The Best Defense Is Offense: How B2B Distributors Can Dominate with a Marketplace

B2B Distribution Strategic Action Plan – March 2017
Executive Summary

Intended Audience: CEO, C-suite and Board of Directors.

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Introduction: Amazon Business is a Major Threat to B2B Distributors

Amazon Business is a major threat to B2B distributors, but large distributors still have time to take action and come out ahead once the dust settles. To succeed, distributors must embrace the new marketplace platform business model that Amazon also employs.

There are multiple ways to capitalize on this marketplace model, as we will discuss further in this white paper. However, only through business model innovation will the largest distributors combat the inevitable disruption spearheaded by Amazon Business, while also gaining market share in their industries.

And, swift action must be taken. Looking at the numbers, Amazon Business’s rapid growth over the last year belies any assertions that it can’t get traction in B2B industries.

In 2016, Amazon Business's marketplace surpassed $1 billion in sales1, and its marketplace has been growing at 20% month over month. It also has more than 9 million product listings, up from less than 4 million a year ago. If the business unit keeps up its pace, it could surpass $8 billion in sales and 15 million listings in 2017.

Amazon’s Price Competitiveness

In our previous whitepaper, “Disruption at the Gates: Monitoring The Threat of Amazon Business,” we examined Amazon’s pricing and
product availability compared to top electrical distributors. We found that Amazon already had much greater catalog depth as well as cheaper prices compared to top electrical distributors. (If you’ve already read our previous whitepaper, feel free to skip ahead to the next section.)

As you can see in the graphic above, Amazon Business’s product catalog depth is far beyond that of its top competitors in the industry. In wiring connectors, Amazon Business has 77,764 listings compared to a Big-4 distributor’s 2,855. The disparity in other categories is even wider.

The common response to this disparity from distributors is that Amazon lacks top quality items. Yet when comparing a Big-4 electrical distributor to Amazon, Amazon had products listed from 106 of the 120 manufacturers offered by a Big-4 distributor. Even worse for distributors, 96 of these 120 distributors, or 80%, already sell directly on Amazon.

In addition to extensive product listings, a number of these distributors also have extensive branding on their Amazon Business storefronts, including intro videos and links to their social media accounts, all of which indicate that they are very active on Amazon’s marketplace.
Finally, we looked at price competitiveness by comparing top-selling products from a Big-4 Distributor with Amazon Business’s listings. In each instance, we were able to find the exact same product offered by the Big-4 distributor on Amazon Business’s marketplace. For the full breakdown, check out our previous whitepaper, but we’ve included one such example below.
Amazon Business was able to beat the price offered on each of these identical items compared to the Big-4 distributor. That many of these items were also available as part of Amazon Prime further widened the disparity.

**Measuring the Financial Impact of Amazon Business**

While we first looked at electrical distribution, this price disparity is already true in many B2B distribution industries. Earlier in March 2017, Grainger CFO Ron Jadin admitted that the company was not competitively priced during his presentation at this year’s annual Raymond James Institutional Investor’s Conference.

While Grainger remains competitive on large contracts, where it offers significant discounts from list pricing, it has fallen behind on small and mid-sized contracts and spot buys. This latter segment makes up some 42% of Grainger’s $10.1 billion in revenue.

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**42% of Grainger’s $10.1 billion in revenue is at risk of being discounted up to 25%**

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**2016 Revenue Growth**
- U.S. Large: -1%
- U.S. Medium: -11%
- Canada: -18%

“As competitors with new lower cost business models are able to operate with lower prices and gross profit on products [...] these competitive pressures could adversely affect Grainger’s sales and profitability.”

**2016 Revenue for Grainger - At Risk (Not Competitively Priced) vs. “Big Contract” Revenue**
This lack of price competitiveness has already started to hurt Grainger’s business, as 2017 revenue growth was negative in North America, its largest market.

During his presentation, Jadin announced that to correct this price gap Grainger would cut web prices on most of its listings by 15-25% over the next 18 months.

In our recent webinar, we showed financial projections resulting from this price cut, and the results were dire. (Link to full webinar video recording is in endnotes.2)

The best-case scenario showed overall revenue staying high, with only a 4.4% drop over the next three years. Yet this small dip in revenue leads to a 56.6% drop in Grainger’s EBIDTA and 54.5% decline in its operating margin by 2019.

We view this estimate as conservative, given that we exempted from our analysis the 58% of revenue that Grainger earns from contracts with large businesses. The only part of its business affected in our analysis is spot buys or smaller contracts where list-price discounting and a sophisticated sales team are less of a factor. We also slowed the price-cut rollout so that it happens over three years rather than the 18 months Grainger has stated publicly.

This analysis demonstrated that even if Amazon Business only commoditizes a handful of small, high-margin items, it can severely impact distributors’ net profit margins even as their overall revenues stay high. We’ve found similar results with top distributors in other B2B industries.

Outlook will likely only get worse for distributors as Amazon wades deeper into the B2B sector

The news will likely only get worse for distributors as Amazon wades deeper into the B2B sector. Per leaked court documents, Amazon has identified custom pricing as a key factor in the success of Amazon Business.

So while distributors’ custom pricing on large contracts may be defensible today, it likely won’t be an inimitable advantage for long. Amazon Business will ultimately put margin and price pressure on those large contracts, just as it does with smaller orders and spot buys today.

While Amazon has specifically and publicly set its sights on industrial supply distributors like Grainger, distributors in related industries like building materials,
metals, chemicals, electrical supply, electronics, auto parts, and medical supply should all be worried.

B2B distributors need to learn from those who have fallen to Amazon before. Consumer retailers only played defense, launching e-commerce sites and not creating a network of third-party sellers. Circuit City went bankrupt. Best Buy lost 40% of its market capitalization from ten years ago. B2B distributors can't afford to repeat the same mistakes. Better yet, they don't have to: they can take action now and go on offense.

How Distributors Can Fight Back: Embrace Platform Innovation

Following our webinar, all of the B2B distributors and industry analysts we spoke to agreed that distributors are in trouble. But they all had the same question: what can these companies do to fight back? This whitepaper intends to answer that question.

The threat from Amazon Business is very significant. But as customer expectations continue to shift and traditional business models start to crumble, there is also an opportunity for innovative distributors in these industries to grow their market share and their business.

The answer for these distributors is to take advantage of their own marketplace platform initiative. With its scale and resources, Amazon Business will likely succeed as a generalist B2B marketplace. This would mean that Amazon will own a substantial portion of many B2B distribution industries.

However, given the size and significant fragmentation present in these industries, there also is tremendous opportunity for vertical-specific marketplaces to emerge before it's too late.
Large, established distributors are well positioned to capitalize on this opportunity. Why? Think of this marketplace model as the modern version of the current distributor business model.

In this white paper, we will briefly cover the advantages of this model compared to the traditional distribution model. However, if you would like a much more in-depth analysis of how platform business models such as marketplaces work, we strongly suggest reading our best-selling book on the subject, Modern Monopolies.3

Additionally, we will look at the considerable advantages that incumbents in these B2B industries will have in making a marketplace successful compared to startups or outside tech companies.

Building platforms has been the secret recipe for success in Silicon Valley for the last 20 years. But now the secret is out, and the time is right for B2B distributors to embrace platform innovation.

With the blueprint we've provided in Modern Monopolies and with the work we do with our clients, we strongly believe that the next generation of successful, multi-billion dollar platforms won't just be tech companies and startups. It will be dominated by traditional businesses that have taken this recipe for industry disruption and turned it to their own advantage.

We will explain how traditional distributors can leverage their existing supply chain and industry knowledge to jumpstart a platform's growth. Like Amazon, they can succeed by employing a hybrid model combining a marketplace with their traditional business models. Additionally, we will look at the potential approaches for embracing platform innovation, which include building, buying, investing, and partnering.

Next, we will discuss how to assess your current business to understand which approach to take. We'll describe the different reasons to favor each approach, as there is no one-size-fits-all solution for each business. The right way to pursue platform innovation will depend on company culture, present capabilities, and the state of your industry, as we will explore.
Finally, we will show you how Applico can help you create your strategic action plan with its marquee advisory offering, Platform Design.

While building a platform is a complex, multi-year endeavor, this white paper will get you on the right path to not just surviving the threat of Amazon Business, but to thriving in spite of it by embracing platform innovation.

In order to make these exchanges happen, platforms harness and create large, scalable networks of users and resources that can be accessed on demand. Platforms create communities and markets that allow users to interact and transact.

Marketplaces like Airbnb, Uber, or Alibaba’s Taobao are one type of platform. But platforms also include content platforms like Instagram or YouTube, social networking platforms like Facebook, development platforms like Apple’s iOS, and payment platforms like PayPal, among several other platform types. Like a marketplace, each of these businesses simply connects producers and consumers to each other and allows them to exchange value.

**Platforms 101**

First, let’s be clear about what we mean when we’re talking about a platform. We’re not talking about a piece of technology or a suite of software tools, as the term is often misused.

We are very specifically talking about a business model.

So what exactly is a platform?

A platform is a business model that facilitates the exchange of value between two or more user groups, typically a consumer and a producer.

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An important part of this business model is that inventory is owned by third parties and is not on the balance sheet of the platform. The platform is solely focused on building and facilitating an external network. Platforms don't own, to use a common phrase, the means of production – instead, they create the means of connection.

What do we call traditional, non-platform companies? We call them linear businesses, because their operations are well described by the typical linear supply chain in which value flows mostly in one direction from the producer down to the consumer.

Linear businesses own their inventory, whether it's a car manufacturer like Ford or a subscription content provider like Netflix.

Linear businesses own their inventory, whether it's a car manufacturer like Ford or a subscription content provider like Netflix, which either creates or directly licenses all of its content. It's important to note that not all tech companies are platform businesses. Technology is an important enabler of the business model, but using modern technology does not automatically make a business a platform.

**The Hybrid Approach**

Not every platform company takes a pure platform approach. Some like Apple and Amazon, take a hybrid approach that combines linear and platform business models. While not right for every industry, combining these two business models can be tremendously effective and lucrative – allowing a business to capitalize on the strengths of each business model.

For example, Apple's core revenue generator is still a linear business: designing and selling hardware, most notably the iPhone.

Even though Apple still earns most of its revenue from selling devices, its core differentiator is its platform, iOS. Remember the slogan for the early iPhone? “There’s an app for that.” Apple knew that its core differentiator was its large network of app developers.

The company had learned the hard way that failing to embrace the platform business model can be fatal. It opted for an entirely closed, linear approach in the desktop computer era and it ultimately lost to Microsoft and nearly went out of business.
While the iPhone was initially closed and linear, Apple quickly built up its development platform and opened it to third-party software developers. Smart move for Apple, as iPhone sales increased 300% (5.4 million to 15.7 million) with 2 billion iOS app downloads in the first year alone after the App Store was launched.

Still today, Apple’s millions-strong network of app developers is the key reason it has stayed in the lead as a premium smartphone seller. Its hardware innovations are quickly commoditized or replicated by competitors. Its network can’t be.

Amazon also has combined a linear and platform approach in its B2C e-commerce business. While Amazon started as a linear bookseller, much of its success in other areas of e-commerce has come from combining its linear approach with its Amazon Marketplace.

The Amazon Marketplace, which consists of third-party sellers listing items on Amazon, has been one of the fastest growing areas of Amazon’s e-commerce business.

*Amazon Marketplace is its fastest growing e-commerce business unit*
The marketplace also is one of the most profitable parts of its business. Amazon takes a cut on all third-party sales on the marketplace, typically 14-30% depending on the product category. It also makes considerable revenue from additional services offer to sellers, most notably Fulfilled By Amazon.

The Fulfilled By Amazon service allows sellers to house their inventory in Amazon warehouses and let Amazon handle shipping when a customer places an order — meaning all FBA items are eligible for Amazon Prime shipping when consumers buy them. Sellers are charged a fulfillment fee per item based on weight, and they are charged a monthly inventory storage cost for each item stored in an Amazon warehouse.

Fulfilled By Amazon is a key reason that Amazon's third-party marketplace has grown so quickly. The Amazon Marketplace had a record year in 2016 and now surpasses 40% of all sales made on Amazon.com.

Additionally, more than 80% of all items listed on Amazon.com are from third-party sellers, meaning the marketplace is a significant factor in enabling the company to capture long-tail sales. Amazon also can use data on third-party sales to help it identify where to invest in its linear e-commerce business.

That's why Amazon still generates the majority of its e-commerce revenue (though less of its profit margin) from the relatively small number of items it sells directly. These items are ones that Amazon has identified as major sellers and where it is strategically important for Amazon to have quality, inexpensive items available. Its white-label Amazon Basics products are a key example, but Amazon also acts as a reseller on a number of other top-selling items.

By combining its platform and linear approach, Amazon captures the best of both worlds. It gets the quality and price control of a linear business with the wide selection and profit margins and wide selection of a marketplace. Its linear business also effectively subsidizes the marketplace, acting as the “first customer” for all of Amazon's logistics, warehousing, and shipping services that it offers to sellers.
The Fulfilled By Amazon example is particularly relevant for large B2B distributors, who have their own logistics and financial services that they can open up to third-party sellers in a marketplace approach.

**How Platforms Become Modern Monopolies**

To understand how platform business models scale, we need to start with the economics of information goods, such as apps, music, or e-books. To create a mobile app, it might cost $250,000 to produce the original version, but creating a copy of that app for user #2 will cost next to nothing. In the language of economics, the app has near-zero marginal cost.

Thanks to the Internet and connected technology, information goods today have a near-zero marginal cost of distribution. The cost to serve one additional customer is basically zero. A typical e-commerce site benefits from this dynamic on the consumer side – serving a large number of customers becomes much cheaper and more efficient than in the past.

Platforms take this advantage a step further. They remove the high fixed cost of creation and extend zero marginal costs to the supply side of the business. If Hyatt wants to add rooms, it needs to build more hotels, or as Marriott did, it needs to acquire them at great cost. When Airbnb wants to add more rooms, it just needs someone to create a new listing on its website. This costs the platform next to nothing. It doesn’t have to build rooms or acquire companies – it needs to acquire users.
Platforms eliminate the marginal cost of production by just focusing on facilitating connections. The network handles production, and it does so more and more efficiently as that network grows.

Platforms eliminate the marginal cost of production

At the same time, the more people join a platform’s network, the more value users get out of joining. Revenue begins to grow much more rapidly than costs. As this happens, the cost of user acquisition declines and the value the platform creates starts to reach the bottom line. In other words, platform businesses become exponentially more efficient as they scale.
Average cost declines while value to each user increases. As a result, a platform’s profit margin significantly increases as its network grows.

The result is that platforms are the natural business model of the Internet: They are pure zero-marginal-cost information businesses.

This networked production radically changes the cost structure of a business and alters the amount of internal resources it needs in order to create value.

Networked production radically changes the cost structure of a business.

Linear businesses generally grow by adding staff or physical assets, or both. Since these tactics create value by controlling production, linear companies have to invest significant resources in expanding their capacity in order to sell more inventory.

But physical assets and employees don’t scale well. Networks do.
While the upfront costs of launching the business are still relatively high, platforms require much less capital expenditure to be successful at scale. They also require far fewer internal resources than linear businesses do. For example, platform companies require relatively few employees to be successful. Uber, Airbnb, and LinkedIn each run their global operations with fewer than 8,000 employees. Similarly, Alibaba had fewer than 35,000 employees at the beginning of 2015. In contrast, Walmart, which has a total sales volume similar to Alibaba, had over 2 million employees.

For platforms, the nature of networked growth and the low marginal cost of production means that expenses typically don’t grow as fast as revenue does. The costs of a linear business will always continue to rise as it grows, while the costs of a platform’s growth tend to level off logarithmically. Thus, the potential market size explodes.

Successful platforms aren’t constrained by the typical U-shaped cost curve that describes most linear businesses. Instead, the unit economics make it possible for successful platforms to grow to near the total size of the market. This means that usually only one or two platform companies will come to dominate a market.
The average cost curves for linear and platform business.

For example, Alibaba controls 56.6% of the Chinese e-commerce market, while Google dominates search, both in the US and Europe (Baidu reigns supreme in China), and iOS and Android dominate smartphone operating systems both in the US and globally.
Linear businesses don’t cease to exist in platform markets. But their growth potential is often severely circumscribed. Niche players still survive by serving segments of the market the platform doesn’t address adequately. Nonetheless, there’s typically one dominant platform, with at most one other business enjoying a sizeable share of the market.

*Traditional industries will not longer be exempt from the brunt of Silicon Valley’s furor.*

As more and more industries become integrated with connected technology, platforms will take over more of the global economy, including traditional industries that have been mostly exempt from the brunt of Silicon Valley’s furor.

**The Financial Upside of Platform Innovation**

It’s not just Applico that believes in platforms. Investors love platforms, too.

Successful platforms have strong moats in the form of their networks and operate at a scale that positions them to dominate their industries. It’s no wonder, then, that platforms are worth more than linear businesses.

According to our research using publicly available market data, investors value platforms more highly than their linear equivalents. Looking at the S&P 500, pure platform businesses or businesses for which a platform is a significant part of their business have an average revenue multiple of 8.9. In contrast, linear businesses are valued between two to four times revenue on average, depending on their business model.4
Taking a more nuanced look specifically at marketplaces, we found similar results. Looking at the EV/Sales Multiple of marketplaces like Amazon, Alibaba, eBay, Copart and Ritchie Brothers Auctioneers compared to top distributors, we found marketplaces were given an average multiple of 6.38x while distributors on average were given a 1.00x multiple.

Other research has found a similar valuation gap between platforms and linear businesses. It also has found that platforms have faster growth, better return on capital and larger profit margins.\(^5\)

With this in mind, it’s clear that incumbent distributors not only have the opportunity to gain significant market share by employing a marketplace model, but they also can significantly improve how public markets value their businesses.
Capturing any kind of intense disruption in an industry is very difficult for an existing company to do, but platform innovation makes it possible. The incumbent has to restructure itself while continuing to run the old, existing model in tandem. For executive management operating in a public environment, this can be a daunting task and requires a long-term vision. With platform innovation, the vision is clear: embrace the platform business model.

The usual catchall phrase for embracing disruption is “digital transformation.”

Typically, digital transformation is meant to bring about the evolution of a legacy business model as it adapts to a changing industry landscape. There are multiple ways to transform a business, but not all of these methods are equally successful.

Frequently, industry leaders will decide to play defense and work to consolidate supply in the industry to prevent a platform from gaining a foothold. For example, Marriott bought Starwood Hotels in 2016 for $13 billion to add 330,000 hotel rooms to its inventory and become the largest hotel chain in the world with over one million aggregate rooms. On the whole, the hotel industry has roughly seven million rooms.

While this approach can provide advantages to the industry consolidator in the short- to midterm, it requires significant resources and time to properly execute a large acquisition and integrate the new company into the acquiring one. This focus also can distract the company from working on the long-term threat of a
platform continuing to disrupt the industry. This approach usually means doubling down on the existing business model rather than exploring new ones.

Another common strategy is to start thinking “mobile first” and focusing on e-commerce. This has been a popular strategy among B2B distribution companies out of necessity, as more and more business customers start to shop online.

Rethinking a linear business model through mobile and connected technologies can bring a great deal of efficiencies for a distributor’s internal operations and more satisfaction to its customers. But if new, lower-cost business models are attacking your industry, this is merely akin to plugging holes in your existing ship. What these companies really need is to figure out how to build a new ship.

For B2B distributors today, this means embracing platform innovation. Since these industries are being disrupted by marketplaces like Amazon, platform innovation is the most proactive approach any company can embark upon for digital transformation and it also has the best risk/reward ratio relative to the other available options. The problem with the other digital transformation tactics is that they don’t take into account the threat in the industry. When the platform business model is poised to take over an industry, like B2B distribution, consolidating supply or “mobilizing” your business is a futile and short-term solution that will at best delay the coming disruption.

Instead, platform innovation is proactive and enables the incumbent to use the disruptor’s business model (the platform) against the disruptor. As history has shown, the only viable, long-term strategy to combat a successful marketplace like Amazon is to embrace a platform, like Walmart has done in retail.
So, what does platform innovation involve? Building, buying, investing in or partnering with a platform business. Then, integrating the benefits from your existing, linear business to help scale the new, hybrid platform-linear business to become a modern monopoly.

However, embracing platform innovation too late can be an expensive and treacherous path.

Walmart serves as a case in point. The company launched the Walmart.com Marketplace in 2009. At the time, Amazon was experiencing rapid growth, partly due to its own marketplace, and Walmart was looking for a way to respond. But Walmart could only attract a very limited number of sellers.

While most anyone could join and sell on the Amazon Marketplace in minutes, getting into the Walmart.com Marketplace was a much more cumbersome process. Concerned about harming its brand with consumers, Walmart didn’t fully embrace an open, platform approach. Sellers were selected based on “reputation, sales projections and alignment with Walmart’s values.” The result was a marketplace that by late 2016 only had about 1,000 third-party sellers. Amazon’s marketplace had millions of seller by comparison.

So despite Walmart’s e-commerce presence having nearly a decade to take hold, only about 3% of its sales came from its website in 2016.

Then in August 2016, Walmart agreed to buy e-commerce startup Jet.com for some $3.3 billion. With Jet’s recent growth rates, Walmart was feeling the heat, especially with Amazon’s continued growth as the number-one platform.

Walmart’s biggest success was training its executive team to think about platforms

$3.3 billion was the price Walmart paid for not taking the Amazon threat more seriously. It likely buys Walmart the second largest e-commerce platform in retail, assuming Jet.com continues to grow. That’s a lot of money to pay for second place.

Still, Walmart’s marketplace wasn’t a complete loss. While the marketplace failed to give Walmart a credible competitor to Amazon, it did succeed in training the company’s executives on the difficulty of building a successful platform. They were willing to pay a premium to acquire Jet.com rather than risk falling further behind.
For today’s B2B distributors, the lesson should be clear. The costs of failing to embrace platform innovation can be considerable. Most don’t have the luxury of buying a multibillion-dollar startup so late in the game. The cost for them, like Circuit City and many other failed retailers, could be even higher.

Can B2B Distributors Succeed at Building Platforms?

When considering embracing platform innovation, most C-suite execs have a common question: What makes you think we can succeed? Building platforms has been a Silicon Valley game for the last few decades. Almost all successful platforms to date have been tech companies and startups. What’s changed?

First, the recipe for building platforms is no longer a secret. As we mentioned in the introduction, the blueprint we’ve provided in Modern Monopolies gives you what you need to start your company’s journey of platform innovation. Alibaba’s success in China also provides a blueprint to follow in the B2B space.

While China is a very different market from the U.S., there are many commonalities when it comes to building a platform in a B2B industry. There also are a few cutting-edge linear companies, like Klöckner in Germany, that have embraced the idea of platform innovation. These companies can provide incumbents with a roadmap for how to start the transformation from linear to platform.

Second, the time is now ripe for B2B marketplaces, as Amazon Business has started to show.
However, you may be thinking you've heard this all before, during the original dot-com boom. Back then, a host of B2B marketplaces launched with the kind of hype and sky-high expectations you would expect from that era.

In 2000, Gartner Group predicted that by 2004, the total transaction volume handled by these marketplaces would reach $7.3 trillion. Goldman Sachs had an only slightly less sanguine prediction of $4.5 trillion by 2005.

Yet by 2001, almost all of these marketplaces had collapsed. As described in more detail in *Modern Monopolies*, suppliers never showed up. The marketplaces had plenty of interested customers but nothing to sell to them. These marketplaces tried to get large industry incumbents on board from the start. But these large incumbents saw little value in a marketplace when they already had well-established sales channels that provided them with better margins. They rightly viewed a marketplace as a threat rather than a potential value-add.

Some of the more enterprising incumbents, like Arrow, invested in a handful of B2B marketplaces at the time in an effort to hedge their bets. But few major distributors actively embraced marketplaces.

Today, market conditions are very different. Back in the dot-com era, B2B marketplaces had to get large players to join or they wouldn't be able to get any supply. Internet access was not sufficiently fast, nor sufficiently widespread to support a marketplace of SME's. Not enough consumers were online at that point to attract these enterprises to join, and most of these enterprises wouldn't even have a website for a few more years, let alone an e-commerce presence.

Additionally, there was no e-commerce payments infrastructure at the time. PayPal didn't even IPO until 2002. And Stripe, the leading successful mobile payment processor, didn't even exist until 2010. In fact, it wasn’t really until the last half-decade that online payments became ubiquitous via smartphones. This was especially true in the more complex B2B market, where you aren’t typically dealing with small purchases.

Without easy access to online payments, marketplaces were unable to remove as much friction from the industry as they can today. Electronic payments now are easy and relatively frictionless.

At the same time, consumer behavior in B2B industries is increasingly shifting toward the standards of B2C. Consumers want price transparency and easy access
to information. In the past, confusion and opacity have bolstered margins in most B2B distribution industries. This is no longer true, as companies like Grainger are learning the hard way. A more open information environment favors platforms, which thrive on transparency and price competitiveness.

Finally, platforms thrive on fragmentation. Supply-side fragmentation makes it easier for a marketplace to attract producers. Successful marketplaces will typically start with a handful of small or midsize producers and build from there.

Marketplaces that start with one large anchor client often end up focused on providing custom solutions for that client and fail to scale sustainably by creating a broader network. Conditions in today’s market support that kind of bottom-up network growth while they didn’t during the dot-com boom.

The time of B2B platforms has come. Now it's time to take advantage of it.

5 Reasons Why Linear Incumbents Have an Advantage in Building the Next Generation of Platforms

Not only is the time ripe for B2B marketplaces, but incumbent distributors also have significant advantages when it comes to building them. While this may seem counterintuitive, it’s true.

1. **Access to Customers and Producers**

   Incumbent distributors already have close access to consumers. One of the biggest challenges every platform faces is the chicken-and-egg problem. In short, the platform needs to acquire both consumers and producers for its network. But without one side of the network there, the other won’t want to join. Via its established customer base, a large linear distributor can more easily overcome this challenge.

   Additionally, large distributors also will have ready access to producers, typically via their M&A departments. Many small and mid-size distributors are already selling on Amazon Business on fake pseudonyms. These existing M&A relationships can prove crucial in getting those first few producers to join your marketplace instead.
Deep Industry Knowledge

Incumbents know how to handle the more complex supply chains within B2B industries. They also understand the more nuanced customer expectations that come from dealing with business clients.

Additionally, these incumbents already know the pain points and challenges of smaller producers and will be able to design a platform that avoids the need for much of the “throw it at the wall and see what sticks” approach to innovation that’s common among startups.

Access to Capital

This one may be obvious, but incumbents have ready access to capital, while most startups are capital starved. Platforms operate very efficiently at scale, but they’re still expensive to start and grow. Building a network is extremely difficult, and it’s more expensive early on when the platform typically has to subsidize participation from its users. Access to funding can prevent a network’s growth from stalling out too soon, and it can help ensure a platform gets to critical mass first.

Maintaining Trust and Quality

One of the key aspects of building a successful marketplace is creating mechanisms that institutionalize trust. This was one of the sticking points for Airbnb, which decided to put trust at the center of its platform via its rating system. Trust is important because it enables users to overcome the fear of interaction risk, i.e., the chance that something may go wrong, whether it's a late delivery, a poor quality or counterfeit item, or worse.

Large incumbents have brands that have been trusted by the industry for decades. This brand will make it easier to get quality producers to join and it will attract quality customers. Networks exhibit what’s known as path-dependent growth. In plain English, this means that quality begets quality. Or inversely, poor quality products will scare away the best users. Starting out on the right foot makes a big difference.

Maintaining quality as network grows is one of the biggest challenges that every platform faces – from Twitter to Alibaba – and incumbent distributors have a big leg up in managing this challenge.
Preventing Platform Leakage

One of the main challenges for platforms, especially marketplaces, is the phenomenon of platform leakage. This leakage occurs when a user starts a transaction on the platform but completes it outside of it. For example, if you summoned your Uber driver then canceled the ride and arranged a lower fare when they arrived, this would be an example of platform leakage. Or likewise if you connected with an Airbnb host on the platform then booked your stay with them outside of it.

Platform leakage is the digital equivalent of showroming in traditional retail, where users would check out items in store and buy them elsewhere online. If not addressed, it can be the death knell to an otherwise successful platform. It was one of the main reasons behind the failure of Homejoy, a home-services marketplace that raised some $64.19 million before going out of business.

Platforms can take reactive measures to mitigate platform leakage, such as blocking the exchange of phone numbers or emails over the platform. They also can prohibit platform leakage in their terms of service and ban any producers caught circumventing the platform.

But the success of these kinds of tactics is limited at best, especially when there's an in-person component to the fulfillment of a transaction, as there is with any delivery or in-home service. The only true way to reduce platform leakage is to provide value through the platform that your users can't get anywhere else, in addition to the platform’s core matchmaking function.

The most common way marketplaces create this type of added value is by providing insurance. Airbnb and Uber both offer insurance that covers any accidents or mishaps that occur while you're completing a stay or trip, respectively. Additionally, they provide a measure of quality control and customer support when things go wrong. In short, they cover or reduce the potential transaction risk. If you transact outside the platform, you take on all the risk yourself.

Platforms can go a lot further than this, though, by providing additional tools and services that make transacting through the platform easier and more reliable. Amazon’s Fulfilled By Amazon program that we covered
Building or Buying vs. Investing or Partnering

If large distributors have considerable advantages when it comes to growing platforms, why haven’t any yet done so at scale? Well, distributors also have a number of organizational challenges when it comes to building or buying platforms.

In order for your digital transformation to be complete, your existing organization needs to adapt to and embrace the new platform business model you built from scratch or just acquired.

Ultimately, owning your own platform has the highest reward, but also the greatest risk. If these challenges seem too daunting, then exploring investment or partnership opportunities could prove to be more appropriate for your organization’s digital transformation.

After we cover what these challenges are, we’ll explain how you can structure your platform innovation initiatives to overcome them.

earlier is a great example. Merchants get access to Amazon’s logistics and warehousing capabilities while consumers get free and fast shipping (with Prime).

Large B2B distribution companies can similarly tap into their existing commercial infrastructure. This can include insurance, financing, and shipping, as well as enterprise-grade software tools that the business can open up to third-party producers who join the platform. These kinds of tools and services are not readily available to startups, but existing distributors can simply tap into services they already use or offer customers to help a platform grow.
New Mental Model: From Closed to Open

The mental model for your business needs to change drastically. Currently, the focus for distributors is internal. Employees work to make, market and sell the company's own assets.

In contrast, platforms are focused on facilitating and growing external networks. The mental model needs to shift from prioritizing what you own to focusing on what you can connect. In other words, your organization needs to shift from a closed to an open mindset. This includes welcoming in direct competitors to your network. Your platform can start with complementary products, but eventually you will need to open up to your competition as well.

Part of this shift in thinking is recognizing that you now have two customer groups: consumers and producers. Your past competitors are now potential customers. While traditional distributors already have established channels for acquiring consumers, most don't have similarly robust processes for converting other distributors into customers.

These two groups have many overlapping needs, but sometimes the interests of one side of the network will conflict with those of the other. For example, producers will want to be favored when it comes to issues like pricing, payment terms, and return policies. Consumers will have a different point of view.

Marketplaces thrive on transparency.

You will need to balance the needs of each side of the network so that both are getting sufficient value out of each transaction. This balancing act is unfamiliar to most linear businesses. Dealing with an external network of producers is very different from organizing a supply chain.

It often helps to have a simple rubric for which side of the network you prioritize. Kickstarter is unabashedly producer-centric while Amazon stresses a customer-first mindset. However, you can't simply focus on one side while ignoring the other. Balancing the needs of both sides of your network often means making concessions in some key areas and making up for it in others.
As an example, marketplaces thrive on transparency, and customers want it, yet for traditional distributors opaqueness bolsters margins. A marketplace will need to do away with the baroque pricing structures that distributors have often employed and offer simple, user-friendly pricing. It will have to find other ways to offer value to producers to make up for this change.

Know that producers are often the most difficult side of the network to acquire long-term, so make sure you have an adequate strategy for retaining your best producers while attracting more.

**Different KPI’s and financial metrics**

Your business’s key metrics need to change as well.

While investors value mature platforms more than they do linear businesses, they often struggle to understand the value of earlier-stage platforms. These businesses lack hard assets – they often own little to no real estate, for example, and no inventory – so they have a low book value. Other than amorphous line items like “goodwill,” traditional financial metrics also don’t have a good way to measure the value of an external network.

*traditional financial metrics don’t measure the value of an external network*

Social networking and content platforms like Facebook, Instagram and YouTube have shifted the focus away from these “hard” financial metrics toward ones like monthly or daily active users. Similarly, marketplace platforms should focus more on metrics like number and percentage of successful transactions, average cart size, and repeat customers.

Metrics like total sales or gross merchandise value (GMV) are often touted by marketplaces because they are the most similar to traditional gross revenue metrics that linear businesses report. While GMV can give you a sense of a marketplace’s market power and market share, it can also be a vanity metric temporarily pumped up by marketing spend.
Maintaining quality as your network grows is another big concern. Topline user growth metrics don’t capture the quality of interactions that your users are having. Often as platforms expand quickly, they compromise quality for more growth. There is a trade off between these objectives, and you need to balance these two priorities carefully. Platforms need scale to be successful, but sacrificing too much quality for short-term quantitative growth will only give you a pyrrhic victory. Don’t end up becoming the Myspace of marketplaces.

Focus on growing your network through repeat business alongside acquiring new customers. Make sure both your consumers and producers are happy. Talk regularly to your users. Marketplaces that fail to retain customers often have a big problem with platform leakage, so make sure you’re providing enough value to your customers (both consumers and producers) to ensure they don’t take their transactions off-platform.

Shifting Operations from Control to Facilitation

Your business needs to shift from a planning and forecasting mindset to an agile mindset.
Planning and forecasting are based on the idea of control. You can set up processes that allow you to control today what you will produce or distribute tomorrow. Because most of a platform's key activities involve external participants, it doesn't control its key assets the way a linear business does.

The network of consumers and producers that a platform supports is often called an ecosystem – and with good reason. Like a real-life ecosystem, a platform's network is constantly changing and adapting to its environment. A platform has to perpetually keep its ear to the ground and adapt to its network, which is as alive as the people that are a part of it.

For these reasons, designing a platform is less about industrial process design and more about sociological insight and continuous behavior design. Your focus shifts from controlling and planning your supply chain to facilitating an ever-evolving external network.

Part of this shift involves focusing less on the kinds of metrics that allow you to make sophisticated financial forecasts and planning decisions and more on user data that allows a platform to get a read on its users and react quickly. Rather than focusing on a few, large initiatives, a platform will test out many smaller ones and iterate on what works.
Misaligned Cost Structures and Incentives

The classic innovator’s dilemma is to be too focused on today's business model at the expense of the future. This challenge is exacerbated when you’re shifting to a new business model that is in many ways the opposite of how your company has operated for decades. The most fundamental example of this difficulty is how and for what your company allocates capital.

For example, while an increasing amount of business is done via e-commerce – Grainger projects as much as 80% of its revenue by 2020 – its cost structures haven’t caught up with this shift. Spending on sales staff and administrative costs still greatly outstrip spending on digital initiatives. Its sales, administrative and warehousing expenses are still almost 30% of revenue, while its online catalog is a mess and difficult to navigate.

Grainger has found that 90% of business is now going direct to consumer, skipping its branches entirely.

Marketplaces often have much leaner cost structures than their linear competitors. Prepare your business to shift toward a more asset-light strategy. Many of today’s assets will become liabilities tomorrow.

For example, Grainger has found that 90% of business is now going direct-to-consumer, skipping its branches entirely. As a result, the company has had to shut down more than 100 branches over the last two years, with more likely to come. As marketplaces take over more of an industry, this rate of change will only increase.

Finally, your employees’ and executives’ financial incentives are all aligned around your current business model. Asking them to execute a radical shift to a new business model while they remain financially aligned with the old one is a recipe for failure.

Asking them to split their attention between the two businesses also is asking for trouble. If you’re trying to build a new ship, you don't want the old crew also manning the new vessel. Typically you will need to hire new people focused on and aligned with your platform initiative. How to structure this initiative so that it addresses all these challenges is what we'll turn to next.
How to Structure your Platform Initiatives

As you can see, while large, incumbent B2B distributors have significant advantages when it comes to starting a platform, the challenges are formidable. Fortunately, there’s a simple way to sidestep many of these issues: make your platform an independent subsidiary.

As you might have guessed, all of these challenges together are usually too much for your current organization to overcome quickly. This magnitude of shift in mental model, culture, capital allocation, and incentives can take years for even the savviest and most devoted C-suites. That’s time that today’s distributors don’t have.

Incumbents’ platform initiatives must be given the independence they require to thrive and grow. The organizational processes and culture that distributors have in place today will stifle a platform and not give it the flexibility it needs.

Typically, designating the platform initiative as its own business unit is not enough. The Walmart.com Marketplace that we covered earlier is a perfect case in point. As we noted, the marketplace was only able to acquire a small number of third-party sellers, in large part due to its stringent entry requirements. These concerns were motivated by the quality-control processes of the existing business and concerns about the marketplace initiative harming Walmart’s brand.

While the Walmart brand could have been a significant help to its marketplace, too close of an affiliation meant the marketplace wasn’t given the chance to be as open as it needed to succeed.
Walmart learned this lesson the hard way. After its Jet.com acquisition, it announced that it will allow its new platform subsidiary to remain independent. This strategy is one that Facebook has also used to great effect with its key acquisitions. On the other end of the spectrum, Yahoo, known for trying to integrate almost all of its acquisitions, has had a number of very expensive failures.

The first step toward harnessing platform innovation is getting this business structure right. Some of the cutting-edge incumbents we mentioned earlier have also used this structure. Klöckner started an entirely separate startup, kloeckner.i, in order to house its homegrown digital and platform initiatives. Kloeckner.i also is led by Klöckner CEO Gisbert Ruehl, but the rest of its team operates autonomously from the core business.

Similarly, Ford recently acquired AI startup Argo AI for $1 billion to bolster its autonomous vehicle program. Rather than incorporating its acquisition into its existing autonomous vehicle business unit, Ford chose to do the opposite. Not only is it letting Argo AI remain independent, it's also moving some personnel from its existing in-house division to the startup. Ford announced that it will even let Argo AI license its software to some of Ford's competitors if needed.

Like these companies, you want your platform initiatives to be fully independent, including being able to serve some of your core business's competitors. You want this business to have its own office, its own dedicated team, and its own compensation structure aligned around the new business model.

It also helps to have a separate cap table, with your core business as the primary owner, to be able to offer equity to attract the talent your business will need. This structure allows you to capture the agility and culture of a startup with the resources and strategic sophistication of a large company.

*ideal scenario is that your platform and your current core business will coexist together*
At the end of the day, the ideal scenario is that your platform and your current core business will coexist together. But the platform needs to reach a level of maturity more on par with your current business model in order for that vision to become a reality.

**Marketplace Investments = Insurance**

If owning your own platform initiative isn't the right path for your distribution company, then investing or partnering could be the next best alternative.

Marketplace startups are looking for strategic capital to help them beat Amazon Business. By providing capital to these startups, you can help them get the financial resources they need while also giving your organization a back-up plan. As an early investor, you could have a path to acquire the marketplace startup if it hits its growth objectives. Arrow invested in a handful of marketplace startups in the late 90's just incase the threat of marketplace disruption escalated. However, as we've stated above, 2017 is very different from 1999 and B2B marketplaces are here to stay.

The multiples for these investments will be much higher than what your organization is used to paying when compared to your M&A activity. And, if you invest in multiple marketplace startups, the benefit you can pass along as a strategic investor will be diluted. If you invest in one marketplace startup, you can provide assistance to that startup by helping with user acquisition for customers and third-party sellers. However, if you have two marketplace startups in a similar industry, how do you decide which marketplace to send these users to? If the industry sees you investing in multiple startups, it also dilutes the confidence and brand loyalty boost that you can provide to any one startup.

**Partnering, Joint Ventures and the Anti-Amazon Alliance**

A lot of companies don't want to see Amazon get another monopoly. This list includes competitive marketplaces from overseas like Alibaba as well as local competitors like Walmart and Jet.com, eBay and many others. Other modern monopolies like Google also have rolled out e-commerce initiatives to rival that of Amazon. Microsoft is rivaling Amazon's AWS with their Azure offering and already has a huge enterprise presence.
There are also a host of other service providers that fear being displaced by the successful growth of Amazon Business such as shipping and logistics companies. Amazon is already a competitor with its Fulfilled By Amazon services with retail customers. However, its expansion into B2B industries could put a significant portion of revenue at risk for most major shipping companies. As B2B distributors switch to Amazon Business, the shipping relationship is with Amazon, not UPS, FedEx or a 3PL.

A competitive marketplace is the only business model that can legitimately prevent Amazon Business from winning in B2B distribution. Can your organization partner with other companies in an AAA (Anti-Amazon Alliance), reducing your risk and exposure to a successful marketplace initiative?
Take Action: Platform Design is Your Blueprint for Platform Innovation

The single most important ingredient for successful platform innovation is executive leadership. In order to succeed, you need buy-in from your C-suite team and Board of Directors. You will want one core C-suite sponsor who is primarily responsible for overseeing your platform initiatives. Ideally this will be the CEO, but CIOs, CTOs and similar C-suite positions are often better positioned to manage the initiatives on an ongoing basis.

That primary C-suite executive also will need an internal champion responsible for the day-to-day management of your platform initiatives. It's important that he or she have a long-term vision for the platform.

From our experience, employees that have been at the company for at least a few years are often the ones best aligned with that time horizon, as they are financially and emotionally invested in the company’s sustained success.

They also know the business, as well as relevant internal stakeholders, and they have the credibility to sell up to other executives. At the same time, this champion needs to be willing to question the status quo and embrace new ways of doing business. And it helps that this person be fluent with cutting-edge digital technology.

This person may exist within your company today or they may not. Often this will depend on company culture. The balance between these three concerns – long-term vision, innovative mindset, and technical capability – will determine if you have the right team in house or need to look to acquire new talent to spearhead your initiative.
Once you have these key people in place, you’re ready to start on the path of platform innovation.

**Taking Action: Platform Design**

If you’re a B2B distributor ready to take action, the first question is what action is appropriate for your organization. The second is what do you need to do in order to execute that initiative successfully. Applico’s marquee advisory offering, Platform Design, answers these questions in a two-month process.

![Chessboard](image)

### Assess the Threat

The first point of action is to assess the threat and get organizational alignment on how that threat could impact your business. If you don’t understand the threat, you can’t effectively solve for the problem (and the opportunity).

For most B2B distributors, the most significant potential marketplace competitor is Amazon Business. If you’re interested in getting a better read on Amazon’s progress in your industry, check out our [Applico Marketplace Tracker tool](#).
You’ll need to understand where a marketplace could attack your business and the impact this could have, both in the immediate and long term. We’ve provided an abbreviated example of what this can look like in our recent webinar on the impact of Amazon Business on Grainger. You can find the recording of it here.

The goal in this phase is to assess multiple scenarios, including the upside potential of each approach to platform innovation as well as the downside potential of not taking action. What is the impact on your business if a marketplace commoditizes even a small portion of the market? As we showed with Grainger, the impact can be disastrous. While overall revenue may still remain high, the marketplace's impact on prices can decimate margins.

Assess your Team and Existing Initiatives

Now that you understand the potential threat, you need to look at how your internal capabilities match up with the potential opportunity. Beyond technical capabilities of your teams, can your organizational culture withstand and the embrace the business transformation involved with building or buying a new, marketplace business model?
Focus on Your Ideal Platform

Now you need to understand what your ideal platform business model would look like in your industry. You probably see multiple platform opportunities across your different business segments. Where is your platform opportunity the greatest and most impactful? And, what does the ideal platform business model look like to meet the needs of consumers and producers in that industry?

For an exercise that will walk you through a quick version of what this part of the Platform Design process looks like for your business, check out our Introduction to Platform Thinking Toolkit.

This toolkit will familiarize you with basic platform concepts like the core transaction and the four functions of a platform. It also includes an exercise and platform business model canvas that will walk you through how to apply platform thinking to your industry.

The goal of this phase is to understand what the potential value gaps in your industry are that a marketplace could capture. You need to identify your potential consumers and producers for a platform and understand how you’re going to get them to join. You will want to get out and talk
to your potential users, meaning both your existing customers as well as potential distributors or manufacturers you would want to join your platform.

Next, look at the technical scope of what you would need to build in order to support this platform business. In addition to a traditional product roadmap, you also want to create a “network roadmap” that details which users you’re targeting and why, and how you’re going to expand the network from there. Your product and network roadmaps should be in sync, so that you’re focused only on building features to support the growth of your network.

For a deeper look at the key aspects of this phase of platform, read *Modern Monopolies*, which explains in detail all of these concepts and how to apply them to your business.

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**Four Approaches to Executing Platform Innovation**

Next, you need to take the inputs from the first three parts of this process and use them to inform your approach to executing platform innovation.

As we mentioned earlier, there are four different approaches to embracing platform innovation. These are building, buying, investing and partnering. None of these are mutually exclusive.
Savvy businesses will often employ a mix of the four. Walmart, for example, has recently launched an incubator and venture arm called Store 8, following its Jet.com acquisition.

Compare the existing landscape of platforms and potential entrants to what you created during platform design.

The further behind you are on each of these aspects – market state, team and culture, and technical capabilities – the harder to build your own marketplace.
Conclusion

For B2B Distributors, the time to take action is now. With major threats like Amazon Business on the horizon or, depending on your industry, already here, the window of opportunity for incumbents to get ahead of the danger is relatively short. The financial projections we've run for Grainger and other B2B distributors show a significant financial impact within just three to five years.

However, while the threat is significant, so is the potential opportunity. Here too the impetus to act now is strong. Given the winner-take-all dynamics of platform markets, there is a significant advantage in getting your network to critical mass first. Laggards in platform innovation will be forced to spend large amounts of capital to catch up. And like Walmart with Jet.com, they will be at best buying a chance to be second place.

For distributors, transitioning to a platform business model will not be easy, but if offers them the chance to gain significant market share while improving their valuation multiples.

Amazon Business has the potential to take a bite out of nearly all B2B distribution industries, and doubling down via acquisitions and industry consolidation will not stem the threat. However, there is significant opportunity in most B2B distribution industries for vertical-specific marketplaces to succeed. The strongest of these marketplaces will become modern monopolies that are able to expand to other industries and potentially take on Amazon Business there as well.
If you’re a distributor interested in platform innovation, you can contact us at info@applicoinc.com

Our two-month Platform Design advisory engagement will help you determine the best ways for your company to defend against the threat of new entrants like Amazon while also mapping out the best approaches for you to go on offense. We also offer execution and growth advisory capabilities that will not only get you to market but also to critical mass.

Our experience helping Fortune 500 companies and multi-billion dollar private companies innovate will enable you to capitalize on the opportunity and get ahead of the threat.
Endnotes


2 You can view the full webinar recording here: http://resources.applicoinc.com/amazon-business-threat-to-b2b-distribution-webinar-video/

3 The book is available here: https://www.amazon.com/Modern-Monopolies-Dominate-Century-Economy/dp/1250091896

4 Our calculations were based off of publicly available market data as of June 2015. Other academic studies over the last several years have yielded similar results.


6 http://fortune.com/2016/05/20/the-silver-lining-in-walmarts-slowing-e-commerce-growth/