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Industrial MRO: mapping the new market opportunities

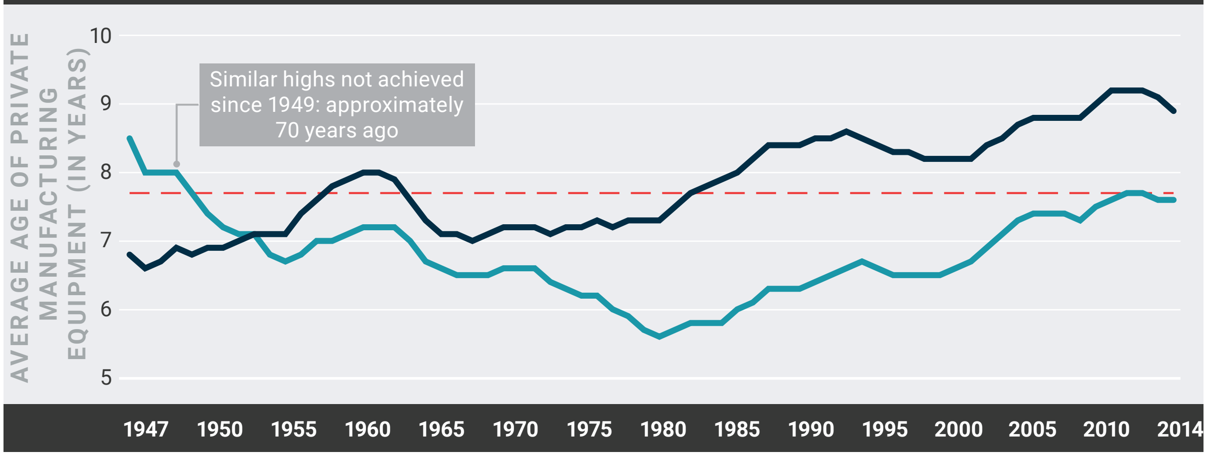
Even though the industrial MRO market remains attractive, distributors still face mounting pricing pressure. And relying on scale and SKU count alone won't help them avoid the commoditization trap. Rather, they'll have to distinguish themselves from rivals by putting customers' priorities at the center of their competitive strategies. The best among them seem to be already reconfiguring their operating models to do just that.

When it comes to the global industrial maintenance, repair, and operations (MRO)[1] market, the picture looks relatively rosy, characterized by healthy, stable cash flow. After all, with manufacturers continually seeking larger profit margins, they've been on a mission to maximize return on net assets (RONA). Rather than replacing equipment, they're rebuilding and repairing what they already have on hand—even for new programs and capacity expansions. The equipment they're using has grown older, with the average age reaching historical highs (figure 1). And as machines age, maintenance costs increase. Thus, we expect manufacturers' spending on MRO to continue rising during the next one to three years in an array of industries, including automotive, aerospace, life sciences, and food manufacturing.

For MRO distributors, the increases could partially offset the negative impact that pricing transparency has inflicted on their revenues and operating cash flows—an impact that has likely eroded suppliers'

[1] MRO supplies comprise items that customer companies buy to support maintenance, repair, and operation. Typically, the items consist of a mix of electrical supplies, personal protective equipment, motors, hand tools, machining consumables, fitting components, and other mechanical devices.

FIGURE 1: MANUFACTURING EQUIPMENT IS AGING



Source: Bureau of Economic Analysis

gross margins. But despite the promise of rising spending on MRO, such suppliers can't afford to relax based on the assumption that scale and stock-keeping-unit (SKU) count alone will safeguard their bottom lines (figure 2). Indeed, AlixPartners' analysis shows that increased scale doesn't necessarily translate into greater revenues or profitability. And even among the biggest players in this market, SKU count doesn't predict profitability either.

PICKING MRO MARKET WINNERS

Clearly, those seeking to pick winners in the MRO market must look beyond simple metrics like scale and number of SKUs. Instead, they must assess various disruptors' potential impacts on MRO companies' gross margins and operating cash flows. Some disruptors have an obviously negative impact on those indicators of MRO suppliers' financial health. For instance, pricing transparency likely limits suppliers' potential upside with regard to cash flow by providing customer companies cost breakdowns and benchmarking inputs. Extended equipment-design life may improve total cost of ownership for customers, but that may reduce long-term MRO costs for new machines, further hurting providers' cash flow. And use of predictive analytics and preventive maintenance reduces customers' spending on expedited service and high-margin products, hurting both gross margins and cash flow for MRO distributors.

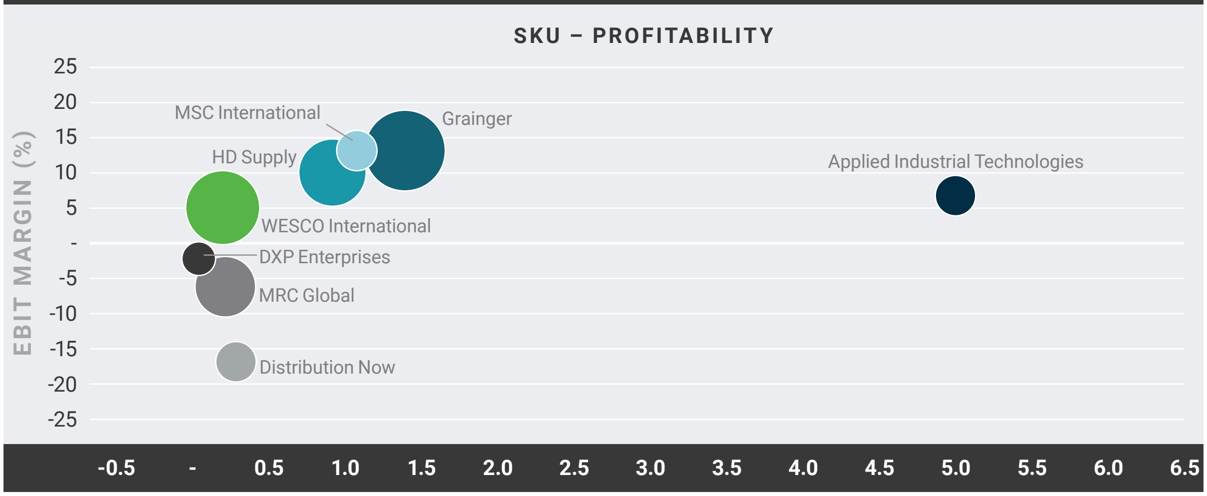
Other disruptors exert more-complex impacts. Take remote equipment monitoring and inspection. Although this disruptor has a neutral impact on MRO providers' gross margins, it could potentially hurt their operating cash flows by improving fault capture and reducing the number of repairs needed. On the other hand, it can have a positive impact on cash flow if a customer misses the data or fails to act quickly enough to prevent deterioration. Likewise, capitalizing on pervasive data and connectivity gains (Manufacturing 4.0) can erode MRO distributors' cash flows by limiting repairs caused by misuse. However, capitalizing on pervasive data and connectivity gains can strengthen their cash flows if it improves the accuracy, timeliness, and reliability of machine-related data (such as cycle-time variation) and oversight of quality data.

But of all of the disruptors that have the power to reshape the MRO market, those related to MRO providers' operating models, including their use of technology, offer the most promise for industry players. The fact is that rather than relying on their scales and SKU counts to gain competitive advantage, forward-thinking MRO suppliers focus on helping their customers reduce MRO usage and costs—which for some manufacturing companies could potentially range from 1 to 1.5% of total cost of goods sold. One recent study found that MRO can reach 5 to 9% of total indirect spend at typical manufacturing companies and as much as 10 to 20% at pharmaceutical and utilities players.[2]

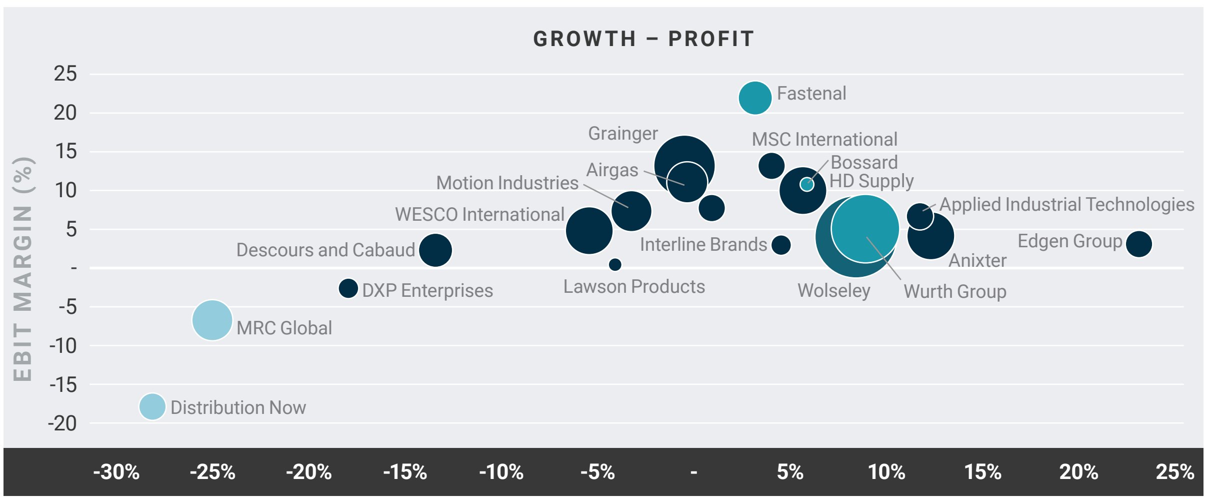
Our interviews with an industry supplier revealed that manufacturers typically want to reduce annual MRO costs by an average of 5%—in part to offset a roughly 3% inflation rate in raw-materials prices. According

[2] Steve Tracey, Kusumal Ruamsook, Lauren Bechtel, and Carol Colgan, "The MRO Revolution: Leaders, Evolvers and Trailers," Supply Chain Management Review, May–June 2016.

FIGURE 2: SCALE AND SKU COUNT DON'T GUARANTEE PROFITABILITY FOR MRO DISTRIBUTORS



Note: Size of bubble depicts revenue size
Source: Company reports

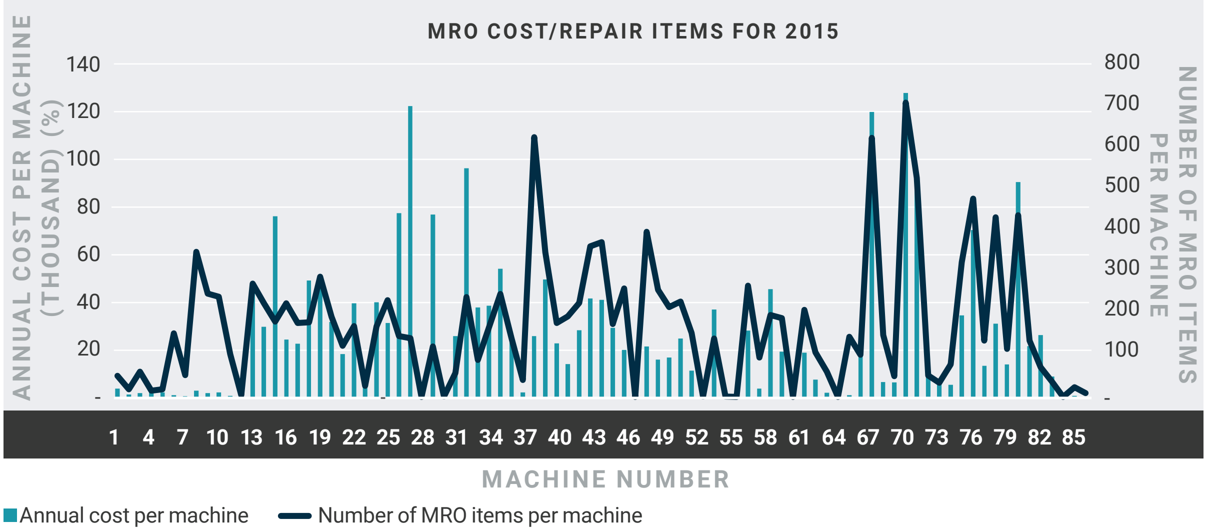


Note: Size of bubble depicts revenue size
Source: Company reports, Capital IQ, and Amadeus

to our analysis of data gathered from MRO savings programs across 200 companies, rationalizing and consolidating MRO suppliers could potentially save companies a percentage of total MRO spend. And customers could capture additional annual savings by negotiating with their suppliers on such matters as value-added services, freight costs, and terms and conditions, including compressed-payment-timing discounts. However, to attain any of those savings, manufacturers have to have a sophisticated understanding of their MRO usage and total costs and must exhibit consistency in their compliance with purchasing, delivery, and payment policies. Plus, they have to know how those factors affect their profitability. And because of competing priorities and a willingness to put off to a later date the efforts required to achieve all of that, very few companies have been able to cultivate that degree of in-depth understanding on their own. Many could benefit from the objective perspective third-party experts provide. Companies' difficulty in conducting such analyses also opens the door for MRO distributors to offer their customers the insights and assistance needed—an apt example of value-added service.

To help their customers get a handle on their MRO costs and improve throughput from their manufacturing equipment and other assets, savvy

FIGURE 3: ANNUAL MRO COST PER MACHINE AND NUMBER OF ITEMS USED PER MACHINE VARY WIDELY AND CREATE INSTABILITY THAT MRO PROVIDERS CAN EXPLOIT



Source: AlixPartners' case experience and analysis

MRO providers are turning to operational and technical innovation—with an eye toward boosting customer lifetime value. As customer lifetime value increases, so should distributors' gross margins and operating cash flows. Indeed, our analysis of 20 companies shows that MRO suppliers that seem to differentiate themselves through such means appear to be achieving outsize margins on earnings before interest and taxes—even if they're not leaders in terms of relative market size. In the sections that follow, we take a closer look at how these moves play out in practice.

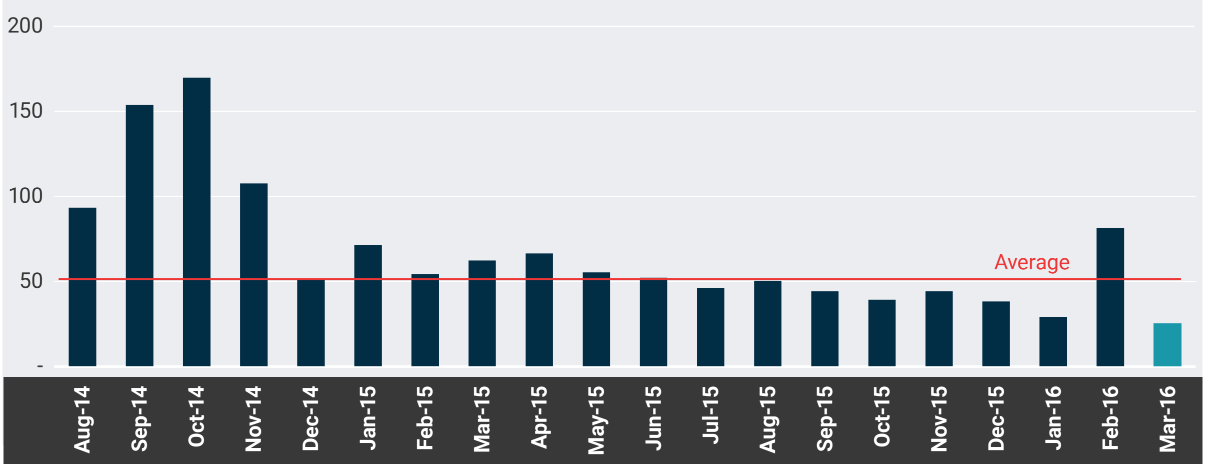
EMBEDDING IN CUSTOMER OPERATIONS TO LEARN MORE ABOUT THEIR CHALLENGES

Leading MRO distributors embed themselves in their customer companies' operations—for example, by operating on-site units located in or near a customer's facility that sells product to that customer. As a result, they garner valuable insights into their customers' thorniest challenges and their most ambitious goals, and they can use those insights to improve the products and services they themselves provide. Value-added services in particular strengthen customers' "stickiness," which translates into greater loyalty and thus higher lifetime value. Examples include having staff on-site at a customer's facility who receive, sort, and stock MRO supply shipments and providing vendor-managed inventory services whereby the distributor takes ownership of a customer's MRO inventory ordering and management processes.

To illustrate, suppliers who take that approach would see that many manufacturers are still seeking to maximize their RONA, while also improving earnings before interest, taxes, depreciation, and amortization. However, a singular focus on maximizing RONA can cause manufacturers to reduce capital expenditures, deferring large-scale maintenance and rebuild projects to make the business cases for new product programs look more attractive to executive management and customers. That strategy leads to more reliance on MRO providers and a greater need for urgent responses from providers in such forms as premium transportation of essential parts and supplies—all of which can translate into higher margins for distributors. (Indeed, some MRO providers have developed same-day-delivery capabilities for customers' core product lines.)

After all, old equipment needs more care and repair, and that can raise per-machine MRO costs (figure 3). Manufacturers with mostly aging equipment may have difficulty in getting parts and services from their MRO providers in time to make needed replacements or repairs (figure 4). But only the most-progressive manufacturers quantify the cost of spare-part stockouts to better manage MRO inventories and responsiveness, suggesting that MRO providers can practice value selling rather than slip into a commodity-supplier mind-set.

FIGURE 4: GENERAL STORES STOCKOUTS ARE COSTLY, AND ONLY THE TOP MANUFACTURERS HAVE A GOOD HANDLE ON THE ASSOCIATED COSTS



Source: AlixPartners' case experience and analysis

On the other hand, changes in the US investment environment—namely, regulatory policies and trade incentives—and a renewed focus on reshoring could reduce overall machine age, leading to a decrease in MRO spending—or at least to a neutral impact on such spending. Thus, the historical trend of revenue growth's following GDP may become altered because active machines and equipment are so old.

CAPITALIZING ON TECHNOLOGY TO HELP CUSTOMERS MANAGE MRO

Leading MRO suppliers are using proven technologies as well as productivity tools and methods from other industries to help take cost out of their customers'—and their own—operations. In so doing, they're managing to distinguish themselves from rivals in a highly competitive environment while also beefing up their bottom lines. Examples are the stocking of consumables in vending machines at a customer's location, which significantly lowers costs for customers by simplifying the process of replacing tools. Some of the vending solutions are storage lockers and carousels that can stand alone or be combined with other machines that promote employee safety and morale. Inventory is managed through network- or Web-based software.

Use of e-commerce could be a game changer for MRO distributors' margins by enabling them to achieve new efficiencies. At the same time, e-commerce could give them easier entrée to their target markets, thereby producing fresh revenue streams. Examples of e-commerce solutions are Websites offering searchable online catalogs with online ordering capabilities and workflow management tools and software that help customers mitigate overall equipment effectiveness losses. Equally promising is proprietary software that can track all SKUs available and help customers and sales representatives see, in real time, which products are in stock and how their prices compare.

As the e-commerce channel becomes more sophisticated in this industry and grows closer to pure play, distributors should become able to start reducing their sales force overheads; and the margin impact of the technology will likely improve further. Indeed, highly utilized e-commerce solutions could help MRO suppliers lower their selling, general, and administrative costs.

To capitalize on the advantages offered by e-commerce, however, MRO suppliers will have to first overcome customers' skepticism about or resistance to such technologies. Perhaps not surprisingly, many manufacturers prefer to stick with the familiar, relationship-based way of doing business with their suppliers. The keys to converting such customers include making it easy for them to use the e-commerce channel and providing training as needed.

CONCLUSION: AN INCREASINGLY TOUGH—AND ATTRACTIVE—MARKET

The industrial MRO market remains attractive, with major players enjoying above-market operating cash flows. Customers' MRO spending will likely continue as manufacturers maintain aging equipment, further improving the market picture. At the same time, MRO distributors must still contend with the threat of commoditization and pricing pressure, the latter having intensified with increased cost element transparency coming from advanced purchasing practices and global competition. The best among them are fighting back—distinguishing themselves from rivals by helping customers reduce MRO costs and getting more throughput and value from their manufacturing assets. Savvy suppliers are also taking a page from other industries' technology books by investing in new tools and such channels as e-commerce and by using technology to provide unique offerings that customers prize, such as vendor-managed-inventory services.

Even as this market remains steeped in tradition, powerful forces (think Amazon) are reshaping the landscape. Among MRO distributors, the ability to drive major change—including rethinking their operating models and technology investment decisions—will likely separate the winners from the losers in the future. **A**

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