The Revolution in Distribution: Challenges and Opportunities

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The design and management of effective and efficient distribution channels offer significant, frequently untapped, opportunities for firms to create unique, long-term strategic advantages. Allegiance (formerly Baxter) in healthcare, Steelcase and Herman Miller in office furniture, IKEA in household furniture, Caterpillar in earthmoving equipment, Wal-Mart, Tesco and Carrefour in groceries and general merchandise, Rockwell Automation (Allen-Bradley) in factory automation, Toys 'R' Us in toys and children's clothing, and Federal Express in package delivery are a few of the companies which have relied on differential knowledge of marketing channels to build impressive positions in their respective industries. Superior performance of channel activities has become a major route to providing extraordinary value to end users. Reducing the amount of time, energy, and effort expended in acquiring goods and services has become as important, if not more so, as being offered a reduction in their purchase prices.

Firms are increasingly recognizing these opportunities in channel management and are rapidly adapting to the dramatic changes that have occurred in the organization of channel activities. Consider the pharmaceutical, grocery, and travel industries, for example. In 1994, three giant pharmaceutical manufacturers—Merck, SmithKline Beecham, and Eli Lilly—spent over $12 billion to purchase three pharmaceutical benefits management (PBM) firms who rely heavily on mail-order distribution—Medco, Diversified Pharmaceutical Services, and the PCS Division of McKesson, respectively. These channel intermediaries have a number of competitive advantages, the most important of which are their exceptional information systems which contain databases linking patients, physicians, managed care organizations, pharmacies, third party payers, and pharmaceuticals prescribed. Merck, SmithKline, and

Eli Lilly have historically been research-and-development-oriented companies. The acquisitions demonstrated each company's conclusion that distribution is increasingly critical to its future. The acquisitions also signaled that each company felt it was unable to meet the challenges of the emerging healthcare environment on its own, i.e., existing distribution skills were inadequate.

A few years ago, media advertising accounted for 70% of the promotional expenditures by grocery manufacturers. More recently, it accounted for less than 40%. Consumer and trade-directed sales promotion activities began to dominate promotion budgets. The largest portion went to trade promotion, i.e., incentives given to retailers and wholesalers to encourage them to 'push' specific brands. What distributors could do for brands became more important than what manufacturers could do.

The quantum improvements in computer technology are making it possible—and financially advantageous—for passengers and airlines to bypass traditional methods of making travel arrangements. Consumers can make travel arrangements over the Internet through Travelocity, a subsidiary of Amer-
The Emphasis on Cost Containment

While it could always be said that organizations and individuals desire to contain the cost of the products and services they purchase, the decade of the 1990s brought an almost frenzied attack on costs. The downsizing of companies worldwide was motivated more by cost containment than by re-engineering. But with the nearly exponential growth of information, communication, and transportation systems, the means available to contain costs have become increasingly more sophisticated.

In the 1960s, the former American Hospital Supply Corporation was the innovator in initiating such systems. But the broader concept of supply chain or value chain management was basically popularized by Michael Porter in his book *Competitive Advantage.* Value chain analysis involves an examination of the economic impact of each step in the extraction/production/distribution process. It begins with the acquisition of raw materials and ends with the sale of products and services to end users. While the concept of value chain analysis has a long tradition in channel management, Porter gave added life to the idea that firms achieve strategic advantage by focusing on the efficient and effective performance of specific value-added stages and on the fact that the entire value chain should be viewed as a system, i.e., as a set of interrelated and interdependent components generating an output.

To a significant extent, this renewed emphasis on value chain analysis has brought with it a growing appreciation for the critical role logistics plays in marketing channels. However, the way in which logistical issues are approached has changed. Traditionally, logistics relied on operations research techniques to examine such issues as the number and location of warehouses required to reduce transportation costs or the appropriate economic order quantity (EOQ) to use in minimizing stockouts or reducing inventory carrying costs. Now, the focus of the logistics decision has shifted to a broader level concerned with costs throughout the whole value chain. Programs such as 'continuous replenishment,' 'just-in-time,' 'quick response,' and 'efficient consumer response' emphasize the need to coordinate inventory levels, delivery patterns, transportation methods, and storage functions throughout an entire distribution system.

One of the major lessons learned from system-wide value chain analyses is that continuous, small lot production at the manufacturing level can sometimes produce savings in inventory and storage costs throughout a channel. These savings more than compensate for the loss in scale economies generated by single-run, large lot production. As a result, knowledgeable channel managers are now concentrating increased attention on securing for their customers the lowest possible 'dead net costs' instead of the...
lowest 'dead net prices.' Thus, when a hospital enters into a stockless purchasing arrangement with Allegiance or Owens and Minor, it expects to reduce its overall cost but not necessarily the overall price of the medical supplies it acquires. Price is only one consideration (and sometimes a very small consideration) in the ultimate or final cost of acquiring, holding, and consuming a product or service. This simple truth is at the core of efforts to contain costs in healthcare, groceries, electronics, major appliances, automobiles, and a host of other industries.

To accurately determine 'dead net costs,' organizations need a measurement system capable of calibrating the costs of individual distribution activities. In addition, adequate accounting rules are needed to allocate the costs accurately across functions and institutions in the value chain. While accounting procedures associated with 'distribution cost analysis' have been around for a long time, they never captured the practitioner's imagination until Robert Kaplan popularized 'activity based costing' in the 1980s and 1990s. These measures have, in turn, been combined with a focus on generating high returns on capital employed (ROCE) as well as economic value added (EVA). The attention of these yardsticks is on the productive use of company assets which is at the core of value chain analysis.

Given the significance of cost containment issues for the competitiveness of individual economies, generally, and for organizations and industries, specifically, we need to place more attention on the subject in our research projects and in our classrooms. Basic questions remain to be answered, such as: Which marketing activities are most likely to be affected by systemswide cost containment efforts? Which level in the channel is most appropriate to initiate, promote, and/or fund a comprehensive value chain analysis? What effect does such an analysis have on the power structure in the channel? How do channel members overcome their distrust of one another so that they can share relevant cost information openly? How do they deal with the on-going conflicts that such analyses undoubtedly create? What have such analyses produced in terms of results? Are some channel members sacrificing more than others in order to make supply chains more productive? If so, how should they be compensated for their sacrifices?

The Popularity of Outsourcing and Strategic Alliances

One of the major concerns that surfaces when value chain analyses are performed has to do with whether it would be preferable for organizations to 'contract out' some of the functions they previously performed on their own. Outsourcing takes many forms including the use of independent trucking firms rather than company fleets, independent warehousing, vendor managed inventory, and third-party facilities management of data processing and other services. 'Outsourcing' has become an important issue, especially as firms downsize and re-engineer: it is critical for firms to reduce their fixed costs and, thereby, become more flexible and maneuverable. Outsourcing converts fixed into variable costs.

The motives for engaging in strategic alliances or partnerships are the same as those for outsourcing. Rather than performing an activity itself, a firm induces another firm to help it. The other firm tends to have scalar and scope economies, technical expertise, and/or market access that the focal firm often does not have.

But strategic alliances differ from typical outsourcing or facilities management arrangements (e.g., hiring Pitney Bowes to run the mailroom or Cap Gemini to take over the data processing), because the parties in an alliance often make mutual investments in idiosyncratic assets—assets whose primary value is related to the specific relationship and cannot be easily deployed to other relationships. These idiosyncratic assets are used by the alliance to create a strategic advantage that can not readily be duplicated by competitors.

Alliances sometimes involve linkages with competitors and/or customers. For example, when Motorola forms a partnership with Nextel to build a nationwide wireless two-way radio communication system which will compete with cellular systems, it is at the same time a supplier of equipment to Nextel and a competitor. The number of these complex alliances has grown enormously in a very short period of time. Many of them have to do with distribution matters, e.g., Xerox maintaining the in-warranty service for Dell Computers.

To a large extent, the decision to outsource or to forge a strategic alliance is a 'make vs. buy' decision. 'Make vs. buy' is a subject that has been extensively examined by marketing channel scholars. The underlying concern is whether coordination of marketing functions is best achieved via vertical integration or via competitive markets (independent firms in conventional channels competing against each other to provide distribution functions). These channel structures offer different tradeoffs between coordination opportunities and the cost associated with exploiting them.

Vertical integration provides the greatest coordination opportunity, however, the cost of performing the channel activities may be high due to limited scale and inherent bureaucratic inefficiencies. On the other hand, cost efficiencies are realized due to specialization and the invisible hand of competitive markets, but coordination opportunities are limited. With all that we know about the 'make vs. buy' decision, is there some way in which
we could transfer those insights directly to answering questions associated with outsourcing and strategic alliances? Are we dealing with the same or different phenomena? If different, how do the theories we have been using need to be adjusted so that they can help management make decisions about when and when not to outsource? Can accurate predictions about the efficacy and longevity of strategic alliances be generated by applying transaction cost analysis, agency theory, and/or political economy perspectives?

An even broader issue is to what extent can truly strategic alliances exist among channel members? Typically, the most committed, long-term interpersonal relationships are monogamous. In supplier-manufacturer relationships, monogamous, sole-source, strategic relationships are possible. However, assortment is a key benefit offered by retailers and wholesalers; these channel members must deal with multiple competitive suppliers in a product category to satisfy the needs of their customers. But special problems, such as the sharing of confidential information, can arise when channel members attempt to develop strategic relationships with competing suppliers. Thus, the need to provide assortment might limit the degree to which strategic channel relationships can develop or might alter the nature of the relationships that do develop. The judicious use of power and the development of trust are keys to finding solutions to these dilemmas.⁵

The Growing Dominance of 'Downstream' Channel Members

It may appear trite to talk about the power of retailers and distributors because of all the notoriety this issue has received in the popular business press. The development of mass media, efficient transportation methods, and sophisticated management information systems has enabled companies in the distributive trades to achieve greater scale economies through more centralized management. These scale economies have led to the emergence of national or super-regional organizations that are large enough to wrest control of a number of distribution activities away from manufacturers.

A plethora of new downstream institutions have arisen over the past 20 years to challenge the status quo. Wal-Mart has grown from a single store in Rogers, Arkansas to the tenth largest corporation in the world in terms of stockholder value. Emergency care clinics provide convenient and timely medical services, formerly only available from hospitals. Category specialists, like Toys 'R' Us, Circuit City, and Sports Authority, now dominate the retail sales of toys, consumer electronics, and athletic goods. Office supply firms like Staples, home improvement centers like Home Depot and Texas Home Centers, and broad assortment warehouse clubs like Makro and Sam's cater to the needs of consumers and small businesses, significantly cutting into the sales made by traditional distributors. Overnight delivery services like Federal Express, TNT and United Parcel Service provide the capability of fulfilling orders for products and services in a day from central warehouses.

The consolidation and emergence of new formats convert into fewer potential accounts (so-called 'buying points') for suppliers to cultivate. And, in virtually every consumer goods category, retailers, not manufacturers, call the 'shots' relative to the terms of trade. One of the major motivations for the merger between Federated Department Stores and Macy's in 1994 was to provide the combined companies with buying power similar to that exercised by J. C. Penny and The May Company, the largest U.S. department store chains prior to the merger.

Given these developments, it is somewhat surprising to find that most of the focus in academic research and in classroom discussions takes the manufacturer's, rather than the distributor's or retailer's, perspective in examining marketing issues. Some manufacturer-oriented research can be easily translated into issues confronting retailers and wholesalers. For example, the distributor's problem of allocating stock and sales effort to brands in a category is similar to the manufacturer's problem of allocating advertising and sales effort to market segments for a brand. On the other hand, the perspective taken by wholesalers and retailers is, as shown below, generally different from that of manufacturers; the former tend to have a unique focus, unique performance measures, and unique marketing tools.⁶

Consistent with the need to provide an assortment, wholesalers and retailers focus on maximizing the performance of a merchandise category, while manufacturers are primarily interested in maximizing the performance from a brand. Channel intermediaries make decisions concerning a set of brands in a category, such as which brands and sizes to include in the set, how the brands are priced relative to each other, and how much investment (inventory levels, marketing support, etc.) should be made in the category. The interrelated demand for the items in a category must be considered to make these decisions correctly.

Decision makers in distribution firms tend to use investment productivity measures in making decisions, while decision makers in manufacturing firms focus more on absolute sales, market share, and profit measures. For example, buyers in retail chains want to maximize both gross margin and inventory turns. These measures of returns (gross margin) and investment (inventory turns) are often combined into one productivity measure, GMROI, to make decisions and evaluate performance. Retail store managers use other productivity measures, such as sales per
employee and sales per square foot, which reflect the assets under their control. Finally, the utilization of all of these assets is incorporated in overall measures of direct profit profitability (DPP). In contrast, brand and product managers, the equivalent position to buyers in retail firms, tend to make decisions that maximize sales and/or profits rather than return on assets.

Manufacturers communicate with customers primarily through advertising, personal selling, sales promotions and publicity. While retailers use these media, they also use tools with sensory appeals such as store layout, visual merchandising, and music.

A major empirical question that is raised by all of these insights about the power and modes of operation of downstream channel members is: What happens when a distributor’s approach is adopted as the starting point for marketing channel design and management? Would the structure and the incentive system be different from that if the manufacturer’s approach were the beginning point? For example, both Wal-Mart and Home Depot have insisted that manufacturers deal with them directly, i.e., that no channel intermediaries service their accounts. Would this result have been derived if manufacturers’ perspectives had been adopted? Other questions might address the long-term implications for manufacturers, in specific, and channels, in general, of retailers dominating marketing decisions. Are retailers willing to become channel ‘captains’ or do they simply wield their power in self-serving, opportunistic ways? What safeguards can manufacturers use, if the latter path is taken? And, now that the shoe is on the other foot, how can manufacturers gain countervailing power? a question that John Kenneth Galbraith asked in reverse over four decades ago when manufacturers were dominant.

The Potential of the Internet

Through the Internet, businesses have the opportunity to communicate interactively with consumers around the world at a low cost. The widespread access to electronic communication has the potential for fundamentally changing the distribution channels for consumer products and perhaps the structure of the retail and consumer goods industries.

Presently retail sales over the Internet are minuscule compared with in-store sales, but some experts believe that electronic retailing may account for as much as 25% of U.S. retail sales by 2010. Electronic retailing is very attractive because it provides the opportunity to collect extensive information about a broad range of products at a low cost—consumers can shop the world from their computers or TV sets. On the other hand, consumer goods manufacturers and retailers are concerned that the opportunity to search easily across many suppliers and compare their offerings will lead to intense price competition and reduced profits.

Retailers and consumers goods manufacturers around the world are ‘putting their foot’ in the river of electronic retailing by setting up home pages, and some, like Tesco and Wal-Mart, are offering merchandise for sale. However, little attention has been directed toward important issues concerning the impact of this channel. Will substantial numbers of consumers be interested in buying merchandise electronically rather than going to stores? What features need to be available in an electronic retailing format to offer superior consumer benefits compared to in-store shopping? Will the low search cost of Internet shopping lead to increased price competition? What can electronic retailers do to differentiate their offering and shield themselves from such price competition? Will manufacturers sell directly to consumers bypassing distributors and retailers or will there be a role for these channel members in electronic retailing? Will new types of channel members arise to broker information and provide lower cost delivery systems to homes?

The answer to these questions relies on an understanding consumer behavior and channel issues, not on advances in technology. The ability to sift through and present vast amounts of information and insure secure transactions electronically is available. In a few years, broad band communications to homes will be commonplace through either cable TV, fiber optic telephone lines, or satellite links. Technology will not impede the growth of electronic retailing but a lack of understanding of consumer and channel behavior might.

The Role of Distribution in Economic Development

Distribution channels play an important role in economic development and the social welfare of countries. To a large extent, distribution holds the key to improving living conditions around the globe. Logistical problems remain major impediments to getting products into the hands of the world’s population in a cost effective manner. For example, China is a major opportunity for marketers to pursue with enthusiasm, but the absence of an efficient distribution infrastructure, especially with regard to the provinces away from the major commercial centers, will slow the development of this opportunity. Massive problems exist throughout most of eastern and central Europe where, during the communist era, state-run enterprises erected distribution systems that were archaic when they opened. The distribution system in the former Soviet Union which promoted hoarding, corruption, and shortages, especially in agricultural commodities, is still largely in place. In
fact, organized crime in Russia is possibly the most effective and powerful channel captain.

Marketing practitioners and scholars have an opportunity to help the developing world achieve standards of living they desire and deserve. The central issue in these economies are channels of distribution, not product, price, or promotion. Consider, for example, the impact that Unilever is having in rural India:

(Unilever) is putting the finishing touches to a system which... could transform rural marketing in India—and in other large developing countries. By displaying individual villages and roads on an electronic map, the general sales manager of Hindustan Lever can plot the best way to supply and service a vast network of rural outlets... the information for the maps is gathered by the company's 2300 stockists—self-employed wholesalers who often work exclusively for Hindustan Lever.... The crucial advantage of the map displays is that they enable managers to see at a glance information which would otherwise be buried in separate files... The network... will reinforce the crucial bridge between head office managers and the customer—a link which is particularly difficult to maintain in developing countries with large rural populations and poor communications.... Rural markets populations are mushrooming in India for basic household goods such as packaged foods, soaps, detergents, and cosmetics.8

The United States, Canada, and some of the countries of Western Europe have the most efficient distribution systems in the world, while Singapore has the most advanced port authority. How can developing economies realize the same efficiencies? What will be the evolutionary stages in these developing distribution systems? Will they parallel the evolution of distribution system of countries like the United States or will they leapfrog stages, installing a modern system now? For example, wireless communication technology may permit the introduction of sophisticated inventory control techniques much more quickly than if hard wiring were required.

It would be instructive to compare developing economies with developed economies and to determine how much effort it will take to close whatever gaps that may exist. For example, the Japanese distribution system is built on the backs of hundreds of thousands of national, regional, local, and neighborhood wholesalers delivering goods to millions of small retail outlets. The system is crumbling, due somewhat to pressure by the United States to open Japanese markets, but due mostly to demands of Japanese consumers who are weary of paying exorbitant prices for products produced in Japan. Why have systems similar to those in Japan been slow to change? Is the resistance due to political agendas, such as the strong interest in maintaining full but inefficient labor employment in Japan, or are there economic/consumer behavior reasons for the differences? Will the demands of consumers promote greater efficiency through consolidation? Or are external trade pressures, especially from potential importers, more influential in producing economic progress?

Conclusion

It is very likely that one of the major problems and/or opportunities facing almost every organization, industry, or society has to do with some aspect of marketing channel design or management. This incredibly grandiose statement is not fancy. We would boldly assert, for example, that the answer to the healthcare concerns in the U.S. can be found in marketing channel theory, because the key to universal healthcare coverage as well as to cost containment lies with the design and management of cost effective healthcare delivery systems (i.e., marketing channels). We can also assert that the future success of the information superhighway depends on the way in which the information will be collected and distributed. The channels for information will be comprised of a wide variety of very disparate actors (e.g., cable, telecommunications, network television, publishing, retail, and motion picture companies) which may have trouble finding ways to 'bond,' in a relationship marketing sense. Even the resurgence of U.S. network television can be interpreted in marketing channel terminology; backward vertical integration into programming, now permitted by the Federal Communications Commission, seems to be the route that the networks are taking to assure their long-term survival.

To belabor the point further would be overkill. What we would hope is that marketing students, scholars and teachers give more attention to the distribution function so that they can help practitioners learn how to solve the problems or seize the very significant opportunities with which they are confronted. A body of literature exists that provides much of the theoretical foundation, but more of a problem-oriented approach now needs to be adopted if there are to be significant contributions to marketing practice.

Bon appetit!

References


