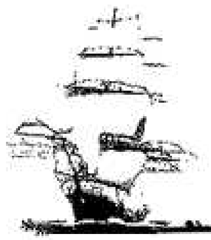

Marketing Channels of Distribution

I. Fundamentals of Channels of Distribution

   A. What are distribution channels? When you walk into a store and buy something off of the shelf, that product represents the end of a sometimes long journey that ends with your purchase. Sometimes the journey begins in a farmer's field or it may begin in a factory. But some series of transactions between buyers and sellers eventually gets it to your store shelf.   This is a distribution channel, which we define more formally as the set of organizations and transactions that make possible the transfer of ownership of some product as it moves from raw materials to final producer to consumer.

   B. What moves through marketing channels? Beyond the products that form the essential purpose of distribution channels, other important assets move through. Below are some of what distribution channels move.

      1. products. Of course.

      2. information. Members of well-managed marketing channels share much information with each other. Most often the information relates directly to the goods being exchanged, but information about customers, competitors, suppliers, etc. are also routinely shared in distribution channels.

      3. money. The products that move through channels must be paid for.

      4. promotional efforts and activities. The exchanges that move the goods to the final consumer often result from intense promotional activities at all levels. Consumers may buy the product on sale or with a coupon or as a result of seeing or reading about the product in advertising. Manufacturers may also provide promotional information and incentives to retailers to carry the product.

   C. Why do we need distribution channels? Because each stage of the marketing channel must profit from exchange, it would seem logical to conclude that consumers would be better off buying directly from producers and bypassing as many channel levels as possible. For some products, this is true; so-called "direct channels serve the consumer well. But for most products, such is not the case. Consider what distribution channels do to save consumers their resources.

      1. Channels reduce the number of contacts necessary to find the most desirable products.   Consider a simple example.

         a. Suppose that to buy shoes, consumers had to go directly to the manufacturer because shoe stores did not exist. If five consumers wanted to each inspect five brands of shoes, then each consumer would have to expend the time and resources necessary to visit the manufacturers' five locations to inspect the shoes. This would require a total of twenty-five contacts ($5 \times 5 = 25$).

b. Now suppose shoe stores existed and five consumers wish to inspect the same five brands of shoes, all carried at a single shoe store. To get the shoes from the five producers to the five consumers, we need only ten contacts. The five producers contact the one shoe store, and the five consumers contact the one shoe store [(5 × 1) + (5 × 1) = 10]. Thus, even though the shoe store makes a profit on the shoes it sells, for an equal selection the consumer saves considerable time, effort, and resources making the slightly higher price worth the savings in other resources.

2. Channels overcome "economic discrepancies." Sometimes called "marketing barriers," these represent gaps in how much , when, and where consumers desire products. Distribution channels provide the means of closing these discrepancies, providing value to the consumer.
   a. Discrepancies of quantity are differences between the amounts demanded by consumers and the amount available to them. Channels make reaching consumers on a mass scale easier. Thus, more goods can be purchased, lowering the costs of production.
   b. Discrepancies of assortment are differences between the variety of products desired by customers and the variety offered to them. As a practical matter, it's easier to buy many needed items during a shopping trip than one. When channels place an assortment of items together in convenient locations, consumers can save considerable resources.
   c. Spatial discrepancies are simply differences between where products are desired and where they're available. The degree to which consumers can shorten the trips needed to acquire necessary products provides them with resource savings.
   d. Temporal discrepancies are the differences between when products are desired and when they're available. Consumers cannot be expected to store all the products they'll likely need for some foreseeable time period. Channels of distribution store products or control the flow of products to consumers such that consumers can have them when needed, eliminating the need for consumer to store large quantities of goods.

D. functions of distribution channels. The resource saving properties of distribution channels described above occur through the variety of functions that distribution channels provide.

1. transactional functions. The movement of goods from raw materials to final consumer requires transactions between the various firms in the distribution channel. Channels help facilitate these transactions.
   a. contacting and promoting. Firms in distribution channels send salespeople out to contact other firms in the channel and promote the items they are selling. For example, the shoe manufacturers leather, rubber, thread, etc. in the production of the shoes they sell.

Suppliers of the materials send salespeople to shoe manufacturers in hopes of persuading them of buying their materials.

b. negotiation. In channels, rarely are the prices of goods set prior to the sale; more often than not terms are negotiated. Channel members perform this function during virtually every transaction. Amounts, prices and discounts, shipping and delivery terms are all decided upon through bargaining.

c. risk taking. Channel members generally own the inventory they attempt to sell. Indeed, they frequently borrow money in order to pay for that inventory. If for some reason they were unable to sell the inventory, they would eat the cost. By owning the inventory they sell, channel members assume risks.

2. logistical functions. Movement of goods to consumers, of course, requires that they be physically transported and mixed with other goods into the varieties consumers find in stores. This implies the following:

a. physical distribution. Channels of distribution are responsible for actually moving and storing goods as they move to the consumer.

b. bulk breaking and assorting goods. Factories produce large quantities of identical or similar goods and ship then out in quantity. In distribution channels, these large lots are broken up into smaller lots (an activity called bulk breaking), then creating varieties desired by consumers (an activity called assorting).

II. Channel Structure and Management

A. Channel structure. As goods move toward consumers, firms in the channel must engage in a series of transactions to make that possible. For example, a factory buys the raw materials and component parts, finishes the products then sells the goods to a wholesaler, who then sells the goods to various retailers, who then make them available for consumers to buy. The fact that these companies interact with one another means that the participating firms form relationships with each other. And these relationships must be managed and governed. The management and governance of these relationships produce a variety of channel structures, the more common of which are described below.

1. conventional channels. As the name implies, conventional channels are the ordinary and standard form of marketing channel. People with a limited understanding of marketing would probably describe a conventional channel if asked to explain how goods move from producers to consumers.

a. Firms in these channels are owned independently from one another and generally do not form long term contracts with each other.

b. Firms in these channels often engage in what is referred to as "transactional exchange," which is characterized by the following:

(1) Members are concerned only with their own immediate performance, not the overall performance of the channel. They do not see how the success of the channel relates to their own success.

(2) They conduct business with other channel members one transaction at a time with no expectations of future transactions with any particular customer or supplier. This is not to say that they don’t desire future business. They just don’t conduct business in a way to build in the expectation of future business.

(3) Businesses in conventional channels often act at “arm’s length” with other channel members. That is, they do not provide other channel members with any information beyond that which is necessary to complete a particular transaction.

(4) Businesses in conventional channels may view other channel members adversarially. That is to say they view other businesses as willing to take advantage of them if the proper precautions are not taken.

2. vertical marketing systems (VMS)

a. characteristic of VMS. In contrast to conventional channels, the VMS sees the channel as a system of firms and the entire channel as a means of delivering value to each other and to the consumer. They realize that their success depends in part on the success of other channel members. As such, they tend to behave much more cooperatively (though not always voluntarily so). Successful VMS engage in some form of relational exchange, which is characterized by the following:

(1) Firms create exchange relationships on the expectation of future exchanges.

(2) Channel members share information with each other and establish structural and permanent linkages between firms, which increase switching costs for all parties.

(3) Exchanges occur in a climate of trust.

b. types of VMS

(1) corporate VMS. Some marketing channels operate under ownership and control of a single company. From producer to retailer, the same company owns multiple or all stages in the distribution channel. Corporate VMS can occur through either forward or backward integration.

(a) Forward integration occurs when a manufacturer purchases its own wholesaling and/or retailing facilities. For example, Sherwin Williams Paints manufacturers its own paints, which they sell through their own chain of retail stores.

(b) Backward integration occurs when a wholesaler or retailer purchases its own manufacturing capabilities. For example, MFI, a large furniture retailer, owns the Hygena Company, which manufacturers much of the furniture MFI sells.

(2) contractual VMS. Independently owned business frequently formalize their business relationships through signing long term contracts that establish legal bonds between them as well as detail the nature of the exchanges that will occur.

(a) wholesaler sponsored chains. As will be discussed shortly, the wholesaler is a shrinking institution in marketing. To stay viable and to prosper, wholesalers in some industries create contractual VMS with independent retailers. Under these arrangements, independent retailers agree to buy most of their inventory from the wholesaler (thereby standardizing the brands) and agree to assume a common name, giving the appearance of a national chain. Examples include Western Auto Stores, Affiliated Foods Grocers, IGA Grocers, and Tru-Value and Ace Hardware Stores.

(b) franchise organization. Franchising is a very popular way to operate distribution channels.

(i) rationale for franchising. Producers use franchising to quickly and inexpensively establish national distribution for their products, while retailers use franchising to operate retail stores with well-established brands and professionally conducted marketing programs.

(ii) typical franchise arrangement. A "franchiser" owns a brand name and the rights to certain unique products or processes. These are licensed to "franchisees," who own the retail outlets. The franchisee agrees to abide by an extremely detailed and tightly controlled "franchise agreement." Examples of franchises abound, but they are particularly popular in industries such as fast food, (McDonald's, Arby's, Taco Bell, etc.) automobile rental (Avis, Hertz, Enterprise), and hotels (Holiday Inn, Comfort Inn).

(3) administered VMS. Most vertical marketing systems arise from the growth in power of a single channel member, usually a retailer. By virtue of its economic clout, the channel member can exert large amounts of control over

the actions of other channel members, obtaining from them high degree of cooperation – all without a contract. Perhaps the classic contemporary example is WalMart, which is known for its "hardball" tactics with suppliers, who generally acquiesce to WalMart's demands because WalMart has access to so many customers. Administered VMS are the most common type of vertical marketing system.

3. Horizontal marketing systems. Rather than establish cooperative relationships among businesses from producers "down" to consumers, companies at the same level of different channels agree to combine in some way to create new marketing opportunities. These arrangements usually occur at the retail level, and frequently involve a single company owning several related but separate retail outlets. For example, Kroger Stores Inc. owns Kroger Grocery Stores, Ralph's Grocery Stores, Mr. Big's Grocery Stores, and a few convenience store chains as well. All these stores share distribution and warehousing operations as well as use their massive size to obtain good deals from producers.

B. Issues in Channel Management.

1. number of outlets. Marketers must decide the number of retail outlets they wish their goods sold through. The decision must balance sales objectives with brand image issues. In general terms, marketers have three choices.

a. exclusive distribution. As the term implies, exclusive distribution works for products that marketers want to have an image of exclusivity.

(1) In exclusive distribution, marketers severely limit the number of outlets through which a product is sold, and frequently involves exclusive dealing where resellers don't carry competing brands

(2) Producers select exclusive distribution because they want to tightly control image, service level, etc.

(4) Exclusive distribution is typically used with specialty products.

b. intensive distribution. At the other end of the spectrum is intensive distribution. With this strategy, a marketer places products in as many retailers in as many resellers willing to do so.

(1) Because of the variety and number of retailers carrying the product, the producer gives up much control over how product is handled by retailer.

(2) This strategy is common with convenience goods.

c. selective distribution. The middle ground between intensive and exclusive distribution strategies is selective distribution, which uses more than a few, but less than all available outlets. The strategy is typically used with shopping products

2. dealing with channel conflict. Businesses in distribution channels invariably experience conflict. That's because buyers and sellers constantly try to get each other to do favors or make concessions. In even the most placid relationships between channel members, occasionally conflict arises.
    a. sources of channel conflict. Conflict between channel members arises from two broad sources: distributive justice issues, and procedural justice issues.
        (1) distributive justice issues. The idea of distributive justice relates to the distribution of rewards and burdens in the channel relationship. Some powerful channel members use their economic clout to maximize their own short term benefits, effective long term channel relationships may require foregoing short term gain for long term channel efficiency.
        (2) procedural justice issues. These issues pertain to the fairness of one the policies and procedures of the channel members in their interactions. Issues of procedural justice become extremely important within contractual channel agreements such as franchises because parties may not simply walk away from the deal creating the conflict. Disagreements may arise that are incompletely covered or not covered at all by the contractual agreement. In such circumstances, more powerful channel members may be seen as taking advantage of the weaker member.
    b. Channel conflict is resolved when one member acquiesces to the wishes of the other. If the acquiescence is coerced, then this sets the stage for future conflict. But for an issue causing immediate conflict, resolution may be obtained by utilizing one of several influence strategies.
        (1) threat. The source of the influence attempt warns the target of negative consequences if the target does not acquiesce.
        (2) punishment. The source of the influence attempt warns the target that the source will enact negative consequences if the target does not acquiesce.
        (3) reward. The source of the influence attempt suggests that positive consequences will result if the target acquiesces.
        (4) promise. The source of the influence attempt suggests that the source will impart positive consequences in exchange for the target's acquiescence.
        (5) request. The source of the influence attempt simply asks the target for acquiescence.
    c. Channel conflict decreases efficiency and performance. Conflict costs money. Cooperation (even when coerced) usually saves money.

III. Channel Intermediaries

A. Wholesaling. It is important to distinguish between wholesaling (a channel function) and wholesalers (firms that perform wholesaling). This is because many producers and retailers have taken on the function of wholesaling themselves, resulting in the decline of many independent wholesalers. Wholesaling activities must still be performed, of course. The difference is in the ownership of the firms that perform it. Wholesalers are simply the firms that facilitate or expedite wholesale transactions.

1. What is wholesaling? Wholesaling is all transactions in which products are exchanged for the following purposes:

   a. resale. Retailers, who sell their products to consumers, must get their products from somewhere. The transactions that put products on retailers' shelves are part of the wholesaling function.

   b. making other products. Manufacturers must acquire materials (raw materials or component parts) of many kinds to use in their own production processes. The transactions through which manufacturers gain possession of these materials are part of the wholesaling function.

   c. general business operations. All firms must acquire products necessary to simply run the business (e.g., office supplies, computer software, etc.). The transactions through which firms acquire these products are part of the wholesaling function.

2. trends in wholesaling.

   a. Although wholesaling remains a critical activity in the distribution of goods and services, the independent wholesaler is in decline. Between 1962 and 1992, sales (not adjusted for inflation) through independent wholesalers grew by almost 40 times. However, the number of independent wholesalers grew by only three times. During this same period, gross domestic product grew by about 13 times. This indicates that wholesale establishment's average size is increasing faster than the economy is growing, but that the number of independent wholesalers is declining relative to the overall domestic economy.

   b. Separating wholesalers from retailers is becoming more difficult.

      (1) Many large national retail chains sell at both the retail and wholesale level. For example, Sam's Clubs (also part of WalMart Corp.) offer memberships to individual families as well as small businesses. Similarly, large office supply retailers such as Office Depot sell to both individuals and businesses.

      (2) Many large retailers actually warehouse their goods in retail showrooms. Lowe's and Home Depot, for example. stack large replacement inventories on top of high heavy duty shelving units and move items down by forklift when needed.

3. wholesaling functions. Wholesalers perform some combination of the following activities.
    a. risk taking. During the transfer of goods, wholesalers assume responsibility for theft, damage, and in some cases, excess or unsold inventory. Many wholesalers provide financing or extend credit to their customers, which also assumes some risk.
    b. warehousing, shipping and handling. These logistical functions are critical for physically getting products to their intended destinations.
    c. market research and information. Wholesalers often provide manufacturers and retailers information about customer trends based on their own sales activities or through sponsoring market research studies. Additionally, wholesalers manage computer information networks that ease customer ordering and information sharing.
    d. promotion. Wholesalers may assist in or completely provide promotional efforts on behalf of other channel members. For example, wholesalers may provide sales assistance, advertising, and other promotional materials.
4. classifying wholesalers. The most basic distinction to make between wholesalers is whether they actually take title to (i.e., own) the goods they sell.
    a. merchant wholesalers – take title to the products they sell. This type of wholesaler may be classified according to the level of service they provide customers.
        (1) full-service wholesalers. The breadth of merchandise offered serves as a basis for classifying full-service merchant wholesalers. Types include general merchandise wholesalers, limited-line wholesalers, and specialty-line wholesalers. The names are fairly self-explanatory.
        (2) limited-service wholesalers. These wholesalers are fairly eclectic in nature. Below are listed a few common types.
            (a) Cash and carry wholesalers serve small retailers who pay cash for merchandise and provide their own shipping. Cash and carry wholesalers are fairly common in groceries and electrical supplies.
            (b) Truck wholesalers (a.k.a., truck jobbers) sell a limited line of merchandise to customers directly off their trucks. These may be found selling produce to small grocers or tools to mechanics and service stations.
            (c) Drop shippers actually own the products they sell, but never take possession of them. Instead, they have them forwarded from the products' points of production directly to their customers' plants. Drop

shippers handle large orders of bulky goods such as lumber, oil or chemicals.

b. agents and brokers. These are wholesalers that do not take title to the goods they sell. Typically, they act as a salesforce for one or manufacturers either on a long-term or short term-basis.

(1) Manufacturers' agents are by far the most common type of agent wholesalers. They sell and take orders on behalf of several manufacturers – usually of noncompeting or complimentary products. For example, a manufacturer of chemical mixing equipment wishing to expand sales overseas may use manufacturer's agents in Europe to sell their products to European customers.

(2) Commission merchants (not a merchant wholesaler – don't let the name confuse you) receive goods on consignment (take possession but not title) to sell to auction markets. Most often found in agricultural commodities, these are also known as "factor merchants," or simply, "factors."

(3) Brokers are a special type of agent wholesaler that attempts to bring buyers and sellers together and help negotiate sales. However, once buyers and sellers have been brought together, the agent's role typically decreases and only serves an advisory function. The broker for example, may not set prices but may shuttle information back and forth between buyer and seller. Common in selling real estate.

B. Retailing. Once again, it's useful to distinguish between retailing and retailers. As with wholesaling, we make this distinction because not all retail sales occur strictly through retailers. Retailing includes the transactions by which products are acquired by individuals and households for personal use or consumption. Retailers are firms that sell products to individuals or households for their personal use or consumption. Again, not all retailing is performed by retailers.

1. trends in retailing

a. increasing polarity. The growth in retailing nationally has been marked by two particularly sharp trends, which seem to have occurred at opposite "poles" in the retailing spectrum:

(1) growth in very large (by physical store size) low price retailers that carry extremely large inventory, offer low levels of individual service, and rely on extremely high merchandise turnover to remain profitable (Lowes, Home Depot, Office Depot, Sam's Club, etc.)

(2) growth in small (by physical store size) limited line, tightly focused, high service specialty retailers such as the Gap, Eddie Bauer, Body Shop, Foot Locker).

b. increasing power in channels. Thirty or forty years ago, marketing channels were dominated by packaged goods manufacturers (Procter and Gamble, Colgate, Kraft). Today, retailers control the "power position" in consumer distribution channels. There are several reasons for this:

(1) The growth in national chain retailers with larger and larger stores gives them access to tremendous numbers of customers.

(2) Better branding by retail stores means that stores themselves become brands. As such, customers become loyal to stores to the same degree they do to product brands.

(3) Retailers adoption of scanner technology gives instant and highly accurate information about what sells best in what combinations and at what price. Manufacturers now rely on retailers for this information.

c. growth of direct channels. Countering the trends toward retailer power is the growth of direct channels. Direct channels exist when manufacturers sell directly to consumers with no wholesalers or retailers at all. Many computers are sold to consumers through direct channels used by companies like Dell and Gateway. Indeed, the Internet will likely make possible direct channels in many industries. Certainly, direct channels will probably not work for all types of products and few believe that they will even come close to replacing channels with marketing intermediaries. Still, direct channels represent an important and growing force in marketing that will permanently change how many consumers shop and businesses sell.

2. major types of retail establishments. The variety of retail establishments has grown enormously in the last few decades. Technology continues to fuel this growth. Given their diversity, retailers could be categorized in many ways. For example, one might divide retailers according to ownership -- independent or chain. Here, we categorize them by the breadth and depth of their product offerings. This list is not exhaustive, but provides examples of most major types of retailers.

a. general merchandise retail stores. These retail establishments stock a broad assortment of merchandise, often with much depth. They often differentiate themselves on the basis of store size, merchandise price and quality, and service level.

(1) Department stores offer wide and deep product mixes, divided into departments. They traditionally focus on quality and service, however, recently competing more on price. (Lazarus, Dillards, Sears)

(2) Discount stores are large limited or self-service stores focused clearly on price. They offer very broad varieties of national and private label general merchandise and are expanding into new merchandise lines and building ever larger stores (WalMart, Meijer)

(3) Supermarkets are large self-service food stores that may also carry a limited amount of nonfood merchandise. (Albertsons, Krogers). Discount stores, however, are increasingly competing with supermarkets.

(4) Warehouse clubs are very large-scale, very limited service, members-only establishments that combine cash & carry wholesaling with deep discount retailing. They feature very broad merchandise lines, with limited depth. (Sam's Club, Price Costco).

(6) Catalog showrooms operate somewhat like warehouse-stores, except they display merchandise in a showroom setting where all but display merchandise is kept out customers' reach. Customers order merchandise from in-store catalogs and take possession of their merchandise as they leave. This particular business model is in decline (Service Merchandise).

b. specialty retailers

(1) Traditional specialty stores, also called limited-line retailers, typically occupy fairly small facilities, but carry a very deep selection of a limited assortment of merchandise. Although chain specialty stores are growing (i.e., Disney Store, Gap, Radio Shack), more than half remain independently owned. Chain specialty retailers, however, are much better suited to compete on price with independents.

(2) Off-price retailers purchase manufacturers' seconds, overruns, returns, and off season merchandise and then sell them at deep discounts relative to department stores. Several off-price retailers have grown into large chains (i.e., Big Lots, TJ Maxx, Marshalls, Stein Mart). A new trend in off-price retailing is the manufacturer's outlet mall.

(3) Category killers are a new and important type of retail store. Category killers are large specialty stores that focus on one or occasionally two product lines and compete on the basis of tremendous selection and price. They earned their name by entering trading areas, quickly gathering large market shares, and taking much business away from smaller, often locally-owned, higher priced specialty stores. Examples include Lowes, Best Buy, and Toys R Us.

c. nonstore retailers. These retailers do not rely on a physical facility to sell their products.

(1) Direct selling is the contemporary version of door-to-door selling. However, direct selling has evolved into a sophisticated retailing process with some well-known brands including Mary Kay, Avon, Amway, World Book

and Kirby. The growth in many of these organizations is phenomenal.

(2) Catalog marketing typically operate in combination with in-store retailing. Well known examples include Sears, JC Penny and Service Merchandise. Others, such as LL Bean rely almost exclusively on catalog sales. Still other well-known retailer that began as catalog marketers have expanded into in-store retailers (Victoria's Secret, Sharper Image).

(3) Television home shopping can occur either through home shopping cable channels or through program length commercials (so-called “infomercials”).

(4) On-line retailing, also called “e-tailing,” often functions much the same as catalog marketing, but through a computer. As technology advances, however, e-tailers will become much more adept at making their on-line presentations more customized and interactive. Many catalog retailers developed sophisticated Web sites that will eventually replace traditional printed catalogs.

(5) Automatic vending is also becoming more sophisticated as digital technology makes dispensing merchandise easier and more reliable.