

# “Changes in the Role of Distribution”

## 2014 Valve Industry Leadership Forum

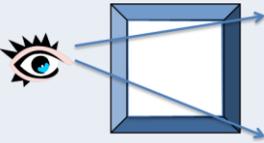
- Steve Bassill, President, QDI Strategies, Inc.



# Manufacturers GTM Strategies Are Being Fundamentally Disrupted

- **One major disruption is that distributors are changing their roles**
  - Manufacturers have built their GTM strategies around the paradigm; distributors are an extension of the manufacturer's sales and marketing organizations
  - However the role of the distributors may be changing through the services they provide; distributors are becoming an extension of their customer's businesses
- **Communication between manufactures and distributors has to increase to be successful in the face of market disruption forces**
  - “The manufacture-distributor conduit to the end-user is critical because the distributor hears things the manufacturer does not....Distributors see field problems that manufacturers don't”
  - As the distributors move more to customer service providers, their visibility to customer needs will increase
  - For manufacturers to continue to successfully innovate they will need to get closer to these customer needs
- **My goal today is to provide a framework that will guide manufacturer / distributor strategies for the future**

# Paradigm Shifts

	Historic Paradigm	Paradigm Shift
Paradigms	Distributor is an extension of manufacturer	Distributor is an extension of customer
	Assess their customer window through capability to sell manufacturer's products	Assess their customer window through nature of relationship with customers
	View marketing across the life cycle of a product	View marketing through the life cycle of customer relationships
	Transfers marketing costs from manufacturers	Transfers operations costs from customers
PST 	Focus of product marketing (PST) and competition	Focus on ecosystem marketing and competition

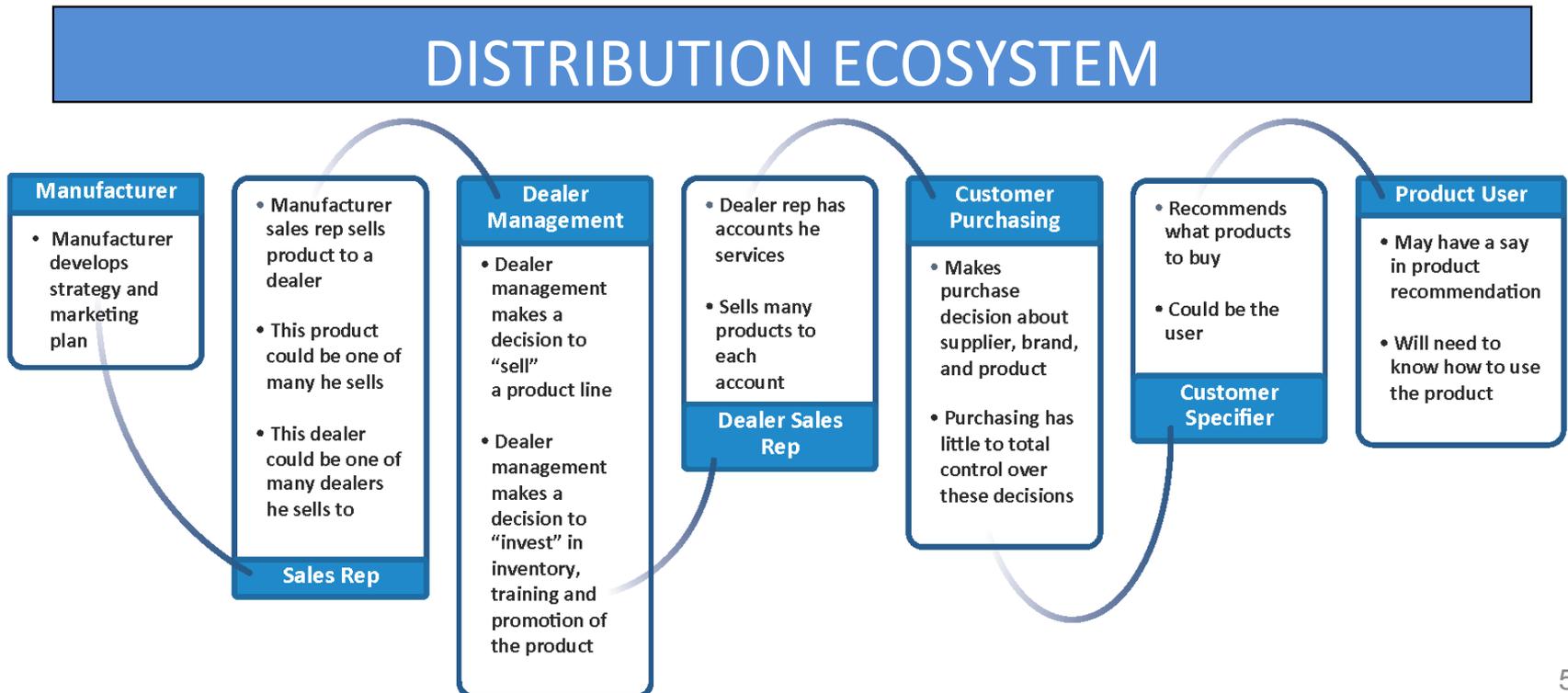
# Disruption Forces

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- Organizational Disruption
- Technology
- Chase for Value
- Changing Customers / Industries
- Consolidation

## Organizational Aging

- The greying of America as the baby-boomers retire is leaving holes in the “institutional knowledge” in marketing systems
- Ecosystem was always complex, but built on a foundation of expertise
  - For the manufacturer, distributor and customer



## Technology Drivers

- **Information technology / driving logistics** and supply chain management –
  - Resulting in faster inventory turns, lower investments in inventory
  - This should put downward pressure on distributor margins as customers squeeze out efficiency savings
- **Information technology increasing flow of information** between manufacturers and distributors, and distributors and customers
  - PRM (partner relationship management)
  - CRM (customer relationship management)
  - E-commerce solutions
  - E-marketing – “little data” harvesting data for sales...

## Web Technology

- **Web technology / driving information exchange** and transactional efficiencies – making it easier for customers to learn, buy and get product support
  - Putting customers closer to manufacturers - more information available directly from manufacturer, building relationships between manufacturer and customers
  - Social media expanding connection points between market participants
  - Customer can configure product online, order it and get pricing – all online – and getting shipping and tracking data as well...
  - Resulting in more direct manufacturer / customer exchange – potentially changing the role of the distributor
    - “The information value that the distributor used to provide has diminished or is gone... All the information on the internet means I’ don’t need distributors to train you”
    - “The internet is trying to commoditize everything – with the internet customers don’t even want to talk to people anymore”

## Smart Product Technology

- **Product technology / smart products** providing information about product status and use, etc., to improve productivity and product life – creating new linkages between customers and suppliers and new paths to greater productivity
  - Customer impact
    - “Condition assessment, leak detection, pressure monitoring – resulting in lower downtime risk, energy, labor and financial savings”
    - “This allows customers to get ahead of any type of problem and repair it before there is a problem”
  - Impact on distribution
    - “20 years ago the channels knew about mechanical things – now the channel must understand software, diagnostics, wireless networks / communications protocols / how to get information out of the system”
    - “The key is having the diagnostics capability to interpret and present the data”
  - Marketing Challenge
    - Who will lead in diagnostics development and implementation?
    - What investments and organizational changes will this force on distributors?
    - Who will control access to this information?

## The Chase for Value

- Everyone wants to increase margins ---
  - Solutions selling is on every marketer's radar
  - Distributors already provide a broad basket of solutions
    - From technical support
    - To integrated supply
    - To project support
    - To fabrication
    - To kitting .....
  - Distributors are developing marketing units to chase value propositions – can't provide all value propositions in one operations structure
  - Manufacturers are looking to sell broader solutions, skids, etc.
    - Manufacturers are expanding to provide a larger piece of the bundle

# Disruption Forces

# Market Changes

- Customers
  - Globalization
  - Consolidation
  - Shrinking work forces
  - More pressure on costs
  - Growth in key NA markets
    - Energy
    - Maybe process returning to NA
- Channels
  - Consolidation
    - Acquisitions
  - Globalization
  - Continued business model evolution (can you be both in one organization?)
    - Technical players
    - Logistics players

# My Perspective

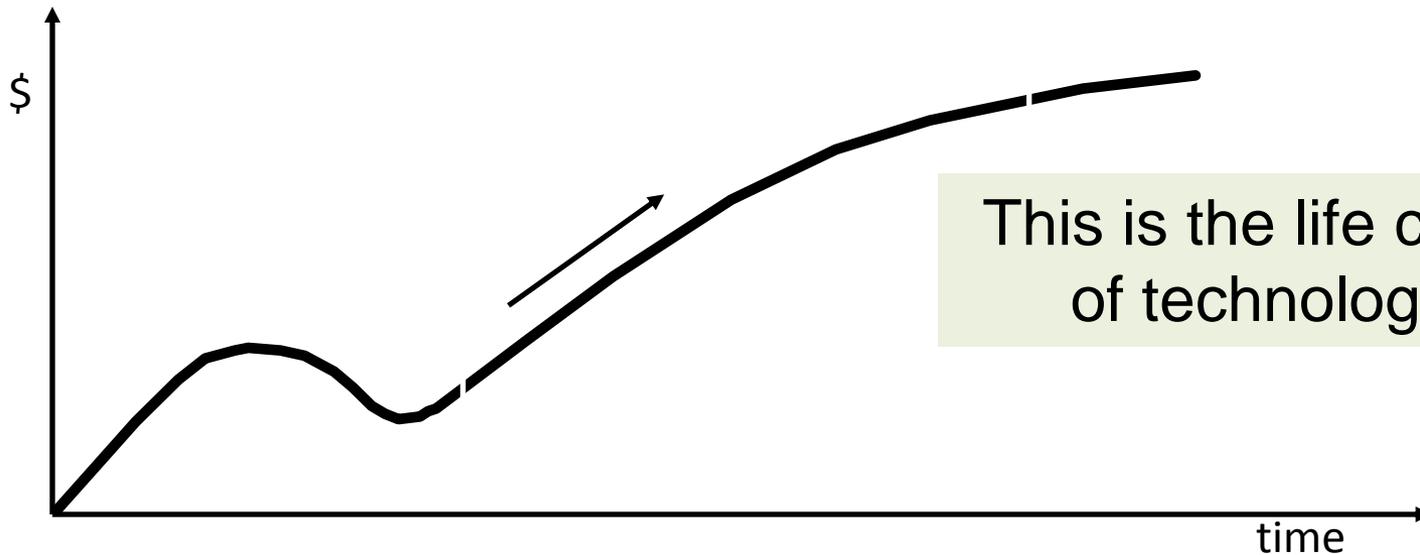
35 Years of Go-to-Market Strategy Consulting

Helping  
Manufacturers  
Develop More  
Effective Marketing  
and  
Distribution  
Strategies

- View the world from the perspective of the manufacturer
  - How do I get my products marketed as effectively and cost efficiently as possible?
  - What should my channel strategy be?
    - My distribution strategy
    - Pricing and policies
    - Channel management program
    - Etc.
- This has led to some definitive marketing models to help manufacturers think about channel strategy
  - Channel models from the 80's

# Market Life Cycle as an Indicator of Go-To-Market / Channel Requirements

Old Framework



## Introduction

- Technology focus
- Innovation buyers
- Few competitors
- Unstable market shares

## Development

- Application focus
- Performance buyers
- Rapid growth
- Many competitors
- Market share determined by "muscle"

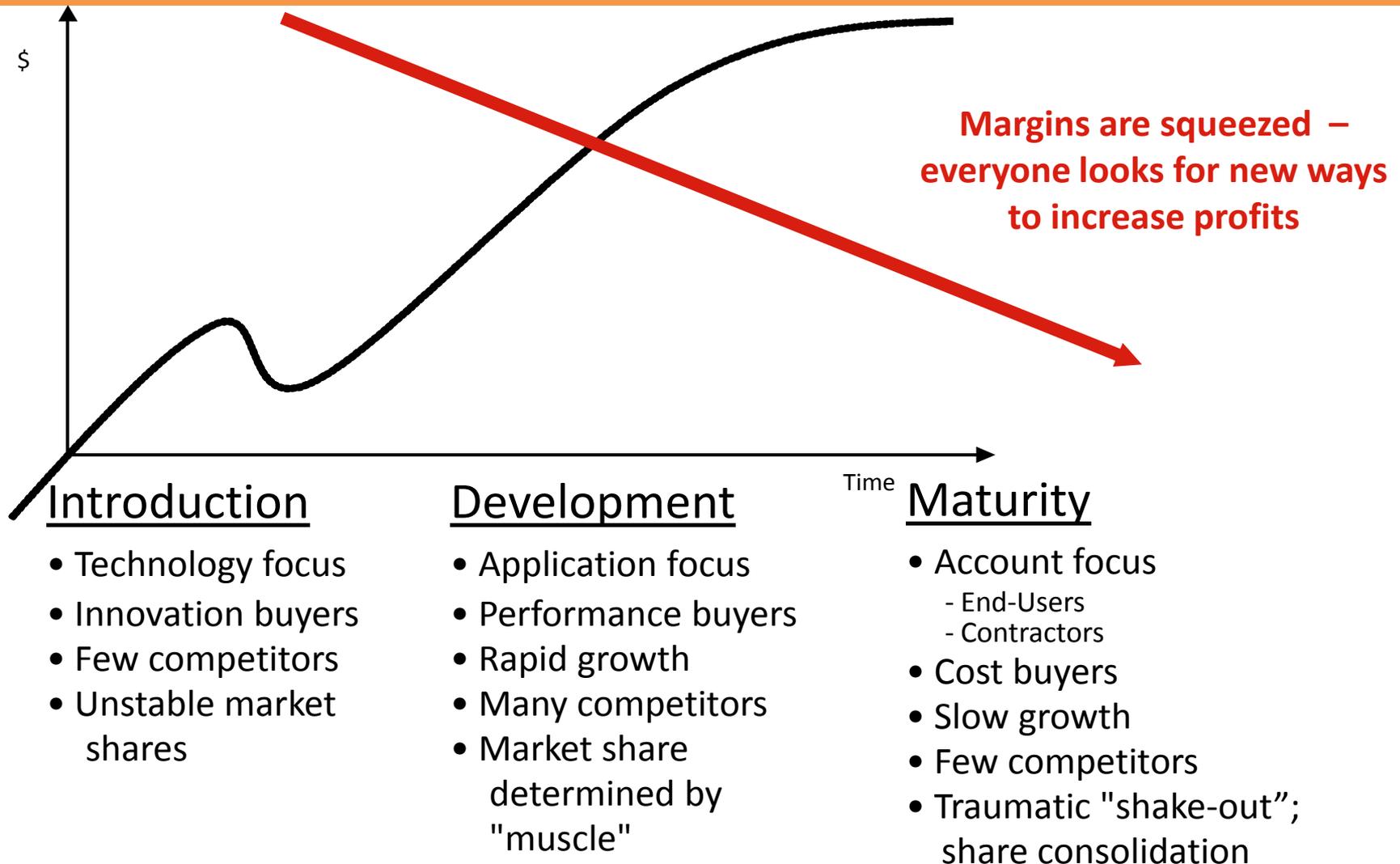
## Maturity

- Account focus
- Cost buyers
- Slow growth
- Few competitors
- Traumatic "shake-out;" share consolidation

# Markets Evolve Over Time

## Market Dictates the Channel Structure and Economics

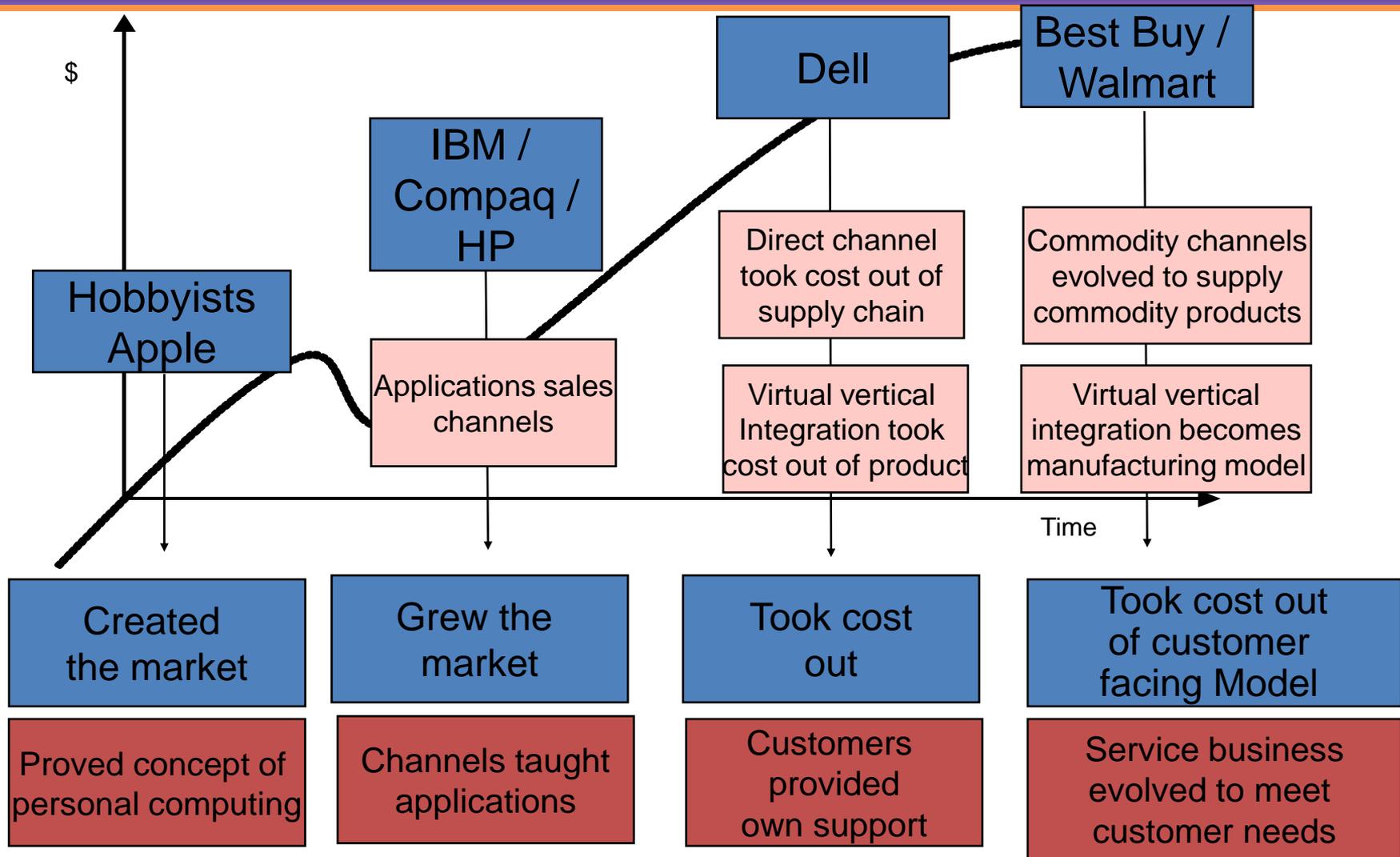
Old  
Framework



# The Computer Market

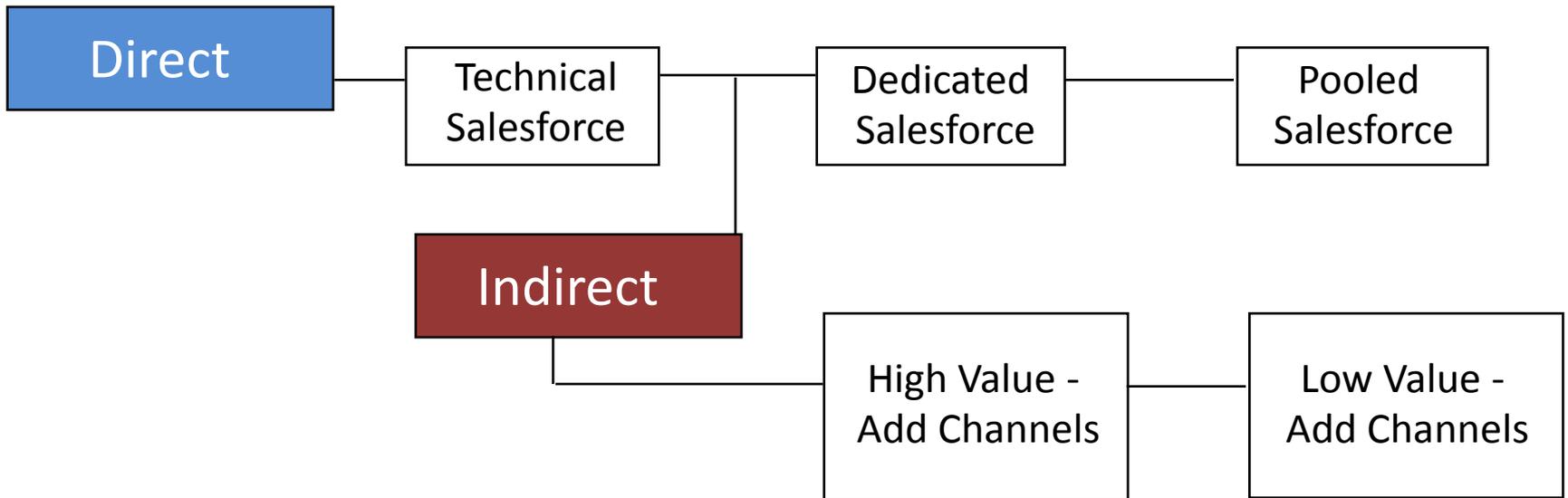
## An Example of Market Evolution

Old Framework



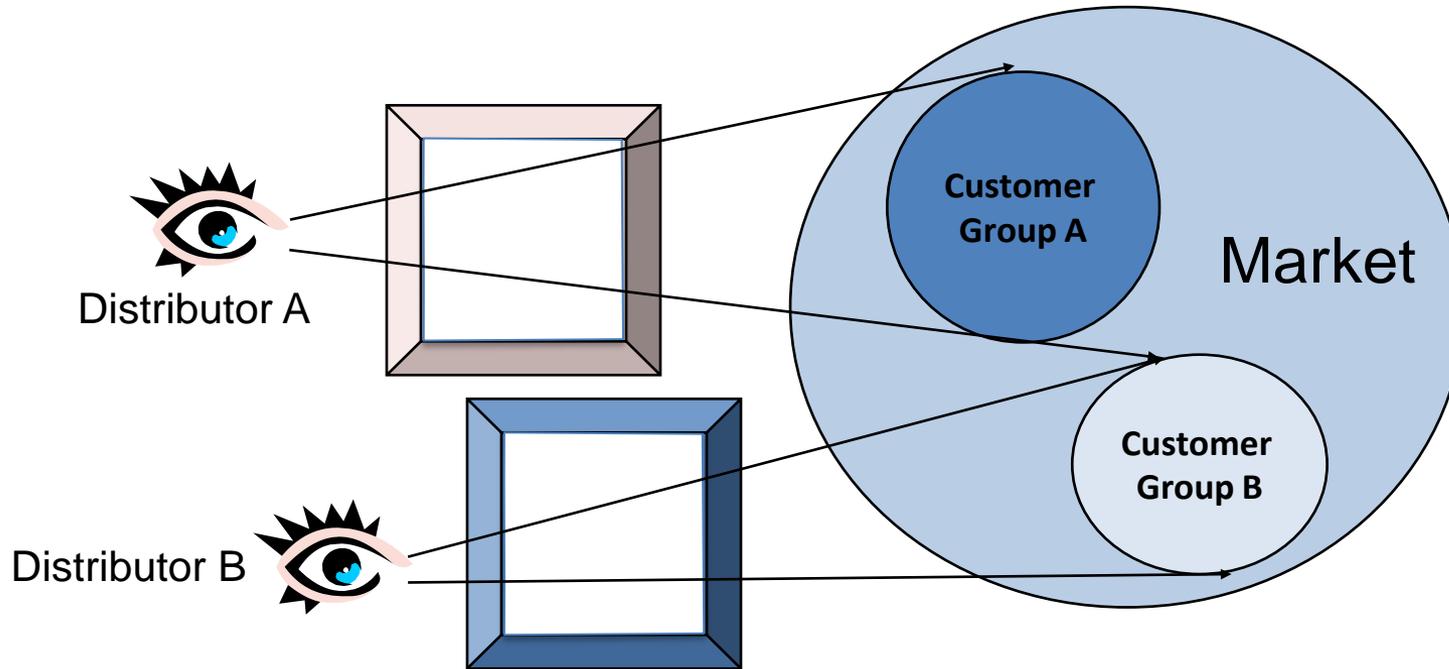
# Channel Structure

Old Framework



# Distributors Evolve: Focus on Specific Customers and Capabilities Creating “Channel Windows”

Old Framework

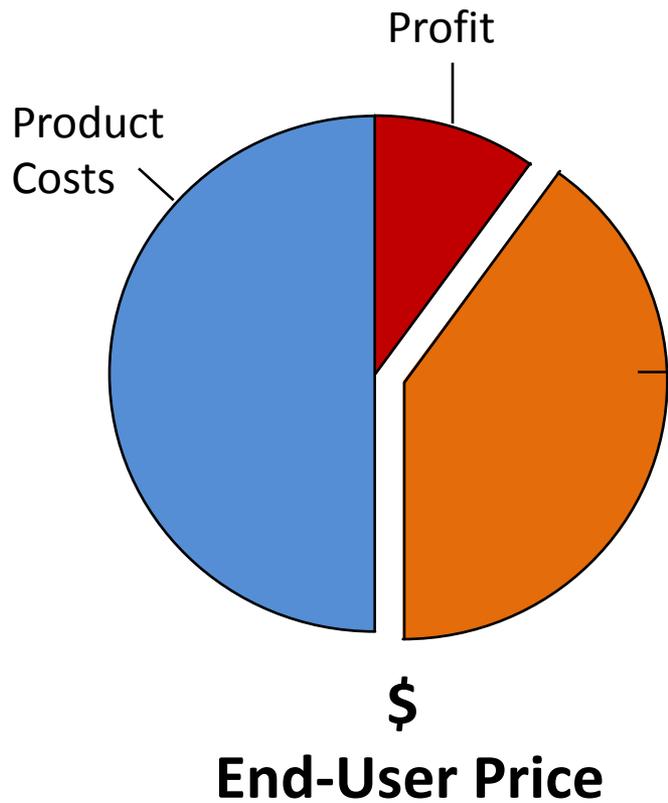


## Windows are a function of a distributor's:

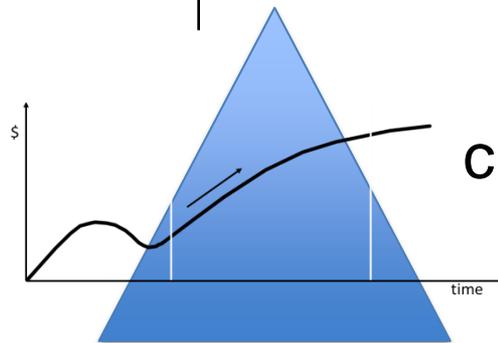
- Customer base
- Technical skills
- Other product lines and services
- Geography
- Owner's Interest and resources

# Mature Market Economics (Manufacturer Perspective)

Old Framework



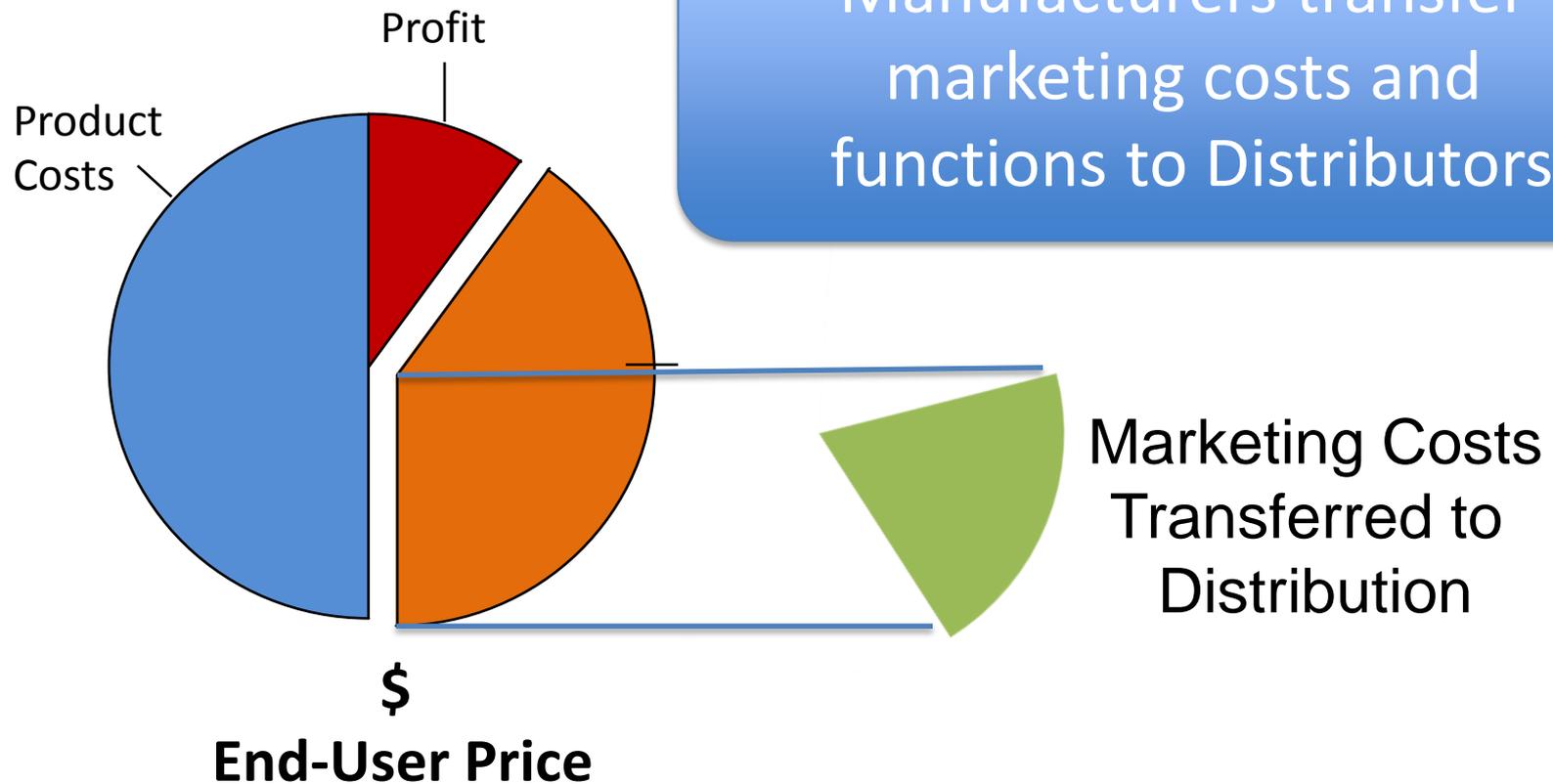
Sales.....	12%
Inventory.....	13%
Service/Support.....	4%
Order Handling.....	3%
Freight.....	1%
Credit.....	3%
Ad/Promotion.....	3%
Overhead Allocation.....	<u>1%</u>
	40%



Varies by customer size and life cycle stage

# Mature Market Economics (Cost Transfer Role)

Old  
Framework



# An Example of the Transfer of Marketing Costs

<b>Mature Products</b>	Total Marketing Cost	Marketing Cost Transferred to a Distributor	Distributor Specialization Efficiency	Distributor's Cost of Doing Business
Sales	12%	8%	80%	6%
Inventory	13%	8%	80%	6%
Service/Support	4%	2%	80%	2%
Order Handling	3%	3%	80%	2%
Freight	1%	1%	80%	1%
Credit	3%	2%	200%	4%
Advertising / Promotion	3%	1%	100%	1%
Overhead Allocation	1%	0%	0%	0%
<b>Total Marketing Costs</b>	<b>40%</b>	<b>25%</b>		<b>22%</b>

The distributor makes money because he is more efficient at these functions than the manufacturer was or could be

# Distributor Economics

Old  
Framework

<b>Profit and Loss Statement</b>	<b>% of Net Sales</b>	
Net Sales	100.0%	
Gross Profit	27.1%	
Operating Expenses	24.1%	
All other Expenses	0.3%	
Profit Before Taxes	2.7%	
<b>Balance Sheet</b>		
	<b>% of Assets</b>	
Cash & Equivalents	4.3%	
A/R	32.9%	
Inventory	35.2%	
All other Current Assets	3.1%	
<b>Total Current Assets</b>		<b>75.5%</b>
Fixed Assets		16.9%
Intangible		2.8%
All other non-current		4.8%
<b>Total Assets</b>		<b>100.0%</b>
<b>Net Worth</b>	<b>34.5%</b>	

A low operating profit business, but.....

Distribution was an asset / Inventory Turns Business (kind of like a bank)

Inventory Turns	Gross Margins	ROII (Return on Inventory Investment)
5	20.0%	100%
4	25.0%	100%
3	33.3%	100%
2	50.0%	100%

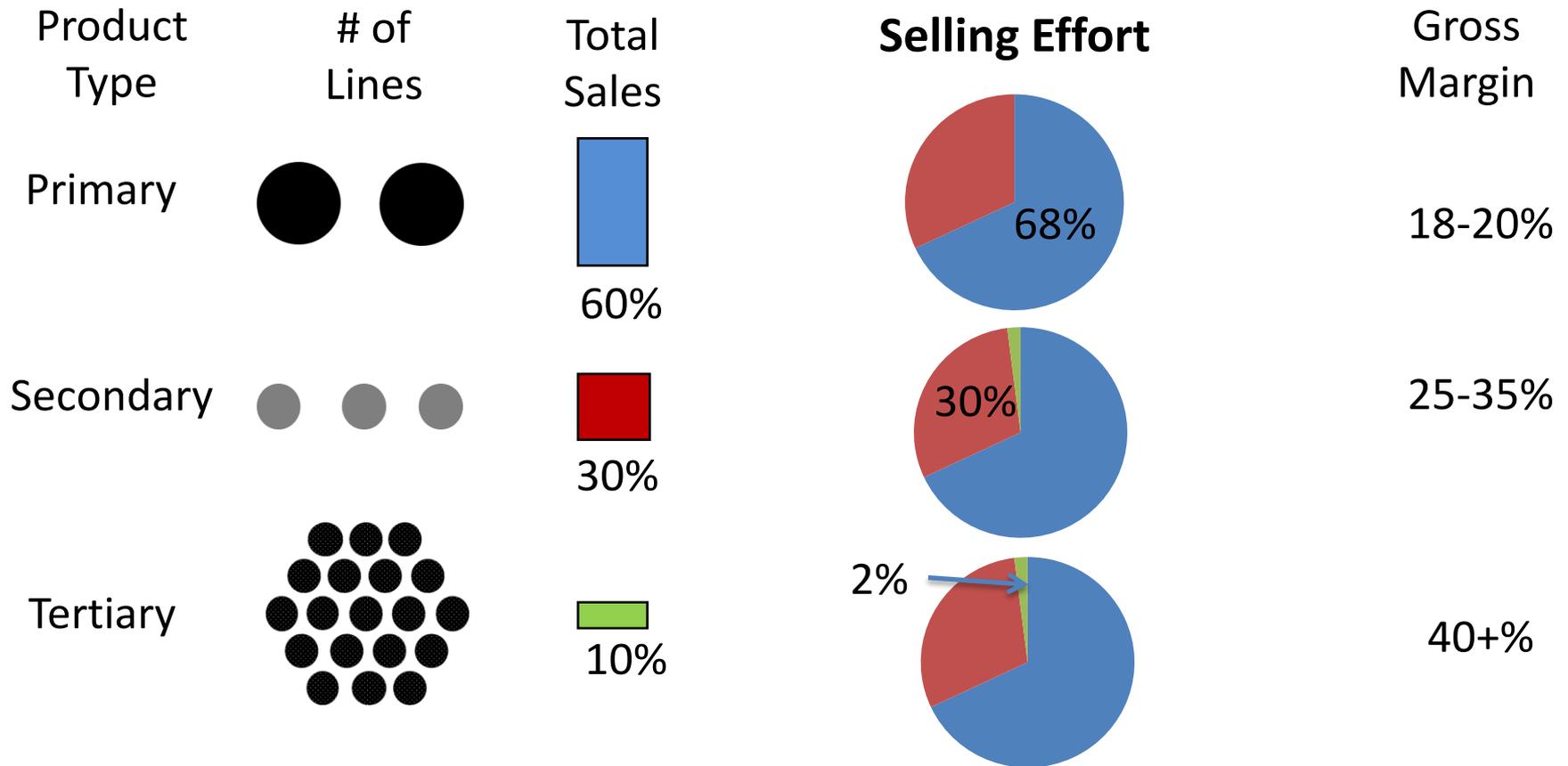
Example of Financials with 1980 margins and inventory

# Product Role

Defines Distributor's Marketing Investments



## Channel Sales



# A Historic View: Distribution through the Manufacturer's Eyes

Old  
Framework

- Role based on “life cycle” position
- Life cycle position will drive distribution economics (margins and operating costs)
- Distributor's customer base / window is driven by what he sells and his capabilities
- Distributor manages asset turns and operating margins
- Distributor sales effort for your product is a function of your product's position in their market basket (PST)

The basic framework for making distribution strategy decisions

# A Look At Distribution

## A Financial Perspective



# Industrial Distribution Financial Ratio Analysis

## RMA (Risk Management Association) Annual Statement Studies Industrial Distribution 1975 – 2012

- SIC 5085 / NAICS 423840 Industrial Supplies  
(All valves until hydraulic and pneumatic were moved out in 2000)

- Inventory Turns
- Assets
- Gross Margins
- Operating Costs
- Operating Profits

### Expectation:

ROII model would expect lower margins with higher turns, keeping ROII constant

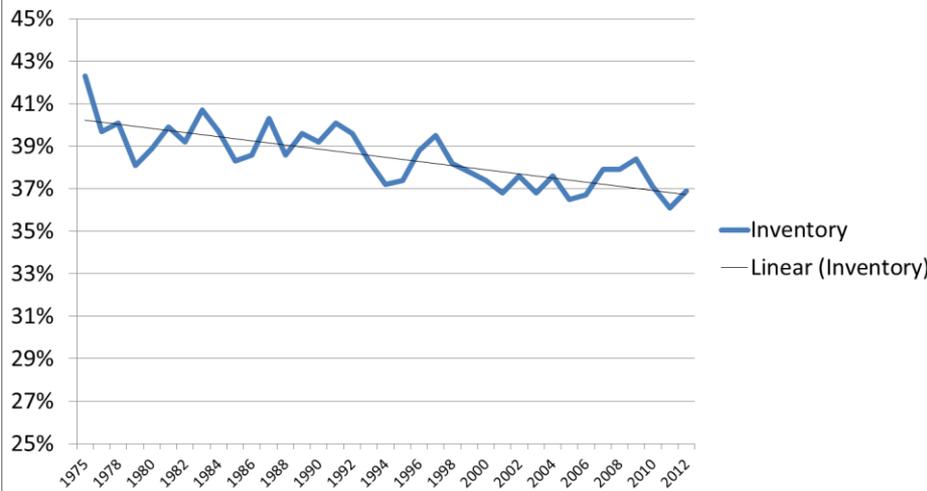
		ROII (Return on Inventory Investment)
Inventory Turns	Gross Margins	
5	20.0%	100%
4	25.0%	100%
3	33.3%	100%
2	50.0%	100%

# Impact on Distribution

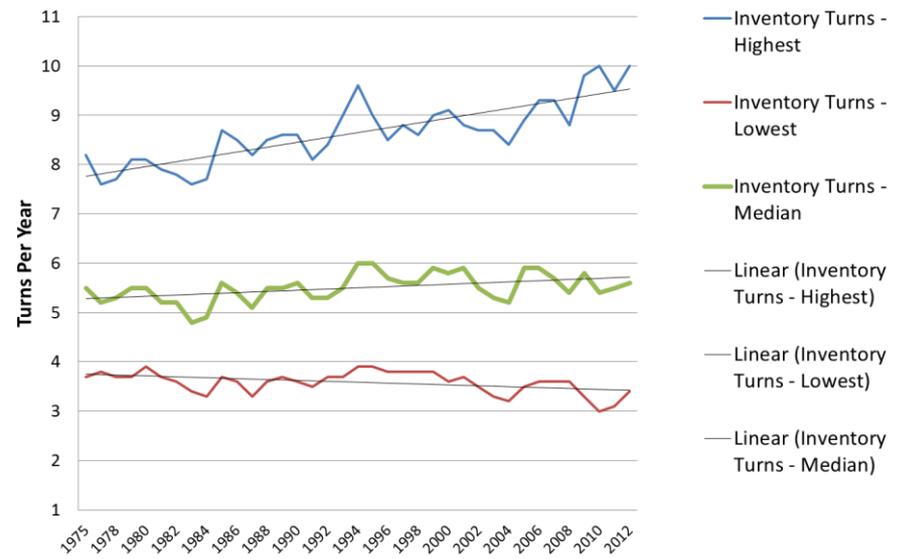
## Inventory Turns Increase

- A reduction in inventory – driven by information and logistics technology (also impact of master distribution)
  - A lower % of assets
  - Higher overall inventory turns – particularly for “high turns” companies

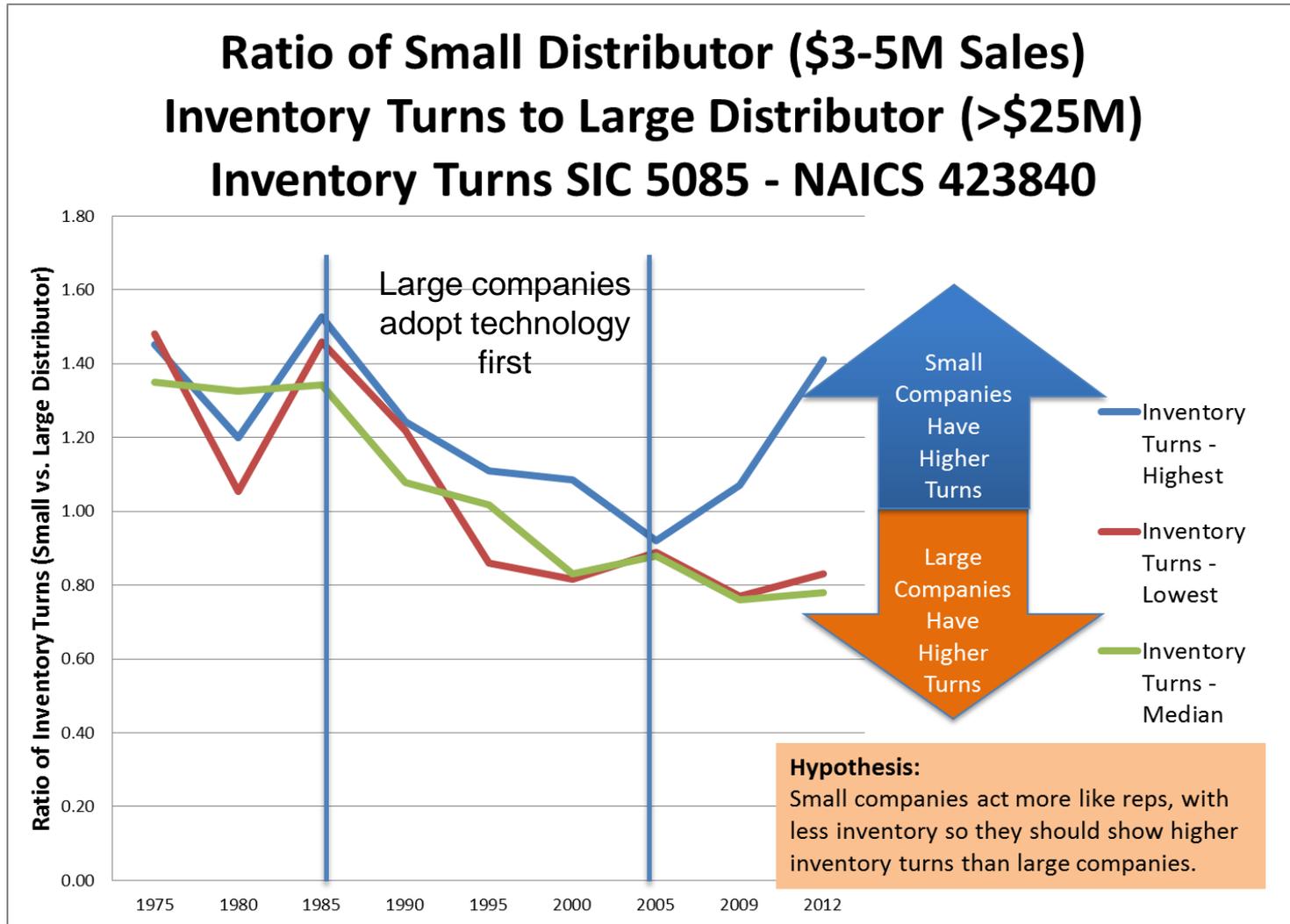
**Inventory as a % of Total Assets  
Between 1975 and 2012  
Industrial Supplies Wholesalers - NAICS 423840  
(Mill Supply)**



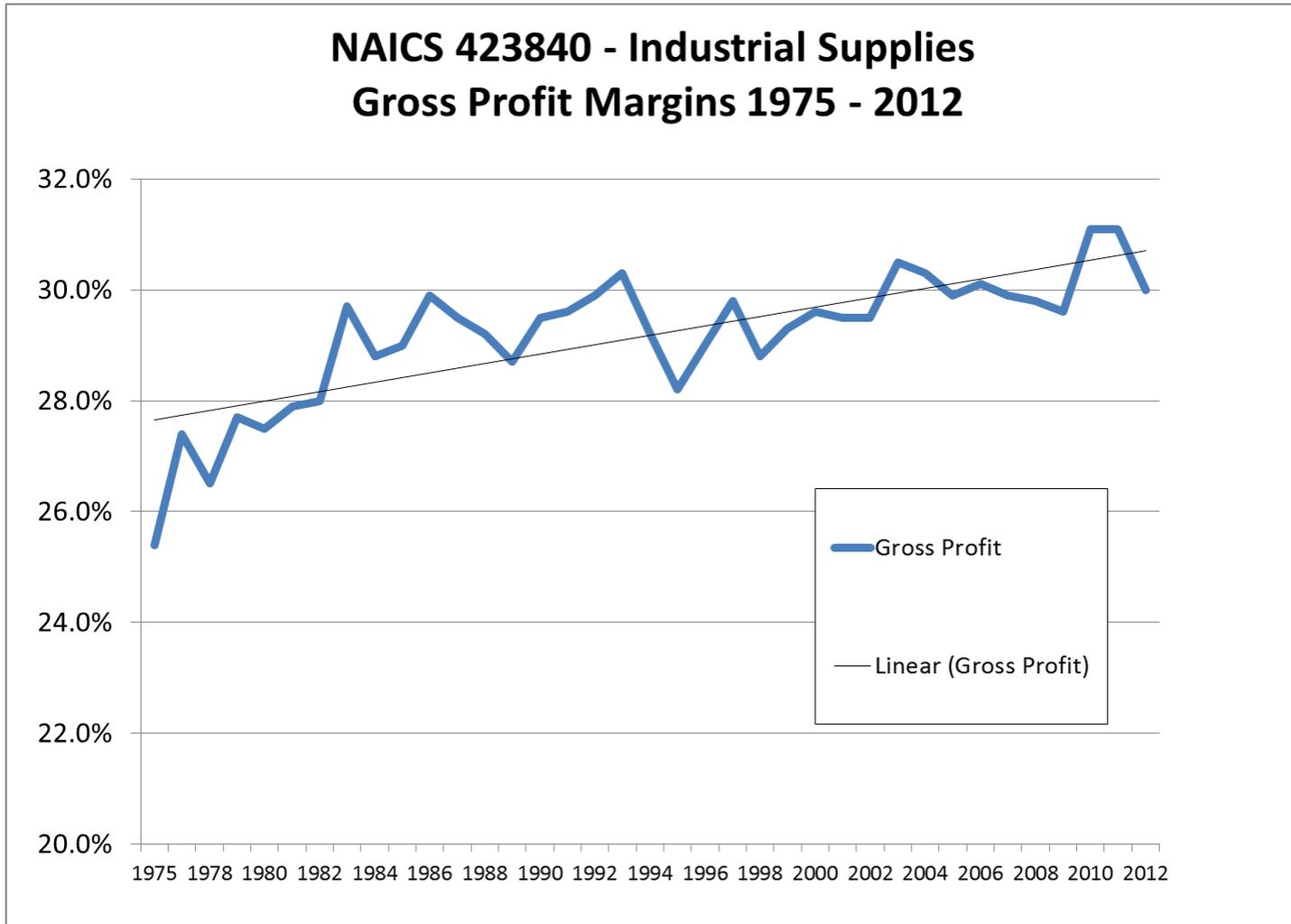
**Inventory Turns For NAICS 428480 - Mill  
Supply**



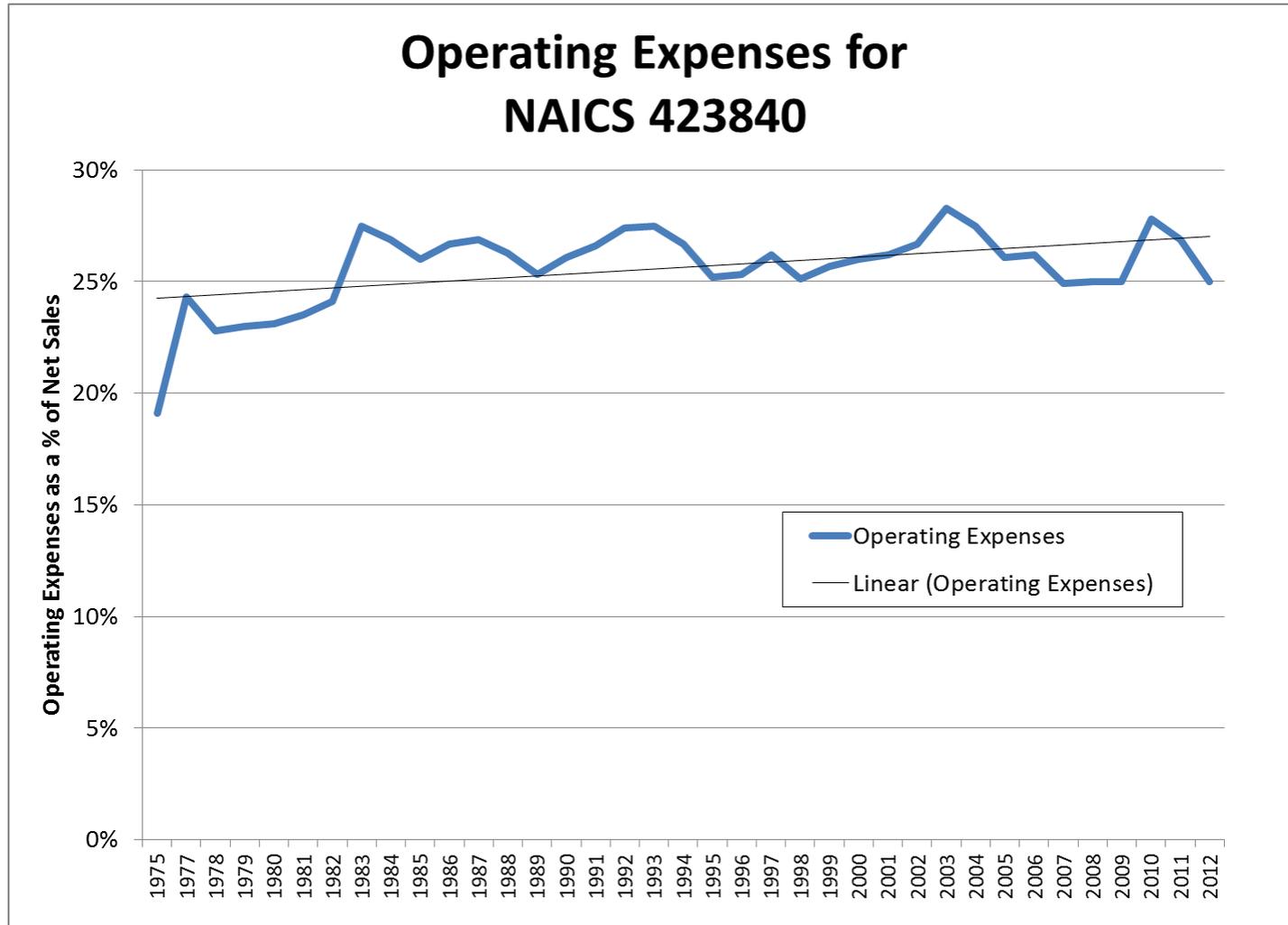
# Large Companies Adopted Technology Faster Resulting in Better Inventory Management



# Gross Margins Are Trending Up



# Operating Expenses are Up Also



# What's Driving Higher Margins and Operating Expenses?

- Shouldn't product margins be decreasing?
  - Selling activity via the internet is commoditizing more product categories
  - More competition with integrated supply contracts
  - More global competition
- The offset to margin pressures is higher service revenues at much higher margins
  - The 59th Annual Survey of Distributor Operations reported that services accounted for 12% of distributor revenue in 2012

# Distributor Focus on Services

- In McGladrey's Distribution Monitor Report
  - Industrial distributors were much more focused on introducing new services than all other types of distributors
  - Services mentioned in sequence of importance to industrial distributors versus all distribution
    - Kitting and assembly
    - Sequencing of orders to customers schedule
    - Light manufacturing
    - Relabeling and repacking
    - RFID labeling
  - Industrial distributors were the most likely to mention seeing services as being most important to their company's growth

# Service Margins Are Offsetting Reduced Product Margins

- Service margins essentially raise total distributor gross margins

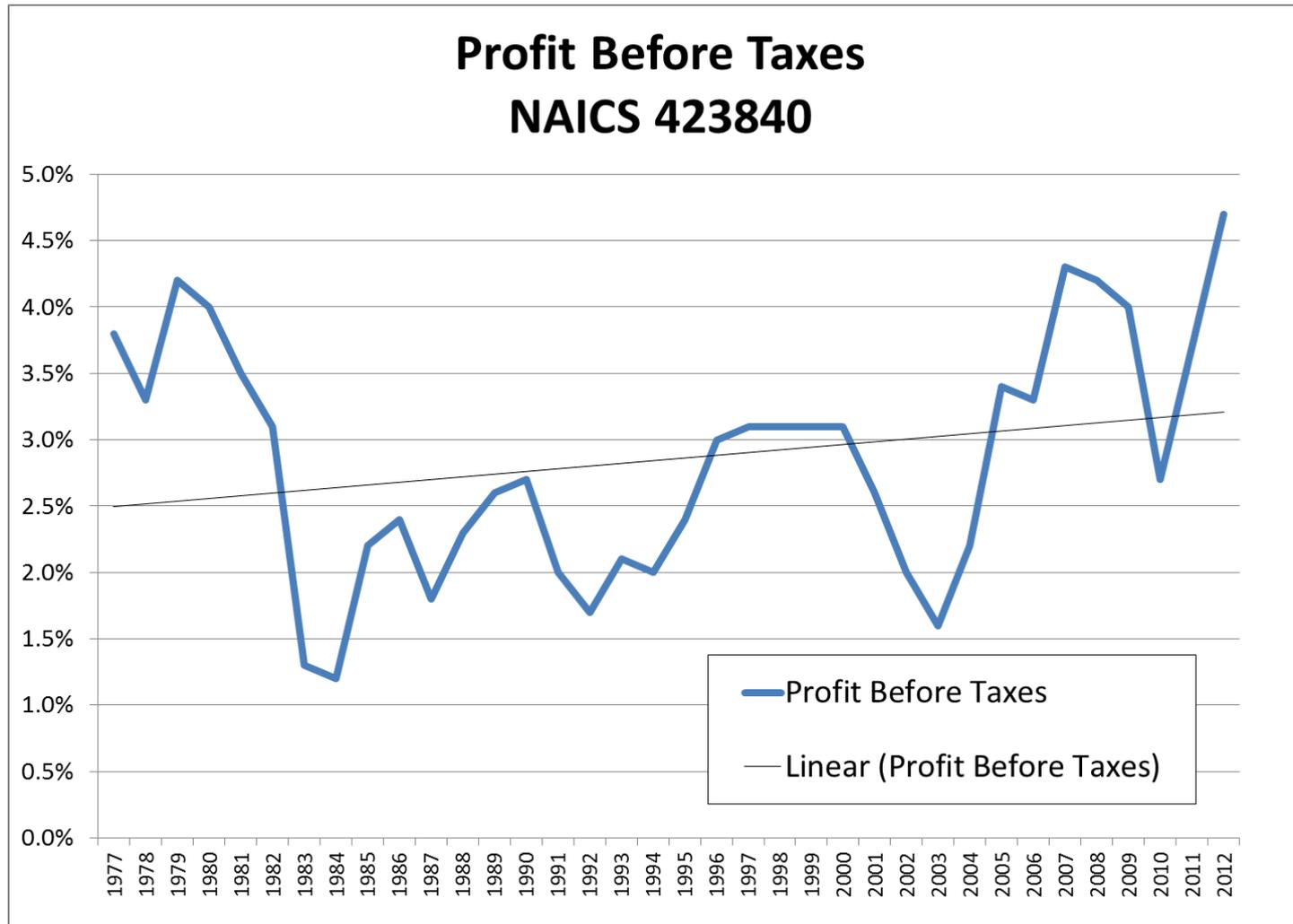
Model of Service Margin Impact on Total Gross Margins

Revenue Source	% of Sales*	Gross Margin**	Contribution to Total Gross Margin
Product Sales	88.0%	27.0%	23.8%
Services	12.0%	60.0%	7.2%
<b>Total Gross Margins</b>			<b>31.0%</b>
*59th Annual Survey of Distributor Operations			
**1978 Gross Margin (RMA SIC 5085) and Estimated Service Margin			

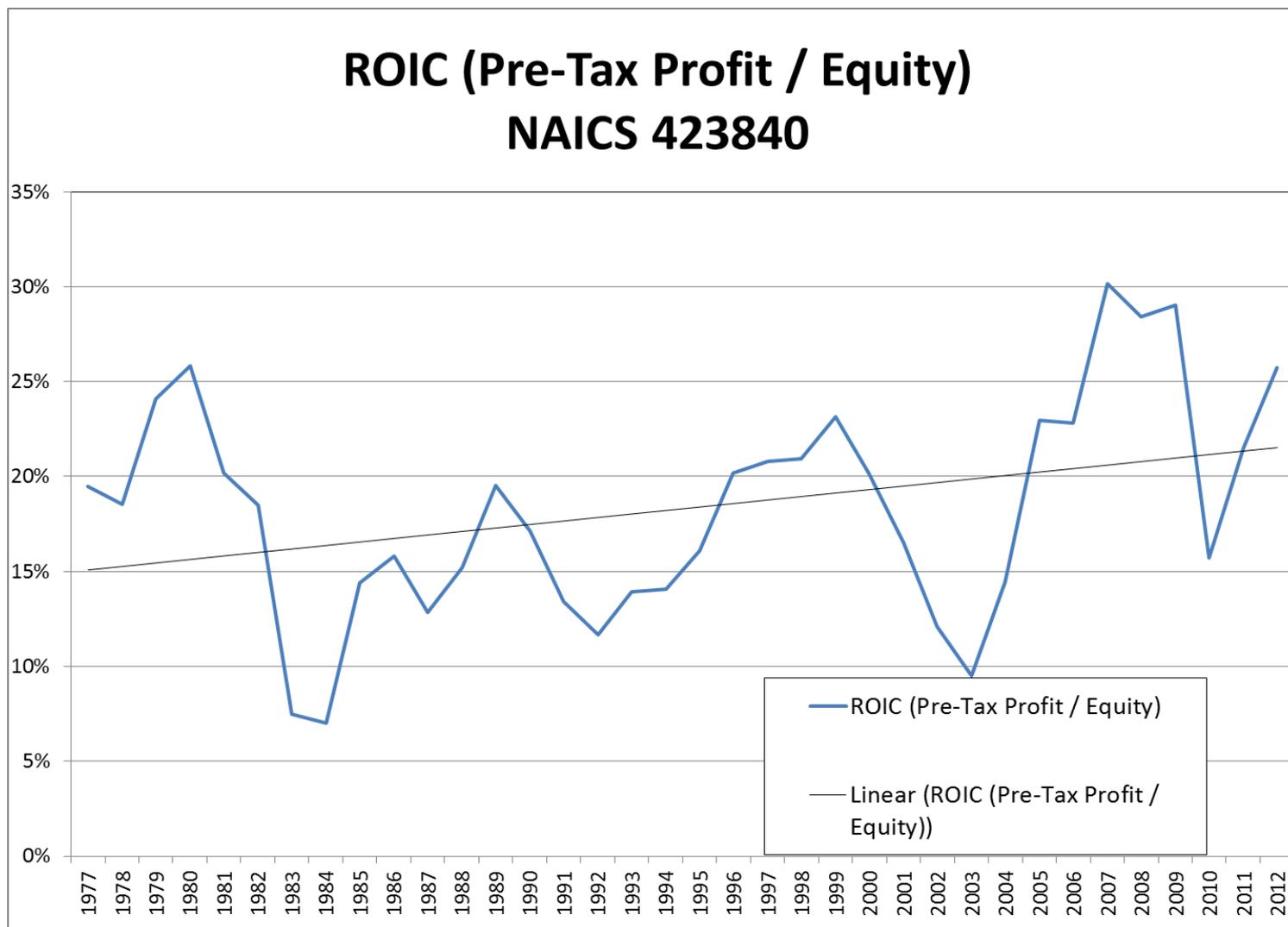
Distributor margins have improved from 27% to 31% -- almost entirely from the introduction of services

\*\* Services average 12% of sales, and products average 88% of sales. The 2012 overall gross margin is 31% which we estimate comes from service margins of 60%, and product margins of 27% (Note: 27% was the 1975 margin).

# Pre-Tax Profits Swing With the Economy, But the Trend is Up for 35 Years



# ROIC (Return on Invested Capital) Swings With the Economy, But the Trend is Up for 35 Years



# Distribution Summary

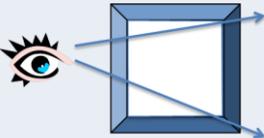
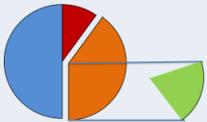
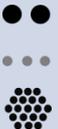
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- Technology and services are driving the evolution of distribution
- These forces have been contributors to the growth in distributor profitability

# A Change In Paradigms From Manufacturer Perspective to Customer Perspective



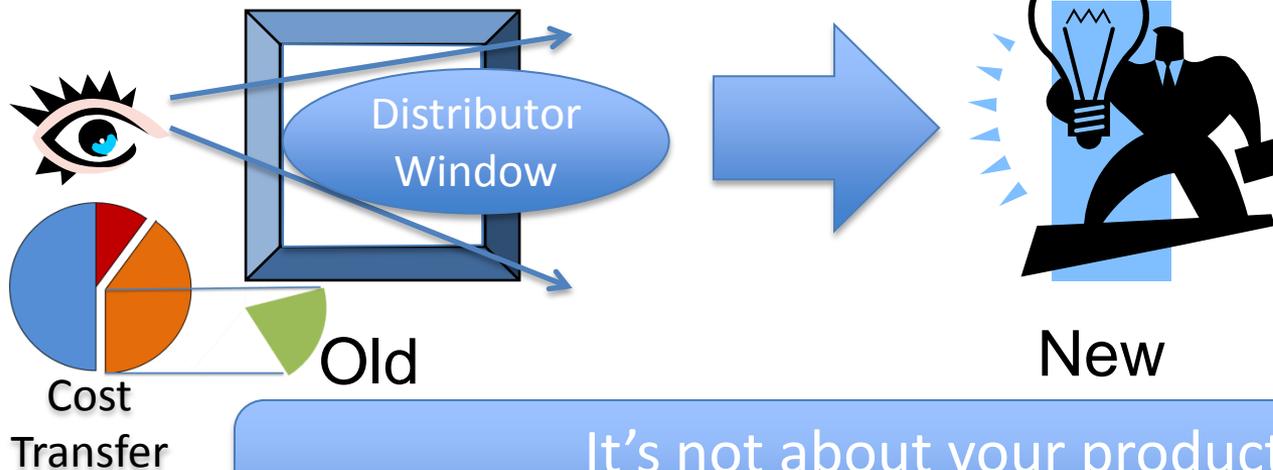
# Paradigm Shifts

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PST 	Focus of product marketing (PST) and competition	Focus on ecosystem marketing and competition

# Paradigm Shift

## Changing Distribution Role

- We must replace our manufacturer perspective
  - Distributors act as marketers for us, transferring marketing costs for customers in their widows
- We change to a new customer perspective
  - Distributors are integrated service partners to their customers, providing greater access to customer needs



### Solutions Provider

To improve the customers bottom line

### Customer Access

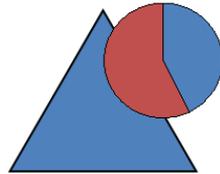
Customers share needs and information with distributors

It's not about your product.  
It's about the customer's business – what he needs.

# Windows Still Exist, But the Nature of Customer Connection Becomes Dominant

Changing  
Distribution  
Role

## ○ **Channel Coverage**



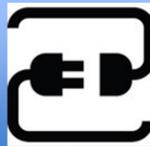
Channel Presence and position in target segments

## ○ **Channel Competency**



Ability to deliver mind share, revenue and post sale support for target customers

## ○ **Channel Connection**



Ability to create and sustain relationships with customer personnel

## ○ **Channel Commitment**

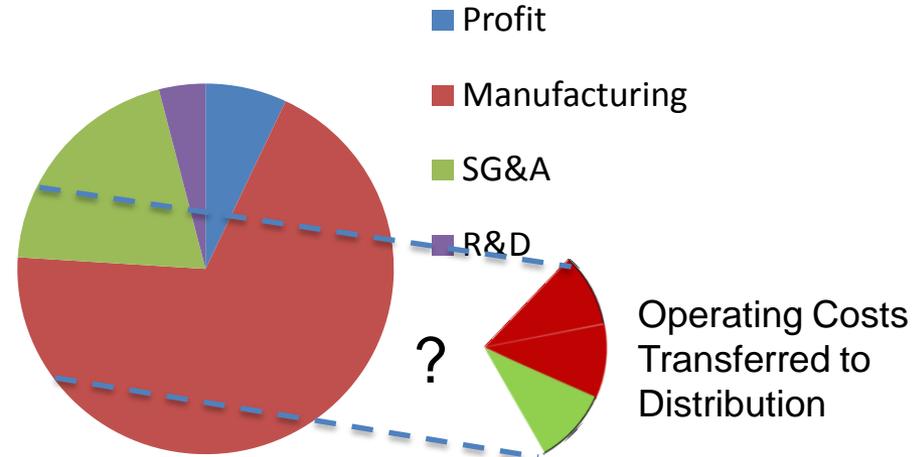
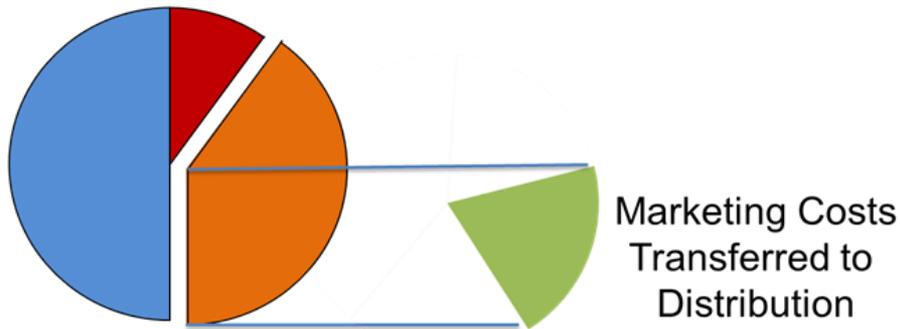
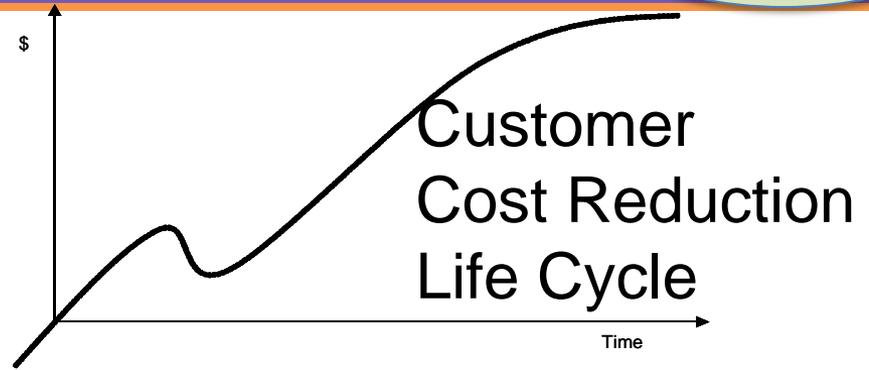
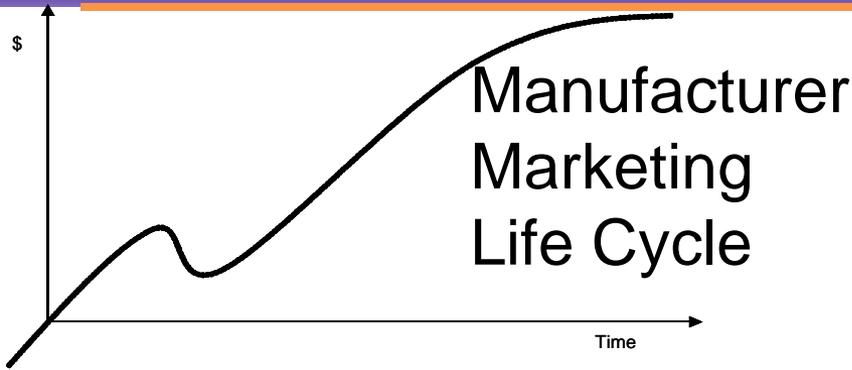


Channel's willingness to work with us

The nature and strength of the distributor's customer "connection" becomes a fundamental dimension of the customer window

# Two Life Cycle Maps

Changing Distribution Role

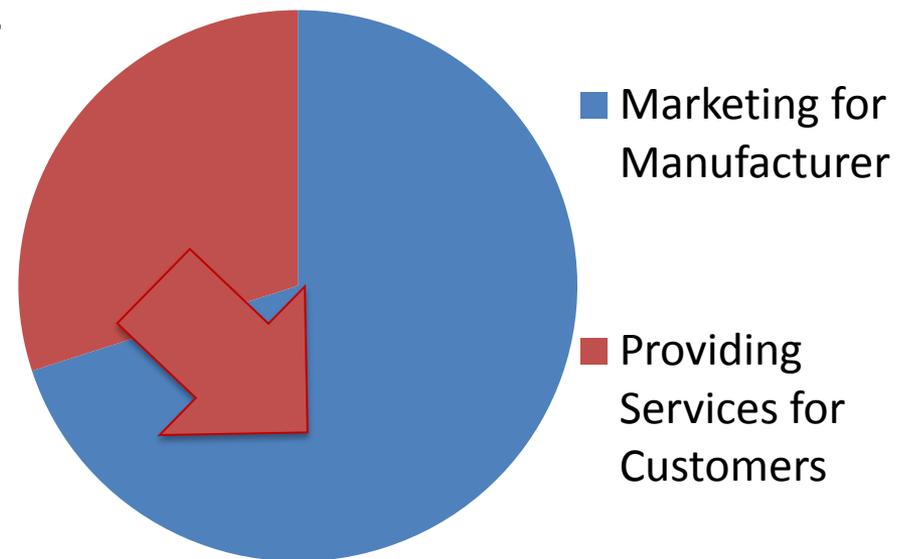


Distributor Role:  
Transfer cost from manufacturer

Distributor Role:  
Transfer cost from the customer

- Transfer of marketing cost for its suppliers
- Transfer of operations costs for its customers
  - Services the distributor offers include:
    - Asset management
    - Maintenance management
    - Purchasing
    - Technical support
    - Etc.

### Distributor Gross Margin Contribution



# New Distribution Paradigm

## Distributor Roles are Driven by Two Forces

Changing  
Distribution  
Role

- Distributor roles are more than a function of a technology life cycle, but also should consider the nature of the relationships between customers and suppliers
  - A Customer Alliance Life Cycle

		Technology Life Cycle		
Difficulty	Customer Alliance Life Cycle	Introduction	Development	Maturity
H	Joint Venture / Development			
	Turst / Partner			
L	Vendor			

# Two Types of Capabilities Driving Customer Alliances

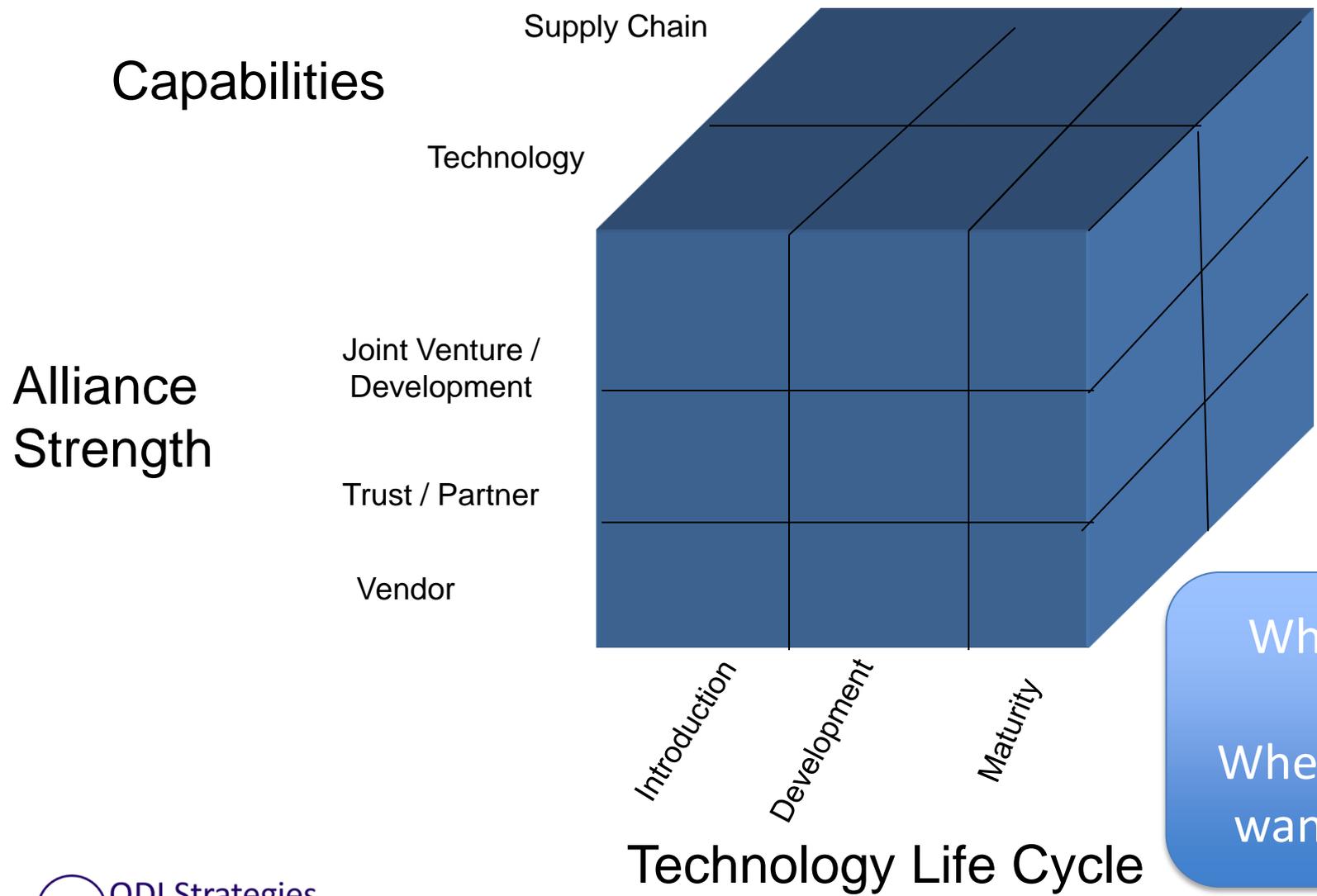
Changing  
Distribution  
Role

- **Logistical / Supply Chain Capability**
  - Materials management
  - Sub-Assembly
  - Facilities management
- **Technology Capability**
  - Support in use of technology
  - Support in adoption of technology
  - Support in development of technology

# New Paradigm Dimensions

Distribution Role Varies Across these Dimensions

Changing Distribution Role

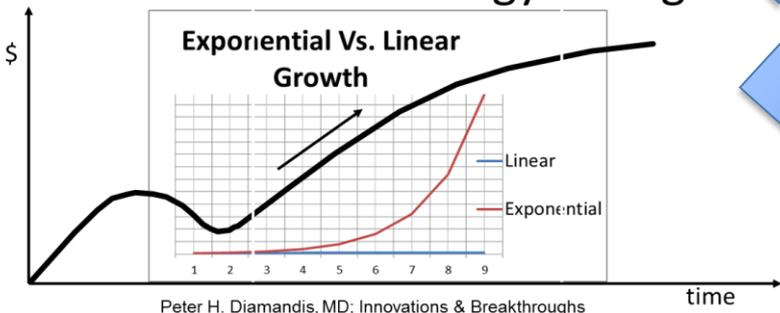


Where are we?  
Where do we want to be?

# In the New Paradigm, Competition Moves from Products To Ecosystems

## TECHNOLOGY

The Rate of Technology Change



Technology is the Driver

## PRODUCTS

Smart-Valve "Information" Benefits

- Protection
- Control
- Monitoring
- Commissioning

## ECOSYSTEMS

Smart / Connected Device Ecosystems



Hospital Model

- 1 •Hospital Management System
- 2 •Department Management Systems
- 3 •Patient Care Management Systems  
•Measure, Diagnose, Prescribe



Manufacturing Model

- 1 •ERP System
- 2 •Process Management Systems
- 3 •Finite Controls



Educational Model

- 1 •Educational Management System
- 2 •Process Management Systems
- 3 •Classroom Control & Decisions  
•Assess, Diagnose, Assign

VHS

Beta-Max

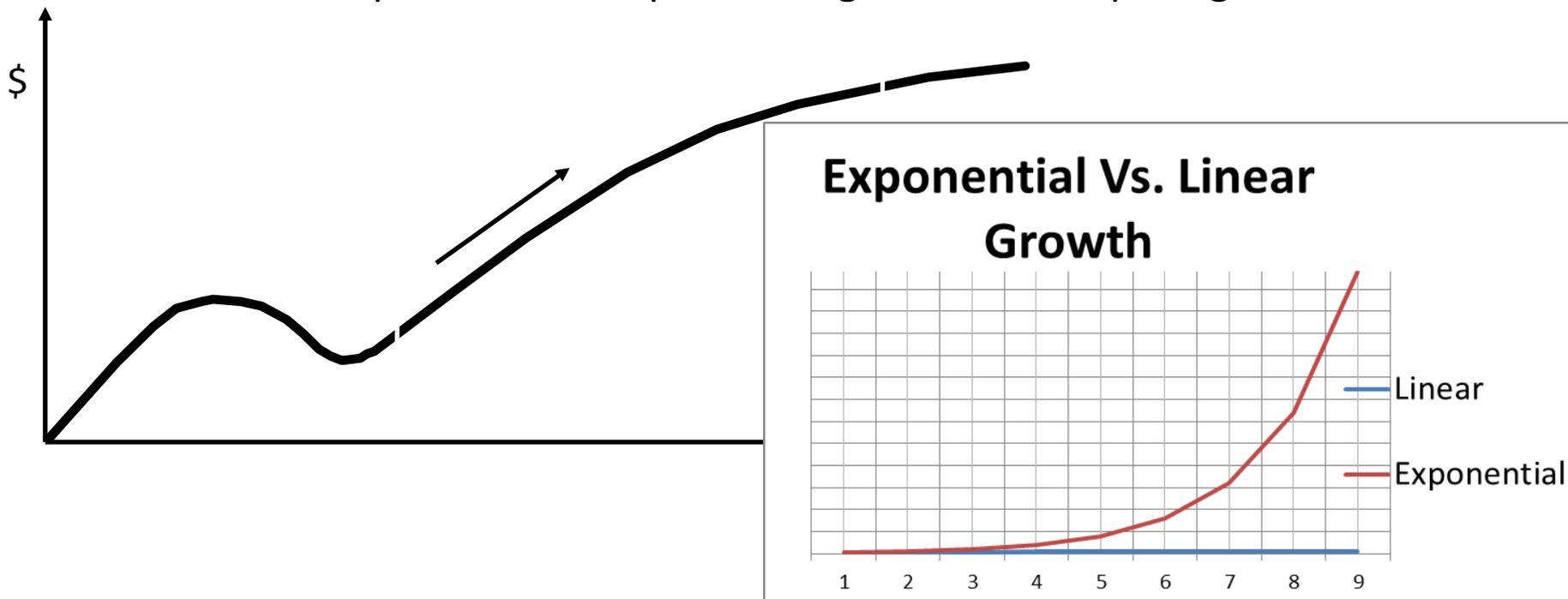
Ecosystems beat better products

# Technology Challenges Manufacturers and Distributors

Changing  
Distribution  
Role

- The rate of technology change

- The speed at which information technology is entering the market is faster than channels are absorbing
- Moore's law predicts the exponential growth of computing



Peter H. Diamandis, MD; Innovations & Breakthroughs

## Smart-Valve “Information” Benefits

- Protection
  - Predictive maintenance
  - Effective asset management programs can then be planned and implemented, maximizing plant utilization and minimizing the risk of unexpected process interruptions
  - Diagnostic graphics show the valve torque and usage profiles, along with service logs, facilitating real time analysis
- Control
  - Precision of control from intelligent electric actuators that have sensors and electronic devices enables changing the position of the valve at any time
- Monitoring
  - Position of valve
  - Condition of valve / actuator
- Commissioning
  - Non-intrusive, intrinsically safe commissioning

# Smart Connected Products Lead to Ecosystem Competition

- **Ecosystem: a network of interactions among market players (manufacturers and their channels and customers) and their environment**
- The competitors who create and manage the most effective Ecosystems win
- Example: Apple vs. Microsoft
  - Gates saw the PC not as a single machine to be fussed over and perfected—the way Apple did with the Macintosh, but as a category of devices that needed a common software platform.
  - Instead of writing a program for thousands of different machines, developers could write it once for Windows and have it run on every PC, no matter who built it.
  - The potential for such wide distribution persuaded developers to spend more time writing software for Microsoft's operating system than for Apple's.
  - Eventually, the winner-take-all laws of platform economics kicked in—Windows machines could run a rich selection of programs, so customers gravitated to them, which further encouraged developers to ignore other platforms.

# Connected Device Information Ecosystem

## What's at Stake in the Information Management War

Changing  
Distribution  
Role

### Analog Models



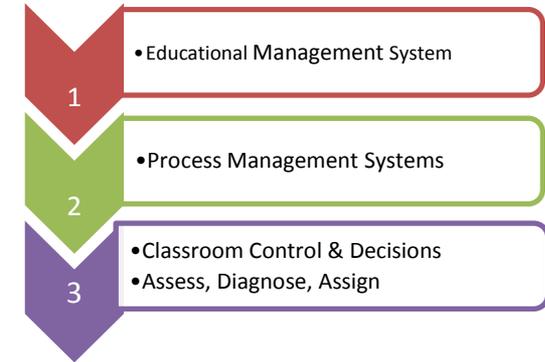
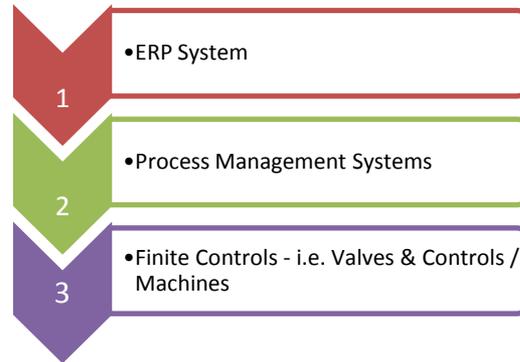
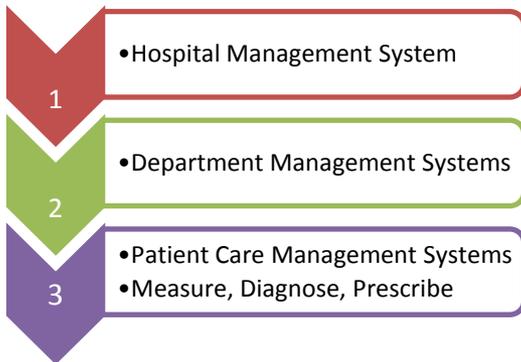
Hospital Model



Manufacturing Model



Educational Model



In these markets over the course of 5-15 years, some solutions became standards while others faded away. Winning solutions impacted new equipment sales, support services, and overall market power.

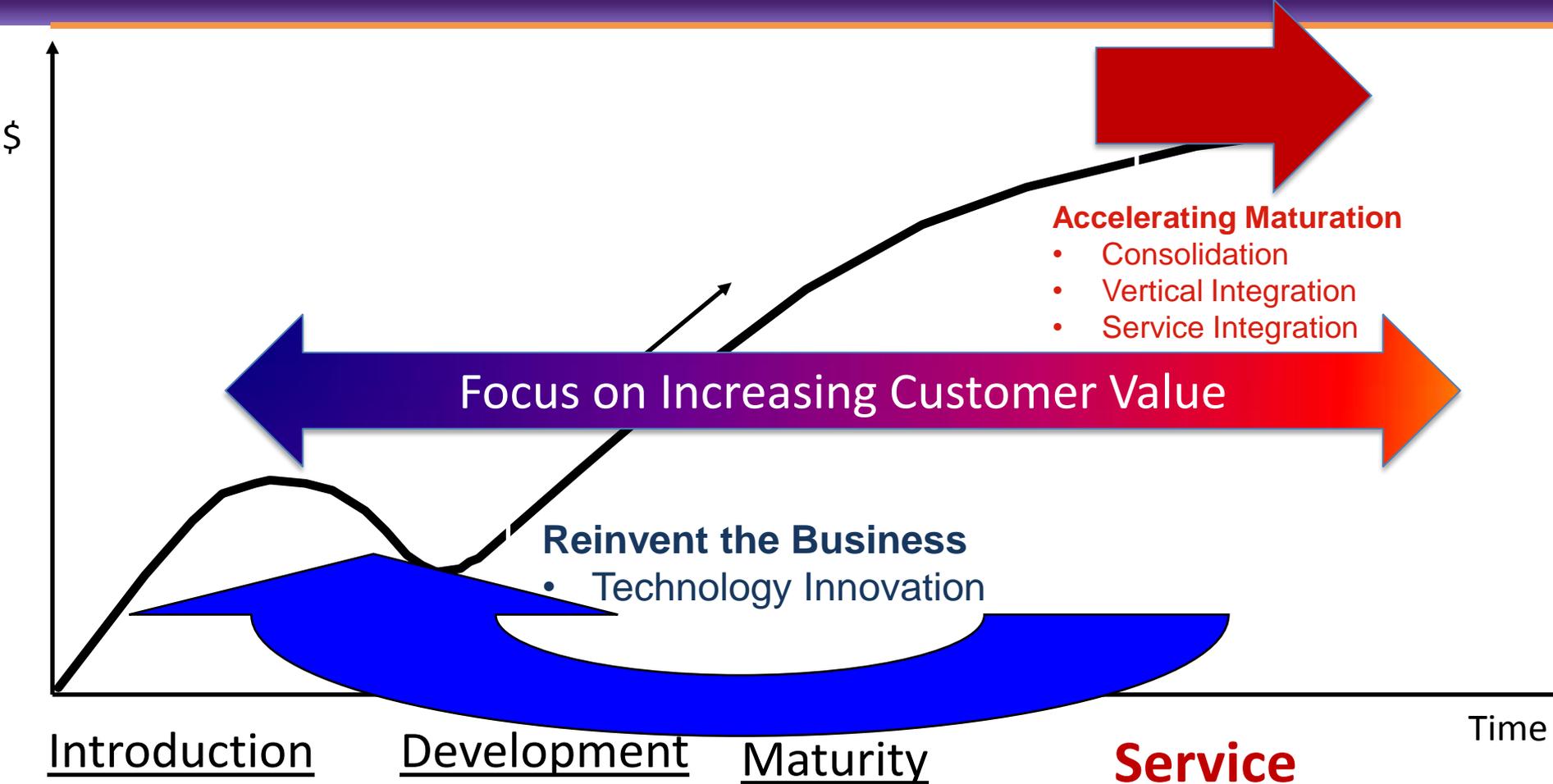
# What Does this Mean for Manufacturers and Distributors?



# Impact on Manufacturer / Distributor Relationship

- Distributor relationships with customers increase as levels of service increase
  - The more important the distributor is to the customer, the more impact the distributor can have on his suppliers
    - Negative supplier impact by using the strength of his customer relationships to leverage pricing, etc. from suppliers
    - Positive supplier impact by sharing the with suppliers the information he can gain through these customer relationships

# New Life Cycle Strategy Options for Manufacturers and Distributors



- Accelerating Maturation**
- Consolidation
  - Vertical Integration
  - Service Integration

**Focus on Increasing Customer Value**

- Reinvent the Business**
- Technology Innovation

- Service**
- **Distributor service models**
    - **Cost Transfer**
    - **Asset Management**

# Where Will Value Come From?

- Helping customer increase performance
- Helping customers reduce cost
- Helping customers reduce risk
- Helping customers meet their changing business needs

Product  
Value

Service  
Value

Information  
Value

Each and all of these create value .....

# Value from Technology

## Learning to Apply Technology is the Challenge

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- The challenge already exists for distributors / channels of all types to learn how to market present-day smart products
- This will only get worse. The rate of change in technology will vastly exceed the traditional channel organizations and ways to learn
- Something has to change

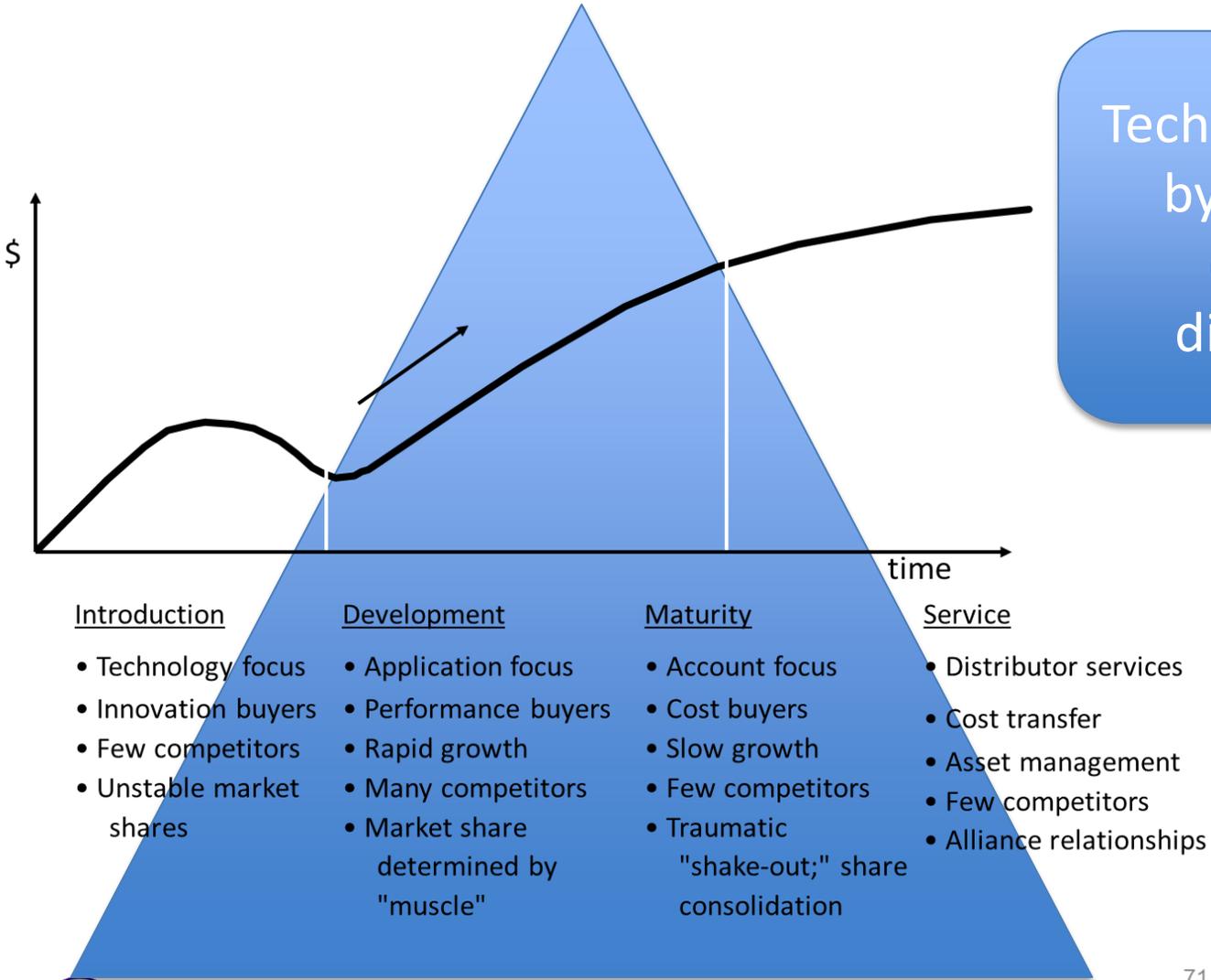
# What Will Your Channels Need From You

- A clear business model
  - How do I make money marketing this new technology? – particularly to cover my substantial investments
- A set of economics that links to performance
  - Probably more functional discounting
- A channel strategy that shows long term commitment
  - Justifying investments

# Implications for All

- Communication will be king
  - Between manufacturer and distributor
  - Between distributors and customers
  - Between manufacturers and customers
- Get closer to your customers
  - Increase transparency (between manufacturers, customers and distributors)
  - Potentially dealing with new buyers (IT / Process control)
- Flexibility is essential
  - Ability to quickly react to changes in customer needs
  - Ability to deploy technologies swiftly
- Ability to control customer experience quality in for a “moving technology target”
- Creation of and participation in winning ecosystems will become the determinant of success

# Still Room For Everybody



Technology is adopted by different sized companies at different speeds

The winners will master the adoption of technology in their businesses

# But, Change is Happening Faster Than We Think



20 Years later... All  
of these fit in your  
pocket...

*... and come for  
free on your smart  
phone!*

# Thank You

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