

Winning in the Evolving Industrial Distribution Landscape

Equity Research

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Industrial Distribution

Expert Interview: Winning in the Evolving Industrial Distribution Landscape

May 22, 2014

Overview. We recently spoke with Jim Tompkins of [Tompkins International](#) about the evolving state of the industrial distribution landscape. Our goal was to better understand current trends in the industrial distribution space and who is best positioned to benefit. Tompkins International provides distribution operations, global supply-chain services, and growth and business strategy consulting. Mr. Tompkins has 35 years of consulting experience and has recently focused on the threat that an evolving marketplace, including e-commerce, poses to the traditional brick-and-mortar distribution model.

Large players likely to put mom-and-pops out of business en masse. According to Mr. Tompkins, industrial distribution is undergoing an evolution driven by seven pillars of change: 1) online success, 2) technology, 3) social commerce, 4) youth culture, customer service, 6) branch relevance, and 7) getting local. Mr. Tompkins believes the future of MRO distribution rests with companies that are willing to innovate and be relevant to the new buyer (who is younger and Internet savvy) and online marketplace. Gradually, the traditional MRO buyer, who valued a print catalog and baseball tickets, is dying. Size alone will not be enough for survival, nor will great technical expertise. Mr. Tompkins sees the future of MRO distribution dominated by several large broadline players and a few specialists who can “go deep” in a single category (think fasteners, metalworking, and bearings). Mr. Tompkins’s view is that large, well-capitalized distributors will put hundreds of thousands of mom-and-pops out of business during the next 10 years. Mr. Tompkins agreed with our view that Grainger is a greater threat to the mom-and-pops than other big B2B online players because Grainger can marry technology, service-minded salespeople, technical advice, and a multi-channel model into one defensible package. Already, we are seeing smaller players decide to get out of the inventory-stocking game and focus instead on technical selling, which increasingly is their only source of competitive advantage.

Seven Tipping Points of Industrial Distribution

1. Online Success
2. Technology
3. Social Commerce
4. Youth Culture
5. Customer Service
6. Branch Relevance
7. Get Local

Source: Tompkins International

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W.W. Grainger, Inc.
Symbol: GWW (NYSE)
Price: \$252.15 (52-Wk.: \$228-\$276)
Stock Rating: **Outperform**
Company Profile: **Established Growth**

Fastenal Company
Symbol: FAST (NASDAQ)
Price: \$48.12 (52-Wk.: \$42-\$53)
Stock Rating: **Outperform**
Company Profile: **Established Growth**

MSC Industrial Direct Co., Inc.
Symbol: MSM (NYSE)
Price: \$89.27 (52-Wk.: \$75-\$93)
Stock Rating: **Outperform**
Company Profile: **Core Growth**

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Where is MRO distribution going? Tompkins International's January 2013 white paper, "Industrial Distribution at a Crossroads," highlighted customers' desire for multi-channel suppliers as a key success factor in MRO distribution. It is critical that distributors service customers under their own terms-how, when, and where. To meet this bar, Mr. Tompkins believes industrial distributors must be interactive, educational, engaging, and personalized in the sales and service approach. Customers have taken a closer look at their entire cost structure (including indirect costs) and are demanding more from suppliers of all sizes. To meet increased customer demands, distributors must be willing to adapt to how customers make purchases. For example, Grainger can customize its e-commerce tools to align with individual-customer buying workflows. His opinion is that where most competitors will struggle is exactly this type of collaboration among all the different customer demands. Remember, every customer has different processes and procedures for buying products. A multi-channel approach makes purchasing more convenient, allows the customer to personalize the experience, and provides different levels of "touch" depending on the technical nature of an order.

E-commerce has become an increasingly important part of the distributor value proposition as customer buying behavior has shifted. Large public distributors have invested heavily to create world-class e-commerce capabilities, and the entrance of giant online retailers also playing in the online B2B space has only brought further attention to the channel. Although existing online B2C and now B2B companies might be a threat to the large public incumbents, specifically through increased price transparency and usability of its website, the low-price and low-service online business model is not new to MRO distribution. In fact, Grainger has invested heavily in Zorotools.com to compete with other Web-only models. Zoro Tools offers more than 400,000 products at super low prices, according to its website. Zoro Tools offers no discounting or services and is tailored to small and medium customers who just want a fast transaction. Zoro Tools uses the same supply chain as the name-brand Grainger.com. We note that the Google reviews of Zoro Tools are excellent and that Zoro Tools has delivered more than 100% sales growth in recent periods.

What does "get local" mean? People want things faster. Even with the increasing importance of a multi-channel approach, getting local is the real key to success. Customers'

expectations for delivery time are being shortened-falling on a matrix depending on product function, customer size, and customer location. Mr. Tompkins has found that the largest customers in top- 40 metro areas expect the shortest delivery times from suppliers. Customers are willing to pay a premium for same-day delivery of certain products but are unwilling to incur shipping costs for lower-priority products. This means distributors must have: 1) the right inventory held locally, 2) local delivery capabilities, and 3) an understanding of where products are being delivered (i.e., end-user, warehouse, or home). Being local allows distributors to provide superior services in an increasingly just-in-time world. Fastenal's extensive branch footprint, large salesforce, and proprietary distribution network have grown around the advantages of being local. Grainger's multi-channel model addresses the need to be local and the recent push of territory sales representatives (TSRs) highlights the importance of being near the customer in the MRO business.

Mr. Tompkins used AutoZone (AZO \$541.66) as an example of getting local. Every day, AutoZone has its local delivery fleet running products over to repair shops. Mechanics are unwilling to waste time picking up supplies and would rather pay a premium for just-in-time delivery. Also, AutoZone delivery and counter guys know a lot about the products they sell. No one can provide better "A-to-B" delivery than UPS (UPS \$101.66; Outperform) and FedEx (FDX \$139.33; Outperform) when it comes to long distances. However, within a single metropolitan area, distributors can deliver product more efficiently, similar to AutoZone, Fastenal, and Grainger. The key is to have the right local inventory and service-minded personnel to flex this advantage.

Full-line players will win out. Mr. Tompkins believes that full-line distributors will eventually win out because they carry the A-Z products customers need to maintain facilities. Grainger and similar B2B online players are well positioned and will put smaller competitors out of business, but not one another. Mr. Tompkins has been impressed with Grainger's execution and believes it is the biggest threat to the mom-and-pops. Full-line distributors benefit from selling high-volume SKUs as well as slower-turning specialty items that require technical support. Relationships are also very important in the B2B world, and displacing existing high-service distributors is even difficult for the large public distributors that offer a better value.

Room for category specialists. Although the future of MRO distribution will be dominated by full-line players, there is room for strong specialists. Mr. Tompkins believes that the old model of selling technical expertise in one product category bundled with commodity products is no longer viable. Instead, the commodity products will go to larger players (which have better pricing and service). Specialists could struggle as the technical products they sell might not create enough volume without the commodity products, too. This type of competitor is best suited to sell its product knowledge on its own through consulting rather than through stocking inventory. To survive, mom-and-pop specialists will have to be so strong in a long-tail product category (such as bearings) that larger players see the barriers to entry as too large. To achieve scale while focusing on a narrow product set, a specialty distributor will need national coverage to create sustainable scale. Although Fastenal and MSC Industrial are becoming broader in their product offerings, we view their scale and

expertise in the fastener and metalworking categories as continued anchors for their success (even between each other).

Finding value in the branch model-being local with a purpose. The evolution of MRO distribution to a multi-channel service model has meant more emphasis on e-commerce and reduced dependence on branches. How has Grainger changed since its e-commerce business has taken off? It has closed branches, increased SKUs, hired more general salespeople and more sales specialists, and added more services. Branch networks will need to be justified as a value-add destination for customers or a critical point in a distributor's supply chain-so, they will need to be local with a purpose. No longer can a branch be a place to cultivate relationships over doughnuts. Put another way, why would you go to Staples when you can buy paper online? The changing role of branches has already been recognized by Grainger. Grainger is removing slow-turning inventory from its showrooms and adding work tables for associates to troubleshoot customer problems. The new branch model is more of an "industrial apple" and lends itself to the consultative relationship that Grainger wants to form with its customers. Although evolving, branches will not disappear because customers find comfort in the local inventory and service as a part of the multi-channel model.

Although Fastenal has slowed its branch rollout over the past five years, the network remains a critical part of its strategy. The facilities provide salespeople with a location to work from and offer local inventory of customer-specific SKUs. The branches are also the final point in Fastenal's supply chain. Unlike other distributors who use FedEx or UPS, Fastenal operates its own supply-chain transportation. Having a network of over 2,600 branches allows Fastenal to provide customers with same-day service.

As the industry evolves, core value proposition does not change. Even with the industry undergoing a rapid evolution, the core value-add of distribution has not changed. Consistently having the right product in the right place at the right time will win customer loyalty-delivery just needs to be faster today and the ordering process needs to be easier. Distributors must understand changes to customer buying preferences and align their selling and operational infrastructure accordingly. Below we highlight Tompkins International's five pillars of industrial distribution success, which are applicable across all channels. As customers increasingly scrutinize all purchasing decisions and the purchasing managers become more Internet savvy, these five points of competitive differentiation are becoming more important.

Five Pillars of Industrial Distribution Success

1. Competitive Prices
2. Product Breadth

3. Availability

4. Speed of Delivery

5. Technical Support

Source: Tompkins International

Jim Tompkins is CEO of Tompkins International. He has written or contributed to more than 30 books and writes the Creating Supply Chain Excellence blog. He can be reached at jtompkins@tompkinsinc.com.

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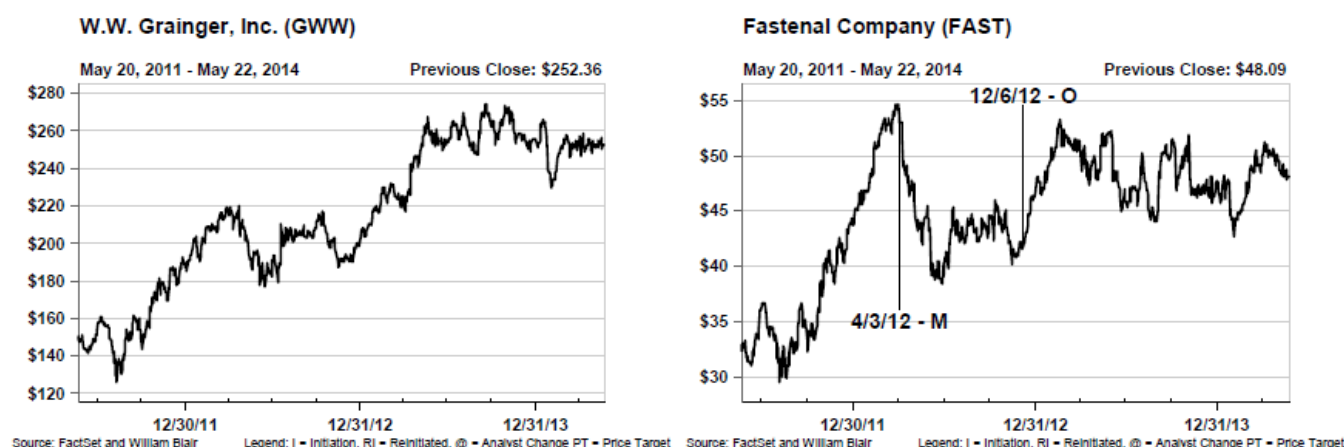
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