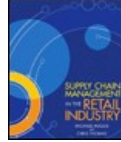


# Chapters *To Go*



## Supply Chain Management in the Retail Industry

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## Chapter 2: The Retail Distribution Channel

### Overview

Early in 2005, IBM Business Consulting Services released a survey that compiled in-depth interviews with more than 100 sales, marketing, and merchandising executives at over 20 consumer products and retail companies. Only 9 percent of the retailers felt their suppliers had “a good understanding” of their business objectives. The gist of the survey was that retailers felt the product manufacturers have focused their efforts on the end users of the products (the consumers), without giving as much priority to the needs of the other members of their distribution channels—namely, the retailers to whom they sell.<sup>[1]</sup>

In addition to a supply chain, manufacturers and retailers participate in another give-and-take relationship known as a **distribution channel** or *marketing channel*. A distribution channel is similar to, but different than, a supply chain. The distribution channel is where the “deals” are made to buy and sell products. Sales, negotiations, and ordering are done by these companies, or departments within companies. Then the supply chain kicks in, to do the “physical” work of manufacturing, transporting, and storing the goods; and facilitating the sales with services like consumer research, extending credit, and providing other services related to making the products attractive to customers and encouraging their ultimate sale.

In this chapter, you will learn about

- The members of a distribution channel and their functions
- How retailers fit into distribution channels
- How channel relationships are managed
- Strategic alliances

One of the catchphrases of the last decade or so is “B2B,” short for “business-to-business.” This is a type of distribution channel in which the end consumer is a business, not an individual.

The lines do blur between modern-day distribution channels and supply chains. But we will attempt to keep them separate as we describe the functions of each in relation to the other.

<sup>[1]</sup> “*Consumer Goods Industry Threatened, According to IBM Survey*,” © CRM Today, a publication of Contact Solutions, Ltd., Athens, Greece, February 18, 2005.

### Participants In The Distribution Channel

There are several types of participants that make up a distribution channel, so let’s begin by listing them, as in Chapter 1 with supply chain participants. You will notice some overlap because, as also previously mentioned, retailers belong to several (or many) different supply chains, each group focused on making and marketing different products.

#### Retailers

The characteristic that sets a retailer apart from other members of its distribution channel is that the retailer is the party who ultimately sells the product to its end user or consumer. As you know if you’ve ever shopped for anything, retailers come in many shapes and sizes, so to speak. Retailers may be grouped according to any of the following four categories:

- **Ownership.** Every brick-and-mortar retailer can be classified as a large, national chain store; a smaller, regional chain store; an independent retailer; or a franchisee.
- **Pricing philosophy.** Stores are generally either discounters or full-price retailers. Within the “discounter” category, there are several subcategories such as factory outlets, consignment stores, dollar stores, specialty discount stores, warehouse membership clubs, and so on.
- **Product assortment.** The breadth and depth of product lines carried by the store depends a lot on its ownership. An Ann Taylor store, for example, sells Ann Taylor branded clothing—not much breadth of product line there, but extensive depth in that line. A Kmart, on the other hand, carries thousands of brands, but perhaps does not have much depth (not many brands) in any given category of product.

- **Service level.** The more exclusive or specialized the store, the more types of services it will generally offer—from a name-branded credit card, to on-site alterations, to liberal return policies for its loyal customers. With the “big box” discounters, on the other hand, customers pay for convenience and bypass traditional service, by bagging their own groceries and the like.

These distinctions between various types of stores will be important as we discuss their participation in certain distribution channels.

## Wholesalers

Wholesalers are intermediaries or middlemen who buy products from manufacturers and resell them to the retailers. They take the same types of financial risks as retailers, since they purchase the products (thereby taking legal responsibility for them), keep them in inventory until they are resold to retailers, and may arrange for shipment to those retailers. Wholesalers can gather product from around a country or region, or can buy foreign product lines by becoming importers.

The term “wholesale” is often used to describe discount retailers (as in “wholesale clubs”), but discounters are retailers, not technically wholesalers. And in B2B channels, wholesalers may be called distributors.

## Agents and Brokers

Agents (sometimes called brokers) are also intermediaries who work between suppliers and retailers (or in B2B channels), but their agreements are different, in that they do not take ownership of the products they sell. They are independent sales representatives who typically work on commission based on sales volume, and they can sell to wholesalers as well as retailers. In B2B arrangements, this means they sell to distributors and end users.

**Resident sales agents** are good examples in retail. They reside in the country to which they sell products, but the products come from a variety of foreign manufacturers. The resident sales agent represents those manufacturers, who pay the agent on commission. A resident sales agent does not always have merchandise warehoused and ready to sell, but he or she does have product samples for which orders can be placed and is responsible for bringing the items through the importation process.

Retailers that don't have the money, time, or manpower to send someone overseas for manufacturers' site visits to check out the new product lines can depend on a resident sales agent to do the job.

**Buying offices** can also be considered a type of agent or broker, since they earn their money pairing up retailers with product lines from various manufacturers.

## The Need for Distribution Channels

Why are all these layers needed in distribution? Why can't a producer simply sell to a retailer, who sells to a consumer? It's a fair question, and in some cases, that is exactly how it happens. But the fact is that many producers are either too small or too large to handle all the necessary functions themselves to get their products to market.

Consider the small, specialty manufacturer who is terrific at making fine leather handbags but may not have the expertise to market its products as well as it makes them, or they may not have the money to hire a team of full-time salespeople to court the customers and secure the orders. An intermediary who works for several small, noncompeting firms can easily handle those functions cost-effectively. An intermediary who specializes in importing and exporting can handle the intricacies of customs paperwork, overseas shipping, and foreign markets, too.

Conversely, large companies need intermediaries because they are also in the business of manufacturing, not marketing. Turning out tens of thousands of cases of soft drinks, for instance, do you think Pepsi has time to take and fill individual orders from households? Channel members like wholesalers and retailers are useful because they are best at specific aspects of sales in their markets, leaving the manufacturers to do what they do best—which is turn out the best possible product.

Having a distribution channel breaks the whole buying and selling process and all its related negotiations into manageable tasks, each performed by companies that specialize in certain skills. Using an import wholesaler, for example, can be handy because they know the laws and customs of the suppliers' nations; and they generally offer their own lines of credit so the retailer won't have to deal with currency exchange or negotiate payment terms with a bank in another country.

Another advantage of the distribution channel is its ability to even out the natural ebbs and flows of a supply chain. This

comes from the ability of some channel members to store excess goods until they are needed, and to stockpile goods in anticipation of seasonal sales peaks. Depending on how close their relationships, channel members may also work together to purchase goods or services in greater quantity at discounts, passing the savings on to customers.

Even for consumers, the distribution chain is handy—*beyond* handy, in fact! It has become a necessity in our society. What if there were no supermarkets, for instance? Can you imagine how much more time and money you would spend having to buy every item at its source? How practical would it be to run out to the nearest farm to pick up a quart of milk and some salad ingredients on your way home from work?

## Types Of Channels

We'll set aside business-to-business channels for now and look at the four simple types of retail distribution channels for consumer products:

- **Direct channel.** This is when the same company that manufactures a product sells it directly to the consumer or end user. Dell, as mentioned in Chapter 1, is a direct channel marketer. Mail-order catalog sales companies, like Lands' End, are also direct channel sellers.
- **Retailer channel.** This is when the producer sells to the retailer, and the retailer sells to the consumer.
- **Wholesaler channel.** Intermediaries play a role here, as the manufacturer sells to a wholesaler . . . who sells to a retailer . . . who sells to the consumer.
- **Agent or broker channel.** The most complex arrangement involves several transactions, often because the merchandise is being imported. The producer sells to an agent . . . who sells to a wholesaler . . . who sells to a retailer . . . who finally sells to the consumer or end user.
- **Dual channel or multiple channel.** This term refers to the use of two or more channels to sell products to different types of customers. A lawnmower manufacturer, for example, might sell some product lines at retail and others to commercial lawn care companies, each requiring different intermediary services.

## How Channels Are Chosen

Although retailers drive distribution channels, it is not usually the retailer who makes the decision to utilize one channel over the others. The producer of the product makes this decision. There are several characteristics of product lines that make them more or less appropriate for a particular type of channel. Briefly, these characteristics can be summarized as follows:

- **The products themselves.** If a product is perishable, like many grocery items, it requires the shortest, most direct distribution channel—which means the fewest possible intermediaries along the way. If a product is customized, like an expensive assembled-to-order computer system, it also benefits from a short distribution channel. There is no need for intermediaries when a customer orders a custom product directly from the company that makes it.

Long distribution channels correspond to small purchases, either because the retailer doesn't carry much inventory or the consumer buys the item in small quantities.

- **The type of customer.** Who are the customers, what do they need and expect from their shopping experience, and where are they willing to go to buy this type of product? How much quantity do they buy at a time? A channel may be chosen because it best reflects the end users' buying habits. Business-to-business customers have completely different needs and buying habits than individual consumers.
- **Market size.** This factor encompasses two things: the population of an area and whether it is urban or rural. It is easier to sell direct to customers in a large city with lots of potential outlets for a product line. The more widely dispersed the stores, the more logical the dependence on agents and wholesalers—or on multiple retailers in different cities—to keep product sales strong and steady.
- **The producer's level of control.** Most top-dollar clothing designers and fragrance manufacturers do not want their products showing up anywhere and everywhere. They've worked hard to build an exclusive reputation, and they expect their distribution channel to work just as hard to protect and enhance their upscale image. These producers will choose a distribution channel that ensures no discount merchants have access to their lines, and they will count on the members of their channel to honor their wishes and not make bargain "deals."

- **The size of the producing company.** A producer is likely to sell direct when the company is large enough to handle the additional responsibilities that intermediaries would otherwise provide—credit to customers, warehouses for their own goods, the ability to hire and train their own sales representatives. Smaller producers require a larger distribution chain in order to fill these roles.
- **The size of the retailers.** A segment of the industry that is fragmented, with most of the stores operating as single units, requires the distribution channel to be longer. This was the case in the 1980s with video rental stores, for example, until Blockbuster Video opened and began its climb to dominate the market.

### Types of Distribution within Channels

The channel members may handle different portions of the transaction, but they must all agree on the end result—that the product(s) will be placed in the market in the manner desired by the producer or manufacturer, and that placement of the product(s) meets the contractual agreements of producer, retailer, and everyone in-between.

Once a channel is selected, the *distribution strategy* can take three different forms. They are listed as follows, from most restrictive to least restrictive—and remember, in retail, the term “restrictive” does not automatically have a negative connotation.

- *Exclusive distribution* is thought of most frequently for high-dollar products such as luxury cars or Rolex watches, but the fact is that even small-ticket items like toys are considered exclusive when they are in high demand.

In an exclusive distribution agreement, one retail store or chain of stores has the legal right to market and sell the product line in a geographic area. Exclusive distribution is sometimes requested by the retailer, not the producer, to ensure that the retailer has something unique, that customers can’t get anywhere else. This may also mean the retailer commits to *not* selling any products that are going to compete with the line. In exchange, the producer or manufacturer offers sales assistance, training, point-of-purchase materials, and other perks to the exclusive distributor.

Such a distribution arrangement can work toward the “exclusive” image of the product (because it’s harder to get), the retailer (for having “the only ones” available), and the manufacturer (by implying that the company is interested in marketing “quality, not quantity.” )

In B2B commerce, exclusive distribution works well for extremely specialized product lines, such as heavy equipment or high-tech products, ordered to the customer’s specifications and budgeted for in advance of the purchase.

- *Selective distribution* means the retailers are carefully screened, and only a few are permitted to carry the product line. As with exclusive distribution, part of the goal here is to enhance the image of the product by making it harder (but certainly not impossible!) to obtain. This allows the retailer to charge full price. The ladies’ clothing industry is full of selective distribution agreements between designer labels and so-called “finer” department stores. (The producers may have other, lower-priced merchandise lines to sell to discounters; but these are generally sold under separate, secondary brand names.)

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### Sharing Information: How Far Should Companies Go?

Business realities do not always support the sharing of data among partners in distribution channels and/or supply chains. It makes sense that concerns about privacy and competitive advantage often lead channel partners to decisions *not* to share some data, such as sales and demand forecasts.

Jim Alexy is the CEO of Network Services Company, a multibillion-dollar distribution organization. Prior to coming to Network Services, he held senior management positions at several of the manufacturers whose products Network Services sells, so he speaks from the perspective of both manufacturer and wholesale distributor.

“In a perfect world, yes, [sharing data] is a great idea,” Jim told us,” But if you do, it’s only a matter of time before some company turns it against you. Each company has its own quarterly management incentive plans, and people will do what they need to do to meet their numbers.”

Companies do share data about things such as product demand and inventory levels. The problem is that they often modify this data to their own advantage—inflating their demand numbers, for instance, in order to ensure that they will get the amount of product they think they will *really* need.

“Most manufacturers have some sort of productivity targets they need to hit,” Jim explained. “When they look at the

demand data they get from customers, it is so inaccurate that if they responded to all the fluctuations, their production costs would go up and they still wouldn't be producing the right items anyway."

So companies take the data that others share with them and run their own projections." When I was CEO at Sweetheart Cups," Jim recalled, "there was a guy who worked for me who built great demand forecast models. He collected all the data and factored in historical trends and ran the model. Then, he looked at the results and tweaked them in places where he had a strong hunch or some special information. And then after all of that, his forecasts *still* weren't as accurate as they could be—because one of our major customers, like McDonald's, wouldn't tell us about a big promotion they were planning to run, and we'd be caught short in 12-ounce cups or something. They didn't always tell us, because they didn't want word to get out and then have a competitor take action to counter their promotion."

As a result of the tinkering that companies do, the data can get pretty distorted at times. Nonetheless, data sharing has enabled some major improvements.

"I think there has been a lot of inventory taken out of the system," said Jim. "Just-In-Time inventory has resulted in major savings for everyone."

Just-In-Time (JIT) inventory is often implemented through a technique called vendor-managed inventory (VMI). Using this technique, as Wal-Mart suppliers do, they can monitor inventory levels of their own products within the companies sell to. The retailers share inventory and sales numbers, so the supplier can keep the inventory stocked at the right levels.

Retailers continuously weigh the costs and benefits of sharing data and working together. Do they work with only a small group of trusted suppliers and allow them to manage their own inventory in-store? Can they risk the downsides of working with only a few suppliers, when things like labor strikes, sudden price hikes, or production problems might leave the stores in the lurch?

And there are more nagging questions: Can they risk confidential information being leaked to competitors? How open should they be with other channel members? It is very hard for companies to develop the level of credibility and trust needed to establish tight working relationships. In the meantime, they do realize the benefits of sharing tools and skills that allow them to analyze data and make decisions.

Like so many other aspects of business, information sharing is a trade-off.

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- *Intensive distribution* is the closest thing to blanket coverage in retail, a "you can find it anywhere" theory of marketing. Snack items, like candy and soft drinks, are great examples of intensive distribution—their individual unit prices are so low that thousands must be sold to make a profit.

Ironically, this intensive product availability requires a large and complex distribution channel in order to cover all the sales outlets, from supermarkets and convenience stores to vending machines and restaurants. Manufacturers of these products depend heavily on their wholesalers to handle the sales functions—and will drop a wholesaler who is not performing well based on sales figures—which makes this type of wholesaling very competitive.

## Channel Relationships

The fact is that modern-day companies are often forced to participate in distribution channels for practical reasons—not really because they want to be "part of the team." They need the efficiency and the economy of scale, although in some ways, this kind of cooperation runs counter to the tough, competitive side of traditional retailing.

Channel cooperation would be ideal—a joint effort of all the members to create a supply chain that is flexible, gives each partner a competitive advantage, and ultimately provides the best product and related services to the customer. However, whether you're selling candy bars or luxury automobiles, conflict does occur when the members of a distribution channel choose different ways to operate within the system, have differing goals, or balk at sharing information. Areas of potential channel conflict are many. They can arise naturally from competition between multiple members of the same channel—retailers or wholesalers—who carry the same product line. They will also occur when retailers have service issues with the products and want to handle returns, repairs, or exchanges differently (say, more generously) than what the manufacturer is willing to do. A very common source of channel conflict is a producer's decision to either increase or decrease prices. The wholesalers take the flack about it from retailers—who, in turn, must listen to consumers' complaints, at least in the case of price hikes.

There is a hierarchy in all distribution channels, whether the participants like it or not. The company that has the most



authority in the channel is referred to as the **channel leader** or **channel captain**. In this case, “authority” means the partner’s ability to either influence or control the behavior of any of the other partners in the channel.

It’s safe to say that no one in any distribution channel or supply chain wields as much authority in retail today as Wal-Mart. The world’s largest retailer literally treats its suppliers like extensions of its own business—manufacturers and wholesalers have free access to real-time data about how their product lines are selling at any Wal-Mart store, any time. Sharing this information allows the suppliers to plan their production runs, make their importing decisions, and so on. Hundreds of manufacturers have offices in Bentonville, Arkansas, just to be conveniently located for Wal-Mart, and they consider it a small price to pay for increased access to their giant retail partner. In exchange, this Channel Captain Extraordinaire can require extraordinary things of its smaller partners, from price cuts to the acquisition and use of expensive new technology like radio frequency identification.

In business-to-business channels, Ford is known for its incredibly collaborative relationships with suppliers, who do more than provide materials and parts—they help design the vehicles Ford produces.<sup>[2]</sup> Similarly, any manufacturer that uses a Just-In-Time (JIT) system, with offices for supplier representatives on-site in its plants, has forged a unique type of channel relationship.

Like any kind of power, channel leadership can be wielded to the benefit or detriment of the other companies. Wal-Mart’s situation aside, channel captains may take the lead in negotiating with a participating company that is not fulfilling its responsibilities—orders are late; the company hasn’t updated its computer systems; it may be struggling financially; the CEO is uncommunicative or argumentative. Whatever the case, if the end result is that it’s bogging down everyone else in the channel, then something must be done.

It is important to note that in a distribution channel, any of the participants can refuse to do business with any of the others—as long as someone amenable to the entire group is tapped to take over the role that the ousted business has played. This game of “musical chairs” is difficult at best, and disastrous at worst. It’s better for everyone if the participants can figure out how to get along.

### Strategic Alliances

A third and similar partnership arrangement between separate companies with products or skills to share is the **strategic alliance**, which allows them to share the use of already-established distribution channels in pursuit of business growth in new markets. Retailers have been forging strategic alliances since the 1950s, and the pace continues unabated today as stores continue to branch into international sales.

A strategic alliance is more than two companies holding shares of each others’ stock, or ordering merchandise jointly for added buying power. In order to be truly strategic, the alliance must have all three of the following characteristics:

1. **It must be collaborative.** It should not involve the stronger channel member barking orders to the weaker one.
2. **It must be horizontal.** That is, it must be forged between companies of the same type, two retailers or two wholesalers.
3. **It must be beneficial to both.** This requires common objectives and the willingness to communicate and share knowledge.

A promising collaboration would be the alliance of two similar types of retailers in two different countries to share product lines, invest in technology together, and learn from each other. In so doing, they use each others’ distribution channels in the new country.

Retailers commonly belong to several strategic alliances. They offer a way to share the risks of business expansion that, if undertaken separately, the individual companies may lack the time, money, or expertise to manage.

<sup>[2]</sup>C. K. Prahalad and Venkatram Ramaswamy (University of Michigan), “Co-Opting Customer Competence,” in *Working Knowledge*, newsletter of the Harvard Business School, Boston, Massachusetts, February 8, 2000.

### Chapter Summary

Companies participate in distribution channels, which determine their supply chain relationships. Channel members negotiate with each other and offer complementary resources and services to move products “down the line” from manufacturers to consumers. Then, the supply chain partners provide the raw materials and logistics to meet the channel requirements.

Retail distribution channels consist of some combination of producers or manufacturers, agents or brokers, wholesalers or distributors, importers, and retailers. Each step along the channel has a specific purpose that is met by one or more member companies. Distribution channels are important because they allow for a continuous flow of product despite the natural peaks and slumps experienced in manufacturing and sales. They also provide efficiency, economies of scale, and cost savings to members of the channel. The types and numbers of channels a retailer participates in depend on many factors, all of which were listed and described in this chapter.

As with any type of business collaboration, pressure to perform can be intense among members of the channel, and numerous areas of potential conflict were discussed, including the dominance of channel leaders, for better or worse. However, most companies cannot avoid being channel members in this competitive and highly technological retail age.

The chapter ended with a brief definition of strategic alliances, partnerships that allow companies to use each other's existing distribution channels to grow business.

### Discussion Questions

1. If retailers “drive the distribution channel,” as stated in this chapter, then why does the ultimate decision about which channel to choose rest with the manufacturers or producers of the products?
2. Think of a product that you buy in the supermarket regularly. Now, describe who the members of its distribution channel might be. From what you notice as a consumer, are they doing a good enough job? Why, or why not?
3. Do you think channel relationships can get too comfortable or cozy; that perhaps sharing information can work against the end users instead of to their benefit? Can you think of any steps or services in a supply chain that should *never* be entrusted to other members of a distribution channel—and if so, why not?
4. In the discussion of potential channel conflict and companies that aren't holding up their end of responsibilities, in each of the situations mentioned (orders are late, CEO is argumentative, etc.), write a paragraph describing what the other channel members might do to remedy the problem without dropping the business from the channel.
5. What would make a producer enter into a strategic alliance for international business? How is it different than what a retailer would consider?

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### The Incredible Journey Continues

By Jennifer Bresnahan

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Swish it, spit it, feel the familiar burn. When you swig a mouthful of Listerine antiseptic mouthwash and watch it go down the bathroom drain, you're witnessing something much more significant than the disappearance of the fiery liquid that kills germs that cause bad breath, plaque, and gingivitis. You're seeing the last step in a complex value chain spanning several continents and requiring months of coordination by countless businesses and individuals. The resources involved in getting a single bottle of aqua Cool Mint Listerine into a customer's medicine cabinet boggle the mind. As it's transformed from raw material to finished product, the product wends its way around the globe and through the value chains and information technology (IT) systems of two “CIO-100” winners,\* the \$13 billion prescription drug and consumer products manufacturer Warner-Lambert Co. and the \$30 billion drugstore chain CVS Corp. Most of the steps involved in manufacturing and distributing Listerine are ongoing, but we've assigned dates to each stage to illustrate the speed of a single bottle's trip through the value chain.

#### MAY 28—DOWN UNDER

Our journey begins in Australia where a farmer is harvesting his spring crop of eucalyptus for eucalyptol, the oil found in its leathery leaves. The farmer sells the crop to an Australian processing company, which spends about four weeks extracting the eucalyptol from the eucalyptus. Morris Plains, New Jersey-based Warner-Lambert (hereafter, WL) partners with a distributor in New Jersey to buy the oil from the Australian company and transport it to WL's Listerine manufacturing and distribution facility in Lititz, Pennsylvania. The load will arrive at Lititz about three months after the harvest, says Robert LeRoy, director of material procurement for WL.

#### JULY 13—BENEATH THE SAND

Half a world away, a Saudi Arabian government-owned operation is drilling deep under the desert for the natural gas



that will yield the synthetic alcohol that gives Listerine its 43-proof punch. Union Carbide Corp. ships the gas via tanker to a refinery in Texas City, Texas, which purifies it and converts it to ethanol. The ethanol is loaded onto another tanker and transported from Texas City through the Gulf of Mexico to New Jersey, where it's transferred to storage tanks and transported via truck or rail to WL's plant. A single shipment of ethanol takes about six to eight weeks to get from Saudi Arabia to Lititz.

**Note:** *CIO* magazine names an annual "top 100" companies for supply chain excellence. The companies' profit figures were updated for 2005 for this article.

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