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C.7 Channel Organization

ALTERNATIVE FORMS OF CHANNEL ORGANIZATION

Selecting a form of channel organization is one of the decisions made in designing the channel of distribution. The channel organization decision interacts with other channel design decisions, especially the program to achieve **channel cooperation** and the **direct versus indirect** decision (see GLOSSARY entries C.6 and C.10).

Trends in Distribution Channel Organization. Major changes have occurred in the organization of distribution channels in the United States in recent decades.[1]

Historically, distribution in our economy has been dominated by **conventional channels,** informal, loosely organized networks of independent manufacturers, wholesalers, and retailers. Members of conventional channels operate autonomously, each motivated to achieve its own goals. Differences

[1]See Bert C. McCammon, Jr., "Perspectives for Distribution Programming," in *Vertical Marketing Systems,* ed. Louis P. Bucklin, (Glenview, Ill.: Scott Foresman & Co., 1970), pp. 32–50.

in these goals often lead to conflicts among channel members that are settled by competitive negotiation rather than by cooperation. Individual channel members tend to be small, adhere to customary ways of doing business, and offer traditional services. In many cases, these characteristics have led conventional channels to be economically inefficient and ineffective in delivering a unified marketing program to consumers.

Vertical marketing systems are displacing conventional channels in many areas of distribution. **Vertical marketing systems** are centrally controlled networks of firms that are coordinated in carrying out marketing programs for products that they distribute. How do vertical marketing systems compare with conventional channels? (1) Unlike conventional channels, vertical marketing systems utilize centrally prepared marketing programs. (2) The firms in a vertical marketing system may or may not be independent businesses, but their marketing activities and decisions are directed and coordinated by centrally prepared marketing programs. (3) In a vertical marketing system, marketing functions are assigned to units in the system based on who can best and most efficiently carry out the task rather than being based on historical precedent. Finally, (4) the membership in a vertical marketing system is more closely controlled with the result that it tends to be more stable.

Types of Vertical Marketing Systems. Vertical marketing systems are classified in terms of the means used to exercise control over channel members.[2] The institution in the channel that has dominant control is called the **channel captain** (see GLOSSARY entry C.6). The channel captain can be any of the channel institutions with sufficient power to control channel members. Although any channel institution might be channel captain, today large manufacturing firms or large integrated chain retailers most often play that role.[3] Few independent retailers or wholesalers have the power or the resources to lead the channel. It is the channel captain that takes the initiative in establishing a vertical marketing system.

There are three classes of vertical marketing systems, although the distinction between them is sometimes blurred. In order of the formality of control, they are administered, contractual, and corporate systems.

- *Administered Systems.* The vertical marketing system most like a conventional channel is the administered system. In **administered systems,** channel leaders have dominant power that allows them to persuade the other system members to coordinate their activities and cooperate in the marketing of products.

  What is the source of this power? A manufacturer can gain power by developing dominant brands that are indispensable to other channel members, by developing and sharing marketing expertise, and by taking the initiative in providing marketing and merchandising programs for their products. Procter and Gamble would be an example of a firm that has developed this kind of dominance in many of its product lines. Integrated chain retailers can also develop channel dominance, thereby permitting an administered system. Their dominance is likely to stem from the power of their retail distribution system. Wal-Mart would be an example of a retailer leading its own administered system.

  In addition to exercising power, the leader of an administered channel must provide the incentives to cooperation normally available in conventional channels. These include discounts and allowances, rights to distribute the product, and various customer services (see GLOSSARY entry C.6).
- *Contractual Systems.* Probably the fastest growing form of vertical marketing system is the contractual system. **Contractual systems** are more formalized than administered systems, using contracts to assure compliance with the marketing program and to define the roles to be played by channel members.

  Three types of contractual systems are com-

[2] The classifications and their description are based on McCammon, "Perspectives for Distribution Programming," pp. 32–50.

[3] See Robert W. Little, "The Marketing Channel: Who Should Lead This Extra-corporate Organization," *Journal of Marketing* 34 (January 1970), pp. 31–8.

monly identified, although there are many variations of each. They are retailer cooperative groups, wholesaler cooperative groups, and franchise systems. Retailer cooperative organizations are formed by independent retailers who agree to pool their purchasing through a cooperatively owned wholesaling operation, thereby gaining buying power. In addition, the cooperative organization sometimes provides other services, such as advertising and merchandising aids, record keeping systems, and store management assistance. Retailer cooperative organizations provide a means by which smaller independent retailers can compete more effectively against large chain retail organizations. Wholesaler cooperative groups are like the retailer groups except that they are sponsored by large wholesale firms. They provide buying power through pooled purchases and a variety of standardized merchandising and store management sytems. Retailer and wholesaler cooperative groups are major market factors in such markets as hardware (ACE Hardware), auto parts (NAPA), groceries (IGA), and drugs (Economost).

In franchise systems the sponsoring organization offers a license to a retail or wholesale organization to conduct business under the franchise name. Well-known franchise systems include fast-food outlets (like McDonald's), automobile dealerships (Ford), and soft drink bottlers (Coca-Cola). In exchange for a franchise fee and investment in the business, franchisees are able to use the franchise name, gain rights to market the product, and benefit from its promotion. They also receive merchandising and management assistance. In return, the franchisee must agree to adhere to marketing and management policies established by the franchisor and, usually, must purchase product from the franchisor or from designated suppliers.

- *Corporate Systems.* When a business integrates vertically by owning the channel members through which it distributes its product, it is termed a **corporate marketing system.** Ownership of the members of the channel allows the channel captain to set common goals, thereby reducing conflict. Gaining compliance with a common marketing program is easier to achieve when all members work for the same firm.

Corporate systems can evolve from forward integration (movement toward the market) by manufacturers or backward integration by retailers and wholesalers (movement toward production). Many manufacturers open their own sales branches or operate their own warehouses so that they can bypass wholesalers, thereby forming partial corporate distribution systems. Less common are manufacturers that integrate all the way to the market by opening their own retail outlets. Thom McCann (Melville) shoe stores, Sherwin Williams paint stores, and Goodyear tire stores are the retail elements of such fully integrated corporate systems.

Backward integration by retailers is very common among large chain retailers that have distribution centers and central buying organizations that perform the wholesaling function. A few large retail organizations have further integrated and gained control over some elements of production. Sears has a policy of maintaining an equity interest in many of its largest suppliers. Some food chains have their own bakeries and dairy products processing plants. Each of these becomes, at least in part, a corporate system.

SELECTING A CHANNEL ORGANIZATION FORM

In designing the channel of distribution, the marketer must decide whether a conventional channel or a vertical marketing system will be used.

Advantages and Disadvantages of Vertical Marketing Systems. From the description, it may appear that vertical marketing systems are always the preferred channel choice. However, such is not the case. There are many products and many companies for which conventional channel membership is superior.

Vertical marketing systems have disadvantages as well as advantages. Looking first at the advantages, vertical marketing systems offer these attributes.[4]

- *Distribution Economies.* The most often mentioned advantage of vertical marketing sys-

[4]Michael E. Porter's discussion of the benefits of vertical integration is very helpful in understanding the benefits of vertical marketing systems. See *Competitive Marketing Strategy* (New York: Free Press, 1980), chap. 14.

tems is that they offer the potential for more efficient, lower-cost distribution. There are several opportunities for economies. By agreeing to combine operations (such as buying, warehousing, or manufacturing), vertical marketing systems can realize economies of scale. This includes economies from greater utilization of facilities, pooling of buying power, or investment in technology not available to small operators. Closely related to this, vertical marketing systems realize efficiencies from standardization. For example, a standardized store design, once prepared, can be used over and over with little additional cost. Efficiencies also occur as duplication is eliminated within the system. Agreements can be reached that assign roles to channel members so that each member specializes and roles do not overlap. It is argued that vertical marketing systems, once established, are more efficient because individual transactions do not have to be negotiated since they are covered by a longer-term, system-wide agreement.

- *Marketing Control.* The availability of distribution economies through vertical marketing systems is a matter of dispute and probably varies widely by situation.[5] In practice, marketers are more likely to turn to vertical marketing systems for the same reason that they turn to direct distribution: to gain control over the marketing program for their products. Under a vertical marketing system, member goals become more congruent and conflict among channel members is lessened. The channel system leader can develop a marketing plan and use it to direct the marketing activities of all channel members. The result is a more coordinated marketing effort. Having some control over channel member activities gives assurance that the planned marketing mix will reach the consumer, helps the marketer maintain control over product and service quality, and improves the ability of marketers to develop competitive differentiation in their products.
- *Environmental Uncertainties.* Distribution through a vertical marketing system removes some of the environmental uncertainties facing products. For wholesalers and retailers, membership in a vertical marketing system can assure a source of supply for desired products. For a manufacturer, it can mean a stable and assured market for its products. There are market situations in which conventional channel members are simply not available for some products. This can lead a manufacturer to form a vertical marketing system as the only alternative for getting the product to market. Likewise, a retailer or wholesaler may form an integrated system in order to obtain a product not otherwise available to them. Vertical marketing systems can also provide insulation against competitive activities. System members will be less influenced by competitive promotions, price changes, and new products if they are members of an established, productive channel system. Vertical marketing systems tend to have more stable membership than do conventional channels.

These advantages of vertical marketing systems are offset by some disadvantages.

- *Loss of Incentive.* In establishing a vertical marketing system, some of the incentive for efficiency and innovation that stems from competiton is lost. In conventional channels, potential channel members vie with one another to be included in the channel. Retailers and wholesalers compete for distribution rights to a product and manufacturers compete to get the best wholesalers and retailers. This competition results in pressure to keep costs and prices low and pressure to enhance the services offered. Competition also provides incentive to develop innovations in hopes that they will result in membership in the channel. In a conventional channel, a channel member is free to choose the best technology, innovation, or product available, regardless of its source.
- *Investment Requirements.* Establishing a vertical marketing system can require a substantial investment on the part of the channel leader. The more controlled the form of system, the greater the likely investment. Integrated corporate systems that require purchase or development of warehouses, retail stores, and creation of sales forces require huge investments. Although some economies may be realized through formation of the systems, the resulting return on investment may be low. Conventional retailers and wholesalers operate on extremely narrow margins and the resulting

[5]For a test of vertical marketing system economies in the insurance field, see Michael Etgar, "Effect of Administrative Control on Efficiency of Vertical Marketing Systems," *Journal of Marketing Research* 13 (February 1976), pp. 12–24.

return on investment is often not great. It is also easy to underestimate the managerial time required to establish and operate a vertical marketing system. The time required is often increased because managers are thrust into a phase of business in which they are not experienced.

- *Inflexibility.* Vertical marketing systems are less flexible than conventional channels. Once the investment has been made in establishing a system, it is important that all sales volume be put through the system in order to recoup the investment. Establishing a vertical marketing system tends to add to the firm's fixed costs, making it more leveraged. Losses during downturns are exaggerated. Members of vertical marketing systems are less able to respond to changes in market conditions. In conventional channels, members are able to change suppliers or middlemen to ones best suited to current conditions. They are able to pick and choose among suppliers to get the best product or the best technology.

Criteria for Deciding on Channel Organization. Both vertical marketing systems and conventional channels have their advantages and disadvantages. In making the choice, marketers must fit the channel organization to the needs of the product, the capability of the firm, and the conditions in the market. Six criteria, in the form of questions to be addressed in making the decision, are suggested below.

- *What Level of Power Does the Firm Have?* In order to form and control a vertical marketing system, a firm must have dominant marketing power. Sources of that power were discussed earlier, but it is likely to be based on control over substantial sales volume, well-known brands, or a distribution network. Firms without market power may wish to join a vertical marketing system (a retailer joining a wholesale cooperative group, for example), but will not be in control of that channel.
- *What Is the Potential for Economies?* If the potential for distribution economies is high, then vertical marketing systems will be more attractive. Potential for distribution economies will be high when the firm controls great sales volume and when distribution cost is high in proportion to total cost. Small firms, single product firms, and those with minimal product handling costs will usually find conventional channels most efficient.
- *How Much Marketing Cooperation Is Needed?* The greater the amount of participation and cooperation needed from channel members to market the product successfully, the greater the need for a vertical marketing system. If a manufacturer needs specialized selling, high levels of customer service, or complex inventory handling, then vertical marketing systems will be more attractive as a means of obtaining the required channel assistance. The same is true for retailers that require customized designs, promotional assistance, or special order processing. Products that "sell themselves" and that can be handled routinely by channel members may be better off in conventional channels.
- *Are Appropriate Channel Members Available?* It is not unusual to find that no appropriate channel is available to distribute a product. This may be because there are no middlemen serving the target market, they are unwilling to accept the product, or they are unwilling to cooperate with the desired marketing program. In such cases, the marketer may be forced to establish an integrated channel, developing or contracting with wholesalers or retailers. Backward integration can also be used if a retailer or wholesaler is unable to find a source of supply for a desired product and elects to develop or contract for manufacturing capacity.
- *Is There Potential for Competitive Differentiation through the Channel System?* There are situations in which establishing a differentiated channel organization will provide a competitive advantage. Many years ago, McDonalds established a franchise system for fast food that provided the control necessary to assure uniform national delivery of food service. This gave the firm competitive advantage over independent restaurants using conventional channels.
- *Is There a Competitive Threat from Integrated Systems?* In some markets, large integrated channel systems realize economies and marketing advantages that threaten the existence of small firms using conventional channels. In such cases, the small firm should consider joining a vertical system to realize some of the advantages being realized by the large integrated firms. Independent food stores, for example, have found it advantageous to join buying cooperatives to gain buying power efficiencies such as those realized by chain stores.

SUGGESTIONS FOR FURTHER READING

ETGAR, MICHAEL. "Effect of Administrative Control on Efficiency of Vertical Marketing Systems." *Journal of Marketing Research* 13 (February 1976), pp. 12–24.

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