

Advanced Electronics Practice

COVID-19 crisis: How distributors can emerge stronger than before

During the current singular crisis, distributors can combine past strategies with new tools to thrive in the next normal.

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Distributors that are struggling during the COVID-19 crisis may look to the last recession for strategies for dealing with downturn, but the current situation is unique in many ways—and the stakes are far higher. In this article, we lay out the profound challenges facing the distribution industry, share insights from previous downturns, and explain the steps distributors must now take to outperform competitors during the recovery and beyond.

Navigating the new landscape by studying the past

The COVID-19 pandemic has made life infinitely more difficult for people and businesses of every description. Despite the efforts of governments, industry, scientists, and healthcare workers, some major markets remain at least partially closed, many supply chains face serious disruptions, and most sectors experience continued low demand. No one can be certain when workers or shoppers will return.

Many distribution leaders face a difficult conundrum. Continuing business as usual may put employees in harm's way or cede ground to suppliers that are increasingly harnessing digital tools to serve customers directly. But the best improvement strategies are unclear. More than six months into the pandemic, companies are still trying to deliver value while protecting people's safety and livelihoods.

To gain deeper insights into the best strategies for dealing with the pandemic, we studied how some companies stayed resilient in previous crises and identified lessons that may be relevant today. We also assessed the pandemic's impact, including trends affecting the distribution industry. Our analysis identified how leaders can stabilize operations and take a through-cycle view to gain competitive advantages. These steps will help them reimagine the future as we enter the next normal.

A downturn with new twists

In this unprecedented crisis, while every marketplace and distributor faces unique challenges, most businesses fall into one of the following three categories based on their demand volume:

1. ***Companies experiencing sharp and unprecedented drops in demand.*** Most of the distributors experiencing large decreases in demand are in the sectors hardest hit by physical distancing and government-recommended isolation guidelines. In kitchen equipment, for example, our analysis showed that demand has dropped by as much as 80 percent. Companies in these sectors are simply aiming to survive a crisis that no one could have anticipated, and they are getting far more creative in their survival methods. Leading food-service distributors have swiftly altered their business models. Some have shifted deliveries to groceries, for which demand has risen, while others have formed partnerships with grocers and other distributors to place their furloughed employees in new roles. Some businesses are also limiting their products to frozen and dry goods to reduce spoilage and inventory costs.
2. ***Companies experiencing an explosive increase in demand.*** The pandemic has spurred demand for many products and services, including medical supplies, safety and cleaning products, toilet paper, canned food, delivery apps, videoconferencing, headsets, and home entertainment. Many distributors in these sectors are struggling to meet demand and have ramped up hiring. Some are reaching out to distributors in other sectors affected by the pandemic or are providing hardship raises and bonuses to employees on the front lines. Leaders in these sectors have established rigorous safety protocols to run warehouses and deliveries; such protocols can serve as examples for others. Unfortunately, even these steps have not been enough to keep up with rising demand or address global supply-chain disruption. Moreover, while explosive demand may seem like a blessing in such difficult times, fulfillment costs have risen sharply in some sectors, hurting bottom lines.
3. ***Companies experiencing muted or irregular demand.*** Some sectors that are not directly affected by the pandemic are experiencing a

For many distributors, the responses that worked in previous recessions are now table stakes.

general business slowdown or a moderate influx of business as people change their routines at home and work. These sectors include maintenance, repair and operations, general industrial services, and packaging. At these companies, leaders are also struggling with the imperative to safeguard livelihoods while meeting business targets. Many businesses in this category have taken aggressive steps to manage cost, mitigate supply-chain disruptions, ration certain products among customers, and shift to remote selling. For many of them, this downturn follows a pattern seen in the past. Distribution continues to shift to e-commerce, prompting companies to invest in digital-sales training and online capabilities. One executive at a leading distribution company told us that the business had made more progress in e-commerce in the past six weeks than in the previous three years.

Despite the day-and-night variability of the distribution business across sectors, we urge all distributors to take a through-cycle view of this crisis, learn from previous downturns, understand what has changed, and take swift action to survive the crisis while preparing for a recovery in the next normal.

Looking back: Lessons from previous crises

Distributors play critical roles across sectors and are therefore rocked by drops in overall GDP and sector-specific shocks. Building-product distribution, for example, was hit hard by the Great Recession, as the housing industry collapsed in the United States. Other sectors also faced demand slowdowns as GDP plunged.

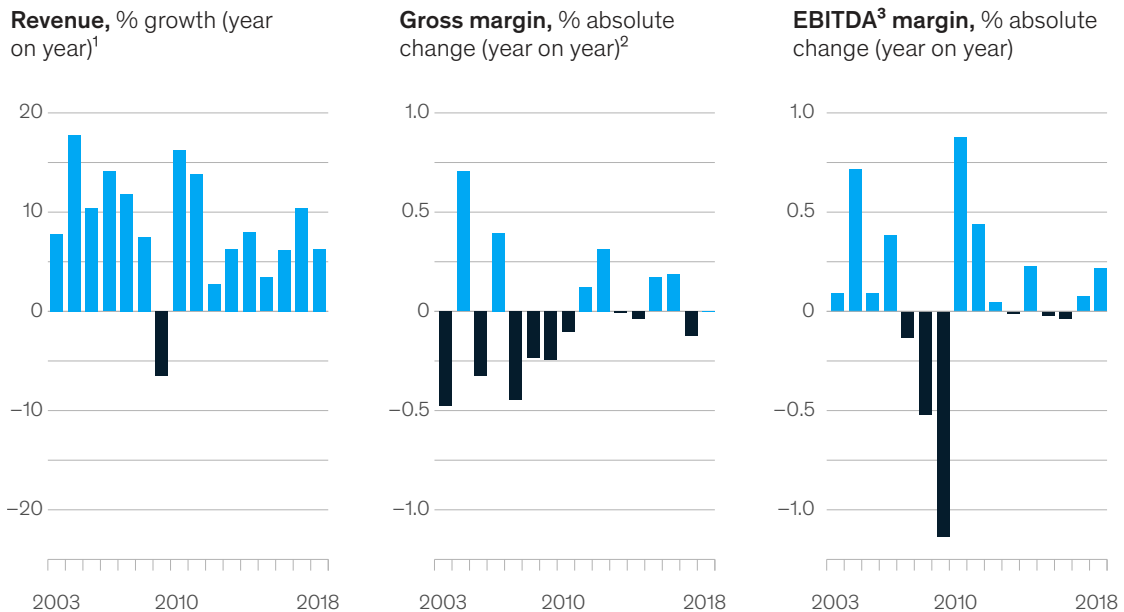
Our analysis of around 100 publicly traded global distributors shows a significant drop in revenue and margin at the height of the Great Recession. In 2009, their year-on-year revenue growth was about –7 percent across sectors, and earnings before interest, taxes, depreciation, and amortization (EBITDA) fell by as much as 40 percent (Exhibit 1). The impact of the recession was particularly acute in the automotive, building-product, and home-furnishing sectors. Across the board, however, distributors struggled to recover the lost margins even as top-line growth recovered. On average, it took them nearly a decade to recover their prerecession margins. Moreover, publicly traded distributors saw a sharp decline in stock prices and total return to shareholders as overall demand softened.

The current downturn may resemble the Great Recession, given declines in demand, consumer buying power, and stock prices, but the changes occurred much more suddenly in 2020. The stock prices of food-service distributors, for example, dropped by more than 50 percent in a matter of weeks rather than months. For many distributors, the need to protect the health of employees, customers, and business partners while managing profound supply-chain disruptions has created a perfect storm.

That said, we believe that history provides valuable lessons. For many distributors, the responses that worked in previous recessions are now table stakes. In our analysis of the approximately 100 publicly traded distributors, we looked at their performance and actions through the previous recession. We

Exhibit 1

Despite top-line growth, distributors did not build margins in the most recent expansion.



¹Revenue growth calculated in local currencies and weighted by average revenue in US dollars over period.

²Weighted by revenue in US dollars.

³Earnings before interest, taxes, depreciation, and amortization.

Source: Corporate Performance Analytics by McKinsey

found that some companies increased revenues and margins faster than peers did and provided shareholders with nearly double the returns of average competitors (Exhibit 2).

How did they do this? Looking into the strategies of high-performing distributors, we found that they used a similar set of levers throughout the downturn:

- ***They developed a nimble cost structure.*** During the onset of the Great Recession, top performers cut costs aggressively and took a cleansheet approach to build organizations fit for the future. Some even increased variable expenses by renting rather than owning equipment and assets. Some also relied more on

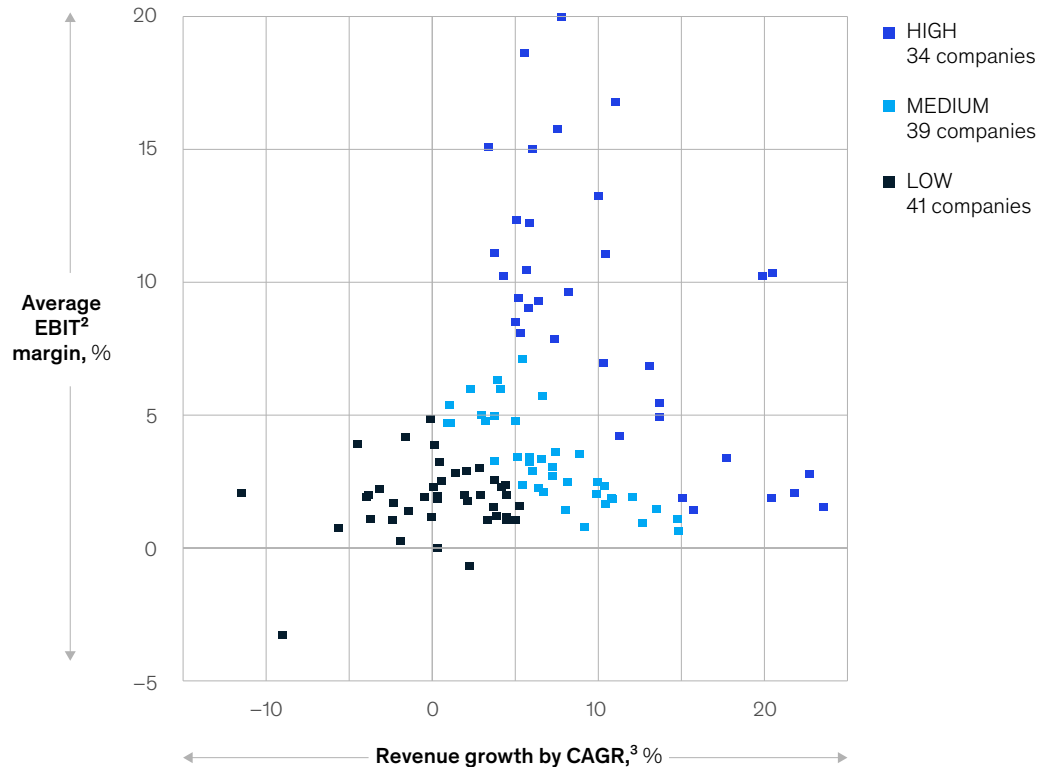
temporary workers. High performers achieved break-even points as low as 60 percent of revenues. They also aggressively managed sales, general, and administrative costs to keep them at relatively constant ratios.

- ***They managed cash more carefully to build war chests.*** High performers were more likely than others to adjust inventories to reflect revenue drops and reduce relative capital-expenditure spend. They monitored and prioritized cash-releasing levers, such as working capital and accounts receivable and payable. Finally, high performers deployed cash with a new understanding of the opportunity costs, keeping dry powder available for strategic efforts.

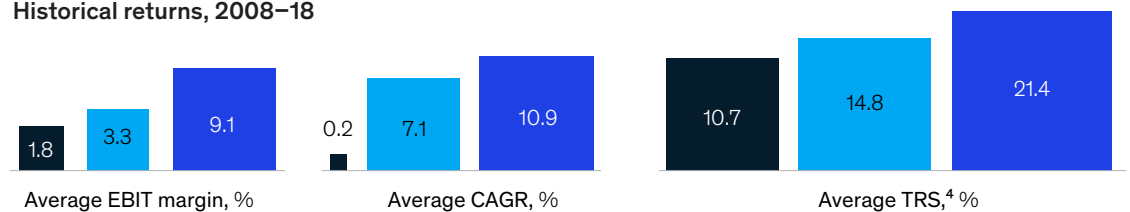
Exhibit 2

Distributor performance varied significantly throughout the last downturn.

Historical performance of top publicly traded distributors, 2008–18¹



Historical returns, 2008–18



¹Global database of >100 distributors.

²Earnings before interest and taxes.

³Compound annual growth rate.

⁴Total returns to shareholders for companies listed on stock market.

Source: Corporate Performance Analytics by McKinsey

— **They diversified revenue streams.** With diversified portfolios, many distributors can shift their focus to high-growth and high-profit customers. For example, building-material distributors with a relatively large presence in repair and remodeling saw more muted declines

in revenue during the Great Recession. In the current downturn, distributors of safety gloves, masks, and cleaning chemicals have benefited by spikes in demand. These increases have balanced sharp declines in other manufacturing-heavy categories, such as fasteners and machinery.

- ***They pursued programmatic M&A.*** Years of research show clear evidence of the value of programmatic M&A through downturns. On average, companies that make frequent small-to-medium-size strategic acquisitions deliver more shareholder value than do competitors with “big bang” M&A strategies. That said, programmatic M&A is a muscle: savvy acquirers make it a pillar of scenario planning and overall strategy, and they deploy top talent full time to find targets, make deals, and manage integrations.

In short, high performers maintain cost discipline while building war chests to move quickly toward profitable growth as opportunities emerge. While the current downturn is unique, the same levers are nevertheless working for leading distributors. The shape of the recovery is still unknown and will likely vary across sectors, but, undoubtedly, companies that keep costs down, take a through-cycle view of capabilities by investing in talent and skills, and make bold, well-considered bets to ride the recovery wave will be among those that emerge strongest. Some will come out on top.

How to succeed in the next normal

Most executive teams have found ways to deal with the ebb and flow of the pandemic, such as by setting clear guidelines to protect the safety of employees, cutting expenses, and closing and reopening offices. Many, however, have yet to focus on what lies ahead. Only a few distributors are now making strategic moves and convening teams to cut through the uncertainty and plan for the recovery.

We believe distributors should consider the following five priorities to succeed in the next normal:

1. ***Revamp the go-to-market strategy and accelerate the omnichannel approach to sales.*** Before the COVID-19 crisis, 50 percent of B2B buyers preferred an omnichannel experience with an e-commerce platform and 60 percent preferred not to interact with a sales representative. This trend has been accelerating rapidly for the past few years. Buyer preference for self-service during the research

and evaluation stage of the customer decision journey more than doubled from 2016 to 2019, and suppliers that offer a seamless digital experience have been rewarded with increased loyalty. They are also likely to become primary suppliers, since nearly three out of four buyers will use a supplier for all their buying needs if they rate it as offering an outstanding digital experience.

The COVID-19 pandemic has solidified these trends and accelerated the shift toward virtual experiences. In fact, over the past few months, more than 90 percent of B2B sales have transitioned to remote selling, and this model is proving more effective. Digital interactions have more than doubled since the crisis began, and our survey results suggest that more than 70 percent of B2B customers will likely sustain a version of this new sales model a year from now. Our research also shows that some distributors with strong e-commerce platforms or a digital presence have been weathering the crisis better.

Many industry leaders are rethinking their go-to-market approaches. Today's crisis could represent a once-in-a-lifetime opportunity to drive change in sales organizations. We recommend that distributors refocus their field sales forces, moving them away from farming accounts and order taking and toward consultative selling and growth, using low-cost and low-touch digital platforms as primary channels. For example, a leading North American healthcare distributor relied on an expensive, high-touch field sales force to collect orders. Representatives saw the company's online platform as a competitive threat, creating a downward spiral in prices and customer experience. After years of revenue decline, leadership decided to invest in growth through an omnichannel sales model that combined field, inside, and digital sales. The leaders prioritized high-growth and high-potential accounts rather than high-revenue accounts. They also shifted the farming of existing accounts to seamless inside sales and online channels. To facilitate the transformation, leaders aligned incentives

with growth, addressed channel conflicts, and doubled down on performance management and sales training. The bets paid off, with revenue growing by roughly 10 percent within a year and margins remaining stable.

2. ***Unleash a digital and analytics awakening.*** This crisis is proving that companies that embrace the digital revolution are significantly more resilient than are others. Amazon, the leading digital distributor, nearly doubled its sales in May and is benefiting from years of investments in digital selling and analytics. All large distributors have one thing in common with Amazon: treasure troves of transaction data across products, brands, and customer segments that can help them anticipate customer needs and offer alternative solutions. For instance, distributors achieve higher value by aligning offerings with customer willingness to pay and promptly addressing customer pain points.

Analytical and digital tools can also unlock productivity in inventory management, warehousing, and delivery. Better demand planning, for example, can help distributors deliver the right products at the right time in the most efficient ways, thereby deepening market penetration. The major challenge for distributors now is deciding not only when to start using digital tools but also where. They can choose from a broad range of proven digital and analytical use cases and launch in just a few weeks. One leading industrial distributor became a digitally enabled powerhouse by applying advanced analytics to commercial and operational use cases, including pricing, cross selling, churn management, and route optimization. The company adopted a start-up mentality in a traditional organization, using pilots to build credibility gradually with the traditional sales team and customers.

3. ***Accelerate supply-chain transparency, resilience, and automation.*** The COVID-19 crisis has demonstrated the vulnerability of the old

supply-chain model, in which the shutdown of a single factory forces some companies to halt operations abruptly. In a recent article, McKinsey leaders Kevin Sneader and Shubham Singhal described the transition from “just in time” to “just in time *and* just in case” supply chains.¹ Their view is that the costs of individual transactions do not matter nearly as much as end-to-end value optimization or a resilient and efficient supply chain, especially for distributors for which product availability at low cost is critical. Distributors are reliable supply-chain partners, but increased disruption should be an impetus to accelerate the shift to a more resilient supply chain by enhancing predictability, transparency, and flexibility while simultaneously driving efficiency. Improvements will come largely through digital enablement.

Supply-chain resiliency was already a hot topic before the pandemic had spread around the world.² Now, industry leaders see resiliency and management of supply-chain risk as more important than ever. To anticipate disruptions and deal with challenges and opportunities, they are taking a closer look at logistics complexity and visibility, product flexibility, customer openness to substitutes, and organizational maturity.

The most resilient distributors are building digitally enabled supply chains that harness automation, the Internet of Things, and advanced analytics. Such moves can deliver significant benefits. For instance, companies making them can better forecast customer needs with digitally enabled predictive analytics and gain increased flexibility with real-time planning. Companies can also provide more individualized services through microsegmentation and mass customization. They can improve decision making through real-time and end-to-end supply-chain transparency. At warehouses and distribution centers, automation can increase efficiency.

¹ Shubham Singhal and Kevin Sneader, “From thinking about the next normal to making it work: What to stop, start, and accelerate,” May 15, 2020, McKinsey.com.

² Knut Aliche and Anna Strigel, “Supply chain risk management is back,” January 28, 2020, McKinsey.com.

4. *Deepen the bench and build the talent pool.*

Winning distributors relentlessly build talent and capabilities to weather storms and emerge in stronger positions. An unprecedented number of people are looking for jobs today, and new remote and flexible working practices give distributors access to talent previously out of reach, such as data scientists in major metropolitan areas. And since remote work has increased efficiency by cutting commuting hours, companies can devote more time and money to training people to use digital and analytics tools. Top talent who used to ignore distributors now see them as essential, presenting opportunities to hiring managers.

5. *Build the right portfolio for the recovery.*

Between 1990 and 2010, companies that reallocated resources delivered 50 percent more in total returns to shareholders than did low resource reallocators. During downturns, they outperformed the others by even wider margins. During crises, capital is scarcer and trade-offs are more difficult, which makes it more important to reallocate resources from underperforming areas to allow bets on new growth areas. As we have explained, M&A will play a big role. Distributors that raise their resource-reallocation ambitions early—in what could be a long down cycle—will inevitably emerge stronger and better positioned for the next era of growth than will their peers. A major North American logistics player began basing

all allocation decisions on a single, condensed view of return on invested capital and growth across business units. A single owner in finance challenged businesses, ran analyses, and managed processes. In just a year, the company mindset and the resulting resource-allocation decisions began to focus on profitable growth rather than pure margin.

This metric- and market-oriented approach is especially valuable today because a segment that seems to have improved year over year may actually be underperforming compared with competitors, necessitating more aggressive resource reallocation. Finance teams will find that they can use advanced analytics to develop a condensed view more quickly than ever.

This is a singular moment. Across industries, the COVID-19 crisis is transforming executives' understanding of their organizational capabilities. Whether it's in areas of productivity or the speed of digital transformations, distributors are getting a better idea of where they stand in market share, valuation, and, most important, ability to compete. Some distributors will use this knowledge to transform themselves and emerge from the downturn fit to compete at the highest levels through the next technological revolution. Those that do not will be left behind.

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The authors wish to thank Christine Burq, Kevin Sachs, and Whitney Zimmerman for their contributions to this article.

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