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The Industrial Distributor:
A Threatened Species?

The industrial distributor has been a marketing mainstay in many business-to-business market segments. The industrial distributor is the company that buys and stocks products from manufacturers and markets it to customers large and small. There are almost 300,000 industrial distributors in the U.S., which represent approximately $2.3 trillion in sales. [i] The latest survey by Industrial Distribution Magazine shows the typical distributor averages sales of around $11 million, is family-owned, and has been in business 38 years.[ii]

The typical industrial distributor is facing far more challenges now than in the past. Let's consider a few:

- Customer consolidation. Customers are getting bigger as a result of growth, mergers, and consolidation. These bigger customers are demanding, and getting, more services and better prices. These bigger customers are in some cases seeking to bypass the distributor altogether and buy direct from the manufacturer.

- More information. There is more product information available – information that in the past would have been available only from the distributor. Many manufacturers are offering "configurators" free of charge. With these, customers can develop their specifications rather than relying on the distributor representative.

- Manufacturer expectations. Many manufacturers have volume-purchasing requirements. These requirements force distributors to "stock up" so the best prices can be had and contracts can be satisfied. These requirements can sometimes force less desirable strategies for distributors.

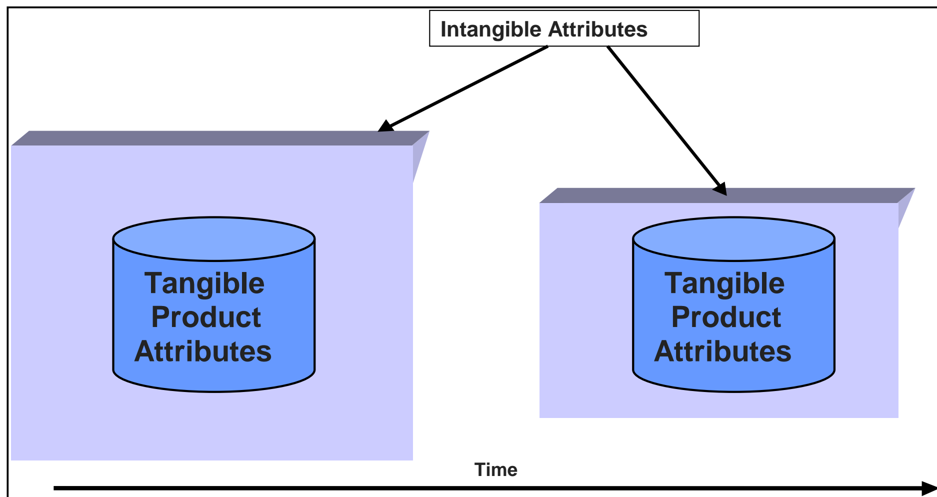
- New technology and new techniques. Information technology makes customer transaction details available to manufacturers. Integrated supply chain management techniques and just-in-time inventory management processes have forced distributors to share this information with manufacturers.

With these forces driving change in the industrial distribution market, it may seem that the industrial distributor is a threatened species. Some are, but there are strategies that offer potential for success. In this paper, we want to present a framework for identifying those strategies that can improve the competitive position and profitability of your distribution company.

Revisit Your Value Proposition

The decision to purchase the typical industrial product is influenced by factors beyond just the tangible characteristics of the product (e.g., performance, durability, price, etc.). Technical information, service, pre-sale support, and many other factors contribute to the successful sale. The amount of value customers attach to intangible attributes changes over time. When products are newer, they attach more value to the intangible attributes. Over time, things change. Customers learn how to use the product and require less technical support. They can easily download technical bulletins from the Internet and get needed information. The tangible product attributes become more important relative to the intangible ones. Price becomes more important. Customers seek alternative ways to purchase the product. The product becomes less

differentiated as alternatives catch up in terms of price and features. Pricing pressures force the manufacturers to squeeze costs out of the distribution channel. This is the product life cycle at work.



What to do? In short, redefine the value bucket! This is what WW Grainger did. They expanded the value bucket by offering tool crib management services, safety programs, and electric motor maintenance and repair services, among others. Grainger realized that customer problems with supplies had more to do with managing these supplies than actually buying them. They expanded their value bucket by solving problems their customers had with managing their tool cribs and other plant supplies.

A New Model for Analyzing Your Products' Value Bucket

In a Harvard Business Review article, Richard Wise and Peter Baumgartner, consultants with Mercer Management Consulting, noted that much of the money spent on products is spent on ancillary services and products (including lost productivity in the case of personal computers) and not on the product itself. For example, expenditures associated with automobile ownership are typically five times the original cost of the product. This includes such things as maintenance costs, insurance, gas, finance, etc. A locomotive has a ratio of 21 to 1 while a personal computer is 5 to 1.[1]

This article presents a useful framework for industrial distributors to analyze their product lines. These non-product costs represent potential areas of opportunity for a distributor. The challenge is being creative in identifying these costs and determining if your company can provide a solution.

The first step in using this model is determining just what the ratio of product costs to other costs is. While conceptually this is easy, getting the details can be very complex. Things to consider are:

- What are all the hard or measurable costs associated with operating the product? Be specific and list them all even if you think your company cannot do anything about them. For example, if you sell a product that consumes significant electric power, you may not be able to sell power (perhaps in the future) but you may be able to offer technology and services that help manage power consumption.

- What are the more intangible costs associated with operating the product? In the case of one industrial distributor, the company distributes chemical process pumps that are critical to a plant's operation. Having a pump down means losing a lot of money. The intangible costs (i.e., risk of a pump failure) are quite high. The distributor started a 24/7 technical support service to which customers quickly subscribed.

- If the ratio between intangible to tangible product cost ratio is low, meaning the value bucket is small, what can you do? One distributor of cabinet hardware decided to solve a major labor and quality problem for some of his customers by developing a subassembly that resulted in much lower labor costs and improved door alignment. Customers loved it, the product margins were high, and it quickly led them to other arenas. They increased their value bucket.

- What do you do if the ratio is high, meaning the value bucket is large? Don't sit still. Remember, all value buckets can shrink over time <u>if you let them</u>. We are aware of one distributor of sporting goods equipment. This company has consistently increased its value bucket over time even in the face of stiff competition, including Wal-Mart.

Implications of the Value Bucket

There are several important implications from this model. These are:

- Trying to expand the value bucket will not work for all products or product groups. If customers do not want it or it increases your company's risk too significantly, look for other alternatives. Be realistic. Don't try to force it.

- Value buckets are constantly changing. More information, improved technology, and customer changes, most especially mergers and acquisition mean industrial distributors are facing dynamic markets. Evaluating the value buckets for your product lines must be an ongoing process.

- Expanding a value bucket can also mean moving into new businesses with success factors that are different from your existing business. For example, the cabinet hardware company noted earlier had to invest in far more engineering capabilities when they launched the new product line—something that required a change in thinking on the part of the CEO.

- There are some industrial distribution markets in which the value bucket cannot be expanded. It is good to recognize this fact as soon as possible and either be willing to accept the lower margins that come with this type of market or look for ways to exit the business.

The value bucket presents a useful framework to help most industrial distributors identify ways to make their businesses more profitable. The changes in most distribution markets are forcing customers and manufacturers to look for the most effective ways to either buy or sell their products and services. Sometimes, the industrial distributor does not fit anymore. Now is the time to take a hard look at your distribution and determine how to succeed. All industrial distributors are not a threatened species.

[i]1997 Census of Manufacturers, Wholesale Trade, United States Department of Commerce.
[ii]*Industrial Distribution Magazine*, Study Summary, 2001.
[iii]*Harvard Business Review*, September-October, 1999, p133-141.

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