Distribution
Channels

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Distribution Channels

Understanding and Managing Channels to Market

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With love to my wife, Jan, and to our children, Laura and Ian

Contents

Preface

This book represents the best part of 30 years' personal and shared experience working with distribution businesses of all types in a variety or roles, starting initially as an accountant with Arthur Andersen, through to the last 18 years as management consultant with VIA International, a firm that specializes in routes to market strategy and implementation. In that time I have had the opportunity to work with some of the world's leading practitioners in the field of distribution channels – and some pretty terrible ones too. In many ways, it was from the clients and situations where things were going wrong that the sharpest lessons could be drawn.

At VIA, we are lucky enough to spend most of our time consulting for some of the world's most successful brands and companies (yes, they still ask for help), which means we have seen an enormous amount of best practice. Often though, these companies are challenged by sheer scale, complexity and channel overlap or conflict which prevents them from seeing the business issues quite as clearly as they might. They are usually relieved to find that we can bring some clarity and objectivity to the situation and can recommend strategies that are rooted in commercial logic to deliver the outcomes they need. Many of these situations have found their way into this book, albeit usually with a cloak of anonymity. You will find many real companies and situations named and described in the book too, but these insights are based on facts already in the public domain or well known among the trade.

Even more usefully, much of our work requires us to go inside the distribution models of our clients' routes to market and investigate the actual measures and business model dynamics operating in the distributors and final-tier trade channel players. This provides the basis for much of the insight into each type of channel business model laid out in the different sections of the book.

Finally, we have had the opportunity to work with many smaller companies and businesses, typically following the introduction of an injection of venture finance, which means that all concerned are expecting a sharp uptick in sales. This growth often has to come from a combination of new customer segments, new markets or new products, which usually means new channels too. There have been some hard lessons learnt along the way about establishing a value proposition that will attract the players in the channels needed to deliver the required growth, and these are laid out for you here too.

All of the content in this book has at some time or other been taught to people in real channel roles or distribution businesses, looking for insights, concepts, frameworks, heuristics and practical lessons that they can take away and apply. For many of the people attending these workshops, English has been their second or even third language, so the experience has been a good test of how to communicate business and financial concepts in terms that make sense to people who work in sales and marketing (and sometimes, vice versa too).

For more information on VIA please visit www.viaint.com.

Acknowledgements

The fact that this book was written at all is down to a German channel manager who asked me at the end of a workshop for a list of books on the subject of channel business models. I found I could not think of any. He planted the seed, which took several more years to germinate.

I am indebted to my professional colleagues and partners at VIA, especially Rosemary Wyatt, Michael White and Guy Swarbrick together with Sharon Davis for their support in allowing me time out to write the book. I have borrowed freely from their expertise as well as from the experiences shared with many current and former colleagues. Their review and feedback has added much to the finished result, as has that of Rob Abshire of Publicis who has shared many of our retail experiences over the past 12 years. In the academic world, the late Professor Erin Andersen at INSEAD was a wonderful source of encouragement, as has been Professor Anne T Coughlan at Kellogg. Of course, none of this would have been possible without the continuing patronage of our clients, who continue to share with us some of their more demanding challenges and issues. We can never say enough how much we appreciate their trust and candour. I would especially like to recognize Phil Darnell of Hewlett-Packard whose vision has inspired some of the more exciting projects we have been privileged to work on.

In the production of this book, I have had the most wonderful support from Sean Daly, who has helped with the layout and formatting of every page and redrawn just about every picture and table too. Any mistakes that remain are down to me.

Finally, I'd like to acknowledge the support of my family, who have left me in peace for long periods interrupted only by teas and coffees, with just the occasional enquiry as to whether it was the butler or the gamekeeper who would be revealed as the villain in the final chapter. Well, now they will have to believe me that it just isn't that sort of book!

Part 1

Introduction and why business models matter

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1

Introduction

Who this book is for

This book is for anyone whose role touches the marketing, sales, distribution and service channels of their industry. It is for anyone whose responsibilities include generating demand and fulfilling customer needs through the provision of products and services. If any of the following terminology forms part of your job description, this book is for you:

- routes to market;
- go-to-market;
- distribution channels;
- channels to market;
- sales channels;
- account, relationship or partnership management;
- business to business;
- business to consumer

This book is for the managers of the businesses that market, distribute, sell and service the products and services of *other* suppliers and it is for anyone who is involved in the frontline of these relationships.

If your role has any commercial element, then this book has you in mind. It is written for people who don't consider themselves to be financial experts but recognize that they need to be masters of the economics of their business and the businesses with which they work. It aims to provide pragmatic insight into the challenges faced by each of the parties involved in the marketing and distribution of products and services (the 'players') and the opportunities that this insight unlocks.

Equally, if you are financially literate but are relatively new to the special dynamics of distribution, then this book should give you a fast track through many years of experience to the unique issues, measures, relationships and success factors that apply, whether you are working for a player in the midst of the value chain, a supplier at one end or a customer at the other.

It is for anyone who manages the relationship between two or more players in the distribution system, be they partner account managers, partner business managers, channel managers, sales managers, buyers, programme managers, etc. And of course it is for the managers and ultimate directors of these critical roles. Everyone involved in these roles needs to know how to demonstrate the commercial impact of their relationship with another player to win and retain business. They also need to understand the way their own business works to build relationships that work for both parties, be they the 'buyer' or 'seller' in the relationship.

For any product to reach its targeted customers and to grow its share of that market, the supplier needs to design and manage a distribution model that works as a business model for all of these intermediaries as well as for the supplier itself. This book is for anyone who is trying to improve the performance of their own business or is charged with influencing the behaviour and activities of the other players with whom they engage to mutual advantage.

There are many books and courses about finance. Some are for financial people; many are for the 'non-financial' manager. Most of these books talk about product companies; some even include a chapter or two about service companies. There are also books about distribution channels and systems, often from a sales or marketing perspective, dealing for example with how to minimize channel conflict or increase your power in the relationship with the channel. However, we have yet to find a book that deals with the business models of companies whose role is primarily to distribute products and services, written for people whose job specification does not require a qualification in accountancy… so here it is!

This book does not aim to teach you how to read balance sheets and profit and loss accounts or how to explain depreciation… though we expect you will probably be able to do these things by the time you have finished it. It will help you to understand:

- why working capital management is critical to distributors;
- how to address the demands for more margin from your retailers or distributors if you are a market share leader;

- how to secure the resources you really need from a supplier to achieve your growth targets;
- how to increase your share of your partners' business even if they claim that you are not as profitable to them as your competitors;
- how to punch above your weight in the distribution system if you have a tiny market share;
- how to ensure you are allocating scarce resources to the channels that will generate the highest returns;
- how to increase your leverage over partners who may not even sell or distribute your products, but whose recommendation is critical to customer preference.

What do we mean by business model?

As this book claims to be all about business models, we had better explain what we mean by the term 'business model'. A business model is how a business makes money from its activities. It is the financial expression of the role, positioning, strategy and execution of a business plan of a specific player in a specific industry. It is the logical financial result of the economics of the structure of the industry and its distribution infrastructure. It is both static – in the form of certain cost structures, margins, capital turns and the like, and dynamic – in the way that costs behave, key ratios change with growth or margins behave under increased competition. So the business model of, say, a distributor of plumbing supplies will have some predictable similarities and some predictable differences with that of a computer products distributor, and further predictable similarities and differences with a sheet music or a cream cake distributor. The same can be said of different players in the same channel eco-system, with their role, balance of power and strategy determining where and how they will make profits, where they have to deploy capital and the scale of both these factors relative to the size of business being done.

In this book we will show you the connection between these forces and the impact they have on the structure of the business model. We will help you to understand the inherent constraints and continual trade-offs with which the managers of each business model are wrestling. We will take you into the ways to improve the business performance of each type of player, whether you are managing it or negotiating with it. These constraints are also opportunities. For example, many retailers cannot hold much inventory on their premises owing to size or cost constraints (attractive retail locations attract a fearsome rent). An enterprising supplier with an efficient distribution logistics capability can offer to supply just in time or manage the inventory on behalf of the retailer, gaining share of category over other suppliers without this capability. The retailer knows it can't afford to be out of stock, so will give up some of its demands for a better margin in return for assurance of full and replenished shelves. Being able to put these two aspects into proportion – or quantifying them – might not seem like selling or marketing, but it will have a much longer-lasting impact on doing business together than offering a short-term product promotion to gain share.

In this book we aim to teach you to fish, so to speak, rather than catching fish for you. We will point out the major breeds of fish, ie the dominant business models and their inherent characteristics, but more as a way to making you the complete angler. This way you should be able to assess the situation of any business model in any distribution system in any market from any perspective (managing the player or buying from or selling to it), work out the issues and opportunities available and identify the strategy that will best help you achieve your particular objectives.

How this book is set out

This book sets out the business models of all the major types of intermediary in a distribution system, in the following structure:

- *The role of the player* – although there are some special cases and exceptions, in most industries the roles of the key players are very consistent. However, the labels that are applied in each industry can vary confusingly and in some cases are used interchangeably and in others can carry quite specific meanings. To make sure the labels applied in your industry do not mislead you, we define the key roles, so you can recognize which players you are dealing with.
- *How their business model works* – the principal characteristics of each player's role in the distribution system determine the fundamental shape of their business model. They will be subject to some well-understood economic dynamics and each will have one or more 'big issues' that define their management's priorities. We orientate you to the key features of the business model and show how these are driven by each player's role and the structure of the industry or distribution system. We explain the business model in plain English and provide a consistent framework for mapping the key numbers. We provide numerous examples of each type of business model so that you can see how the

forces in its market have shaped its business profile and affected its business performance.

- *The measures that matter and how to manage the business using them* – we define and explain all the key measures and how and why they are used. We provide some basic benchmarks to give you a sense of the norms for each measure and help you understand what can be done to improve each measure. We show you how the measures interact so that you understand the pressures that managers of each player are under and the trade-offs they are constantly juggling. We provide some case studies and examples of how failing businesses have been turned around and how successful players have executed their strategies in detail.
- *How to sell to that player* – once you understand the key objectives of the managers you are dealing with, you can ensure that you position your own company's value proposition in terms that will mean something. You can show how your proposals will impact their business model to the good. You can demonstrate that allocating more resource to your products and services is good for both of you, and that attacking the segments in which you want to grow is going to deliver a higher return on investment for them. Equally you can defend your corner, when asked to concede margin or increase market development funding, by pointing out how little this will benefit their overall performance. We aim to increase your confidence to go high in your account relationships by understanding the overall business model and taking the conversation up to the strategic level.

At the end of this book, we have provided all the useful quick reference material you might need and a glossary of technical terms.

Although we encourage you to read the entire book to learn what a powerful resource it can be for you with its hundreds of examples and insights, we also encourage you to dip into the book when confronted with specific challenges or new situations. Some of the more technical elements of the business models will not make compelling reading until you are dealing with a real issue and then you will welcome the detail of the explanations and the depth of the examples.

Although we aim to educate you through this book in the general and specific aspects of business models, with lots of practical, real examples, every so often we will express a point of view. It seems that there are still some lessons that have yet to be learnt and entrenched behaviours that defy commercial logic: market share leaders employing the tactics of the new entrant, distributors and resellers discounting products that are in short supply, capital wasted without any understanding of its true cost. We aim to give you, the reader, the benefit of years of hands-on management and consulting insight to help you avoid these pitfalls. Take heed, or you could find your competitor is the first to break the mould and win the business from under your nose!

2

Why business models matter

Distribution matters

Typically around half the price paid for a product by a customer is absorbed by the activities involved in getting that product to the customer (and the customer to the product). And this is a proportion that has increased significantly over the past 15 years as production costs have fallen while markets have segmented and media and distribution channels have multiplied. Typically, this is the proportion of costs which is least well controlled and least well understood.

Markets are fragmenting as trends in consumer and business demographics create additional and more distinct customer segments. To make matters worse, product and service innovations are multiplying the options available. Even simple, commodity-type products may now be distributed to multiple customer segments through multiple routes that differ by country or region. Many of these routes to market involve one or more types of intermediary, such as wholesalers, distributors, dealers, brokers, aggregators and retailers, or rely upon influencers who shape customer preference or act as specifiers or their behalf, such as architects or designers. Very few companies can tell you what it costs to sell through a particular route to market whether that be direct, one-tier (eg supplier to dealer to customer) or two-tier (eg supplier to distributor to retailer to customer) distribution. Fewer still can inform you of the profitability of specific intermediaries. We have found wide variation in the costs and profitability of channels and specific intermediaries in every industry and distribution system we have investigated. Companies that have invested in analysing and understanding the business models of their distribution system have been able to take significant cost out of their own business, increasing profits or reducing prices to gain an edge over the competition.

Routes to market control access. Without the right routes to market, you simply won't reach your target market. Coca-Cola's burning desire throughout the 1990s was to make it easier and easier to buy a Coca-Cola. Just look at the result – there is virtually nowhere in the world where you are more than a few minutes from being able to buy a Coke at any time of the day or night. Many industrial companies are still struggling with access, unable to find the channels that will (note 'will', not can) take their products to market. Building access can be expensive, requiring extensive internal systems and infrastructure to be able to sense market demand, gather and evaluate sales forecasts, deploy marketing programmes and promotions, plan and execute complex logistics. It is a tough balancing act to increase access to the market while ensuring your network is profitable and capable of handling the growth you want. You may look to your distribution channels to generate demand for your products and services as well as fulfil it. Classically the local agent appointed in foreign markets is charged with exactly this responsibility, with compensation closely tied to the achievement of sales targets with only back office support from the supplier. Alternatively, you may want the channel to fulfil demand you have generated or even generate demand for you to fulfil. Your market access depends on understanding the role you want your channels to play and the cost and investment that are commensurate with the return generated.

Routes to market control brand. How can you deliver and fulfil your brand promise, unless you manage your routes to market properly and control your distribution? If your brand is built on quality attributes, you need your channels of distribution to execute on those attributes. Not only just at the point of purchase, but also if the product goes wrong or when the customer needs ongoing service and support. How well you incentivize and reward your channels will have a big impact on the ultimate customer experience and your brand. And if your brand is built on low price, you need your channels to be aligned in eliminating every unnecessary activity that incurs cost.

Often, routes to market control product differentiation. You want your product or offering to be different from your competitors'. Routes to market play a vital role in enabling this. Often, the channel you use is the sole way of demonstrating that your product is different from your competitors'. Dell in the computer industry is a good example of this, selling a product that is over 95 per cent the same as all its competitors (with the chips and operating software coming from standard suppliers Intel and Microsoft). Its channel – online direct – is its primary differentiator, offering price and flexibility advantages over its competition which, until recently, has gone to market through retail and dealer channels.

And all the time, your chief finance officer wants more for less. Never before have the costs and benefits of marketing and distribution come under such close scrutiny. With a combination of significant costs, complexity, dependencies on external partners and variety by market, it is now critical to understand and manage your distribution business model.

Challenging business dynamics

Distribution businesses are inherently difficult businesses to get right. To see why, we first need to set out the typical types of distribution players and define their role in a distribution system.

In Figure 2.1, you will see that there are three basic structures for a distribution system:

- **Direct** – in this structure, the supplier owns and manages all the resources in the value chain through to the customer (or a particular set of customers). Companies employing this model have multiplied since the internet enabled online direct distribution. Examples include Dell in the computer business, easyJet in the low-cost airline business, Charles Schwab in securities and Lands End in clothing. Each of these companies has made a virtue out of increasing customer convenience or reducing cost, or both, by employing the direct model. In addition they gain valuable customer insight through the direct interaction and can adjust prices and promotional offers instantly to respond to demand and supply issues. It is a model that also includes the direct sales force typically seen calling on the very large corporate accounts in most business-to-business sectors.
- **One-tier distribution** – this structure is defined by employing one set of intermediaries between the company and its customers to increase reach (such as overseas agents), provide special services to complete the customer offer (such as conservatory installers) or position the product within established channels for the customer (such as retailers), where

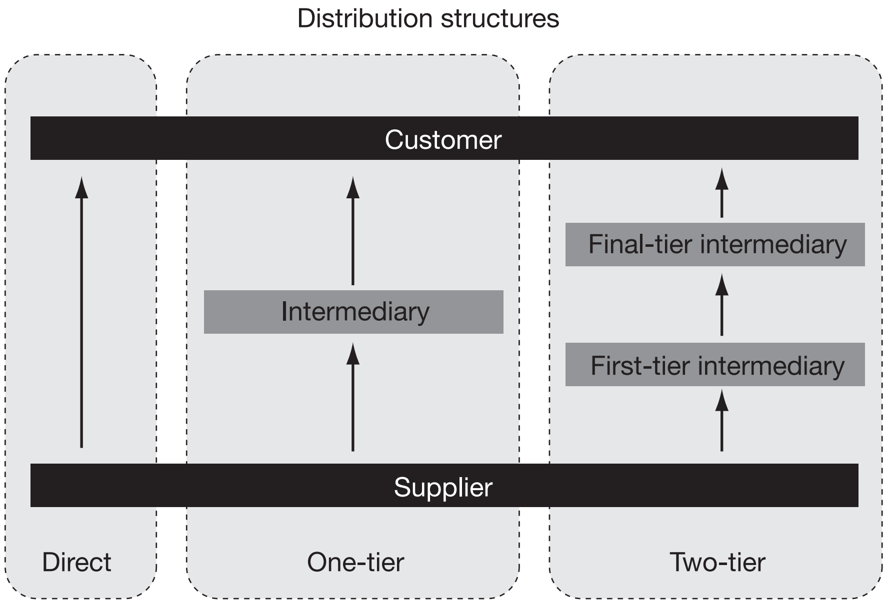

Figure 2.1 Typical distribution structures

it would make no sense for the supplier to try to persuade customers to change their shopping and buying habits. The benefits include easy and often immediate access to well-defined segments of customers or the leveraging of investments made by the intermediaries, such as overseas agents, warehouses and established sales forces. The disadvantages include the need to grant an acceptable trading margin to the intermediary and a degree of dilution of focus because the intermediary sells many brands, including potentially direct competitors (think how many varieties of soft drink or cereal are on offer in the average grocery store). In addition, the distancing of the customer by interjecting a layer of intermediaries can be a major disadvantage, depending on what information the intermediary is willing, or contracted, to share with the supplier.

- **Two-tier distribution** – in many markets there are potentially thousands of intermediaries who service the customer segments a supplier is seeking to reach. Each of these may handle only a few sales a month and the cost of finding them and managing a commercial relationship with them cannot be recovered from the margin on such a low volume