12 Marketing Channels

Delivering Customer Value

Chapter Preview

We now arrive at the third marketing mix tool—distribution. Firms rarely work alone in creating value for customers and building profitable customer relationships. Instead, most are only a single link in a larger supply chain and marketing channel. As such, an individual firm's success depends not only on how well *it* performs but also on how well its *entire marketing channel* competes with competitors' channels. To be good at customer relationship management, a company must also be good at partner relationship management. The first part of this chapter explores the nature of marketing channels and the marketer's channel design and management decisions. We then examine physical distribution—or logistics—an area that is growing dramatically in importance and sophistication. In the next chapter, we'll look more closely at two major channel intermediaries: retailers and wholesalers.

We start by looking at a company whose groundbreaking, customer-centered distribution strategy took it to the top of its industry.

Enterprise: Leaving Car Rental Competitors in the Rear View Mirror

Quick, which rental car company is number one? Chances are good that you said Hertz. Okay, who's number two? That must be Avis, you say. After all, for years Avis's advertising said, "We're #2, so we try harder!" But if you said Hertz or Avis, you're about to be surprised. By any measure—most revenues, employees, transactions, or number of vehicles—the number-one rental-car company in the world is Enterprise Holdings, which owns and operates the Enterprise Rent-A-Car, Alamo Rent A Car, and National Car Rental brands. Even more, this is no recent development. Enterprise left number-two Hertz in its rearview mirror in the late 1990s and has never looked back.

What may have fooled you is that the Hertz brand was for a long time number one in airport car rentals. However, with all of its combined brands and markets, Enterprise Holdings now captures 53 percent of the total rental car market with Hertz a distant second at 16 percent.[1] What's more, by all estimates, the privately owned Enterprise is much more profitable as well.

How did Enterprise become such a powerful industry leader? The company might argue that it was through better prices or better marketing. But what contributed most to Enterprise taking the lead was an industry-changing, customer-driven distribution strategy. While competitors such as Hertz and Avis focused on serving travelers at airports, Enterprise developed a new distribution doorway to a large and untapped segment. It opened off-airport, neighborhood locations that provided short-term car-replacement rentals for people whose cars were wrecked, stolen, or being serviced or for people who simply wanted a different car for a short trip or a special occasion.

It all started more than half a century ago when Enterprise founder Jack Taylor discovered an unmet customer need. He was working at a St. Louis auto dealership, and customers often asked him where they could get a replacement car when theirs was in the shop for repairs or body work. To meet this need, Taylor opened a car-leasing business. But rather than compete head-on with the likes of Hertz and Avis serving travelers at airports, Taylor located his rental offices in center-city and neighborhood areas, closer to his target customers. These locations also gave Taylor a cost advantage: Property rents were lower, and he didn't have to pay airport taxes and fees.

This groundbreaking distribution strategy worked, and the business grew quickly. As the Taylor family opened multiple locations in St. Louis and other cities, they renamed the business Enterprise Rent-A-Car after the U.S. Navy aircraft carrier on which Jack Taylor had served as a naval aviator. Enterprise continued to focus steadfastly on what it called the "home city" market, primarily serving customers who'd been in wrecks or whose cars were being serviced. Enterprise branch managers developed strong relationships with local

Thanks to an industry-changing, customer-driven distribution strategy, Enterprise left number-two Hertz in its rearview mirror more than a decade ago and has never looked back.

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auto insurance adjusters, dealership sales and service personnel, and body shops and service garages, making Enterprise a popular neighborhood rental car provider.

Customers in the home city market had special needs. Often, they were at the scene of a wreck or at a repair shop and had no way to get to an Enterprise office to pick up a rental car. So the company came up with another game-changing idea—picking customers up wherever they happen to be and bringing them back to the rental office. Hence, the tagline: "Pick Enterprise. We'll Pick You Up," which remains the Enterprise Rent-A-Car brand's main value proposition to this day.

By the late 1980s, Enterprise had a large nationwide network of company-owned, off-airport locations. From this strong base, in the mid-1990s Enterprise began expanding its distribution system by directly challenging Hertz and Avis in the on-airport market. A decade later, it had set up operations in 240 airports in North America and Europe. Then, in late 2007, the Taylor family purchased the Vanguard Car Rental Group, which owned the National and Alamo brands. National focused on the corporate-negotiated airport market, while Alamo served primarily the leisure traveler airport market.

With the Vanguard acquisition, Enterprise Holdings now captures a more than 31 percent share of the airport market, putting it ahead of Avis Budget Group and Hertz. That, combined with its share of the off-airport market, makes Enterprise Holdings the runaway leader in overall car rentals. It now operates 7,600 locations in the United States and four other countries.

Another secret to Enterprise's success is its passion for creating customer satisfaction. To measure satisfaction, Enterprise developed what it calls its ESQi (Enterprise Service Quality index). The company calls some two million customers a year and asks a simple question: "Were you completely satisfied with the service?" Enterprise managers don't get promoted unless they keep customers *completely* satisfied. It's as simple as that. If customer feedback is bad, "we call it going to ESQi jail," says an Enterprise human resources manager. "Until the numbers start to improve, you're going nowhere." As a result, for six years running, customers have rated the Enterprise Rent-A-Car brand number one in the annual J.D. Power U.S. Car Rental Satisfaction Study.

Looking ahead, rather than resting on its laurels, Enterprise Rent-A-Car continues to seek better ways to keep customers happy by getting cars where people want them. The enterprising company has now motored into yet another innovative distribution venue—"car sharing" and hourly rentals—called WeCar. This operation parks automobiles at convenient locations on college campuses and in densely populated urban areas, where residents often don't own cars and where business commuters would like to have occasional car access. Enterprise is also targeting businesses that want to have WeCar vehicles available in their parking lots for commuting employees to use. WeCar members pay $35 for an annual membership fee, depending on the location. They can then rent conveniently located, fuel-efficient cars (mostly Toyota Prius hybrids) for $10 per hour or $60 to $75 for the day; the rate includes gas and a 200-mile allotment. Renting a WeCar vehicle is a simple get-in-and-go operation. Just pass your member key fob over a sensor to unlock the car, open the glove box, and enter a PIN to release the car key.

Thus, Enterprise Holdings continues to move ahead aggressively with its winning distribution strategy. Says Andy Taylor, founder Jack's son and now long-time CEO, "We own the high ground in this business and we aren't going to give it up. As the dynamics of our industry continue to evolve, it's clear to us that the future belongs to the service providers who offer the broadest array of services for anyone who needs or wants to rent a car." The company intends to make cars available wherever, whenever, and however customers want them.[2]

As the Enterprise story shows, good distribution strategies can contribute strongly to customer value and create competitive advantage for a firm. But firms cannot bring value to customers by themselves. Instead, they must work closely with other firms in a larger value delivery network.

Objective OUTLINE

Objective 1 Explain why companies use marketing channels and discuss the functions these channels perform.

Supply Chains and the Value Delivery Network (340–341)

The Nature and Importance of Marketing Channels (341–344)

Objective 2 Discuss how channel members interact and how they organize to perform the work of the channel.

Channel Behavior and Organization (344–351)

Objective 3 Identify the major channel alternatives open to a company.

Channel Design Decisions (351–354)

Objective 4 Explain how companies select, motivate, and evaluate channel members.

Channel Management Decisions (354–357)

Objective 5 Discuss the nature and importance of marketing logistics and integrated supply chain management.

Marketing Logistics and Supply Chain Management (357–365)

Author Comment These are pretty hefty terms for a really simple concept: A company can't go it alone in creating customer value. It must work within an entire network of partners to accomplish this task. Individual companies and brands don't compete; their entire value delivery networks do.

Supply Chains and the Value Delivery Network (pp 340–341)

Producing a product or service and making it available to buyers requires building relationships not only with customers but also with key suppliers and resellers in the company's *supply chain*. This supply chain consists of upstream and downstream partners. Upstream from the company is the set of firms that supply the raw materials, components, parts, information, finances, and expertise needed to create a product or service. Marketers, however, have traditionally focused on the downstream side of the supply chain—on the *marketing channels* (or *distribution channels*) that look toward the customer. Downstream marketing channel partners, such as wholesalers and retailers, form a vital connection between the firm and its customers.

The term *supply chain* may be too limited—it takes a *make-and-sell* view of the business. It suggests that raw materials, productive inputs, and factory capacity should serve as the starting point for market planning. A better term would be *demand chain* because it suggests a *sense-and-respond* view of the market. Under this view, planning starts by identifying the needs of target customers, to which the company responds by organizing a chain of resources and activities with the goal of creating customer value.

Yet, even a demand chain view of a business may be too limited because it takes a step-by-step, linear view of purchase-production-consumption activities. With the advent of the Internet and other technologies, however, companies are now forming more numerous and complex relationships with other firms. For example, Ford manages many supply chains—think about all the parts it takes to create a vehicle, from radios to catalytic converters to tires to transistors. Ford also sponsors or transacts on many B-to-B Web sites and online purchasing exchanges as needs arise. Like Ford, most large companies today are engaged in building and managing a complex, continuously evolving *value delivery network*.

As defined in Chapter 2, a **value delivery network** is made up of the company, suppliers, distributors, and, ultimately, customers who "partner" with each other to improve the performance of the entire system. For example, in making and marketing just one of its many models for the global market—say the Ford Escape hybrid—Ford manages a huge network of people within Ford plus thousand of suppliers and dealers outside the company who work together effectively to give final customers "the most fuel-efficient SUV on the market."

Value delivery network: In making and marketing just one of its many models—say, the Ford Escape hybrid—Ford manages a huge network of people within Ford plus thousand of suppliers and dealers outside the company who work together to give final customers "the most fuel-efficient SUV on the market."

Value delivery network
A network composed of the company, suppliers, distributors, and, ultimately, customers who "partner" with each other to improve the performance of the entire system in delivering customer value.

This chapter focuses on marketing channels—on the downstream side of the value delivery network. We examine four major questions concerning marketing channels: What is the nature of marketing channels and why are they important? How do channel firms interact and organize to do the work of the channel? What problems do companies face in designing and managing their channels? What role do physical distribution and supply chain management play in attracting and satisfying customers? In Chapter 13, we will look at marketing channel issues from the viewpoint of retailers and wholesalers.

Author Comment | In this section, we look at the downstream side of the value delivery network—the marketing channel organizations that connect the company and its customers. To understand their value, imagine life without retailers—say, without grocery stores or department stores.

The Nature and Importance of Marketing Channels (pp 341–344)

Few producers sell their goods directly to final users. Instead, most use intermediaries to bring their products to market. They try to forge a **marketing channel** (or **distribution channel**)—a set of interdependent organizations that help make a product or service available for use or consumption by the consumer or business user.

Marketing channel (or distribution channel)
A set of interdependent organizations that help make a product or service available for use or consumption by the consumer or business user.

A company's channel decisions directly affect every other marketing decision. Pricing depends on whether the company works with national discount chains, uses high-quality specialty stores, or sells directly to consumers via the Web. The firm's sales force and communications decisions depend on how much persuasion, training, motivation, and support its channel partners need. Whether a company develops or acquires certain new products may depend on how well those products fit the capabilities of its channel members. For example, Kodak initially sold its EasyShare printers only in Best Buy stores because of the retailer's on-the-floor sales staff and their ability to educate buyers on the economics of paying a higher initial printer price but lower long-term ink costs.

Companies often pay too little attention to their distribution channels—sometimes with damaging results. In contrast, many companies have used imaginative distribution systems to gain a competitive advantage. Enterprise revolutionized the car-rental business by setting up off-airport rental offices. Apple turned the retail music business on its head by selling music for the iPod via the Internet on iTunes. And FedEx's creative and imposing distribution system made it a leader in express delivery.

Distribution channel decisions often involve long-term commitments to other firms. For example, companies such as Ford, McDonald's, or HP can easily change their advertising, pricing, or promotion programs. They can scrap old products and introduce new ones as market tastes demand. But when they set up distribution channels through contracts with franchisees, independent dealers, or large retailers, they cannot readily replace these channels with company-owned stores or Web sites if the conditions change. Therefore, management must design its channels carefully, with an eye on both tomorrow's likely selling environment and today's.

How Channel Members Add Value

Why do producers give some of the selling job to channel partners? After all, doing so means giving up some control over how and to whom they sell their products. Producers use intermediaries because they create greater efficiency in making goods available to target markets. Through their contacts, experience, specialization, and scale of operation, intermediaries usually offer the firm more than it can achieve on its own.

Figure 12.1 shows how using intermediaries can provide economies. Figure 12.1A shows three manufacturers, each using direct marketing to reach three customers. This system requires nine different contacts. Figure 12.1B shows the three manufacturers working through one distributor, which contacts the three customers. This system requires only six contacts. In this way, intermediaries reduce the amount of work that must be done by both producers and consumers.

From the economic system's point of view, the role of marketing intermediaries is to transform the assortments of products made by producers into the assortments wanted by consumers. Producers make narrow assortments of products in large quantities, but consumers want broad assortments of products in small quantities. Marketing channel members buy large quantities from many producers and break them down into the smaller quantities and broader assortments desired by consumers.

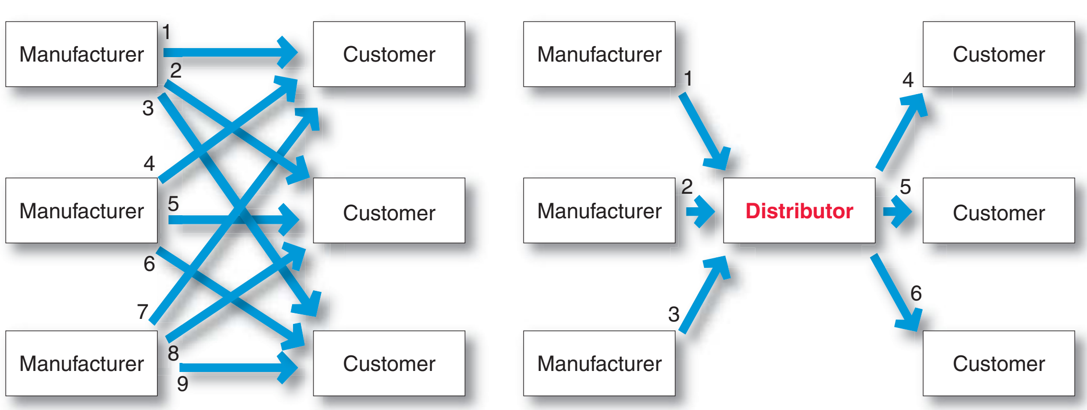
For example, Unilever makes millions of bars of Lever 2000 hand soap each week, but you want to buy only a few bars at a time. So big food, drug, and discount retailers, such as Kroger, Walgreens, and Target, buy Lever 2000 by the truckload and stock it on their stores' shelves. In turn, you can buy a single bar of Lever 2000, along with a shopping cart full of small quantities of toothpaste, shampoo, and other related products as you need them. Thus, intermediaries play an important role in matching supply and demand.

In making products and services available to consumers, channel members add value by bridging the major time, place, and possession gaps that separate goods and services from those who use them. Members of the marketing channel perform many key functions. Some help to complete transactions:

- *Information:* Gathering and distributing marketing research and intelligence information about actors and forces in the marketing environment needed for planning and aiding exchange.
- *Promotion:* Developing and spreading persuasive communications about an offer.
- *Contact:* Finding and communicating with prospective buyers.
- *Matching:* Shaping and fitting the offer to the buyer's needs, including activities such as manufacturing, grading, assembling, and packaging.

FIGURE | 12.1
How Adding a Distributor Reduces the Number of Channel Transactions

Marketing channel intermediaries make buying a lot easier for consumers. Again, think about life without grocery retailers. How would you go about buying that 12-pack of Coke or any of the hundreds of other items that you now routinely drop into your shopping cart?



A. Number of contacts without a distributor
M × C = 3 × 3 = 9

B. Number of contacts with a distributor
M + C = 3 + 3 = 6

- *Negotiation:* Reaching an agreement on price and other terms of the offer so that ownership or possession can be transferred.

Others help to fulfill the completed transactions:

- *Physical distribution:* Transporting and storing goods.
- *Financing:* Acquiring and using funds to cover the costs of the channel work.
- *Risk taking:* Assuming the risks of carrying out the channel work.

The question is not *whether* these functions need to be performed—they must be—but rather *who* will perform them. To the extent that the manufacturer performs these functions, its costs go up, and, therefore, its prices must be higher. When some of these functions are shifted to intermediaries, the producer's costs and prices may be lower, but the intermediaries must charge more to cover the costs of their work. In dividing the work of the channel, the various functions should be assigned to the channel members who can add the most value for the cost.

Number of Channel Levels

Channel level
A layer of intermediaries that performs some work in bringing the product and its ownership closer to the final buyer.

Direct marketing channel
A marketing channel that has no intermediary levels.

Indirect marketing channel
Channel containing one or more intermediary levels.

Companies can design their distribution channels to make products and services available to customers in different ways. Each layer of marketing intermediaries that performs some work in bringing the product and its ownership closer to the final buyer is a **channel level**. Because both the producer and the final consumer perform some work, they are part of every channel.

The *number of intermediary levels* indicates the *length* of a channel. **Figure 12.2A** shows several consumer distribution channels of different lengths. Channel 1, called a **direct marketing channel**, has no intermediary levels; the company sells directly to consumers. For example, Mary Kay Cosmetics and Amway sell their products door-to-door, through home and office sales parties, and on the Internet; GEICO sells insurance direct via the telephone and the Internet. The remaining channels in Figure 12.2A are **indirect marketing channels**, containing one or more intermediaries.

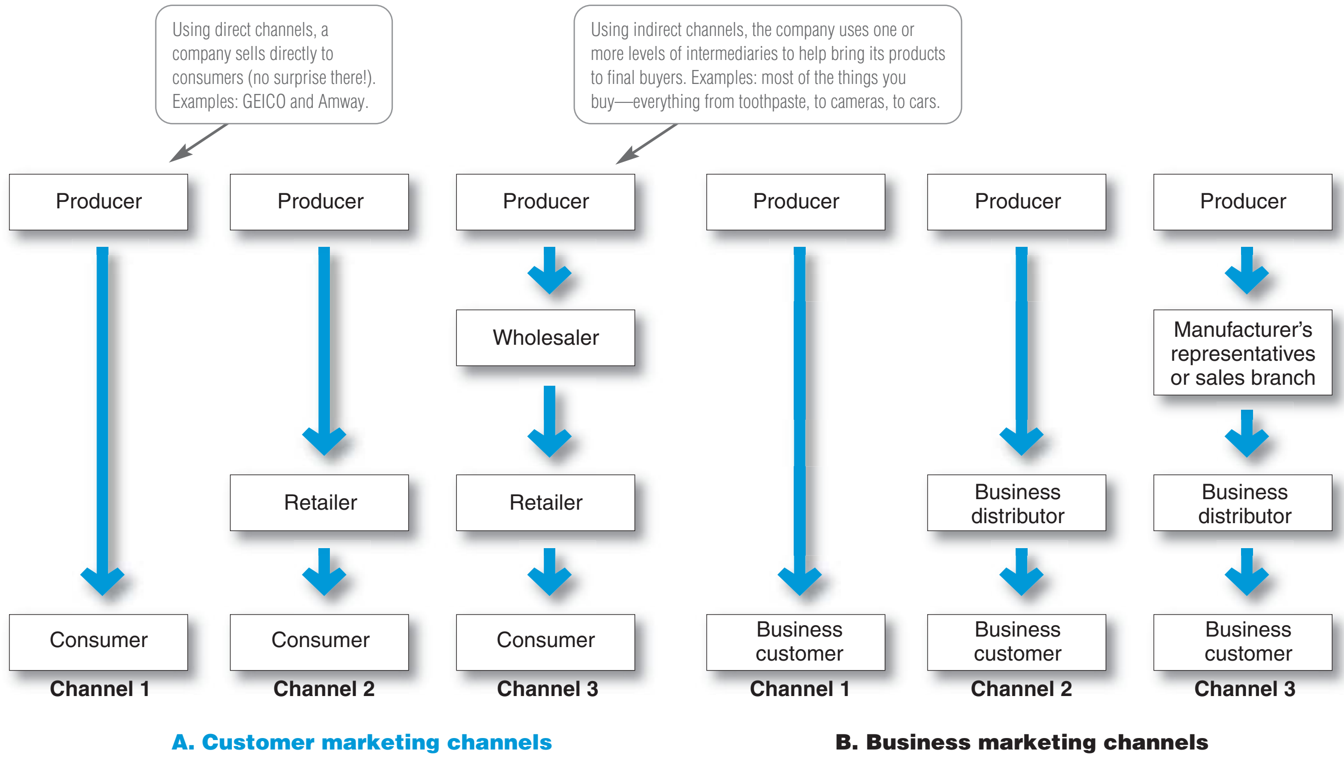


FIGURE | 12.2
Consumer and Business Marketing Channels

Figure 12.2B shows some common business distribution channels. The business marketer can use its own sales force to sell directly to business customers. Or it can sell to various types of intermediaries, who in turn sell to these customers. Consumer and business marketing channels with even more levels can sometimes be found, but these are less common. From the producer's point of view, a greater number of levels means less control and greater channel complexity. Moreover, all the institutions in the channel are connected by several types of *flows*. These include the *physical flow* of products, the *flow of ownership*, the *payment flow*, the *information flow*, and the *promotion flow*. These flows can make even channels with only one or a few levels very complex.

Author Comment Channels are made up of more than just boxes and arrows on paper. They are behavioral systems made up of real companies and people who interact to accomplish their individual and collective goals. Like groups of people, sometimes they work well together and sometimes they don't.

Channel Behavior and Organization (pp 344–351)

Distribution channels are more than simple collections of firms tied together by various flows. They are complex behavioral systems in which people and companies interact to accomplish individual, company, and channel goals. Some channel systems consist of only informal interactions among loosely organized firms. Others consist of formal interactions guided by strong organizational structures. Moreover, channel systems do not stand still; new types of intermediaries emerge, and whole new channel systems evolve. Here we look at channel behavior and how members organize to do the work of the channel.

Channel Behavior

A marketing channel consists of firms that have partnered for their common good. Each channel member depends on the others. For example, a Ford dealer depends on Ford to design cars that meet customer needs. In turn, Ford depends on the dealer to attract customers, persuade them to buy Ford cars, and service the cars after the sale. Each Ford dealer also depends on other dealers to provide good sales and service that will uphold the brand's reputation. In fact, the success of individual Ford dealers depends on how well the entire Ford marketing channel competes with the channels of other auto manufacturers.

Each channel member plays a specialized role in the channel. For example, the role of consumer electronics maker Samsung is to produce electronics products that consumers will like and create demand through national advertising. Best Buy's role is to display these Samsung products in convenient locations, answer buyers' questions, and complete sales. The channel will be most effective when each member assumes the tasks it can do best.

Ideally, because the success of individual channel members depends on overall channel success, all channel firms should work together smoothly. They should understand and accept their roles, coordinate their activities, and cooperate to attain overall channel goals. However, individual channel members rarely take such a broad view. Cooperating to achieve overall channel goals sometimes means giving up individual company goals. Although channel members depend on one another, they often act alone in their own short-run best interests. They often disagree on who should do what and for what rewards. Such disagreements over goals, roles, and rewards generate **channel conflict**.

Channel conflict
Disagreement among marketing channel members on goals, roles, and rewards—who should do what and for what rewards.

Horizontal conflict occurs among firms at the same level of the channel. For instance, some Ford dealers in Chicago might complain that other dealers in the city steal sales from them by pricing too low or advertising outside their assigned territories. Or Holiday Inn franchisees might complain about other Holiday Inn operators overcharging guests or giving poor service, hurting the overall Holiday Inn image.

Vertical conflict, conflicts between different levels of the same channel, is even more common. ◉ In recent years, for example, Burger King has had a steady stream of conflicts with its franchised dealers over everything from increased ad spending and offensive ads to the prices it charges for cheeseburgers. At issue is the chain's right to dictate policies to franchisees.[3]

The price of a double cheeseburger has generated a lot of heat among Burger King franchisees. In an ongoing dispute, the burger chain insisted that the sandwich be sold for no more than $1—in line with other items on its "Value Menu." Burger King saw the value price as key to competing effectively in the current economic environment. But the company's franchisees claimed that they would lose money at that price. To re-

In recent years, Burger King has had a steady stream of conflicts with its franchised dealers over everything from advertising content to the price of its cheeseburgers.

solve the dispute, angry franchisees filed a lawsuit (only one of several over the years) asserting that Burger King's franchise agreements don't allow it to dictate prices. (The company had won a separate case in 2008 requiring franchisees to offer the Value Menu, which is core to its efforts to attract price-conscious consumers.) After months of public wrangling, Burger King finally let franchisees have it their way. It introduced a $1 double-patty burger with just one slice of cheese, instead of two, cutting the cost of ingredients. The regular quarter-pound double cheeseburger with two pieces of cheese remained on the Value Menu but was priced at $1.19.

Some conflict in the channel takes the form of healthy competition. Such competition can be good for the channel; without it, the channel could become passive and noninnovative. For example, Burger King's conflict with its franchisees might represent normal give-and-take over the respective rights of the channel partners. But severe or prolonged conflict can disrupt channel effectiveness and cause lasting harm to channel relationships. Burger King should manage the channel conflict carefully to keep it from getting out of hand.

Vertical Marketing Systems

For the channel as a whole to perform well, each channel member's role must be specified, and channel conflict must be managed. The channel will perform better if it includes a firm, agency, or mechanism that provides leadership and has the power to assign roles and manage conflict.

Historically, *conventional distribution channels* have lacked such leadership and power, often resulting in damaging conflict and poor performance. One of the biggest channel developments over the years has been the emergence of *vertical marketing systems* that provide channel leadership. **Figure 12.3** contrasts the two types of channel arrangements.

Conventional distribution channel
A channel consisting of one or more independent producers, wholesalers, and retailers, each a separate business seeking to maximize its own profits, even at the expense of profits for the system as a whole.

Vertical marketing system (VMS)
A distribution channel structure in which producers, wholesalers, and retailers act as a unified system. One channel member owns the others, has contracts with them, or has so much power that they all cooperate.

Corporate VMS
A vertical marketing system that combines successive stages of production and distribution under single ownership—channel leadership is established through common ownership.

A **conventional distribution channel** consists of one or more independent producers, wholesalers, and retailers. Each is a separate business seeking to maximize its own profits, perhaps even at the expense of the system as a whole. No channel member has much control over the other members, and no formal means exists for assigning roles and resolving channel conflict.

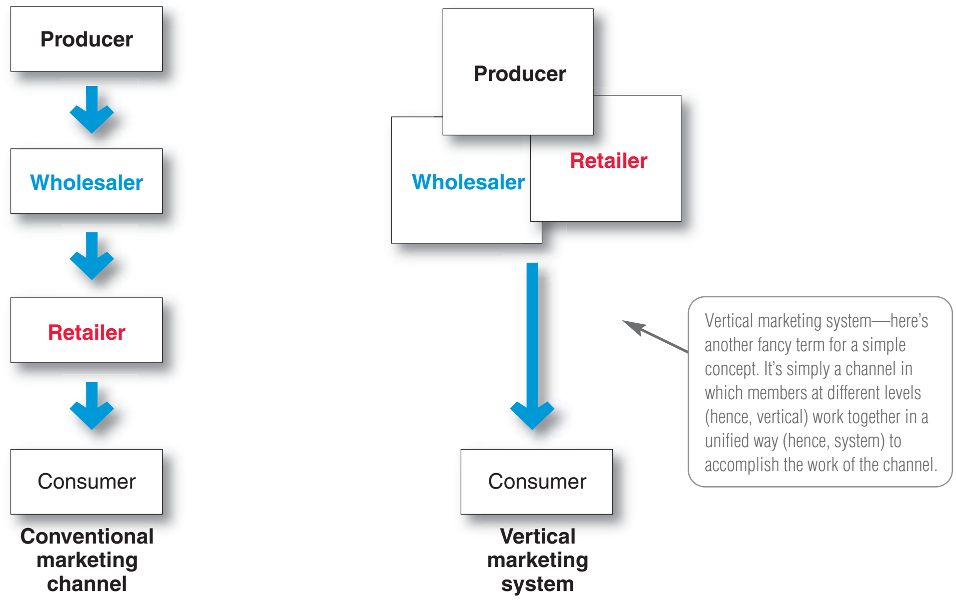
In contrast, a **vertical marketing system (VMS)** consists of producers, wholesalers, and retailers acting as a unified system. One channel member owns the others, has contracts with them, or wields so much power that they must all cooperate. The VMS can be dominated by the producer, the wholesaler, or the retailer.

We look now at three major types of VMSs: *corporate*, *contractual*, and *administered*. Each uses a different means for setting up leadership and power in the channel.

Corporate VMS

A **corporate VMS** integrates successive stages of production and distribution under single ownership. Coordination and conflict management are attained through regular organizational channels. For example, the grocery giant Kroger owns and operates 40 manufacturing plants—18 dairies, 10 deli and bakery plants, five grocery product plants, three beverage plants, two meat plants, and two cheese plants—that crank out 40 percent of the more than 14,000 private label items found on its store shelves. Little-known Italian eyewear maker Luxottica produces many famous eyewear brands—including its own Ray-Ban and Oakley brands and licensed brands such as Burberry, Chanel, Polo Ralph Lauren, Dolce&Gabbana, Donna Karan, Prada, Versace, and Bulgari. It then sells these brands through some of the

FIGURE | 12.3
Comparison of Conventional Distribution Channel with Vertical Marketing System



Contractual VMS
A vertical marketing system in which independent firms at different levels of production and distribution join together through contracts.

Franchise organization
A contractual vertical marketing system in which a channel member, called a franchisor, links several stages in the production-distribution process.

world's largest optical chains—LensCrafters, Pearle Vision, and Sunglass Hut—that it also owns.[4] Controlling the entire distribution chain has turned Spanish clothing chain Zara into the world's fastest-growing fashion retailer (see Real Marketing 12.1).

Contractual VMS

A **contractual VMS** consists of independent firms at different levels of production and distribution who join together through contracts to obtain more economies or sales impact than each could achieve alone. Channel members coordinate their activities and manage conflict through contractual agreements.

The **franchise organization** is the most common type of contractual relationship. A channel member called a *franchisor* links several stages in the production-distribution process. In the United States alone, some 1,500 franchise businesses and 883,000 franchise outlets account for more than $844 billion of economic output. Industry analysts estimate that a new franchise outlet opens somewhere in the United States every eight minutes and that about one out of every 12 retail business outlets is a franchised business.[5] Almost every kind of business has been franchised—from motels and fast-food restaurants to dental centers and dating services, from wedding consultants and maid services to fitness centers and funeral homes.

Franchising systems: Almost every kind of business has been franchised—from motels and fast-food restaurants to dating services and cleaning and handyman companies.

There are three types of franchises. The first type is the *manufacturer-sponsored retailer franchise system*—for example, Ford and its network of independent franchised dealers. The second type is the *manufacturer-sponsored wholesaler franchise system*—Coca-Cola licenses bottlers (wholesalers) in various markets who buy Coca-Cola syrup concentrate and then bottle and sell the finished product to retailers in local markets. The third type is the *service-firm-sponsored retailer franchise system*—for example, Burger King and its nearly 10,500 franchisee-operated restaurants around the world. Other examples can be found in everything from auto rentals (Hertz, Avis), apparel retailers (The Athlete's Foot, Plato's Closet), and motels (Holiday Inn, Ramada Inn) to real estate (Century 21) and personal services (Great Clips, Mr. Handyman, Molly Maid).

The fact that most consumers cannot tell the difference between contractual and corporate VMSs shows how successfully

Real Marketing 12.1

Zara: Fast Fashions—*Really* Fast

Fashion retailer Zara is on a tear. It sells "cheap chic"—stylish designs that resemble those of big-name fashion houses but at moderate prices. Zara is the prototype for a new breed of "fast-fashion" retailers, companies that recognize and respond to the latest fashion trends quickly and nimbly. While competing retailers are still working out their designs, Zara has already put the latest fashion into its stores and is moving on to the next big thing.

Zara has attracted a near cultlike clientele in recent years. Following the recent economic slide, even upscale shoppers are swarming to buy Zara's stylish but affordable offerings. Thanks to Zara's torrid growth, the sales, profits, and store presence of its parent company, Spain-based Inditex, have more than quadrupled since 2000. Despite the poor economy, Inditex opened 450 stores last year, while other big retailers such as Gap closed stores. Despite the poor economy, Inditex's sales grew 9 percent last year. By comparison, Gap's sales *fell*. As a result, Inditex has now sprinted past Gap to become the world's largest clothing retailer. Inditex's 4,670 stores in 74 countries sewed up $14.9 billion in sales last year.

Zara clearly sells the right goods for these times. But its amazing success comes not just from *what* it sells. Perhaps more important, success comes from how and how fast Zara's cutting-edge distribution system *delivers* what it sells to eagerly awaiting customers. Zara delivers fast fashion—*really* fast fashion. Through vertical integration, Zara controls all phases of the fashion process, from design and manufacturing to distribution through its own managed stores. The company's integrated supply system makes Zara faster, more flexible, and more efficient than international competitors such as Gap, Benetton, and H&M. Zara can take a new fashion concept through design, manufacturing, and store-shelf placement in as little as two weeks, whereas competitors often take six months or more. And the resulting low costs let Zara offer the very latest midmarket chic at downmarket prices.

The whole process starts with input about what consumers want. Zara store managers act as trend spotters. They patrol store aisles using handheld computers, reporting in real time what's selling and what's not selling. They talk with customers to learn what they're looking for but not yet finding. At the same time, Zara trend seekers roam fashion shows in Paris and concerts in Tokyo, looking for young people who might be wearing something new or different. Then they're on the phone to company headquarters in tiny La Coruña, Spain, reporting on what they've seen and heard. Back home, based on this and other feedback, the company's team of 300 designers, 200 specifically for Zara, conjures up a prolific flow of hot new fashions.

Once the designers have done their work, production begins. But rather than relying on a hodgepodge of slow-moving suppliers in Asia, as most competitors do, Zara makes 40 percent of its own fabrics and produces more than half of its own clothes. Even farmed-out manufacturing goes primarily to local contractors. Almost all clothes sold in Zara's stores worldwide are made quickly and efficiently at or near company headquarters in a remote corner of northwest Spain.

Finished goods then feed into Zara's modern distribution centers, which ship them immediately and directly to stores around the world, saving time, eliminating the need for warehouses, and keeping inventories low. The highly automated centers can sort, pack, label, and allocate up to 80,000 items per hour.

Again, the key word describing Zara's distribution system is *fast*. The time between receiving an order at the distribution center to the delivery of goods to a store averages 24 hours for European stores and a maximum of 48 hours for American or Asian stores. Zara stores receive small shipments of new merchandise two to three times each week, compared with competing chains' outlets, which get large shipments seasonally, usually just four to six times per year.

Speedy design and distribution allows Zara to introduce a copious supply of new fashions—some 30,000 items last year, compared with a competitor average of less than 10,000. The combination of a large number of new fashions delivered in frequent small batches gives Zara stores a continually updated merchandise mix that brings customers back more often. Zara customers visit the store an average of 17 times per year, compared to less than five customer visits at competing stores. Fast turnover also results in less outdated and discounted merchandise. Because Zara makes what consumers already want or are now wearing, it doesn't have to guess what will be hot six months in the future.

In all, Zara's carefully integrated design and distribution process gives the fast-moving retailer a tremendous competitive advantage.

Controlling the entire distribution chain makes Zara more flexible and more efficient—a virtual blur compared with its competitors. It can take a new line from design to production to worldwide distribution in its own stores in less than a month (versus an industry average of nine months).

Continued on next page

Its turbocharged system gets out the goods customers what, when they want them—perhaps even before:

> A few summers ago, Zara managed to latch onto one of the season's hottest trends in just four weeks. The process started when trend spotters spread the word back to headquarters: White eyelet—cotton with tiny holes in it—was set to become white-hot. A quick telephone survey of Zara store managers confirmed that the fabric could be a winner, so in-house designers got down to work. They zapped patterns electronically to Zara's factory across the street, and the fabric was cut. Local subcontractors stitched white-eyelet V-neck belted dresses—think Jackie Kennedy, circa 1960—and finished them in less than a week. The $129 dresses were inspected, tagged, and transported through a tunnel under the street to a distribution center. From there, they were quickly dispatched to Zara stores from New York to Tokyo—where they were flying off the racks just two days later.

Sources: Emilie Marsh, "Zara Helps Lift Inditex 4th-Qtr Net," *WWD*, March 18, 2010, p. 11; Cecilie Rohwedder, "Zara Grows as Retail Rivals Struggle," *Wall Street Journal*, March 26, 2009, p. B1; Kerry Capell, "Fashion Conquistador," *BusinessWeek*, September 4, 2006, pp. 38–39; Rohwedder, "Turbocharged Supply Chain May Speed Zara Past Gap as Top Clothing Retailer," *Globe and Mail*, March 26, 2009, p. B12; www.gap.com, accessed April 2010; and information from the Inditex Press Dossier, www.inditex.com/en/press/information/press_kit, accessed October 2010.

Administered VMS
A vertical marketing system that coordinates successive stages of production and distribution through the size and power of one of the parties.

Horizontal marketing system
A channel arrangement in which two or more companies at one level join together to follow a new marketing opportunity.

Multichannel distribution system
A distribution system in which a single firm sets up two or more marketing channels to reach one or more customer segments.

the contractual organizations compete with corporate chains. Chapter 13 presents a fuller discussion of the various contractual VMSs.

Administered VMS

In an **administered VMS**, leadership is assumed not through common ownership or contractual ties but through the size and power of one or a few dominant channel members. Manufacturers of a top brand can obtain strong trade cooperation and support from resellers. For example, GE, P&G, and Kraft can command unusual cooperation from resellers regarding displays, shelf space, promotions, and price policies. In turn, large retailers such as Walmart, Home Depot, and Barnes & Noble can exert strong influence on the many manufacturers that supply the products they sell.

Horizontal Marketing Systems

Another channel development is the **horizontal marketing system**, in which two or more companies at one level join together to follow a new marketing opportunity. By working together, companies can combine their financial, production, or marketing resources to accomplish more than any one company could alone.

Companies might join forces with competitors or noncompetitors. They might work with each other on a temporary or permanent basis, or they may create a separate company. For example, McDonald's places "express" versions of its restaurants in Walmart stores. McDonald's benefits from Walmart's heavy store traffic, and Walmart keeps hungry shoppers from needing to go elsewhere to eat.

Horizontal marketing channels: McDonald's places "express" versions of its restaurants in Walmart stores. McDonald's benefits from Walmart's heavy store traffic, and Walmart keeps hungry shoppers from needing to go elsewhere to eat.

Competitors Microsoft and Yahoo! have joined forces to create a horizontal Internet search alliance. For the next decade, Microsoft's Bing will be the search engine on Yahoo! Web sites, serving up the same search results listings available directly through Bing. In turn, Yahoo! will focus on creating a richer search experience by integrating strong Yahoo! content and providing tools to tailor the Yahoo! user experience. Although they haven't been able to do it individually, together Microsoft and Yahoo! might become a strong challenger to search leader Google.[6]

Multichannel distribution: John Deere sells its familiar green and yellow lawn and garden equipment to consumers and commercial users through several channels, including Lowe's home improvement stores and online. It sells its agricultural equipment through the premium John Deere dealer network.

Multichannel Distribution Systems

In the past, many companies used a single channel to sell to a single market or market segment. Today, with the proliferation of customer segments and channel possibilities, more and more companies have adopted **multichannel distribution systems**. Such multichannel marketing occurs when a single firm sets up two or more marketing channels to reach one or more customer segments. The use of multichannel systems has increased greatly in recent years.

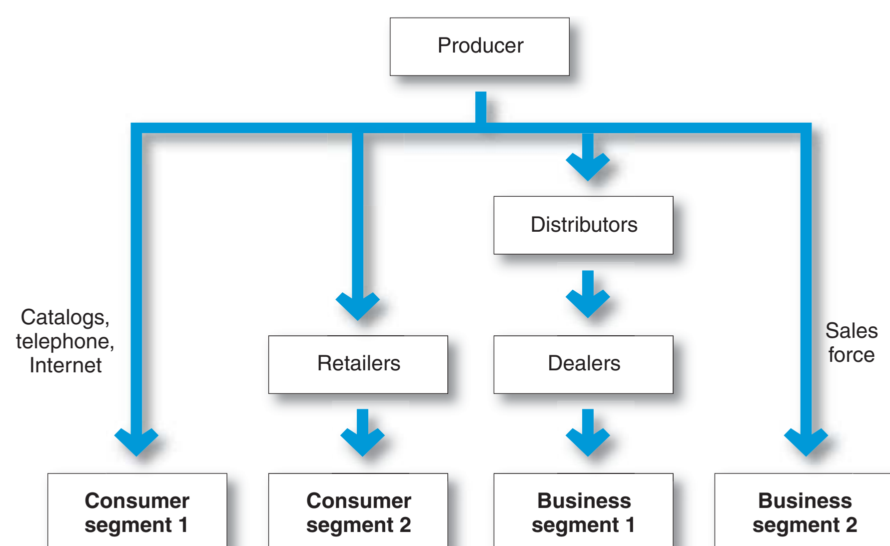
Figure 12.4 shows a multichannel marketing system. In the figure, the producer sells directly to consumer segment 1 using catalogs, telemarketing, and the Internet and reaches consumer segment 2 through retailers. It sells indirectly to business segment 1 through distributors and dealers and to business segment 2 through its own sales force.

These days, almost every large company and many small ones distribute through multiple channels. For example, John Deere sells its familiar green and yellow lawn and garden tractors, mowers, and outdoor power products to consumers and commercial users through several channels, including John Deere retailers, Lowe's home improvement stores, and online. It sells and services its tractors, combines, planters, and other agricultural equipment through its premium John Deere dealer network. And it sells large construction and forestry equipment through selected large, full-service John Deere dealers and their sales forces.

Multichannel distribution systems offer many advantages to companies facing large and complex markets. With each new channel, the company expands its sales and market coverage and gains opportunities to tailor its products and services to the specific needs of diverse customer segments. But such multichannel systems are harder to control, and they generate conflict as more channels compete for customers and sales. For example, when John Deere began selling selected consumer products through Lowe's home improvement stores, many of its dealers complained loudly. To avoid such conflicts in its Internet marketing channels, the company routes all of its Web site sales to John Deere dealers.

FIGURE | 12.4
Multichannel Distribution System

Most large companies distribute through multiple channels. For example, you could buy a familiar green and yellow John Deere lawn tractor from a neighborhood John Deere dealer or from Lowe's. A large farm or forestry business would buy larger John Deere equipment from a premium full-service John Deere dealer and its sales force.



Changing Channel Organization

Disintermediation
The cutting out of marketing channel intermediaries by product or service producers or the displacement of traditional resellers by radical new types of intermediaries.

Changes in technology and the explosive growth of direct and online marketing are having a profound impact on the nature and design of marketing channels. One major trend is toward **disintermediation**—a big term with a clear message and important consequences. Disintermediation occurs when product or service producers cut out intermediaries and go directly to final buyers or when radically new types of channel intermediaries displace traditional ones.

Thus, in many industries, traditional intermediaries are dropping by the wayside. For example, Southwest, JetBlue, and other airlines sell tickets directly to final buyers, cutting travel agents from their marketing channels altogether. In other cases, new forms of resellers are displacing traditional intermediaries. For example, online marketers have taken business from traditional brick-and-mortar retailers. Consumers can buy hotel rooms and airline tickets from Expedia.com and Travelocity.com; electronics from Sonystyle.com; clothes and accessories from Bluefly.com; and books, videos, toys, jewelry, sports, consumer electronics, home and garden items, and almost anything else from Amazon.com—all without ever stepping into a traditional retail store. Online music download services such as iTunes and Amazon.com are threatening the very existence of traditional music-store retailers. In fact, once-dominant music retailers such as Tower Records have declared bankruptcy and closed their doors for good.

Disintermediation presents both opportunities and problems for producers and resellers. Channel innovators who find new ways to add value in the channel can sweep aside traditional resellers and reap the rewards. In turn, traditional intermediaries must continue to innovate to avoid being swept aside. For example, when Netflix pioneered online video rentals, it sent traditional brick-and-mortar video stores such as Blockbuster reeling. To meet the threat, Blockbuster developed its own online DVD rental service, but it was too little too late. In late 2010, Blockbuster declared Chapter 11 bankruptcy and closed hundreds of stores. Now, both Netflix and a reorganized Blockbuster face disintermediation threats from an even hotter channel—digital video downloads and video on demand. But instead of simply watching digital video distribution developments, Netflix intends to lead them:[7]

> Netflix has already added a "Watch Instantly" feature to its Web site that allows subscribers to instantly stream near-DVD quality video for a growing list of movie titles and TV programs. And it recently announced that it will soon let users stream movies to selected cell phones. "Our intention," says Netflix founder and CEO Reed Hastings, "is to get [our Watch Instantly] service to every Internet-connected screen, from cell phones to laptops to Wi-Fi-enabled plasma screens." In this way, Netflix plans to disintermediate its own distribution model before others can do it. To Hastings, the key to the future is all in how Netflix defines itself. "If [you] think of Netflix as a DVD rental business, [you're] right to be scared," he says. But "if [you] think of Netflix as an online movie service with multiple different delivery models, then [you're] a lot less scared. We're only now starting to deliver [on] that second vision."

Netflix faces dramatic changes in how movies and other entertainment content will be distributed. Instead of simply watching the developments, Netflix intends to lead them.

Similarly, to remain competitive, product and service producers must develop new channel opportunities, such as the Internet and other direct channels. However, developing these new channels often brings them into direct competition with their established channels, resulting in conflict.

To ease this problem, companies often look for ways to make going direct a plus for the entire channel.

For example, guitar and amp maker Fender knows that many customers would prefer to buy its guitars, amps, and accessories online. But selling directly through its Web site would create conflicts with retail partners, from large chains such as Guitar Center, Sam Ash, and Best Buy to small shops scattered throughout the world, such as the Musician's Junkyard in Windsor, Vermont, or Freddy for Music in Amman, Jordan. So Fender's Web site provides detailed information about the company's products, but you can't buy a new Fender Stratocaster or Acoustasonic guitar there. Instead, the Fender Web site refers you to resellers' Web sites and stores. Thus, Fender's direct marketing helps both the company and its channel partners.

Author Comment | Like everything else in marketing, good channel design begins with analyzing customer needs. Remember, marketing channels are really *customer-value delivery networks*.

Channel Design Decisions (pp 351–354)

We now look at several channel decisions manufacturers face. In designing marketing channels, manufacturers struggle between what is ideal and what is practical. A new firm with limited capital usually starts by selling in a limited market area. Deciding on the best channels might not be a problem: The problem might simply be how to convince one or a few good intermediaries to handle the line.

If successful, the new firm can branch out to new markets through existing intermediaries. In smaller markets, the firm might sell directly to retailers; in larger markets, it might sell through distributors. In one part of the country, it might grant exclusive franchises; in another, it might sell through all available outlets. Then it might add a Web store that sells directly to hard-to-reach customers. In this way, channel systems often evolve to meet market opportunities and conditions.

For maximum effectiveness, however, channel analysis and decision making should be more purposeful. **Marketing channel design** calls for analyzing consumer needs, setting channel objectives, identifying major channel alternatives, and evaluating those alternatives.

Marketing channel design
Designing effective marketing channels by analyzing customer needs, setting channel objectives, identifying major channel alternatives, and evaluating those alternatives.

Analyzing Consumer Needs

As noted previously, marketing channels are part of the overall *customer-value delivery network*. Each channel member and level adds value for the customer. Thus, designing the marketing channel starts with finding out what target consumers want from the channel. Do consumers want to buy from nearby locations or are they willing to travel to more distant and centralized locations? Would customers rather buy in person, by phone, or online? Do they value breadth of assortment or do they prefer specialization? Do consumers want many add-on services (delivery, installation, repairs), or will they obtain these services elsewhere? The faster the delivery, the greater the assortment provided, and the more add-on services supplied, the greater the channel's service level.

Providing the fastest delivery, the greatest assortment, and the most services may not be possible or practical. The company and its channel members may not have the resources or skills needed to provide all the desired services. Also, providing higher levels of service results in higher costs for the channel and higher prices for consumers. ◉ For example, your local hardware store probably provides more personalized service, a more convenient location, and less shopping hassle than the nearest huge Home Depot or Lowe's store. But it may also charge higher prices. The company must balance consumer needs not only against the feasibility and costs of meeting these needs but also against customer price preferences. The success of discount retailing shows that consumers will often accept lower service levels in exchange for lower prices.

◉ **Meeting customers' channel service needs: Your local hardware store probably provides more personalized service, a more convenient location, and less shopping hassle than a huge Home Depot or Lowe's store. But it may also charge higher prices.**

Setting Channel Objectives

Companies should state their marketing channel objectives in terms of targeted levels of customer service. Usually, a company can identify several segments wanting different levels of service. The company should decide which segments to serve and the best channels to use in each case. In each segment, the company wants to minimize the total channel cost of meeting customer-service requirements.

The company's channel objectives are also influenced by the nature of the company, its products, its marketing intermediaries, its competitors, and the environment. For example, the company's size and financial situation determine which marketing functions it can handle itself and which it must give to intermediaries. Companies selling perishable products may require more direct marketing to avoid delays and too much handling.

In some cases, a company may want to compete in or near the same outlets that carry competitors' products. For example, Maytag wants its appliances displayed alongside competing brands to facilitate comparison shopping. In other cases, companies may avoid the channels used by competitors. Mary Kay Cosmetics, for example, sells directly to consumers through its corps of more than two million independent beauty consultants in more than 35 markets worldwide rather than going head-to-head with other cosmetics makers for scarce positions in retail stores.[8] GEICO primarily markets auto and homeowner's insurance directly to consumers via the telephone and the Internet rather than through agents.

Finally, environmental factors such as economic conditions and legal constraints may affect channel objectives and design. For example, in a depressed economy, producers want to distribute their goods in the most economical way, using shorter channels and dropping unneeded services that add to the final price of the goods.

Identifying Major Alternatives

When the company has defined its channel objectives, it should next identify its major channel alternatives in terms of the *types* of intermediaries, the *number* of intermediaries, and the *responsibilities* of each channel member.

Types of Intermediaries

A firm should identify the types of channel members available to carry out its channel work. Most companies face many channel member choices. For example, until recently, Dell sold directly to final consumers and business buyers only through its sophisticated phone and Internet marketing channel. It also sold directly to large corporate, institutional, and government buyers using its direct sales force. However, to reach more consumers and match competitors such as HP, Dell now sells indirectly through retailers such as Best Buy, Staples, and Walmart. It also sells indirectly through value-added resellers, independent distributors and dealers who develop computer systems and applications tailored to the special needs of small- and medium-sized business customers.

Using many types of resellers in a channel provides both benefits and drawbacks. For example, by selling through retailers and value-added resellers in addition to its own direct channels, Dell can reach more and different kinds of buyers. However, the new channels will be more difficult to manage and control. And the direct and indirect channels will compete with each other for many of the same customers, causing potential conflict. In fact, Dell often finds itself "stuck in the middle," with its direct sales reps complaining about competition from retail stores, while its value-added resellers complain that the direct sales reps are undercutting their business.

Number of Marketing Intermediaries

Intensive distribution
Stocking the product in as many outlets as possible.

Companies must also determine the number of channel members to use at each level. Three strategies are available: intensive distribution, exclusive distribution, and selective distribution. Producers of convenience products and common raw materials typically seek **intensive distribution**—a strategy in which they stock their products in as many outlets

● **Exclusive distribution: Luxury carmakers such as Bentley sell exclusively through a limited number of retailers. Such limited distribution enhances a car's image and generates stronger retailer support.**

as possible. These products must be available where and when consumers want them. For example, toothpaste, candy, and other similar items are sold in millions of outlets to provide maximum brand exposure and consumer convenience. Kraft, Coca-Cola, Kimberly-Clark, and other consumer-goods companies distribute their products in this way.

By contrast, some producers purposely limit the number of intermediaries handling their products. The extreme form of this practice is **exclusive distribution**, in which the producer gives only a limited number of dealers the exclusive right to distribute its products in their territories. Exclusive distribution is often found in the distribution of luxury brands. ● For example, exclusive Bentley automobiles are typically sold by only a handful of authorized dealers in any given market area. By granting exclusive distribution, Bentley gains stronger dealer selling support and more control over dealer prices, promotion, and services. Exclusive distribution also enhances the brand's image and allows for higher markups.

Between intensive and exclusive distribution lies **selective distribution**—the use of more than one but fewer than all the intermediaries who are willing to carry a company's products. Most television, furniture, and home appliance brands are distributed in this manner. For example, Whirlpool and GE sell their major appliances through dealer networks and selected large retailers. By using selective distribution, they can develop good working relationships with selected channel members and expect a better-than-average selling effort. Selective distribution gives producers good market coverage with more control and less cost than does intensive distribution.

Exclusive distribution
Giving a limited number of dealers the exclusive right to distribute the company's products in their territories.

Selective distribution
The use of more than one but fewer than all the intermediaries who are willing to carry the company's products.

Responsibilities of Channel Members

The producer and the intermediaries need to agree on the terms and responsibilities of each channel member. They should agree on price policies, conditions of sale, territory rights, and the specific services to be performed by each party. The producer should establish a list price and a fair set of discounts for the intermediaries. It must define each channel member's territory, and it should be careful about where it places new resellers.

Mutual services and duties need to be spelled out carefully, especially in franchise and exclusive distribution channels. For example, McDonald's provides franchisees with promotional support, a record-keeping system, training at Hamburger University, and general management assistance. In turn, franchisees must meet company standards for physical facilities and food quality, cooperate with new promotion programs, provide requested information, and buy specified food products.

Evaluating the Major Alternatives

Suppose a company has identified several channel alternatives and wants to select the one that will best satisfy its long-run objectives. Each alternative should be evaluated against economic, control, and adaptability criteria.

Using *economic criteria*, a company compares the likely sales, costs, and profitability of different channel alternatives. What will be the investment required by each channel alternative, and what returns will result? The company must also consider *control issues*. Using intermediaries usually means giving them some control over the marketing of the product, and some intermediaries take more control than others. Other things being equal, the company prefers to keep as much control as possible. Finally, the company must apply *adaptability criteria*. Channels often involve long-term commitments, yet the company wants to keep the channel flexible so that it can adapt to environmental changes. Thus, to be considered, a channel involving long-term commitments should be greatly superior on economic and control grounds.

Designing International Distribution Channels

International marketers face many additional complexities in designing their channels. Each country has its own unique distribution system that has evolved over time and changes very slowly. These channel systems can vary widely from country to country. Thus, global marketers must usually adapt their channel strategies to the existing structures within each country.

In some markets, the distribution system is complex and hard to penetrate, consisting of many layers and large numbers of intermediaries. For example, many Western companies find Japan's distribution system difficult to navigate. It's steeped in tradition and very complex, with many distributors touching one product before it makes it to the store shelf.

At the other extreme, distribution systems in developing countries may be scattered, inefficient, or altogether lacking. For example, China and India are huge markets—each with a population well over one billion people. However, because of inadequate distribution systems, most companies can profitably access only a small portion of the population located in each country's most affluent cities. "China is a very decentralized market," notes a China trade expert. "[It's] made up of two dozen distinct markets sprawling across 2,000 cities. Each has its own culture. . . . It's like operating in an asteroid belt." China's distribution system is so fragmented that logistics costs to wrap, bundle, load, unload, sort, reload, and transport goods amount to more than 22 percent of the nation's GDP, far higher than in most other countries. (U.S. logistics costs account for just over 10 percent of the nation's GDP.) After years of effort, even Walmart executives admit that they have been unable to assemble an efficient supply chain in China.[9]

International channel complexities: When the Chinese government banned door-to-door selling, Avon had to abandon its traditional direct marketing approach and sell through retail shops.

Sometimes customs or government regulation can greatly restrict how a company distributes products in global markets. For example, an inefficient distribution structure wasn't the cause of problems for Avon in China; the cause was restrictive government regulation. Fearing the growth of multilevel marketing schemes, the Chinese government banned door-to-door selling altogether in 1998, forcing Avon to abandon its traditional direct marketing approach and sell through retail shops. In 2006, the Chinese government gave Avon and other direct sellers permission to sell door-to-door again, but that permission is tangled in a web of restrictions. Fortunately for Avon, its earlier focus on store sales is helping it weather the restrictions better than most other direct sellers. In fact, through a combination of direct and retail sales, Avon's sales in China are now booming.[10]

International marketers face a wide range of channel alternatives. Designing efficient and effective channel systems between and within various country markets poses a difficult challenge. We discuss international distribution decisions further in Chapter 19.

Author Comment | Now it's time to implement the chosen channel design and work with selected channel members to manage and motivate them.

Channel Management Decisions (pp 354–356)

Once the company has reviewed its channel alternatives and determined the best channel design, it must implement and manage the chosen channel. **Marketing channel management** calls for selecting, managing, and motivating individual channel members and evaluating their performance over time.

Selecting Channel Members

Marketing channel management
Selecting, managing, and motivating individual channel members and evaluating their performance over time.

Producers vary in their ability to attract qualified marketing intermediaries. Some producers have no trouble signing up channel members. For example, when Toyota first introduced its Lexus line in the United States, it had no trouble attracting new dealers. In fact, it had to turn down many would-be resellers.

At the other extreme are producers who have to work hard to line up enough qualified intermediaries. For example, when Timex first tried to sell its inexpensive watches through regular jewelry stores, most jewelry stores refused to carry them. The company then managed to get its watches into mass-merchandise outlets. This turned out to be a wise decision because of the rapid growth of mass merchandising.

Even established brands may have difficulty gaining and keeping desired distribution, especially when dealing with powerful resellers. For example, in an effort to streamline its product assortment, Walmart recently removed Glad and Hefty food storage bags from its shelves. It now carries only Ziploc and its own Great Value store brand (produced by the makers of Hefty). Walmart's decision was a real blow to the Glad and Hefty brands, which captured one-third or more of their sales through the giant retailer.[11]

When selecting intermediaries, the company should determine what characteristics distinguish the better ones. It will want to evaluate each channel member's years in business, other lines carried, growth and profit record, cooperativeness, and reputation. If the intermediaries are sales agents, the company will want to evaluate the number and character of other lines carried and the size and quality of the sales force. If the intermediary is a retail store that wants exclusive or selective distribution, the company will want to evaluate the store's customers, location, and future growth potential.

Managing and Motivating Channel Members

Once selected, channel members must be continuously managed and motivated to do their best. The company must sell not only *through* the intermediaries but also *to* and *with* them. Most companies see their intermediaries as first-line customers and partners. They practice strong *partner relationship management* (*PRM*) to forge long-term partnerships with channel members. This creates a value delivery system that meets the needs of both the company *and* its marketing partners.

In managing its channels, a company must convince distributors that they can succeed better by working together as a part of a cohesive value delivery system. Thus, P&G works closely with Target to create superior value for final consumers. The two jointly plan merchandising goals and strategies, inventory levels, and advertising and promotion programs.

Similarly, heavy-equipment manufacturer Caterpillar and its worldwide network of independent dealers work in close harmony to find better ways to bring value to customers.[12]

> One-hundred-year-old Caterpillar produces innovative, high-quality products. Yet the most important reason for Caterpillar's dominance is its distribution network of 220 outstanding independent dealers worldwide. Caterpillar and its dealers work as partners. According to a former Caterpillar CEO: "After the product leaves our door, the dealers take over. They are the ones on the front line. They're the ones who live with the product for its lifetime. They're the ones customers see." ◉ When a big piece of Caterpillar equipment breaks down, customers know that they can count on Caterpillar and its outstanding dealer network for support. Dealers play a vital role in almost every aspect of Caterpillar's operations, from product design and delivery to product service and support.
>
> Caterpillar really knows its dealers and cares about their success. It closely monitors each dealership's sales, market position, service capability, and financial situation. When it sees a problem, it jumps in to help. In addition to more formal business ties, Caterpillar forms close personal ties with dealers in a kind of family relationship. Caterpillar and its dealers feel a deep pride in what they are accomplishing together. As the former CEO puts it, "There's a camaraderie among our dealers around the world that really makes it more than just a financial arrangement. They feel that what

Caterpillar works closely with its worldwide network of independent dealers to find better ways to bring value to customers. When a big piece of CAT equipment breaks down, customers know they can count on Caterpillar and its outstanding dealer network for support.

they're doing is good for the world because they are part of an organization that makes, sells, and tends to the machines that make the world work."

As a result of its partnership with dealers, Caterpillar dominates the world's markets for heavy construction, mining, and logging equipment. Its familiar yellow tractors, crawlers, loaders, bulldozers, and trucks capture some 40 percent of the worldwide heavy-equipment business, twice that of number-two Komatsu.

Many companies are now installing integrated high-tech PRM systems to coordinate their whole-channel marketing efforts. Just as they use CRM software systems to help manage relationships with important customers, companies can now use PRM and supply chain management (SCM) software to help recruit, train, organize, manage, motivate, and evaluate relationships with channel partners.

Evaluating Channel Members

The company must regularly check channel member performance against standards such as sales quotas, average inventory levels, customer delivery time, treatment of damaged and lost goods, cooperation in company promotion and training programs, and services to the customer. The company should recognize and reward intermediaries who are performing well and adding good value for consumers. Those who are performing poorly should be assisted or, as a last resort, replaced.

Finally, companies need to be sensitive to their channel partners. Those who treat their partners poorly risk not only losing their support but also causing some legal problems. The next section describes various rights and duties pertaining to companies and other channel members.

Public Policy and Distribution Decisions (pp 356–357)

For the most part, companies are legally free to develop whatever channel arrangements suit them. In fact, the laws affecting channels seek to prevent the exclusionary tactics of some companies that might keep another company from using a desired channel. Most channel law deals with the mutual rights and duties of channel members once they have formed a relationship.

Many producers and wholesalers like to develop exclusive channels for their products. When the seller allows only certain outlets to carry its products, this strategy is called *exclusive distribution*. When the seller requires that these dealers not handle competitors' products, its strategy is called *exclusive dealing*. Both parties can benefit from exclusive arrangements: The seller obtains more loyal and dependable outlets, and the dealers obtain a steady source of supply and stronger seller support. But exclusive arrangements also exclude other producers from selling to these dealers. This situation brings exclusive dealing contracts under the scope of the Clayton Act of 1914. They are legal as long as they do not substantially lessen competition or tend to create a monopoly and as long as both parties enter into the agreement voluntarily.

Exclusive dealing often includes *exclusive territorial agreements*. The producer may agree not to sell to other dealers in a given area, or the buyer may agree to sell only in its own territory. The first practice is normal under franchise systems as a way to increase dealer enthusiasm and commitment. It is also perfectly legal—a seller has no legal obligation to sell through more outlets than it wishes. The second practice, whereby the producer tries to keep a dealer from selling outside its territory, has become a major legal issue.

Producers of a strong brand sometimes sell it to dealers only if the dealers will take some or all the rest of the line. This is called full-line forcing. Such *tying agreements* are not necessarily illegal, but they violate the Clayton Act if they tend to lessen competition substantially. The practice may prevent consumers from freely choosing among competing suppliers of these other brands.

Finally, producers are free to select their dealers, but their right to terminate dealers is somewhat restricted. In general, sellers can drop dealers "for cause." However, they cannot drop dealers if, for example, the dealers refuse to cooperate in a doubtful legal arrangement, such as exclusive dealing or tying agreements.

Author Comment | Marketers used to call this plain old "physical distribution." But as these titles suggest, the topic has grown in importance, complexity, and sophistication.

Marketing Logistics and Supply Chain Management (pp 357–365)

In today's global marketplace, selling a product is sometimes easier than getting it to customers. Companies must decide on the best way to store, handle, and move their products and services so that they are available to customers in the right assortments, at the right time, and in the right place. Logistics effectiveness has a major impact on both customer satisfaction and company costs. Here we consider the nature and importance of logistics management in the supply chain, the goals of the logistics system, major logistics functions, and the need for integrated supply chain management.

Nature and Importance of Marketing Logistics

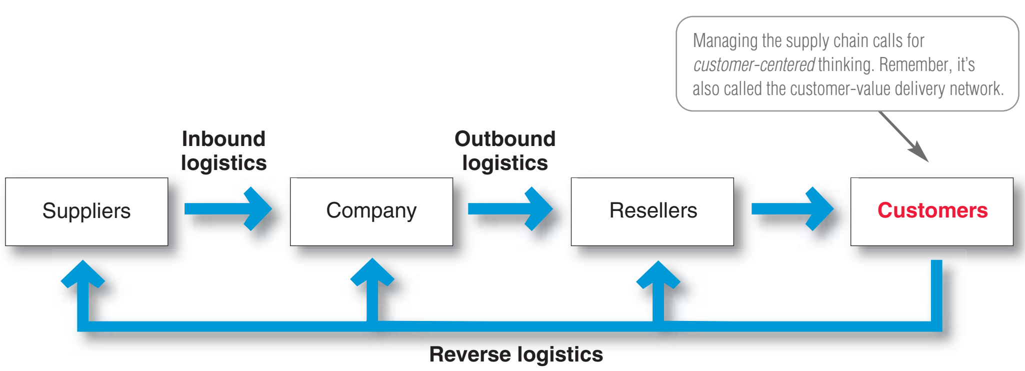
Marketing logistics (or physical distribution)
Planning, implementing, and controlling the physical flow of materials, final goods, and related information from points of origin to points of consumption to meet customer requirements at a profit.

Supply chain management
Managing upstream and downstream value-added flows of materials, final goods, and related information among suppliers, the company, resellers, and final consumers.

To some managers, marketing logistics means only trucks and warehouses. But modern logistics is much more than this. **Marketing logistics**—also called **physical distribution**—involves planning, implementing, and controlling the physical flow of goods, services, and related information from points of origin to points of consumption to meet customer requirements at a profit. In short, it involves getting the right product to the right customer in the right place at the right time.

In the past, physical distribution planners typically started with products at the plant and then tried to find low-cost solutions to get them to customers. However, today's marketers prefer *customer-centered* logistics thinking, which starts with the marketplace and works backward to the factory or even to sources of supply. Marketing logistics involves not only *outbound distribution* (moving products from the factory to resellers and ultimately to customers) but also *inbound distribution* (moving products and materials from suppliers to the factory) and *reverse distribution* (moving broken, unwanted, or excess products returned by consumers or resellers). That is, it involves entire **supply chain management**—managing upstream and downstream value-added flows of materials, final goods, and related information among suppliers, the company, resellers, and final consumers, as shown in **Figure 12.5**.

FIGURE | 12.5
Supply Chain Management



Logistics: American companies spent $1.3 trillion last year—about 10 percent of the U.S. GDP—to wrap, bundle, load, unload, sort, reload, and transport goods.

The logistics manager's task is to coordinate the activities of suppliers, purchasing agents, marketers, channel members, and customers. These activities include forecasting, information systems, purchasing, production planning, order processing, inventory, warehousing, and transportation planning.

Companies today are placing greater emphasis on logistics for several reasons. First, companies can gain a powerful competitive advantage by using improved logistics to give customers better service or lower prices. Second, improved logistics can yield tremendous cost savings to both a company and its customers. As much as 20 percent of an average product's price is accounted for by shipping and transport alone. This far exceeds the cost of advertising and many other marketing costs. American companies spent $1.3 trillion last year—about 10 percent of GDP—to wrap, bundle, load, unload, sort, reload, and transport goods. That's more than the national GDPs of all but 12 countries worldwide. Even more, as fuel and other costs rise, so do logistics costs. For example, the cost of shipping one 40-foot container from Shanghai to the United States rose from $3,000 in 2000 to more than $8,000 last year.[13]

Shaving off even a small fraction of logistics costs can mean substantial savings. For example, Walmart recently undertook a program of logistics improvements through more efficient sourcing, better inventory management, and greater supply chain productivity that will reduce supply chain costs by 5–15 percent over the next five years—that's a whopping $4 billion to $12 billion.[14]

Third, the explosion in product variety has created a need for improved logistics management. For example, in 1911 the typical A&P grocery store carried only 270 items. The store manager could keep track of this inventory on about 10 pages of notebook paper stuffed in a shirt pocket. Today, the average A&P carries a bewildering stock of more than 25,000 items. A Walmart Supercenter store carries more than 100,000 products, 30,000 of which are grocery products.[15] Ordering, shipping, stocking, and controlling such a variety of products presents a sizable logistics challenge.

Improvements in information technology have also created opportunities for major gains in distribution efficiency. Today's companies are using sophisticated supply chain management software, Web-based logistics systems, point-of-sale scanners, RFID tags, satellite tracking, and electronic transfer of order and payment data. Such technology lets them quickly and efficiently manage the flow of goods, information, and finances through the supply chain.

Finally, more than almost any other marketing function, logistics affects the environment and a firm's environmental sustainability efforts. Transportation, warehousing, packaging, and other logistics functions are typically the biggest supply chain contributors to the company's environmental footprint. At the same time, they also provide one of the most fertile areas for cost savings. So developing a *green supply chain* is not only environmentally responsible but can also be profitable. "Sustainability shouldn't be about Washington jamming green stuff down your throat," says one supply chain expert. "This is a lot about money, about reducing costs."[16] (See Real Marketing 12.2.)

Goals of the Logistics System

Some companies state their logistics objective as providing maximum customer service at the least cost. Unfortunately, as nice as this sounds, no logistics system can *both* maximize customer service *and* minimize distribution costs. Maximum customer service implies rapid delivery, large inventories, flexible assortments, liberal returns policies, and other services—all of which raise distribution costs. In contrast, minimum distribution costs imply slower delivery, smaller inventories, and larger shipping lots—which represent a lower level of overall customer service.

The goal of marketing logistics should be to provide a *targeted* level of customer service at the least cost. A company must first research the importance of various distribution services to

Real Marketing 12.2

Greening the Supply Chain:
It's the Right Thing to Do—And It's Profitable, Too

You may remember the old song in which Kermit the Frog laments, "it's not easy bein' green." That's often as true for company supply chains as it is for the Muppet. Greening up a company's channels often takes substantial commitment, ingenuity, and investment. Although challenging, however, today's supply channels are getting ever greener.

Companies have many reasons for reducing the environmental impact of their supply chains. For one thing, in the not too distant future, if companies don't green up voluntarily, a host of "green laws" and sustainability regulations enacted around the world will require them to do so. For another, many large customers—from HP to Walmart to the federal government—are demanding it. "Environmental sustainability is fast becoming a critical element in supplier selection and performance evaluation," says a channels expert. Supply chain managers "need to begin thinking green, and quickly, or they chance risking relationships with prime customers." Perhaps even more important than *having* to do it, designing more environmentally responsible supply chains is simply the *right* thing to do. It's one more way that companies can contribute to saving our world for future generations.

But that's all pretty heady stuff. As it turns out, companies have a more immediate and practical reason for turning their supply chains green. Not only are green channels good for the world, they're also good for the company's bottom line. Companies green their supply chains through greater efficiency, and greater efficiency means lower costs and higher profits. This cost-savings side of environmental responsibility makes good sense. The very logistics activities that create the biggest environmental footprint—such as transportation, warehousing, and packaging—are also the ones that account for a lion's share of logistics costs, especially in an age of scarce resources and soaring energy prices. Although it may require an up-front investment, it doesn't cost more to green up channels. In the long run, it usually costs less.

Here are a few examples of how creating greener supply chains can benefit both the environment and the company's bottom line:

- Stonyfield Farm, the world's largest yogurt maker, recently set up a small, dedicated truck fleet to make regional deliveries in New England and replaced its national less-than-truckload distribution network with a regional multistop truckload system. As a result, Stonyfield now moves more product in fewer trucks, cutting in half the number of miles traveled. The changes produced a 40 percent reduction in transportation-related carbon dioxide emissions; they also knocked an eye-popping 8 percent off Stonyfield's shipping expenses. Says Stonyfield's director of logistics, "We're surprised. We understand that environmental responsibility can be profitable. We expected some savings, but not really in this range."
- Consumer package goods maker SC Johnson made a seemingly simple but smart—and profitable—change in the way it packs its trucks. Under the old system, a load of its Ziploc products filled a truck trailer before reaching the maximum weight limit. In contrast, a load of Windex glass cleaner hit the maximum weight before the trailer was full. By strategically mixing the two products, SC Johnson found it could send the same amount of products with 2,098 fewer shipments, while burning 168,000 fewer gallons of diesel fuel and eliminating 1,882 tons of greenhouse gasses. Says the company's director of environmental issues, "Loading a truck may seem simple, but making sure that a truck is truly full is a science. Consistently hitting a trailer's maximum weight provided a huge opportunity to reduce our energy consumption, cut our greenhouse gas emissions, and save money [in the bargain]."
- Con-way, a $4.2 billion freight transportation company, made the simple decision to lower the maximum speed of its truck fleet from 65 miles per hour to 62 miles per hour. This small three-mile-per-hour change produced a savings of six million gallons of fuel per year and an emissions reduction equivalent to taking 12,000 to 15,000 cars off the road. Similarly, grocery retailer Safeway switched its fleet of 1,000 trucks to run on cleaner-burning biodiesel fuel. This change will reduce annual carbon dioxide emissions by 75 million pounds—equivalent to taking another 7,500 cars off the road.
- Walmart is perhaps the world's biggest green-channels champion. Among dozens of other major initiatives (see Real Marketing 20.1), the giant retailer is now installing more efficient engines and tires, hybrid drive systems, and other technologies in its fleet of 7,000 trucks in an effort to reduce carbon dioxide emissions and increase efficiency 25 percent by 2012. Walmart is also pressuring its throng of suppliers to clean up their environmental acts. For example, it recently set a goal to reduce supplier packaging by 5 percent. Given Walmart's size, even small changes make a substantial impact. For instance, it convinced P&G to produce Charmin toilet paper in more-shippable compact

Con-way made the simple decision to lower the maximum speed of its truck fleet by 3 miles per hour, which produced a savings of 6 million gallons of fuel per year and emissions reductions equivalent to taking 12,000 to 15,000 cars off of the road.

Continued on next page

rolls: a six-pack of Charmin Mega Roll contains as much paper as a regular pack of 24 rolls. This change alone saves 89.5 million cardboard rolls and 360,000 pounds of plastic wrapping a year. Logistics-wise, it also allows Walmart to ship 42 percent more units on its trucks, saving about 54,000 gallons of fuel. More broadly, Walmart estimates that the reduced supplier-packaging initiative will produce savings of $3.4 billion and prevent 667,000 metric tons of carbon dioxide emissions, equivalent to removing 213,000 trucks from the road.

So when it comes to supply chains, Kermit might be right—it's not easy bein' green. But it's now more necessary than ever, and it can pay big returns. It's a challenging area, says one supply chain expert, "but if you look at it from a pure profit-and-loss perspective, it's also a rich one." Another expert concludes, "It's now easier than ever to build a green supply chain without going into the red, while actually saving cash along the way."

Sources: Quotes, examples, and other information from Bill Mongelluzzo, "Supply Chain Expert Sees Profits in Sustainability," *Journal of Commerce*, March 11, 2010; Connie Robbins Gentry, "Green Means Go," *Chain Store Age*, March 2009, p. 47; Daniel P. Bearth, "Finding Profit in Green Logistics," *Transport Topics*, January 21, 2008, p. S4; Dan R. Robinson and Shannon Wilcox, "The Greening of the Supply Chain," *Logistics Management*, October 2008; William Hoffman, "Supplying Sustainability," *Traffic World*, April 7, 2008; "Supply Chain Standard: Going Green without Going into the Red," *Logistics Manager*, March 2009, p. 22; and "Supply Chain Standard: Take the Green Route Out of the Red," *Logistics Manager*, May 2009, p. 28.

customers and then set desired service levels for each segment. The objective is to maximize *profits*, not sales. Therefore, the company must weigh the benefits of providing higher levels of service against the costs. Some companies offer less service than their competitors and charge a lower price. Other companies offer more service and charge higher prices to cover higher costs.

Major Logistics Functions

Given a set of logistics objectives, the company is ready to design a logistics system that will minimize the cost of attaining these objectives. The major logistics functions include *warehousing*, *inventory management*, *transportation*, and *logistics information management*.

Warehousing

Production and consumption cycles rarely match, so most companies must store their goods while they wait to be sold. For example, Snapper, Toro, and other lawn mower manufacturers run their factories all year long and store up products for the heavy spring and summer buying seasons. The storage function overcomes differences in needed quantities and timing, ensuring that products are available when customers are ready to buy them.

A company must decide on *how many* and *what types* of warehouses it needs and *where* they will be located. The company might use either *storage warehouses* or *distribution centers*. Storage warehouses store goods for moderate to long periods. **Distribution centers** are designed to move goods rather than just store them. They are large and highly automated warehouses designed to receive goods from various plants and suppliers, take orders, fill them efficiently, and deliver goods to customers as quickly as possible.

Distribution center
A large, highly automated warehouse designed to receive goods from various plants and suppliers, take orders, fill them efficiently, and deliver goods to customers as quickly as possible.

For example, Walmart operates a network of 147 huge distribution centers. A single center, serving the daily needs of 75–100 Walmart stores, typically contains some one million square feet of space (about 20 football fields) under a single roof. At a typical center, laser scanners route as many as 190,000 cases of goods per day along five miles of conveyer belts, and the center's 500 to 1,000 workers load or unload some 500 trucks daily. Walmart's Monroe, Georgia, distribution center contains a 127,000-square-foot freezer (that's about 2.5 football fields) that can hold 10,000 pallets—room enough for 58 million Popsicles.[17]

Like almost everything else these days, warehousing has seen dramatic changes in technology in recent years. Outdated materials-handling methods are steadily being replaced by newer, computer-controlled systems requiring few employees. Computers and scanners read orders and direct lift trucks, electric hoists, or robots to gather goods, move them to


High-tech distribution centers: Staples employs a team of super-retrievers—in day-glo orange—to keep its warehouse humming.

loading docks, and issue invoices. For example, office supplies retailer Staples now employs "a team of super-retrievers—in day-glo orange—that keep its warehouse humming":[18]

> Imagine a team of employees that works 16 hours a day, seven days a week. They never call in sick or show up late because they never leave the building. They demand no benefits, require no health insurance, and receive no paychecks. And they never complain. Sounds like a bunch of robots, huh? They are, in fact, robots—and they're dramatically changing the way Staples delivers notepads, pens, and paper clips to its customers. Every day, Staples' huge Chambersburg, Pennsylvania, distribution center receives thousands of customer orders, each containing a wide range of office supply items. Having people run around a warehouse looking for those items is expensive, especially when the company has promised to delight customers by delivering orders the next day.
>
> Enter the robots. On the distribution center floor, the 150 robots resemble a well-trained breed of working dogs, say, golden retrievers. When orders come in, a centralized computer tells the robots where to find racks with the appropriate items. The robots retrieve the racks and carry them to picking stations, then wait patiently as humans pull the correct products and place them in boxes. When orders are filled, the robots neatly park the racks back among the rest. The robots pretty much take care of themselves. When they run low on power, they head to battery-charging terminals, or, as warehouse personnel say, "They get themselves a drink of water." The robots now run 50 percent of the Chambersburg facility, where average daily output is up 60 percent since they arrived on the scene.

Inventory Management

Inventory management also affects customer satisfaction. Here, managers must maintain the delicate balance between carrying too little inventory and carrying too much. With too little stock, the firm risks not having products when customers want to buy. To remedy this, the firm may need costly emergency shipments or production. Carrying too much inventory results in higher-than-necessary inventory-carrying costs and stock obsolescence. Thus, in managing inventory, firms must balance the costs of carrying larger inventories against resulting sales and profits.

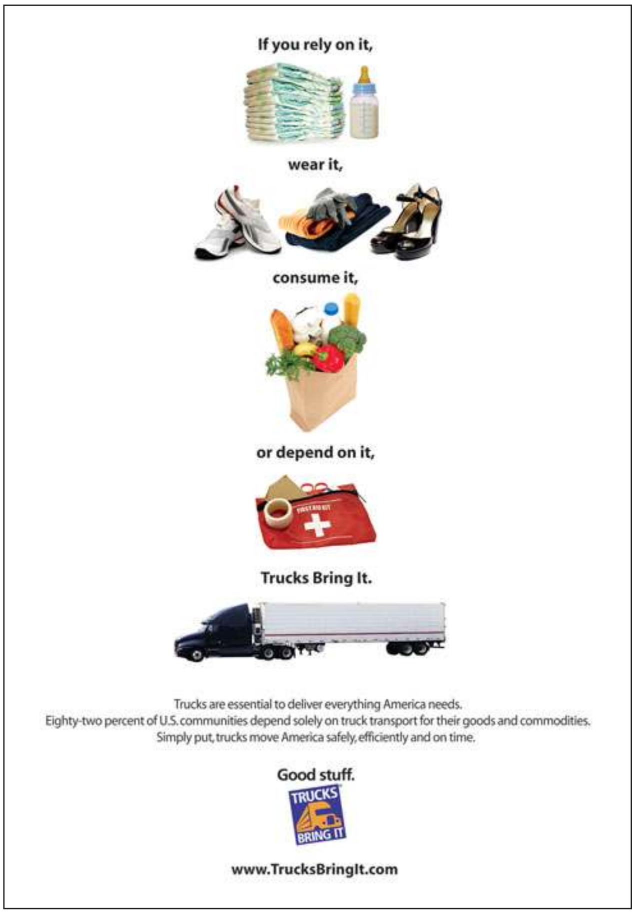
Many companies have greatly reduced their inventories and related costs through *just-in-time* logistics systems. With such systems, producers and retailers carry only small inventories of parts or merchandise, often enough for only a few days of operations. New stock arrives exactly when needed, rather than being stored in inventory until being used. Just-in-time systems require accurate forecasting along with fast, frequent, and flexible delivery so that new supplies will be available when needed. However, these systems result in substantial savings in inventory-carrying and handling costs.

Marketers are always looking for new ways to make inventory management more efficient. In the not-too-distant future, handling inventory might even become fully automated. For example, in Chapter 3 we discussed RFID or "smart tag" technology, by which small transmitter chips are embedded in or placed on products and packaging on everything from flowers and razors to tires. "Smart" products could make the entire supply chain—which accounts for nearly 75 percent of a product's cost—intelligent and automated.

Companies using RFID would know, at any time, exactly where a product is located physically within the supply chain. "Smart shelves" would not only tell them when it's time to reorder but also place the order automatically with their suppliers. Such exciting new information technology applications will revolutionize distribution as we know it. Many large and resourceful marketing companies, such as Walmart, P&G, Kraft, IBM, HP, and Best Buy, are investing heavily to make the full use of RFID technology a reality.[19]

Transportation

The choice of transportation carriers affects the pricing of products, delivery performance, and the condition of goods when they arrive—all of which will affect customer satisfaction. In shipping goods to its warehouses, dealers, and customers, the company can choose among five main transportation modes: truck, rail, water, pipeline, and air, along with an alternative mode for digital products—the Internet.



Truck transportation: More than 80 percent of American communities depend solely on the trucking industry for the delivery of their goods. "Good stuff. Trucks bring it."

Trucks have increased their share of transportation steadily and now account for more than 68 percent of total freight tonnage in the United States. U.S. trucks travel more than 431 billion miles a year—more than double the distance traveled 25 years ago—carrying 10.2 billion tons of freight. According to the American Trucking Association, 80 percent of U.S. communities depend solely on trucks for their goods and commodities. Trucks are highly flexible in their routing and time schedules, and they can usually offer faster service than railroads. They are efficient for short hauls of high-value merchandise. Trucking firms have evolved in recent years to become full-service providers of global transportation services. For example, large trucking firms now offer everything from satellite tracking, Web-based shipment management, and logistics planning software to cross-border shipping operations.[20]

Railroads account for 37 percent of the total cargo ton-miles moved. They are one of the most cost-effective modes for shipping large amounts of bulk products—coal, sand, minerals, and farm and forest products—over long distances. In recent years, railroads have increased their customer services by designing new equipment to handle special categories of goods, providing flatcars for carrying truck trailers by rail (piggyback), and providing in-transit services such as the diversion of shipped goods to other destinations en route and the processing of goods en route.

Water carriers, which account for about 5 percent of the cargo ton-miles, transport large amounts of goods by ships and barges on U.S. coastal and inland waterways. Although the cost of water transportation is very low for shipping bulky, low-value, nonperishable products such as sand, coal, grain, oil, and metallic ores, water transportation is the slowest mode and may be affected by the weather. *Pipelines*, which account for about 1 percent of the cargo ton-miles, are a specialized means of shipping petroleum, natural gas, and chemicals from sources to markets. Most pipelines are used by their owners to ship their own products.

Although *air* carriers transport less than 1 percent of the cargo ton-miles of the nation's goods, they are an important transportation mode. Airfreight rates are much higher than rail or truck rates, but airfreight is ideal when speed is needed or distant markets have to be reached. Among the most frequently airfreighted products are perishables (fresh fish, cut flowers) and high-value, low-bulk items (technical instruments, jewelry). Companies find that airfreight also reduces inventory levels, packaging costs, and the number of warehouses needed.

The *Internet* carries digital products from producer to customer via satellite, cable, or phone wire. Software firms, the media, music and video companies, and education all make use of the Internet to transport digital products. Although these firms primarily use traditional transportation to distribute DVDs, newspapers, and more, the Internet holds the potential for lower product distribution costs. Whereas planes, trucks, and trains move freight and packages, digital technology moves information bits.

Intermodal transportation
Combining two or more modes of transportation.

Shippers also use **intermodal transportation**—combining two or more modes of transportation. The total cargo ton-miles moved via multiple modes is 14 percent. *Piggyback* describes the use of rail and trucks; *fishyback*, water and trucks; *trainship*, water and rail; and *airtruck*, air and trucks. Combining modes provides advantages that no single mode can deliver. Each combination offers advantages to the shipper. For example, not only is piggyback cheaper than trucking alone, but it also provides flexibility and convenience.

In choosing a transportation mode for a product, shippers must balance many considerations: speed, dependability, availability, cost, and others. Thus, if a shipper needs speed, air and truck are the prime choices. If the goal is low cost, then water or rail might be best.

Logistics Information Management

Companies manage their supply chains through information. Channel partners often link up to share information and make better joint logistics decisions. From a logistics perspective, flows of information, such as customer transactions, billing, shipment and inventory levels, and even customer data, are closely linked to channel performance. Companies need simple, accessible, fast, and accurate processes for capturing, processing, and sharing channel information.

Information can be shared and managed in many ways, but most sharing takes place through traditional or Internet-based *electronic data interchange* (*EDI*), the computerized exchange of data between organizations, which primarily is transmitted via the Internet. Walmart, for example, requires EDI links with its more than 90,000 suppliers. If new suppliers don't have EDI capability, Walmart will work with them to find and implement the needed software. "EDI has proven to be the most efficient way of conducting business with our product suppliers," says Walmart. "This system of exchanging information . . . allows us to improve customer service, lower expenses, and increase productivity."[21]

In some cases, suppliers might actually be asked to generate orders and arrange deliveries for their customers. Many large retailers—such as Walmart and Home Depot—work closely with major suppliers such as P&G or Black & Decker to set up *vendor-managed inventory* (VMI) systems or *continuous inventory replenishment* systems. Using VMI, the customer shares real-time data on sales and current inventory levels with the supplier. The supplier then takes full responsibility for managing inventories and deliveries. Some retailers even go so far as to shift inventory and delivery costs to the supplier. Such systems require close cooperation between the buyer and seller.

Integrated Logistics Management

Integrated logistics management
The logistics concept that emphasizes teamwork—both inside the company and among all the marketing channel organizations—to maximize the performance of the entire distribution system.

Today, more and more companies are adopting the concept of **integrated logistics management**. This concept recognizes that providing better customer service and trimming distribution costs require *teamwork*, both inside the company and among all the marketing channel organizations. Inside, the company's various departments must work closely together to maximize its own logistics performance. Outside, the company must integrate its logistics system with those of its suppliers and customers to maximize the performance of the entire distribution network.

Cross-Functional Teamwork Inside the Company

Most companies assign responsibility for various logistics activities to many different departments—marketing, sales, finance, operations, and purchasing. Too often, each function tries to optimize its own logistics performance without regard for the activities of the other functions. However, transportation, inventory, warehousing, and information management activities interact, often in an inverse way. Lower inventory levels reduce inventory-carrying costs. But they may also reduce customer service and increase costs from stockouts, back orders, special production runs, and costly fast-freight shipments. Because distribution activities involve strong trade-offs, decisions by different functions must be coordinated to achieve better overall logistics performance.

The goal of integrated supply chain management is to harmonize all of the company's logistics decisions. Close working relationships among departments can be achieved in several ways. Some companies have created permanent logistics committees composed of managers responsible for different physical distribution activities. Companies can also create

Integrated logistics management: Many companies now employ sophisticated, systemwide supply chain management software, which is available from companies such as Logility.

supply chain manager positions that link the logistics activities of functional areas. For example, P&G has created product supply managers who manage all the supply chain activities for each product category. Many companies have a vice president of logistics with cross-functional authority.

Finally, companies can employ sophisticated, systemwide supply chain management software, now available from a wide range of software enterprises large and small, from SAP and Oracle to Infor and Logility. The worldwide market for supply chain management software topped $6.6 billion last year and will reach an estimated $11.6 billion by 2013.[22] The important thing is that the company must coordinate its logistics and marketing activities to create high market satisfaction at a reasonable cost.

Building Logistics Partnerships

Companies must do more than improve their own logistics. They must also work with other channel partners to improve whole-channel distribution. The members of a marketing channel are linked closely in creating customer value and building customer relationships. One company's distribution system is another company's supply system. The success of each channel member depends on the performance of the entire supply chain. For example, IKEA can create its stylish but affordable furniture and deliver the "IKEA lifestyle" only if its entire supply chain—consisting of thousands of merchandise designers and suppliers, transport companies, warehouses, and service providers—operates at maximum efficiency and customer-focused effectiveness.

Smart companies coordinate their logistics strategies and forge strong partnerships with suppliers and customers to improve customer service and reduce channel costs. Many companies have created *cross-functional*, *cross-company teams*. For example, P&G has a team of more than 200 people working in Bentonville, Arkansas, home of Walmart. The P&Gers work jointly with their counterparts at Walmart to find ways to squeeze costs out of their distribution system. Working together benefits not only P&G and Walmart but also their shared, final consumers.

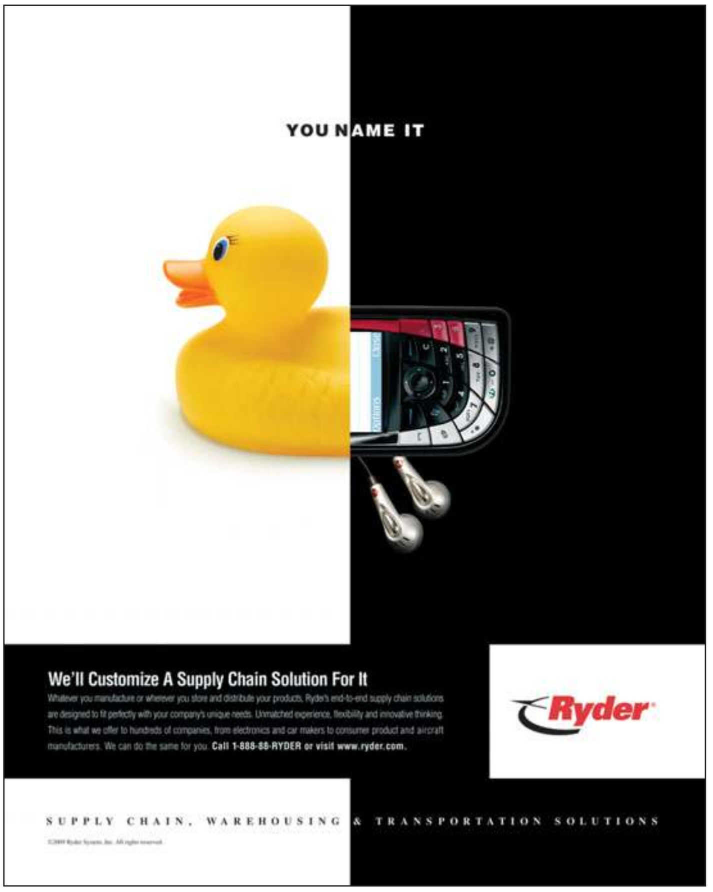
Other companies partner through *shared projects*. For example, many large retailers conduct joint in-store programs with suppliers. Home Depot allows key suppliers to use its stores as a testing ground for new merchandising programs. The suppliers spend time at Home Depot stores watching how their product sells and how customers relate to it. They then create programs specially tailored to Home Depot and its customers. Clearly, both the supplier and the customer benefit from such partnerships. The point is that all supply chain members must work together in the cause of bringing value to final consumers.

Third-Party Logistics

Third-party logistics (3PL) provider
An independent logistics provider that performs any or all of the functions required to get a client's product to market.

Most big companies love to make and sell their products. But many loathe the associated logistics "grunt work." They detest the bundling, loading, unloading, sorting, storing, reloading, transporting, customs clearing, and tracking required to supply their factories and get products to their customers. They hate it so much that a growing number of firms now outsource some or all of their logistics to **third-party logistics (3PL) providers**. Here's an example:[23]

> Whirlpool's ultimate goal is to create loyal customers who continue to buy its brands over their lifetimes. One key loyalty factor is good repair service, which in turn depends on fast and reliable parts distribution. Only a few years ago, however, Whirlpool's replacement parts distribution system was fragmented and ineffective,



Third-party logistics (3PL): Companies such as Ryder help clients tighten up sluggish, overstuffed supply chains, slash inventories, and get products to customers more quickly and reliably.

often causing frustrating customer service delays. "Whirlpool is the world's largest manufacturer and marketer of appliances, but we're not necessarily experts in parts warehousing and distribution," says Whirlpool's national director of parts operations. So to help fix the problem, Whirlpool turned the entire job over to 3PL provider Ryder, which quickly streamlined Whirlpool's service parts distribution system. Ryder now provides order fulfillment and worldwide distribution of Whirlpool's service parts across six continents to hundreds of customers that include, in addition to end consumers, the Sears service network, authorized repair centers, and independent parts distributors that in turn ship parts out to a network of service companies and technicians. "Through our partnership with Ryder, we are now operating at our highest service level ever," says the Whirlpool executive. "We've . . . dramatically reduced [our parts distribution] costs. Our order cycle time has improved, and our customers are getting their parts more quickly."

The 3PL providers—companies such as Ryder, UPS Supply Chain Solutions, Penske Logistics, BAX Global, DHL Logistics, and FedEx Logistics—help clients tighten up sluggish, overstuffed supply chains, slash inventories, and get products to customers more quickly and reliably. According to a survey of chief logistics executives at *Fortune 500* companies, 82 percent of these companies use 3PL (also called *outsourced logistics* or *contract logistics*) services. In all, North American shippers spend 47 percent of their logistics budget on outsourced logistics; European and Asian shippers spend more than 62 percent. In just the past 10 years, the revenues for 3PL companies in the United States has more than doubled in size to $105 billion and is expected to grow 7 percent annually.[24]

Companies use third-party logistics providers for several reasons. First, because getting the product to market is their main focus, these providers can often do it more efficiently and at lower cost. Outsourcing typically results in 15–30 percent in cost savings. Second, outsourcing logistics frees a company to focus more intensely on its core business. Finally, integrated logistics companies understand increasingly complex logistics environments.

3PL partners can be especially helpful to companies attempting to expand their global market coverage. For example, companies distributing their products across Europe face a bewildering array of environmental restrictions that affect logistics, including packaging standards, truck size and weight limits, and noise and emissions pollution controls. By outsourcing its logistics, a company can gain a complete pan-European distribution system without incurring the costs, delays, and risks associated with setting up its own system.

REVIEWING Objectives AND KEY Terms

Some companies pay too little attention to their distribution channels, but others have used imaginative distribution systems to gain competitive advantage. A company's channel decisions directly affect every other marketing decision. Management must make channel decisions carefully, incorporating today's needs with tomorrow's likely selling environment.

Objective 1 Explain why companies use marketing channels and discuss the functions these channels perform. **(pp 340–341)**

In creating customer value, a company can't go it alone. It must work within an entire network of partners—a value delivery network—to accomplish this task. Individual companies and brands don't compete, their entire value delivery networks do.

Most producers use intermediaries to bring their products to market. They forge a *marketing channel* (or *distribution channel*)—a set of interdependent organizations involved in the process of making a product or service available for use or consumption by the consumer or business user. Through their contacts, experience, specialization, and scale of operation, intermediaries usually offer the firm more than it can achieve on its own.

Marketing channels perform many key functions. Some help *complete* transactions by gathering and distributing *information* needed for planning and aiding exchange, developing and spreading persuasive *communications* about an offer, performing *contact* work (finding and communicating with prospective buyers), *matching* (shaping and fitting the offer to the buyer's needs), and entering into *negotiation* to reach an agreement on price and other terms of the offer so that ownership can be transferred. Other functions help to *fulfill* the completed transactions by offering *physical distribution* (transporting and storing goods), *financing* (acquiring and using funds to cover the costs of the channel work, and *risk taking* (assuming the risks of carrying out the channel work.

Objective 2 Discuss how channel members interact and how they organize to perform the work of the channel. **(pp 344–351)**

The channel will be most effective when each member assumes the tasks it can do best. Ideally, because the success of individual channel members depends on overall channel success, all channel firms should work together smoothly. They should understand and accept their roles, coordinate their goals and activities, and cooperate to attain overall channel goals. By cooperating, they can more effectively sense, serve, and satisfy the target market.

In a large company, the formal organization structure assigns roles and provides needed leadership. But in a distribution channel composed of independent firms, leadership and power are not formally set. Traditionally, distribution channels have lacked the leadership needed to assign roles and manage conflict. In recent years, however, new types of channel organizations have appeared that provide stronger leadership and improved performance.

Objective 3 Identify the major channel alternatives open to a company. **(pp 351–354)**

Channel alternatives vary from direct selling to using one, two, three, or more intermediary *channel levels*. Marketing channels face continuous and sometimes dramatic change. Three of the most important trends are the growth of *vertical*, *horizontal*, and *multichannel marketing systems*. These trends affect channel cooperation, conflict, and competition.

Channel design begins with assessing customer channel service needs and company channel objectives and constraints. The company then identifies the major channel alternatives in terms of the *types* of intermediaries, the *number* of intermediaries, and the *channel responsibilities* of each. Each channel alternative must be evaluated according to economic, control, and adaptive criteria. *Channel management* calls for selecting qualified intermediaries and motivating them. Individual channel members must be evaluated regularly.

Objective 4 Explain how companies select, motivate, and evaluate channel members. **(pp 354–357)**

Producers vary in their ability to attract qualified marketing intermediaries. Some producers have no trouble signing up channel members. Others have to work hard to line up enough qualified intermediaries. When selecting intermediaries, the company should evaluate each channel member's qualifications and select those that best fit its channel objectives.

Once selected, channel members must be continuously motivated to do their best. The company must sell not only *through* the intermediaries but also *with* them. It should forge strong partnerships with channel members to create a marketing system that meets the needs of both the manufacturer *and* the partners.

Objective 5 Discuss the nature and importance of marketing logistics and integrated supply chain management. **(pp 357–365)**

Marketing logistics (or *physical distribution*) is an area of potentially high cost savings and improved customer satisfaction. Marketing logistics addresses not only *outbound distribution* but also *inbound distribution* and *reverse distribution*. That is, it involves the entire *supply chain management*—managing value-added flows between suppliers, the company, resellers, and final users. No logistics system can both maximize customer service and minimize distribution costs. Instead, the goal of logistics management is to provide a *targeted* level of service at the least cost. The major logistics functions include *warehousing*, *inventory management*, *transportation*, and *logistics information management*.

The *integrated supply chain management concept* recognizes that improved logistics requires teamwork in the form of close working relationships across functional areas inside the company and across various organizations in the supply chain. Companies can achieve logistics harmony among functions by creating cross-functional logistics teams, integrative supply manager positions, and senior-level logistics executives with cross-functional authority. Channel partnerships can take the form of cross-company teams, shared projects, and information-sharing systems. Today, some companies are outsourcing their logistics functions to third-party logistics (3PL) providers to save costs, increase efficiency, and gain faster and more effective access to global markets.

KEY Terms

OBJECTIVE 1

Value delivery network (p 341)
Marketing channel (distribution channel; p 341)
Channel level (p 343)
Direct marketing channel (p 343)
Indirect marketing channel (p 343)

OBJECTIVE 2

Channel conflict (p 344)
Conventional distribution channel (p 345)
Vertical marketing system (VMS; p 345)
Corporate VMS (p 345)
Contractual VMS (p 346)
Franchise organization (p 346)
Administered VMS (p 348)
Horizontal marketing system (p 348)
Multichannel distribution system (p 349)
Disintermediation (p 350)

OBJECTIVE 3

Marketing channel design (p 351)
Intensive distribution (p 352)
Exclusive distribution (p 353)
Selective distribution (p 353)

OBJECTIVE 4

Marketing channel management (p 354)

OBJECTIVE 5

Marketing logistics (physical distribution; p 357)
Supply chain management (p 357)
Distribution center (p 360)
Intermodal transportation (p 362)
Integrated logistics management (p 363)
Third-party logistics (3PL) provider (p 364)

PEARSON mymarketinglab

- Check your understanding of the concepts and key terms using the mypearsonmarketinglab study plan for this chapter.
- Apply the concepts in a business context using the simulation entitled **Supply Chain**.

DISCUSSING & APPLYING THE Concepts

Discussing the Issues

1. Describe the key functions performed by marketing channel members. (AACSB: Communication)
2. Compare and contrast direct and indirect marketing channels and discuss the types of *flows* in a distribution channel. (AACSB: Communication)
3. What is a franchise organization? Discuss the types of franchise organizations and give an example of each. (AACSB: Communication; Reflective Thinking)
4. Describe the three strategies available regarding the number of intermediaries and discuss the types of products for which each is appropriate. (AACSB: Communication; Reflective Thinking)
5. Discuss the complexities international marketers face when designing channels in other countries. (AACSB: Communication)
6. List and briefly describe the major logistics functions. Give an example of a decision a logistics manager would make for each major function. (AACSB: Communication; Reflective Thinking)

Applying the Concepts

1. In a small group, debate whether or not the Internet will result in disintermediation of the following retail stores: (1) video rental stores, (2) music stores, and (3) clothing stores. (AACSB: Communication; Reflective Thinking)
2. Consumer packaged goods manufacturers typically distribute products to retailers through wholesalers. However, Walmart deals directly with manufacturers, many having offices in Bentonville, Arkansas, and catering just to Walmart. Discuss the consequences of manufacturers, such as Kraft and P&G, distributing products directly to one or more large retailers while distributing the same products indirectly to smaller retailers through wholesalers. (AACSB: Communication; Reflective Thinking)
3. Visit http://www.youtube.com/watch?v=eob532iEpqk and watch the "The Future Market" video. What impact will RFID tags have on each major logistical function? What are the biggest current obstacles in adopting this technology? (AACSB: Communication; Use of IT; Reflective Thinking)

FOCUS ON Technology

Brewing craft beer is both an art and a science, and Sonia Collin, a Belgian researcher, is trying to devise a way for this highly perishable beer to have a longer shelf life. If successful, brewers can ship more beer longer distances. Hoping to boost exports of homegrown products, the Belgian government is investing $7 million for research, with $1.7 million of that allocated to Ms. Collins' research. A $250,000 tasting machine in her laboratory identifies the chemical compounds in a sample of beer, which allowed researchers to recommend using organic ingredients, adjusting the oxygen and yeast levels, and reducing the time the beer is at high temperatures in the brewing process. Although pasteurization and bottling methods allow giants such as Heineken and Anheuser to export their brews, aficionados prefer the more delicate flavor of craft beers. But craft brews don't travel well—time and sunlight are its worst enemies—so they are limited to local distribution. Most craft beers lose flavor in less than three months.

1. Describe the channel of distribution for a craft beer from Belgium to your city or town. How many channel levels will be involved? (AACSB: Communication; Reflective Thinking)
2. Discuss the options facing Belgian craft brewers desiring to sell their products in the United States if researchers cannot discover a way to sufficiently extend the shelf life of craft beers. (AACSB: Communication; Reflective Thinking)

FOCUS ON Ethics

Tension is escalating between apparel retailers and suppliers during the economic recovery. Retailers previously placed orders almost a year in advance, and suppliers produced high volumes cheaply. Now many retailers are placing small initial orders, and if styles take off with consumers, they quickly reorder—a tactic known as "chasing." Teen retailer Aeropostale has been buying conservatively and chasing for items that are hot with buyers. Appropriate inventory levels in the apparel industry have always been difficult to predict, but it appears that retailers are pushing this worry back to suppliers.

1. Discuss the concerns of suppliers (i.e., garment makers) and retailers in the apparel channel of distribution. Is it fair that retailers should expect suppliers to respond so quickly? Is it fair that suppliers should demand long lead times? (AACSB: Communication; Ethical Reasoning; Reflective Thinking)
2. What type of channel conflict does this represent? Are there any benefits from this conflict? (AACSB: Communication; Reflective Thinking)

MARKETING & THE Economy

Expedia.com

When the travel business takes a hit, so do travel intermediaries. As individuals and businesses have cut back their travel budgets over the past few years, travel Web sites in general faced financial difficulties. With Priceline.com returning to its "name your own price" roots, competition is becoming tougher than ever. Even Expedia, the market leader, has had to drastically reformulate its strategy to survive. To keep customers from bypassing travel sites and booking directly with airlines, Expedia permanently eliminated its $10 booking fee. Most recently, it has engaged in a new branding campaign called "Where you book matters," which targets frequent leisure travelers and seeks to earn their loyalty. Compared to Priceline's singular focus on price, Expedia is aiming higher up on the food chain. It wants to establish itself as the generic place to shop for all things travel, highlighting its full range of services. In a market driven by frugality, this approach might seem risky. But as travel now shows signs of renewed life, Expedia might be turning things around quicker than the rest. Its recent U.S. bookings are up 20 percent, compared to a 16 percent increase for Priceline.

1. As an intermediary, does Expedia have power to spur demand when the travel industry suffers?
2. Is Expedia taking the right approach with its branding and promotional strategy?
3. If the economy doesn't recover as quickly as hoped, will Expedia be in good shape?

MARKETING BY THE Numbers

Consumers typically buy products such as toiletries, food, and clothing from retailers rather than directly from the manufacturer. Likewise, retailers buy from wholesalers. Resellers perform functions for the manufacturer and the consumer and mark up the price to reflect that value. Refer to Appendix 2 to answer the following questions.

1. If a manufacturer sells its laundry detergent to a wholesaler for $2.50, at what price will the wholesaler sell it to a retailer if the wholesaler wants a 15 percent margin based on the selling price? (AACSB: Communication; Analytical Reasoning)
2. If a retailer wants a 20 percent margin based on the selling price, at what price will the retailer sell the product to consumers? (AACSB: Communication; Analytical Reasoning)

VIDEO Case

Progressive

Progressive has attained top-tier status in the insurance industry by focusing on innovation. Progressive was the first company to offer drive-in claims services, installment payment of premiums, and 24/7 customer service. But some of Progressive's most innovative moves involve its channels of distribution. Whereas most insurance companies distribute their products to consumers via intermediary agents or direct-to-consumer methods, Progressive was one of the first companies to recognize the value in doing both. In the late 1980s, it augmented its agency distribution with a direct 800-number channel.

In 1995, Progressive moved into the future by becoming the first major insurer in the world to launch a Web site. In 1997, customers could buy auto insurance policies online in real time. Today, at Progressive's Web site, customers can do everything from managing their own account information to reporting claims directly. Progressive even offers one-stop concierge claim service.

After viewing the Progressive video, answer the following questions about marketing channels:

1. Apply the concept of the supply chain to Progressive.
2. Using the model of consumer and business channels found in the chapter, sketch out as many channels for Progressive as you can. How does each of these channels meet distinct customer needs?
3. Discuss the various ways that Progressive has had an impact on the insurance industry.

COMPANY Case

Netflix: Disintermediator or Disintermediated?

Baseball great Yogi Berra, known more for his mangled phrasing than for his baseball prowess, once said, "The future ain't what it used to be." For Netflix, the world's largest online movie-rental service, no matter how you say it, figuring out the future is challenging and a bit scary. Netflix faces dramatic changes in how movies and other entertainment content will be distributed. So, will Netflix be among the disintermediat*ors* or among the disintermediat*ed*?

Less than a decade ago, if you wanted to watch a movie in the comfort of your own home, your only choice was to roust yourself out of your recliner and trot down to the local Blockbuster or other neighborhood movie-rental store. Blockbuster is still the world's largest store-rental chain with over 9,000 stores in 25 countries and $4.1 billion in annual sales. But its revenues have been flat or in decline for the past few years. To make matters worse, it has lost money in all but one of the last 13 years—over $550 million in 2009 alone! Blockbuster's stock price has plummeted to a mere $0.28 a share while the company teeters on the brink of bankruptcy. This riches-to-rags story underscores the fact that the old model for distributing movies is simply not working anymore.

One thing about the future is certain. The business of distributing home video is full of disruption and confusion. Things are really changing, and the dust is far from settling. HBO offers its classic subscription service as well as its new premium service, HBO On Demand. Then there's Redbox, the Coinstar Company that rents DVDs for a dollar a day through vending machines in more than 25,000 convenience stores, supermarkets, and fast-food restaurants. That's from a company that no one had even heard of just a few years ago. Adding even more chaos to the mix, Hulu leads the army of start-ups and veterans that show full-length movies, TV shows, and clips for free, as long as you're willing to watch some ads.

THE NETFLIX REVOLUTION

But amid the chaos, Netflix has carved out its own successful niche. Netflix CEO Reed Hastings remains focused on a well-defined strategy with unwavering commitment. That strategy outlines not only what Netflix will do but also what it won't do. The company won't distribute content in brick-and-mortar stores, through vending machines, as pay-per-view, or in an ad-supported format. "Commercial-free subscription is where we can compete. It's our best shot."

Netflix is demonstrating how its model can flexibly reach millions of viewers through various channels. In the late 1990s, Netflix pioneered a new way to rent movies—via the Web and direct mail. For a monthly subscription fee, members could create a movie wish list online. The company would then send out a set of DVDs from that list via the USPS. One of Netflix's main selling points was that members could keep the DVDs as long as they wanted. When they were done with them, they simply returned the DVDs in the mail with a prepaid return envelope. Netflix then automatically sent the next set of DVDs from the member's list.

The Netflix DVD-by-mail model was quickly favored by hundreds of thousands of viewers, then by millions. It's easy to see why. As Netflix's clever ad campaign has been pointing out, there is no hassle or cost from those trips to the video store. There is no worry about late fees. The selection from more than 100,000 DVD titles dwarfs anything that a brick-and-mortar store could hold. Finding rare, old, documentary, or independent films is easy. And the cost of renting—set by members based on how many DVDs they can check out at one time—is always the same and as little as $5 a month.

NOTHING LASTS FOREVER

As much as this Netflix model revolutionized the movie rental business, Hastings quickly points out that it will not last forever. In fact, he predicts that the Netflix core business model will be in decline in as little as three years. What Netflix has in store offers a rare case of how a company manages a still-hot business as it watches the clock tick down. Rather than clinging to an entrenched business model, Netflix is determined to out-innovate its competitors. In fact, in a true sign of forward thinking, Hastings avoided naming the company something catchy like "Movies-by-Mail" when he founded it. He knew that such branding would be far too limiting to allow dynamic change.

Netflix's innovation really took off just a little more than three years ago when it launched Instant Watch, a feature that allowed members to stream videos instantly via their computers as part of their monthly membership fee. At first, the selection was slim—only a few thousand movies available for streaming—and the quality wasn't all that great. But Netflix has been hard at work expanding its library of streaming videos. That library now stands at more than 17,000 films and TV shows and is growing rapidly. And with technology advancements, viewers can watch movies in beautiful high-definition, full-screen splendor.

As media touchpoints exploded, Hastings knew that Netflix's growth would be limited if it streamed only to computers and laptops. So Hastings assembled a team to develop a prototype set-top box that would access the Web through a viewer's broadband connection, allowing members to stream movies remotely to their TVs from the comfort of their couches. Barry McCarthy, Netflix's chief financial officer, recalls that Hastings was so infatuated with the plan that it could be described only as "Apple lust." But just as Netflix neared a public unveiling of the set-top box, Netflix executives had an epiphany. "Are we out of our [minds]?" McCarthy recalls thinking. "We don't even know what we don't know about this business." The Netflix-only set-top box is now available, but Netflix turned it over to Roku, a small electronics company.

At that critical turning point, Hastings and his team realized that they had to move into other distribution points. They decided that it made much more sense to partner with experts who already market popular devices. Netflix moved quickly. Now, every xBox, PlayStation, and Wii has become a home theatre, allowing members full access to Netflix's streaming library. The same access can be had through Blu-ray DVD players and TiVo DVRs.

Hastings also sees a future with Web-enabled TVs. He believes that in five to ten years, viewers will interact with the big screen in the same way they now interact with the small screen. "We'll be calling up movies and channels and Web sites with a click of a button or just a spoken word: 'Wizard of Oz.' Or 'ESPN.' Or 'Netflix.'" In small measure, it's already happening. Instant Watch is available on TVs from Sony, LG, and Vizio. Netflix's streaming service is available only through U.S.-based Web addresses for now. But with a projected 500 million Web-connected devices worldwide by 2013, Netflix plans to expand internationally.

Along with TVs, DVD players, and gaming platforms, Netflix is also moving into mobile devices. It now offers an Instant Watch app for Windows Phone 7 and Apple's iPad and iPhone. Other mobile platforms will follow soon, including Google's Android.

FOCUS ON THE CUSTOMER

As Blockbuster's financial performance has plummeted, Netflix's has skyrocketed. With more than 12 million members and 2.5 billion movie views under its belt, annual revenue has increased 70 percent in the past three years to $1.7 billion. Profits have climbed 130 percent. And in less than two years, Netflix stock has risen from $20 a share to $118. That's a return on investment of more than 500 percent for those savvy enough to have bought in at the right time. Such performance is even more amazing when you consider that it happened in the midst of a global economic meltdown. "We were growing at 25 percent when the economy was growing. We're growing at 25 percent now," says Hastings.

Hastings has no intention of slowing down. And it isn't just about distribution points. The dynamic Hastings is on a crusade to improve the viewing experience of its members. "For most people, they watch one or two movies a week. Only maybe once a month do they get a movie that's like, 'Wow. I loved that movie!'

It really is a hard problem to figure out which ones to watch with your valuable time. We're trying to get it to where every other movie that you watch from Netflix is 'Wow. I loved that movie!' As we get closer to achieving that, we increase human happiness with movies."

Netflix has its work cut out for it. The various delivery models being pursued by its competitors and the complexities of dealing with content producers don't make it any easier. But with unlimited DVDs by mail and unlimited instant streaming to computers, TVs, and other Web-enabled devices for a flat $8.99 a month, the future looks bright for Netflix.

Questions for Discussion

1. As completely as possible, sketch the value chain for Netflix from the production of content to viewer.

2. How do horizontal and vertical conflict impact Netflix?

3. How does Netflix add value for customers through distribution functions?

4. What threats does Netflix face in the future?

5. Will Netflix be successful in the long term? Why or why not?

Sources: Patricia Sellers, "Netflix CEO Focuses on the Future," *Fortune*, July 22, 2009, accessed at http://postcards.blogs.fortune.cnn.com/2009/07/22/netflix-ceo-focuses-on-the-future/; Chuck Salter, "The World's 50 Most Innovative Companies: #12 Netflix," *Fast Company*, February 17, 2010, p. 68; Nick Wingfield, "Netflix Boss Plots Life after the DVD," *Wall Street Journal*, June 23, 2009, p. A1; Beth Snyder Bulik, "How Netflix Stays Ahead of Shifting Consumer Behavior," *Advertising Age*, February 22, 2010, p. 28.