Chapter 5

Export Channels of Distribution

Global competition is motivating firms to seek innovative ways of entering new markets. Export managers have to decide which marketing functions are to be delegated to other intermediaries or partners and which are to be performed internally. Selecting and managing the right distribution systems is the key to successful internationalization. They provide a competitive advantage in global markets by helping identify market opportunities. Channels are also more difficult to change and thus require careful planning.

Williamson (1991) argues that contracting is determined by the governance mechanism that seeks to minimize transaction costs. He states that "assets specificity, uncertainty, and frequency" determine the efficient transaction governance form. Specific assets are involved in investments made in market research, branding, product design, and human assets. "Uncertainty" refers to changes in market forces stemming from individuals' limited information or opportunistic motives of other actors. "Frequency" concerns frequency and volume of transactions. Studies indicate that asset specificity, uncertainty, and frequency in volume of transactions are associated with direct forms of market entry (vertical integration). There is an incentive to integrate distribution channels to minimize transaction costs (McNaughton, 1996; Tesfom, Lutz, and Ghauri, 2004). In many developing countries, direct entry may be needed, in spite of their limited market size, due to the problem of asset specificity and lack of contract enforcing institutions.

Export firms can be involved in two principal channels of distribution when marketing abroad:

Indirect channels. With indirect channels, the firm exports through an independent local middleman who assumes responsibility for moving the product overseas. Indirect exporting entails reliance on another firm to act as a sales intermediary and to assume responsibility for marketing and shipping the product overseas. The manufacturer incurs no start-up cost, and this method provides small firms with little experience in foreign trade access to overseas markets without their direct involvement. However, using indirect channels has certain disadvantages: (1) the manufacturer loses control over the marketing of its product overseas, and (2) the manufacturer's success totally depends on the initiative and efforts of the chosen intermediary. The latter could provide low priority to, or even discontinue marketing, the firm's products when the competitor's product provides a better sales or profit potential.

Direct channels. With direct channels, the firm sells directly to foreign distributors, retailers, or trading companies. Direct sales can also be made through agents located in a foreign country. Direct exporting can be expensive and time consuming. However, it offers manufacturers opportunities to learn about their markets and customers in order to forge better relationships with their trading partners. It also allows firms greater control over various activities. Heli Modified, Inc., of Maine, which manufactures custom-made handles for motorcycles, attributes much of its export success to U.S. government agencies as well as its international network of sales agents and distributors. The company now exports to approximately twenty-five countries on four continents.

The decision to market products directly or use the services of an intermediary is based on several important factors.

International Marketing Objectives of the Firm

The marketing objectives of the firm with respect to sales, market share, profitability, and level of financial commitment will often determine channel choice. Direct exporting is likely to provide opportunities for high profit margins even though it requires a high degree of financial commitment.

Manufacturer's Resources and Experience

A direct channel structure may be neither feasible nor desirable in light of the firm's limited resources and/or commitment. Small to medium-sized firms appear to use indirect channels due to their limited resources and small export volumes, whereas large firms use similar channels because of trade barriers in the host country that may restrict or prohibit direct forms of ownership (Kogut, 1986). Firms tend to use independent intermediaries during the early phases of their internationalization efforts compared to those with greater experience (Anderson and Coughlin, 1987; Kim, Nugent, and Yhee, 1997).

Availability and Capability of Intermediary

Every country has certain distribution patterns that have evolved over the years and are complemented by supportive institutions. Firms that have used specific types of distribution channels in certain countries may find it difficult to use similar channels in other countries. This occurs in cases in which distributors have exclusive arrangements with other suppliers/competitors or when such channels do not exist.

Customer and Product Characteristics

If the number of consumers is large and concentrated in major population centers, the company may opt for direct or multiple channels of distribution. In Japan, for example, over half of the population lives in the Tokyo-Nagoya-Osaka market area (Cateora, 1996). Another factor is that customers may also have developed a habit of buying from a particular channel and are reluctant to change in the short term.

Direct exporting is often preferable if customers are geographically homogeneous, have similar buying habits, and are limited in number, which allows for direct customer contact and greater control (Seifert and Ford, 1989). The choice of channel structure is primarily dictated by market considerations. However, in certain situations, the nature of the product determines channel choice. In a study on export channels of distribution in the United States, 52.7 percent of the respondents indicated that the distribution was primarily dictated by the market, while 15.5 percent stated that the choice was dictated by the nature of the product exported (Seifert and Ford, 1989). For example, industrial equipment of considerable size and value that requires more after-sales service is usually exported to the user or through the use of other direct channels. Direct channels are also frequently used for products of a perishable nature or high unit value (since it will bring more profit) or for products that are custom-made or highly differentiated. Smaller equipment, industrial supplies, and consumer goods, on the other hand, tend to have longer channels. In Canada, for example, consumer goods are purchased by importing wholesalers, department stores, mail-order houses, chain stores, and single-line retailers.

Marketing Environment

The use of direct channels is more likely in countries that are more similar in culture to the exporter’s home country. For example, U.S. sales to Canada are characterized by short (direct) marketing channels compared to the indirect channels used in Japan and Southeast Asia. In certain cases, firms have limited options in the selection of appropriate channels for their products. In the lumber industry, the use of export intermediaries is the norm in many countries. In Finland, over 90 percent of distribution of nondurable consumer goods is handled by four wholesale chains. Exporters have to use these distribution channels to gain a significant penetration of the market (Czinkota, Ronkainen, and Moffett, 2003). Legislation in certain countries requires that foreign firms be represented by local firms that are wholly owned by nationals of the country. Exporters must market their goods indirectly by appointing a local agent or distributor. Some studies support the use of direct/integrated channels when there is a high degree of environmental uncertainty. The establishment of integrated channels is intended to place the firm closer to the market so as to react and adapt to unforeseen circumstances (Klein, Frazier, and Roth, 1990).

Control and Coverage

A direct or integrated channel affords the manufacturer more control over its distribution and its link to the end user. However, it is not a practical option for firms that do not have adequate foreign market knowledge or the necessary financial, operational, and strategic capabilities.

Firms that use indirect channels are still able to exercise control mechanisms to coordinate and influence foreign intermediary actions. Two types of controls are available for the manufacturer/exporter: process controls and output controls. Under process controls, the manufacturer's intervention is intended to influence the means intermediaries use to achieve desirable ends (selling technique, servicing procedure, promotion, etc.). Output controls are used to influence indirectly the ends achieved by the distributor. The latter includes monitoring sales volume, profits, and other performance-based indicators (Bello and Gilliland, 1997). It is important to note the following salient points with respect to manufacturers' coordination and control of independent foreign intermediaries:

- Manufacturers must rely on both unilateral and bilateral (collaboration) control mechanisms in order to organize and manage their export relationships with independent foreign intermediaries.
- The use of output controls tends to have a positive impact on foreign intermediaries' overall performance. Process controls, however, do not appear to account for performance benefits, largely due to manufacturers' inadequate knowledge of foreign marketing procedures.

- Firms that export highly technical and sophisticated products tend to exercise high levels of control (process and output controls) over foreign intermediaries in order to protect their proprietary rights (trade secrets/know-how) as well as to address unique customer needs.

In terms of coverage, firms that use longer channels tend to use different intermediaries (intensive coverage). However, recent studies show a positive relationship between channel directness and intensive coverage. This means that firms employing direct methods to reach their overseas customers tend to use a large number of different types of channel intermediaries.

Types of Intermediaries

One of the distinguishing features of direct and indirect channel alternatives is the location of the second channel. If the second channel is located in the producer's country, it is considered an indirect channel, whereas if it is located in the buyer's country, it is assumed to be a direct channel. This means that agents, distributors, or other middlemen could be in either category, depending on whether they are located in the buyer's or seller's country. Channel alternatives are also defined on the basis of ownership of the distribution channel: a direct channel is one owned and managed by the company, as opposed to one in which distribution is handled by outside agents and middlemen. A firm's channel structure is also defined in terms of the percentage of equity held in the distribution organization: majority ownership (greater than 50 percent) is treated as a direct or integrated channel, while less than majority ownership is considered an indirect channel. The first definition of channel alternatives is used in this chapter.

INDIRECT CHANNELS

Several intermediaries are associated with indirect channels and each type offers distinct advantages. Indirect channels are classified here on the basis of their functions.

Exporters That Sell on Behalf of the Manufacturer

Manufacturer's Export Agents (MEAs)

Manufacturer's export agents usually represent various manufacturers of related and noncompeting products. They may also operate on an exclusive basis. It is an ideal channel to use especially in cases involving a widespread or thin overseas market. It is also used when the product is new and demand conditions are uncertain. The usual roles of the MEA are as follows:

- Handle direct marketing, promotion, shipping, and sometimes financing of merchandise. The agent does not offer all services.
- Take possession but not title to the goods. The MEA works for commission; risk of loss remains with the manufacturer.
- Represent the manufacturer on a continuous or permanent basis as defined in the contract.

Export Management Companies (EMCs)

Export management companies act as the export department for one or several manufacturers of noncompetitive products. Over 2,000 EMCs in the United States provide manufacturers with extensive services that include, but are not limited to, market analyses, documentation, financial and legal services, purchase for resale, and agency services (locating and arranging sale). An EMC often does extensive research on foreign markets, conducts its own advertising and promotion, serves as a shipping/forwarding agent, and provides legal advice on intellectual property matters. It also collects and furnishes credit information on overseas customers.

Most EMCs are small and usually specialize by product, foreign market, or both. Some are capable of performing only limited functions such as strategic planning or promotion. Export management companies solicit and carry on business in their own name or in the name of the manufacturer for a commission, salary, or retainer plus commission. Occasionally, they purchase products by direct payment or financing for resale to their own customers. Export management companies may operate as agents or distributors. The following are some of the disadvantages of using EMCs:

- Manufacturer may lose control over foreign sales. To retain sufficient control, manufacturers should ask for regular reports on marketing efforts, promotion, sales, and so forth. This right to review marketing plans and efforts should be included in the agreement.
- Export management companies that work on commission may lose interest if sales do not happen immediately. They may be less interested in new or unknown products and may not provide sufficient attention to small clients.
- Exporters may not learn international business since EMCs do most of the work related to exports.

Despite these disadvantages, EMCs have marketing and distribution contacts overseas and provide the benefit of economies of scale. Export management companies obtain low freight rates by consolidating shipments of several principals. By providing a range of services, they also help manufacturers to concentrate on other areas.

Export Trading Companies (ETCs)

Trading companies are the most traditional and dominant intermediary in many countries. In Japan, they date back to the nineteenth century and in Western countries, their origins can be traced back to colonial times. They are also prevalent in many less developed countries. They are demand driven; that is, they identify the needs of overseas customers and often act as independent distributors linking buyers and sellers to arrange transactions. They buy and sell goods as merchants taking title to the merchandise. Some work on a commission. They may also handle goods on consignment.

In the United States, an ETC is a legally defined entity under the Export Trading Company Act. It is difficult to set up ETCs unless certain special certifications and requirements are met: the U.S. Export Trading Act allows bank participation in trading companies thus facilitating better access to capital and more trading transactions. Antitrust provisions were also relaxed to allow firms to form joint ventures and share the cost of developing foreign markets. By 2002, about 186 individual ETCs covering more than 5,000 firms had been certified by the U.S. Department of Commerce. Trade associations often apply for certification for their members. To be effective, ETCs must balance between the demands of the markets and the supply of the members (trade association; see International Perspective 5.1).

Trading companies offer services to manufacturers similar to those provided by EMCs. However, there are some differences between the two channels:

- Trading companies offer more services and have more diverse product lines than export management companies. Trading companies are also larger and better financed than EMCs.
- Trading companies are not exclusively restricted to export-import activities. Some are also engaged in production, resource development, and commercial banking. Korean trading companies, such as Daewoo and Hyundai, for example, are heavily involved in manufacturing. Some trading companies, such as Mitsubishi (Japan) and Cobec (Brazil), are affiliated with banks and engaged in extension of traditional banking into commercial fields (Meloan and Graham, 1995).

The disadvantages of ETCs are similar to the ones mentioned for EMCs.

INTERNATIONAL PERSPECTIVE 5.1.
Export Trading Companies in Global Markets

Trading companies have been the most traditional channels for international commercial activity. Trading companies supported by governments, such as the English East India Company (1600), the Dutch East India Company (1602), and the French Compagme des Indes Orientales (1664), were established and enjoyed not only exclusive trading rights but also military protection in exchange for tax payments. Today, trading companies also perform the important function of exporting, importing, investing, and countertrading. In Japan, for example, the Sogo Shosha, which includes the top nine trading companies such as Mitsubishi and Mitsui, conducts about two-thirds of the country's imports and a half of its exports. In Korea, trading companies similar in scope to the Sogo Shosha (Daewoo, Hyundai, Samsung) are responsible for a substantial part of the country's exports and imports. In addition to trade, trading companies in these countries are involved in mega projects, participate in joint ventures and act as financial deal makers. The success of these conglomerates is due to: (1) extensive market information that allows for product or area diversification, (2) economies of scale that allows them to obtain preferential freight rates, etc., and (3) preferential access to capital markets that makes it easy to undertake large or risky transactions.

In view of the success of these trading companies, Brazil, Turkey, and the United States have enacted domestic legislation that allows the establishment of trading companies. The Brazilian Decree (No. 1298) of 1972, for example, sets up conditions for the registration of new enterprises with the government and allows local producers to export by selling to a trading company without losing their export incentives. In the United States, the Export Trading Company Act of 1982 allows businesses to join together to export goods and services or to assist unrelated companies to export their products without fear of violating antitrust legislation. Bank participation in trading companies was permitted to enable better access to capital. The legality of any action can be ascertained by precertification of planned activities with the U.S. Department of Commerce.

Exporters That Buy for Their Overseas Customers

Export Commission Agents (ECAs)

Export commission agents represent foreign buyers such as import firms and large industrial users and seek to obtain products that match the buyer's preferences and requirements. They reside and conduct business in the exporter's country and are paid a commission by their foreign clients. In certain cases, ECAs may be foreign government agencies or quasi-government firms empowered to locate and purchase desired goods. They could operate from a permanent office location in supplier countries or undertake foreign government purchasing missions when the need arises. In some countries, the exporter may receive payment from a confirming house when the goods are shipped. The confirming house may also carry out some functions performed by the commission agent or resident buyer (making arrangements for the shipper, and so on). For the exporter, this is an easy way to access a foreign market. There is little credit risk, and the exporter has only to fill the order.

Another variation of the ECA is the resident buyer. The major factor that distinguishes the resident buyer from other ECAs is that in the case of the former, a long-term relationship is established in which the resident buyer not only undertakes the purchasing function for the overseas principal at the best possible price, but also ensures timely delivery of merchandise and facilitates principal's visits to suppliers and vendors. This allows foreign buyers to maintain a close and continuous contact with overseas sources of supply. One disadvantage of using such channels is that the exporter has little control over the marketing of products (Onkvisit and Shaw, 1997).

Exporters That Buy and Sell for Their Own Accounts

Export Merchants

Export merchants purchase products directly from manufacturers, pack and mark them according to their own specifications, and resell to their overseas customers. They take title to the goods and sell under their own names, and, hence, assume all risks associated with ownership. Export merchants generally handle undifferentiated products or products for which brands are not important. In view of their vast organizational networks, they are a powerful commercial entity dominating trade in certain countries.

When export merchants, after receiving an order, place an order with the manufacturer to deliver the goods directly to the overseas customer, they are called export drop shippers. In this case, the manufacturer is paid by the drop shipper, who in turn, is paid by the overseas buyer. Such intermediaries are commonly used to export bulky (high-freight), low-unit value products such as construction materials, coal, lumber, and so forth.

Another variation of export merchant is the export distributor (located in the exporter's country). Export distributors have exclusive rights to sell manufacturers' products in overseas markets. They represent several manufacturers and act as EMCs.

The disadvantage of export merchants as export intermediaries relates to lack of control over marketing, promotion, or pricing.

Cooperative Exporters (CEs)

These are manufacturers or service firms that sell the products of other companies in foreign markets along with their own (Ball et al., 2004). This generally occurs when a company has a contract with an overseas buyer to provide a wide range of products or services. Often, the company may not have all the products required under the contract and turns to other companies to provide the remaining products. The company (providing the remaining products) could sell its products without incurring export marketing or distribution costs. This helps small manufacturers that lack the ability/resources to export. This channel is often used to export products that are complementary to that of the exporting firm. A good example of this is the case of a heavy equipment manufacturer that wants to fill the demand of its overseas customers for water drilling equipment. The heavy equipment company exports the drilling equipment along with its product to its customers (Sletten, 1994). Companies engage in cooperative exporting in order to broaden the product lines they offer to foreign markets or to bolster decreasing export sales. In the 1980s, for example, the French chemical company Rhone-Poutenc sold products of several manufacturers through its extensive global sales network.

Export Cartels

These are organizations of firms in the same industry for the sole purpose of marketing their products overseas. They include the Webb-Pomerene Associations (WPAs) in the United States, as well as certain export cartels in Japan. The WPAs are exempted from antitrust laws under the U.S. Export Trade Act of 1918 and permitted to set prices, allocate orders, sell products, negotiate, and consolidate freight, as well as arrange shipment. There are WPAs in various areas such as pulp, movies, sulphur, and so on. Webb-Pomerene Associations are not permitted for services and the arrangement is not suitable for differentiated products because a common association label often replaces individual product brands. In addition to member firms' loss of individual identity, WPAs are vulnerable to lack of group cohesion, similar to other cartels, which undermines their effectiveness. Under the Export Trade Act, the only requirement to operate as a WPA is that the association must file with the Federal Trade Commission within thirty days after formation (see International Perspective 5.2).

INTERNATIONAL PERSPECTIVE 5.2.
Indirect Channel Structures

Advantages

- Little or no investment or marketing experience needed. Suitable for firms with limited resources or experience.
- Helps increase overall sales and cash flow.
- Good way to test-market products, develop goodwill, and allow clients to be familiar with firm's trade name or trademark before making substantial commitment.

Disadvantages

- Firm's profit margin may be dwindled due to commissions and other payments to foreign intermediaries.
- Limited contact/feedback from end users.
- Loss of control over marketing and pricing. Firm totally dependent on the marketing initiative and effort of foreign intermediary. Product may be priced too high or too low.
- Foreign intermediary may not provide product support or may damage market potential.
- Limited opportunity to learn international business know-how and develop marketing contacts. Creates difficulty in taking over the business after the relationship has ended.

DIRECT CHANNELS

A company could use different avenues to sell its product overseas employing the direct channel structure. Direct exporting provides more control over the export process, potentially higher profits, and a closer relationship to the overseas buyer and the market place. However, the firm needs to devote more time, personnel, and other corporate resources than needed in the case of indirect exporting.

Direct Marketing from the Home Country

A firm may sell directly to a foreign retailer or end user, and this is often accomplished through catalog sales or traveling sales representatives who are domestic employees of the exporting firm. Such marketing channels are a viable alternative for many companies that sell books, magazines, housewares, cosmetics, travel, and financial services. Foreign end users include foreign governments and institutions such as banks, schools, hospitals, or businesses. Buyers can be identified at trade shows, through international publications, and so on. If products are specifically designed for each customer, company representatives are more effective than agents or distributors. The growing use of the Internet is also likely to dramatically increase the sale of product and/or services directly to the retailer or end user. For example, Amazon.com has become one of the biggest bookstores in the United States with over 2.5 million titles. Its books are sold through the Internet. Direct sales can also be undertaken through foreign sales branches or subsidiaries. A foreign sales branch handles all aspects of the sales distribution and promotion, displays manufacturer's product lines, and provides services. The foreign sales subsidiary, although similar to the branch, has broader responsibilities. All foreign orders are channeled through the subsidiary, which subsequently sells to foreign buyers. Direct marketing is also used when the manufacturer or retailer desires to increase its revenues and profits while providing its products or services at a lower cost. The firm could also provide better product support services and further enhance its image and reputation.

A major problem with direct sales to consumers results from duty and clearance problems. A country's import regulations may prohibit or limit the direct purchase of merchandise from overseas. Thus it is important to evaluate a country's trade regulations before orders are processed and effected.

Marketing Through Overseas Agents and Distributors

Overseas Agents

Overseas agents are independent sales representatives of various noncompeting suppliers. They are residents of the country or region where the product is sold and usually work on a commission basis, pay their own expenses, and assume no financial risk or responsibility. Agents rarely take delivery of and never take title to goods and are authorized to solicit purchases within their marketing territory and to advise firms on orders placed by prospective purchasers. The prices to be charged are agreed on between the exporters and the overseas customers. Overseas agents usually do not provide product support services to customers. Agency agreements must be drafted carefully so as to clearly indicate that agents are not employees of the exporting companies because of potential legal and financial implications, such as payment of benefits upon termination. In some countries, agents are required to register with the government as commercial agents.

Overseas agents are used when firms intend to (1) sell products to small markets that do not attract distributor interest, (2) market to distinct individual customers (custom-made for individuals or projects), (3) sell heavy equipment, machinery, or other big ticket items that cannot be easily stocked, or (4) solicit public or private bids. Firms deal directly with the customers (after agents inform the firms of the orders) with respect to price, delivery, sales, service, and warranty bonds. Given their limited role, agents are not required to have extensive training or to make a substantial financial commitment. They are valuable for their personal contacts and intelligence and help reach markets that would otherwise be inaccessible. The major disadvantages of using agents are: (1) legal and financial problems in the event of termination (local laws in many countries discriminate against alien firms [principals] in their contractual relationships with local agents), (2) firms assume the attendant risks and responsibilities, ranging from pricing and delivery to sales services including collections, and (3) agents have limited training and knowledge about the product and this may adversely impact product sales.

Overseas Distributors

These are independent merchants that import products for resale and are compensated by the markup they charge their customers. Overseas distributors take delivery of and title to the goods and have contractual arrangements with the exporters as well as the customers. No contractual relationships exist between the exporters and the customers and the distributors may not legally obligate exporters to third parties. Distributors may be given exclusive representation for a certain territory, often in return for agreeing not to handle competing merchandise. Certain countries require the registration and approval of distributors (and agents) as well as the representation agreement.

Distributors, unlike agents, take possession of goods and also provide the necessary pre- and postsales services. They carry inventory and spare parts and maintain adequate facilities and personnel for normal service operations. They are responsible for advertising and promotion. Some of the disadvantages of using distributors are: (1) loss of control over marketing and pricing (they may price the product too high or too low), (2) limited access to or feed-back from customers, (3) limited opportunity to learn international business know-how and about developments in foreign markets, and (4) dealer protection legislation in many countries that may make it difficult and expensive to terminate relationships with distributors (see International Perspectives 5.3 and 5.4).

INTERNATIONAL PERSPECTIVE 5.3.
The Japanese Distribution System

Distribution channels in Japan are very different from our own; they are as inefficient as they are complex. The system is characterized by multiple layers of wholesalers who have developed close, personal relationships with other wholesalers, manufacturers, importers, and retailers. Moreover, these intimate relationships often serve as an informal barrier to U.S. companies wishing to sell directly to end users or retailers.

Many American exporters find retailers/end users unwilling to disrupt their longstanding, personal relationships with Japanese suppliers even when the U.S. company can offer a product of superior or equal quality at a cheaper price. Many Japanese retailers/end users are unwilling to make the switch to an “unreliable” foreign supplier. They fear a lack of commitment on the part of the foreign supplier will lead to problems. This system, although inefficient, does offer some important advantages for the participants. First, these close business relationships make it far easier for retailers/distributors to suggest product modifications and improvements. Second, this system encourages the sharing of information on product trends, innovations, competition, and overall market opportunities. Third, it contributes to a more cooperative business relationship.

The number of retail outlets in Japan is nearly the same as in the United States, despite the fact that the population of Japan is roughly half that of the United States and Japan is slightly smaller in geographical size than California. Distribution channels vary considerably from industry to industry and product to product, with particular differences between consumer and industrial goods. A foreign firm must understand existing distribution channels in order to utilize them or develop an innovative approach.

LOCATING, CONTACTING, AND EVALUATING AGENTS AND DISTRIBUTORS

Once the firm has identified markets in which to use agents and distributors, it could locate these intermediaries by using various sources: government trade offices (The Department of Commerce in the United States), chambers of commerce, trade shows, international banks and other firms, trade and professional associations, and advertisements in foreign trade publications. After identifying potential agents and distributors in each desired market, the firm should write directly to each, indicating its interest in appointing a representative and including a brochure describing the firm’s history, resources, product line, personnel, and other pertinent information.

INTERNATIONAL PERSPECTIVE 5.4. Parallel versus Multiple Exporters

Parallel (gray) market goods are products that enter a country outside regular, authorized distribution channels. They differ from black market products since they often enter the market legally. Factors contributing to the rise of parallel exports include:

- Substantial differences in the prevailing prices of the same product between two national markets.
- Differences in marketing and administrative expenses between the authorized distributor and the parallel distributor.
- Sale of distressed merchandise at deep discount to overseas markets sometimes gives rise to re-exports to the home market.
- Price discounts to distributors in the home market but not to nearby foreign markets.
- The authorized foreign distributor may have restrictive credit terms or unable (or unwilling) to carry sufficient inventory to service the market.

There is a flourishing market in parallel market goods in the United States in cars, watches, etc., estimated at over $6 billion (U.S.). The major problems created by parallel export channels is (1) reduction in sales and profits for the authorized distributor, (2) disruption in manufacturer-distribution relations, and (3) difficulty in maintaining a consistent image, quality, and reputation of a product.

Companies recognizing these problems should develop appropriate corporate policies such as creating product differentiation between the domestic and exported product, flexibility in the export price of the product sold to the foreign distributor.

Multiple channels are used by many firms in order to gain long-term sustainable advantages in global markets. A firm could supplement agents with their own salespersons to prevent lock-in and establish a credible alternative. A few strategic markets can be identified and developed by integration, while other markets are served by third parties, thus spreading the risk. Such channels are common in sectors where transaction costs and uncertainty are high (knowledge-intensive sectors like software development).

Evaluation and selection of potential representatives (agents or distributors) is often based on some of the following factors: local reputation and overall background, experience with a similar product or industry and adequate knowledge of the market, commitment not to represent competing brands, genuine interest and ability to devote sufficient time and effort to the product line. In the case of distributors, it is also important to evaluate sales organization; financial, marketing, and promotion capability; installation and after-sales service; timely payments; and similar characteristics. Once the firm has selected an agent or distributor based on the aforementioned criteria, the next step will be to negotiate a formal agreement. Foreign representatives are also interested in firms that are committed to the market and willing to provide the necessary product support and training. They also want to protect their territory from sales by third parties or the firm itself.

CONTRACTS WITH FOREIGN AGENTS AND DISTRIBUTORS (REPRESENTATIVES)

It is estimated that about 50 percent of global trade is handled through overseas agents and distributors. Laws governing agents and distributors are complex and vary from country to country. In certain countries, protective legislation favors local representatives with respect to such matters as market exclusivity and duration or termination of contracts. In the event of termination without good cause, for example, a Belgian distributor is entitled to an indemnity.

Similar laws exist in France, Germany, and other countries. In Germany, maximum compensation payable to agents usually equals one year's gross commissions based on an average over the previous five years or the period of existence of the agency, whichever is shorter. In countries such as Egypt, Indonesia, Japan, and South Korea, representation agreements must be formally registered with and their contents must be approved by the appropriate authority. In many Latin American countries, local law governs service contracts if the services are to be performed in local jurisdictions and any representative agreement that is not in conformity with local law will be invalid and unenforceable. Thus, it is important that in the negotiation and drafting of such agreements, sufficient attention is given to the impact of local laws and other pertinent issues.

MAJOR CLAUSES IN REPRESENTATION AGREEMENTS

Definition of Territory

The contract should define the geographical scope of the territory to be represented by the agent or distributor and whether the representative has sole marketing rights. In exclusive contracts, the agreement has to clearly specify whether the firm reserves the right to sell certain product lines to a specific class of buyers such as governments or quasi-government agencies.

If agreements do not explicitly state that they are exclusive, they will often be deemed exclusive if no other representatives have been appointed within a reasonable time. The contract should also state whether the representative could appoint subagents or subdistributors and the latter's status in relation to the firm. It is also important to explicitly state the intention of the parties not to create an employer-employee relationship due to financial and tax implications.

Definition of Product

The contract should identify those products or product lines covered by the agreement as well as the procedures for the addition of successive products. It should also provide for the alteration or deletion of certain product lines based on the exporter's continued production, representative's performance, or other events.

Representative's Rights and Obligations

The agreement should state that the representative will do its best to promote and market the product and cooperate to attain the objectives of the exporting firm. It should also include (1) the representative's commitment to periodically inform the exporter of all pertinent information related to market conditions and its activities; (2) the parties' agreement to provide due protection to each other's confidential information as defined in the contract, which often includes seller's patents, trade secrets, and know-how, as well as the representative's marketing information including customer lists; (3) a provision as to whose responsibility it is to arrange for all the necessary approvals, licenses, and other requirements for the entry and sale of goods in the foreign country; and (4) the right of the representative to carry noncompetitive and complementary products.

An agency agreement should state the nature and scope of an agent's authority to bind the exporter (which is often denied) as well as the agent's discretion with respect to pricing. All sales of products are to be in accordance with the price list and discount structure as established in the contract. The parties could also agree on mechanisms to implement changes in prices and terms. It is also important to stipulate the amount of compensation (commission) when it accrues to the account of the agent, and the time of payment. Most agreements state that all commissions shall not become due and payable until full settlement has been received by the firm. The agent could also be given the responsibility for collection with respect to sales it initiated.

Distributor agreements should state clearly that the overseas distributor acts as a buyer and not as an agent of the seller. The agreement could require the distributor to maintain adequate inventories, facilities, and competent personnel. The exporter could sometimes stipulate that orders representing a minimum value or quantity shall be placed within a fixed time. The agreement also defines the advertising and promotion responsibilities of the distributor, including an undertaking to advertise in certain magazines or journals a minimum number of times a year at its own expense, for example:

> The distributor agrees during the lifetime of this contract to provide and pay for not less than seven full-page advertisements per year, appearing at regular monthly intervals in the national journals or magazines of the industry circulating generally throughout the territory.

Exporter's Rights and Obligations

In agency contracts, the exporter is often required to provide the agent with its price schedules, catalogs, and brochures describing the company, its product and other pertinent features. In distributor contracts, the exporter is required to provide the distributor and his or her personnel with training and technical assistance as is reasonably required in order to service, maintain, and repair products. In both agency and distributor agreements, the exporter should warrant that the product complies only with the specified standards of quality and also state the party that will be responsible for warranty service.

The exporter is also required to provide sufficient supplies of the product and new developments in products, as well as marketing and sales plans.

Definition of Price

In agency agreements, all sales of products are made in accordance with the price list and discount structure agreed upon between the parties. However, the seller reserves the right to change prices at any time, usually upon a thirty- or sixty-days' prior notice.

Distributor agreements also contain provisions relating to the price to be charged by the seller upon purchase of goods by the distributor. Any discounts available are also stated. In the case of products that are affected by inflation, the parties could set a definite price ruling on a specific date, such as the date of the sales contract or shipment. The parties could also agree that the exporter charge the distributor the best price it provides other customers at the time of sale (the most-favored-customer price) except for those products supplied to a holding company, subsidiary, or other associated companies of the supplier. The distributor agreement should also stipulate the terms of shipment such as FOB (free on board) or CIF (cost, insurance, and freight), as well as the method of payment (open account, letter of credit, etc.), for example:

> The prices specified are in U.S. dollars, exclusive of taxes and governmental charges, freight, insurance and other transportation charges. Payment shall be on consignment. The product will be shipped FOB (Miami) to the buyer's address in Colombia.

Renewal or Termination of Contract

In many countries, issues relating to appointment, renewal, or termination of representatives are largely determined by local law. Many foreign representation agreements provide for a short trial period followed by a longer-term appointment if the representative's performance proves satisfactory. It is important to state the duration of appointment and the basis for renewal or termination. Any renewal or termination requires an act of notification to the representative.

In certain countries, the longer the period the representative has been appointed, the more difficult and expensive it is to terminate the contract. Representative agreements are terminated in cases when one of the parties is guilty of nonperformance or of not performing to the satisfaction of the other party, for example:

> In the event that either party should breach any term or condition of this agreement or fail to perform any of its obligations or undertakings, the other party may notify the defaulting party of such default, and if such default is not rectified within sixty days, the party giving notice shall have the right, at its election, to terminate the agreement.

The previous clause is often used to terminate nonperforming representatives. It is, however, important to set certain targets and objective performance criteria against which representative's performance will be measured: sales volume, inventory turnover rates, advertising, and market share. It is also advisable to include other causes of termination, such as the following:

Right to Terminate Without Cause

A significant number of contracts allow for termination of the contract by either party with no prerequisite of action or omission by the other party upon giving advance notice, for example:

> Either party shall have the right to terminate the agreement at any time by giving not less than 180 days prior written notice of termination to the other party.

Force Majeure

Most contracts state the occurrence of specific events beyond the control of the parties as a basis for termination of the contract. The enumerated actions or events fall into four major categories: (1) acts of God, (2) wars and civil disorder, (3) acts of government such as exchange controls or host government regulations, and (4) other acts beyond the parties' control.

Other Causes of Termination

Some contracts provide for termination of the contract in cases such as bankruptcy or liquidation of either party, assignment of contractual rights or duties, change of ownership or management, and nonexclusivity, or the firm's decision to establish its own sales office or assembly operations.

In most countries, the exporter can terminate a representative in accordance with the contractual terms and without payment of indemnity. In situations lacking reasonable ground for termination, courts impose a liability for unjust termination that is often based on the volume of sales, goodwill developed by the representative, and duration of the contract. A typical formula is to award a one year's profit or commission to the distributor or agent based on an average over the previous five years or the duration of the contract, whichever is shorter. It may also include cost of termination of the representative's personnel.

Applicable Law and Dispute Settlement

The parties are at liberty to agree between themselves as to what rules should govern their contract. Most contracts state the applicable law to be that of the manufacturer's home state. This indicates the strong bargaining position of exporters and the latter's clear preference to be governed by laws about which they are well informed, including how the contract will function and its repercussions on the whole commercial and legal situation of the parties. In cases with no express or implied choice of law, courts have to decide what law should govern the parties' contract based on the terms and nature of the contract. Many factors are used to settle this issue in the absence of an express choice of law, including the place of contract, the place of performance, and the location of the subject matter of the contract, as well as the place of incorporation and place of business of the parties. The contract should also provide for a forum (court) to settle the dispute relating to the validity, interpretation, and performance of the agreement.

Many representative contracts also provide that any dispute between the parties shall be submitted to arbitration for final settlement in accordance with the rules of the International Chamber of Commerce.

MAINTAINING AND MOTIVATING OVERSEAS REPRESENTATIVES

Agents and distributors can be motivated in many ways to do the best possible job of marketing and promoting the firm's product. This could be accomplished by, for example, developing good communications through regular visits from the home office, the organization of conferences, or providing inexpensive free trips for representatives during a given period. It is also important to inform representatives of company's goals and principles and to keep them abreast of new developments in the product line, supplies, and promotion strategies, and to assist in training and market development. Firms could also motivate representatives through provision of better credit terms or price adjustments based on sales volume or other performance-based criteria.

CHAPTER SUMMARY

Introduction

Channels of distribution used to market products abroad:

1. *Indirect channels:* Exports through independent parties acting as sales intermediary.
2. *Direct channels:* Direct sales to foreign distributors, retailers, or trading companies.

Determinants of Channel Selection to Market Products Abroad

1. International marketing objectives of the firm
2. Manufacturer's resources and experience
3. Availability and capability of intermediary
4. Customer and product characteristics

5. Marketing environment
6. Control and coverage

Indirect Channels

Types of indirect channels:

1. *Exporters that sell on behalf of the manufacturer:* Manufacturer's export agents, export management companies, international trading companies
2. *Exporters that buy for their overseas customers:* Export commission agents
3. *Exporters that buy and sell on their own account:* Export merchants, cooperative exporters, WPAs

Direct Channels

Types of direct channels:

1. Direct marketing from the home country
2. Marketing through overseas agents and distributors: Overseas agents, overseas distributors

Major Clauses in Representation Agreements

1. Definition of territory and product
2. Representative's rights and obligations
3. Exporter's rights and obligations
4. Definition of price
5. Renewal or termination of contract

REVIEW QUESTIONS

1. Distinguish between direct and indirect channels of distribution. What are the advantages and disadvantages of using indirect channels?
2. Discuss three major determinants of channel selection to market products abroad.
3. Do firms that export high-technology products exercise high levels of control?
4. Discuss the role and function of manufacturer's export agents.

5. Discuss the disadvantages of using export management companies.
6. What are the differences between export trading companies and export management companies?
7. Briefly describe Webb-Pomerene Associations (WPAs).
8. What are some of the disadvantages of using overseas distributors?
9. State some of the clauses (provisions) in representation agreements.
10. Briefly describe force majeure.

CASE 5.1. EXPORT CHANNEL DECISIONS OF TWO U.S. COMPANIES

Wayne Engineering: Wayne Engineering, Inc., is a leading manufacturer of side loaders, recycling vehicles, and recycling and garbage trucks. It uses Tradesur, Inc., to handle the promotion, marketing, and distribution of its products in overseas markets.

TradeSur is an export management company (EMC) located in San Diego, California, with over eighteen years of experience in the export market. It has established distribution channels in several countries. As an EMC, its major functions include the following: (1) promotion, marketing, and distribution of U.S.–made construction equipment in Latin America and Europe; (2) handling complex logistics and outsourcing of various phases of the production process when necessary; (3) managing complex construction and infrastructure requirements by coordinating with multiple manufacturers of equipment worldwide and assembling the end product; (4) establishment of links with several financial institutions to help overseas buyers to finance their purchases, enhance their cash flows, and expand U.S. exports; and (5) arrangement of independent financing of turnkey projects for qualified government agencies and corporations from eligible foreign countries.

Farouk Systems: Farouk Systems, Inc. (FS), a Houston-based manufacturer of natural hair care and spa products wanted to get a foothold in Southeast Asia, following its successful entry in over sixty countries including China. The company sought distributors in Singapore to market its products. With the help of the U.S. Commercial Service, which locates potential buyers and distributors for U.S. firms, the company was able to appoint a distributor from a list of prospective candidates.

Singapore was considered a good market for U.S. beauty care products because Singaporean women spend an average of nearly $80 a year on such goods, compared with 17 cents spent by women in China. There is, however, intense competition from various providers in the market.

Final selection of the distributor (True Line Beauty) was based on a number of factors: experience within the Southeast Asian market, solid foundations within the industry, experience in conducting hair shows and educational seminars, sound financial position, personal chemistry, and gut instinct. They also considered the extent to which the potential candidates were willing to look at the long-term perspective and invest in the brand.

The distributor, True Line Beauty (TLB) was formed twelve years ago and has twenty employees. True Line Beauty asked for and received exclusive distribution rights in a number of other countries including Malaysia and Taiwan. Its sales force travel across the country explaining the benefits of the product, such as natural ingredients that are environmentally friendly, and offering incentives, such as refunds if the product does not sell or one free bottle for every so many sold. Once a new beauty shop or spa has shown interest, TLB provides training for stylists, demonstrates new cutting and coloring techniques using FS products.

Efforts have been quite slow in developing markets outside Singapore. True Line Beauty's approach appears to focus on tackling one market at a time. If certain specified performance benchmarks (such as sales, profit margins) as stated in the contract remain unmet over a given period of time, the U.S. company has the option of finding another distributor with the requisite capability to do the job. However, flexibility is the key in evaluating performance expectations and establishing goodwill.

CASE 5.2. THE INTERNET AND EXPORTING: A FOCUS ON DEVELOPING COUNTRIES

A business that would like to succeed in export markets needs information about market prospects and must continually fine tune its marketing skills, which includes the use of the Internet and Web-based resources to sell and promote products as well as generate new clients. For example, an export company that plans to participate in an international trade fair in an overseas market should do some Internet research on the prospective market to evaluate demand.

Analysts predict that about 10 percent of total business-to-consumer sales of U.S. retailers will be online. Business-to-business sales volume is also expected to outpace business-to-consumer sales by a factor of twenty within the next few years. The Internet enables exporters to interact directly with overseas customers. Furthermore, it facilitates product customization and the provision of extended services. Even though these new possibilities pose a serious threat to export intermediaries, a virtual market presence is not likely to be a substitute for existing networks since physical distribution channels still have several positional advantages compared with virtually organized ones. A number of value added services, for example, can only be provided via traditional distribution outlets. The Internet will not entirely replace the need for interpersonal relations and trust building. The Internet also poses organizational and managerial challenges (Peterson, Welch, and Liesch, 2002). It is plausible to contend that the Internet provides an infrastructure for carrying information and digital services, which is complementary to the existing marketing channel structure, improving performance (Anderson, 2005). In industries characterized by a high degree of information content such as publishing, travel, and financial services, export intermediation is undergoing a radical change. It has also given rise to new channels of export intermediation (e-Bay, Amazon, etc.), which were not previously available.

A study by Freund and Weinhold (2000) on the effect of the Internet on international trade shows its increasing and significant impact from 1997 to 1999. The study shows that a 10 percent increase in the relative number of Web hosts in one country would lead to about 1 percent greater trade. It also finds the effect of the Internet to be stronger for poor countries than for rich ones. However, the Internet does not seem to have reduced the impact of distance on trade. Clarke and Wallsten (2004) also find a positive correlation between Internet penetration in developing countries and their increasing exports to developed countries.

In many countries, global business-to-business Web sites have already been set up in a number of industries. Daimler-Chrysler, GM, and Ford have started an Internet-based market (COVISINT) for car parts worldwide; e-steel is established to link buyers and sellers of steel products around the world. In Egypt, some seventy-five products are marketed on the Internet. Adelphi, a leather products maker in Kenya, started a Web site with the intention of expanding into the global market. Global orders are executed through international courier firms such as DHL.

In spite of the increase in the number of users, Internet penetration rates in most developing countries remain low (see Table 5.1). Online trade is limited. Other factors contributing to lower than average e-commerce activity include low per capita incomes, low credit card usage, lack of relevant products or services, or poor logistics and fulfillment services.

In more advanced developing nations such as Taiwan, for example, the Internet is widely used in most sectors of the economy. Taiwanese firms are more concerned with improving forward linkages to their customers than

TABLE 5.1. Internet Users (Thousands) and Hosts (Thousands) by Region

Region	Internet Users	Internet Hosts
Africa	7,943	281
Latin America and Caribbean	35,459	3,412
North America	170,200	109,084
Asia	201,079	10,803
Western Europe	166,387	18,363
Oceana (Australia, New Zealand, and others)	10,500	3,035
Developing Countries	189,882	7,279
Developed Countries	401,686	137,700

Source: Adapted from International Telecommunications Union (ITU), 2003.

improving backward linkages to their suppliers. In spite of the diffusion of the Internet, concerns over security and privacy in online trading represent the most significant barrier to its use in international business transactions.

Questions

1. Would you advise Wayne Engineering to use overseas distributors to market its products abroad?
2. What are some of the limitations of the Internet in facilitating the expansion of exports from developing countries?