IBM Global Business Services
Executive Report

Wholesale

IBM Institute for Business Value

Creating connections

Strategies for today's electrical and industrial distributors

IBM Institute for Business Value

IBM Global Business Services, through the IBM Institute for Business Value, develops fact-based strategic insights for senior executives around critical public and private sector issues. This executive report is based on an in-depth study by the Institute's research team. It is part of an ongoing commitment by IBM Global Business Services to provide analysis and viewpoints that help companies realize business value. You may contact the authors or send an e-mail to iibv@us.ibm.com for more information.

By Guy Blissett, Robin Kahn and Maureen Stancik Boyce

Electrical and industrial wholesaler distributors have historically delivered benefits to both their suppliers and customers through the efficient storage and movement of goods, but the sustainability of this value proposition as a driver of long-term growth is being eroded by growing supply chain and product complexity, increased competition, evolving customer expectations and shifting economics. To build a foundation for value creation and avoid getting left in the stock room, we believe electrical and industrial wholesalers and distributors need to define and execute an expanded value proposition, build data-driven operations and create an adaptable business model.

Historically, electrical and industrial distributors have provided value primarily through the efficient storage and movement of goods. The sustainability of this classic value proposition, however, is in jeopardy, as an evolving customer profile, more complex products and operations, increasing competition and shifting economics are necessitating changes in the way distributors approach the market. Industry and economic events have certainly highlighted the profound challenges of being an inventory manager during periods of volatile demand, especially when supply chain visibility is less than perfect and significant lags exist in sensing those demand changes.

Perhaps primary among many concerns for wholesale distributors in developed markets is the ongoing decline in the core customer bases for their operations. Consolidation of residential builders, and reduced expectations for robust growth in the residential and commercial real estate markets, and massive declines in automotive and other industrial activity are impacting distributor growth prospects.

As well, a top tier of mega-distributors is arising that is outstripping competitors with economies of scale and scope and, in some cases, swallowing rivals to grow further. In addition, third-party logistics providers (3PLs) are blurring traditional industry lines and marketing offerings tailored specifically to traditional electrical and industrial wholesale distributors' customers.

Meanwhile, electrical and industrial wholesale distributors must contend with increasingly complex and custom products moving upstream and downstream in a supply chain that is ever-more global, intricate and broadly scrutinized – yet one that has little cushion due to widespread adoption of Just in Time (JIT) inventory and increased risk of obsolescence.

These stark realities demand a dramatically different type of distribution business. To remain competitive, electrical and industrial distributors must:

- ***Execute an expanded value propositio***n – Excelling at the traditional industry basics remains important but is no longer sufficient; leading distributors proactively craft and manage a strategic portfolio of products and services designed to differentiate their brands and forge deeper relationships with core customers.
- ***Become data-driven*** – Distributors that rely on paper-based processes and forecasts calculated in spreadsheets are losing to more nimble, information-driven competitors. Leaders use realtime data and automated solutions to generate a holistic view of the business and the supply chain, anticipate customer needs, have heightened visibility to demand and customer forecasts, identify opportunities and operate more efficiently.
- ***Increase business model agility*** – The capabilities necessary to deliver new and innovative services and operate at higher levels of efficiency will not always come from within. Leading distributors partner and collaborate, delivering greater value through targeted investment and application of scarce resources.

The potential for robust future revenue opportunities exists in the electrical and industrial distribution segment, but to grow and gain share in this consolidating industry, electrical and industrial wholesale distributors must develop differentiating capabilities that offer real value to their customers.

A top tier of mega-distributors is outstripping competitors with economies of scale and scope.

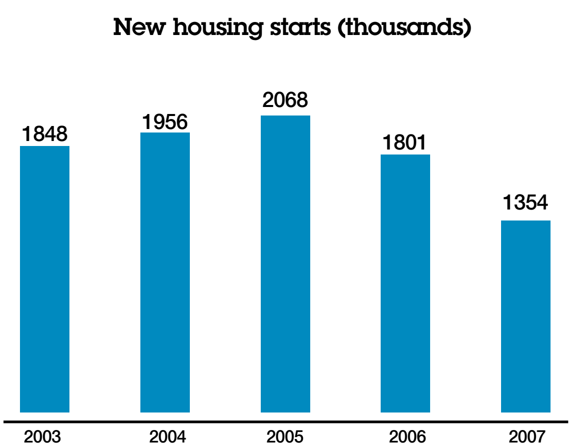
New realities in electrical and industrial distribution

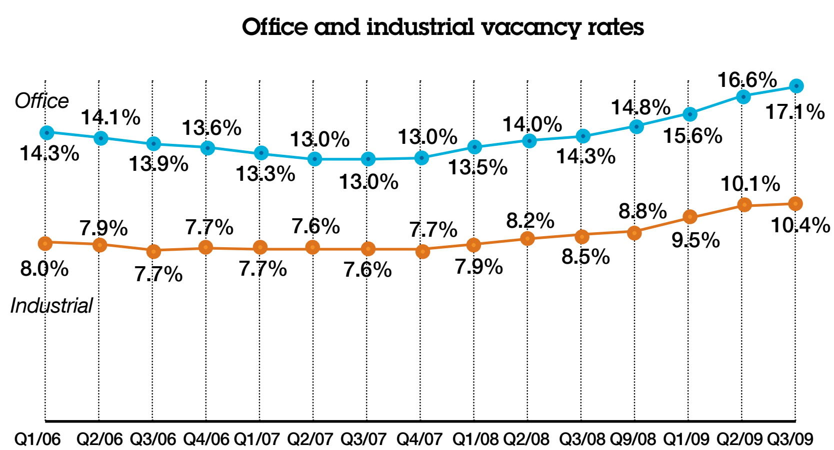
Customer consolidation and contraction

Many of the traditional customers of electrical and industrial wholesale distributors – including commercial and residential builders, chemical companies and manufacturers – are becoming fewer in number and larger in scale. In the United States, for example, the 10 largest home builders, now account for 39 percent of the market, and industry analysts anticipate that number to rise to 50 percent by 2010.[1] By comparison, just five years ago, these builders accounted for only 34 percent of housing starts. With their commanding size and purchasing power, these larger, more powerful and often more sophisticated customers can demand new services, dictate lower prices, and stipulate ever higher service levels. Some of the larger players are even bypassing wholesaler distributors and purchasing products directly from the manufacturer – at or below distributor cost.

At the same time the number of customers is shrinking, many are also experiencing decreased business volume. Housing starts have declined precipitously since 2003 – even before the global credit crisis. Vacancy rates for offices and industrial buildings, another major source of wholesaler distributor revenue, are up significantly (see Figure 1).[2] As opportunities for business dwindle, competition among wholesale distributors is likely to become increasingly fierce, and those that win business will likely have to make deeper-than-normal price concessions and enhanced services.

Another traditional customer base for electrical and industrial wholesaler distributors, the manufacturing sector, has also experienced dramatic changes in recent years, and is likely to continue doing so. Rapid and massive turmoil in the automotive industry will likely impact demand for years to come as manufacturing operations and assembly plants are shuttered and their suppliers are forced to close and/or downsize.





Source: Builder Online, U.S. Census Bureau New Residential Construction ; “A Passing Grade on Prognostications,” Electrical Wholesaling, January 1, 2007; grubb-ellis.com

Figure 1: Residential and commercial real estate are key indicators for wholesale-distribution.

Manufacturers throughout the world are continually evaluating their supply chains and operations for possible cost savings through relocation of manufacturing plants, assembly operations and distribution centers to low-cost locales. In the United States, this analysis has led to the exportation of many manufacturing operations, contributing to a decline in related employment. More than four out of five wholesale distributors have indicated that their customers have moved operations to China in the past two years, forcing these companies to either aggressively seek new domestic business or expand their operations overseas.[3]

As employment and number of manufacturing plants decline, electrical and industrial wholesale distributors may need to turn their attention toward servicing the increasingly advanced automation, sensor and actuator technology used in today's manufacturing operations. Other potential opportunities for revenue replacement may arise from such industries as pharmaceutical and high-tech manufacturing, which in the United States are benefiting from an influx of foreign investment.

Another potential bright spot for electrical and industrial distributors may be likely growth in smart infrastructure and green investments. The increased role of sensors, controllers and actuators in delivering more intelligent, instrumented and interconnected traffic flows, electrical grids, food supply, water, oil exploration and retail operations will create opportunities for forward thinking electrical and industrial distributors.

Smart infrastructure and green investments represent a potential bright spot for wholesale distributors.

Increased purchasing power sparks more demanding customers

Heightened competition, diverse product and service needs and increasingly complex markets make for an ever more demanding customer base, one that requires responsiveness and flexibility from wholesale distributors.

To achieve this flexible posture, distributors must understand the factors influencing customer purchasing decisions. In the past, for example, even large-scale builders often lacked the purchasing power, technological sophistication and transportation resources to stock the many small parts needed and efficiently convey them to building sites. In this era of consolidation and acquisition, however, some of these same builders are now turning to self-fulfillment for many of their needs. These customers are looking for significant price concessions from their remaining distributors, as well as an array of differentiating services, such as onsite, consignment inventory and liberal payment and returns policies. They want to know what the wholesale distributor can economically deliver that builders cannot provide for themselves – services such as expedited delivery and enhanced inventory management programs..

For those customers still firmly entrenched in the traditional supplier-distributor-customer relationship, wholesale distributors need to understand the diverse needs that drive purchasing decisions in various market segments.

- *Commercial contractors*, traditionally award contracts through a highly competitive bidding process and are after the lowest price. Although they value such services as next day delivery and prefer name-brand products, price is almost always the determining factor in their selection of vendor partners, putting significant pressure on already margin-challenged wholesale distributors.

- *Residential contractors* can more easily pass costs through to home buyers. They generally favor "one-stop" shopping to lower their order costs, are often willing to buy private-label products and value knowledgeable and accessible counter services from their distributor partners.
- Price is a secondary consideration for *MRO manufacturers* as well, which are driven by "break-fix" situations that require immediate attention. For them, service is paramount. Because of the immediacy involved in their day-to-day operations, their usual preference is to demand proven, name-brand products. They will use private-label or non-branded products rarely, and then only for non-critical systems.
- *OEM manufacturers* tend to want it all. Price, one-stop shopping and on-time, accurate deliveries are all key factors in their purchasing decisions. Historically the overriding attribute they sought was supplier reliability, but increasingly, deep technological knowledge is a decisive attribute in supplier selection.

Each of these customer segments brings with it both new challenges as well as new opportunities. Leading distributors are able to anticipate and respond to the opportunities and increasingly tailor their own strategy, business model and operations to best serve their target customers.

Environmental focus

Not only are the factors that influence purchasing decisions changing, so are the products and services customers are demanding. A growing emphasis on environmentally friendly business models and products is requiring a new approach to product sourcing, marketing, merchandising, inventory management and distribution. In an online poll conducted by "Industrial Distribution" magazine, 69 percent of respondents said their customers are asking them to provide environmentally friendly products and services, and 74 percent said green products are on their radar screen.[4]

For example, commercial tenants are increasingly demanding LEED (Leadership in Energy Efficiency and Environmental Design)[5] certified buildings in order to reduce operating costs and in some cases lower the carbon footprints of their own products. While LEED certified buildings are more efficient than conventional buildings, design and construction costs are higher. Construction principles are more complex and there is less availability of building components that meet LEED standards.

Distributors must be knowledgeable about qualification requirements at various levels of LEED certification, the underlying cost-benefit trade-offs, and payback periods and be able to supply the appropriate products to capitalize on this emerging trend. Even during periods of general contraction, the growth in environmentally friendly construction – and the specialized knowledge it requires – is often stretching builders' resources and their knowledge.[6] Indeed the green construction market, which grew five fold between 2005 and 2008 to $49 billion, could reach $140 billion by 2013.[7]

Homebuyers are also increasingly emphasizing energy efficiency in their purchasing decisions. Such items as fluorescent light bulbs, solar panels and water-conserving toilets are in significant demand. Contractors and manufacturers are looking to reduce carbon footprint and increase energy efficiency, as well as reduce/recycle hazardous waste. Even utilities are offering customer incentives for conservation. In 2007, for example, 71 percent of utilities offered energy efficient rebates to their customers, up from 46 percent in 2004.[8]

With the rise of the socially conscious consumer, opportunities that didn't exist just a short time ago – such as the provision of environmentally responsible climate control systems, for example – have the potential to provide a new source of revenue for distributors-wholesalers.

Tech savvy customers and suppliers raising the bar

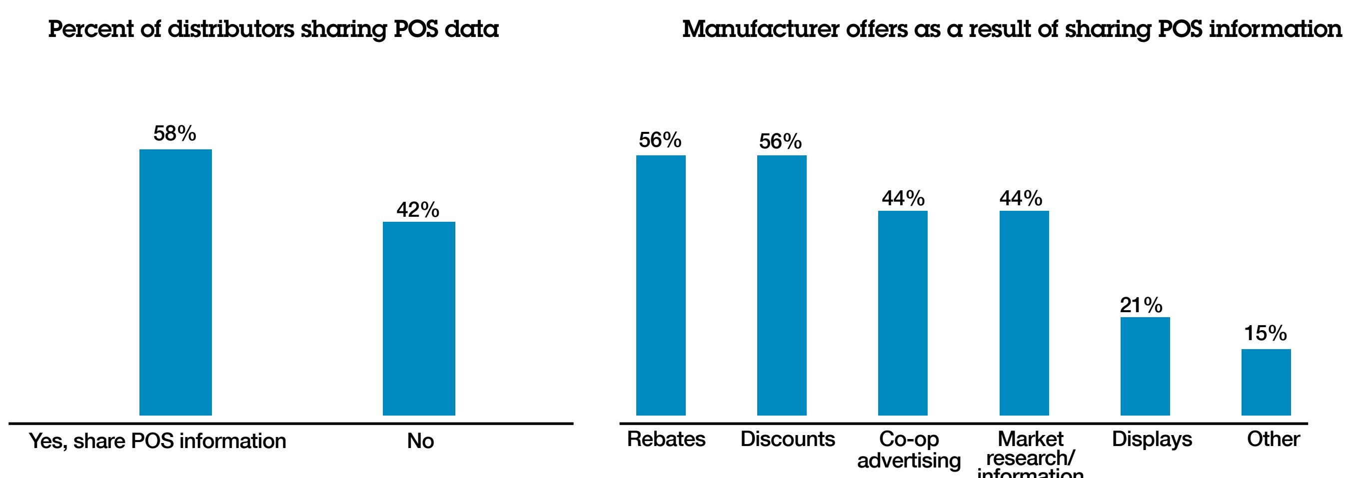
The primary sales tool traditionally employed by distributors over the years was the comprehensive, printed catalog that typically detailed every item available in their inventory. These familiar and impressive volumes were generally printed and/or updated yearly and proudly mailed to customers and prospects.

While those catalogs are often still a distributor fixture – for example, Grainger's 2007 catalog, with more than 3,000 pages of product and technical information, had 138,000 MRO products – growing customer usage of the Internet continues to shift the sales, marketing, merchandising and even customer service emphasis to the online channel.[9]

Today, 26 percent of industrial distributor revenue comes from Web or e-mail ordering, compared to just 8 percent in 2003.[10] Indeed, tech savvy customers now expect product information – such as, detailed specifications, product pictures, installation instructions, compatibility and warranty information – to be available and accessible, up-to-date, downloadable and available for integration into their own Web sites.

Going forward, multi-channel integration will be vital to capturing customer information at various touch points and delivering a consistent, integrated customer experience. This will include empowering the sales force – wherever they are – with information and tools to better service their customers. This will include the ability to optimize and tailor pricing dynamically. Focused effort should be made toward providing automated or IT-based options that emulate the personal attention and detail provided by in-person ordering. Consistency in products, services and messaging is now a core requirement across all channels.

As end customers become increasingly demanding and knowledgeable, the need for deeper and more current insights about their purchasing behaviors is a must. Innovative wholesale distributors are taking a lead role by capturing, aggregating and sharing downstream inventory, forecast and POS data, as well as specific customer insights with their suppliers. In addition to driving top line revenues over the long term, some are being more directly and immediately rewarded for their efforts with financial incentives from the suppliers themselves (See Figure 2).



Source: Industrial Distribution's 61st Annual Survey of Distributor Operations, Pembroke Consulting, Sept. 2007

Figure 2: Wholesale distributor positioning in the supply chain creates opportunities for boosting collaboration.

Implications of new realities

Consolidation is creating fewer customers with higher demands for increased service.

Increased purchasing power puts pressure on distributors to maintain margins.

Environmental focus places a premium on the maintenance of current products to meet customer demand and reduce losses due to obsolete inventory.

Shifts in the customer base are driving changes in required skills, capabilities and value propositions.

The emergence of online sales and communications channels requires distributors and their employees to be more knowledgeable and sophisticated about products and channels, potentially requiring continuous employee training and the recruitment of additional, highly educated talent.

Increasing operational complexity

Energy efficiency, safety, private label

With more sophisticated end uses for electrical and communications equipment, wholesale distributors are facing challenges in inventory management that go far beyond the traditional issue of matching supply and demand in a commodities-driven market. Several decades ago, a simple on-off electrical switch, for example, might suffice for a very wide range of end uses. With high-tech products becoming more and more common, many parts are now specific to single applications, requiring the stocking of an ever-expanding inventory to meet customer demand (e.g., light switches with timers and motion sensors).

Coupled with this, is the greater focus by both customers and consumers on energy efficiency and product safety. Such items as compact fluorescent lights and automatic shutters with sun detection – not even on the horizon a short-time ago – are now in considerable demand. And with consumer recalls high on the collective consciousness of the world, attention is focused on products that contain hazardous substances, incorporate dangerous protrusions or create electrical hot spots. Identifying and culling these from the supply chain – and replacing them with safer alternatives – is a complicated proposition.

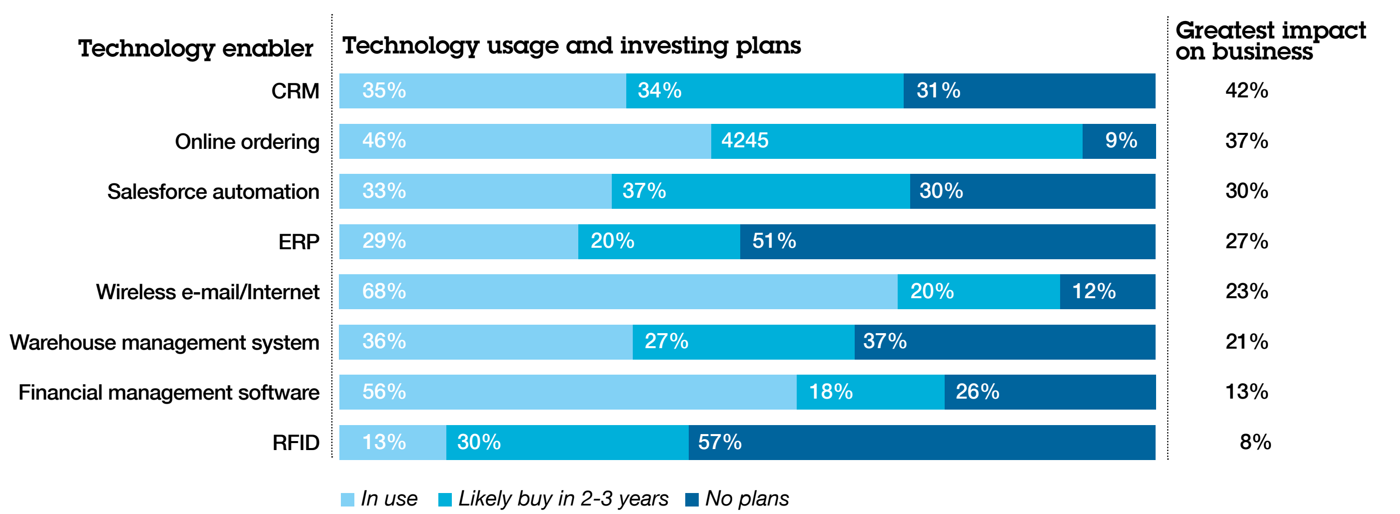
Seemingly not content to watch their traditional suppliers flood the market with products, distributors themselves are adding complexity to inventory management and product selection. Like their counterparts in such sectors as food distribution and apparel, distributors are introducing their own private label brands as they set their sights on higher margins. Innovative and responsive manufacturers of branded products, in turn, continuously improve their products to maintain differentiation. The net result industrywide is more SKUs, shorter product life cycles and greater inventory management challenges.

Limited technology

To manage this overwhelming complexity in number and variety of products, distributors should leverage the technological resources at their disposal. Yet, distributor IT spending substantially lags that of customers and transportation/logistics providers, suggesting a potential shortfall in capabilities. Suppliers want from their distributors realtime information on location and disposition of inventory and usage data. Customers want delivery and returns status.

What this means for the wholesaler-distributor is that core enablers like master data management and governance should take on increased importance. As well, data synchronization and inventory visibility are requirements, both of which will likely require increased investment. Usage insights are also necessary to allow production, shipment and promotional activities to match demand.

Unfortunately, many distributors today are unsophisticated in their use of technology for business collaboration and planning (see Figure 3). And future plans reveal technology infrastructure will improve in some areas, such as online ordering, but not in others, such as RFID and ERP. Distributors are, essentially, underinvested in the areas that are perceived to have the greatest impact, and this is a must change if they plan to "stay in the game."



Source: Industrial Distribution's 61st Annual Survey of Distributor Operations, Pembroke Consulting, Sept. 2007

Figure 3: **Technology adoption and investment plans vary widely, a reflection of the industry's diversity.**

Expanding regulations and mandates

Even as wholesale distributors tackle the immediate competitive and supply chain pressures facing them, they must also be prepared to respond to a shifting and increasingly onerous regulatory environment. As the products themselves become more sophisticated, and supply chains more complex, integrated and extended new regulations are being enacted regarding their use, safety and functionality, as well as to manage the impact of their global trade. For example, varying degrees of certification are needed for not only a number of new products, but also for the components that comprise them. Previously mentioned LEED certification requirements place increasing demands on builders and their suppliers in the United States to stock specific products and to make sure those products meet stringent requirements. Some products – such as certain types of batteries – must be disposed of according to local Hazmat regulations. For example, RoHS (restriction of hazardous substances in electrical and electronic equipment) bans products with high levels of lead, cadmium, mercury and other "hazardous" substances in the United Kingdom.[11] Others may require mandatory recycling. Yet others may need certification by either regulatory or "watchdog" organizations to be used in energy efficient or environmentally friendly applications.

As a growing number of wholesalers turn to private label products as a means to potentially boost gross margins, these regulations, as well as potential product liability issues, are becoming increasing important to manage – and a source of potential risk.

On the financial side, wholesale distributors face the rigorous accounting and reporting mandates of Sarbanes-Oxley, along with their usual financial challenges of maintaining compliance with strict price, promotion and marketing regulations.

Additionally, emergent areas such as sustainability, fair trade and carbon footprints all now demand oversight and ongoing assessment – and are also often subject to regulatory scrutiny. The need for enhanced oversight in these areas demands that wholesale distributors develop and maintain more robust product tracking and tracing capabilities in order to accurately identify potential product performance and safety issues as well as to facilitate regulatory reporting compliance.

Despite the administrative and operational cost of these issues, non-compliance is potentially brand fatal – as a result of penalties, fines and customer/consumer estrangement.

Consolidation and competition

In the United States, electrical and industrial distribution is largely comprised of small and mid-sized companies, about 41,000 industrial and 7,000 electrical, most with fewer than 100 employees.[12] While this industry segment remains highly fragmented, it is consolidating, and a top tier of mega-distributors is emerging (see sidebar).

Private-label products represent both a way to potentially boost margins and a source of risk.

Electrical and industrial wholesale distributor consolidation

Electrical and industrial wholesale distributors are following the prevailing trend in the general distribution industry, with fewer and fewer players accounting for larger and larger shares of business.

In 2008, for example, Sonepar acquired ESSCO Wholesale Electric to expand its footprint in the United States.[13] In 2007, Rexel acquired Hagemeyer for US$4.5 billion and then sells the U.S., Asia-Pacific and some European parts to Sonepar.[14] Also in 2007, Wesco acquired J-Mark, Inc. and Monti Electrical Supply. And in 2006, Rexel acquired GE Supply.[15]

The threat of acquisition, however, is not confined to industry insiders: outside investors are driving consolidation as well. Since 1999, the number of private equity groups with a stated interest in acquiring distribution companies has doubled.[16] The electrical and industrial-service segment is no exception. In 2007, Home Depot sold HD Supply to Bain Capital, the Carlyle Group and Clayton Dubilier & Rice for US $8.5 billion.[17] And in April 2008, Industrial Distribution Group agreed to be acquired by Luther King Capital Management for US $134 million.[18]

These emerging mega-distributors have some distinct advantages. Their scale gives them pricing leverage with suppliers. A sizable top line funds improvements in technology and marketing and branding capabilities. And as they establish common processes and systems, they can assume the role of consolidator – acquiring a stream of competitors with complementary capabilities, useful assets or, perhaps most important, target customers.

Private equity investors, while cautious, continue to see opportunities for acquisition and consolidation in this highly fragmented industry. Their outsider perspective led them to question industry "norms" and to discard outdated, untenable business strategies. And because many small and mid-tier distributors are well behind the technology curve, investors can often gain substantial efficiencies through strategic IT investment. In the wake of the global credit crisis, it remains to be seen when funds will be again be available for the aggressive M&A activity seen over the past five plus years.

In addition to industry rivals and outside investors, electrical and industrial distributors face intense competition from rapidly expanding 3PLs. Although 3PLs and distributors have historically focused on meeting different customer needs, which required different capabilities, they now find themselves competitors as they both expand their offerings.

Aggressive investment in technology has allowed forward-thinking 3PLs to provide increasingly sophisticated services. Already, 80 percent of the 200 largest logistics companies offer services that compete directly with wholesale distributors.[19] No longer do the likes of FedEx, UPS and DHL focus exclusively on overnight delivery of small packages. They have become full-service logistics companies, with efficient inventory management practices, a proven distribution and tracking system, a focus on customer service and an underlying, ultra-modern infrastructure that makes them formidable players in the market.[20]

UPS makes inroads in supply chain services

UPS – historically a package delivery service – is fast gaining as a significant competitor in supply chain services. UPS is leveraging scale, reach and infrastructure to offer distributor customers sophisticated warehousing, logistics, IT and operational solutions, and eroding the traditional value proposition of distributors.

UPS has demonstrated its broad expertise across many industries and distribution functions.

Sourcing
UPS Supply Chain Solutions (SCS) helped a Fortune 200 company that manufactures engineering products and systems launch a strategic sourcing initiative to negotiate long-term supplier partnerships. The diversity and geographic dispersion of the business units added complexity in two key areas: MRO and packaging. Through a supplier/vendor rationalization process, UPS narrowed the list of packaging suppliers from 100 to 10. By increasing business to these preferred suppliers, lower packaging prices were negotiated as was free shipping. On the MRO side, UPS leveraged commodities and market knowledge to reduce 1,000 MRO supplier relationships down to 15 preferred partnerships. The company estimates that UPS helped speed the launch by 19 months, and cost savings have exceeded original targets.

Distribution
Honeywell's aftermarket North American auto parts distribution centers were highly fragmented, resulting in inconsistent service and long order cycles. UPS recommended collapsing five distribution centers to two to optimize service levels and lower complexity. The two distribution centers leverage sophisticated IT systems and automation such as a customized warehouse management systems, an electronic "pick-to-light" system and electronic eyes, improving order accuracy to nearly 100 percent and automating sorting. Honeywell sends orders electronically through UPS' transportation management system which generates carrier options and consolidation opportunities to minimize transportation costs and improve service. As a result, customer delivery dates have improved and shipments per purchase dropped from three to one.

Transportation
UPS analyzed Harley Davidson's inbound transportation processes and found LTL was increasing freight expense. UPS determined that cross-docking would combine shipments from multiple suppliers and reduce inbound shipments significantly. This process has also enabled Harley to gain efficiencies with parts and accessory shipments to dealers. Previously, all parts were shipped to a distribution center in Wisconsin, where they were stocked, picked, packed and sent LTL to dealers. UPS leverages its network and sends less than 1,000 pound shipments to dealers and cross-docks orders more than 1,000 pounds at UPS cross-docking facilities. The net effect of UPS' efforts has been to lower Harley transportation costs and speed up delivery times.

mplications of increasing operational complexity

Overall added complexity increases premium on improved supply chain visibility and advanced planning and forecasting capabilities.

Data-driven capabilities such as price and inventory optimization become true marketplace differentiators.

Scale gains in importance as a means of leveraging required investments across a broader operational base.

Delivering greater value as a distributor

Today's unforgiving business environment demands that electrical and industrial distributors apply a deep understanding of customer and market needs to deliver greater value. To deliver on this, we believe three imperatives will be critical:

- ***Execute an expanded value proposition*** – Choices such as which customers to serve, which suppliers to represent, whether to sell private label goods and which services to offer are growing more complex and critical. Electrical and industrial distributors need a systematic approach for evaluating their product and service options and aligning and optimizing their portfolios with the needs of their targeted customers.
- ***Become data-driven*** – Electrical and industrial distributors can no longer afford to act on intuition; -- their success depends on capturing, storing and communicating the right data and analyzing it to manage all aspects of the business, from which customers to serve to which products to carry. Indeed, if distributors cannot catch up to their suppliers and customers in this vital area, they'll continue to lose business to more progressive competitors.
- ***Increase business model agility*** – Business is changing more quickly than ever. According to the 2008 IBM Global CEO Study, 83 percent of CEOs indicated they expect significant change over the next three years, as compared to 65 percent in 2006.[22] To capitalize on emerging opportunities and flex with market fluctuations, electrical and industrial distributors need more adaptable and integrated businesses models that leverage partnerships and collaboration. The "own everything" approach, which has long dominated the industry, is no longer sustainable.

Execute an expanded value proposition

Unfocused distributors that try to be "all things to all customers" risk under-serving the customers they value most, and may well find their brands undifferentiated as competition intensifies. In today's hyper-competitive environment, wholesalers must clearly define both how and where they deliver value in the new ecosystem.

Leading distributors are much more targeted. They actively manage a portfolio of products (both branded and private label), services (both free and fee) and service levels (100-percent availability, no minimum order quantity and such) that is based on the needs of their target customers and strategically aligned with their own brands.

This is not to imply they abandon their core capabilities. On the contrary, the new generation of distributors still provides transportation and storage services, but they do so in more sophisticated and profitable ways. They leverage rich operational data together with activity-based costing to identify revenue and cost drivers and efficiency opportunities. Performing the basics with excellence helps them move from transactional customer relationships to strategic, value-added partnerships.

Products

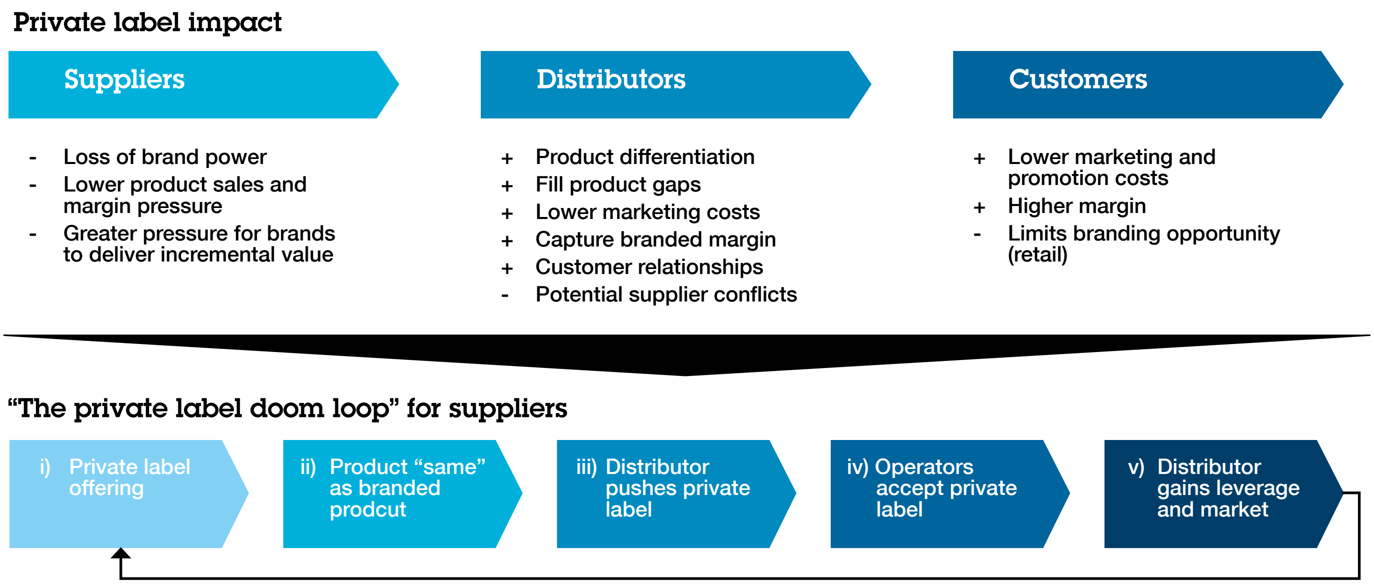
The proliferation of products and customer and consumer segments complicates distributors' product portfolio decisions. Distributors must become much more sophisticated about selecting the products they sell – finding the optimal mix of both manufacturer and private label brands.

A deep understanding of which products and which suppliers drive revenue growth and contribute to customer satisfaction is essential to today's distributor. Leading distributors undertake "cost to carry" analysis to determine the profitability impact of factors such as minimum order size, pricing structures, payment terms, logistics performance, and shipment and configuration options. This analysis, when coupled with an understanding of customer needs, allows distributors to dynamically model how product and supplier changes affect revenues and profits.

Retailers have long recognized the power of private label products, which help increase brand awareness, market share and margins. Similar opportunities exist for forward-thinking distributors. In fact, many leading electrical and industrial distributors have launched such offerings.

However, the benefits of maintaining a private-label brand, assuming the distributor has the necessary product lifecycle management expertise to successfully compete, should be weighed against the various challenges. Along with the traditional benefits and drawbacks of these offerings, distributors must also deal with managing the supply chain in a global economy, Private-label products are often sourced offshore, such as China, India and eastern Europe, resulting in increased potential for variability compared to in-house or domestic sourcing. Quality and safety issues increase the chances for costly recalls. Product traceability is more complex. Plus, there is the added – and not insubstantial – burden of another trading partner in an already complicated supply chain. For distributors contemplating private label offerings, it's critical to model the full impact on the business – including the potential negative reaction of key suppliers (see Figure 4).

In trying to be "all things to all customers," unfocused distributors risk under-serving customers.



Source: IBM Institute for Business Value Analysis; Electrical Wholesaling, "The 5-Ton Elephant", five part series by Allen Ray and David Gordon, January 2007; The Private Label Strategy, Allen Ray and David Gordon; www.channelmkt.com/, www.allenray.com

Figure 4: The impact of private label.

Services

History has clearly predisposed customers to expect "free services" from their suppliers. However, as these services have become more diverse and costly to deliver, distributors are increasingly demanding their customers pay for them.

Before proceeding, however, distributors must ask themselves several key market questions:

Distributors need to understand what services customers value...and what they will pay for.

- What services do customers value… and what are they willing to pay for?
- How do services affect acquisition and retention of our target customers?
- Do the contemplated services reinforce our brand?
- Are the service offerings a sustainable source of competitive advantage?
- What services are competitors offering… and at what price?

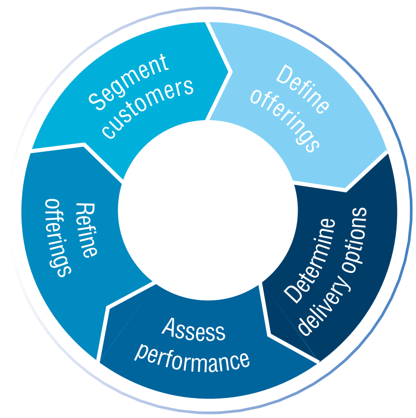
For many distributors, providing new fee-based services will require additional capabilities and investments. For instance, distributors may need to build market awareness and train their sales forces in consultative and portfolio selling techniques. Their financial capabilities may need upgrading to develop dynamic pricing models and track service offering profitability. And new IT driven capabilities may be required to actually deliver the service and provide associated online support.

The continued growth of integrated supply represents both a challenge and opportunity. As the volume of MRO spend channeled through integrated supply contracts grows opportunities expand for innovative distributors to forge new service offerings and pricing models in partnership with key customers. However these same opportunities require an ability to measure, monitor and manage a new type of business, one where costs can be more difficult to identify, measure and allocate – and where margins can remain tight despite expanded, on premise investment in inventory and personnel.

As deployment of RFID among leading electrical and industrial manufacturers rapidly expands pressure grows on their distributor customers to get up the adoption curve – offering advanced inventory tracking services to their customers. Companies such as Honda, Airbus, Volkswagen, BMW, Nokia, and Philips Semiconductors have all already deployed RFID to improve product and shipment tracking, overall supply chain visibility and manufacturing efficiency.

Managing the portfolio as a whole

To keep their portfolios relevant, leading electrical and industrial distributors manage them in an iterative fashion as outlined in Figure 5:



Source: IBM Institute for Business Value.

Figure 5: **Optimizing the portfolio is an ongoing process in a changing marketplace..**

- ***Segment customers*** – This analysis should consider a variety of dimensions, such as a customer's profitability, products and services preferences, purchasing patterns and even strategic importance.
- ***Define offerings*** – Offerings fall into two groups: those that are core and integral to the company's operations and brand, and, second, the additional services and capabilities that are priced separately. Distributors must carefully evaluate how much of their portfolio can be pushed into this second category.
- ***Determine delivery options*** – When deciding how to deliver a particular offering, electrical and industrial distributors should explore a variety of alternatives, including partnerships, outsourcing and brokers. With activity-based costing data and data-driven estimates of adoption, companies can evaluate different methods of delivery and develop flexible pricing models.

- ***Assess performance*** – Distributors will want to refine customer segmentation by monitoring uptake and customer satisfaction, calculating offering profitability and evaluating competitors' responses.
- ***Refine offerings*** – Based on these assessments, specific offerings may need adjustment. But distributors should also reevaluate the portfolio as a whole to identify gaps, reallocate resources and, when necessary, withdraw a failing offering.

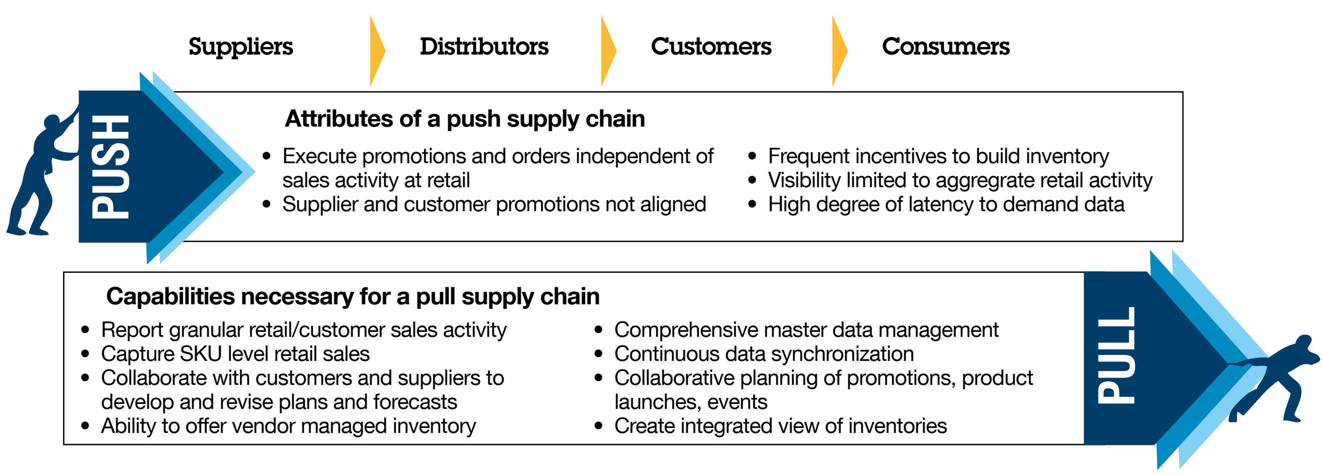
Become data-driven

Leading electrical and industrial wholesale distributors place a premium on data. It's as integral to running their businesses as trucks, warehouses and forklifts. They invest in capturing and storing information as well as sophisticated analytical tools and capabilities to develop insights they then can apply across the business. Notably, leaders don't hoard data; they're valued as trading partners because they share information and insights.

Being data-driven helps distributors:

- Move from a push to a pull supply chain
- Develop, market and sell more compelling products and services
- Optimize working assets
- Deliver traceability and transparency consistently.
- Move from a push to a pull supply chain

Supply chain visibility is the central nervous system of the electrical and industrial distribution business – and the lack of timely, accurate data can be paralyzing. However, data-driven supply chain capabilities help distributors reduce inventories, improve responsiveness, decrease out-of-stocks and increase revenues (see Figure 6).



Source: IBM Institute for Business Value.

Figure 6: **Being data-driven accelerates a distributor's evolution from a push to a pull supply chain.**

Data-driven wholesalers plan and execute their business based on market activity. They synchronize orders and inventory levels with customer demand. They increasingly integrate their operations with the action forecasts, plans and MRO schedules of their customer base. They use IT to facilitate collaboration among customers and suppliers so to reduce inventories, avoid overstocks and mitigate the risk of product obsolescence, which is increasingly important given the sophistication of the products they sell. Manufacturer promotions and other incentives help boost profitability, but are not primary drivers of what and how they buy.

Develop, market and sell more compelling products and services

Customer and consumer insights are critical to data-driven wholesalers. They provide the means to differentiate and deliver value to both customers and suppliers.

When developing insights, leading distributors cast a wide net, collecting sales, market, competitor, and customer satisfaction data from numerous sources. After leveraging IT tools to cleanse and align data, they use sophisticated analysis software to segment customers, tailor offerings, optimize prices, and market effectively.

Being data-driven also allows distributors to equip their sales forces with realtime information about inventory availability, customer order and payment history, product information and incentive pricing structures. This contributes to improved customer service as well as higher revenues.

Integrated master data is essential to many of the new service offerings customers are seeking. Collaborative sales and operations planning, vendor managed inventory and customer insights are some of the services that depend on realtime data and seamlessly integrated systems.

Optimize working assets

Distribution has historically been an asset-intensive business – requiring physical assets, such as trucks, warehouses and racking systems, as well as financial, intellectual and human capital assets. And while electrical and industrial distribution remains asset intensive, forward-thinking distributors no longer feel obliged to own all these assets and constantly search for ways to deploy capital to best support growth initiatives.

These distributors leverage a rich set of data about their own costs and performance, as well as external factors, to assess areas such as:

- How adjusting inventory levels may impact order fulfillment rates, customer satisfaction and overall profitability
- Whether deploying a warehouse management system might facilitate a reduction in storage requirements
- How altering customer payment terms might increase average shipment size, reduce order frequency and accelerate inventory turnover.

Data-driven distributors explore both traditional and nontraditional alternatives to managing asset requirements. To avoid over-investment in physical assets, some leading distributors now assess their logistics requirements in capacity terms (e.g., cubic feet). This approach allows distributors to reduce fixed assets and costs (e.g., trucks and warehouses) by leveraging third-party resources for peak requirements.

Data-driven wholesalers plan and execute their business based on market activity.

Deliver visibility, traceability and transparency consistently

Across the electrical and industrial industry, stakeholders are concerned about an expanding list of safety and corporate responsibility issues. Consumers want to know where products come from, customers want to know whether electrical and industrial products were sourced responsibly and regulators want to know how it was handled throughout the supply chain. Satisfying these concerns is vital to brand image – not only for manufacturers and builders, but also electrical and industrial distributors.

Customers are passing these demands upstream to supply chain partners. And as these informational needs rise, electrical and industrial distributors must capture and communicate an expanding set of data. As products flow through the supply chain, distributors must track movement, processing activities and attribute changes – and make this information accessible to their trading partners. Each link in this information chain is critical. Without distributor participation, suppliers and customers cannot fully satisfy consumer and regulatory traceability requirements.

Increase business model agility

Many distributors continue to manage their businesses in functional silos: supply chain, information systems, finance, HR and such. However, leading distributors increasingly manage the business as a collection of capabilities that span traditional organizational boundaries. Each capability – such as inbound logistics, customer account servicing or route planning – has a specific purpose and is composed of related tasks and resources.

This approach allows distributors to rethink investment and resource allocations, focusing on areas that are differentiating and value creating (e.g., customer insights) and reducing investment in commodity capabilities (e.g., order processing).

In addition, since many of the business capabilities are currently supported by disparate IT systems and applications, a complementary IT assessment is needed to deliver on business model agility.

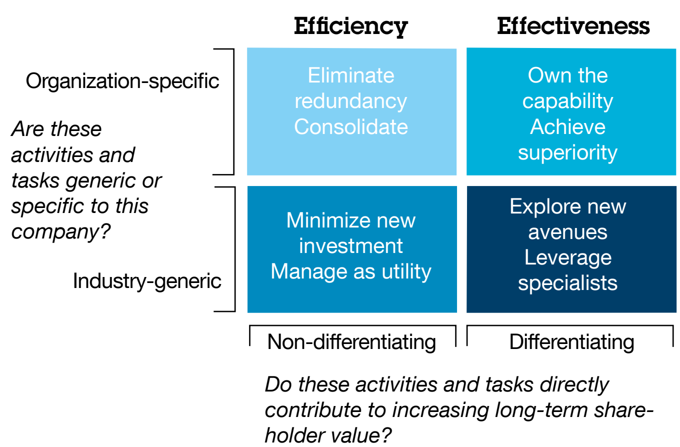
Given the high volume of merger and acquisition activity in electrical and industrial distribution, this analysis is particularly beneficial as it facilitates more effective integration and faster realization of synergies.

A decision-making framework like Figure 7 can help distributors determine how best to manage a particular capability and allocate scarce investment funds.

Partnering, collaborating and outsourcing

For many in the electrical and industrial distribution segment, an "own it all" culture still dominates. They maintain their own fleet of trucks, own their warehouses and technology. This mind-set results in high capital expenditures and fixed costs – and a business model that cannot "flex" with economic cycles or exploit new opportunities. Unless distributors can overcome this cultural hurdle, they will struggle to develop relevant products and services and redeploy resources toward the highest value.

Leading distributors manage their business as a collection of capabilities…not assets.



Source: IBM Institute for Business Value.

Figure 7: **Distributors need to assess each capability to determine the most appropriate way to source, invest and manage it..**

Managing the business as a collection of capabilities highlights areas where partnering, collaborating or outsourcing may offer strategic benefits. These approaches can provide quick access to new capabilities and technologies – often at lower cost and with shared risk. Forward-thinking distributors are working closely with redistributors to cost effectively support the low-volume requirements of their customers, leveraging 3PLs to meet customer-specific requirements or to cover regions where their own presence is limited, and partnering with software vendors to offer online services.

Creating a culture that welcomes change

When making such fundamental shifts in their value propositions, electrical and industrial distributors' greatest obstacle may be resistance to change within their own organizations. Business realities demand new ways of working and measuring performance – selling based on value, collaborating with partners, segmenting customers and offering customized services, just to name a few. All of which can be disconcerting for existing employees and may well require an infusion of new skills and talent.

Leading distributors ease the transition by providing training, tools and incentives. Their executives inspire enthusiasm and build excitement about new opportunities. These distributors' change programs target specific business outcomes, track and communicate results and reward success.

But perhaps most important, amid all the necessary change, these distributors carefully preserve the positive aspects of their current cultures – whether that be a small company atmosphere, deep product knowledge or close customer relationships. These intangible attributes may indeed be some of their strongest differentiators.

Conclusion

As you look toward the future, are you limiting yourself by adhering to a traditional view of the supplier-distributor-customer relationship, or are you reinventing yourself to provide greater service and value to your customers?

The following questions can help you pinpoint areas where your company may need to step up its execution:

- What capabilities matter most to your customers?
- How does your strategy differentiate you from others?
- How do you leverage your unique position in the supply chain?
- How successful are you at capturing customers and market share within a consolidating customer base?
- Does your portfolio of products and services reflect the changing needs of your customers and suppliers?
- Are you more likely to acquire or be acquired?
- What steps are you taking to meet escalating expectations for supply chain visibility, product traceability and environmental responsibility?

These are times of unprecedented complexity and change in the distribution business. Increasing competition, the emergence of mega-distributors and fewer customers are increasing pricing pressures and creating the demand for more customized services. Large customers, formerly the foundation for wholesale-distributor revenue, are turning more and more to self-shipping and fulfillment. Upstart competitors, with efficient and effective technological capabilities, are gaining market share. 3PL companies have become both partners and competitors.

To claim their positions in this rapidly evolving industry, electrical and industrial wholesale distributors must look beyond their traditional roles and make new connections with their customers. We believe the market share winners will be those that execute an expanded value proposition, drive their businesses based on realtime, contextual data and transition to a flexible business model that provides a conduit to new opportunities.

About the authors

Guy Blissett is the Consumer Products Leader for the IBM Institute for Business Value. He has extensive experience in the consumer products industry and is a frequent speaker at industry events, most recently at the Grocery Manufacturers Association Information Systems/Logistics Distribution (IS/LD) Conference. He has also published numerous papers, including "The Future of the CP Industry: The end of the world… or a world of opportunity?" "Establishing trust through traceability: Protect and empower your brand for today's 'Omni Consumer," and "Enabling Multifaceted Innovation: Consumer Products CEOs reaching beyond the familiar." Guy can be contacted at *guy.blissett@us.ibm.com*.

Robin Kahn is a business consultant with over 20 years of experience in management consulting, equity research and strategic marketing. She has worked with the IBM Institute for Business Value for the past two years, conducting research related to the consumer products and financial services industries. Robin can be reached at *rkahn@us.ibm.com*.

Maureen Stancik Boyce, PhD, is an Associate Partner and the Distribution Sector Team Leader for the IBM Institute for Business Value. She has 14 years of business strategy experience in retail and other consumer-related industries. Maureen can be reached at *staboyce@us.ibm.com*.

Contributors

Paul St. Germain, IBM Business Development Executive, IBM General Business Wholesale Distribution

Michael Briglia, IBM Vice President and Americas Distribution Sector Leader

The right partner for a changing world

At IBM, we collaborate with our clients, bringing together business insight, advanced research and technology to give them a distinct advantage in today's rapidly changing environment. Through our integrated approach to business design and execution, we help turn strategies into action. And with expertise in 17 industries and global capabilities that span 170 countries, we can help clients anticipate change and profit from new opportunities.

References

1 Builder Online. http://www.builderonline.com/builder100/2008.aspx

2 "Office Market Trends, Q3 2009;" "Industrial Market Trends, Q3 2009." Grubb & Ellis. www.grubb-ellis.com

3 U.S. Bureau of Economic Analysis, May 24, 2007; U.S. Department of Labor, Bureau of Labor Statistics, September 2007; Industrial Distribution's 61st Annual Survey of Distributor Operations, Pembroke Consulting, Sept. 2007.

4 "The Move to Become Green Takes Hold in the Supply Chain", *Industrial Distribution*, March 1, 2008.

5 Cortese, Amy. " 'Green' Buildings Don't Have to be New." *The New York Times*. January 27, 2008.

6 Krieger, Sari. "Green Gap: As environmentally friendly construction takes off, a question looms." *The Wall Street Journal*, November 16, 2008.

7 "Green Outlook 2009: Trends Driving Change," McGraw-Hill Construction. November 18, 2008.

8 Utilities" and Customers' Use of Energy Efficiency Rebates Grow," findarticles.com, March 5, 2008;

9 Avery, Susan. "Grainger publishes new catalog with more than 138,000 MRO items. *Purchasing magazine*. March 1, 2007.

10 "61st Annual Survey of Distributor Operations." *Industrial Distribution*. 2007. www.inddist.comwww.rohs.gov.uk

11 "Restriction of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment Regulation." RoHS. www.rohs.gov.uk

12 Ibid.

13 "Sonepar USA acquires Essco Wholesale Electric." *Industrial Distribution*. May 19, 2008.

14 Young, Lindsay. "Distributor M&A Activity Heats Up." *Modern Distribution Management*. February 25, 2006.

15 "Clayton, Dubilier & Rice and Kohlberg Kravis Roberts to Acquire U.S. Electrical and industrialservice From Ahold." *Business Wire*. May 2, 2007.

16 "IDG to Accept Luther King Capital Management's Bid," *Modern Distribution Management*, April 26, 2008.

17 Fein, Adam J. "Facing the Forces of Change: Lead the Way in the Supply Chain." Pembroke Consulting. 2007.

18 IBM Institute for Business Value analysis.

19 UPS and UPS-supply chain colutions company Web sites. www.ups.com/content/corp/index.jsx; www.ups-scs.com/; www.ups-scs.com/solutions/case_automotive.html#harley; www.ups-scs.com/solutions/case_automotive.html#industrial; www.ups-scs.com/solutions/case_studies/cs_vehicle_parts.pdf

20 "The Enterprise of the Future: IBM Global CEO Study." IBM Corporation. May 2008.

21 Blissett, Guy. "Establishing trust through traceability: Protect and empower your brand for today's 'Omni Consumer'." IBM Institute for Business Value. June 2007; Pohle, George and Jeff Hittner. "Attaining sustainable growth through corporate social responsibility." IBM Institute for Business Value. February 2008.

IBM Global Services
Route 100
Somers, NY 10589
U.S.A.

Produced in the United States of America
December 2009

GBE03273-USEN-00