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Industrials & Electronics Practice

Lessons from transformers: How some distributors reset and won

In an exceptionally challenging marketplace, a few distributors are outperforming others by wide margins. Here's what they do differently.

This article is a collaborative effort by Alex Abdelnour, Brooke Daniels, Brandon Heriford, Rob McCarthy, and Kevin Sachs, representing views from McKinsey's Distribution service line.

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Disruption is accelerating in distribution. For years, distributors have faced the threats of disintermediation, ever-rising customer expectations, and pressure from e-commerce and omnichannel competitors. Then came a global pandemic and unprecedented supply chain challenges, labor shortages, and geopolitical tensions, as well as sharply higher interest rates and the specter of recession.

The industry as a whole has always been resilient, but these and other challenges have truly tested its resolve. Some distributors have faltered in the face of declining revenues and narrowing margins; others have weathered the storms and held their ground. A few—roughly one in ten—have thrived, improving their ROIC by almost 30 percent and increasing their revenues by an average of almost 9 percent CAGR, their profits by around five percentage points, and their EBITDA margins by nearly seven percentage points in the past few years (Exhibit 1).

What do these outperformers have in common? Our research shows that the winning distributors don't just outperform—they transform. They use strategic M&A to build economies of scale, acquire talent, and gain access to new customers and markets. They maintain a relentless focus on the customer, increase their profits holistically, improve and expand their product assortments, and offer more value-added services and a better digital experience.

In this article, we not only review the distribution industry's long-standing and new challenges but also explain how some companies beat the odds.

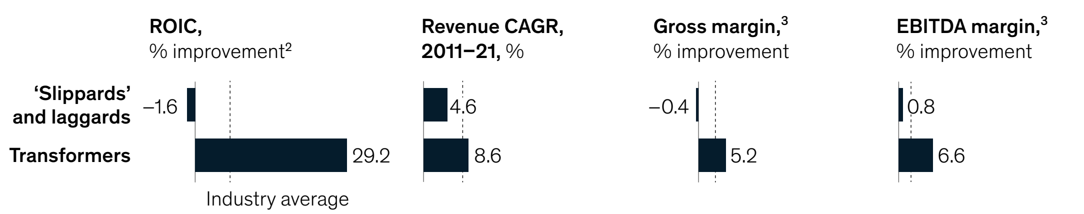
The business is tough, and getting tougher

In 2019, we published a report on the coming shakeout in distribution, outlining the industry-disrupting trends, such as OEM disintermediation,

Exhibit 1

Transformers drive revenue and margin growth in the distribution industry.

Change for transformers[1] vs distribution industry average, 2011–21, by metric



Transformers had considerable ROIC boost, with industry-leading growth, excellent margin management, and efficient use of capital

Transformers outgrew sector and were 2× more active than industry average in M&A

Transformers maintained gross-margin discipline while leveraging scale to improve supplier and pricing power

Transformers doubled down on SG&A improvement, considerably outperforming market

[1]Categorization of 83 companies based on 3-year average ROIC, as defined, in 2011 and 2021.
[2]Difference of 3-year average of 2019, 2020, and 2021 from 3-year average of 2009, 2010, and 2011.
[3]2021 data.
Source: Corporate Performance Analytics by McKinsey

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Every distributor needs to prepare for economic uncertainty—and to look for crucial opportunities that competitors may miss.

rising customer expectations, and powerful new entrants. That shakeout is still under way. Since then, our experience and updated research have helped us identify a combination of old and new threats to growth and profitability across the distribution industry.

Fed rate increases and uncertainty about a recession

Although distribution as a whole fared better than other industries did in the latest recession, today's volatile marketplace is putting intense new pressures on most players, especially those with heavy warehousing and delivery costs. No relief is in sight. Distributors in some sectors are now publicly flagging concerns about their growth and margin outlooks.

Experts have not reached a consensus on the likelihood of a recession or how deep or long it will be if there is one, and nobody can be sure what other economic or geopolitical shocks will materialize over the near to medium term. We can be confident, however, that the US Federal Reserve will continue to keep rates elevated for at least the next few quarters. That will put pressure on the operating results of many companies and reduce their leverage for M&A.

No matter how the next few months unfold, every distributor needs to prepare for economic uncertainty—and to look for crucial opportunities that competitors may miss.

Suppliers continue to build direct relationships with customers

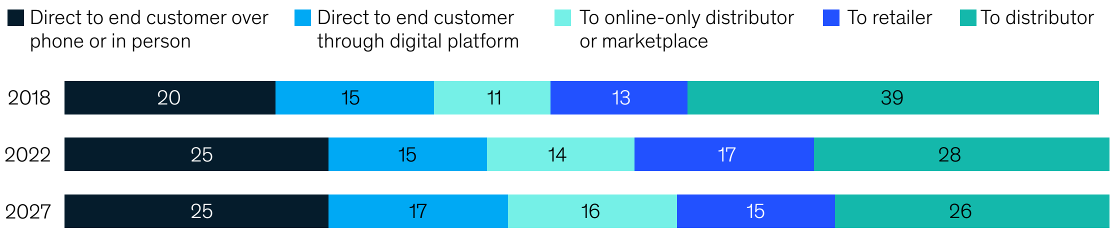
Disintermediation continues to accelerate as more manufacturers than ever look for ways to cut out intermediaries. The COVID-19 crisis supercharged manufacturers' investments in digital and direct-to-customer capabilities, raising the risk of disintermediation even more. In a 2022 McKinsey survey that included more than 100 suppliers with distribution channels, about 70 percent said they expected their share of direct-to-customer sales to rise in the next five years. More than 80 percent reported significant investments in their direct-to-customer capabilities, made in hopes of reaching customers directly and becoming the main driver of the customer experience.

In a 2018 McKinsey survey that included more than 100 suppliers, the respondents estimated that their share of channel through distribution at almost 40 percent. In our 2022 survey, the estimated share is closer to 30 percent, and respondents expect it to drop even more in the coming years (Exhibit 2). Although the magnitude of this shift is uncertain, it remains telling that suppliers expect their share of distribution to decline rather than expand. Direct-to-end-customer channels and online-only channels will probably capture this share. Our survey indicates that manufacturers of auto parts, packaging, and industrial equipment are more likely to extend their direct end-customer reach than other companies, but the overall trend is visible in nearly every

Exhibit 2

Manufacturers see direct-to-customer and digital channels as increasingly important.

Estimated distributor share of channel, average % across respondents



Source: McKinsey Distribution Practice Supplier Survey, 109 participants, 2022

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sector—and accelerating as digital investments and capabilities expand.

Customer expectations continue to rise

Customers continue to expect more from distributors (Exhibit 3). When we asked them in 2018 how their distributors provided the most value, the top three choices were range of products, product availability, and customer service. But in 2022, customers ranked value-added services as one of their top three expectations from distribution providers, up from a ranking of eighth in 2018.[1]

The availability, range, and price of products remain core customer requirements. However, the relative importance of true value-added services and capabilities (such as prefabrication, cost savings, and design or other services that address customer pain points) has grown considerably. This development is especially visible in subsectors such as electronics; industrial equipment; and heating, ventilation, and air conditioning (HVAC) and plumbing. Our discussions with industry players confirm this point. As one executive put it, "We want to see innovation from our distribution partners, expanding on their existing engineering talent or product knowledge. Can our distributor partner help us conduct preventive maintenance or make urgent repairs? These are some of the things that will matter more to us over time."

Other notable shifts in the expectations of buyers include the ability to conduct transactions online, which rose five spots in our recent survey, trading rankings with sales rep relationships. Customers are looking for easier and convenient transactions from their distribution partners, in addition to turnkey services and offerings. We expect that share of customers to go on rising as the digital purchasing experience becomes more seamless.

The growing threat of nontraditional disruptors

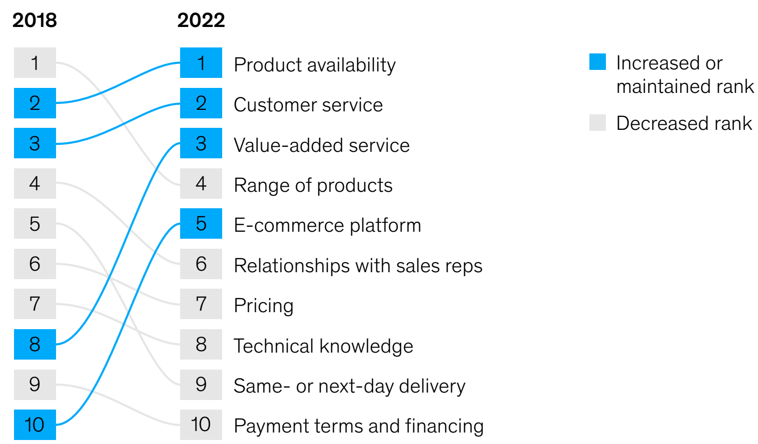
New and compelling marketplaces, many of them between customers and distributors, are appearing online across sectors. They are slowly coming to

[1] McKinsey Distribution service line's customer surveys in 2018 (250 participants) and June 2022 (117 participants), as well as interviews with experts.

Exhibit 3

Customers expect more, including value-added services and digitization, from distributors.

Value contribution of distributors compared with alternatives, respondent rankings[1]



[1]Question: Across your purchase needs, where do you think distributors provide most value compared with manufacturers and online-only players?
Source: McKinsey Distribution Practice Customer Survey, 250 participants in 2018, 117 participants in 2022; McKinsey analysis

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own the customer relationship and threatening to relegate traditional distribution to a low-margin link in supply chains. For example, Amazon Business, which has increased its revenues to more than $20 billion since its launch in 2015, is still taking share from many longtime distributors. The company now serves more than five million customers and continues to expand its product offerings across subsectors, including IT, auto parts, construction, and medical supplies. This expansion seems likely to continue—nearly 80 percent of the suppliers we surveyed said they are willing to sell through Amazon Business.

Other disruptors include big-box retailers such as Home Depot, which is creating a distinctive omnichannel go-to-market experience with its half-million “orange-blooded associates,” thousands of retail stores, and millions of app users. As retailers move into distribution, other emerging digital solutions and aggregators, such as Vetcove and Hyphen, help customers to compare the distributors’ offerings and prices. Innovators are attracting money—about $2.5 billion in venture capital was invested in the B2B industrial sector in 2021, up 80 percent annually over the past few years.

In short, the “moats” of technical expertise and sales rep relationships that once protected distributors from digital attackers are drying up. Forward-thinking distributors are revising their strategic plans and making targeted investments in technology to gain new capabilities and provide customers with new offerings and experiences.

The profile of a winner

Despite the headwinds, transformers in the industry have met the moment. They are responding to these powerful trends and uncertainties with broader customer offerings, more disciplined margin management, and the acceleration of new acquisitions and partnerships. And they are using technology to optimize their operations and the customer experience.

Some sectors have done better than others (Exhibit 4). Building products and HVAC and plumbing, for example, benefited from positive momentum across the real-estate market over the past few years. But not all companies in these sectors transformed themselves: the winners rode the market tailwinds with careful planning, rigorous execution, and strategic M&A. Here's how transformers move ahead of the competition.

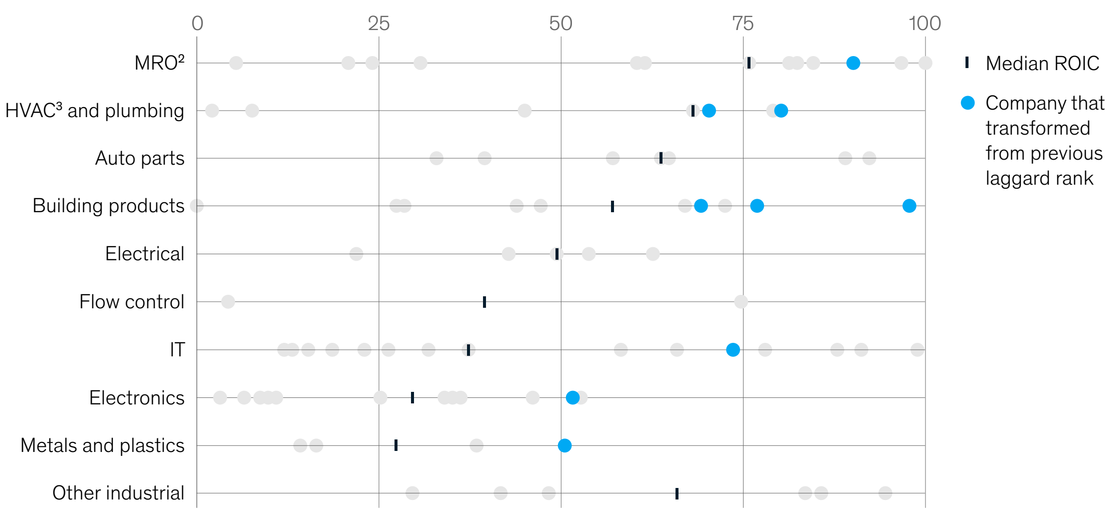
1. Transformers know that scale matters and masterfully use M&A to become some of the largest players in their segments

Transformers use M&A masterfully to gain share and capabilities and to enter attractive new markets. The average deal in distribution is nearly twice as large today as it was five years ago.[2] Programmatic M&A—a steady cadence of local, tactical, and strategic deals—tends to create more value over time. Research shows that companies

Exhibit 4

Some distribution sectors outperformed, and a few companies transformed, in the past few years.

ROIC of selected distribution companies, by sector, percentile[1]



[1]ROIC as 3-year average of 2019, 2020, and 2021. Covers 81 companies with ROIC data available.
[2]Maintenance, repair, and operations.
[3]Heating, ventilation, and air conditioning.
Source: Corporate Performance Analytics by McKinsey

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[2] For more on this topic, see "Programmatic M&A: Winning in the new normal," McKinsey, March 21, 2022.

leveraging M&A as a core growth engine grow faster and deliver more TSR.[3] Transformers across the distribution sector engaged in twice as many M&A transactions as the overall set did.

Builders FirstSource, for example, has transformed its performance in the past five years, delivering more than four times the ROIC of its average counterparts. Its strategic M&A (including a merger with BMC Stock Holdings), sharp focus on margin improvement, and industry-leading organic growth helped position the company as a transformer in the building-products sector. Watsco, a "near-transformer" on the cusp of outperformance, has completed six strategic deals in the past five years, acquiring smaller private distributors and their revenues at a deep discount to prevailing valuations. These moves have helped the company to execute a strong value-compounding strategy. Its structurally attractive enterprise-value-to-revenue multiple has helped it to make deals strategically and to raise its ROIC by 12 percentage points since 2017.

Transformers and top performers in general understand that scale will always matter in distribution, so they build their capabilities for programmatic M&A systematically over time.

2. Transformers choose growth, focusing on the core business but investing in assortments, adjacencies, and value-added services

The depth, breadth, and availability of products will continue to be differentiators and top buying factors for most customers. Transformers offer an average of 20 percent more product categories and wider SKU assortments than their typical competitors do, and many transformers access new segments and product offerings over time. The best not only widen their assortment mix but also enhance it to meet customer requirements and optimize for profitable growth.

The plumbing supplier Ferguson Enterprises, for example, made expanding its assortment mix and service offerings a strategic imperative. In the past five years, the company broadened its offerings from about a million to more than 3.5 million products. It also invested significantly in its private-brand business, which expanded from 6.6 percent of total sales in 2018 to more than 8.6 percent in 2021. Including the recent launch of Durastar (the company's line of HVAC products), Ferguson has used its growing assortment mix and strategic product portfolio to expand its ROIC by 30 percent since 2018 and to achieve a double-digit EBITDA margin of 10.7 percent in 2022.

To meet customers' increasingly varied needs, transformers also understand that they have to invest in new add-on services, including supply chain solutions, as well as installation, maintenance, planning, and testing services. Transformers generally offer more value-added services than the broader peer group does. That drives profitable growth by adding to the margins of transformers and making them "stickier" for customers.

UFP Industries, which serves the manufactured-housing industry, found its way to higher margins by offering customers more than products: over the past few years, it has invested in developing a broad offering of services for construction, design, project management, installation, and framing. UFP's principal competitive advantages now include engineering and design capabilities, as well as the ability to provide turnkey packages for its products. Revenue growth has topped 30 percent annually over the past five years. ROIC has risen by 270 percent, and EBITDA margins by 3.8 percentage points since 2018.

3. Transformers use better e-commerce and omnichannel experiences to keep customers

Nearly a third of customers we surveyed in 2022 said they preferred digital-only buying platforms and think this trend will continue to grow over the next five years. A similar share of suppliers say that distributors can become better channel partners by improving their digital capabilities. Transformers understand this imperative. Many have spent

[3] Paul Daume, Tobias Lundberg, Anika Montag, and Jeff Rudnicki, "The flip side of large M&A deals," McKinsey, March 25, 2022.

Transformers use digital innovation to become more efficient in other business areas, including the supply chain and operations.

the past few years building more compelling omnichannel customer experiences. At times they have even disrupted themselves. These companies use digital innovation to become more efficient in other business areas, including the supply chain and operations, as well. For example, the industrial and maintenance, repair, and operations (MRO) supplier Global Industrial, which recently became a transformer, has achieved a 60 percent bump in ROIC over the past five years. Global has taken a digitally enabled approach, using its core value proposition of sales relationships and product knowledge to redefine the end-to-end customer purchase, service, and delivery experience through digital means.

Global Industrial relies on a customer-centric strategy of personalized commerce. It understood that to compete with Amazon and other fast-moving disruptors loaded with cash and talent, it had to have a better position in the fragmented MRO sector. The data it captures through its digital platform yields insights into the preferences and requirements of customers, and that helps Global build their loyalty. Most of Global's transactions now come through electronic orders, which helped increase the company's EBITDA margins by 2.5 percentage points.

4. Transformers focus relentlessly on profitable growth

Transformers enjoy EBITDA margin growth that's 2.6 times above the industry average, and more than eight times higher than that of the laggards. Performance ceilings are falling, and the gap between transformers and others has widened sharply since 2019: the transformers' average EBITDA margin more than tripled, to 9.6 percent, from 3.1, while the overall industry moved to 8.9 percent, from 6.4, over the same period. Transformers also improved their SG&A efficiency (SG&A as a share revenue) by 1.4 percentage points and expanded their gross margins by five percentage points—60 percent above the industry average.

The building-products transformer BlueLinx, for example, delivered all-time-high gross profits, adjusted EBITDA, and earnings per share in 2021. It increased its gross margins by 280 basis points, to 18.2 percent, primarily by shifting the product mix to higher-margin categories and value-added services. The company did benefit from tailwinds in lumber commodities, but it made profitable growth the first goal of its strategy, highlighting its commitment to a performance-driven culture, including a fast-acting leadership team. BlueLinx reduced its SG&A as a share of revenue by 25 percent—one of the biggest SG&A efficiency improvements across all of its counterparts in the industry (including other transformers) in the past three years.

Transformers understand that scale alone isn't enough: profitable growth is the true measure of performance. The best long-term bets are investments in commercial and operational capabilities that link growth with distinctive margin outperformance.

Making it happen

In any transformational endeavor, significantly improving performance is difficult and requires a relentless commitment to change. Almost every organization hopes to transform itself, and some are ready to do so, but only a handful succeed. In studying—and supporting—many companies that have succeeded in realizing the promise of transformation, we have identified five practices that help improve the odds of success:

— *Build M&A muscle.* Transformers purposefully build their capabilities and reputations as acquirers. They always begin by crafting an M&A strategy aligned tightly with their corporate strategy and building deal teams skilled and proactive in deal sourcing; M&A "muscle memory" is important in distribution. Transformers also regularly reallocate their M&A capital to the business units aligned most closely with the overall strategy. The most successful acquirers look well beyond strategic and financial due diligence to understand each target's integration-planning requirements and culture. They keep the "soft stuff" front and center when integrating companies—and maximize the synergies.

— *Take a holistic view of growth.* Particularly in a market where competition is likely to rise as growth slows, growth is more critical than ever. Distributors that grow faster pursue a holistic-growth blueprint: focusing on the core while investing in select adjacencies and breakaway ideas. This approach includes maintaining a disciplined focus on the organic-growth strategy and the effectiveness of the sales force—for instance, using a deep knowledge of customer requirements to identify executable business solutions and expanding product line participation to improve the top line.

— *Pursue profitable growth above all.* The best distributors focus relentlessly on margin control through strategic pricing and category management by investing in and building distinctive competencies in these areas. They also invest in profitable growth opportunities, including private-label expansion and high-margin service offerings. Meanwhile, these companies maintain tight controls on SG&A and operations, including process optimization and productivity improvement levers, such as automation.

— *Understand that the customer is king.* As new entrants and disruptive technologies gain share, a diminishing value proposition is one of the greatest risks for the industry. To win and keep customers that now have more options than ever, the best distributors position themselves as core value chain partners that provide and expand their value-based services and offerings. Many industry leaders build unique ecosystems to address customer pain points, and they use their unique product and technical knowledge to create profitable and repeatable services.

— *Digital is not merely an option—invest wisely or be left behind.* Customers compare the distributors' omnichannel shopping experiences not with those of other distributors but with those of big retailers, banks, and other consumer-facing businesses. As OEMs continue to build their customer-facing digital capabilities, and new tech-enabled entrants target the industry's huge profit pools, digital can be either an opportunity or an existential threat. Outperformers have not only made digital a strategic imperative but also drafted digital road maps based on where the puck is going, not where it is now. Most are also looking to compete smarter, not harder—forging partnerships rather than rivalries to gain digital traction in the B2B value chain.

Challenging times will continue to test the mettle of even the strongest companies in the industry: an uncertain economy, paired with industry-specific disruptive trends, means that business as usual is not likely to maintain the status quo, let alone to deliver transformational performance. Fortunately, a few companies have shown that profitable growth is possible even in an exceptionally unpredictable marketplace. Companies can set themselves apart from their competitors well into the future by transforming themselves: focusing on strategic inorganic growth; meeting customer requirements for services, assortments, and digital operations; and managing their margins carefully. Which companies will rise to become the industry transformers during the next five years? Only time will tell.

Alex Abdelnour and **Brandon Heriford** are partners in McKinsey's Atlanta office, **Brooke Daniels** is a partner in the New York office, **Rob McCarthy** is a senior knowledge expert in the Boston office, and **Kevin Sachs** is a senior partner in the Denver office.

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