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Distribution Models, Competitive Advantage and Disruption

The intensity of competition in the business world is increasing at an accelerating rate. Globalization and new technologies are breaking down traditional barriers, and supply options are becoming more transparent to customers. The pathway to success is different now compared to the industrial era, where companies produced intellectual property, packaged and sold it as a standalone or bundled offering. Increasingly, customers are searching less for discrete products, and more for solutions that satisfy perceived needs.* Therefore, a sustainable distribution model that delivers considerable value to the consumer is paramount, and it is from this 'value add' that a portion of the economics can be extracted from the customer. Simple distribution scale no longer provides the same level of protection it once did. As a result, modern distribution models must employ multiple layers of competitive advantage to remain relevant to their customers.

In this paper we outline some of the distribution models we view as having developed sustainable advantages which are difficult to disrupt as a new entrant. It is by no means an exhaustive analysis as businesses rarely fit neatly into specificly defined parameters. However, where traditional economic models fail by simplifying the competitive landscape by assuming that every firm is more or less the same, here we attempt to describe businesses and their respective distribution models in terms of frameworks. In doing so we attempt to draw out some of the subtle elements of their competitive advantages.

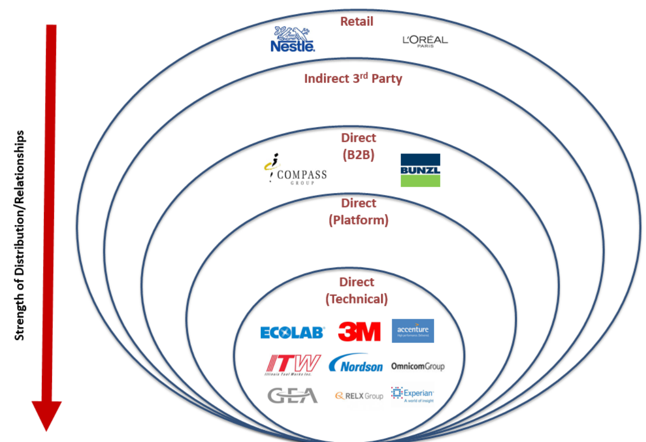
Part of the shift in strategic thinking that successful businesses have embraced to remain relevant is articulated well by business strategist, Michael Porter:

"The most common error of all is that competitive success comes from 'being the best'. This mindset is highly intuitive. It is also self-destructive, leading to a zero-sum race to the bottom. Only by competing to be unique can an organization achieve sustained superior performance".°

Referencing businesses we have analysed and visited over the years we will attempt to demonstrate how unique distribution models allow businesses to capture a sustainable portion of economic value over the long term. In attempting to distil a complex topic into more manageable bites we will explore four broad (and non-exhaustive) frameworks:

1) Direct distribution: where the manufacturer distributes directly to the end client or 'Business to Business' distribution. We draw special emphasis to direct 'technical' relationships.
2) Direct platform distribution: online models or network effects.
3) Indirect third party distribution: product aggregation built on scale or route density.
4) Retail distribution: 'Business to Consumer' distribution.

Generally we have found the strength of distribution increases as the seller's relationship moves from indirect to direct, and as the sale moves from generic to technical, which in turn leads to lower customer attrition rates and greater pricing power. Our portfolio is represented graphically to this end below.



Direct 'Business to Business' Technical Distribution (B2B)

In most cases, the most attractive form of distribution for a manufacturer is one where there is no third party disrupting the client relationship, negating the risk of the third party taking a disproportionate share of the economics or potentially damaging the company brand. Where these direct relationships exist they are typically quite difficult to dislodge, especially when the product being sold is critical, technical or specialist in nature. It is within B2B models and Platform companies where the "lollapalooza" effect is most likely to be found. This effect is where two or more advantages come together and are compounded on a tremendous scale, as described by Charlie Munger:

"I've been searching for lollapalooza results all my life, so I'm very interested in models that explain their occurrence. Often results are not linear. You get a little bit more mass, and you get a lollapalooza result. Adding success factors so that a bigger combination drives success, often in non-linear fashion, as one is reminded by the concept of breakpoint and the concept of critical mass in physics."

Typically where you find this effect in business is where a combination of multiple forms of competitive advantage are layered together and combined with a tailwind of customer demand. In many instances the ways in which the competitive advantages come together are not obvious; and in many cases it is the company's distribution model that draws those advantages together.

For example, Ecolab is a business that at its basic level is a chemical manufacturing company. At first pass an investor may struggle to understand how this business sustains Return on Invested Capital (ROIC) above 25%, or how it has managed to grow its Earnings per Share (EPS) by 14% compound over the last decade; surely the manufacturing of chemicals is a commoditized business? With further work, the layers of competitive advantage are peeled back, and it becomes clear that to compete against Ecolab is a formidable task.

One of the core functions provided by the business to its clients is the manufacture and delivery of cleaning chemicals into hospitality sites. If we were to imagine the pitch by an Ecolab sales person to a multinational restaurant chain, it might be sequenced in the following way: "We have chemicals that are safe to handle and use by low skilled or untrained workers. Our chemicals are delivered in block/ solid form and distributed into purpose built, wall mounted equipment, ensuring safety and reliability. Our direct sales force will monitor your chemical requirements and deliver them on a 'just in time' basis, saving you storage costs. Our chemicals will not be cheaper on a standalone basis, but our solution will the most cost effective on a total use basis; we will save you water, power and reduce waste. If your washing equipment failed during a shift, one of our 26,000 technicians will be on hand to communicate with our operational support team to trouble shoot the issue, regardless of whether the equipment was manufactured by Ecolab or not, so long as you are using our chemicals. We will compare your machine with identical third party equipment we have on site to ensure we understand the fault and instruct our representative on how to fix the issue. Finally, we can deliver this service in over 100 countries worldwide".

For a competitor to be a credible threat, it would have to overcome complex chemistry, sales, logistics, safety and total cost of service hurdles. If we assumed these were overcome, the entrant would need to solve the dilemma of investing in 26,000 technicians to support the product. In the case of Ecolab it is the direct relationship with the client on a sales and support basis that draws the other formidable competitive advantages together, which simply would not be possible if the company sold via third party distributors. And it is the competitive advantages described above coupled with the desire for companies to reduce cost by reducing water and power consumption, both from a best practices and government mandate standpoint, that creates the lollapalooza effect which drives outstanding economics for Ecolab.

Direct Platform Distribution

In many cases a platform business will be formed by creating a network effect, where by virtue of aggregating virtual inventory, the platform (portal/ ecosystem/ network) will attract customers. By attracting customers more third party businesses will seek access to those customers by posting their inventory, thereby enacting a virtual loop which reinforces the power of the aggregator's distribution model. In such instances, the platform will often not own inventory, and will rarely have significant capital employed, resulting in exceptional returns and cash generation.

1. Platform Distribution: Portal

A good example of a business that has executed platform distribution well is London-based real estate portal, Rightmove. As the first UK internet portal to disintermediate the old media newspaper franchises by providing access to electronic property inventory at scale, the company has developed a formidable virtuous loop. Rightmove has 40% more inventory than the number two competitor, which in turn drives 2.9x the consumer engagement of the nearest competitor.[†] Matching the maximum number of vendors with the maximum number of buyers creates a powerful distribution model, while owning no inventory with almost zero marginal cost per listing. Rightmove owns the relationship with the consumer (the buyer) and also the relationship with potential new vendors. As such, Rightmove has moved into adjacent markets such as banner ads for real estate agents looking to attract new vendors; in essence providing the digital equivalent of a "Sold By" sign, helping agents secure inventory while collecting a fee along the way.

2. Platform Distribution: Ecosystem

Disintermediation can sometimes be achieved by closing a loop, rather than displacing a competing product. Apple's foray into music was successful as it removed the friction from a music purchase, and turned the transaction into an impulse buy. Yes, the iPod was a great device, but there were already plenty of digital music players in the market at the time of the iPod's release. The genius in the distribution model was the seamless process of sampling, accessing, purchasing and storing the music. In doing so Apple disrupted the 'business to business' distribution model (record label to record shop) and replaced it with a 'business to consumer' model (Apple to consumer). Arguably it was at this point that Apple began to own the customer relationship, creating an ecosystem which allowed it to move into other markets such as the iPhone, Apple TV and other adjacencies.

3. Platform Distribution: Network

Global payment networks are businesses that are difficult to replicate and have withstood a barrage of competitive threats over the years. Visa, founded in 1958 and MasterCard, founded in 1966 are the only open loop credit card networks operating on a global basis. While their processing technologies provide a level of protection from competition, far more important than this is the simple issue of acceptance. By having billions of consumers engaged in loyalty programs and enjoying the safety of credit card fraud protection (credit card companies and merchants take on fraud risk, which isn't always the case with a debit transaction), Visa and MasterCard have an army of potential customers to offer merchants as an incentive to install payment terminals. Replicating this global network, which has been built over a multi-decade time frame, at scale, with embedded fraud protection data analytics is a formidable barrier for a potential market entrant. The advantage is described well by Visa CEO Charles Scharf:

"We spend a tremendous amount of time thinking about disintermediation risk, so we don't take it lightly. But I always tell people, creating a network isn't hard. It's just creating authorization, clearing, settlement, you can all get a couple of people to do it for you in a couple of days. That's not the value that we provide. The value that we provide, it starts with the safety, security, and reliability that I talked about. It is all about the fact that we're accepted at 40 million locations across the world. It's the fact that we give merchants access to 2.5 billion cards with all the standards that we have. But more importantly, on the issuing side (banks) and more and more over time on the merchant side (retail partners), we're the payments partner for the people we do business with. And once you move away from the biggest banks in the world, most think of us as the extension of what they do."[+]

Where new technologies are perceived to be a threat, often those new businesses add volume to the "rails" (authorising, clearing, settlement) of the existing payment networks. An example of this is Apple Pay, which despite having an incredible consumer network lacks the requisite skills in fraud protection and processing to perform the payment task itself. Instead it partners with MasterCard for payment execution.

Other potential competitors repelled over the years have been telco companies and other utilities. Cell phone carriers have some of the key elements of the required infrastructure to compete; the ability to track and bill transactions, and a large existing customer base, so they have the major elements of a payments system. The missing components are customer service, chargebacks, fraud and (the real issue) a merchant network. Verizon and AT&T backed by other German telcos tried to enter the payments market in 2010 and failed[˜].

4. Platform Distribution: System

The Global Distribution System (GDS) within the travel sector provides a clear example of an incumbent underestimating the power of direct distribution. GDS systems, which connect an airline's inventory directly to travel agencies' systems (including online agencies such as Expedia or Webjet), now account for over 50% of global airline bookings. In the mid 1990's, airlines assumed that the middlemen who came between them and their passengers were structurally challenged. Airlines believed travelers would eventually buy tickets either from the airlines' own websites or from price-comparison engines which linked to the airlines' computers over the web. So why pay commissions to agents? And why continue to own reservation systems, especially since regulators had stopped them from interfering with travel agents' GDS screens to place their own flights at the top? So Lufthansa, Air France and Iberia sold the majority of their shares in Amadeus; American Airlines exited Sabre; British Airways and KLM sold out of Galileo; and so on. Underestimating the power of direct distribution turned out to be a great mistake for the airlines. Scale benefits led to rapid market share consolidation, with Amadeus commanding a 45% share of the GDS market, resulting in formidable bargaining power. The aviation industry vastly underestimated the role the GDS systems played in aggregating complex inventory and distributing it in an efficient manner. In doing so, the airlines effectively gave away their direct relationship with their customers and a significant profit margin to the GDS owners. By owing the travel agency relationship, Amadeus has drawn on the GDS technology to expand into the hotel market and other adjacencies, driving home its distribution advantage.

Indirect Third Party Distribution (Wholesalers)

The old model of third party distribution built on scale, physical assets, inventory management, low cost delivery and outbound sales is under threat. Greater price transparency for clients, and lower cost to serve due to online sales models have reduced the barriers to entry for new entrants acting as aggregators. However, some third party aggregators are finding ways of providing added services to clients, thereby improving the stickiness of their customer bases.

Take the example of Henry Schein, a third party distributor of healthcare products to dentist, veterinary and physician's practices, primarily in the United States. Looking specifically at the company's dental business, Henry Schein has a 40% share of the US market. This share was initially built on a mail order business and the scale advantages that came with acquisitions consolidating the market over a multi-decade timeframe. Henry Schein's legacy of distribution scale has allowed it to connect with a wide range of customers, which in turn positioned the company to develop the most comprehensive depository of industry data available in the market. Using this data, management is able to inform clients that they are under-charging for procedures or demonstrate inefficiencies within their respective practices. Management does not charge for this service, however it is only available to clients that purchase minimum volumes via the Henry Schein network.

Furthermore, Henry Schein will provide an Enterprise Resource Planning (ERP) system to help practices manage their respective offices. The system will help with billing analysis, productivity, customer communication and inventory management; all critical components required to run a small

organization. Interestingly, Henry Schein prices its ERP below where comparable systems are sold on a standalone basis. Where Henry Schein extracts value is via the inventory management system within the ERP that links directly with Henry Schein's online inventory purchasing function, thereby driving repeat purchasing activity. By using its legacy distribution assets and its database of procedural information, Henry Schein can enhance its distribution model and create customer locks well beyond those developed by standard distribution businesses.

Retail 'Business to Consumer' Distribution (B2C)

The most prevalent model is the traditional store network where either proprietary product or aggregated third party product is sold. In many cases these businesses can be quite fickle if exposed to changing consumer preferences or fashion trends. However, there are businesses for whom their distribution models protect them from rapidly changing consumer preferences or the threat of new entrants, both physical and online.

Costco uses a membership-only warehouse club business model. In this model, consumers pay a membership fee to access the low-cost products available at Costco stores. Costco's strategy is cost leadership which is achieved by keeping its distribution strategy exceptionally simple. The stores are effectively large warehouses, with bare concrete floors, exposed steel beams in the ceiling and merchandise remains stacked on the pallets on which it arrived. The efficiency of the distribution system is enhanced by limiting choice, stocking 4000 different items compared to around 50,000 for the average super-market, concentrating its buying power to fewer suppliers and reducing logistics costs. The savings derived from low-cost distribution and operations is returned to the customer via the gross margin; Costco marks up product only 15% compared to 25% for a standard super market. By keeping the distribution simple, Costco can bring its buying power to bear on behalf of its customers, driving customer loyalty and repeat purchase.

Measuring the Power of Distribution, Competitive Advantage and Potential for Disruption

Our team spends a lot of time assessing the potential for disruption amongst our "focus list" (the list of businesses we have assessed as passing our quality filter). We pay special attention to the early signs of competitive erosion. We pay particular attention to the customer retention ratio; the rate at which the company is losing customers which may suggest the emergence of new or reinvigorated competition. We remain laser focused on market share changes and where possible attempt to reconcile management comments with industry data. Also, the subtle signs of competitive fade can manifest in the financials. An example of this is through the balance sheet and cash flow statement as movements in working capital balances. Firstly in inventory build, which may be an obvious sign of competitive leakage, but fade can also become apparent in receivables. Is a receivable blowout a sign that the products or services supplied by this company are becoming less useful to the client; why are customers not paying their invoices on time?

Perhaps the most critical issue we address in assessing competitive position is the frequency of new entrants into an industry, especially as new entrant competition is often repelled by the strength of the incumbent's distribution systems. The team at AKO Capital, based in London, do a good job of articulating the need for focus on this issue:

*"Some industries or products are more likely to come under competitive attack than others. If an industry has many new players popping up all the time, beware: barriers to entry are low. However, industries with low barriers to entry may still have high barriers to success and scale – just look at the restaurant industry. Still, a regular flow of new small entrants can destroy economics. By the law of large numbers, the sheer frequency of new entrants can eventually lead to one of them becoming successful and disruptive. The fact that an industry has few or no new entrants is usually a good sign. It indicates that barriers to entry are high and tends to lead to more rational competition. Observing many older players in the industry is also encouraging – it's a sign that long-term survival is possible."^*

Nordson

Nordson provides an excellent case study of a business repelling new entrants. Nordson manufactures products used to dispense, apply and control adhesives, coatings, polymers, sealants and other fluids. It was started in 1954 but has roots back to 1909, indicating that as an old competitor it is possible to survive.

We can also test the power of Nordson's distribution system by assessing the success of new entrants attempting to compete. At the core of Nordson's product set is the manufacture of hot melt adhesive dispensing systems where its products are used to seal cartons and affix electronic circuit boards to mobile phone chips, amongst other applications. Nordson has a formidable market position, with market share of over 60%, some five times its nearest competitor. While Nordson has very good technology it is the direct sales and service team that provides industry-leading support everywhere in the world that protects the business from competition. Direct distribution and on-the-ground servicing infrastructure throughout the world is a significant competitive advantage; most competitors go through distributors, or operate only regionally and as such are not able to support national or global customers. Nordson's direct, highly consultative sales approach helps to better understand customer needs, provides input into research and development and helps to lock-in aftermarket revenue. Sales reps are usually on the floor of the customer every week or two.

When high quality fluids dispensing company Graco attempted to enter the market a few years ago, we had the opportunity to test Nordson's competitive position. Despite Graco having comparable (arguably better) dispensing technology, the

company was unable to match Nordson's direct sales and servicing capability. Graco sells via indirect distributors and lacks the technical support necessary to reduce factory down time. This confirmed to us that Nordson has the characteristics we are drawn to; a market leading position that has sustained over decades, direct technical distribution and an ability to repel new entrants.

CONCLUSION

While description of the various distribution models rarely falls neatly into predetermined buckets, having a broad framework for thinking about distribution is helpful in assessing competitive advantage. While the barriers to entry for business have dropped overall due to the disruptive force of the internet, amongst other technologies, the barriers to success remain high. Increasingly customers are looking for solutions for perceived needs rather than discrete products, therefore 'distribution scale' is no longer the source of competitive advantage it once was. The majority of the E&P International Focus Portfolio holdings sell via direct distribution, generally deploying a technical 'white coat to white coat' sales force that create sticky relationships with low customer attrition rates. It is those businesses with direct distribution where we are most likely to find the lollapalooza effect that can result in powerful investment outcomes and durable competitive advantages.

Appendix

*Business Models, Business Strategy, and Innovation. Teece, 2009

˚Understanding Michael Porter. Magretta, 2012

†ComScore; Market share of time on desktop and mobile

⁺Bernstein Strategic Decisions Conference, June 2016

ǂGoldman Sachs Global Internet Conference, May 2007

^Quality Investing. Cunningham, Eide, Hargreaves, 2016

˜Telco payment venture targets Visa and MasterCard. Reuters, 2010

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