

Place (Distribution)

Place, more commonly called **distribution**¹, includes the organizations (a company and its partners), locations (quantity and type), and processes (physical, digital, intellectual) that:

- Enable the creation and fulfillment of customer demand, and
- Provide any required post-purchase service.

Effective distribution provides customers with **convenience** in the form of

- **Availability** (what, where, when - the right product, at the right place, at the right time)
- **Access** (customers' awareness of the availability and authorization to purchase)
- **Support** (e.g. pre-sales advice, sales promotion and merchandising, post-service repairs).

Distribution management has both strategic and logistical dimensions.

Strategic distribution is a competitive advantage that accrues generally from the configuration of a **distribution network** (who, what, where, when) and, more specifically, from the selection of partners (i.e. *middlemen*) who **intermediate** between the company and the customer by performing necessary fulfillment and service activities

Logistical distribution, which is geared to efficiently supporting the strategic objectives, refers to the **storage and movement of goods, information, and money** between the manufacturer and the final customer.² Logistics is sometimes inappropriately viewed as an exclusive operations function. In reality, marketing often has a major role in the day-to-day logistics process with functions ranging from sales forecasting and demand management³ to inventory

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This note was developed by Prof. Ken Homa as background for class discussions and is incomplete without extensive supplemental oral elaboration.

¹ In marketing jargon, "distribution" can be either a verb (to store and move goods) or a noun (places where goods are available, or entities involved in the distribution process).

² The movement or "flows" can be bi-directional. Information is constantly flowing in both directions. When customers return products, the logistics are reversed: goods flow from the customer back to the manufacturer, and money from the manufacturer to the customer.

³ Demand management is a proactive effort to shape demand patterns and customer expectations. For example, a company may incentivize pre-season orders to level out production requirements.

planning and the allocation of short supplies.

Marketing decisions regarding the structure of a distribution network (strategy) often set the bounds on the logistics service quality a company delivers, and the corresponding cost and investment economics.

Specific distribution-related decisions include:

- (a) the **number of layers** between the company and the customer (channel depth)
- (b) the specific **type of partners** in each layer (e.g. wholesalers or distributors, mass merchants or high-end specialty retailers)
- (c) the **number of partners** at each layer (channel breadth)
- (d) the **placement of partners** (location, density).

These strategic and logistical decisions frame the **distribution channels** (from a marketing perspective) or **downstream supply chain**⁴ (from an operations perspective) for a company's products.

Distribution Strategy

More specifically, a company's distribution strategy is largely defined by decisions on the number and type of **customer interfaces**. That is, **order entry points** (where and how orders are placed) and **fulfillment nodes** (where and how customers obtain finished goods).

At the extremes are two fundamental fulfillment options: **direct distribution** from the manufacturer to customers, and **intermediated (indirect) distribution** through **aggregators** that carry products from multiple suppliers (who may themselves be complementors or competitors).

For consumer products⁵, aggregators fall into two broad categories: **remote access** (catalogers, eCommerce companies) or **local access** (typically brick and mortar retail stores).

Remote access fulfillment typically involves the submission of an order via mail, telephone, or the internet to a centralized site with shipments made to a customer's specified location from one or more

⁴ The "downstream" supply chain goes from the manufacturer to the customer. The "upstream" supply chain goes from the manufacturer back to the input sources (i.e. raw material, parts, and component suppliers).

⁵ This note will focus on consumer products distribution. With minor "tweaking", the basic concepts are generalizable to industrial products and services.

remote distribution centers, usually via a 3rd party carrier such as UPS or FedEx.

Local access fulfillment is the traditional and still more prevalent form. Inventory is maintained at physical outlets for immediate on-site purchase by customers, or with remote orders placed for subsequent pick-up by customers.

An increasing number of manufacturers have implemented direct fulfillment capabilities. Manufacturers that fulfill directly typically do so remotely (from factories or central distribution facilities), though some have local presence with retail stores (e.g. Sherwin-Williams paints) or factory outlet stores (which are primarily used to clear excess inventories and outdated merchandise).

Some companies have coordinated their remote and local capabilities. For example, Best Buy allows customers to order on the web, and either receive direct shipments or pick-up (or return) products at local stores. Gateway has opened local stores for demonstrating products and closing sales that are remotely fulfilled.

In general, both direct and intermediated fulfillment are becoming increasingly integral to most companies' retail distribution strategy.

Retail Distribution Strategies

The development of a retail distribution strategy involves the type, number, and location of fulfillment partners.

For example, Coke seeks to be ubiquitous (“always within an arm’s length”) with very broad distribution across markets via numerous outlets of many different types (e.g. grocery and convenience stores, restaurants, vending machines)

At the other end of the continuum, some companies choose to distribute their products through relatively few, geographically clustered specialty stores (e.g. innovative, tech-based entertainment products distributed through electronics stores like Best Buy or Circuit City).

A retail distribution strategy is primarily driven by three inter-related objectives:

1. Broadening **market coverage**
2. Enlisting **product support** (from retailers)
3. Containing **channel conflict** (among retailers, and across channels).

1. Market Coverage

The primary objective of distribution strategy is to provide sufficiently broad, gap-free market coverage, i.e. being made available in enough outlets so that customers have convenient access for purchases.

For some products, effective coverage is achieved with **exclusive or selective distribution** through relatively few specialized stores; other products (like Coke) require **intensive distribution** with a dense, often heterogeneous population of outlets.

The appropriate level of market coverage is situation-specific, depending on **product characteristics**, and on **customers' buying behavior**.

For example, exclusive distribution may be appropriate for specialty goods (like expensive, high fashion watches) that are sought out by customers, that may require in-store selling, and that may even accrue an “**image halo**” from the apparent exclusivity.

But, sales of frequently bought, commodity-like products (sometimes called **convenience goods**) are often driven by **proximate availability**, so intensive distribution is usually appropriate and sometimes mandatory⁶.

Many products follow a systematic progression over their life cycle, moving from more exclusive to more intensive distribution as the product matures.

<u>PLC Stage</u>	<u>Primary distribution</u>
Introduction	Specialty stores
Growth	High service
Maturity	Mass merchants
Decline	Lowest cost

Measuring coverage

Market coverage can be quantitatively characterized as the number of outlets carrying a product as a percentage of total outlets (sometimes called **distribution coverage** or simply “distribution”), or **ACV** (all commodity volume) - the percentage of outlets carrying a product weighted by each outlet's category sales. For example, a small hardware store would count equal to a Wal-mart store in a

⁶ A marketing cliché is that these products and brands can't risk being “out of sight, out of mind” and must, therefore, be “in sight always”.

measurement of distribution coverage, but would be weighted less in an ACV metric.

Of course, the “quantity” of outlets carrying a product does not necessarily connote distribution “quality”, so metrics should be carefully tailored to reflect presence in strategically appropriate outlets. In many instances, being in the wrong places may be more harmful than being in too few places. In the development of a distribution strategy, “quality” is both critical and very specific with respect to product “fit” (e.g. prestige goods in high-end outlets) and retailer support.

2. Product Support

The second retail distribution strategy objective is to enlist product support. That is, to select and motivate partners who:

- (a) Maintain adequate inventories
- (b) Display the product in desirable locations (e.g. eye-level shelves, high traffic areas)
- (c) Advertise and promote (special displays and signing, discounted sales prices, inclusion in flyers and ads)
- (d) Sell the product (educating customers, demonstrating the product, ‘closing the sale’)
- (e) Install and service the product.

Measuring Support

Quantitative measures of support include the percentage of category shelf space, share of ads or promotions, the number of displays, order close rates, and customer satisfaction indices.

The ultimate support metric, though, is **share where carried** (percentage of category sales in stores that carry the product) relative to overall market share.

Exclusive and Shared Distribution

At the retail level, there are two distinct types of distribution: **exclusive distribution**⁷ (the retailer carries only one brand), and **shared distribution** among many brands. For example, soft drink brands share distribution in grocery stores (all major brands are carried), but have exclusive rights at some venues (e.g. restaurants, sports arenas, college campuses, vending machines). Securing distribution at the exclusive venues (that, by definition, offer 100% share where carried) typically requires companies to deeply discount prices or pay rights fees. Winning in shared distribution is a function of traditional day-to-day, hand-to-hand marketing combat, including strong brand recognition, aggressive pricing, prominent display presence, and demand-driving promotions.

Matching Products and Support

The specific support (level and type) that a product requires hinges primarily on the **product characteristics** (simple or complex; high end or mass market; position along the product life cycle).

At the most basic intuitive level, the required support depends on whether a product is “bought” (well known and demanded), or needs to be “sold” (unrecognized product, brand or need).

At one extreme, products that are highly innovative (new technology or uses) and distinctive (from other products and brands) may require aggressive selling at store level to educate customers and close the sale. So, specialty stores with highly motivated, well-trained personnel salespeople⁸ may be required, especially during the product’s introductory phases.

At the other extreme, for commodity-like products that are well known and understood, the distribution goal may be to establish very broad distribution coverage (i.e. a plethora of outlets, by type and in number). Since the products do not require much explaining or selling (i.e. they are bought not sold), the challenge is simply to provide convenience (availability and access), with occasional promotional emphasis. In these instances, mass merchants and discounters might be most appropriate.

⁷ Exclusive distribution is sometime called **binary distribution** since it is an all or nothing proposition.

⁸ Often, the motivation is driven by manufacturer “spiffs” which are special incentive payments made directly to salespeople based on product-specific sales. Similarly, salespeople are often trained by manufacturer’s representatives and provided with manufacturer produced sales aids (e.g. sales scripts, FAQs, reference articles).

Securing Distribution

Companies often find that their conceptualized ideal distribution pattern may be constrained by the willingness of retailers to carry and support the product. Securing distribution is often a formidable challenge, especially for small or unproven companies or brands.

In general, retailers make decisions on whether or not to carry a specific product based on the **prospective retail profitability** of the products.⁹ Among the factors commonly considered are:

- (a) gaps (versus duplication) in the retailers product line assortment
- (b) track record (credibility) of the supplier
- (c) projected retail margins (initially and over time)
- (d) anticipated promotion support (e.g. advertising, displays, “deals”)
- (e) compatibility of logistics infrastructures (location of facilities, information systems)
- (f) the supplier’s market position (clout)

Historically, manufacturers - especially big national brands – held the balance of power over most retailers and could, more or less, force them to carry products and provide support. In the past couple of decades, though, the balance of power has generally shifted to the retailers, largely due to retail consolidation (the big have gotten bigger) and the emergence of **power retailers** like Wal-mart and Home Depot.

Still, large prominent brands and companies (like P&G, Kellogg) that have proven track records, established customer relationships, and in-place infrastructures (e.g. regional DCs, real-time data links) have an advantage securing distribution quickly and broadly with target accounts, especially for new, high margin products. The potential financial returns for retailers are relatively high, risk is contained, and sometimes from a pragmatic perspective, the retailer has no real choice.

On the other hand, while small upstart companies may crave distribution through the power retailers, they often find that the high-volume retailers are reluctant to take on the cost burden and risk of reallocating valuable shelf space to unproven suppliers, brands, and products.

⁹ Sophisticated retailers think in terms of **direct product profitability per linear foot**, i.e. the true net profit a product generates relative to the space allocated to the product.

Slotting Fees

In part to defray initialization costs and mitigate risk (to the retailer), an increasing number of retailers have instituted **slotting fees**, payments made to the retailer whenever new products are adopted.

Many retailers set their slotting fees based on very liberal cost accounting that may overstate their incurred costs, and some even include an explicit profit mark-up that is over and above their set-up costs. The net effect of the escalating slotting fees is to raise the ante for securing distribution, sometimes to a level that erects **de facto economic barriers**, excluding all but the biggest, most deep-pocketed suppliers.

3. Channel Conflict

The third retail distribution strategy objective is to contain channel conflict.

Given that their prospective profitability is the primary reason that retailers carry products, projected profit margins and sales volume are critical variables.

On a macro basis, a product’s inherent market value drives customer demand, and largely determines aggregate sales volume and average pricing.

On a more micro basis (i.e. from the perspective of a specific retailer), sales are a share of the total sales volume in a specific trading area and margins are a direct function of prevailing (or lowest prices) offered by competing retailers.

Horizontal Channel Conflict

The implication is that the intensity of competition among retailers is a major driver of retailer support (or lack thereof). Invariably, as a product’s distribution base is broadened (more accounts, stores, and types of stores are added), the likelihood of **horizontal channel conflict**¹⁰ increases. As channel conflict increases, retailers’ support for a product typically decreases. While channel conflict can rarely be eliminated completely, it is critical to contain it.

In most instances, horizontal channel conflict boils down to a question of economics: retailer profits are pushed below acceptable levels as a result of direct or

¹⁰ Horizontal channel conflict is between and among organizations operating in the same “layer” of the distribution network. **Vertical channel conflict**, which will be discussed later, is between organizations at different levels of the network, e.g. between manufacturers and retailers.

indirect competitive behavior.

Horizontal channel conflict is increasingly common in real life as companies attempt to reach different customer segments by utilizing **multiple distribution channels** (including direct from the manufacturer).

More specifically, when multiple channels are employed and distribution intensity increases, three profit threats may confront a retailer: **sales cannibalization**, **margin dilution**, and **customer diversion**¹¹.

Consider the following cases:

- (a) A mature, commodity-like product is sold through traditional grocery stores that attempt to maintain margins at roughly 30%. The manufacturer makes a comparable product available through warehouse club stores that price to operate at 5% margins by maintaining a very bare bones overhead structure¹².
- (b) A broadly distributed, heavily advertised, branded product becomes a "traffic builder" for some retailers. That is, they price the product at or below cost to attract customers to their stores, hoping that the customers will also purchase other higher margin merchandise.
- (c) A new, complex product is introduced through a select group of specialized retailers who compete on service (i.e. front-end consultative selling) not price. As volume builds for the product, similar versions are offered through "category killer"¹³ discounters who offer no in-store service and compete based on low prices.
- (d) A manufacturer that has traditionally sold its products through full-service specialty retailers decides to have its salesforce call directly on particularly large customers, bypassing the retailers, and decides to hop on the eCommerce bandwagon by selling to price-sensitive customers via the internet at "factory direct" prices.

¹¹ Customer diversion is sometimes referred to as "channel leakage".

¹² By law, manufacturers may not dictate intermediaries' prices. The practice, called **retail price maintenance**, was at one time allowed under so-called "Fair Trade" laws that were intended to protect small and full service stores. Now, manufacturers may suggest but not enforce MSRP (manufacturer's suggested retail prices).

¹³ Retailers like Home Depot, Staples, and Toys 'R Us are usually called category killers since they dominate their respective product categories with very high, concentrated sales volume driven by low prices. Traditional retailers sometimes call this type of retailer "category margin killers" because of their low price strategies.

In all of the above cases, there is the potential for significant channel conflict that is virtually certain to deteriorate retail economics (i.e. lower sales, prices, and profits), which may result in a reduction of aggregate support for the products.

In case (a), if the grocery stores don't narrow the price spread, they will have some of their **sales cannibalized** by the warehouse stores and will likely lose market share since the market is mature (i.e. slow / no growth).

In case (b), all retailers are likely to suffer **margin dilution** to the extent that they cut prices (either on an everyday or promotional basis) in an attempt to maintain their market shares.

In case (c), the full service stores may have some of their **customers diverted** to the discounters. That is, customers may take advantage of the pre-sales service, but then buy at the low price outlet. Or the stores may suffer **margin dilution** if they accede to customers who benchmark against "low-balling" competitors and negotiate lower prices¹⁴.

Case (d) is often the most controversial and emotional of the channel conflict situations since the manufacturer is involved. The specialty store may be hit by a profitability triple threat: some sales will **cannibalized** by the manufacturer's direct sales force; some full-service customers will be **diverted** to buy directly from the manufacturer; and margins will be **diluted** if prices are reduced to match the factory direct prices.

In both cases (c) and (d), the full service retailers are likely to become economically demotivated and shift their sales attention to more profitable products. As a result, the product may lose its primary sources of market support.

As the above cases illustrate, the dominating distribution objective, broadening market coverage (i.e. increasing customers' convenience), is somewhat at odds with the other two - enlisting product support and avoiding channel conflict. While a company may want broad rather than selective distribution, and may want to attack different market segments through multiple channels of distribution, the stark reality is that intensive hybrid distribution may, if not very carefully managed, result in horizontal channel conflict, deteriorating retail economics, and eventual loss of critical retail-level product support.

¹⁴ This customer practice is commonly referred to as "best-balling", i.e. negotiating based on the lowest price found in the market.

Mitigating Channel Conflict

While some level of channel conflict is inevitable, especially as products mature, it can be (and should be) mitigated.

In order to contain the level of conflict, companies need to embrace distribution philosophies that:

- (a) **Adopt a long-run perspective** and refrain from opportunistic initiatives that may jeopardize established channel relationships for the sake of potentially transient short-term gains.
- (b) **Are respectful of system economics**, recognizing that channel partners must earn fair financial returns to stay motivated.
- (c) **Stay open and flexible** by avoiding restrictive long-run agreements (formal or “common law”) that foreclose adaptation to changing markets.

On a more tactical level, companies should:

- (a) **Avoid premature distribution through margin-crunching channels** despite their sometimes alluring potential to satisfy the “thrill of volume”.
- (b) **Delineate clear rules for territorial coverage and “account ownership”** so that competing channels (including the manufacturer direct channel) avoid fighting over the same set of customers.
- (c) **Build and maintain “fences” between competing channels** to minimize leakage. For example, many companies market different brands to different intermediaries, or offer derivative models that are similar to, but different from their base products, that match the needs of different channels (e.g. newest full featured models to specialty stores, older “stripped down” models to discounters), and that “shelter” retailers from head-to-head price competition.

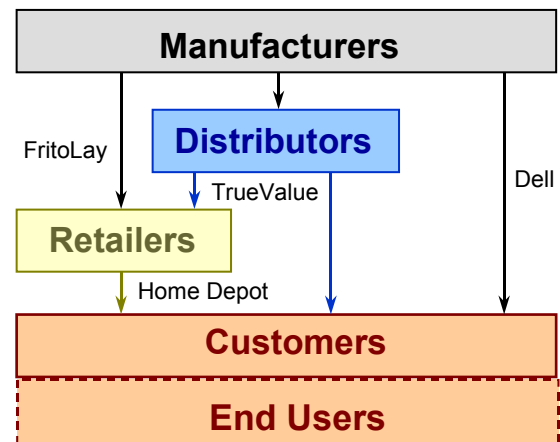
Distribution Logistics

The second dimension of distribution is logistical.

Again, a company’s distribution strategy is largely defined by decisions on the number and type of customer interfaces.

Once the retail distribution strategy is set, the management focus shifts to distribution logistics (i.e. moving goods from the manufacturer, through any intermediaries, to the customer).¹⁵

To achieve its strategic distribution objectives, a company may choose to use few layers of intermediaries (called **short distribution channels**), or relatively many layers (**long distribution channels**).



For example:

Dell sells directly to customers.

Frito Lay distributes directly to retail stores.

Home Depot stores receive most shipments directly from manufacturers.

Cotter- TrueValue (a hardware cooperative) receives shipments from many manufacturers and redistributes to independent hardware retailers

¹⁵ For logical simplicity, this discussion considers the link between strategic and logistical distribution to be sequential. In reality, the linkage iterative, not sequential.

At one extreme, the shortest of channels is **direct distribution**, i.e. a customer places an order directly with the company, and the company ships the goods directly to customers.

In the 'old days', direct distribution was largely restricted to higher priced products (like industrial equipment) or to companies with relatively broad lines of high volume products that could be aggregated to provide the necessary operating efficiencies of scale or scope (e.g. catalog companies like Lands End).

In the digital era, an increasing number of companies are willing and able to distribute to customers directly.

From a logistical perspective, the web provides a cheap, effective way to process customer orders, and efficient package delivery networks (UPS, FedEx) provide a relatively cost-effective way to transport small quantity orders directly to customers. Further, since finished goods inventory can be centralized, service levels can be maintained at high levels with relatively low stocks (largely because of lower required safety stocks).

At the other logistical extreme are long, highly **intermediated distribution channels**. For example a company may sell to a specialized distributor who sells to a wholesaler who sells to a retailer who sells to a final customer.

Rationale for Intermediation

The rationale for intermediation can be illustrated with a very simple illustration: consider a relatively small set of 5 complementary suppliers that all sell to a common population of 100 customers. If each supplier were to sell directly to all of the customers, there would be 500 supplier-customer interface links (5 suppliers times 100 customers).

What if, an intermediary were inserted between the suppliers and the customers to aggregate products from the 5 suppliers for shipments to the same customers? That is, customers place orders with the aggregators and receive consolidated shipments directly from them.

Simple mathematics simplifies the system by cutting the number of interfaces from 500 to 105 (5 links between suppliers and the aggregator, and 100 links between the aggregator and the customers).

Several insights can be drawn from this simple illustration and common sense:

- (a) **Intermediaries can add real value**. Broadly speaking, intermediaries typically perform one or more of four basic functions:

Breaking Bulk: taking large quantities (truck loads, pallets) and “breaking” them into smaller units (e.g. mixed cases of individual units)

Modifying products in ways that range from simple repackaging, labeling, and price-marking to light manufacturing and final assembly (e.g. merging base products and locality-specific add-ons such as power supply modules)

Creating assortments: gathering products that customers want to receive on single orders.

Batching orders for improved operating efficiency

- (b) **Intermediaries can materially improve distribution economics**. From an economic perspective, a manufacturer may lack the **scale, scope, systems or specialized knowledge** required to perform all distribution activities effectively.

As in the illustrative situation above, a distributor may be able to aggregate products from multiple suppliers and sort orders from many customers into economical batches that enable cost-effective order processing and transportation¹⁶.

Further, intermediaries may have, based on their experience, developed **best practices** (i.e. tailored operating procedures) that may be supported by targeted investment in specialized, high-efficiency equipment. Manufacturers may be reluctant to make such specialized investments.

And more broadly, manufacturers may have no practical choice but to engage intermediaries as a means of **syndicating investment**. For example, it would be financially prohibitive for soft drink companies to own all of the bottlers in their worldwide distribution network, even if such structure would be strategically desirable. The investment would simply be too big for any one company.

¹⁶ Transportation rate schedules significantly disadvantage small shipments that are inherently costly. The most expensive combinations are small quantities (like single units) shipped for fast-delivery (same or next day).

(c) **Intermediaries can develop extraordinarily deep market presence and customer relationships.**

Often, intermediaries have particularly keen market knowledge since they are closer to the market than manufacturers.

Some customers prefer dealing with intermediaries since they simplify transaction interfaces (efficiency), offer a broad line of products (choice), and provide an apparently independent, customer-oriented perspective (impartial credibility). As a result, intermediaries often develop strong, leveragable relationships with customers that manufacturer's have difficulty replicating. Said differently, a drawback of intermediation is that it distances manufacturers from their customers.

Channel Length

Most typically, the length of distribution channels falls somewhere on the continuum between direct and heavily intermediated.

From a conceptual perspective, the decision as to where on the continuum a company should operate depends on two key factors:

- (a) **Scope and nature of the value added services** required to take a product from the manufacturer to customers
- (b) **Relative effectiveness (cost and service quality) of alternative providers** of the services

Value-added Distribution Tasks

More specifically, certain value-added logistics tasks must be performed to distribute a product.

In the simplest cases, a customer order must be processed (received, validated, credit checked, matched to inventory, scheduled for shipment) and the product shipped to the customer, either from the end of the production line (make to order) or out of some company's inventory (make to stock).

In more typically complex cases, products may need to be bundled with other products (e.g. to compile a usable system, or to accrue quantity discounts for transportation economies), slightly modified to meet customer specifications (e.g. small features added or deleted, bulk quantities may be packaged into smaller units), installed and fine-tuned at the customer site, and serviced after it is put in use.

Once the necessary value-added activities are

identified, the pivotal question is: who can most effectively perform the activities from both cost and quality perspectives - the company or third party intermediaries.

If a company operates under the direct model, it must perform all of the value added activities. By doing so, the company is able to retain all of the system profits (the difference between total accumulated costs and the price customers pay for the product).

If a company has an infrastructure in place (facilities, people, systems) and has adequate relevant scale (i.e. enough volume to make operations economical), then direct distribution may be a viable alternative.

Channel Disintermediation

During the eCommerce frenzy, many start-ups built their business propositions on the back of **disintermediation** – that is, eliminating one or more participants in an established supply chain.

The rationale for disintermediation was that eliminating “costly middlemen” could increase system profits (by paring unnecessary activities and costs) and would shift profits to the disintermediator.

So, by distributing more directly to customers (i.e. disintermediating), eComm companies could, at least in concept, cut prices (passing along some of the cost savings) and earn high profits (in part by recapturing profits currently being pocketed by the middlemen).

But, sometimes lost in the disintermediation frenzy was the very basic fact that most (if not all) of the activities that intermediaries do, need to be done by somebody. If the intermediaries don't do them, then either the company must, or customers must (e.g. placing orders directly via the net, picking-up merchandise at drop-off depots, getting help from ‘intelligent’ phone systems). By definition, necessary value-added activities don't just go away!

In many (bordering on most) instances, companies find that intermediaries (such as distributors) have better facilities, have specialized knowledge and processes, and have the relevant scale (an adequate volume of related products) to do a more efficient job on many value added activities.

For example, an industrial products distributor can assemble big, multi-product orders that are more economical to ship.

And, with very few exceptions (e.g. Gateway, Sherwin-Williams, the Gap), manufacturers conclude that operating their own brick and mortar stores are neither necessary nor economically viable.

Many companies that tried to disintermediate discovered that they are not capable of performing many of the tasks economically since they don't have the necessary economic scale or specialized competencies. The disintermediated systems turn out to be less quality- and cost-effective, and the companies are forced to **reintermediate**, by adding complementary intermediaries.

Outsourcing

Similarly, many companies that have traditionally distributed directly to customers have started **outsourcing** distribution activities to third party experts.

These companies have concluded that basic distribution activities are important, but not strategic to their businesses, that they lack core competencies in the functional areas, and that they lack the relevant volume to be cost-effective.

They enlist the services of specialized distribution companies and turn over all or parts of the distribution processes to them. In other words, they intermedate systems that were previously disintermediated.

The bottom line is that while some intermediaries may be inefficient or gouge for unreasonably high profits, the evolutionary survivors are typically effective at their specialized tasks (i.e. competitive costs and quality), and price their services for a fair profit.

So, most companies optimize their cost and quality of service through a network of intermediaries, each performing some necessary value added activities for which they are compensated (to cover their costs and generate profit).

Supply Chain Management

Managing a network of intermediaries is a formidable challenge, especially for long distribution channels.

From the logistical perspective, the process is called **supply chain management (SCM)**.

SCM's goal is to construct a chain of partners that optimizes cost and service quality as a system (i.e. achieving a global optimum).

More specifically, there are four keys to effective supply chain management:

- (1) *Smooth synchronization: of activities*
- (2) *Fact-based evaluation of performance*
- (3) *Fair compensation for services*
- (4) *Authentic commitment to partnership*

(1) Synchronization

Synchronizing the supply chain is, in essence, getting all of the partners operating in a manner that is mutually supportive (flexible, cooperative) and seamless (smooth, unnoticed by customers).

The synchronization process starts with a clear definition of **roles and responsibilities**. That is, making sure that all supply chain partners know specifically what tasks they are expected to perform (e.g. storing goods, modifying them, reassembling quantities, price marking), when they are expected to do them (lead times and deadlines), how they are expected to perform them (i.e. to what operating specifications), and what results are expected (sales quotas, customer satisfaction ratings).

Often, **vertical channel conflict** (i.e. between layers of the supply chain) occurs due to ambiguous or conflicting roles and responsibilities. That is, conflicts such as poor service levels, passive sales efforts, and missed deadlines.

On a day-to day basis, many tasks and activities require **operating synchronization**: entering orders, conforming schedules, tracking shipments, communicating status information, invoicing, collecting payments, processing returns, resolving disputes¹⁷. Whenever a partner has a **process failure**, the entire supply chain may be disrupted and annoying **operational conflict** may occur.

PSI Planning

Over time, the bulk of the operating synchronization activity is **PSI planning** (production, sales, and inventory) which is the information-based scheduling of product flows throughout the system.

PSI planning, which is a marketing functional responsibility in many companies¹⁸, begins with a forecast of future **demand** (unconstrained by operational factors such as capacity limits) that is meshed against current and targeted **inventory** levels (depleting excesses, accumulating for peak periods) to determine a desired level of new **production**. The manufacturing functional organization then applies the constraints¹⁹ to set a feasible production schedule. The planned new production is matched with the inventory plan to determine the expected level of anticipated **sales** (demand adjusted for constraints) that can be reflected in sales quotas and sales compensation schemes.

Keeping in mind that distribution is granular and temporal (i.e. the right product at the right place at the right time), the PSI must be planned for each step or stage in the supply chain²⁰. So, as supply chains get longer (i.e. more layers added) and more complex (i.e. more types of intermediaries), the PSI planning process becomes more challenging.

The key to effective PSI planning is accurate, timely information flows.

Supply chains move both goods and information, and, generally, it is both cheaper and faster to move digital information than physical goods.

¹⁷ It is increasingly common for many of these tasks to be executed digitally (i.e. computer-to-computer), elevating the need for companies to implement reasonably state-of-the-art information systems that are compatible with those of adjacent supply chain partners.

¹⁸ Some companies assign PSI planning to logistics organizations; an increasing number of companies are now establishing dedicated organizations called "Supply Chain Management". Even under these organization schemes, marketing plays an important role.

¹⁹ These constraints may be hard constraints (can't) or soft constraints (don't want to). For example, plant capacity is a hard constraint; unwillingness to work overtime is a soft constraint).

²⁰ This granular level of planning is usually called DRP: distribution requirements planning

Demand Flow – ECR

Accordingly, many supply chains have shifted from a traditional **push system** (the manufacturer projects demand and pushes inventory to intermediaries who are responsible for storing the inventory until it is sold through) to an efficiency-based pull or **demand flow system** (real-time information triggers orders for inventory that flows through the system).

Companies that plan effectively based on real-time information are able to eliminate inefficient physical moves (e.g. accumulation of excess or obsolete inventory, premium transportation for small shipments) and dramatically increase the efficiency of their supply chains

Some companies have taken PSI planning to very high levels of cooperative sophistication. For example, P&G was the pioneer in a process called **efficient customer response**. The essence of **ECR** is to link the supplier (P&G in this case) with distribution channel partners (such as Wal-mart and Kroger) so that real-time PSI information flows in up and down the supply chain (from supplier to retailer and back) as a basis for scheduling operationally efficient movements of goods. ECR is the current pinnacle of supply chain synchronization.

(2) Performance Evaluation

The second key to effective supply chain management is fact-based evaluation of performance of supply chain partners.

These evaluations should be on-going (bordering on real-time), objective (i.e. quantitative whenever possible), and directly linked to customers' escalating service quality expectations.

For example, customers reasonably expect at least:

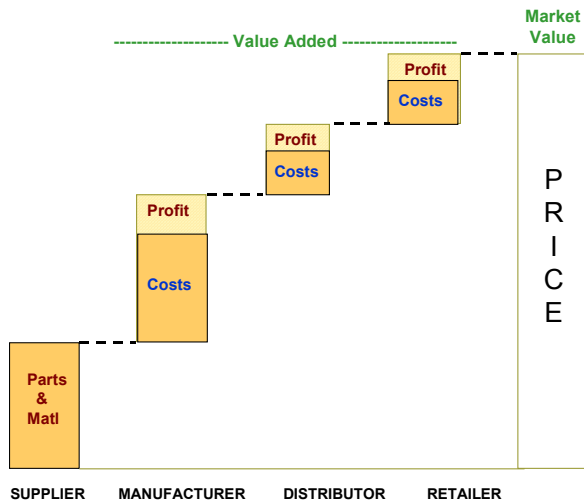
- Hassle-free order entry (prompt, user-friendly)
- High fill rates (available when ordered)
- Consistent cycle times (predicable order to receipt times)
- Dependable deliveries (on time, intact)
- Timely order tracking (real-time status)
- Accurate invoicing (right quantities and prices)
- Appropriate post-sales service (installation, returns, repairs)

So, specific metrics should be adopted that measure performance along these dimensions.

(3) Fair Compensation

The third key to effective SCM is fair compensation for services provided.

The underlying principle of fair compensation is that all high performance supply chain partners are entitled to earn an acceptable return for the value added services that they provide.



Customers pay some final price to acquire a product based on how they value the perceived benefits that the product delivers.

The price paid can be thought of as the sum of the accumulated costs (e.g. basic inputs like parts and materials, and the cost of value added services), the aggregate profits earned (at each step of the supply chain), and the actual value added (reflecting how much customers benefit from the product).

The difference between the price and the accumulated costs is the aggregate profit to be shared by supply chain partners.

Assuming that aggregate profits are generally fair, the question is how to apportion the pool, and whether the result is specifically fair to each supply chain participant.

At all levels, partners expect (and are entitled to) fair profits. These profits are most appropriately evaluated relative to the corresponding level of investment, i.e. the ROI earned.

If all performing partners (high quality, low cost) earn an acceptable return (based on their goals), the system is in equilibrium. If partners are undercompensated (again, based on their expectations), they are likely to opt out of the system or compromise the quality level of services provided.

For example, consider the soft drink industry's economic profile:

- Concentrate producers (Coke, Pepsi) earn high ROIs, driven by very high margins on syrup, a relatively low investment in physical assets, and high spending on brand-building promotion;
- Bottlers, who generally have less aggressive ROI targets than the CPs, have substantial investments in assets (bottling plants, trucks), earn modest margins from retailers and restaurants, and earn very high margins on vending machines;
- Retailers (like grocery chains) earn high ROIs despite low percentage margins, because they get substantial promotional support from concentrate producers and bottlers that accelerates inventory turnover to very high levels;
- Restaurants earn high ROIs from very high margins on beverage sales that complement their lower margin food sales.

The bottom line is that all channel partners in the soft drink supply chain earn acceptable returns (albeit in very different ways, and based on their idiosyncratic internal goals) and the system is, more or less, in equilibrium.

(4) Partnership Commitment

The fourth key to effective supply chain management is an authentic commitment to partnership.

In the past, supply chain relationships were often arm's-length and sometimes adversarial. Now, most companies recognize that an efficient supply chain is a competitive necessity that is best achieved through "true" cooperative partnerships that include:

- Agreement to mutually beneficial objectives (strategic and operational)
- Confidence in respective abilities to execute (to minimize "checking" and task duplication)
- Openness, including a willingness to share proprietary information (i.e. "open the books")
- Timely and forthright communications regarding both opportunities and challenges
- Flexibility to respond to "outlier" situations such as rush orders, special handling, credit crunches.
- Adaptability to change, including a willingness to "go own ways" when interests diverge.

Conclusion

Distribution, which is arguably the least understood and most overlooked of the traditional marketing Ps (place), is becoming central to many marketing strategies (especially in electronic commerce) and fundamental to a companies' operational effectiveness.