CHAPTER 12

Marketing Channels Delivering Customer Value

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 a company whose groundbreaking, customer-centred distribution strategy took it to the top of its industry.

Quick, which rental-car company is number one? Chances are good that you said Hertz. Okay, who's number two? That must be Avis, you say. After all, for years Avis advertising has said, "We're #2, so we try harder!" But if you said Hertz or Avis, you're about to be surprised. By any measure—most locations, revenues, profits, or number of cars—the number-one North American rental-car company is Enterprise Rent-A-Car. What's more, this is no recent development. Enterprise left number-two Hertz in its rear-view mirror in the late 1990s and has never looked back.

What may have fooled you is that for a long time, Hertz was number one in airport car rentals. However, with estimated revenues of US$9.5 billion and growing, Enterprise now has 30 percent more overall car rental sales than Hertz. What's more, analysts estimate that the privately owned Enterprise is twice as profitable as Hertz.

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

The tagline "Pick Enterprise. We'll Pick You Up" remains the company's main value proposition.

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

Taylor's groundbreaking distribution strategy worked and the business grew quickly. As he opened multiple locations in St. Louis and other cities, he renamed his business Enterprise Rent-A-Car after the U.S. Navy aircraft carrier on which he had served as a naval aviator. Enterprise continued to focus steadfastly on what it called the "home-city" market, primarily serving customers who'd been in wrecks or whose cars were being serviced. Enterprise branch managers developed strong relationships with local auto insurance adjusters, dealership sales and service personnel, and body shops and service garages, making Enterprise their preferred neighbourhood rental-car provider.

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

By the late 1980s, Enterprise had a large nationwide network of company-owned off-airport locations and a virtual lock on the home-city market. From this strong base, in the mid-1990s Enterprise began expanding its distribution system by directly challenging Hertz and Avis in the on-airport market. A decade later, it had operations in 230 airports in North America and Europe. Enterprise opened its first Canadian branch in 1993 in Windsor, Ontario, and since then has experienced double-digit growth in Canada. It now employs 2800 Canadians, and has over 35 000 vehicles and 400 locations, including 23 offices serving Canadian airports. In late 2007, Enterprise purchased the Vanguard Car Rental Group, which owned the National and Alamo brands. National focused on the corporate negotiated rental market while Alamo served primarily the leisure traveller airport market.

With the Vanguard acquisition, Enterprise now captures a 27.4 percent share of the airport market, putting it neck-and-neck with Hertz at 28.5 percent and jointly owned Avis/Budget at 30.1 percent. That, combined with its more than 55 percent share of the off-airport market, makes Enterprise the runaway leader in overall car rental sales. Enterprise owns a stunning one-half of all North American rental cars and is the world's largest automobile buyer. Last year, it purchased 800 000 cars to support its 7900 locations in the United States and four other countries.

While competitors Hertz and Avis focused on serving travellers at airports, Enterprise opened off-airport, neighbourhood locations that provided short-term car-replacement rentals for people whose cars were wrecked, stolen, or being serviced.

However, rather than resting on its laurels, Enterprise continues to seek better ways to get its cars where customers want them. The enterprising company is now motoring into yet another innovative distribution venue—"car sharing" and hourly rentals. Car sharing was pioneered in the late 1990s by Zipcar, which operates on parking-starved university campuses and in congested urban areas, where it rents cars on an hourly or daily basis to people who want to run errands or make short trips. Zipcar does not currently serve the Canadian university market but does have branches serving the general public in Vancouver and Toronto.

Enterprise has now revved up its own car-sharing program, WeCar. This new operation will park automobiles at convenient locations in densely populated urban areas, where residents often don't own cars and where business

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.

commuters would like to have occasional car access. Enterprise will also target businesses that want to have WeCar vehicles available in their parking lots for commuting employees to use. WeCar members pay a US$35 annual membership fee. They can then rent conveniently located, fuel-efficient cars (mostly Toyota Prius hybrids) for US$10 per hour or US$30 overnight—the rate includes gas and a 200-mile allotment. Renting a WeCar vehicle is a simple get-in-and-go operation. Just pass your member key fob over a sensor to unlock the car, then open the glove box and enter a PIN to release the car key. Although the car-sharing market now belongs to tiny Zipcar, a US$100 million company that has cars on more than 70 university campuses in several large metropolitan areas, look for giant Enterprise to perfect and expand the new distribution concept.

Thus, Enterprise continues to move ahead aggressively with its winning distribution strategy. Says Andy Taylor, founder Jack's son and now longtime Enterprise CEO, "We own the high ground in this business and we aren't going to give it up. As the dynamics of our industry continue to evolve, it's clear to us that the future belongs to the service providers who offer the broadest array of services for anyone who needs or wants to rent a car." The company intends to make cars available wherever, whenever, and however customers want them.[1]

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

1 Supply Chains and the Value Delivery Network

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 in delivering customer value.

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 toward the customer. Downstream marketing channel partners, such as wholesalers and retailers, form a vital connection between the firm and its customers.

The term *supply chain* may be too limited—it takes a *make-and-sell* view of the business. It suggests that raw materials, productive inputs, and factory capacity should serve as the starting point for market planning. A better term would be *demand chain* because it suggests a *sense-and-respond* view of the market. Under this view, planning starts 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 websites 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, in making and marketing its iPod touch products, Apple manages an entire network of people within Apple plus suppliers and resellers outside the company who work together effectively to give final customers "so much to touch."

Value delivery network: In making and marketing iPod touch products, Apple manages an entire network of people within Apple plus suppliers and resellers outside the company who work effectively together to give final customers "so much to touch."

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

The Nature and Importance of Marketing Channels

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.

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. For example, Kodak initially sold its EasyShare printers only in Best Buy stores to take advantage of the retailer's on-the-floor sales staff and their ability to educate buyers on the economics of paying higher initial prices but lower long-term ink costs.

Companies often pay too little attention to their distribution channels, sometimes with damaging results. In contrast, many companies have used imaginative distribution systems to *gain* a competitive advantage. FedEx's creative and imposing distribution system made it a leader in express delivery. Enterprise revolutionized the car-rental business by setting up off-airport rental offices. And Amazon.com pioneered the sales of books and a wide range of other goods via the Internet.

Distribution channel decisions often involve long-term commitments to other firms. For example, companies such as Ford, HP, 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 websites 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.

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 assortment of products made by producers into the assortment 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.

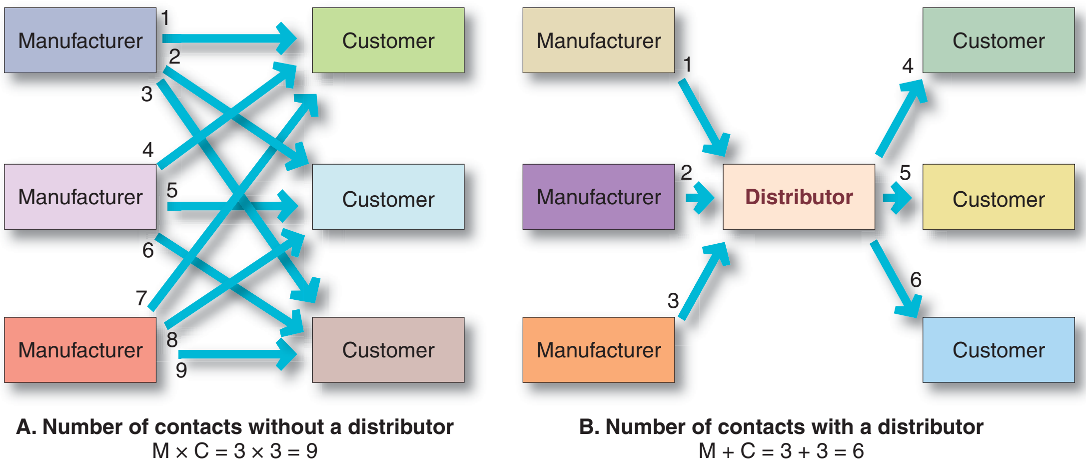

Figure 12.1 How adding a distributor reduces the number of channel transactions

For example, Unilever makes millions of bars of 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 Superstore, Shoppers Drug Mart, and Walmart, buy Lever 2000 by the truckload and stock it on their store 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.

And a new item that has been added to the list of functions to be performed within the supply chain is *environmental sustainability*. Take the case of Toronto-based Grand & Toy:

> In 2007, Grand & Toy, Canada's leading provider of business solutions, announced a new corporate strategy aimed at becoming a leader in environmental sustainability. Among its initiatives was a plan to significantly reduce its environmental footprint in supply chain carbon intensity, packaging, recycling of waste, and distribution centre management. In just a few short years, Grand & Toy has established itself as a leader in sustainable procurement practices, In 2009, for example, the company sponsored two free sustainable procurement showcases to help supply chain management professionals understand how sustainability is becoming a key driver for innovative procurement solutions, and how to adopt sustainable supply chain practices when working with suppliers and partners that maximize both profitability and corporate social responsibility.[2]

Grand & Toy's sustainability vision involves "powering the potential of Canadian businesses to lead the journey towards sustainability."

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 must be higher. When some of these functions are shifted to intermediaries, the producer's costs and prices may be lower, but the intermediaries must charge more to cover the costs of their work. In dividing the work of the channel, the various functions should be assigned to the channel members who can add the most value for the cost.

Number of Channel Levels

Companies can design their distribution channels to make products and services available to customers in different ways. Each layer of marketing intermediaries that perform 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; Veseys, located in York, Prince Edward Island, sells its plants and bulbs to gardeners across the country through mail catalogues, by telephone, and online. The remaining channels in Figure 12.2A are indirect marketing channels, containing one or more intermediaries.

Channel level
A layer of intermediaries that perform 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
A marketing channel containing one or more intermediary levels.

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.

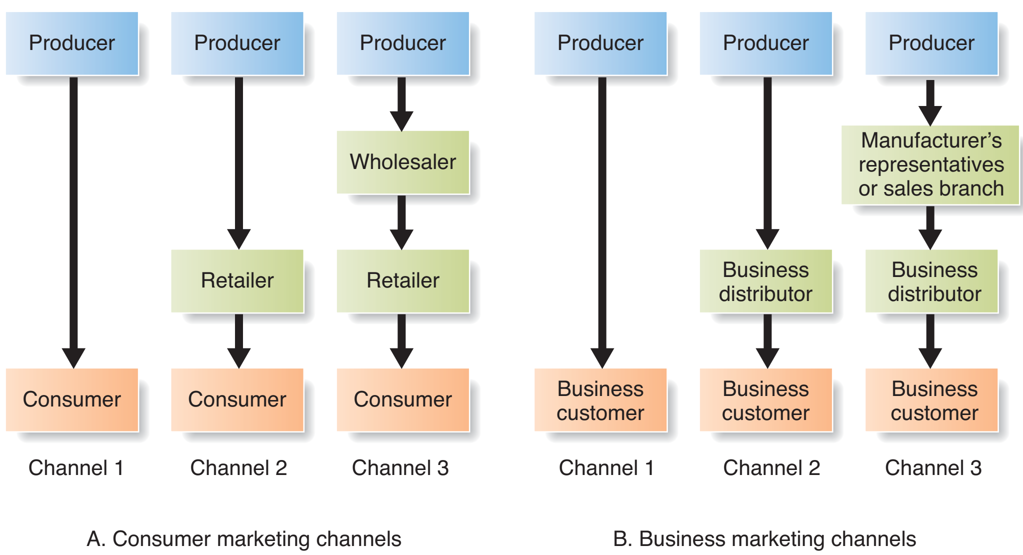

Figure 12.2 Consumer and business marketing channels

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Channel Behaviour and Organization

Distribution channels are more than simple collections of firms tied together by various flows. They are complex behavioural 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 behaviour and at how members organize to do the work of the channel.

Channel Behaviour

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, consumer electronics maker Samsung's role is to produce electronics products that consumers will like and to create demand through national advertising. Future Shop'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.

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

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 about who should do what and for what rewards. Such disagreements over goals, roles, and rewards generate **channel conflict**.

Channel conflict: Goodyear created conflict with its premier independent-dealer channel when it began selling through mass-merchant retailers. Fractured dealer relations weakened the Goodyear name and dropped the company into a more than decade-long profit funk.

Horizontal conflict occurs among firms at the same level of the channel. For instance, some Ford dealers in Vancouver might complain that 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:

> For more than 60 years Goodyear sold replacement tires exclusively through its premier network of independent Goodyear dealers. Then, in the 1990s, Goodyear shattered tradition and jolted its dealers by agreeing to sell its tires through mass merchants such as Sears and Walmart, placing dealers in direct competition with the nation's

most potent retailers. Goodyear claimed that value-minded tire buyers were increasingly buying from cheaper, multibrand discount outlets and department stores, and that it simply had to put its tires where many consumers were going to buy them.

Not surprisingly, Goodyear's aggressive moves into new channels set off a surge of 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 of cheaper private-label tires. Such dealer actions weakened the Goodyear name, and the company's replacement tire sales—which make up 71 percent of its revenues—went flat, dropping the company into a more than decade-long profit funk. Although Goodyear has since actively set about repairing fractured dealer relations, it still has not fully recovered. "We lost sight of the fact that it's in our interest that our dealers succeed," admits a Goodyear executive.[3]

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, can disrupt channel effectiveness and cause lasting harm to channel relationships. Companies should manage channel conflict to keep it from getting out of hand.

Vertical Marketing Systems

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 must all cooperate.

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. The Forzani Group, headquartered in Calgary, is an example of a retail-dominated VMS. It owns and operates a range of sporting

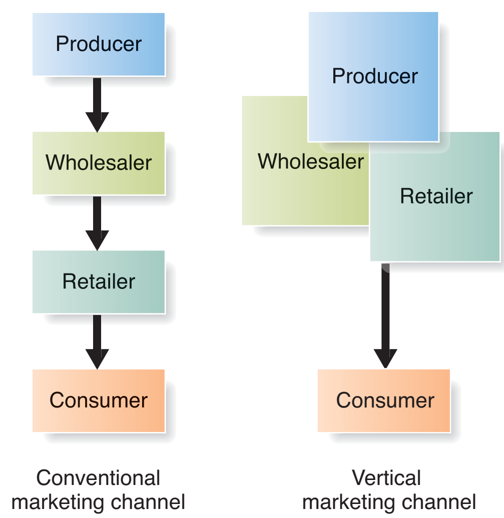


Figure 12.3 Comparison of a conventional distribution channel with vertical marketing system

goods stores including Sport Chek, Coast Mountain Sports, Sport Mart, Athletes World, Hockey Experts, and National Sports.

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

Corporate VMS

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

A **corporate VMS** integrates successive stages of production and distribution under single ownership. Coordination and conflict management are attained through regular organizational channels. For example, U.S. grocery giant Kroger owns and operates 42 factories that crank out more than 8000 private-label items found on its store shelves. Similarly, to help supply products for its 1760 grocery stores, Safeway owns and operates nine milk plants, eight bakery plants, four ice cream plants, four soft drink bottling plants, and four fruit and vegetable processing plants. And little-known Italian eyewear maker Luxottica produces many famous eyewear brands—including its own Ray-Ban brand and licensed brands such as Polo Ralph Lauren, Dolce & Gabbana, Prada, Versace, and Bvlgari. It then sells these brands through two of the world's largest optical chains, LensCrafters and Sunglass Hut, which it also owns.[4]

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. New designs feed into Zara manufacturing centres, which ship finished products directly to 1161 Zara stores in 68 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 the Gap, Benetton, and H&M. And Zara's low costs let it offer midmarket chic at downmarket prices.
>
> A couple of summers ago, Zara managed to latch onto one of the season's hottest trends in just four weeks (versus an industry average of nine months). The process started when trendspotters spread the word back to headquarters: White eyelet—cotton with tiny holes in it—was set to become white-hot. A quick telephone survey of Zara store managers confirmed that the fabric could be a winner, so in-house designers got down to work. They zapped patterns electronically to Zara's factory across the street, and the fabric was cut. Local subcontractors stitched white-eyelet V-neck belted dresses—think Jackie Kennedy, circa 1960—and finished them in less than a week. The US$129 dresses were inspected, tagged, and transported through a tunnel under the street to a distribution centre. From there, they were quickly dispatched to Zara stores from New York to Tokyo—where they were flying off the racks just two days later. In all, the company's stylish but affordable offerings have attracted a cult following. Zara store sales grew almost 40 percent last year to nearly US$9.8 billion.[5]

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

Contractual VMS

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

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 franchisor, links several stages in the production–distribution process.

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. Franchising has been the fastest-growing retailing form in Canada, growing more than 20 percent since 1993. It is estimated that Canada has four times more franchises per capita than the United States, with over 78 000 franchises across the country. Canadian franchising employs over 1 million people and represents over $100 billion in annual sales.[6] Almost every kind of business has been franchised—from motels and fast-food restaurants to dental centres and dating services, from wedding consultants and maid services to fitness centres 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), the motel business (Holiday Inn, Ramada), and more recently in health care (Vancouver-based Nurse Next Door).

> Let's face it: Canadians are getting older. And with the aging population comes a greater need for quality senior home health care. Enter Ken Sim and John DeHart, founders of Nurse Next Door Home Healthcare Services, who sought to "provide high quality services that could help improve the lives of those struggling with sick or aging family members." Established in 2001, the company began franchising in 2007. By 2009, Nurse Next Door had 30 franchises across Canada and continues to expand at a rate of two franchises per month across North America—a staggering 3400 percent growth rate since 2001! The company's success has largely been attributed to the way it supports its franchise operators. For example, client calls are handled through a centralized call centre in Vancouver, freeing franchisees from the time-consuming task of fielding urgent calls around the clock. Nurse Next Door is highly selective about which franchisee applicants it takes on, and those that are successful receive the highest level of support and training possible. The company has earned a number of awards, including being named the sixth best midsize franchise system in North America by *Franchise Business Review* in 2009. As it looks toward the future, Nurse Next Door's goal is to generate $1 billion in sales and have 500 franchisees worldwide by 2021. Given its explosive growth and the aging world population, this goal seems very achievable.[7]

Nurse Next Door's strategy of "treating franchisees like customers it aims to retain for decades" has led to rapid growth for this Canadian company.

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.

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, General Electric, Procter & Gamble, and Kraft can command unusual cooperation from resellers regarding displays, shelf space, promotions, and price policies. Large retailers such as Walmart, Home Depot, and Chapters Indigo can exert strong influence on the manufacturers that supply the products they sell.

Horizontal Marketing Systems

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

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 Walmart stores. McDonald's benefits from Walmart's heavy store traffic, and Walmart keeps hungry shoppers from needing to go elsewhere to eat. In another example, once major competitors, Canada's two largest wineries, T.G. Bright & Co. and Cartier Inniskillin Vintners Inc., formed an alliance so that they could increase their economies of scale and resources. This was necessary because they wanted to export to the U.S. market, which is dominated by huge American vintners, such as E.&J. Gallo.

Such channel arrangements also work well globally. For example, McDonald's recently joined forces with Sinopec, China's largest gasoline retailer, to place drive-through restaurants at Sinopec's more than 31 000 gas stations. The move greatly speeds McDonald's expansion into China while at the same time pulling hungry motorists into Sinopec gas stations.[8]

Horizontal marketing systems: McDonald's recently joined forces with Sinopec, China's largest gasoline retailer, to place restaurants at its more than 31 000 gas stations. Here, the presidents of the two companies shake hands while announcing the partnership.

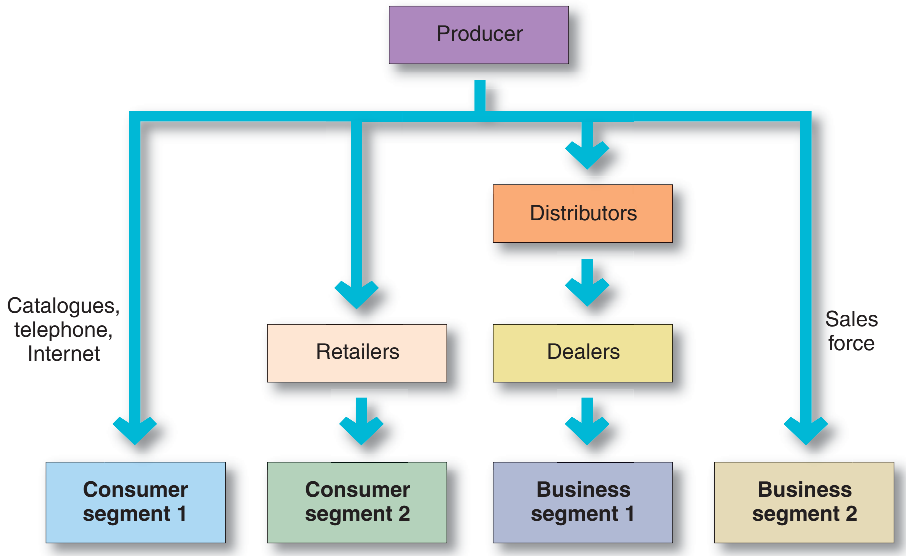
Multichannel Distribution Systems

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.

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 marketing system. In the figure, the producer sells directly to consumer segment 1 using direct-mail catalogues, telemarketing, and the Internet and reaches consumer segment 2 through retailers. It sells indirectly to business

Figure 12.4 Multichannel distribution system



segment 1 through distributors and dealers and to business segment 2 through its own sales force.

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

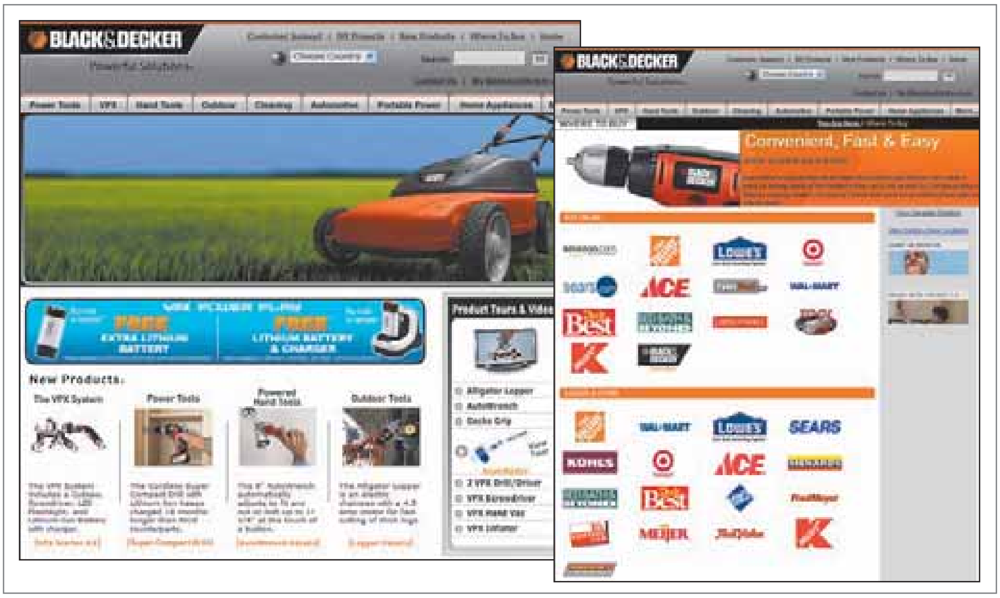
Multichannel distribution systems offer many advantages to companies facing large and complex markets. With each new channel, the company expands its sales and market coverage and gains opportunities to tailor its products and services to the specific needs of diverse customer segments. But such multichannel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

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.

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.

Thus, in many industries traditional intermediaries are dropping by the wayside. For example, Air Canada is selling directly to final buyers, cutting travel agents from its 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 to the Internet. Consumers can buy airline tickets and hotel rooms from Expedia.ca and Travelzoo.com; electronics from SonyStyle.com; clothes and accessories from Bluefly.com; and books, videos, toys, jewellery, sports, consumer electronics, home and garden items, and almost anything else from Amazon.ca—all without ever stepping into a traditional retail store. Online music download services such as iTunes and Yahoo! Music are threatening the very existence of traditional music-store retailers.



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

In fact, once-dominant music retailer Tower Records declared bankruptcy and closed its doors for good.

Disintermediation presents both opportunities and problems for producers and resellers. Channel innovators who find new ways to add value in the channel can sweep aside traditional resellers and reap the rewards. In turn, traditional intermediaries must continue to innovate to avoid being swept aside. For example, when Netflix pioneered online video rentals, it sent traditional brick-and-mortar video-rental stores such as Blockbuster reeling. To meet the threat, Blockbuster developed its own online DVD-rental service. Now, both Netflix and Blockbuster face disintermediation threats from an even hotter channel—digital video distribution (see Real Marketing 12.1).

Similarly, to remain competitive, product and service producers must develop new channel opportunities such as the Internet and other direct channels. However, developing these new channels often brings them into direct competition with their established channels, resulting in conflict. To ease this problem, companies often look for ways to make going direct a plus for the entire channel. For example, Black & Decker knows that many customers would prefer to buy its power tools and outdoor power equipment online. But selling directly through its website would create conflicts with important and powerful retail partners such as Home Depot, Lowe's, Walmart, and Amazon.ca. So, although Black & Decker's website provides detailed information about the company's products, you can't buy a new Black & Decker cordless drill, laser level, or leaf blower there. Instead, the Black & Decker website refers you to resellers' websites and stores. Thus, Black & Decker's direct marketing helps both the company and its channel partners.

3 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.

Real Marketing 12.1

Netflix: Disintermediator or Disintermediated?

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

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

Less than a decade ago, if you wanted to watch a movie in the comfort of your own home, your only choice was to roust yourself out of that easy chair and trot down to the local Blockbuster or another neighbourhood movie-rental store. In fact, that's how most people still do it. Blockbuster has grown to become the world's largest store-rental chain, with more than 7800 outlets worldwide and more than US$5.5 billion in annual sales.

But now, thanks to Netflix, that distribution model is changing quickly. In the late 1990s, Netflix pioneered a new way to rent movies—via the Web and direct mail. With Netflix, you pay a monthly subscription fee and create a movie wish list online. Netflix mails you a set number of DVDs from your list at a given time, which you can keep for as long as you like. As you return the DVDs in prepaid return envelopes, Netflix automatically sends you new ones from your list. While Netflix is not available in Canada, Zip.ca offers a very similar service, offering Canadians over 72 000 titles to choose from.

Netflix offers lots of advantages over the traditional Blockbuster brick-and-mortar system. With store video rentals, you have to make a special trip whenever you want a movie, and if you don't plan ahead, you'll probably find the latest hot releases out of stock. As for finding copies of oldies but goodies, or an old documentary or independent film, forget it—stores can hold only a limited selection of DVDs. Finally, many consumers are frustrated by short due dates and those dreaded late return fees. In contrast, Netflix isn't bound by store-space limitations. It offers a huge selection of more than 90 000 titles and 40 million DVDs. The Netflix system eliminates store trips—you always have a stack of DVDs on hand. And there are no per-movie charges, no due dates, and no late fees.

Since first opening its virtual doors, Netflix has continued to add innovative features. Its "dynamic queue" lets customers select as many movie titles as they wish and rank them by preference. Netflix has also developed an online recommendation system, called Cinematch, to help customers find movies they'll love based on their own past ratings, member and critic reviews, and top-rented lists.

As a result, more and more customers are signing up with Netflix. Membership has grown to more than 7.5 million subscribers, and in just the past two years, sales and profits have surged 77 percent and 60 percent, respectively. Meanwhile, Netflix's success has sent Blockbuster and other video-rental stores reeling. As Netflix sales and profits have soared, Blockbuster's sales have lagged and losses have mounted. The video rental giant has lost money in 10 of the last 11 years. Although the traditional brick-and-mortar video-rental market is still alive and kicking, it's stagnating as the red-hot online channel gains momentum.

To meet the disintermediation threat, Blockbuster introduced its own online video-rental service. In fact, Blockbuster Total Access takes the new distribution model one step further. Total Access customers can order videos online and then return or exchange them either through the mail or at their local Blockbuster store. Blockbuster's online business quickly grew to over 2 million subscribers before levelling off.

However, for the most part, Blockbuster is still struggling to find the right formula.

And so the video-rental channels battle continues. Blockbuster claims the advantages of a click-and-mortar model that offers both online and store services. In contrast, Netflix sees physical stores as an unnecessary and costly limitation. Says Netflix founder and CEO Reed Hastings, "For people who'd love never to go into a Blockbuster store ever again, we offer better selection, better tools for choosing movies, and more consistent overnight delivery." Either way, there's no going back to the past—the two competitors are rapidly disintermediating store-only video-rental outfits.

But just as the present isn't what it used to be, neither is the future. At the same time that Netflix is displacing traditional store channels, it faces its own disintermediation threat from a potentially even hotter channel—digital video distribution in the form of digital downloads and video on demand (VOD). Digital distribution is a fact of life in the music industry, where music download services are quickly making traditional CD retailers obsolete. Most experts agree that it's only a matter of time before digital video distribution displaces DVD video sales and rentals.

In fact, it's already begun. These days, you can download all kinds of video entertainment—from movies and TV shows to ads and amateur videos—to your computer, iPod, or even your cellphone. Satellite and cable TV companies are promising VOD services that will let you view movies and other video entertainment on television whenever and wherever you wish. And video-rental download services such as CinemaNow are already offering a growing list of downloadable titles via the Web.

Digital video downloads and video on demand create obvious cost, distribution, and customer convenience advantages over physically producing and distributing DVDs. For sure, the digital video distribution industry still faces problems. Downloading videos can take a lot of time and yields less-than-DVD quality. Perhaps the biggest barrier so far—Hollywood has been cautious about granting video distribution rights, severely limiting the number of available titles. In time, however, all these limitations will likely dissipate. When that happens, it could be lights out for the DVD sales and rental industry.

Netflix CEO Hastings understands the future challenges. "We're sure that we're going to be buying cars in 25 years, whereas renting DVDs through the mail in 25 years—for sure that's not going to exist," he says. The solution? Keep innovating. Instead of simply watching digital video distribution developments, Netflix intends to lead them. Netflix has already added a "watch instantly" feature to its website that allows subscribers to instantly stream near-DVD-quality video for a limited but growing list of movie titles and TV programs. "Our intention," says Hastings, "is to get [our watch instantly] service to every Internet-connected screen, from cellphones to laptops to WiFi-enabled plasma screens." In this way, Netflix plans to disintermediate its own distribution model before others can do it. Compared to the United States, the online DVD market in Canada is still in its infancy. Thus, it is anticipated that Canadian firms like Zip.ca will experience more modest growth, primarily because of the lack of content rights in this country as compared to those in the Unites States.

To Hastings, the key to the future is all in how Netflix defines itself. "If [you] think of Netflix as a DVD rental business, [you're] right to be scared," he says. But "if [you] think of Netflix as an online movie service with multiple different delivery models, then [you're] a lot less scared. We're only now starting to deliver [on] that second vision." When asked what Netflix will be like in five years, Hasting responds, "We hope to be much larger, have more subscribers, and be successfully expanding into online video."

Sources: Quotes and other information from Matthew Boyle, "Reed Hastings," *Fortune*, May 28, 2007, p. 30; Nick Wingfield, "Netflix vs. Naysayers," *Wall Street Journal*, March 27, 2007, p. B1; Yuval Rosenberg, "What's Next for Netflix?" *Fortune*, November 29, 2006, p. 172; Paul R. La Monica, "DVD or Download?" *CNNMoney.com*, June 26, 2006; Nancy Macdonald, "Blockbuster Proves It's Not Dead Yet," *Maclean's*, March 17, 2008, p. 36; Michael V. Copeland, "Netflix Lives!" *Fortune*, April 28, 2008, p. 40; "Netflix, Inc.," *Hoover's Company Records*, April 15, 2008, p.100752; "Online DVD Rental Firms Find Big Profits in Tough Times," *CBC News*, January 27, 2009; and information from www.netflix.com and www.blockbuster.com, accessed November 2008.

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

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

Analyzing Consumer Needs

As noted previously, marketing channels are part of the overall *customer-value delivery network*. Each channel member and level adds value for the customer. Thus, designing the marketing channel starts with finding out what target consumers want from the channel. Do consumers want to buy from nearby locations or are they willing to travel to more distant centralized locations? Would they rather buy in person, by phone, or online? Do they value breadth of assortment or do they prefer specialization? Do consumers want many add-on services (delivery, 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, companies may avoid the channels used by competitors. Mary Kay, for example, sells direct to consumers through its network of more than 1 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 primarily markets automobile and homeowner's insurance directly to consumers via the telephone and Internet rather than through agents.

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

Identifying Major Alternatives

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

Types of Intermediaries

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

Using many types of resellers in a channel provides both benefits and drawbacks. For example, by selling through retailers and value-added resellers in addition to its own direct channels, Dell can reach more and different kinds of buyers. However, the new channels will be more difficult to manage and control. And the direct and indirect channels will compete with each other for many of the same customers, causing potential conflict. In fact, Dell is already finding itself "stuck in the middle," with its direct sales reps complaining about new competition from retail stores, while at the same time value-added resellers complain that the direct sales reps are undercutting their business.[9]

Number of Marketing Intermediaries

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

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

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

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, exclusive Rolex watches are typically sold by only a handful of authorized dealers in any given market area. By granting exclusive distribution, Rolex gains stronger dealer selling support and more control over dealer prices, promotion, and services. Exclusive distribution also enhances the brand's image and allows for higher markups.

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, Whirlpool and General Electric 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 with intensive distribution.

Exclusive distribution: Rolex sells its watches exclusively through only a handful of authorized dealers in any given market. Such limited distribution enhances the brand's image and generates stronger retailer support.

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 and food quality, cooperate with new promotion programs, provide requested information, and buy specified food products.

Evaluating the Major Alternatives

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

Using *economic criteria*, a company compares the likely sales, costs, and profitability of different channel alternatives. What will

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

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, inefficient, or altogether lacking. For example, China and India are huge markets, each with a population of well over 1 billion people. However, because of inadequate distribution systems, most companies can profitably access only a small portion of the population located in each country's most affluent cities. "China is a very decentralized market," notes one China trade expert. "[It's] made up of two dozen distinct markets sprawling across 2000 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 years of effort, even Walmart executives admit that they have been unable to assemble an efficient supply chain in China.[10]

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, forcing Avon to abandon its traditional direct-marketing approach and sell through retail shops. The Chinese government recently gave Avon and other direct sellers permission to sell door-to-door again, but that permission is tangled in a web of restrictions. Fortunately for Avon, its earlier focus on store sales is helping it weather the restrictions better than most other direct sellers.[11]

International marketers face a wide range of channel alternatives. Designing efficient and effective channel systems between and within various national markets poses a difficult challenge. We discuss international distribution decisions further in Chapter 18.

4

Channel Management Decisions

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

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

Partnering with marketing channel members: The Samsung Power Partner Program turns important resellers into strong, motivated marketing partners by helping them be more effective and profitable at selling Samsung.

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 North America, it had no trouble attracting new dealers. In fact, it had to turn down many would-be resellers.

At the other extreme are producers who have to work hard to line up enough qualified intermediaries. For example, in 1986 when distributors were approached about an unknown new game called Nintendo, many refused to carry the product: They had recently been burned by the failure of Atari. But two Canadian distributors, Larry Wasser and Morey Chaplick, owners of Beamscope, accepted the product. Not a bad move considering that within one year after that decision their sales went from next to nothing to \$24 million![12] Similarly, when Timex first tried to sell its inexpensive watches through regular jewellery stores, most jewellery 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 practise strong *partner relationship management (PRM)* to forge long-term partnerships with channel members. This creates a value delivery system that meets the needs of both the company *and* its marketing partners. For example, heavy-equipment manufacturer Caterpillar and its worldwide network of independent 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 (see Real Marketing 12.2).

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. For example, Samsung's information technology division works closely with value-added resellers through the industry-leading Samsung Power Partner Program (P3):

> The Samsung P3 program creates close partnerships with important value-added resellers (VARs)—channel firms that assemble IT solutions for their own customers using products from Samsung and other manufacturers. Through the Power Partner Program, Samsung provides extensive presale, selling, and postsale tools and support to some 17 255 registered North American VAR partners at one of three levels—silver, gold, or platinum. For example, platinum-level partners—those selling US\$500 000 or more of Samsung IT products per year—receive access to a searchable online product and

Real Marketing 12.2

With the Help of Its Dealer Network, the Big Cat Is Purring

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

For more than eight 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 around the world. Caterpillar sells more than 300 products in nearly 200 countries, with sales of more than US$45 billion annually. Over the past four years, sales have nearly doubled and profits have more than tripled. The big Cat captures some 40 percent of the worldwide heavy-equipment business, twice that of number-two Komatsu. The waiting line for some of Caterpillar's biggest equipment is three years long. In Canada, Caterpillar distributes its products through independent dealerships, such as Finning (Canada), located in Edmonton, Alberta. Finning is one of Caterpillar's largest dealerships and aims to be Caterpillar's best global business partner, providing unrivalled services that earn customer loyalty.

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 distribution network of 181 outstanding independent dealers worldwide, who work with Caterpillar to do a superb job of taking care of every customer need. According to a former Caterpillar CEO:

> After the product leaves our door, the dealers take over. They are the ones on the front line. They're the ones who live with the product for its lifetime. They're the ones customers see. . . . 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 [$45-billion-plus] company called Caterpillar. But the dealers create the image of a company that doesn't stand just 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 BHP Billiton, a Caterpillar customer that operates the huge Antamina mine in Peru:

> More than a mile in length, the Antamina mine sits 14 100 oxygen-deprived feet above sea level in the Peruvian Andes. From the rim of the vast open pit, huge mechanized beasts of burden below look like scuttling yellow insects. Descend the dirt ramps to the floor of

the pit, however, and those bugs are transformed into Caterpillars. The industrial ballet goes on every hour of every day here, as Cat machines—giant trucks, mechanical shovels, scrapers, and other brutes—carve out massive amounts of copper and zinc from the earth. Forty-nine of those yellow bugs are mammoth 200- to 250-ton Caterpillar 793C and 793D trucks, 43-foot-high machines, costing millions of dollars each, which are powered by a diesel engine with more oomph than a tank. Made in Decatur, Illinois, each truck is shipped in pieces to Lima, hauled to the job site in nine tractor-trailers, and then assembled. Like sharks pursued by pilot fish, the big trucks are surrounded by a bevy of smaller Caterpillar equipment—wheel loaders to fill them, motor graders to keep the roads cleared, and bulldozers to clean up the spills. All told, BHP uses more than US$200 million worth of Caterpillar machinery at Antamina—and it will spend another US$200 million servicing them over their working life.

When equipment breaks down, BHP loses money fast. It gladly pays a premium price for machines and service it can count on. In fact, Caterpillar's reputation for gold-standard quality and service allows it to charge 10 percent to 20 percent more than its competitors. Customers know that they can count on Caterpillar and its outstanding dealer network for superb support.

The close working relationship between Caterpillar and its dealers comes down to more than just formal contracts and business agreements. Caterpillar really knows its dealers and cares about their success. It closely monitors each dealership's sales, market position, service capability, financial situation, and other performance measures. When it sees a problem, it jumps in to help. As a result, Caterpillar dealerships, many of which are longstanding family businesses, tend to be stable and profitable.

Caterpillar believes that it should "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 US$1 billion in just three years but didn't lose a single dealer. In contrast, competitors' dealers struggled and many failed. As a result, Caterpillar emerged with its distribution partnerships intact and its competitive position stronger than ever.

Caterpillar provides 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 23 distribution centres and 1500 service facilities around the world, which stock more than 150 000 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, from the Alaskan tundra to the deserts of Timbuktu. 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 costly days for a part.

Finally, 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 integrated distribution system serves as a major source of competitive advantage, for both the company and its independent dealers. 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 a former CEO puts it, "There's a camaraderie among our dealers around the world that really makes it more than just a financial arrangement. They feel that what 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."

Sources: Quotes, examples, and other information from Alex Taylor III, "Caterpillar," *Fortune*, August 20, 2007, pp. 48–54; Donald V. Fites, "Make Your Dealers Your Partners," *Harvard Business Review*, March–April 1996, pp. 84–95; Tony Reid, "Caterpillar Predicts Record Sales, Profits," *McClatchy Tribune Business News,* March 19, 2008; and information accessed at www.caterpillar.com, November 2008.

pricing database and downloadable marketing materials. They can tap into partner-only Samsung training programs, special seminars, and conferences. A dedicated Samsung P3 team helps partners find good sales prospects and initiate sales. Then, a dedicated Samsung field sales rep works with each partner to close deals, and inside sales reps provide the partner with information and technical support. Platinum partners even participate in Samsung's Reseller Council. Finally, the P3 program rewards high-performing reseller–partners with rebates, discount promotions, bonuses, and sales awards. In all, the Power Partner Program turns important resellers into strong, motivated marketing partners by helping them be more effective and profitable at selling Samsung.[13]

Many companies are now installing integrated high-tech partner relationship management (PRM) 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.

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

Supply chain management, logistics, and distribution present managers with countless ethical dilemmas—everything from what types of suppliers a company should use to the types of influence strategies that are appropriate to ensure channel members comply with channel policies. Under the heading "Fulfilment Practices," the Canadian Marketing Association's Code of Ethics covers some ethical issues with regard to distribution. For example, it stipulates that goods should be shipped within 30 days of the receipt of a properly completed order (or within the time limit stated in the original offer), and notes that customers have the right to cancel orders without penalty if this time frame is not respected. The American Marketing Association's (AMA) Code of Ethics (under which Canadian marketers also operate) focuses on issues of market power in the section dealing with distribution. Ethical marketers are advised not to manipulate product availability for purposes of exploitation and not to use coercion in the marketing channel. The AMA code puts into question practices around these issues:[14]

1. *Exclusive dealing.* 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 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 exclude other producers from selling to these dealers. 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.

2. *Exclusive territories.* 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.

3. *Tying agreements.* 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—*full-line forcing*. Even though the practice isn't illegal, it causes considerable channel conflict.

4. *Dealers' rights.* Producers are free to select their dealers, but their right to terminate dealers is somewhat restricted. In general, sellers can drop dealers "for cause." But they cannot drop dealers if, for example, the dealers refuse to cooperate in a questionable legal arrangement, such as exclusive dealing or tying agreements.
5. *Sources of supply.* As price competition increases in many industries, many firms look to overseas suppliers who can provide them with low-cost inputs. A number of ethical concerns have arisen as a result of this practice, including the loss of jobs in Canada's manufacturing sector and the use of overseas suppliers that follow questionable practices. For example, in the sporting goods market, firms have been criticized for using suppliers that pay low wages (wages far below what they pay celebrities to endorse their products) to suppliers that are reported to produce goods in *sweatshops* that use child or prison labour. Few Canadians want to think that the high-fashion apparel they wear or the sports equipment they use is made by children forced into labour instead of going to school.

5

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. 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

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

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

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

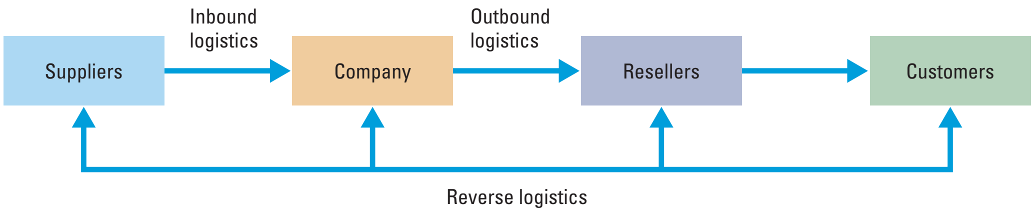
In the past, physical distribution planners typically started with products at the plant and then tried to find low-cost solutions to get them to customers. However, today's marketers prefer *customer-centred* logistics thinking, which starts with the marketplace and works backward to the factory, or 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.

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

Figure 12.5 Supply chain management



marketing costs. North American companies spent over US$1.3 trillion last year to wrap, bundle, load, unload, sort, reload, and transport goods. That's more than the national GDPs of all but 12 countries worldwide. What's more, these costs have risen more than 50 percent over the past decade. 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 US$4 billion.[15] Shaving off even a small fraction of these costs can mean substantial savings.

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 (which now goes by the name Metro) carries a bewildering stock of more than 25 000 items. A Walmart Supercentre store carries more than 100 000 products, 30 000 of which are grocery products.[16] Ordering, shipping, stocking, and controlling such a variety of products presents a sizable logistics challenge.

Improvements in information technology have also created opportunities for major gains in distribution efficiency. Today's companies are using sophisticated supply chain management software, web-based logistics systems, point-of-sale scanners, 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.

Finally, more than almost any other marketing function, logistics affects the environment and a firm's environmental sustainability efforts. Transportation, warehousing, packaging, and other logistics functions are typically the biggest supply chain contributors to the company's environmental footprint. At the same time, they also provide one of the most fertile areas for cost savings. So developing a *green supply chain* is not only environmentally responsible, it can also be profitable. "Your CO_2 footprint of transportation and your cost of fuel are permanently linked," says one logistics manager. "The good news is if you can reduce logistics costs you can write an environmental story about it."[17]

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

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 return 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.

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

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 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 centres.* Storage warehouses store goods for moderate to long periods. **Distribution centres** are designed to move goods rather than just store them. They are large and highly automated warehouses designed to receive goods from various plants and suppliers, take orders, fill them efficiently, and deliver goods to customers as quickly as possible.

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

For example, Walmart Canada operates a network of seven huge Canadian distribution centres, with plans to open another $115 million, 400 000 square-foot refrigerated hub north of Calgary in 2010. At a typical centre, laser scanners route as many as 190 000 cases of goods per day along several kilometres of conveyor belts, and a centre's workers load or unload some 500 trucks daily. The newest sustainable distribution facility in Balzac, Alberta, will also use only renewable energy and an array of other green systems, furthering Walmart's commitment to long-term environmental sustainability.[18]

Like almost everything else these days, warehousing has seen dramatic changes in technology in recent years. Outdated materials-handling methods are steadily being replaced by newer, computer-controlled systems requiring few employees. Computers and scanners read orders and direct lift trucks, electric hoists, or robots to gather goods, move them to loading docks, and issue invoices. For example, office supplies retailer Staples now employs "a team of super-retrievers—in day-glo orange—that keep its warehouse humming":

> Imagine a team of employees that works 16 hours a day, seven days a week. They never call in sick or show up late, because they never leave the building. They demand no benefits, require no health insurance, and receive no pay cheques. And they never complain. Sounds like a bunch of robots, huh? They are, in fact, robots—and they're dramatically changing the way Staples delivers notepads, pens, and paper clips to its customers. Every day, Staples' huge Chambersburg, Pennsylvania, distribution centre receives thousands of customer orders, each containing a wide range of office supply items. Having people run around a warehouse looking for those items is expensive, especially when the company has promised to delight customers by delivering orders the next day.

Enter the robots. On the distribution centre floor, the 150 robots most resemble a well-trained breed of working dogs, say, golden retrievers. When orders come in, a centralized computer tells the robots where to find racks with the appropriate items. The robots retrieve the racks and carry them to picking stations, then wait patiently as humans pull the correct products and place them in boxes. When orders are filled, the robots neatly park the racks back among the rest. The robots pretty much take care of themselves. When they run low on power, they head to battery-charging terminals or, as warehouse personnel say, "They get themselves a drink of water." The robots now run 50 percent of the Chambersburg facility, where average daily output is up 60 percent since they arrived on the scene.[19]

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. New stock arrives exactly when needed, rather than being stored in inventory until being used. Just-in-time systems require accurate forecasting along with fast, frequent, and flexible delivery so that new supplies will be available when needed. However, these systems result in substantial savings in inventory-carrying and handling costs.

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

Companies using RFID would know, at any time, exactly where a product is located physically within the supply chain. "Smart shelves" would not only tell them when it's time to reorder, but 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 Walmart, Procter & Gamble, Kraft, IBM, HP, and Best Buy, are investing heavily to make the full use of RFID technology a reality.[20]

Transportation

Intermodal transportation
Combining two or more modes of 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. Rather than choosing a single carrier, **intermodal transportation** (combining two or more modes of transportation) is increasingly being used. For example, products manufactured in Alberta may be shipped first by rail in containers that are then loaded onto trucks for delivery in the Toronto area or loaded onto ships in Montreal for transportation overseas.

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 transactions, billing, shipment and 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 but most sharing takes place through traditional or Internet-based *electronic data interchange (EDI)*, the computerized exchange of data between organizations. Walmart, for example, maintains EDI links with almost all of its 91 000 suppliers.[21]

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

Cross-Functional Teamwork Inside the Company

Most companies assign responsibility for various logistics activities to many different departments—marketing, sales, finance, operations, and purchasing. Too often, each function tries to optimize its own logistics performance without regard for the activities of the other functions. However, transportation, inventory, warehousing, and information management activities interact, often in an inverse way. Lower inventory levels reduce inventory-carrying costs. But they may also reduce customer service and increase costs from stock-outs, 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 a wide range of software enterprises large and small, from SAP and Oracle to Infor and Logility. The worldwide market for supply chain management software topped an estimated US$6.5 billion in 2006 and will reach an estimated US$11.6 billion by 2013.[22] The important thing is that the company must coordinate its logistics and marketing activities to create high market satisfaction at a reasonable cost.

REVIEWING OBJECTIVES AND KEY TERMS

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.

OBJECTIVE 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).

OBJECTIVE 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.

OBJECTIVE 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.

OBJECTIVE 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 *with* them. It should work to forge strong partnerships with channel members 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.

OBJECTIVE 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 *warehousing, inventory management, transportation*, and *logistics information management*.

The *integrated supply chain management concept* recognizes that improved logistics requires teamwork in the form of close working relationships across functional areas inside the company and across various organizations in the supply chain.

KEY TERMS

Objective 1
- **Value delivery network** (p xxx)
- **Marketing channel (distribution channel)** (p xxx)
- **Channel level** (p xxx)
- **Direct marketing channel** (p xxx)
- **Indirect marketing channel** (p xxx)

Objective 2
- **Channel conflict** (p xxx)
- **Conventional distribution channel** (p xxx)
- **Vertical marketing system (VMS)** (p xxx)
- **Corporate VMS** (p xxx)
- **Contractual VMS** (p xxx)
- **Franchise organization** (p xxx)
- **Administered VMS** (p xxx)
- **Horizontal marketing system** (p xxx)
- **Multichannel distribution system** (p xxx)
- **Disintermediation** (p xxx)

Objective 3
- **Marketing channel design** (p xxx)
- **Intensive distribution** (p xxx)
- **Exclusive distribution** (p xxx)
- **Selective distribution** (p xxx)

Objective 4
- **Marketing channel management** (p xxx)

Objective 5
- **Marketing logistics (physical distribution)** (p xxx)
- **Supply chain management** (p xxx)
- **Distribution centre** (p xxx)
- **Intermodal transportation** (p xxx)

DISCUSSING AND APPLYING THE CONCEPTS

Discussing the Concepts

1. Explain how channel members add value for manufacturers and consumers.
2. Discuss the various types of conflict that may arise in the channel of distribution. Is all channel conflict bad?
3. What factors should a cosmetics company consider when designing its marketing channel for a new low-priced line of cosmetics?
4. Describe the major types of vertical marketing systems and provide an example of each.
5. Discuss the complexities international marketers face when designing channels in other countries.
6. List and briefly describe the major logistics functions. Provide an example of a decision a logistics manager would make for each major function.

Applying the Concepts

1. ExerWise, 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 ExerWise.
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. Visit http://electronics.howstuffworks.com/rfid.htm# and watch the video "How UPS Smart Labels Work." You can also learn more about RFID technology from this site. What impact will RFID tags have on each of the major logistical functions? What are the biggest current obstacles to adopting this technology?

FOCUS ON TECHNOLOGY

If you're eager to get the latest movie released on DVD, you don't have to go any farther than your iTunes account on your computer. In the past, these movies weren't available from Apple's iTunes until several weeks after they were released, but major movie studios are allowing Apple to sell movies the day they are released on DVD. Consumers have been able to get movies on the same day as the DVD release from services such as CinemaNow and Movielink for a few years, but those etailers don't have the same clout as iTunes, which is now the biggest retailer of music in North America. Although movie studios get less revenue than selling through traditional retail channels, their profits will be bigger because of lower costs.

1. What costs are movie studios reducing by using this alternative channel of distribution?
2. Is this an example of disintermediation? Will electronic distribution displace traditional distribution channels for movies?

FOCUS ON ETHICS

Parallel imports, gray products, and *price diversion* all represent the same activity—diverting imported products meant for one market at lower prices and reselling them at higher profits in other markets. This happens in many industries, including pharmaceuticals, apparel, high-tech electronics, auto parts, luxury goods, cosmetics, and tobacco. The textbook you're using now might be a gray product if it was intended for an international market but you purchased it from Amazon.ca for much less than what you'd pay at your bookstore or the publisher's website. And the designer sweater you bought at Winners most likely got into those stores through gray market trading. Although North American laws prohibit importing prescription drugs from abroad, the same is not true in other countries. For example, gray traders purchase pharmaceutical drugs in poorer countries, such as Greece and Spain, and resell them in the United Kingdom or Sweden, where higher prices garner profits for the traders. In fact, parallel importing of most products is legal, and some experts claim that it's just the free market at work. In some cases, though, counterfeit goods are mixed in with the legitimate brands.

1. Learn more about this phenomenon. Who receives value in such transactions? Who loses value?
2. How are manufacturers dealing with this problem?

MARKETING BY THE NUMBERS

Lightco, Inc. is a manufacturer of decorative lighting fixtures sold primarily in Eastern Canada. Lightco wants to expand to Central and Western Canada and intends to hire 10 new sales representatives to secure distribution for its products. Sales reps will acquire new retail accounts and manage those accounts after acquisition. Each sales rep earns a salary of $50 000 plus 2 percent commission. Each retailer generates an average $50 000 in revenue for Lightco. Refer to Appendix 3: Marketing by the Numbers, to answer the following questions:

1. If Lightco's contribution margin is 40 percent, what increase in sales will it need to break even on the increase in fixed costs to hire the new sales reps?
2. How many new retail accounts must the company acquire to break even on this tactic? What average number of accounts must each new rep acquire?

VIDEO CASE

Progressive

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

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

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

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

Visit MyMarketinglab at www.pearsoned.ca/mymarketinglab to view the video segment related to this case.

COMPANY CASE

Zara: The Technology Giant of the Fashion World

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. Walmart, 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 spokesperson 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 Topshop, Spain's Mango, and the Netherland's 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 Gap or Abercrombie & 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, 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 2000 to 4000 items introduced by both H&M and the 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.

As part of its strategy to introduce more new items with greater frequency, Zara also produces items in smaller batches. Thus, it assumes less risk if an item doesn't sell well. But smaller batches also mean 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 have to 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 have to follow the industry pattern of marking products 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 more than 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-sale 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 in their area. Thus, store managers help shape designs by ensuring that the creative teams have real-time information based on the observed tastes of actual consumers. 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, mostly in 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 to maximize time efficiency. Nearly all Zara clothes for its stores worldwide are produced in a 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, and 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 labour 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 1495 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, men's Massimo Dutti, and casual and sportswear chain Pull & Bear. Recently, Inditex opened its first nonclothing chain, Zara Home. Each chain operates under the same style of vertical integration perfected at Zara.

Making speed the main goal of its supply chain has really paid off for Inditex. In only three years, its sales and profits more than doubled. Last year, revenues increased over 15 percent over the previous year to US$14.5 billion. Not bad considering retail revenue growth worldwide averages single digits, and many major retailers were feeling the effects of slowing economies. Perhaps more importantly, Inditex's total profits grew by 25 percent last year to US$1.8 billion. Most of this performance was driven by Zara, now ranked number 64 on Interbrand's list of top 100 most valuable worldwide brands.

Although Inditex has grown rapidly, it wants more. Last year it opened 560 new stores worldwide (most of those were Zara stores) and plans to do the same this year. It's even considering an entry into the fast-growing Indian market. Global retailers are pushing into India in droves in response to India's thirst for premium brands. Zara can really capitalize on this trend. With more than one ribbon-cutting ceremony per day, Inditex could increase its number of stores from the current 3890 to more than 5000 stores in more than 70 countries by the end of this decade.

European fast-fashion retailers have thus far expanded cautiously in the United States (Zara has only 32 stores state-side). 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 USA":

U.S. retailers are finally looking at lost sales as lost revenue. They know that to capture maximum sales they need to turn their inventory much more quickly. The disadvantage of importing from China is that it requires a longer lead time of between three and 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 more quickly, 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, but the 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-alike 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 employ? List all the benefits that Zara receives by having adopted this system.
4. Does Zara experience 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: James Hall, "Zara Helps Fashion Profit for Inditex," *Daily Telegraph*, April 1, 2008, p. 12; Christopher Bjork, "New Stores Boost Inditex's Results," *Wall Street Journal*, June 12, 2008, p. B4; "The Future of Fast-Fashion," *The Economist*, June 18, 2005, accessed online at www.economist.com; John Tagliabue, "A Rival to Gap that Operates Like Dell," *New York Times*, May 30, 2003, p. W1; Elizabeth Nash, "Dressed For Success," *Independent*, March 31, 2006, p. 22; Sarah Mower, "The Zara Phenomenon," *Evening Standard*, January 13, 2006, p. 30; also see www.inditex.com, accessed November 2008.