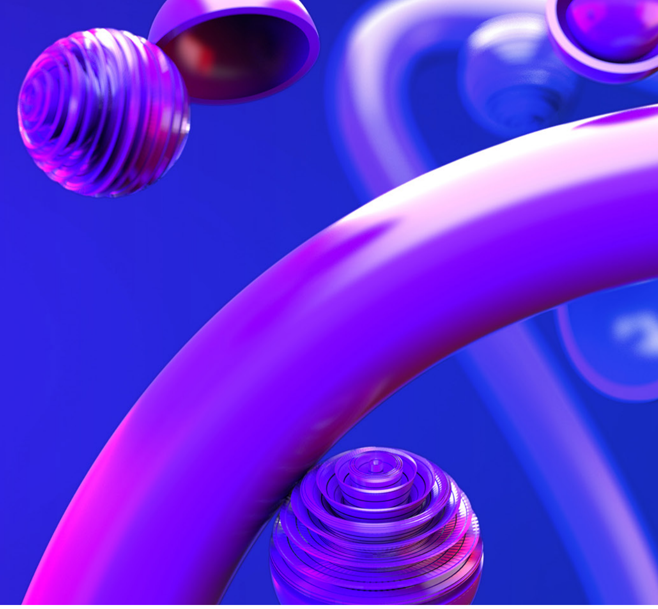
KPMG

Transformation of wholesale distribution



In a recent survey, nearly half of all business-to-business (B2B) sellers reported that they are adding business-to-consumer (B2C) tactics such as personalized offers and customer loyalty programs to their marketing strategies.[1]

In a December 2022 KPMG publication, Welcome to the Retailization of Wholesale Distribution, Brian Higgins noted that

> "(E)very seller in the B2C world is now familiar with how customer expectations for service, delivery, and support have evolved. Wholesale distribution has experienced its own version of this shift—with increased demand for digital experiences, hands off sales processes, and sustainable practices—but that shift has been easier to ignore because it happened more slowly. Today, those preferences have caught up with wholesale distribution. No longer can distributors rely on the traditional "pick, pack, and ship" model to keep their customers happy. They're now serving B2B buyers who want a B2C customer experience."[2]

B2B customers now expect to receive better options and insights, transparency, the ability to have touchless transactions and access to new, and better, customer-centric solutions. Simultaneously, wholesale distributors are also facing challenges caused by the pandemic, global economic conditions, and supply chain de-coupling. These challenges are causing uncertain supplier lead times, unforeseen price changes and supply shortages which, in turn, impact customer satisfaction, revenue attainment and profitability.

Wholesale distribution companies across all segments are responding. Businesses that have not changed much in half a century are quickly digitalizing every aspect of their business. Many are fundamentally changing how they operate, both from the top-down and bottom-up perspectives, to drive innovation and enhance customer experience. Companies are reallocating capital (both financial and human) from low-value routine activities to high-value activities such as product innovation and unique customer interactions, while investing in technologies to provide the tools to enable their employees to work smarter, faster, and with a higher win rate.

Ways in which the distribution industry is being transformed

There are several major trends that are shaping the way wholesale distributors do business and interact with their customers:

[1] "Marketing Trends 2022," Oracle Marketing, 2022

[2] Welcome to the "Retailization" of Wholesale Distribution (KPMG)

01 Retailization

B2B buyers now expect a personalized and engaged user experience—similar to the familiar customer experience that B2B buyers experience in their personal lives as consumers. Wholesale distributors are going through a "Retailization" of the entire way in which they interact with their customers to deliver such desired experiences. Wholesale distributors must now deliver a seamless experience that instantly can provide relevant information, recommendations, and easy-to-follow, intuitive interactions.

02 Automation and robotics

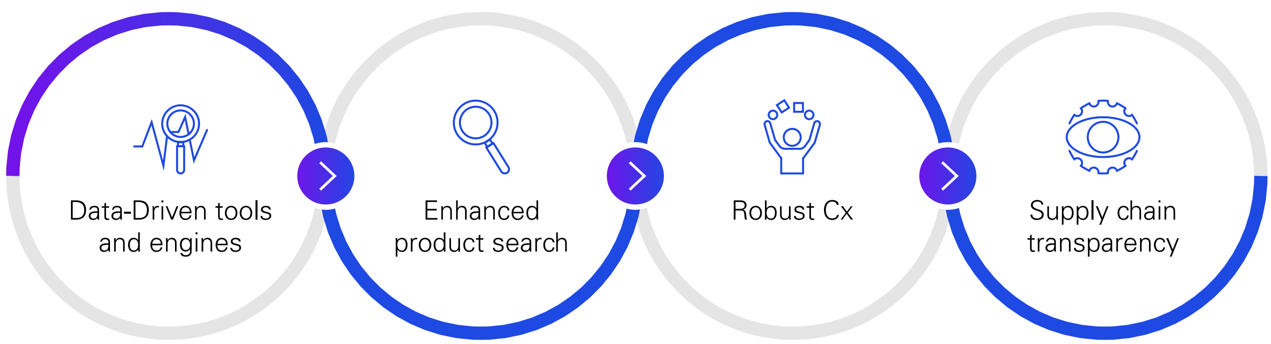
Wholesale distributors are adopting automation and robotics technologies to improve efficiency and reduce costs in their operations. This includes using automated warehouse systems, autonomous vehicles, and robotic process automation (RPA) to streamline processes and improve accuracy.

03 Everything-as-a-Service (XaaS)

B2B buyers are no longer content with just purchasing a physical product. They now expect a range of services related to that product, such as logistics, installation, maintenance, embedded software, and technical support. For customers executing complex projects, collaboration and tailored solutions are becoming the norm.

> By pivoting to offer XaaS, a distributor can collaborate more closely with the customer to help ensure business/service continuity and create new/long-term revenue streams. This level of integration in a business relationship is built to evolve together.

Retailization



Retailization of wholesale distribution

Enhancing the customer experience (CX) is at the heart of Retailization. To meet the growing demand for enhanced product information and search capabilities, distribution companies are developing new cloud-based platforms to provide customers with enhanced product information and product search capabilities as well as access to relevant, real-time accurate data. These platforms are often built around a "single pane of glass" (SPOG) that aggregates the most essential information from multiple systems into a single, easy-to-use dashboard with clean, smooth interfaces.

The capabilities that these platforms provide to customers rely heavily on data. As intermediaries between manufacturers and sellers, wholesale distributors are uniquely positioned to collect vast amounts of data. However, until recently, technological and organizational constraints limited the ability of wholesale distributors to effectively exploit the data they collected. To overcome these constraints, leading wholesale distributors are investing in the infrastructure necessary to leverage their data using predictive and suggestive analytics such as recommendation engines.

By analyzing a customer's buying trends, as well as connections based on what is in a customer's shopping cart, wholesale distributors can make recommendations that increase the total purchase or can recommend a replacement item for a shopping cart item that might drive higher margins for the distributor, oftentimes recommending one of the distributor's owned brand or "white label" products. Data can drive an upsell or cross-sell win, leading to increased customer satisfaction and loyalty.

Another key component of Retailization is transparency around the supply chain. Increasingly, customers are demanding (and getting) real-time SKU level visibility from source to delivery, as well as proactive communications regarding progress and delays. Real-time on-demand supply chain transparency requires distributors to invest in a comprehensive warehouse management system (WMS) that is fully integrated with technologies such as blockchain, radio frequency identification (RFID) tracking, automated storage and retrieval systems (AS/RS). It requires investment in internet of things (IoT) technologies to track products and material through the supply chain. It also requires greater collaboration with suppliers, including integration of various technologies.

Wholesale distributors are also expanding the channels in which they can interact with customers by quickly evolving from the traditional single channel to multichannel, omnichannel and, for a select few, unified channel.[3] A unified channel enables vendors or customers to reach its distributor wherever they are, using their preferred communication method. This approach allows for thorough integration of all customer information across all channels, helping to ensure a consistent and efficient experience for all parties involved.

Wholesale distributors are transforming their customer interactions by embracing the concept of XaaS (sometimes referred to by the clunky term "servitization") where they deliver more value-added services, bundles and subscription offerings that often bring a higher margin, expanded revenue base, and customer stickiness. Subscription models have seen increasing acceptance by customers who often would prefer an opex rather than capex vehicle for asset acquisitions, while distributors benefit from creating recurring revenue streams. The bundled product concept is interesting as a distributor may bundle several third-party products or software that it sells with one or more of such distributor's own technology to deliver a combined solution (e.g., HVAC as a service, building lighting as a service) which has created entirely new ways for distributors to move upstream in the value chain, but also has created tensions as it increasingly creates situations in which distributors may be directly competing with vendors.

The shift to an XaaS model is transforming wholesale distributor's business models in several ways, including:

1. **Revenue models**: Wholesale distributors are shifting from traditional product-based revenue models to service-based models. Instead of selling a product once and generating revenue from that sale, distributors are increasingly generating recurring revenue by providing ongoing services and support often using a subscription invoice and billing model.
2. **Customer relationships**: XaaS requires a closer relationship between companies and their customers. Wholesale distributors are focusing on building long-term relationships with customers, providing ongoing support, and delivering value beyond the initial sale.
3. **Technology**: XaaS requires wholesale distributors to adopt new technologies to support their service offerings. This includes technologies for data analytics, automation, and customer relationship management.
4. **Organizational structure**: XaaS requires wholesale distributors to restructure their organizations to support service delivery. This may involve creating new departments or teams focused on service delivery, or retraining existing employees to support new service offerings.

Automation and robotics

Automation and robotics are transforming the wholesale distribution industry by improving efficiency, reducing costs, and enhancing the customer experience. With the rise of e-commerce and the increasing demand for faster and more accurate order fulfillment, wholesale distributors are turning to automation and robotics technologies to streamline their operations and meet these evolving customer expectations.

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[3] Unified channel is similar to omnichannel in that it generally refers to the integration of multiple communication channel, however, omnichannel environments are generally composed of stand-alone systems that require integrations which can make it difficult to deliver consistent customer experience. For example, a company may have an omnichannel that includes in store sales, online sales direct to consumer, and distributor sales. While there is often some interaction among these, they remain three distinct channels over which some degree of omnichannel strategy and function applies. Unified channel, on the other hand, typically refers to a single platform that serves as an end-to-end solution that provides customers with a seamless experience as they move thru each stage of the customer journey. In Unified channel, customer interaction points seamlessly interact and interoperate with each other rather than in isolated silos.

Investing in automation and robotics can provide several benefits for wholesale distributors. For example, automated warehouse systems can improve inventory management and reduce the time and labor required for order picking and packing. Autonomous vehicles can optimize delivery routes and reduce transportation costs, while RPA can automate repetitive tasks such as data entry and order processing, freeing up employees to focus on higher-value tasks.

Overall, automation and robotics are becoming increasingly important in the distribution industry as wholesale distributors seek to remain competitive in a rapidly changing market. If a distributor fails to adopt robotics and automation, it may fall behind its competitors in terms of efficiency, cost savings, and customer experience. This could lead to a loss of market share and revenue, as customers may choose to do business with competitors who offer more advanced and efficient services.

Impact on tax and transfer pricing

Unsurprisingly, business changes of this magnitude may result in a plethora of tax issues, risks, and opportunities. New goods and services, and new business models, result in new transactions. The character and source of income of such transactions, as well as the taxability (and creditability) of such taxes present often novel issues for companies to analyze. Moving from selling a widget to selling a service could mean changing the characterization of product sales and licenses to services which impact how, where, and when the profits are taxed. Similarly, the indirect tax consequences—above the line taxes like VAT or sales and use tax which are often imposed on gross transaction values—could similarly be upended.

Two key themes are evident across companies undergoing a digital transformation—new high-value assets are being created in a short period of time, and these value creating activities are often not co-located (physically or from an IP ownership perspective) with existing organizational value drivers.

Companies that are not tracking this evolution carefully could wake up one day to find their transfer pricing to be fractured and tax risk spanning across their global profile. This sort of digital value is often created in parts of the business and by teams that have not often been the focus of transfer pricing work, other than perhaps a decades-old "technology fee." Companies that feel they have a solid APA or a CSA that covers their non-routine profits may now have to deal with value creation outside the terms of such agreements. New development, enhancement, maintenance, protection and exploitation (DEMPE) activities associated with newly developed IP will need to be considered. In addition, given the globally distributed workforce footprints common across the distribution industry, a range of tax issues associated with global use of the digital assets must also be considered. The digitalization of the sector also brings along new types of risks to be managed—cyber security risks, data privacy risks, and new operational risks. The management of these risks may not align with how the company historically managed risks or reported the related transfer pricing impacts of risk control.

So what? Do these changes necessitate that tax and finance leaders take action, or merely monitor risk? Doing nothing is rarely a good option, and in the face of digital transformation it could result in not only lost opportunity, but material tax exposures for the organization. Where intercompany development agreements do not properly capture new types of IP, and new sources of value, transfer pricing exposure grows rapidly. This transfer pricing exposure exists not only on the pricing of existing intercompany agreements but also on any potential exit or exploitation of the technology by affiliates elsewhere in the organization. In addition, the changing characterization of the way distributors deliver value to their customers and vendors means that there could be hidden indirect tax exposures accruing out of sight of the company's leadership. Given the speed at which digital transformation is occurring, tax departments should increase the cadence of their review of such matters.

However, fear not, all tax related news is not negative. First, tax departments that get ahead of this evolution can typically mitigate and manage the impacts to transfer pricing and indirect taxes. Second, many wholesale distributors have responded not by simply blunting the negative impacts of transformation, but instead by engaging in affirmative planning that effectively follows the business change in a way that aligns the tax structure with the business and creates tax savings. Such planning is "business first" and can reduce tax on foreign business profits, as well as US state and federal taxes generated on US customer sales. Applying a value chain management approach,[4] such companies have been able to achieve alignment,

[4] *i.e.*, identifying operational value drivers, assessing their comparative contributions to value, and organizing the key functions, assets and control of risks associated with developing and delivering such value, in a tax efficient manner.

operational goals, and tax savings. For many C-level executives such integrated tax and business planning allows the company to use the annual tax savings as a "pay for" towards incremental digital investments.

How can KPMG help?

Identify the risks and opportunities. We have used value chain analysis (VCA) to help wholesale distribution companies better understand how digital transformation is impacting their business and to identify and size risks created by digital transformation. We use operating model and governance reviews to assess DEMPE, risk control, and other current state operational issues related to digital intangibles. In addition, where potential exposures are related to subpart F and similar tax regimes, our reviews have included an assessment of software development and release as well as software delivery operations in order to assess the facts-driven tax results.

Financial reporting support. Similar to a stand-alone risk assessment, we can support a company in assessing the ASC 740 reporting requirements, developing tax technical and accounting conclusions, documenting facts and technical results in an opinion or technical position memorandum, and creating an audit-ready support file.

Mitigate exposure. We have worked with companies to "play defense" against potentially negative transfer pricing results. We have helped clients mitigate risk by refining their intercompany agreements. We have restructured their governance and internal controls to transform their DEMPE and risk control substance footprint, and to refine operations to minimize adverse impacts. In some cases, we have modified roles, responsibilities, and functions to influence DEMPE and risk control impacts to profit allocation. Such modifications have included creating or revising stage gate decision making processes, budgeting and approval, responsibility matrices (such as RACI), delegations of authority, etc., while in other cases our focus has been towards documenting the current reality.

Capture value creation as tax savings. We have worked with large wholesale distributors to design and implement operating models for their digital transformation that align with the business plans, help the company achieve operational objectives (such as optimizing global talent models, managing quality and control, while simultaneously becoming more agile and globally distributed, and aligning a fast growing digital function to a singular strategy), while also capturing the value of their digital transformation in the form of tax savings. We have used various solutions including digital centers of excellence (DCOE) and data hubs to centralize key functions, and ownership of digital intangibles into operating models that drive meaningful business benefits coupled with tax savings.

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