

A techie takeover in an old-school industry

March 3 2017, by Nancy Dahlberg, Miami Herald

Think about the last time your air conditioner failed you. You didn't go to Home Depot and walk out with a compressor on your cart. The heart of the AC business is the contractor, waiting for your call, serving people all day who might melt if their unit is not fixed - or at least feel like they will.

The traditional HVAC - business-speak for heating, ventilation and air conditioning - industry is ripe for technology transformation - not to eliminate the contractor but to help him do his job more efficiently. Greater efficiency translates to more repairs accomplished, more products sold and more profits.

For Miami-based Watsco, that's the goal.

For the past three decades, the publicly traded Watsco was on a nationwide buying spree, scooping up distributors of air-conditioning and heating equipment and related parts and supplies to become the dominant player in the U.S. Now the company is seeking to transform its industry with technology that can increase efficiency and mine new revenue streams. To do so, the company has invested tens of millions developing new technology platforms and applications.

The opportunity is large because the HVAC industry is very fragmented. While Watsco's sales are \$4.2 billion - about four times the revenue of its largest competitor - it has just 15 percent of the market, said Senior Vice President Barry Logan. "Our competition is much smaller, much different, much more local," he said.

The company has started an incubator to turn ideas into mobile apps that help the contractor - Watsco's customer - parse real-time data to speed his processes, leaving more time to do more jobs. And that helps Watsco sell more of the hundreds of thousands of products its distributors carry.

To facilitate those sales, Watsco has developed a robust e-commerce platform for all its products. It's building, partnering with and investing in startups, inside and outside the company, that develop solutions that can help Watsco's business units or provide new revenue streams. And Watsco has built or integrated new technologies to make every part of Watsco's massive supply chain more efficient, down to how the warehouses are stocked and truck routes are planned.

In the process, Watsco has gone on a hiring spree, becoming a large employer of top tech talent in the Miami area, one of the missing ingredients as the region attempts to build a robust tech ecosystem. Five years ago, Watsco's tech team was 60 people; now it is 175, and growing.

In announcing record year and quarterly earnings last month, Chairman and CEO Albert H. Nahmad talked about Watsco's technology strategy during a conference call with analysts. "There is a great deal more to do and accomplish, but we are excited about our progress so far. ... For us, it is not only an offensive play but it is a defensive play to develop this technology."

"We are transforming this old school business in this old school industry," A.J. Nahmad, president of Watsco and Albert's son, said in a recent interview with the Miami Herald. "We are in the very early innings still, but we think we can do it better and faster and out-compete anybody now and we are looking for lots of great people to help us do this at all levels."

To do so, this conventional corporation is embracing a startup culture.

"A lot of young people who want to work in startups only think about the path of joining a new startup. But if you want to be part of a startup culture and build new products and disrupt, then corporations are an alternative," said Ivan Rapin-Smith, managing director of Watsco Ventures and an engineer who has spent his entire career founding, accelerating or investing in startups. "Corporations embracing the startup way of doing innovation is a very strong recent trend. Like Watsco, corporations across the world are opening innovation labs or starting funding arms or incubators or a combination of different initiatives. And I think this will be happening more and more, and that is a good thing."

To be sure, Watsco had been very successful being traditional, producing a 21 percent compounded annual total shareholder return over the last 25 years. But while he was in business school reading company case studies, A.J. Nahmad began thinking about how tech could take his father's company even further. "What I saw at the foundation of all these great processes and technologies of all these great companies was data - clean, well-organized data to make decisions across the entire universe of the company."

About six years ago, Watsco began its digital move. One of the first steps was creating a better way to see, track and analyze data in real time on any device anywhere around the world, said A.J. Nahmad, who is leading the digital strategy. "About 1,500 to 1,600 people every day in the company are accessing that data, slicing and dicing different views, seeing reports, setting up alerts. Business leaders can see trends and patterns and ultimately opportunities to make business decisions to change behaviors so they can make more money in the marketplace. That can affect every part of the marketplace."

Today Watsco has an entire data analytics team, directed by Chief Technology Officer Steven Rupp, who was hired six years ago to help guide the tech transformation. Watsco is also building a business-to-

business e-commerce platform to ease the buying process for its customers - the contractors, who live in their trucks, job to job. "They are the definition of time-is-money," Nahmad said.

"Today with our apps, the contractor can see the model you have, all the literature ever written about that unit, see if parts are in stock and where. He can, with one click, place an order through his own account, and by the time he gets to the store, the product can be picked up in an express lane. Out of there in 30 seconds, rather than 30 minutes. He's happy, we're happy," Nahmad said. "If he can do three jobs rather than two jobs a day, that is a win for everybody."

Watsco now has an application that manages all product information for 500,000 products it sells - a product line that likely will grow to 1 million in the next couple of years, said the executives. The app includes information on product availability, components, accessories, substitute items and recommendations. The company also now has tools to optimize its supply chain for parts and equipment - and by all measures that is massive: 565 warehouses across the country with 13 million square feet, fulfilling 7 million customer orders a year.

"Historically we turn (inventory) four times. If you turn it five times, you unlock \$150 million in free cash flow, big numbers," Nahmad said.

"Now we have a piece of software that brings real math and science and algorithms and predictive analytics to how much of what items we should buy so we have the right amount at the right place at the right time."

Another digital transformation involves the warehouses themselves: How they should be laid out, racked and stacked to minimize footsteps, limit pick times and ultimately reduce warehouse real estate.

And to keep these innovations coming - and to build new revenue

streams for the company - Watsco two years ago plucked some top talent from the startup ecosystem.

"Not in a million years did I ever think I would be working for an HVAC company," said Rapin-Smith, who most recently ran an accelerator program for tech startups. "But A.J. and the team here really embrace innovation and digital transformation. Watsco has a true strategic commitment to innovation and a long-term vision."

On the eighth floor of Watsco headquarters, the Watsco Ventures division is incubating a handful of internal startups. Each has a team including software developers, designers, customer support and business expertise. "We are very open to experimenting with new startups. We don't say, 'Oh that is too risky,'" Rapin-Smith said.

For example, OnCall Air, launched in the fourth quarter of 2016, helps contractors generate proposals. With a professional look and feel, it can quickly create multiple proposals, with add-ons, accessories, warranties and financing options embedded into the proposals. "It's helping our customers sell more so they can buy more and everybody wins," A.J. Nahmad said.

Another startup is Rev, a sales app for [business intelligence](#) that Watsco is building with a partner. Developers used gaming techniques to make the app engaging and easy to use. From it, the 1,000 salespeople at Watsco receive relevant data about their accounts, such as what their customers are buying and not buying and where there are opportunities to sell them more, Nahmad said. "At the same time, it pits them all against each other in a fantasy sports-like competition, so it is gamification of the sales force. They love it - because if you aren't a competitive salesperson, you probably shouldn't be in sales."

As the team built the app, Watsco realized that the technology could be

useful to any company with a large sales force. Its partner is now selling the app to other types of companies, creating a new revenue stream for both parties.

One of Watsco Venture's startup partnerships is San Diego-based HouseCall, a mobile-first approach that helps consumers find and book service professionals. It also enables contractors to capture incoming calls, dispatch technicians and create invoices. Another is SBE, a technology-aided approach to business training and coaching that Watsco can offer exclusively to its customers.

ComfortUp.com is an e-commerce tool for consumers as well as rural contractors, and Watsco Ventures is also exploring internet of things initiatives, Rapin-Smith said. "Anytime we see an opportunity that is a problem worth solving and could add value to a contractor or to a consumer or a manufacturer, we always think, what's the best strategy? Do we build it ourselves, do we invest, do we partner?"

Watsco's corporate technology strategy is already showing results. In its recent earnings call with analysts, Watsco highlighted progress made in 2016, including:

- Weekly users of Watsco's e-commerce apps grew by 220 percent last year, while online transactions grew by 127 percent. Line items per order grew 28 percent when the apps were used.
- More than 1,500 internal users are now using its Business Intelligence platform, up 12 percent, and the average number of BI queries per day increased 31 percent per user. Sales people using BI had seven times better sales performance, and store managers had five times better performance vs. non-users, the company said.
- Because of warehousing efficiencies, the company reduced its needs by

500,000 square feet in 2016. The company made dramatic improvements in inventory turnover at locations that have fully adopted the technologies.

Over the past three years, as Watsco's tech strategy has moved from research to execution, the company has invested about \$50 million on "development, execution, adoption and spreading the word to 88,000 customers and 5,000 employees," Logan said. Its tech spending is currently running about \$23 million annually, he said.

Financial and industry analysts are taking note. David Manthey, senior research analyst with Baird Equity Research, attended an investor conference about Watsco's tech strategy in December, where Watsco highlighted benefits of its initiatives. "We came away with increased confidence that these initiatives will help solidify the company's distant No. 1 position," Manthey said. His firm rates the stock as an "outperform."

Zacks Equity Research recently reported: "Watsco is actively transforming its business into the digital age by investing in innovative platforms for [mobile apps](#), eCommerce, business intelligence and [supply chain](#) optimization. The company's strategic goals will help to further reinforce its leadership position, accelerate sales and profit growth, increase the speed and convenience of customer service. It will also extend its reach to new geographies and sales channels." Zacks currently rates the stock a "hold."

The big goal: widescale adoption within its business units and with customers. "Today we are a \$4.2 billion company with 8 percent margins and we talk about being \$10 billion with 15 percent margins," said A.J. Nahmad. "We have an insatiable appetite for growth."

But the strategy is for the long term. "If we didn't do what we are doing,

there is the threat someone could come and do it to us. So we are disrupting ourselves before somebody else does it to us," he said.

"This is the new Watsco."

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WATSCO TECHNOLOGY STRATEGY AT A GLANCE

Since 2012, Watsco's technology team has grown from about 60 employees to 175 employees. Technology-related costs are currently running approximately \$23 million annually.

Examples of innovations launched by Watsco to enhance the buying experience for its 88,000 customers and service capabilities of personnel at its 565 locations include:

- Mobile apps, e-commerce and other online tools using the industry's most data-rich catalog of product information.
- Business intelligence and data analytics to enable more insightful decision-making by more than 600 finance managers across the [company](#).
- Supply chain optimization to improve fill-rates, increase inventory turns and reduce real estate requirements and other operational costs over the long term.
- Comprehensive order fulfillment software and implementation of wireless warehouses to improve operational efficiency for more than 7 million annual customer transactions.

Source: Watsco

WATSCO BY THE NUMBERS

\$4.2 billion: Revenues in 2016

\$183 million: Net income in 2016

\$5.4 billion: Current market capitalization

5,000: Number of Watsco employees in its 565 locations, including its Miami headquarters

88,000: Number of contractors that buy HVAC parts and accessories through Watsco locations

175: Number of employees on tech team

\$50 million: Amount Watsco has spent in past three years on technology R&D and initiatives

Source: Watsco

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Citation: A techie takeover in an old-school industry (2017, March 3) retrieved 6 May 2024 from <https://phys.org/news/2017-03-techie-takeover-old-school-industry.html>

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