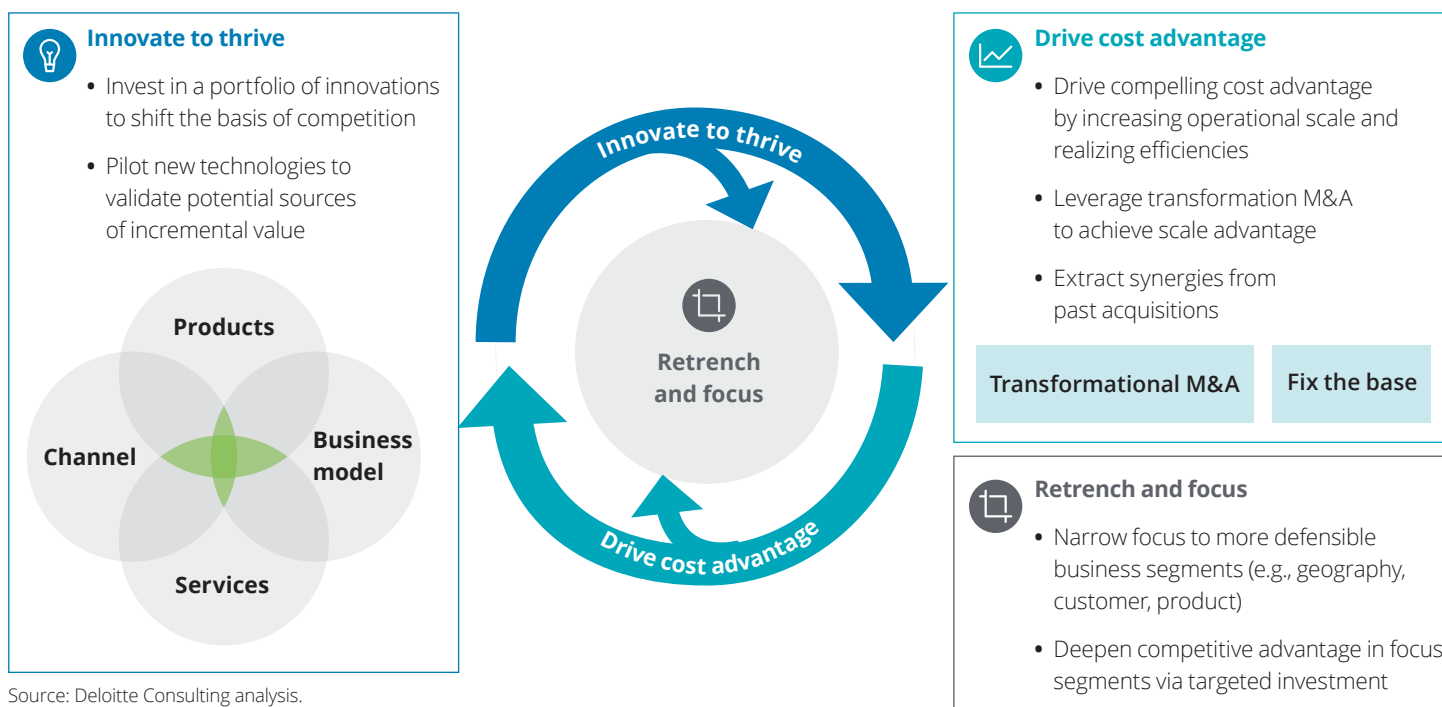
Distributors can frame their responses to the questions through the lens of these options—answers to where to play and how to win will vary significantly depending on which of the three options are driving the strategy.

Depending on their objectives and the realities of their business (e.g., intense competition from online-only players), a distributor can align their corporate strategy against just one of these options or apply the individual options to discrete segments of their business. For a distributor who is seeking to become the low-cost provider, breakthrough technical service innovations may not be very important. But if the aspiration is anchored on delivering an exceptional customer experience, then innovations that leverage digital self-service, a seamless omnichannel experience and a deep understanding of unmet customer needs will be critical.

We see compelling examples from other industries for each strategy listed that can provide lessons and inspiration for distributors.

Figure 5. Strategic options for navigating the industry inflection point

The three strategic options are not mutually exclusive; a distributor may leverage elements of each across its various business units and segments.



Source: Deloitte Consulting analysis.

Retrench and focus

The essence of this strategy is to sharply define where you will and will not play, focusing on defensible segments and allocating additional resources against sustainable sources of competitive advantage. For companies under intense competitive pressure this option can create breathing room, allowing the business to transform and in some cases ultimately thrive. Here again, digital tools and capabilities play a key enabling and accelerating role, allowing companies executing a retrench-and-focus strategy to curate and deliver an experience and value proposition tailored to the needs of target segments.

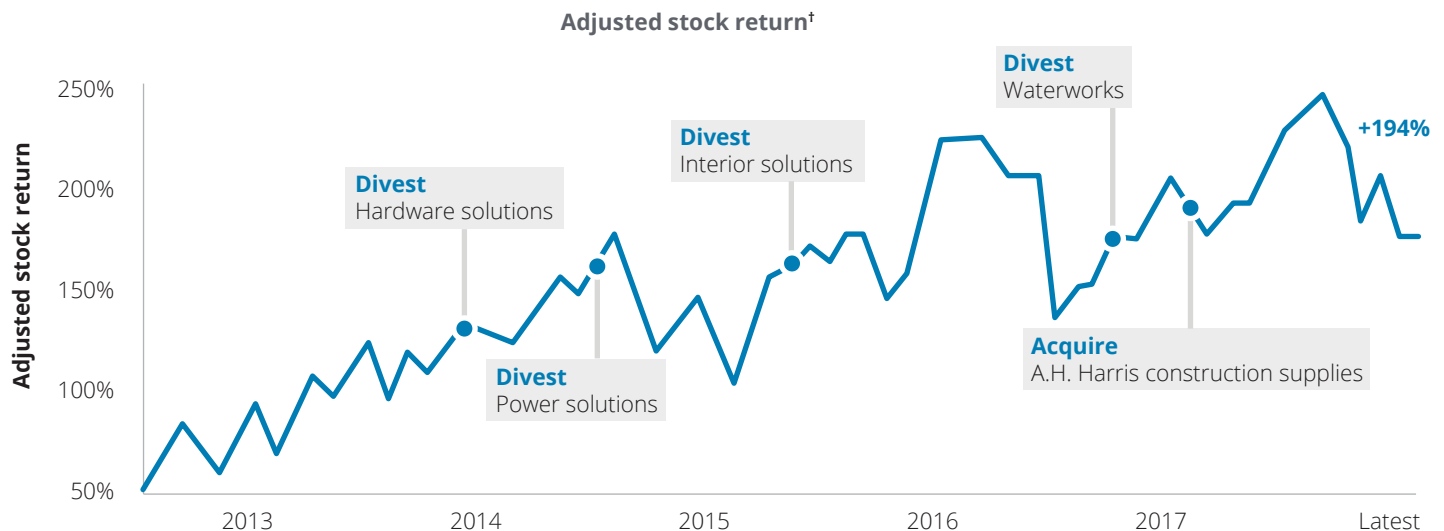
In some ways and in many situations this strategy is a reaction to strategies that, in the face of intense competitive dynamics, customer requests, and/or supplier mandates, encouraged distributors to continually broaden the scope of their business to encompass more categories, brands, products, services, and segments. For many distributors the accumulated calcification of expenses and costs from multiple tuck-in acquisitions has

exacerbated this condition. These distributors may have grown revenues, but they added cost and complexity to their operations, lost their customer focus, and confused their go-to-market strategy. Add to this the ability of agile competitors (see *New competitors and business models* section on page 7) to target and serve high-profit segments of a business and the very future of a distributor business can be imperiled with the loss of just 10 percent of sales.

The key to making a retrench-and-focus strategy successful is a candid and complete understanding of what drives customer profitability, including what elements of your value proposition are worth paying for and which elements are considered table stakes. Armed with this information, distributors should make some tough decisions as to which markets and segments are defensible, where they can compete, and where they should retrench.

Figure 6. HD Supply narrows its focus

In the period since its IPO, HD Supply has diligently executed a strategy to narrow its focus on building supplies and facilities maintenance. It simplified its business model from eight disparate business units down to two, sharpened its focus against those two businesses, consolidated its leadership at the Atlanta headquarters, and sharply reduced debt and associated interest. While shedding 35 percent of its 2013 net sales volume as a result of these actions, the stock market has recognized and rewarded this focused strategy.¹⁰



[†] Stock return was adjusted for splits and dividends.

Source: HD Supply Holdings, Inc. SEC filings and quarterly earnings press releases; S&P Capital IQ database; Deloitte Consulting analysis.

Founded in 1908 as a holding company, General Motors (GM) bought Buick the day after its founding and added numerous brands and businesses over the many years of its existence. Indeed, GM grew into a multinational corporation and one of the world's largest manufacturers, employing more than 600,000 workers in the United States at its peak and enjoying a US market share that topped 50.7 percent in 1962.¹¹ However, by the 1970s, the company faced a multitude of challenges.

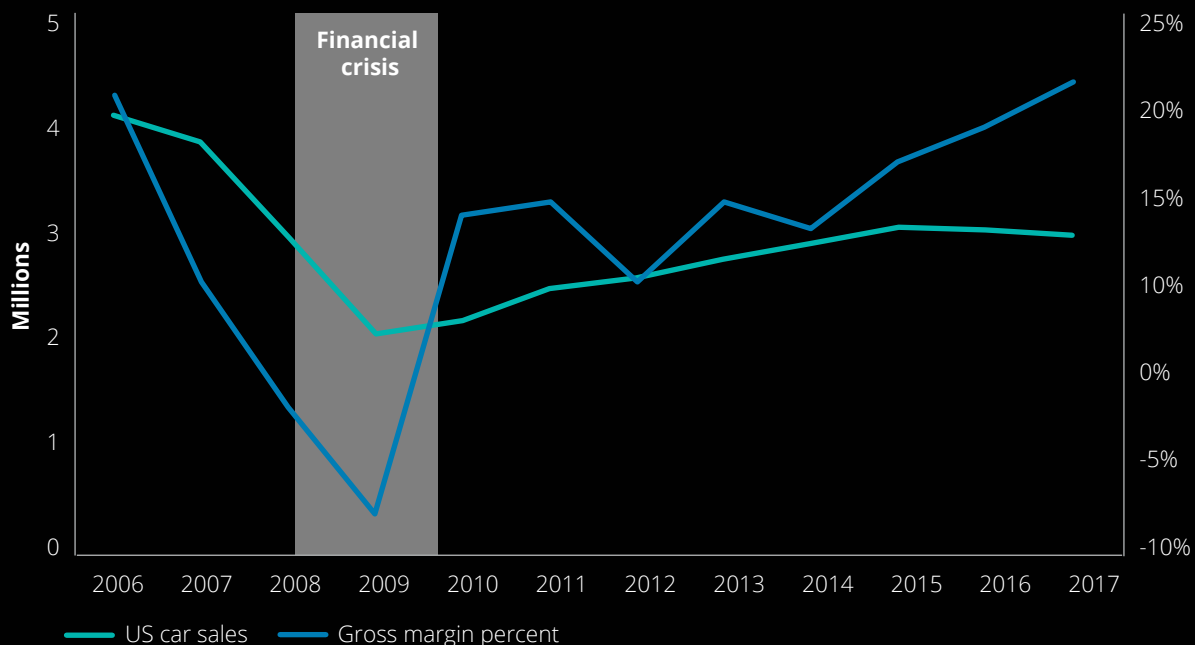
GM had accumulated a disparate portfolio of brands and businesses; faced intense competition from traditional and emerging players; was burdened with high overhead, operating leverage, and declining unit volumes; and also needed to invest in innovation and the automation of its factories. Indeed, as a result of these challenges, the company's operating margins had declined from roughly 9 percent in the 1960s to near 0 percent in the late 1990s and early 2000s.¹² In response, the company embarked on an extended and ongoing retrench-and-focus strategy.

In executing the retrench strategy, GM has (along with other steps) discontinued some of its most iconic automotive brands and eliminated the associated business units, divested several other brands and operations, shuttered numerous assembly and propulsion plants, rationalized more than 1,000 dealerships from its network, and reduced its workforce by the tens of thousands through attrition and other actions.

GM is now able to focus on its remaining business, driving a 300 basis point increase in EBIT margin and a sharply reduced unit volume, realizing 75 percent of global sales from five architectures, and doubling the resources allocated to its electric vehicle and autonomous vehicle programs.

Figure 7. General Motors retrench and focus

As it executed its strategy, GM sold and divested numerous noncore brands and businesses and sharply reduced its unit volumes while boosting margins.



Source: General Motors SEC filings and annual reports, <http://gmauthority.com/blog/gm/general-motors-sales-numbers/>; <https://knoema.com/nyscxme/u-s-vehicle-sales-market-share-by-company-1961-2016>; Deloitte Consulting analysis.

Driving cost advantage

In their search for an effective response to the disruptive forces impacting their business and eroding financial performance, many distributors have turned to transactional M&A. However, the impact of serial tuck-in acquisitions, which add incremental revenue and scale, can be more of a palliative than a cure. Generally, the transactions lack sufficient size to enable a step-change in cost structure, do not fundamentally alter the competitive dynamics in a market, and have minimal impact on a distributor's negotiating leverage with either customers or suppliers. In contrast, a strategy that has been successfully applied in industries such as oil & gas and pharmaceuticals is that of leveraging transformational M&A to drive sustainable, differentiating cost advantage. As digital tools and capabilities enable entirely new business models (see *New competitors and business models* section on page 7), the pressures on distributor businesses for efficiency and effectiveness grow. Quickly gaining and leveraging scale is typically an important potential strategy for a distributor business or business unit.

Fundamentally, distributors looking to win at the inflection point should assume additional risk, think big, and reposition themselves for the long term. Large-scale mergers and acquisitions create the opportunity to not only grow top-line revenues and market share, but also add sufficient scale to enable the changes in a distributor's cost structure that place competitors at a disadvantage. To this end, it is imperative that distributors apply rigor and dedication to driving out available post-merger integration savings. Savings can typically be found in areas like inventory, sourcing, and pricing but can also include sales-force effectiveness and product cross-sell and upsell.

It is notable that digital capabilities—in addition to impacting disruptive forces—can be game changers for distributors looking to rapidly realize a compelling cost advantage. Tools such as RPA that have already changed the game in the financial services industry are rapidly finding a home in distribution. RPA automates manual activities by performing repetitive rules-based tasks, delivering efficiency and effectiveness benefits for activities such as invoice processing. Digital tools can also enable distributors to shift work to where it is best done and to effect changes to the operating model through centralization, standardization, and virtualization (e.g., shared services, outsourcing, and offshoring).

The more transformational opportunity, however, is often in changing the balance of power with customers and suppliers who—in some lines of trade—exert an outsize influence on how and where a distributor can play. For example, in certain electrical and industrial supply product categories, the leading suppliers influence which geographic territories a distributor can sell into, and which products are specified and quoted in response to customer bid requests. These factors can also be decisive when it comes to M&A transactions as the value of a particular distributor business is frequently linked to and, in some cases, determined by its line card. Any distributor that sells into the industrial automation market knows all too well the value of each of the top supplier's brands. Transformational M&A—in addition to creating a cost-advantage opportunity—offers the potential to shift the relationship dynamics with suppliers, giving the distributor a stronger voice over how, what, and where they can sell.

To date, the distribution industry does not have an extensive track record of transformational M&A. However, we see hopeful examples in recent liquor and wine, food, and chemical distribution transactions. Time will tell whether the companies behind these transactions are able to drive transformation and create sustainable advantage—and whether distributors in other lines of trade follow in their footsteps in trying to harness the power of transformational M&A.

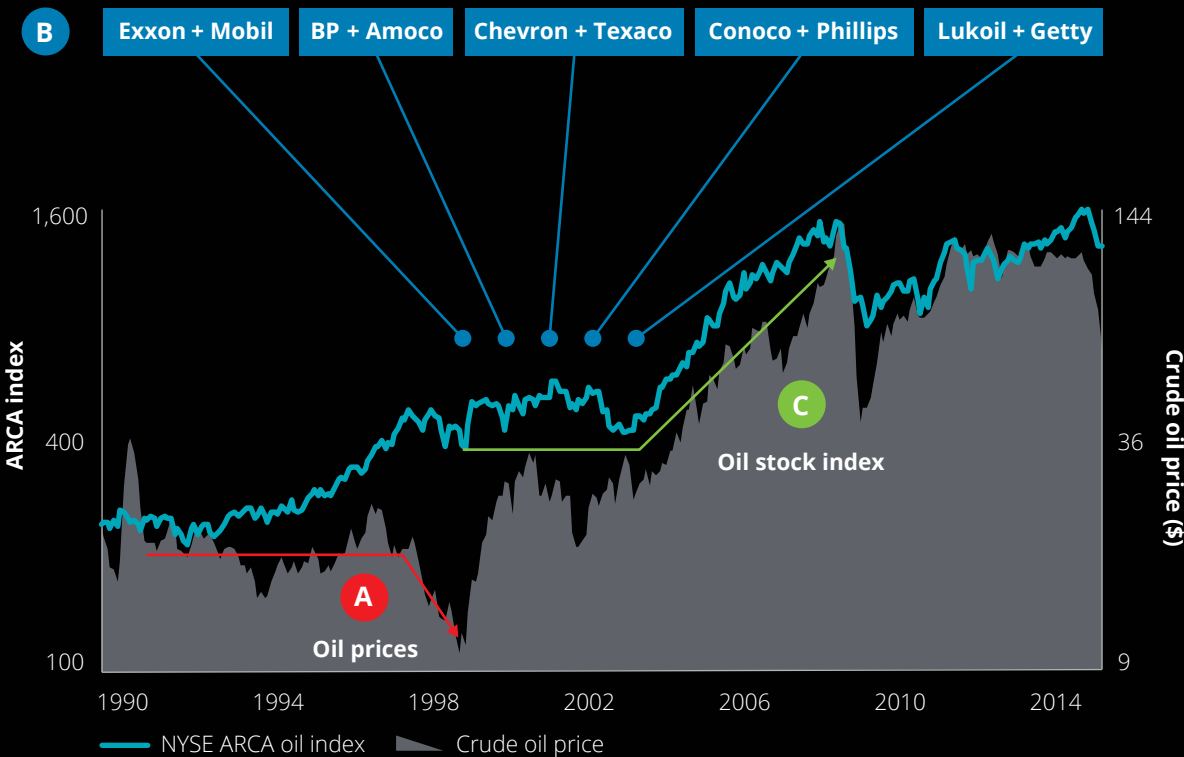
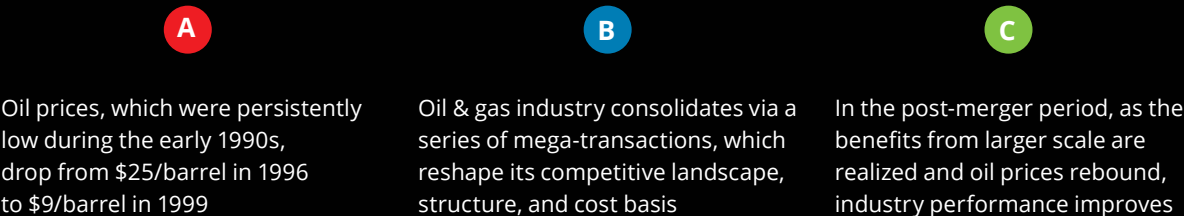


In the 1990s, companies in the oil & gas industry executed a series of transactions to reshape their structure and competitive landscape. These transactions included Exxon merging with Mobil and Conoco with Phillips, while BP purchased Amoco and Chevron acquired Texaco. Through these transactions—with a total value of approximately \$190 billion—these companies bolstered their oil reserves, strengthened their market positions, and realized substantial cost synergies.

Figure 8. Oil & gas industry M&A drives cost advantage

Companies in the oil & gas industry executed a series of transformational acquisitions for competitive advantage.

Oil & gas industry:



Source: Thomson One; Deloitte Consulting analysis.

Innovate to thrive

For many companies, innovation is a core competency and essential source of sustainable differentiation and value creation. A diverse set of companies—including 3M, Proctor & Gamble, Amazon, and Apple, all of which have championed and excel at innovation—can be sources of insight and inspiration for other aspiring companies. Increasingly, this set of aspiring innovators includes distributors. Although this represents a heavy lift for companies used to incremental changes and burdened by orthodoxies, a growing number of distributors have publicly announced sizable investments to drive innovation. These have ranged from partnerships with universities and other institutions, to the establishment of innovation hubs and incubators, to creating venture capital funds focused on innovation.

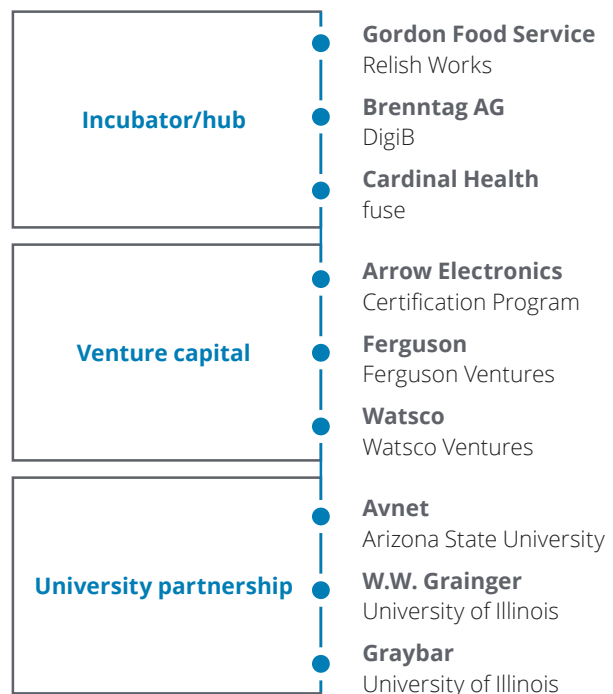
Services and solutions focused on supply chain and inventory management capabilities are—not surprisingly—a focal point of many distributor innovation activities. As a starting point, this makes sense as distributors look to leverage their traditional capabilities and sources of value creation. Increasingly, however, distributors are leveraging more leading-edge digital capabilities to develop new offerings (e.g., blockchain, digital marketplaces, drones), deliver new experiences (e.g., online portals that offer self-service tools, digital services, marketing insights, and financial services), and enable new business models (e.g., as a service pricing for products as diverse as lighting, chemicals, and flooring). As with other companies and industries, a key to successful innovation is leveraging multiple types of innovation rather than narrowly focusing in one or two domains.

For example, a jan/san distributor could deploy a sensor-based chemical leasing business model that would charge customers not based on units of product, but through a capacity-based measure. Examples might include selling its private-label-brand disinfectant to a fast-casual restaurant based on the square footage of surface area treated (e.g., kitchen counters), or selling detergent to a hotel based on the number of sheets and towels washed. In each case, IoT and other sensors could be used to measure volumes and assess the required level of cleaning; to monitor storage volumes and trigger automated replenishments; and, coupled with machine learning analytics, assess process efficiency and make improvement recommendations (e.g., use warmer water in the rinse cycle to reduce time). Such an approach reduces the distributor's incentive to push incremental product sales just to achieve revenue targets and instead incents both parties to reduce consumption without sacrificing efficacy.

Building-supplies distributor Ferguson Enterprises is driving innovation via Ferguson Ventures, which is focused on finding partners in three key areas: connected ecosystems, digital experiences, and emerging technologies (e.g., virtual reality, IoT, artificial intelligence, and machine learning).¹³ And Graybar is opening an innovation lab on the University of Illinois campus to bring in fresh ideas and collaborate with students and faculty on developing digital capabilities in the supply chain.¹⁴

Distributor investments in innovation are taking an increasingly diverse number of paths, reflecting the various aspirations, maturity levels, and levels of commitment that exist in the industry. A handful of distributors have established a physical presence for their innovation efforts in the form of an incubator or hub. These include Gordon Food Service, Brenntag, and Cardinal Health. Another group, which includes Arrow, Ferguson and Watsco, has embraced more of a venture-capital model and seeks to fund relevant innovations of others. Still another group has established partnerships with universities as a means of attracting and incubating talent and ideas.

Figure 9. Noteworthy innovation examples from wholesale distribution



Source: Deloitte Consulting analysis.

A particularly noteworthy example is the partnership between Arrow Electronics, a \$30 billion global distributor of electronics and enterprise computing solutions, and Indiegogo, a platform that provides entrepreneurs with exposure to their innovative products, potentially securing the funding, tools, and services needed to bring product ideas to fruition and potentially to market. Arrow would also potentially act as a distributor.¹⁵

Conclusion

Disruptive forces—enabled and accelerated by digital—are rapidly reshaping wholesale distribution. These forces are shifting the basis of competition, upending traditional value propositions, enabling new business models and creating high-growth opportunities for those nimble and innovative enough to capitalize on them. Taken together, these dynamics are creating a true inflection point for the industry.

Inflection points are not intrinsically negative—they are typically indicative, however, of a point of no return with regards to the previous state. To win at this critical juncture, distributors should develop and execute strategies that exploit opportunities, leverage strengths, and focus scarce resources. As we have discussed, among the key strategies for distributors to evaluate and leverage (as appropriate) for their business and situation are:

- **Innovate to thrive:** Develop the capabilities to effectively manage and grow innovation, including a portfolio of differentiating and valuable product and service offerings.
- **Retrench and focus:** Narrow the focus of the business to truly defensible segments, and invest to reinforce competitive moats.
- **Drive cost advantage:** Change the game by leveraging transformational M&A to grow the size of the organization and then relentlessly drive available efficiencies and scale economies.

The disruptive forces we have identified will likely continue to interact and evolve and will be joined by others. In this more dynamic environment a robust strategy accompanied by a nimble business model and steady leadership can be differentiating. Acknowledging and assessing the impact of the disruptions will also be key to navigating the inflection point, for as noted science fiction author William Gibson stated on National Public Radio's *Fresh Air* in 1993, "The future is already here—it's just not very evenly distributed."

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