

Previewing the Concepts

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'll start with a look at Caterpillar. You might think that Caterpillar's success, and its ability to charge premium prices, rests on the quality of the heavy construction and mining equipment that it produces. But Caterpillar sees things differently. The company's dominance, it claims, results from its unparalleled distribution and customer support system—from the strong and caring partnerships that it has built with independent Caterpillar dealers. Read on and see why.

Marketing Channels and Supply Chain Management

For more than seven decades, Caterpillar has dominated the world's markets for heavy construction, mining, and logging equipment. Its familiar yellow tractors, crawlers, loaders, bulldozers, and trucks are a common sight at any construction area. Caterpillar sells more than 300 products in nearly 200 countries, with sales approaching \$40 billion annually. Over the past two years, sales have grown 60 percent; profits have shot up 250 percent. The big Cat captures some 37 percent of the worldwide construction and farm equipment business, more than double that of number-two Komatsu. The waiting line for some of Caterpillar's biggest equipment is years long.

Many factors contribute to Caterpillar's enduring success—high-quality products, flexible and efficient manufacturing, and a steady stream of innovative new products. Yet these are not the most important reasons for Caterpillar's dominance. Instead, Caterpillar credits its focus on customers and its corps of 200 outstanding independent dealers worldwide, who do a superb job of taking care of every customer need. According to former Caterpillar CEO Donald Fites:

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. . . . They're out there making sure that when a machine is delivered, it's in the condition it's supposed to be in. They're out there training a customer's operators. They service a product frequently throughout its life, carefully monitoring a machine's health and scheduling repairs to prevent costly downtime. The customer . . . knows that there is a [\$40-billion-plus] company called Caterpillar. But the dealers create the image of a company that doesn't just stand *behind* its products but *with* its products, anywhere in the world. Our dealers are the reason that our motto—Buy the Iron, Get the Company—is not an empty slogan.

"Buy the Iron, Get the Company"—that's a powerful value proposition. It means that when you buy Cat equipment, you become a member of the Caterpillar family. Caterpillar and its dealers work in close harmony to find better ways to bring value to customers. Dealers play a vital role in almost every aspect of Caterpillar's operations, from product design and delivery, to product service and support, to market intelligence and customer feedback.

In the heavy-equipment industry, in which equipment downtime can mean big losses, Caterpillar's exceptional service gives it a huge advantage in winning and



keeping customers. Consider Freeport-McMoRan, a Cat customer that operates one of the world's largest copper and gold mines, 24 hours a day, 365 days a year. High in the mountains of Indonesia, the mine is accessible only by aerial cableway or helicopter. Freeport-McMoRan relies on more than 500 pieces of Caterpillar mining and construction equipment—worth several hundred million dollars—including loaders, tractors, and mammoth 240-ton, 2,000-plus-horsepower trucks. Many of these machines cost well over \$1 million apiece. When equipment breaks down, Freeport-McMoRan loses money fast. Freeport-McMoRan gladly pays a premium price for machines and service it can count on. It knows that it can count on Caterpillar and its outstanding distribution network for superb support.

The close working relationship between Caterpillar and its dealers comes down to more than just formal contracts and business agreements. The powerful partnership rests on a handful of basic principles and practices:

- *Dealer profitability:* Caterpillar's rule: "Share the gain as well as the pain." When times are good, Caterpillar shares the bounty with its dealers rather than trying to grab all the riches for itself. When times are bad, Caterpillar protects its dealers. In the mid-1980s, facing a depressed global construction-equipment market and cutthroat competition, Caterpillar sheltered its dealers by absorbing much of the economic damage. It lost almost \$1 billion dollars in just three years but didn't

Objectives

1. explain why companies use marketing channels and discuss the functions these channels perform
2. discuss how channel members interact and how they organize to perform the work of the channel
3. identify the major channel alternatives open to a company
4. explain how companies select, motivate, and evaluate channel members
5. discuss the nature and importance of marketing logistics and integrated supply chain management

lose a single dealer. In contrast, competitors' dealers struggled and many failed. As a result, Caterpillar emerged with its distribution system intact and its competitive position stronger than ever.

- **Extraordinary dealer support:** Nowhere is this support more apparent than in the company's parts delivery system, the fastest and most reliable in the industry. Caterpillar maintains 36 distribution centers and 1,500 service facilities around the world, which stock 320,000 different parts and ship 84,000 items per day, every day of the year. In turn, dealers have made huge investments in inventory, warehouses, fleets of trucks, service bays, diagnostic and service equipment, and information technology. Together, Caterpillar and its dealers guarantee parts delivery within 48 hours anywhere in the world. The company ships 80 percent of parts orders immediately and 99 percent on the same day the order is received. In contrast, it's not unusual for competitors' customers to wait four or five days for a part.
- **Communications:** Caterpillar communicates with its dealers—fully, frequently, and honestly. According to Fites, "There are no secrets between us and our dealers. We have the financial statements and key operating data of every dealer in the world. . . . In addition, virtually all Caterpillar and dealer employees have real-time access to continually updated databases of service information, sales trends and forecasts, customer satisfaction surveys, and other critical data."
- **Dealer performance:** Caterpillar does all it can to ensure that its dealerships are run well. It closely monitors each dealership's sales, market position, service capability, financial situation, and other performance measures. It genuinely wants each dealer to succeed, and when it sees a problem, it jumps in to help. As a result, Caterpillar dealerships, many of which are family businesses, tend to be stable and profitable.
- **Personal relationships:** In addition to more formal business ties, Cat forms close personal ties with its dealers in a kind of family relationship. One Caterpillar executive relates the following example: "When I see Chappy Chapman, a retired executive vice-president . . . , out on the golf course, he always asks about particular dealers or about their children, who may be running the business now. And every time I see those dealers, they inquire, 'How's Chappy?' That's the sort of relationship we have. . . . I consider the majority of dealers personal friends."

Thus, Caterpillar's superb distribution system serves as a major source of competitive advantage. The system is built on a firm base of mutual trust and shared dreams. Caterpillar and its dealers feel a deep pride in what they are accomplishing together. As Fites 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 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."¹

Most firms cannot bring value to customers by themselves. Instead, they must work closely with other firms in a larger value delivery network.

Supply Chains and the Value Delivery Network

Producing a product or service and making it available to buyers requires building relationships not just 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 forward toward the customer. Downstream marketing channel partners, such as wholesalers and retailers, form a vital connection between the firm and its customers.

Both upstream and downstream partners may also be part of other firms' supply chains. But it is the unique design of each company's supply chain that enables it to deliver superior

Value delivery network

The network made up of the company, suppliers, distributors, and ultimately customers who “partner” with each other to improve the performance of the entire system.

value to customers. An individual firm's success depends not only on how well it performs, but also on how well its entire supply chain and marketing channel competes with competitors' channels.

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 with 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.

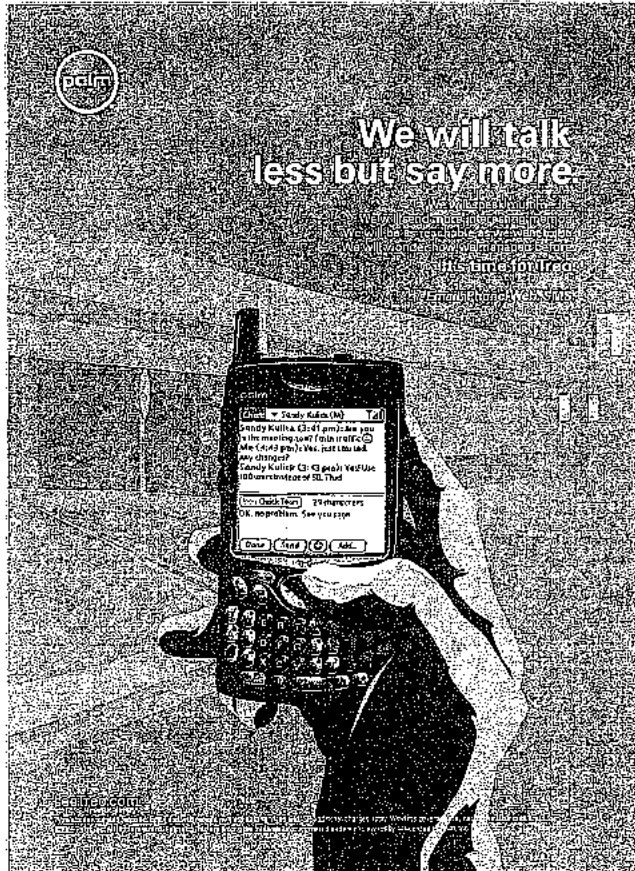
Even a demand chain view of a business may be too limited, because it takes a *step-by-step*, linear view of purchase-production-consumption activities. With the advent of the Internet and other technologies, however, companies are forming more numerous and complex relationships with other firms. For example, Ford manages numerous supply chains. It also sponsors or transacts on many B2B Web sites and online purchasing exchanges as needs arise. Like Ford, most large companies today are engaged in building and managing a *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, Palm, the leading manufacturer of handheld devices, manages a whole community of suppliers and assemblers of semiconductor components, plastic cases, LCD displays, and accessories. Its network also includes offline and online resellers, and 45,000 complementors who have created more than 5,000 applications for the Palm operating systems.

This chapter focuses on marketing channels—on the *downstream side* of the value delivery network. However, it is important to remember that this is only part of the full value network. To bring value to customers, companies need upstream supplier partners just as they need downstream channel partners. Increasingly, marketers are participating in and influencing their company's upstream activities as well as its downstream activities. More than marketing channel managers, they are becoming full value-network managers.

The chapter examines 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.



Value delivery network: Palm, Inc., manages a whole community of suppliers, assemblers, resellers, and complementors who must work effectively together to make life easier for Palm's customers.

Marketing channel (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.

The Nature and Importance of Marketing Channels

Few producers sell their goods directly to the 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.

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.

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. FedEx's creative and imposing distribution system made it a leader in express delivery. Dell revolutionized its industry by selling personal computers directly to consumers rather than through retail stores. Amazon.com pioneered the sales of books and a wide range of other goods via the Internet. And Calyx & Corolla led the way in selling fresh flowers and plants direct to consumers by phone and from its Web site, cutting a week or more off the time it takes flowers to reach consumers through conventional retail channels.

Distribution channel decisions often involve long-term commitments to other firms. For example, companies such as Ford, Hewlett-Packard, or McDonald's 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 conditions change. Therefore, management must design its channels carefully, with an eye on tomorrow's likely selling environment as well as 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.

■ Innovative marketing channels: Calyx & Corolla sells fresh flowers and plants directly to consumers by phone and from its Web site, cutting a week or more off the time it takes flowers to reach consumers through conventional retail channels.



FIGURE 12.1
How using a marketing
intermediary reduces the
number of channel
transactions

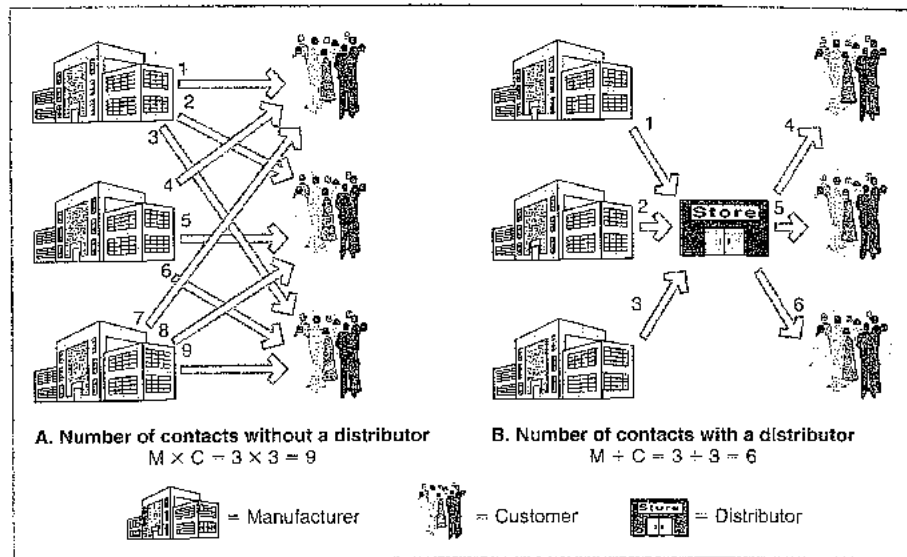


Figure 12.1 shows how using intermediaries can provide economies. Figure 12.1A shows three manufacturers, each using direct marketing to reach three customers. This system requires nine different contacts. Figure 12.1B shows the three manufacturers working through one distributor, which contacts the 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 wanted by consumers.

For example, Unilever makes millions of bars Lever 2000 hand soap each day, but you want to buy only a few bars at a time. So big food, drug, and discount retailers, such as Kroger, Walgreens, and Wal-Mart, buy Lever 2000 by the truckload and stock it on their store's 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 would 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.
- **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.

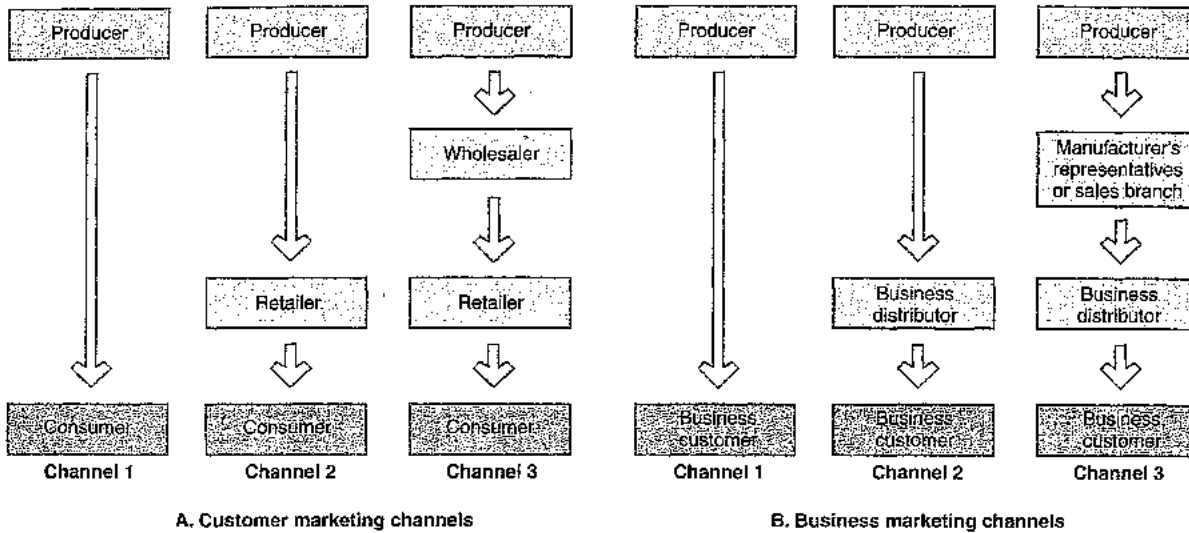


FIGURE 12.2 Consumer and business marketing channels

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 its prices become 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

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 the producer and the final consumer both 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 and Amway sell their products door-to-door, through home and office sales parties, and on the Web; GEICO sells direct via the telephone and the Internet. The remaining channels in Figure 12.2A are **indirect marketing channels**, containing one or more intermediaries.

Figure 12.2B 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 less often. From the producer's point of view, a greater number of levels means less control and greater channel complexity. Moreover, all of 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.

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.

Channel Behavior and Organization

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 only of 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 at 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 consumer needs. In turn, Ford depends on the dealer to attract consumers, persuade them to buy Ford cars, and service 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, Samsung's role is to produce consumer electronics products that consumers will like and to create demand through national advertising. Best Buy's role is to display these Samsung products in convenient locations, to answer buyers' questions, and to 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.

Horizontal conflict occurs among firms at the same level of the channel. For instance, some Ford dealers in Chicago might complain the other dealers in the city steal sales from them by pricing too low or by 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. For example, Goodyear created hard feelings and conflict with its premier independent-dealer channel when it began selling through mass-merchant retailers (see Real Marketing 12.1). Similarly, Revlon came into serious conflict with its department store channels when it cozied up to mass merchants.²

A few years back, Revlon made a big commitment to mass-market retailers such as Wal-Mart, Target, and CVS, all but snubbing better department stores. That strategy worked well initially. However, the mass merchants are sophisticated and demanding, and they quickly abandon brands that aren't working. That happened recently with Revlon's important new Vital Radiance line of cosmetics targeted toward aging boomers. When Revlon failed to deliver on the promised marketing support for Vital Radiance—it spent only \$700,000 during the three-month launch versus P&G's \$9 million during the same period for its own CoverGirl Advanced Radiance cosmetics—the mass-merchant channels backed away from the brand. For example, only 647 of CVS's 5,300 stores carried the new line. Meanwhile, the snubbed department stores are now lukewarm toward Revlon's prestige lines. An alienated Federated Department Stores, which operates Macy's and Bloomingdale's, refused to carry Revlon's new Flair prestige fragrance altogether. Says one retailing expert, "The prestige channel doesn't trust Revlon not to run back to the discount channel if sales for Flair don't fly."

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. But severe or prolonged conflict, as in the case of Goodyear and Revlon, can disrupt channel effectiveness and cause lasting harm to channel relationships. Companies should manage channel conflict to keep it from getting out of hand.

Channel conflict

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

Real Marketing

For more than 60 years, Goodyear sold replacement tires exclusively through its premier network of 5,300 independent Goodyear dealers. Both Goodyear and its dealers profited from this partnership. Goodyear received the undivided attention and loyalty of its single-brand dealers, and the dealers gained the exclusive right to sell the highly respected Goodyear tire line. In mid-1992, however, Goodyear shattered tradition and jolted its dealers by agreeing to sell its tires through Sears auto centers. Similar pacts soon followed with Wal-Mart and Sam's Club, placing dealers in direct competition with the nation's most potent retailers.

To add insult to injury, beyond selling its branded tires through large retailers, Goodyear began selling private-branded tires through Wal-Mart and other discounters. It even opened its own no-frills, quick-serve Just Tires discount stores designed to fend off low-priced competitors. All of these moves created fierce new competition for Goodyear's independent dealers.

Goodyear claimed that the channel changes were essential. Tires had become more of an impulse item, and value-minded tire buyers were increasingly buying from cheaper, multibrand discount outlets and department stores. The market share of these outlets had grown 30 percent in the previous



Channel conflict: Following more than a decade of damaging conflict with its prized independent dealer network, Goodyear has actively set about repairing fractured dealer relations. The result: a remarkable turnaround that has Goodyear now rolling, rolling, rolling.

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.

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.

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, wholesaler, or 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.

five years, while that of tire dealers had fallen 4 percent. Marketing research showed that one out of four Wal-Mart customers was a potential Goodyear buyer and that these buyers came from a segment unlikely to be reached by independent Goodyear dealers. By selling exclusively through its dealer network, Goodyear claimed, it simply wasn't putting its tires where many consumers were going to buy them.

The shifts in consumer buying were also causing problems for dealers. Unfortunately, however, as Goodyear expanded into the needed new channels, it took few steps to protect its prized dealer network. Although it offered an ample variety of premium lines, Goodyear provided its dealers with none of the lower-priced lines that many consumers were demanding. Dealers complained not just about competition from megaretailers but also about shoddy treatment and unfair pricing from Goodyear. For example, to sell more tires, Goodyear offered volume discounts to its biggest retailers and wholesalers. "The result was pricing insanity," notes one observer. "Some smaller dealers were paying more for tires than what Sears charged at retail."

Not surprisingly, Goodyear's aggressive moves into new channels set off a surge of dysfunctional channel conflict, and dealer relations deteriorated rapidly. Some of Goodyear's best dealers defected to competitors. Other angry dealers struck back by taking on competing brands and by aggressively promoting cheaper, private-label tires that offered higher margins to dealers and more appeal to value-conscious consumers. U.S. dealers in California even took Goodyear to court in a class action suit, causing Goodyear to somewhat restrict the tire lines sold through its new channels there. Says one former dealer, "After someone punches you in the face a few times, you say, 'Enough is enough.'"

Such dealer actions weakened the Goodyear name and the premium price that it could command. Goodyear's replacement tire sales—which make up 72 percent of the company's revenues—went

flat, dropping the company into a decade-long profit funk. By 2002, Goodyear was fighting off rumors of bankruptcy.

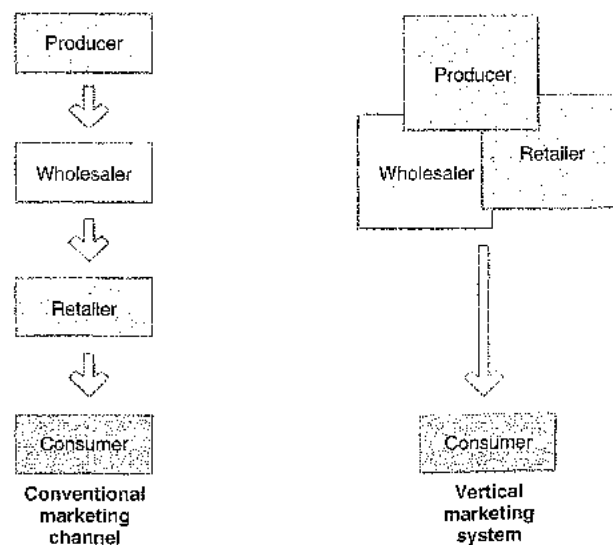
In 2003, however, Goodyear regained its senses and refocused its strategy. After years of chasing volume by selling low-margin tires to mid-market buyers, the company began focusing on higher-performance, higher-margin tire lines. More importantly, Goodyear actively set about repairing fractured dealer relations. It began supporting dealers with more fair and consistent pricing, on-time order fulfillment, strong marketing support, and hot new products sold exclusively through the dealer network.

The new strategic direction had an immediate and impressive impact. In the two years following the redirection, Goodyear's sales exploded 30 percent, profits went from searing red to healthy black, and the company's stock price quadrupled. Goodyear is now rolling, rolling, rolling. And dealer relations have turned around dramatically. At a recent meeting with dealers in Nashville, Tennessee, Goodyear chief executive Robert Keegan received a "roaring standing ovation" from dealers.

Despite its recent successes, however, the company still faces many bumps in the road ahead. Completely patching Goodyear's dealer relations, damaged over many years, will take time. "We still have a long way to go on this," admits Goodyear's VP for replacement tire sales. "We lost sight of the fact that it's in our interest that our dealers succeed." An industry analyst agrees: "Goodyear... must stay proactive about keeping dealers satisfied. It's an everyday effort involving all of the company's interactions with dealers."

Sources: Quotes and other information from "No Time to Rest for Goodyear," *Tire Business*, February 13, 2006, p. 8; Kevin Kelleher, "Giving Dealers a Raw Deal," *Business 2.0*, December 2004, pp. 82-84; Jonathan Fahey, "Rolling, Rolling, Rolling," *Forbes*, November 28, 2005, pp. 54-56; and Goodyear: annual reports and other information accessed at www.goodyear.com, September 2006.

FIGURE 12.3
Comparison of conventional
distribution channel with
vertical marketing system



Corporate VMS

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

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, grocery giant Kroger owns and operates 42 factories that crank out more than 8,000 private label items found on its store shelves. Giant Food Stores operates an ice-cube processing facility, a soft-drink bottling operation, its own dairy, an ice cream plant, and a bakery that supplies Giant stores with everything from bagels to birthday cakes. And little-known Italian eyewear maker Luxottica produces many famous eyewear brands—including Ray-Ban, Vogue, Anne Klein, Ferragamo, and Bvlgari. It then sells these brands through two of the world's largest optical chains, LensCrafters and Sunglass Hut, which it also owns.³

Controlling the entire distribution chain has turned Spanish clothing chain Zara into the world's fastest-growing fashion retailer.

The secret to Zara's success is its control over almost every aspect of the supply chain, from design and production to its own worldwide distribution network. Zara makes 40 percent of its own fabrics and produces more than half of its own clothes, rather than relying on a hodgepodge of slow-moving suppliers. More than 11,000 new items every season take shape in Zara's own design centers, supported by real-time sales data. New designs feed into Zara manufacturing centers, which ship finished products directly to 918 Zara stores in 64 countries, saving time, eliminating the need for warehouses, and keeping inventories low. Effective vertical integration makes Zara faster, more flexible, and more efficient than international competitors such as Gap, Benetton, and H&M. Its finely tuned distribution systems makes Zara seem more like Dell or Wal-Mart than Gucci or Louis Vuitton. Zara can make a new line from start to finish in less than 15 days, so a look seen on MTV can be in Zara stores within a month, versus an industry average of nine months. And Zara's low costs let it offer midmarket chic at downmarket prices. The company's stylish but affordable offerings have attracted a cult following, and Zara store sales grew more than 18 percent last year to \$4.4 billion.⁴



Corporate VMS: Zara's success stems from its control over almost every aspect of the supply chain, from design and production to its own worldwide distribution network.

Contractual VMS

A vertical marketing system in which independent firms at different levels of production and distribution join together through contracts to obtain more economies or sales impact than they could achieve alone.

Franchise organization

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

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. Coordination and conflict management are attained through contractual agreements among channel members.

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, more 760,000 franchise outlets account for more than \$1.5 trillion in annual sales. 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.

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—examples are found in the auto-rental business (Hertz/Avis), the fast-food service business (McDonald's, Burger King), and the motel business (Holiday Inn, Ramada Inn).

The fact that most consumers cannot tell the difference between contractual and corporate VMSs shows how successfully the contractual organizations compete with corporate chains. Chapter 13 presents a fuller discussion of the various contractual VMSs.

Administered VMS

Administered VMS

A vertical marketing system that coordinates successive stages of production and distribution, not through common ownership or contractual ties, but 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.

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, Procter & Gamble, and Kraft can command unusual cooperation from resellers regarding displays, shelf space, promotions, and price policies. Large retailers such as Wal-Mart, Home Depot, and Barnes & Noble can exert strong influence on the 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 now places "express" versions of its restaurants in Wal-Mart stores.

McDonald's benefits from Wal-Mart's heavy store traffic, while Wal-Mart keeps hungry shoppers from having to go elsewhere to eat. McDonald's also recently joined forces with Sinopec, China's largest gasoline retailer, to place restaurants at its more than 30,000 gas stations. The move greatly speeds McDonald's expansion into China while at the same time pulling hungry motorists into Sinopec gas stations.⁶

Such channel arrangements also work well globally. For example, because of its excellent coverage of international markets, Nestlé jointly sells General Mills' cereal brands in 80 countries outside North America. Similarly, Coca-Cola and Nestlé formed a joint venture, Beverage Partners Worldwide, to market ready-to-drink coffees, teas, and flavored milks in more than 40 countries worldwide. Coke provides worldwide experience in marketing and distributing beverages, and Nestlé contributes two established brand names—Nescafé and Nestea.⁷



Horizontal marketing systems: McDonald's recently joined forces with Sinopec, China's largest gasoline retailer, to place restaurants at its more than 30,000 gas stations. Here, the presidents of the two companies shake hands while announcing the partnership.

Multichannel distribution system

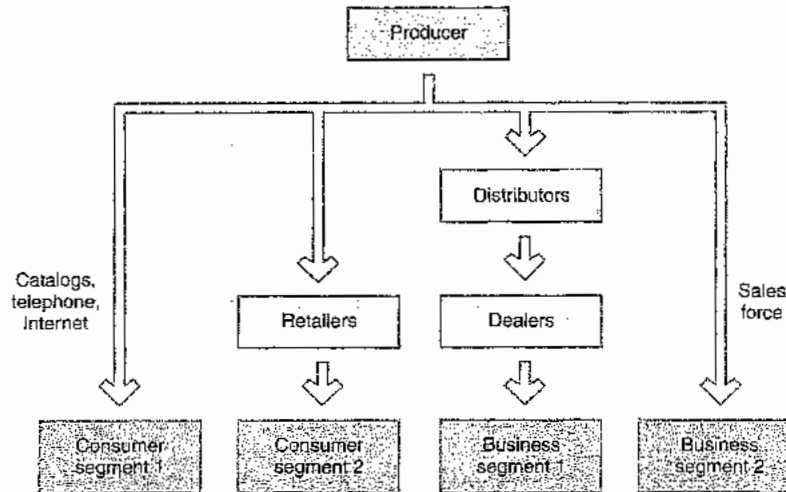
A distribution system in which a single firm sets up two or more marketing channels to reach one or more customer segments.

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—often called *hybrid marketing channels*. 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 distribution system. In the figure, the producer sells directly to consumer segment 1 using direct-mail 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.

FIGURE 12.4
Multichannel distribution
system



These days, almost every large company and many small ones distribute through multiple channels. Fidelity Investments reaches customers by telephone, over the Internet, and through its branch offices. It invites its customer to “call, click, or visit” Fidelity. Urban Outfitters markets itself through its traditional retail outlets, a direct-response Internet site, its mail-order catalog, and as a retailer on Amazon.com.

Hewlett-Packard uses multiple channels to serve dozens of segments and niches, ranging from large corporate and institutional buyers to small businesses to home office buyers. The HP sales force sells the company’s information technology equipment and services to large and mid-size business customers. HP also sells through a network of distributors and value-added resellers, which sell HP computers, systems, and services to a variety of special business segments. Home office buyers can buy HP personal computers and printers from specialty computer stores or any of several large retailers, such as Best Buy or Circuit City. And business, government, and home office buyers can buy directly from HP by phone or online from the company’s Web site (www.hp.com).

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 HP began selling directly to customers through its own Web site, many of its retail dealers cried “unfair competition.” Many salespeople felt that they were being undercut by the new “inside channels.”

Changing Channel Organization

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, companies such as Dell and Southwest Airlines sell directly to final buyers, cutting retailers from their marketing channels altogether. In other cases, new forms of resellers are displacing traditional intermediaries. For example, online marketing is growing rapidly, taking business from traditional brick-and-mortar retailers. Consumers can buy 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. And online music download services such as iTunes and Musicmatch are threatening the very existence of traditional music-store retailers (see Real Marketing 12.2).

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.

Real Marketing

12.1 Buying music can be a pretty frustrating experience. Perhaps you can identify with the following scenario:

You whistle a happy tune as you stroll into Tower Records to do a little music shopping. But when you pick up *The Essential Bruce Springsteen*, your temperature starts to rise. You should be ecstatic at the discovery of 12 new releases by the Boss, but instead you're furious: You can't buy them unless you shell out \$25.99 for the entire three-CD set that includes 30 "career-spanning classics" that you already own from his other hit records. You shove Bruce back into his display case and pick up *The Ragpicker's Dream*, by Mark Knopfler. It has one funny, tender tune that you love, called "Devil Baby"—but what about those other 16 songs? It'll cost you \$23.99 to find out. Suddenly, everything seems like a crapshoot. Why do they keep insisting that you buy an entire CD when you can just go online and get only the tunes you really want from iTunes or Musicmatch for 99 cents each? Fed up, you walk away without buying anything.

Experiences like these, coupled with revolutionary changes in the way music is being distributed and purchased, have thrown the music industry into turmoil. Today, online music download services, such as Yahoo's Musicmatch, AOL's MusicNow, Buy.com's BuyMusic, and Apple's iTunes, offer an attractive alternative to buying overpriced standard CDs from the limited assortments of traditional music retailers. Instead, you can go online, choose from hundreds of thousands of individual tracks, digitally download one or a dozen in any of several formats, burn them onto a CD or dump them into your iPod, and listen to them wherever and whenever you please.

It seems like everyone is getting into the music download business these days. Coffee chain Starbucks opened an in-store music service—Hear Music—letting customers burn downloaded tracks onto CDs while sipping their lattes. Mobile phone makers are now unveiling music-purchase service to go with their music-playing phones that can hold thousands of downloaded songs. And fearsome competitors such as Microsoft and Sony have launched their own online music stores.

These new distribution options are great for consumers. But the new channel forms threaten the very existence of traditional music retailers. There's even a fancy word to describe this phenomenon—*disintermediation*. Strictly speaking, disintermediation means the elimination of a layer of intermediaries from a marketing channel—skipping a step between the source of a product or service and its consumers. For example, when Dell began selling personal computers directly to consumers, it eliminated—or disintermediated—retailers from the traditional PC distribution channel.

More broadly, disintermediation includes not only the elimination of channel levels through direct marketing but also the displacement



Disintermediation: Online music download services are threatening to make traditional CD sellers obsolete. For example, once-dominant Tower Records recently closed its doors for good.

of traditional resellers by radically new types of intermediaries. For example, only a few decades ago, most recorded music was sold through independent music retailers or small chains. Many of these smaller retailers were later disintermediated by large specialty music superstores, such as Tower Records, Virgin Records, and Musicland. The superstores, in turn, have faced growing competition from broad-line discount retailers such as Wal-Mart and Best Buy. In fact, Wal-Mart is currently the world's number-one CD seller. Within the past decade, sales of CDs by traditional music retailers has slipped from 50 percent to less than 32 percent, while Wal-Mart and other superstores have seen their share jump from 28 percent to 54 percent.

Now, the surge of new online music sellers is threatening to make traditional CD sellers obsolete. "Tower Records and the other music-store chains are in a dizzying tizzy," comments one industry expert. Overall retail CD sales have dropped nearly 20 percent since 1999—the year Napster (the original music download site) was launched. Over the past five years, Tower Records has been in and out of bankruptcy, closing more than half of its stores to help pay off debts. Number-two Musicland declared bankruptcy, shuttered more than two-thirds of its stores (only 345 remain), and sold out to Trans World Entertainment. Smaller chains such as National Record Mart have disappeared altogether. Things will likely get worse before they get better. One retail consultant predicts that half of today's music stores will be out of business within five years and that, eventually, "CDs, DVDs, and other forms of physical media will become obsolete."

How are the traditional retailers responding to the disintermediation threat? Some are following the "if you can't beat them, join them" principle by creating their own downloading services. For example, Best Buy partnered with Napster to offer music downloads, as did Virgin Records. Wal-Mart offers in-store and online downloads a bargain rate of only 88 cents a song. And Tower Records recently unveiled a download service to complement its brick-and-mortar locations.

(continues)

Music stores do still have several advantages over their online counterparts. The stores have a larger base of existing customers, and a physical store provides a shopping experience for customers that's difficult to duplicate online. Retailers can morph their stores into comfortable, sociable gathering spots where people hang out, chat with friends, listen to music, go to album signings, and perhaps attend a live performance. Taking advantage of this notion, Musicland recently unveiled a new store-within-a-store concept called Graze, a mesh-enclosed lounge complete with couches, a video wall, a sound system, and pumped-in smells of citrus and chocolate. "Musicland execs are betting that the new ambiance will persuade shoppers to linger, listen—and buy," says an analyst.

But the traditional store retailers also face daunting economics. Store rents are rising while CD prices are falling. And running stores generates considerable inventory and store operating costs. New online entrants face none of those traditional distribution costs. Moreover, whereas store retailers can physically stock only a limited number of in-print titles, the music download sites can provide millions of selections and offer out-of-print songs.

What's more, whereas music stores are stuck selling pre-compiled CDs at high album prices, music download sites let customers buy only the songs they want at low per-song rates. Finally, the old retailing model of selling CDs like they were LP vinyl records doesn't work so well anymore. That was fine in an era when people had one stereo in

the living room and maybe one in the kids' room. But now consumers want music in a variety of formats that they can play anywhere, anytime: on boomboxes, car stereos, computers, and digital players such as Apple's iPod, which can store thousands of songs in a nifty credit-card-sized device.

Thus, disintermediation is a big word but the meaning is clear. Disintermediation occurs only when a new channel form succeeds in serving customers better than the old channels. Marketers who continually seek new ways to create value for customers have little to fear. However, those who fall behind in adding value risk being swept aside. Will today's music-store retailers survive? Stay iTuned.

Sources: Opening extract adapted from Paul Keegan, "Is the Music Store Over?" *Business 2.0*, March 2004, pp. 114-118. Other quotes and information from Rob Levine, "Luring MP3ers Back to the Mall," *Business 2.0*, January-February 2006, p. 32; Lórin Cipolla, "Music's on the Menu," *Promo*, May 1, 2004; Mike Hughlett, "More Companies Enter Musical Phone Field," *Knight Ridder Tribune News*, June 16, 2005, p. 1; "How to Get Your Music Mobile," *Music Week*, June 25, 2005, p. S11; Jon Ortiz, "As Big Chains Flail, He's Got the Beat," *Sacramento Bee*, March 9, 2006, p. D1; Dale Kasler, "Tower Gets New Leader," *Sacramento Bee*, July 29, 2006, p. D1; Chris Serres, "Buyer Surfaces for Bankrupt Musicland," *Star Tribune*, February 26, 2006, p. 1D.

Disintermediation presents problems and opportunities for both producers and intermediaries. To avoid being swept aside, traditional intermediaries must find new ways to add value in the supply chain. To remain competitive, product and service producers must develop new channel opportunities, such as Internet and other direct channels. However, developing these new channels often brings them into direct competition with their established channels, resulting in conflict.

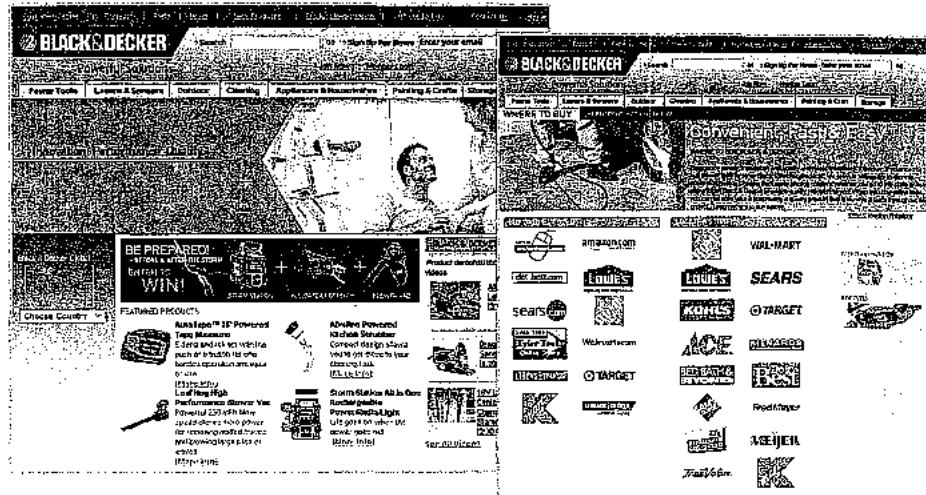
To ease this problem, companies often look for ways to make going direct a plus for the entire channel. For example, Black & Decker knows that many customers would prefer to buy its power tools and outdoor power equipment online. But selling directly through its Web site would create conflicts with important and powerful retail partners, such as Home Depot, Lowe's, Target, Wal-Mart, and Amazon.com. So, although Black & Decker's Web site provides detailed information about the company's products, you can't buy a Black & Decker cordless drill, laser level, leaf blower, or anything else there. Instead, the Black & Decker site refers you to resellers' Web sites and stores. Thus, Black & Decker's direct marketing helps both the company and its channel partners.

✿ Channel Design Decisions

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 the 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.

❑ Avoiding disintermediation problems: Black & Decker's Web site provides detailed information, but you can't buy any of the company's products there. Instead, Black & Decker refers you to resellers' Web sites and stores.



For maximum effectiveness, however, channel analysis and decision making should be more purposeful. Designing a channel system calls for analyzing consumer needs, setting channel objectives, identifying major channel alternatives, and evaluating them.

Analyzing Consumer Needs

As noted previously, marketing channels are part of the overall *customer value delivery network*. Each channel member 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 centralized locations? Would they rather buy in person, over the phone, through the mail, or online? Do they value breadth of assortment or do they prefer specialization? Do consumers want many add-on services (delivery, credit, repairs, installation), or will they obtain these 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, greatest assortment, and 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. 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.

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. In other cases, producers may avoid the channels used by competitors. Mary Kay Cosmetics, for example, sells direct to consumers through its corps of more than one million independent beauty consultants in 34 markets worldwide rather than going head-to-head with other cosmetics makers for scarce positions in retail stores. And GEICO Direct

markets auto and homeowner's insurance directly to consumers via the telephone and Web 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 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. For example, suppose a manufacturer of test equipment has developed an audio device that detects poor mechanical connections in machines with moving parts. Company executives think this product would have a market in all industries in which electric, combustion, or steam engines are made or used. The company's current sales force is small, and the problem is how best to reach these different industries. The following channel alternatives might emerge:

Company sales force: Expand the company's direct sales force. Assign outside salespeople to territories and have them contact all prospects in the area, or develop separate company sales forces for different industries. Or, add an inside telesales operation in which telephone salespeople handle small or midsize companies.

Manufacturer's agency: Hire manufacturer's agents—independent firms whose sales forces handle related products from many companies—in different regions or industries to sell the new test equipment.

Industrial distributors: Find distributors in the different regions or industries who will buy and carry the new line. Give them exclusive distribution, good margins, product training, and promotional support.

Intensive distribution

Stocking the product in as many outlets as possible.

Exclusive distribution

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

Number of Marketing Intermediaries

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 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 automobiles and prestige women's clothing. For example, Bentley dealers are few and far between—even large cities may have only one dealer. By granting exclusive distribution, Bentley gains



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

stronger distributor selling support and more control over dealer prices, promotion, credit, and services. Exclusive distribution also enhances the car's image and allows for higher markups.

Selective distribution

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

Between intensive and exclusive distribution lies selective distribution—the use of more than one, but fewer than all, of 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, KitchenAid, 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.

➔ Responsibilities of Channel Members

The producer and intermediaries need to agree on the terms and responsibilities of each channel member. They should agree on price policies, conditions of sale, territorial rights, and specific services to be performed by each party. The producer should establish a list price and a fair set of discounts for 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, 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 adaptive 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 adaptive 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. At the other extreme, distribution systems in developing countries may be scattered and inefficient, or altogether lacking. For example, China and India are huge markets, each with populations over one billion. 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 amount to 15 percent of the nation's GDP, far higher than in most other countries. After ten years of effort, even Wal-Mart executives admit that they have been unable to assemble an efficient supply chain in China.⁸



International channel complexities: Banned from door-to-door selling in China, Avon fell behind trying to sell through retail stores. Here, Chinese consumers buy Avon products at a supermarket in Shanghai. The Chinese government only recently gave Avon permission to sell door to door.

Sometimes customs or government regulation can greatly restrict how a company distributes products in global markets. For example, it wasn't an inefficient distribution structure that caused problems for Avon in China—it was restrictive government regulations. Fearing the growth of multilevel marketing schemes, the Chinese government banned door-to-door selling altogether in 1998. Forced to abandon its traditional direct marketing approach and to try selling through retail shops, Avon fell behind its more store-oriented competitors. The Chinese government has only recently given Avon permission to sell door to door, and the company has much catching up to do.⁹

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.

Channel Management Decisions

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

Selecting Channel Members

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. When Polaroid started, for example, it could not get photography stores to carry its new cameras, and it had to go to mass-merchandising outlets. Similarly, when the U.S. Time Company first tried to sell its inexpensive Timex 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.

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.

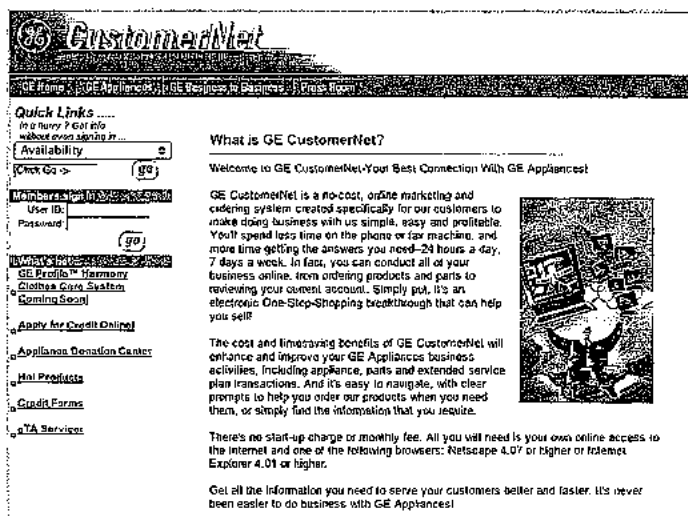
Managing and Motivating Channel Members

Once selected, channel members must be continuously managed and motivated to do their best. The company must sell not only *through* the intermediaries but *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 marketing 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, Procter & Gamble and Wal-Mart work together to create superior value for final consumers. They jointly plan merchandising goals and strategies, inventory levels, and advertising and promotion plans. Similarly, GE Appliances has created an alternative distribution system called *CustomerNet* to coordinate, support, and motivate its dealers.

GE CustomerNet gives dealers instant online access to GE Appliances' distribution and order-processing system, 24 hours a day, 7 days a week. By logging on to the GE CustomerNet Web site, dealers can obtain product specifications, photos, feature lists, and side-by-side model comparisons for hundreds of GE appliance models.

They can check on product availability and prices, place orders, and review order status. They can even create custom brochures, order point-of-purchase materials, or download "advertising slicks"—professionally prepared GE appliance ads ready for insertion in local media. GE promises next-day delivery on most appliance models, so dealers need carry only display models in their stores. This greatly reduces inventory costs, making even small dealers more price competitive. GE CustomerNet also helps dealers to sell GE appliances more easily and effectively. A dealer can put a computer terminal on the showroom floor, where salespeople and customers together can use the system to dig through detailed product descriptions and check availability for GE's entire line of appliances. Perhaps the biggest benefit to GE Appliances, however, is that the system builds strong bonds between the company and its dealers and motivates dealers to put more push behind the company's products.¹⁰



Creating dealer satisfaction and profitability: Using GE's CustomerNet system, dealers have instant online access to GE Appliances' distribution system, 24 hours a day, 7 days a week to check on product availability and prices, place orders, and review order status. "Simply put, it's an electronic one-stop shopping breakthrough that can help you sell."

Many companies are now installing integrated high-tech partner relationship management systems to coordinate their whole-channel marketing efforts. Just as they use customer relationship management (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 producer 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. A company may periodically "requalify" its intermediaries and prune the weaker ones.

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

Public Policy and Distribution Decisions

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 the 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 of the rest of the line. This is called full-line forcing. Such *tying agreements* are not necessarily illegal, but they do 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.¹¹

Marketing Logistics and Supply Chain Management

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. Physical distribution and 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, goals of the logistics system, major logistics functions, and the need for integrated supply chain management.

Nature and Importance of Marketing Logistics

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 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.

The logistics manager's task is to coordinate 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.

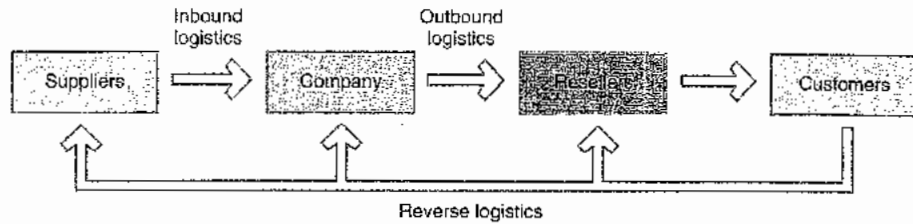
Marketing logistics (physical distribution)

The tasks involved in 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.

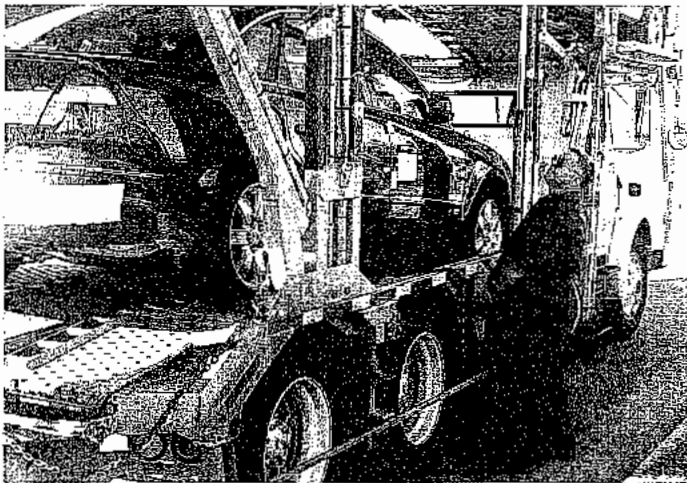
Supply chain management

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

FIGURE 12.5
Supply chain management



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 the 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. Last year, American companies spent almost \$1.2 trillion—about 9.6 percent of gross domestic product—to wrap, bundle, load, unload, sort, reload, and transport goods. By itself, Ford has more than 500 million tons of finished vehicles, production parts, and aftermarket parts in transit at any given time, running up an annual logistics bill of around \$4 billion.¹² Shaving off even a small fraction of these costs can mean substantial savings.



■ The importance of logistics: At any given time, Ford has more than 500 million tons of finished vehicles, production parts, and aftermarket parts in transit, running up an annual logistics bill of around \$4 billion.

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 Wal-Mart Supercenter store carries more than 100,000 products, 30,000 of which are grocery products.¹³ Ordering, shipping, stocking, and controlling such a variety of products presents a sizable logistics challenge.

Finally, improvements in information technology have 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, uniform product codes, 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.

Goals of the Logistics System

Some companies state their logistics objective as providing maximum customer service at the least cost. Unfortunately, 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 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 tangible 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.

For example, Wal-Mart operates a network of more than 100 huge U.S. distribution centers and another 57 around the globe. A single center, which might serve the daily needs of 120 Wal-Mart stores, typically contains some 1.2 million square feet of space (about 29 football fields) under a single roof. One huge center near Williamsburg, Virginia, contains more than 3 million square feet. At a typical center, laser scanners route as many as 190,000 cases of goods per day along 11 miles of conveyor belts, and the center's 1,000 workers load or unload some 500 trucks daily. Wal-Mart's Monroe, Georgia, distribution center contains a 127,000-square-foot freezer that can hold 10,000 pallets—room enough for 58 million Popsicles.¹⁴

Like almost everything else these days, warehousing has seen dramatic changes in technology in recent years. Older, multistoried warehouses with outdated materials-handling methods are steadily being replaced by newer, single-storied *automated warehouses* with advanced, computer-controlled materials-handling systems requiring few employees. Computers and scanners read orders and direct lift trucks, electric hoists, or robots to gather goods, move them to loading docks, and issue invoices.

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 only enough for a few days of operations. For example, Dell, a master just-in-time producer, carries just 2 to 3 days of inventory, whereas competitors might carry 40 days or even 60.¹⁵ 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

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.



❏ Logistics technology: In the not-too-distant future, RFID or "smart tag" technology could make the entire supply chain—which accounts for nearly 75 percent of a product's cost—intelligent and automated.

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 would 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 Procter & Gamble, IBM, Wal-Mart, Levi Strauss, and Best Buy, are investing heavily to make the full use of RFID technology a reality.¹⁶

Transportation

The choice of transportation carriers affects the pricing of products, delivery performance, and condition of the 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.

Trucks have increased their share of transportation steadily and now account for nearly 35 percent of total cargo ton-miles (more than 60 percent of actual tonnage).¹⁷ Each year in the United States, trucks travel more than 216 billion miles—a distance that has more than doubled over the past 20 years—carrying 11 billion

tons of freight worth over \$9 trillion. 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 added many services in recent years. For example, Roadway Express now offers everything from satellite tracking and 24-hour shipment information to logistics planning software and "border ambassadors" who expedite cross-border shipping operations.

Railroads account for 31 percent of 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 flat-cars 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 11 percent of 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 also account for about 16 percent of 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 5 percent of the nation's goods, they are an important

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transportation mode. Airfreight rates are much higher than rail or truck rates, but airfreight is ideal when speed is needed or distant markets must 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 modem, or telephone wire. Software firms, the media, music companies, and education all make use of the Internet to transport digital products. Although these firms primarily use traditional transportation to distribute CDs, 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. *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 pipeline might be best.

Logistics Information Management

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

Information can be shared and managed in many ways—by mail or telephone, through salespeople, or through traditional or Internet-based *electronic data interchange (EDI)*, the computerized exchange of data between organizations. Wal-Mart, for example, maintains EDI links with almost all of its 91,000 suppliers. And where it once took eight weeks, using EDI, Krispy Kreme can now turn around 1,000 supplier invoices and process the checks in only a single week.¹⁸

In some cases, suppliers might actually be asked to generate orders and arrange deliveries for their customers. Many large retailers—such as Wal-Mart and Home Depot—work closely with major suppliers such as Procter & Gamble 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

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 the company's 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 system.

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.

Cross-Functional Teamwork Inside the Company

In most companies, responsibility for various logistics activities is assigned to many different departments—marketing, sales, finance, operations, 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 order-processing 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, made up of managers responsible for different physical distribution activities. Companies can also create supply chain manager positions that link the logistics activities of functional areas. For example, Procter & Gamble has created supply managers, who manage all of the supply chain activities for each of its product categories. 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 wide range of software enterprises large and small, from SAP to RiverOne and Logility.¹⁹ 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, Procter & Gamble has a team of more than 200 people working in Bentonville, Arkansas, home of Wal-Mart.²⁰ The P&Gers work jointly with their counterparts at Wal-Mart to find ways to squeeze costs out of their distribution system. Working together benefits not only P&G and Wal-Mart but also their shared final consumers.

Other companies partner through *shared projects*. For example, many large retailers are working closely with suppliers on in-store programs. 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

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 to get products out to 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**.

UPS can help you shorten your supply chain. For a technical explanation, see figures A and B.

A. BEFORE BROWN

B. AFTER BROWN

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Third party logistics: UPS's Supply Chain Solutions group can help a company shorten its supply chains and turn it into a strategic asset.

Third-party logistics (3PL) provider

An independent logistics provider that performs any or all of the functions required to get their client's product to market.

These "3PLs"—companies such as UPS Supply Chain Solutions, Penske Logistics, BAX Global, Ryder System, FedEx Logistics, or Roadway Logistics Services—help clients to tighten up sluggish, overstuffed supply chains, slash inventories, and get products to customers more quickly and reliably. For example, UPS's Supply Chain Services unit provides clients with a wide range of logistics services, from inventory control, warehousing, and transportation management to customer service and fulfillment. According to a recent survey of chief logistics executives at Fortune 500 companies, 82 percent of these companies use third-party logistics (also called *3PL*, *outsourced logistics*, or *contract logistics*) services. In just the past ten years, the 3PL market has tripled in size to more than \$100 billion.²¹

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 percent to 30 percent 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. This 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 the Concepts

Marketing channel decisions are among the most important decisions that management faces. 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. Some companies pay too little attention to their distribution channels, but others have used imaginative distribution systems to gain competitive advantage.

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

Most producers use intermediaries to bring their products to market. They try to 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; by developing and spreading persuasive *communications* about an offer; by performing *contact work*—finding and communicating with prospective buyers; by *matching*—shaping and fitting the offer to the buyer's needs; and by 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.

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

The channel will be most effective when each member is assigned 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 made up 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.

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

Each firm identifies alternative ways to reach its market. Available means 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.

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

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 who 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 to them. It should work to forge long-term partnerships with their channel partners to create a marketing system that meets the needs of both the manufacturer and the partners. The company must also regularly check channel member performance against established performance standards, rewarding intermediaries who are performing well and assisting or replacing weaker ones.

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

Just as firms are giving the marketing concept increased recognition, more business firms are paying attention to *marketing logistics* (or *physical distribution*). Logistics 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 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 *order processing*, *warehousing*, *inventory management*, and *transportation*.

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.

Reviewing the Key Terms

Administered VMS 343	Distribution center 354	Intermodal transportation 356	Selective distribution 349
Channel conflict 339	Exclusive distribution 348	Marketing channel (distribution channel) 335	Supply chain management 352
Channel level 338	Franchise organization 342	Marketing logistics (physical distribution) 352	Third-party logistics (3PL) provider 358
Contractual VMS 342	Horizontal marketing system 343	Multichannel distribution system 343	Value delivery network 335
Conventional distribution channel 340	Indirect marketing channel 338		Vertical marketing system (VMS) 340
Corporate VMS 342	Integrated logistics management 356		
Direct marketing channel 338	Intensive distribution 348		
Disintermediation 344			

Discussing the Concepts

1. What is the difference between a supply chain and a value-delivery network?
2. How might a distribution channel evolve from a conventional distribution channel to a vertical marketing system?
3. The chapter cites Hewlett-Packard and Fidelity Investment as companies employing multichannel distribution. Discuss the pros and cons of choosing hybrid marketing channels.
4. What factors does a cosmetics company need to consider when designing its marketing channel for a new low-priced line of cosmetics?
5. Identify the primary challenges an organization faces in managing its channel members. What are some of the methods companies use to motivate channel partners?
6. Give three reasons why supply chain management is an important part of the value-delivery network.

Applying the Concepts

1. EserWise, a new company marketing a high-end Ab Toner exercise machine, is considering *direct marketing* versus selling through Strongs, a national sporting-goods retailer. As the buyer for Strongs, explain the functions your retail chain can offer to EserWise.
2. Ward's Berry Farm specializes in fresh strawberries, which it sells to a variety of retailers through a produce wholesale distributor. Form a small group and have each member assume one of the following roles: berry farmer, wholesaler, and grocery retailer. In your role, discuss three things that might have recently angered you about the other channel members. Take turns voicing your gripes and attempting to resolve the conflict.
3. Oracle offers software solutions for supply chain management. Go to Oracle's Web site at <http://www.oracle.com/applications/scm/index.html> and explore its supply chain products. List five ways these products might help managers improve their supply chain management.

Focus on Technology

RFID, radio frequency identification, is one of the most exciting recent technical innovations relating to a company's logistics operations. Applications involve placing small tags containing tiny electronic RFID chips on containers, pallets, cartons, or even individual products. The tags transmit a radio signal to readers, which translate and store the product-identification data. In the past, the costs of the RFID tags have been prohibitively expensive. However, thanks to improved semiconductor technology, chips can now be produced at reasonable prices. Improvements in software, telecommunications, and data sharing have all worked to move RFID to center stage for logistics managers. In fact,

Wal-Mart, a pioneer in RFID application, has issued mandates to its suppliers that force them to begin using RFID tags on pallet shipments. As additional retailers adopt this technology and spread it through their value networks, analysts expect that RFID will become the standard for product identification.

1. What impact would RFID applications have on each of the major logistical functions?
2. What are the biggest current obstacles to adopting this technology?
3. How could RFID improve the customer experience?

Focus on Ethics

Slotting fees are a one-time fee paid by food manufacturers to retailers for allotting shelf space to a new product. The manufacturer buys the product's way into the marketing channel. An FTC survey shows the average slotting fee per chain for a new product is about \$10,000, and suppliers report total slotting fees in the \$1,000,000 to \$2,000,000 range. The many critics of this system claim that grocery retailers have too much power in this situation. They also assert that the slotting fee system is unfair to small manufacturers who cannot afford such large fees. Slotting fees have been called everything from a bribe to a retailer's addiction, a questionable source of income that many retailers have come to rely on to survive. Retailers claim that they need the additional funds to offset the costs associated with new products. To stock a new product, they must shift other products on the shelf, move products in the warehouse, and

update computer systems. In addition, retailers say they run the risk of costs associated with the potential failure of the product. In response to the cries of small manufacturers that these fees create unfair competition, retailers sometimes waive slotting fees for the smaller companies.

1. Assess slotting fees from the points of view of both the retailer and the producer. Which side do you support?
2. How might slotting fees affect a manufacturer's decision when selecting channel members?
3. Go to www.ftc.gov/opa/2003/11/slottingallowance.htm to read about the FTC report on slotting fees. What did you learn from the government's report on slotting fees?

Video Case

Hasbro

It all started with GI Joe back in 1964. That was when Hasbro, now a \$3 billion company operating in more than 100 countries, launched the now-legendary toy and pioneered the action figure category. Since then, the company has developed scores of new toys that are well known to children and adults around the world. Hasbro's brands include games such as Hungry Hungry Hippos, Parcheesi, Risk, Trouble, Scrabble, Outburst, Twister, Pictionary, Boggle, and Monopoly. The company also sells Tinkertoys, Lite-Brite, Transformers, Glowworms, Mr. Potato Head, VideoNow, and Play-Doh.

Today, to keep up with constantly changing trends in the marketplace, Hasbro develops almost 1,000 new products annually and launches nearly 80 percent of those products within a year's time. Getting all of those products to consumers requires a reliable and efficient supply

chain and a well-tuned marketing channel. Hasbro's products can be found in toy stores, drugstores, wholesale stores, and even grocery stores.

After viewing the video featuring Hasbro, answer the following questions about marketing channels and supply chain management.

1. What levels of distribution does Hasbro use? How does the company keep both mass merchandisers and other channels from competing directly with one another?
2. How does Hasbro use distribution channels to build stronger relationships with customers?
3. How does Hasbro partner with its channel members to deliver better value to consumers?

One global retailer is expanding at a dizzying pace. It's on track for what appears to be world domination of its industry. Having built its own state-of-the-art distribution network, the company is leaving the competition in the dust in terms of sales and profits, not to mention speed of inventory management and turnover. Wal-Mart you might think? Dell possibly? Although these two retail giants definitely fit the description, we're talking here about Zara, the flagship specialty chain of Spain-based clothing conglomerate, Inditex.

This dynamic retailer is known for selling stylish designs that resemble those of big-name fashion houses but at moderate prices. "We sell the latest trends at low prices, but our clients value our design, quality, and constant innovation," a company spokesman said. "That gives us the advantage even in highly competitive, developed markets, including Britain." More interesting is the way that Zara achieves its mission.

FAST FASHION—THE NEWEST WAVE

A handful of European specialty clothing retailers are taking the fashion world by storm with a business model that has come to be known as "fast fashion." In short, these companies can recognize and respond to fashion trends very quickly, create products that mirror the trends, and get those products onto shelves much faster and more frequently than the industry norm. Fast-fashion retailers include Sweden's Hennes & Mauritz (H&M), Britain's Top Shop, Spain's Mango, and the Netherlands' Mexx. Although all of these companies are successfully employing the fast-fashion concept, Zara leads the pack on virtually every level.

For example, "fast" at Zara means that it can take a product from concept through design, manufacturing, and store shelf placement in as little as two weeks, much quicker than any of its fast-fashion competitors. For more mainstream clothing chains, such as the United States' Gap and Abercrombie and Fitch, the process takes months.

This gives Zara the advantage of virtually copying fashions from the pages of *Vogue* and having them on the streets in dozens of countries before the next issue of the magazine even hits the newsstands! When Spain's Crown Prince Felipe and Letizia Ortiz Rocasolano announced their engagement in 2003, the bride-to-be wore a stylish white trouser suit. This raised some eyebrows, given that it violated royal protocol. But European women loved it and within a few weeks, hundreds of them were wearing a nearly identical outfit they had purchased from Zara.

But Zara is more than just fast. It's also prolific. In a typical year, Zara launches about 11,000 new items. Compare that to the 2,000 to 4,000 items introduced by both H&M and Gap. In the fashion world, this difference is huge. Zara stores receive new merchandise two to three times each week, whereas most clothing retailers get large shipments on a seasonal basis, four to six times per year.

By introducing new products with frequency and in higher numbers, Zara produces smaller batches of items. Thus, it assumes less risk if an item doesn't sell well. But smaller batches also means exclusivity, a unique benefit

from a mass-market retailer that draws young fashionistas through Zara's doors like a magnet. When items sell out, they are not restocked with another shipment. Instead, the next Zara shipment contains something new, something different. Popular items can appear and disappear within a week. Consumers know that if they like something, they must buy it or miss out. Customers are enticed to check out store stock more often, leading to very high levels of repeat patronage. But it also means that Zara doesn't need to follow the industry pattern of marking prices down as the season progresses. Thus, Zara reaps the benefit of prices that average much closer to the list price.

THE VERTICAL SECRET TO ZARA'S SUCCESS

Just how does Zara achieve such mind-blowing responsiveness? The answer lies in its distribution system. In 1975, Amancio Ortega opened the first Zara store in Spain's remote northwest town of La Coruña, home to Zara's headquarters. Having already worked in the textile industry for two decades, his experience led him to design a system in which he could control every aspect of the supply chain, from design and production to distribution and retailing. He knew, for example, that in the textile business, the biggest markups were made by wholesalers and retailers. He was determined to maintain control over these activities. Ortega's original philosophy forms the heart of Zara's unique, rapid-fire supply chain today. But it's Zara's high-tech information system that has taken vertical integration in the company to an unprecedented level. According to CEO Pablo Isla, "Our information system is absolutely avant-garde. It's what links the shop to our designers and our distribution system."

Zara's vertically integrated system makes the starting point of a product concept hard to nail down. At Zara's headquarters, creative teams of over 300 professionals carry out the design process. But they act on information fed to them from the stores. This goes far beyond typical point-of-sales data. Store managers act as trend spotters. Every day they report hot fads to headquarters, enabling popular lines to be tweaked and slow movers to be whisked away within hours. If customers are asking for a rounded neck on a vest rather than a V neck, such an item can be in stores in seven to ten days. This process would take traditional retailers months.

Managers also consult a personal digital assistant every evening to check what new designs are available and place their orders according to what they think will sell best to their customers. Thus, store managers help shape designs by ensuring that the creative teams have real-time information based on the observed tastes of actual consumers. Mr. Ortega refers to this as the democratization of fashion.

When it comes to sourcing, Zara's supply chain is unique as well. Current conventional wisdom calls for manufacturers in all industries to outsource their goods globally to the cheapest provider. Thus, most of Zara's competitors contract manufacturing out to low-wage countries, notably

(case continues)

(case continued)

Asia. But Zara makes 40 percent of its own fabrics and produces more than half of its own clothes, rather than relying on a hodgepodge of slow-moving suppliers. Even things that are farmed out are done locally in order to maximize time efficiency. Nearly all Zara clothes for its stores worldwide are produced in its remote Northeast corner of Spain.

As it completes designs, Zara cuts fabric in-house. It then sends the designs to one of several hundred local cooperatives for sewing, minimizing the time for raw material distribution. When items return to Zara's facilities, they are ironed by an assembly line of workers who specialize in a specific task (lapels, shoulders, on so on). Clothing items are wrapped in plastic and transported on conveyor belts to a group of giant warehouses.

Zara's warehouses are a vision of modern automation as swift and efficient as any automotive or consumer electronics plant. Human labor is a rare sight in these cavernous buildings. Customized machines patterned after the equipment used by overnight parcel services process up to 80,000 items an hour. The computerized system sorts, packs, labels, and allocates clothing items to every one of Zara's 1,000-plus stores. For stores within a 24-hour drive, Zara delivers goods by truck, whereas it ships merchandise via cargo jet to stores farther away.

DOMESTIC MANUFACTURING PAYS OFF

The same philosophy that has produced such good results for Zara has led parent company Inditex to diversify. Its other chains now include underwear retailer Oysho, teen-oriented Bershka and Stradivarius, children's Kiddy's Class, menswear Massimo Dutti, and casual and sportswear chain Pull & Bear. Recently, Inditex opened its first non-clothing chain, Zara Home. Each chain operates under the same style of vertical integration honed at Zara.

Making speed the main goal of its supply chain has really paid off for Inditex. In 2005, sales grew by a whopping 21 percent over the prior year to \$8.15 billion (retail revenue growth worldwide averages single-digit increases). That puts Inditex ahead of H&M in the fast-fashion category for the first time. During the same period, profits soared by 26 percent to \$973 million. Most of this performance was driven by Zara, now ranked number 73 on Interbrand's list of top 100 most valuable worldwide brands. Although Inditex has grown rapidly, it only wants more. In 2005, it opened 448 new stores (H&M added only 145) and had plans for 490 more. With more than one ribbon-cutting ceremony per day, Inditex could increase its number of stores from the current 2,900 to as many as 5,000 stores in 70 countries by the end of this decade.

European fast-fashion retailers have thus far expanded very cautiously in the United States (Zara has only 19 stores stateside). But the threat has U.S. clothing retailers rethinking the models they have relied on for years. According to one analyst, the industry may soon experience a reversal from outsourcing to China to "Made in the U.S.A.":

"U.S. retailers are finally looking at lost sales as lost revenue. They know that in order to capture maximum sales they need to turn their inventory much quicker. The disadvantage of importing from China is that it requires a longer lead time of between three to six months from the time an order is placed to when the inventory is stocked in stores. By then the trends may have changed and you're stuck with all the unsold inventory. If retailers want to refresh their merchandise quicker, they will have to consider sourcing at least some of the merchandise locally."

So being the fastest of the fast-fashion retailers has not only paid off for Zara, its model has reconfigured the fashion landscape everywhere. Zara has blazed a trail for cheaper and cheaper fashion-led mass retailers, has put the squeeze on mid-priced fashion, and has forced luxury brands to scramble to find ways to set themselves apart from Zara's look-a-like designs. Leadership certainly has its perks.

Questions for Discussion

1. As completely as possible, sketch the supply chain for Zara from raw materials to consumer purchase.
2. Discuss the concepts of horizontal and vertical conflict as they relate to Zara.
3. Which type of vertical marketing system does Zara exhibit? List all the benefits that Zara receives by having adopted this system.
4. Does Zara incur disadvantages from its "fast-fashion" distribution system? Are these disadvantages offset by the advantages?
5. How does Zara add value for the customer through major logistics functions?

Sources: "The Future of Fast Fashion," *The Economist*, June 18, 2005; Rachel Tiplady, "Zara: Taking the Lead in Fast Fashion," *BusinessWeek Online*, April 4, 2006; John Tagliabue, "A Rival to Gap that Operates Like Dell," *New York Times*, May 30, 2003, p. W1; Elizabeth Nash, "Dressed for Success," *The Independent*, March 31, 2006, p. 22; Parija Bhatnagar, "Is 'Made in U.S.A.' Back in Vogue?" www.CNNMoney.com, March 1, 2005; Sarah Mower, "The Zara Phenomenon," *The Evening Standard*, January 13, 2006, p. 30; and www.inditex.com, August 2006.