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Distributors Who Price Low, Take Sales, and Make More Money

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The title, upon first glance, seems an oxymoron. The prevailing profit logic in distribution has been to capture as much value as possible in pricing, sell solutions wherever possible, and keep a lid on expenses. Distribution is an uber-mature industry with most sectors going back over 100 years. Everybody knows, more than less, what everybody knows.

While distributors pore over PAR reports, review rebate income ad nauseam, and trade profit outlooks with their non-competitor peers, there is a class of firms that are quietly mounting a revolution outside industry norms. They offer a low price, grow sales at a pace often much faster than the industry average, and are becoming threats to established distribution firms. They are called Transactional Distributors and several have developed national footprints in the past few years. They will, if they continue to sprout up and grow at their current pace, change the industry.

Transactional Distribution

We penned our first article on Transactional Distribution[1] when the first models were serving niche markets at the cusp of the new Millennium. At the time, the entities were using e-commerce to consummate sales while reducing the branch footprint. They offered limited sales assistance, better than average technology, and a low price to attract sales. The price differential, primarily, came from a reduction in operating costs, including greatly reduced sales assistance and reduced bricks and mortar. Some firms developed overseas supply chains and combined low-cost, foreign-sourced inventory with the reduction in operating cost. In most instances, the companies were small in sales, with $50 million in top-line revenues being the largest. They were, however, growing entities that confused traditional full-service distributors, who testified it was unlikely they were making money.

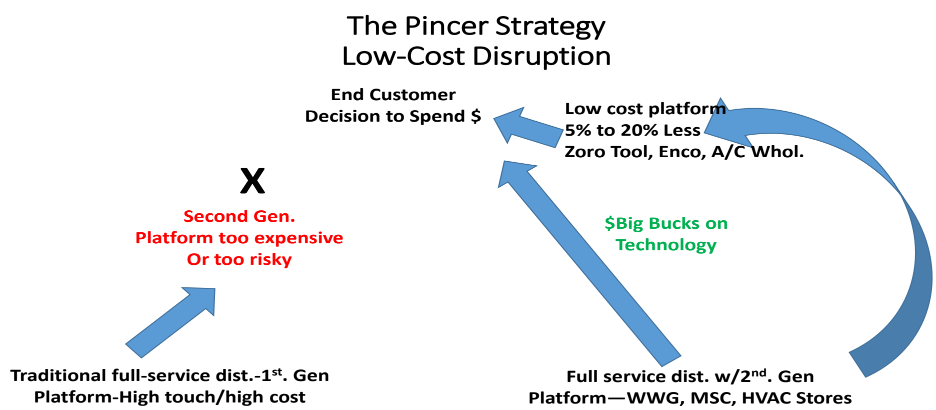
A decade later, transactional distributors and platforms are found in most of the four dozen product vertical markets that make up durable goods distribution. Many of the firms are significantly larger than they were a decade ago, with sales going into the hundreds of millions of dollars. Traditional wholesalers, in the current day, continue to give these distributors little credence. They simply are not as visible as more traditional competitors comprised of national chains and regional powerhouses. Our view is entirely different. We believe transactional distributors and their variants pose the most potent threat of the last 30 years to full-service distribution. Our forecast is that these distributors will grow at the expense of their full-service competitors and, in fact, they are taking away sales from traditional distribution today. Hence, it behooves full-service distributors to learn as much as they can about these competitors and how they operate. They will grow significantly in the next five years, as e-commerce is scheduled to grow at a 7% to 10% CAGR.[2]

Transactional M.O. and Evidence

Transactional distributors use best-in-class technology in e-commerce and fulfillment to draw customers to their sites. It is not surprising that several of the largest are brands of large wholesale firms with significant online activity through the traditional platform. Exhibit 1 gives an overview of the transactional distributor and their competitive advantage.

Traditional distribution firms, on the left of the Exhibit, have traditional e-commerce platforms typically comprised of proprietary programmed software or B2C platforms adapted to B2B transactions. These systems are called First Generation and represent two-thirds of distributor e-commerce efforts. We deem these platforms as functional but they don't offer a modern-day customer experience. On the right hand part of the Exhibit are modern day entities that represent both full-service distributors and transactional distributors with second generation e-commerce technology. Second generation technology is the term for the technology used by leading companies in B2B e-commerce. The technology list includes: B2B specific transaction software with user base, PIM, faceted search, procurement punch-out, and mobile app(s). Only a third or so of distributors have second generation technology which, based on our research, costs a minimum of $2MM for the first couple of years.[3]

Exhibit I



As firms build out their second generation platform, they have the opportunity to launch online "brands" with differing value propositions. In Exhibit I, on the right hand side where the "curved" arrow is placed, we have illustrated three of these brands. Grainger and MSC Industrial, leading MRO suppliers with best-in-class technology and significant experience in e-commerce, have launched "low cost" brands which don't dilute the value of their parent companies. Another entity, HVACStores, sells condensing units direct to home owners through a site titled "ACWholesalers." The rise of low-cost brands and other online brands is just beginning but, from what we can find, their performance is impressive including:

- Zoro Tool, a Grainger entity, grew from no sales to over $300MM in revenues from 2010 to 2015 including growth in the recent quarter when the corporate parent's growth declined
- ACWholesalers, division of HVACStores, is on the Inc. Magazine's fastest growing small companies with prices 15% to over 30% lower than purchasing through traditional wholesaler to dealer channel(s)

- CivicSolar, a California-based solar supply house, competes on a gross margin percent of sales that is less than half of traditional wholesaler competitors

We have found online brands in most of the four dozen vertical product-market sectors of the durable goods sector of the U.S. economy. The firms use technology and cost reduction to reduce the price while improving the customer experience. Strategically, they use both full-service and transactional platforms as a pincer movement against traditional full-service competitors.

Reduce the price and improve the customer experience

B2B channels have added value in a multitude of ways. In the last decade, traditional distribution firms have remained competitive by moving further into their customers' value chain by offering assembly, design and field repair services. As distributors mine smaller increments of value, their operating platform and its cost balloons. Fully half of distributors have services they charge for and the number is growing. [4] There are increasingly fewer service/market platforms on which scale can be sought. The more configurations of services and products for individual customers there are means an explosion in downtime or changeover time to operations and IT. Ergo, distributor operating structures are often convoluted with inherent inefficiencies and ripe for low-cost, stripped-down service and product competitors.

The transactional distribution platform enters a time and marketplace where distributors are increasingly inefficient, as they have increased revenues through differing services, products, and markets. These offerings, however, are often under multiple branch roofs and operating flows are in conflict. Transactional distributors strip away all but the most basic of services except processing the order, extending credit, invoicing, and shipping. There is some sales back-up for customers but it is minimal. As much as possible, transactional distributors rely on best-in-class e-commerce technology for the customer to self-serve.

Reductions in sales, brick and mortar, and operating streamlining can be significant. Our experience is that transactional distributors go to market at prices that are 5% to 20%+ lower than full-service firms. They offer half or more of the efficiencies back to the customer as a reduced price, which means their operating leverage over the full-service model is in the 10% to 40% range. While 5% to 20% or more price reduction may not seem attractive, one must realize that most distributors struggle to earn 3% return on sales. The ability for a full-service firm to compete on price with a transactional entity is unsustainable. As profitability goes, transactional distributors have, typically, twice the ROS than traditional distributors (3% for traditional firms to 6% or more for transactional firms). Their profit is driven from their low-cost operating platform and simple service strategy.

Product offerings from transactional firms are typically the common products that move quickly. The SKUs are manageable, as they represent the 20% of items that represent 80% of sales. Asset management is easier and asset returns are higher for transactional firms, as products are more accurately forecasted because they are those most commonly used. Returns and dead stock are significantly less than full-service distribution.

Many full-service distribution firms tout their value including full sales service. Increasingly, full-sales service is viewed by buyers as a detriment. Buyers must contact their assigned seller or an inside seller for assistance during business hours. Our research on MRO/Industrial buyers finds that most prefer second generation e-commerce for ordering versus contact with the sales force. Advantages of self-service include the ability to order any time and when it is convenient, to the ability to check price, product specifications, and order status without a phone wait.

The full sales force cost is where many traditional distribution firms lose the order to the transactional competitor. The personal sales call and inside sales support is expensive. We calculate the cost of full-sales service, per invoice, in the $35 to $45 range. An example of the calculation is in Exhibit II.

From the exhibit, an average stock invoice of $375 is used in a sales territory of $1.6MM and full salary and benefits for the outside seller are set at $108,000. Additionally, the inside sales cost is $60,500 in salary and benefits and workload is 5,040 invoices at two to three lines each. Combining the efforts on a per invoice basis leads to a sales cost of $37. This is compared to an e-commerce order cost of less than $5. If an account purchases 1,000 invoices, the sales support cost is $37,000. This takes special meaning in industries where most products (70% to 80%) are commodities and the customer knows them better than the distributor. From Exhibit II, the sales support cost is 10% of the invoice value.

Most transactional distributors provide sales support in the form of product or application specialists. Their staffs are, however, very lean and capacity is added as customer need for additional support is determined.

Stock Sales Invoice
Full Sales Support Cost Exhibit II

- Average invoice of $375 at 22% GM or $82.5 GM$
- Outside sales cost and benefits--$90K 20% support or $108k-Covers $1.6MM in sales or 4266 invoices=$25/Invoice
- Inside sales cost and benefits--$55000 + 10% support=$60.5K
- Inside workload in a year=20 invoices/day x 252 days=5040 invoices per year=$12/invoice
- Average stock invoice has 2-3 lines
- Sales cost of a stock invoice is $37, Average cost of e-sale is < $5 Invoice
- *For each 1000 invoices of stock products-customer pays $37,000 in sales costs-and they know the products better than you*

Many wholesalers are sales driven; they rely on the sales force to secure, price, and specify services for the customer. In new technology industries or capital goods sales, the involvement of a sales force to heavily influence or control the marketing mix and operating platform makes sense. However, in mature products industries, sales control of the customer relationship can add costs without corresponding increases in value. These industries are susceptible to low-cost, simplified platforms with a very good price, and any number of industries including retail, groceries, and consumer non-durable goods have been transformed by transactional entrants.

The movement of large wholesalers including Grainger and MSC Industrial toward a transactional brand is acknowledgement that the strategy and enabling technology have come of age. The sales cultures, dominant in wholesaling today, will lose a significant amount of their power. The option away from a sales supported transaction is said best by Ian Meakins, CEO of Wolseley, “price-focused customers don’t necessarily need or want salespeople calling on them…Wolseley keeps its cost to serve for these customers low by increasingly serving them through its e-commerce channel.”[5]

The Technology and Management Barrier

Almost all of the transactional distributors we reviewed have significant technology investments including: Current B2B transaction platform, PIM, Faceted Search, Procurement Punch-Out, and Mobile App. Investment costs for the technology are all over the map, but best-in-class software including integration and people costs is somewhere in the range of $2MM for the first two years. After this, other costs become substantial, including ongoing in-house personnel, content development and management, and other software. The build-out of the software for a modern-day customer experience is called the Digital Strategy. It is the first major hurdle in most distributors' challenge to compete in the online space.

Once the Digital Strategy is underway, we encourage distributors to begin planning for the Digital Transformation or the move to get sales, marketing, and operations in alignment. This includes new plans and deployments for the sales effort, development and usage of product managers to deliver content and a complete user experience, and reformatting of logistics to fulfill and ship online orders.

Some 60% of e-commerce wash-outs are in the digital transformation stage and the issues are largely cultural. Almost all of the successful transactional distributors are either start-ups where there is no prevailing culture or the existing culture establishes a new entity with new management. Why? Traditional distributor cultures are hands-on and take great pride in personal engagement with the customer. Letting the customer self-serve is extremely difficult for career sellers. Hence, the most successful transaction entities, within an existing distribution firm, are separate organizations with a separate brand and dedicated management.

Conclusion

The progression of e-commerce in the B2B sector and development of new and better software allows distributors to offer a self-serve customer experience of high quality. Research finds that modern e-commerce systems are preferred by buyers over placing orders with sales assistance and within traditional business hours. A new brand of wholesaler, the transactional firm, is growing and makes use of technology to reduce service costs and pass the savings on to the customer. Costs are reduced in sales support, brick and mortar, and operating platforms. Customers get, on average, a price decrease in the range of 7% to 15% over full sales service organizations.

Transactional distributors are growing at the expense of their full-service competitors. They are found in many of the four dozen vertical product/market sectors in durable goods distribution. They pose a significant and disruptive threat to full-service distributors and are forecast to grow as end users migrate online for their purchases.

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[1] Benfield, S. "Rise of the Transactional Distributor," *Progressive Distributor*, Fall 2002.
[2] Forrester Research forecasts of B2B e-commerce growth is 7% to 10% CAGR through 2020 and depending on type of market served.

[3] Benfield, S. "Sticker Shock: The cost of second generation e-commerce. . ." *Industrial Supply*, July/August 2015 at: http://www.industrialsupplymagazine.com/pages/Print-edition---JulAug15_sticker-shock.php
[4] Benfield, S. Distributor Growth Research, TUG Infor Conference, 2013, Orlando.
[5] Meakins, I. "Wolseley's Customer Segmentation Strategy," MDM Online, J. Holtmeier, Sept. 30, 2015