When You Finish This Chapter, You Should

1. Understand what product classes suggest about Place objectives.

2. Understand why some firms use direct channel systems while others rely on intermediaries and indirect systems.

3. Understand how and why marketing specialists develop to make channel systems more effective.

4. Understand how to develop cooperative relationships and avoid conflict in channel systems.

5. Know how channel members in vertical marketing systems shift and share functions—to meet customer needs.

6. Understand the differences between intensive, selective, and exclusive distribution.

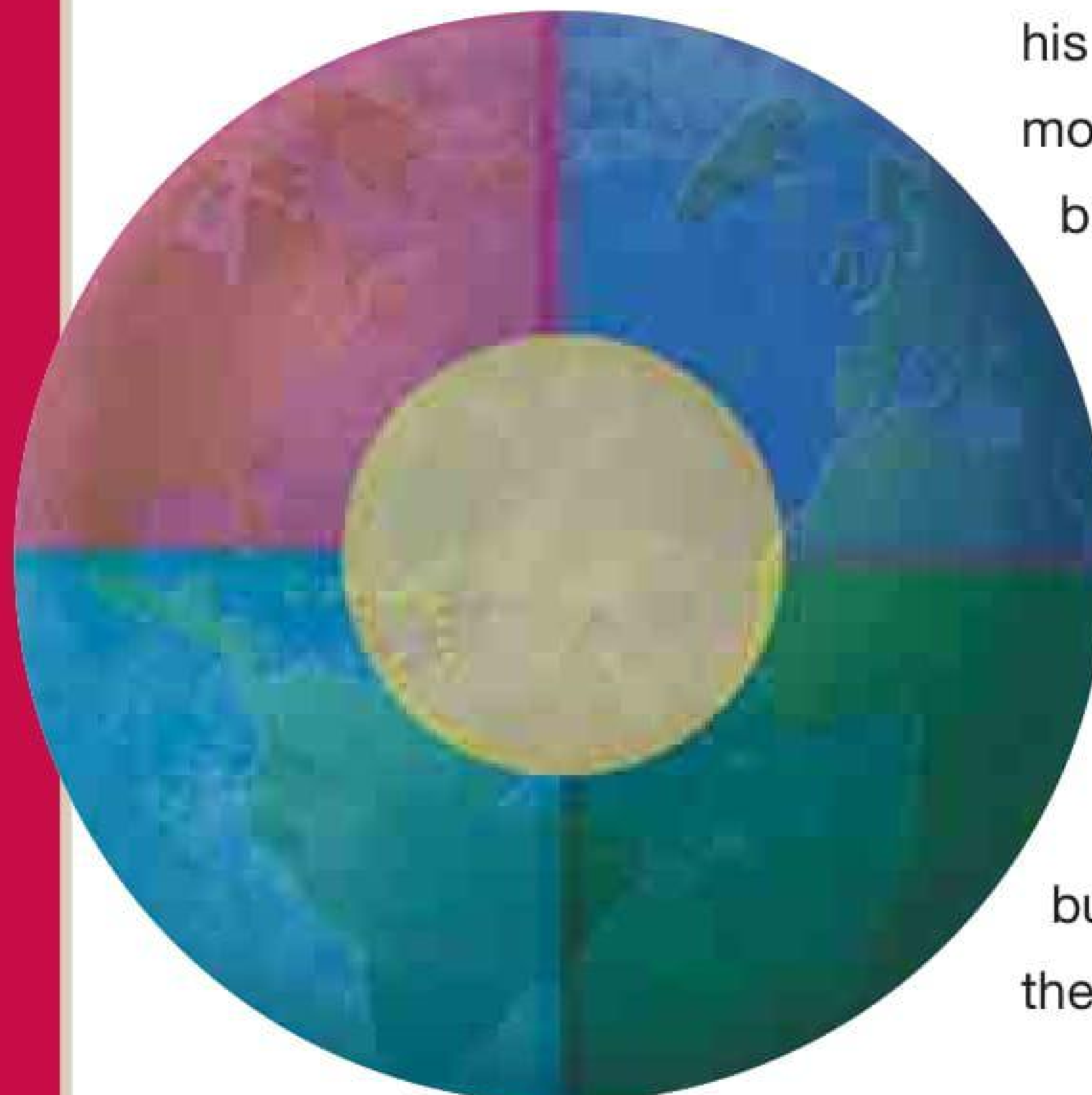
7. Understand the important new terms (shown in red).

Chapter Eleven

Place and Development of Channel Systems

Steve Bollic's small firm creates video game software. In the summer of 2001, he learned that Ingram Book Group, a book wholesaler, had formed an alliance with Valley Media, Inc., a distributor of music and entertainment products. Most people in his product-market would have glossed over that news, but in his previous job Bollic had gotten a taste of what it might mean: tough new competition from game producers whose distribution channels focused on the big retail chains.

Bollic had been a manager for the Intimate Bookshops, a small chain of shops that for decades had been *the* place to buy books in his college-town market. He moved on to start his video game business even before the Intimate had its final clearance sale and closed its doors for good. After all, sales of books through independent bookshops dropped by over 25 percent in the 1990s. Like the Intimate, many went out of business because of changes in the channels of distribution for

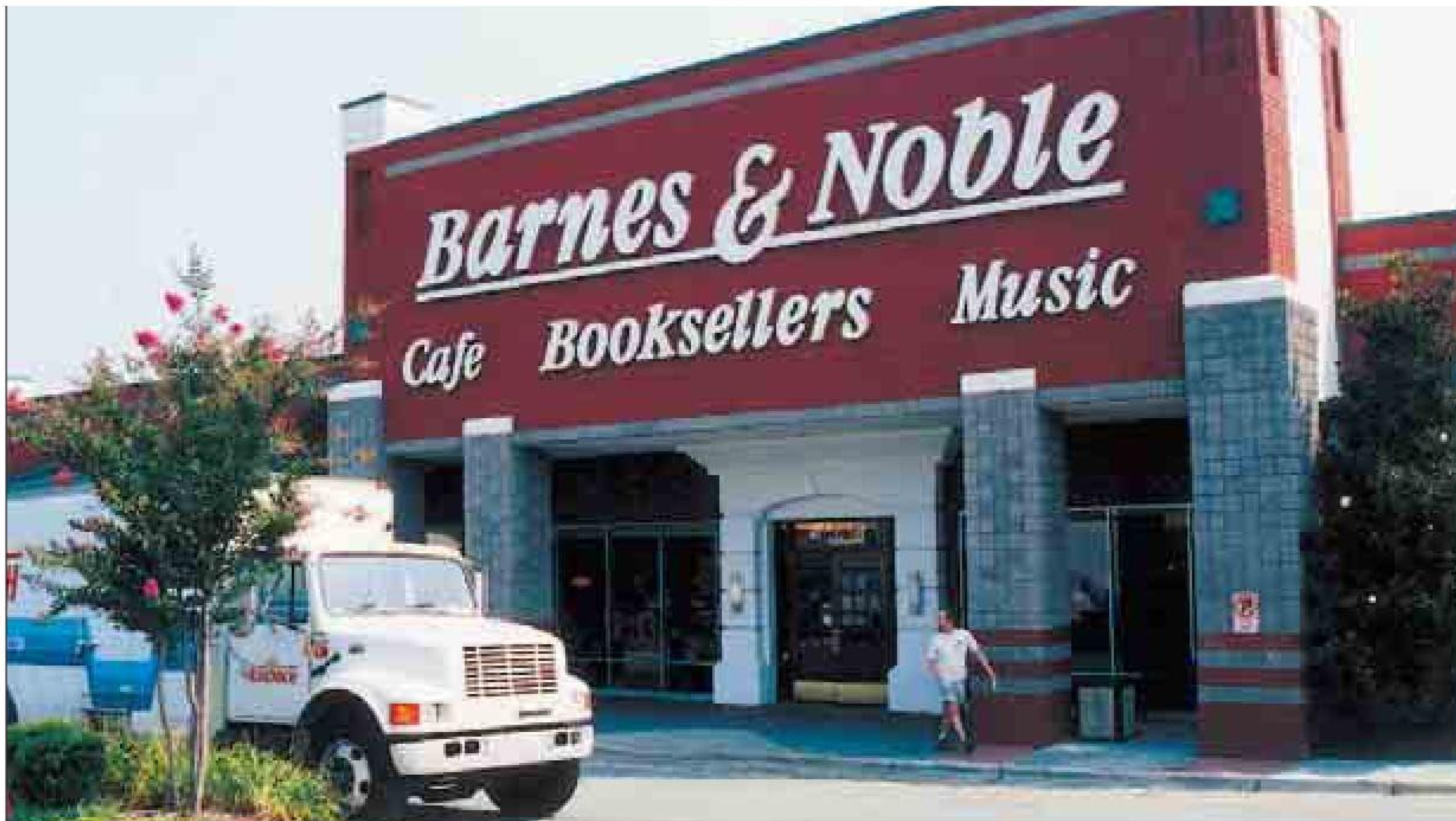


place

price

promotion

produc



books. Many small publishers with whom they worked also had troubles.

At the Intimate, competitors had chipped away at sales over the years. But the coffin nail was not driven by mail-order book clubs, or by the religious book store that opened in town, or even by used textbook brokers who ate into that business. Rather, the bigger issue was the big national chains. They had buying clout with publishers and could demand lower prices for larger quantities. They also had aggressive marketing programs to woo consumers. The Intimate had lost some customers to the frequent-buyer discount and special-order service at Walden Books. Others went to Barnes and Noble for the selection—and the coffee bar. Wal-Mart carried only a few best-sellers, but its low prices turned shoppers into impulse buyers. Some of the Intimate's ex-customers were no longer shopping in any store. Rather, they were ordering books online from Amazon.com.

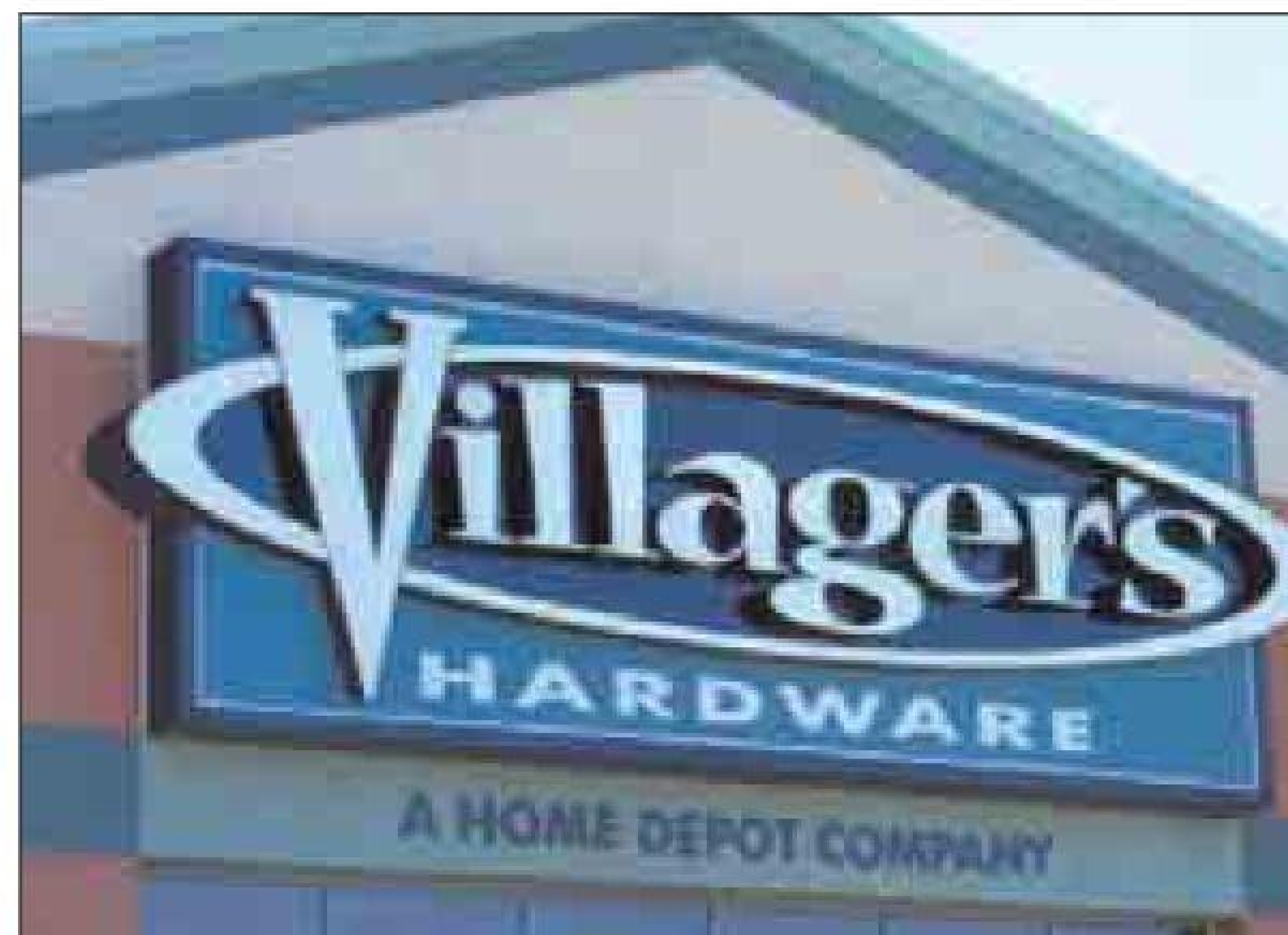
Operating from its website, Amazon offers consumers an amazing selection of over two million books. As Amazon ads pop up on-screen, web surfers may think the selection is even greater. But Bollic knew that in reality Amazon's warehouse keeps inventory on only a couple thousand of the fastest-selling books. That's because Amazon fills most orders through wholesalers. And that takes us back to Ingram Book Group. It has been the hidden giant behind many big book retailers, including Internet sellers. For example, in 1998 it handled more than 60 percent of Amazon's orders. At the same time it was a major supplier for Barnes and Noble. There are good reasons. Its distribution customer service is hard to match. Orders flow into Ingram's computers

electronically, and most are assembled and shipped the same day from its inventory of 500,000 titles. With a half-dozen warehouses spread across the country, Ingram gets 95 percent of its shipments to the retailer within 48 hours. You can see why Barnes and Noble wanted to merge with Ingram; this vertical integration would have made the combined firm even more efficient and powerful.

When that merger fell through, Barnes and Noble expanded its own distribution centers, inventory, and logistics systems to become more efficient on its own. Ingram, in turn, is getting new business by offering its retailer-customers new services—like sending books directly to the consumer. But Ingram is also adding music and entertainment products, like video games, to its line. That's because many of the retailer-customers it serves are scrambling their product lines to include the best sellers among these categories. With video games becoming a mature product, it is not a complete surprise that distribution intensity is expanding. But it may mean that Bollic will need to decide whether to join one of these new channel systems or stick with the specialists who helped him get started.[1]

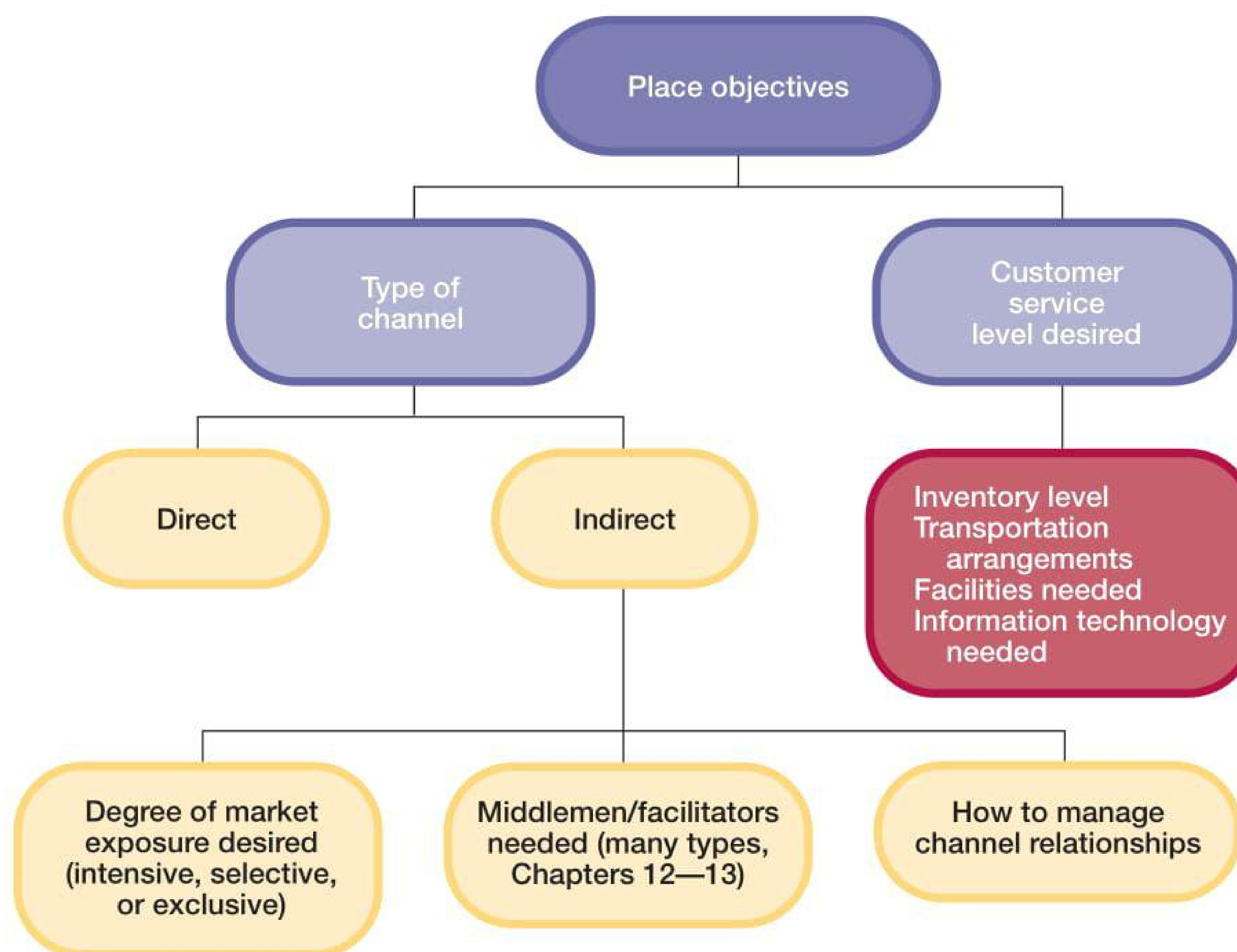
Place Decisions Are an Important Part of Marketing Strategy

As this example shows, offering customers a good product at a reasonable price is important to a successful marketing strategy. But it's not the whole story. Managers must also think about **Place**—making goods and services available in the right quantities and locations—when customers want them. And when different target markets have different needs, a number of Place variations may be required. Our opening case also makes it clear that new Place arrangements can dramatically change the competition in a product-market. This is especially important in business today because many firms are trying to use new information technologies, including websites and aspects of e-commerce, to reach customers directly. Of course, not every consumer (or business customer) wants to buy products online;



To provide solutions to problems faced by more different types of home improvement customers, Home Depot has supplemented its home improvement warehouse stores with Expo Design Centers and smaller Villager's Hardware Stores.

Exhibit 11-1
Strategy Decision Areas in Place



but the numbers are increasing, prompting firms to rethink the ways that they can provide greater value to their target markets.

In the next three chapters, we'll deal with the many important strategy decisions that a marketing manager must make concerning Place. Exhibit 11-1 gives an overview. We'll start in this chapter with a discussion of the type of channel that's needed to meet customers' needs. We'll show why specialists are often involved and how they come together to form a **channel of distribution**—any series of firms or individuals who participate in the flow of products from producer to final user or consumer. We'll also consider how to manage relations among channel members to reduce conflict and improve cooperation.

In Chapter 12, we'll expand our coverage of Place to include decisions that a marketing manager makes to decide what level of distribution service to offer—and why he must coordinate storing and transporting activities—providing the desired service at a reasonable cost. Then, in Chapter 13, we'll take a closer look at the many different types of retailing and wholesaling firms. We'll consider their role in channels as well as the strategy decisions they make to satisfy their own customers.

Place Decisions Are Guided by "Ideal" Place Objectives

All marketing managers want to be sure that their goods and services are available in the right quantities and locations—when customers want them. But customers may have different needs with respect to time, place, and possession utility as they make different purchases.

Product classes suggest Place objectives

You've already seen this with the product classes—which summarize consumers' urgency to have needs satisfied and willingness to seek information, shop, and compare. Now you should be able to use the product classes to handle Place decisions.

© The McGraw–Hill Companies, 2002

Most pet food companies focus on distribution through grocery stores, but Science Diet brand premium pet foods reach consumers in the U.S., Japan, and Italy through a different channel—veterinary offices and pet stores. Because Science Diet has developed cooperative relationships with other members of this channel, Science Diet products often get special promotion support at the point of purchase.

Exhibit 9-3 shows the relationship between consumer product classes and ideal Place objectives. Similarly, Exhibit 9-4 shows the business product classes and how they relate to customer needs. Study these exhibits carefully. They set the framework for making Place decisions. In particular, the product classes help us decide how much market exposure we'll need in each geographic area.

Place system is not automatic

A product may be sold both to final consumers and business customers, and each type of customer may want to purchase in different ways. Further, several different product classes may be involved if different market segments view a product in different ways. Thus, just as there is no automatic classification for a specific product, we can't automatically decide the one best Place arrangement.

However, people in a particular target market should have similar attitudes and therefore should be satisfied with the same Place system. If different target segments view a product in different ways, marketing managers may need to develop several strategies, each with its own Place arrangements.

Place decisions have long-run effects

The marketing manager must also consider Place objectives in relation to the product life cycle; see Exhibit 10-2. Place decisions often have long-run effects. They're usually harder to change than Product, Price, and Promotion decisions. Many firms that thought they could quickly establish effective websites for direct online sales, for example, found that it took several years and millions of dollars to work out the kinks. It can take even longer to develop effective working relationships with others in the channel. Legal contracts with channel partners may also limit changes. And it's hard to move retail stores and wholesale facilities once leases are signed and customer shopping patterns are settled. Yet as products mature, they typically need broader distribution to reach different target customers.

The distribution of premium pet foods followed this pattern. A decade ago, supermarkets wouldn't carry specialized pet foods because there wasn't much demand. So marketing managers for Science Diet products concentrated on getting distribution through pet shops and veterinary offices. These pet professionals were already focused on Science Diet's target market. Science Diet's sales in this channel grew rapidly. What's more, profit margins on the specialty foods were much higher than on traditional fare. Seeing that this market was growing, Purina, Kal Kan, and other producers developed new products and worked with their supermarket channels to

set up special "nutrition centers" on the pet food aisle. P&G bought Iams and pushed for distribution in pet superstores, at mass-merchandisers, and online. Perhaps the competition among channels was inevitable. But Science Diet is still doing well in its own channel. It's also using the same approach to expand into other countries. In pet stores in Japan and Italy, for example, Science Diet attracts new customers with special displays, samples, and free literature.[2]

Channel System May Be Direct or Indirect

One of the most basic Place decisions producers must make is whether to handle the whole distribution themselves—perhaps by relying on direct-to-customer e-commerce selling—or use wholesalers, retailers, and other specialists (see Exhibit 11-1). Middlemen, in turn, must select the producers they'll work with.

Why a firm might want to use direct distribution

Many firms prefer to distribute directly to the final customer or consumer. One reason is that they want complete control over the marketing job. They may think that they can serve target customers at a lower cost or do the work more effectively than middlemen. Further, working with independent middlemen with different objectives can be troublesome.

The Internet makes direct distribution easier

Website-based e-commerce systems give many firms direct access to prospects and customers whom it would have been difficult or impossible to reach in the past. Even very small, specialized firms may be able to establish a web page and draw customers from all over the world. Of course, there are limitations. If a customer wants a salesperson to demonstrate a product, then a "virtual store" may not be adequate. However, the concept of distribution over the Internet is still evolving. Some firms now use live camera "feeds" while talking with the customer over an Internet video phone. Other innovations are being tested. Regardless, if it's with the help of technology or by other more traditional means, there often *are* great advantages in selling directly to the final user or consumer.

Direct contact with customers

If a firm is in direct contact with its customers, it is more aware of changes in customer attitudes. It is in a better position to adjust its marketing mix quickly because there is no need to convince other channel members to help. If a product needs an aggressive selling effort or special technical service, the marketing manager can ensure that salespeople receive the necessary training and motivation. In contrast, middlemen often carry products of several competing producers. So they might not give any one item the special emphasis its producer wants.

In the U.S. and many other developed nations, Unilever relies primarily on indirect distribution through a variety of wholesalers and retailers. However, in Spain it delivers frozen foods directly to consumer homes, and in Vietnam a mobile store brings products to local consumers. And now some products are sold direct to consumers from an Internet website.

When Snapple bought SoBe's main wholesaler in New Jersey, other goods wholesalers were not available and SoBe was left with limited distribution. So marketers for SoBe sold directly to retailers. Getting retailer cooperation and good shelf space was easier when SoBe provided its own coolers.

Suitable middlemen are not available

A firm may have to go direct if suitable middlemen are not available or will not cooperate. For example, Apple is again opening its own stores in hopes of getting more in-store promotional emphasis on what's different about its iMac computers.[3]

Middlemen who have the best contacts with the target market may be hesitant to add unproven vendors or new products, especially really new products that don't fit well with their current business. Many new products die because the producer can't find willing middlemen and doesn't have the financial resources to handle direct distribution.

In the United States, the Census Bureau publishes detailed data concerning wholesalers and retailers, including breakdowns by kind of business, product line, and geographic territory. Similar information is available for Canada and many other countries, including most of those in the European Union. Most of this data is available online. It can be very valuable in strategy planning—especially to learn whether potential channel members are serving a target market. You can also learn what sales volume current middlemen are achieving.

Common with business customers and services

Many business products are sold direct-to-customer. Rolm, for example, sells its computerized voice mail systems direct. Alcan sells aluminum to General Motors direct. And Honda sells its motors direct to lawn mower producers. This is understandable since in business markets there are fewer transactions and orders are larger. In addition, customers may be concentrated in a small geographic area, making distribution easier. Further, once relationships are established e-commerce systems can provide an efficient way to handle orders, inventory replenishment, and routine information needs (such as delivery schedules).

Service firms often use direct channels. If the service must be produced in the presence of customers, there may be little need for middlemen. An accounting firm like Arthur Andersen, for example, must deal directly with its customers. However, many firms that produce physical goods turn to middlemen specialists to help provide the services customers expect as part of the product. Maytag may hope that its authorized dealers don't get many repair calls, but the service is available when customers need it. Here the middleman produces the service.[4]

Some consumer products are sold direct

Many companies that produce consumer products have websites where a consumer can place a direct order. But for most consumer products this is still a small part of total sales. Most consumer products are sold through middlemen.

Internet

Internet Exercise Gateway is a computer company that uses direct distribution to its customers in the U.S. Go to the Gateway website (www.gateway.com) and think about how it is organized. Is the website organized well to help Gateway reach different segments of customers in the U.S.?

Of course, some consumer products are sold direct to consumers' homes. Tupperware, Mary Kay and Avon cosmetics, Electrolux vacuum cleaners, Amway household products, and Fuller Brush products are examples. Most of these firms rely on direct selling, which involves personal sales contact between a representative of the company and an individual consumer. However, most of these "salespeople" are *not* company employees. Rather, they usually work as independent middlemen, and the companies that they sell for refer to them as dealers, distributors, agents, or some similar term. So in a strict technical sense, this is not really direct producer-to-consumer distribution. That does not mean, however, that this approach is unimportant. It has grown both in the U.S. and in international markets. In fact, many U.S. firms are finding that it's the best way to crack open international markets. Some of the distribution arrangements might surprise you. For example, Mattel has teamed up with Avon door-to-door representatives to sell its Barbie dolls in China.[5]

Don't be confused by the term *direct marketing*

An increasing number of firms now rely on **direct marketing**—direct communication between a seller and an individual customer using a promotion method other than face-to-face personal selling. Sometimes direct marketing promotion is coupled with direct distribution from a producer to consumers. Park Seed Company, for example, sells the seeds it grows directly to consumers with a mail catalog. However, many firms that use direct marketing promotion distribute their products through middlemen. So the term *direct marketing* is primarily concerned with the Promotion area, not Place decisions. We'll talk about direct marketing promotion in more detail in Chapter 14.[6]

When indirect channels are best

Even if a producer wants to handle the whole distribution job, sometimes it's simply not possible. Customers often have established buying patterns. For example, Square D, a producer of electrical supplies, might want to sell directly to electrical contractors. It can certainly set up a website for online orders or even open sales offices in key markets. But if contractors like to make all of their purchases in one convenient stop—at a local electrical wholesaler—the only practical way to reach them is through a wholesaler.

Consumers want convenience

Similarly, consumers are spread throughout many geographic areas and often prefer to shop for certain products at specific places. Some consumers, for instance, see Sears as *the* place to shop for tires, so they'll only buy the brands that Sears carries. Similarly, a consumer may see a Walgreens drugstore as *the* place to shop for emergency items—because it's conveniently located in the neighborhood. Moreover, if retailers who serve target customers make most of their purchases from specific wholesalers, the producer may have to work with these wholesalers. This is one reason why most firms that produce consumer products rely so heavily on indirect channels (see Exhibit 2-10).[7]

Middlemen may invest in inventory

Direct distribution usually requires a significant investment in facilities, people, and information technology. A new company, one that has limited financial resources, or one that wants to retain flexibility, may want to avoid that investment by working with established middlemen.

Middlemen may further reduce a producer's investment and need for working capital by buying the producer's output and carrying it in inventory until it's sold. If customers want a good "right now," there must be an inventory available to make the sale. And if customers are spread over a large area, it will probably be necessary to have widespread distribution.

Middlemen may reduce credit risk

Some middlemen play a critical role by providing credit to customers at the end of the channel. This financing function may be very important to small business customers; it provides their working capital. Even if the producer could afford to provide credit, a middleman who knows local customers can help reduce credit risks. As sales via the Internet grow, sellers are looking for faster and better ways to check the credit ratings of distant customers. It's an unhappy day when the marketing manager learns that a customer who was shipped goods based on an online order can't pay the invoice.

As these examples suggest, there may be a number of reasons why a producer might want to work with a specific wholesaler or retailer. However, the most important reason for using an indirect channel of distribution is that an intermediary can often help producers serve customer needs better and at lower cost. Remember that we discussed this briefly in Chapter 1 (see Exhibit 1-3). Now we'll go into more detail so you'll be able to plan different kinds of distribution channels.

Channel Specialists May Reduce Discrepancies and Separations

The assortment and quantity of products customers want may be different from the assortment and quantity of products companies produce. Producers are often located far from their customers and may not know how best to reach them. Customers in turn may not know about their choices. Specialists develop to adjust these discrepancies and separations.[8]

Middlemen may supply needed information

Specialists often help provide information to bring buyers and sellers together. For example, most consumers don't know much about the wide variety of home and auto insurance policies available from many different insurance companies. A local independent insurance agent may help them decide which policy, and which insurance company, best fits their needs. In the same vein, a furniture retailer can help a customer find a producer who has a certain style chair with just the right combination of fabric and finish.

Middlemen who are close to their customers are often in a better position to anticipate customer needs and forecast demand more accurately. This information can help reduce inventory costs in the whole channel—and it may help the producer smooth out production.

Most producers seek help from specialists when they first enter international markets. Specialists can provide crucial information about customer needs and insights into differences in the marketing environment.

Discrepancies of quantity and assortment

Discrepancy of quantity means the difference between the quantity of products it is economical for a producer to make and the quantity final users or consumers normally want. For example, most manufacturers of golf balls produce large quantities—perhaps 200,000 to 500,000 in a given time period. The average golfer, however, wants only a few balls at a time. Adjusting for this discrepancy usually requires middlemen—wholesalers and retailers.

Office Depot, a large office supplies chain, accumulates products from many producers at its distribution center and then breaks bulk to provide the convenient assortments that consumers expect to find at individual Office Depot stores.

Producers typically specialize by product—and therefore another discrepancy develops. **Discrepancy of assortment** means the difference between the lines a typical producer makes and the assortment final consumers or users want. Most golfers, for example, need more than golf balls. They want golf shoes, gloves, clubs, a bag, and, of course, a golf course to play on. And they usually don't want to shop for each item separately. So, again, there is a need for wholesalers and retailers to adjust these discrepancies.

In actual practice, bringing products to customers isn't as simple as the golf example. Specializing only in golfing products may not achieve all the economies possible in a channel of distribution. Retailers who specialize in sports products usually carry even wider assortments. And they buy from a variety of wholesalers who specialize by product line. Some of these wholesalers supply other wholesalers. These complications will be discussed later. The important thing to remember is that discrepancies in quantity and assortment cause distribution problems for producers and explain why many specialists develop.

Channel specialists adjust discrepancies with regrouping activities

Regrouping activities adjust the quantities and/or assortments of products handled at each level in a channel of distribution.

There are four regrouping activities: accumulating, bulk-breaking, sorting, and assorting. When one or more of these activities is needed, a marketing specialist may develop to fill this need.

Adjusting quantity discrepancies by accumulating and bulk-breaking

Accumulating involves collecting products from many small producers. Much of the coffee that comes from Colombia is grown on small farms in the mountains. Accumulating the small crops into larger quantities is a way of getting the lowest transporting rate and making it more convenient for distant food processing companies to buy and handle it. Accumulating is especially important in less-developed countries and in other situations, like agricultural markets, where there are many small producers.

Accumulating is also important with professional services because they often involve the combined work of a number of individuals, each of whom is a specialized producer. A hospital makes it easier for patients by accumulating the services of a number of health care specialists, many of whom may not actually work for the hospital.

To reach its place objectives, Sprint sells PCS phones and its wireless services through 12,000 outlets, including retail chains like Staples and its own Sprint PCS Centers.

Many middlemen who operate from Internet websites focus on accumulating. Specialized sites for everything from Chinese art to Dutch flower bulbs bring together the output of many producers.

Bulk-breaking involves dividing larger quantities into smaller quantities as products get closer to the final market. Sometimes this even starts at the producer's level. A golf ball producer may need 25 wholesalers to help sell its output. And the bulk-breaking may involve several levels of middlemen. Wholesalers may sell smaller quantities to other wholesalers or directly to retailers. Retailers continue breaking bulk as they sell individual items to their customers.

Adjusting assortment discrepancies by sorting and assorting

Different types of specialists adjust assortment discrepancies. They perform two types of regrouping activities: sorting and assorting.

Sorting means separating products into grades and qualities desired by different target markets. For example, an investment firm might offer its customers a chance to buy shares in a mutual fund made up only of stocks for certain types of companies—high-growth firms, ones that pay regular dividends, or ones that have good environmental track records.

Similarly, a wholesaler that specializes in serving convenience stores may focus on smaller packages of frequently used products, whereas a wholesaler working with restaurants and hotels might handle only very large institutional sizes.

Sorting is also a very important process for raw materials. Nature produces what it will—and then the products must be sorted to meet the needs of different target markets.

Assorting means putting together a variety of products to give a target market what it wants. This usually is done by those closest to the final consumer or user—retailers or wholesalers who try to supply a wide assortment of products for the convenience of their customers. A grocery store is a good example. But some assortments involve very different products. A wholesaler selling Yazoo tractors and mowers to golf courses might also carry Pennington grass seed, Scott fertilizer, and even golf ball washers or irrigation systems—for its customers' convenience.

Watch for changes

Sometimes these discrepancies are adjusted badly—especially when consumer wants and attitudes shift rapidly. When cellular phones suddenly became popular, an opportunity developed for a new specialist. Cellular phone dealers came on the scene to help customers figure out what type of cellular phone and service would meet their needs. After all, the traditional phone companies didn't initially offer these services. However, it cost the sellers of cellular services about $300 per customer to sell through dealers. As the market grew and the competition for customers

A channel captain can improve the performance of the whole channel—by developing strategies that help everyone in the channel do a better job of meeting the needs of target customers at the end of the channel.

heated up, electronics stores wanted a piece of the action, and they were willing to take a smaller markup. Now that the market is much more established, many cellular service providers are finding it cheaper to sell from a website or use their own salespeople.[9]

Specialists should develop to adjust discrepancies *if they must be adjusted.* But there is no point in having middlemen just because that's the way it's been done in the past. Sometimes a breakthrough opportunity can come from finding a better way to reduce discrepancies—perhaps eliminating some steps in the channel. Many small manufacturers of business products can now reach more customers in distant markets with an Internet website than it was previously possible for them to reach with independent manufacturers reps who sold on commission (but otherwise left distribution to the firm). If it costs the firm less to establish an order-taking website and advertise it by e-mail, at an industry community site, or in a trade magazine, the cost advantage can translate to lower prices and a marketing mix that is a better value for some target segments.[10]

Channel Relationship Must Be Managed

Marketing manager must choose type of channel relationship

Middlemen specialists can help make a channel more efficient. But there may be problems getting the different firms in a channel to work together well. How well they work together depends on the type of relationship they have. This should be carefully considered since marketing managers usually have choices about what type of channel system to join or develop.

The whole channel should have a product-market commitment

Ideally, all of the members of a channel system should have a shared *product-market commitment*—with all members focusing on the same target market at the end of the channel and sharing the various marketing functions in appropriate ways. When members of a channel do this, they are better able to compete effectively for the customer's business.

This simple idea is very important. Unfortunately, many marketing managers overlook it because it's not the way their firms have traditionally handled relationships with others in the channel.

Traditional channel systems involve weak relationships

In **traditional channel systems,** the various channel members make little or no effort to cooperate with each other. They buy and sell from each other—and that's the extent of their relationship. Each channel member does only what it considers to be in its own best interest; it doesn't worry much about the effect of its policies on other members of the channel. This is shortsighted, but it's easy to see how it can happen. The objectives of the various channel members may be different. For example, General Electric wants a wholesaler of electrical building supplies to sell GE products. But an independent wholesaler who carries an assortment of products from different producers may not care whose products get sold. The wholesaler just wants happy customers and a good profit margin.

Conflict gets in the way

Specialization has the potential to make a channel more efficient—but not if the specialists are so independent that the channel doesn't work smoothly. Because members of traditional channel systems often have different objectives—and different ideas about how things should be done—conflict is common.

There are two basic types of conflict in channels of distribution. Vertical conflicts occur between firms at different levels in the channel of distribution. For example, a producer and a retailer may disagree about how much shelf space or promotion effort the retailer should give the producer's product. Or conflict may arise if a producer that wants to reduce its excess inventory pushes a wholesaler to carry more inventory than the wholesaler really needs.

Recently there was vertical conflict between big recording companies—like Sony, Warner Music, and Capitol-EMI—and their retail outlets that wanted to sell used CDs as well as new releases. Retailers were responding to consumers who liked the low cost of used CDs, but the recording companies argued that the used CDs ate into their sales and deprived artists of royalties. When Wherehouse Entertainment (a large retail music chain) started to sell used CDs—at about half the price of new ones—several recording companies said that they would halt cooperative advertising payments to any retailer that sold used CDs. Garth Brooks, the best-selling artist at the time, underscored the conflict and the recording companies' point of view. He said that he would not release his new CDs to any stores that were selling used CDs.[11]

Horizontal conflicts occur between firms at the same level in the channel of distribution. For example, a furniture store that keeps a complete line of furniture on display isn't happy to find out that a store down the street is offering customers lower prices on special orders of the same items. The discounter is getting a free ride from the competing store's investment in inventory. And nothing gets an independent retailer more charged up than finding out that a chain store is selling some product for less than the wholesale price the independent pays.

Traditional channel systems are still typical, and very important, in some industries. The members of these channels have their independence, but they may pay for it too. As we will see, such channels are declining in importance—with good reason.[12]

Cooperative relationships share common objectives

Potential channel conflicts should be anticipated and, if possible, resolved. Usually the best way to do that is to get everyone in the channel working together in a cooperative relationship that is focused on the same basic objective—satisfying the customer at the end of the channel. This leads us away from traditional channels to cooperative channel relationships and the channel captain concept.

Channel captain can guide channel relationships

Each channel system should act as a unit, where each member of the channel collaborates to serve customers at the end of the channel. In this view, cooperation is everyone's responsibility. However, some firms are in a better position to take the lead in the relationship and in coordinating the whole channel effort. This situation calls for a **channel captain**—a manager who helps direct the activities of a whole channel and tries to avoid or solve channel conflicts.

For example, when Harley-Davidson saw an opportunity to expand sales of its popular fashion accessories, it was difficult for motorcycle dealers to devote enough space to all of the different styles and sizes. Harley considered selling the items directly from its own website, but that would take sales away from dealers who were working hard to help Harley sell both cycles and fashions. So Harley's president asked a group of dealers and Harley managers to work together to come up with a plan they all liked. The result was a website that sells Harley products through the dealer that is closest to the customer.[13]

The concept of a single channel captain is logical. But some channels, including most traditional ones, don't have a recognized captain. The various firms don't act as a system. The reason may be lack of leadership or the fact that members of the system don't understand their interrelationship. Many managers—more concerned with individual firms immediately above and below them—seem unaware that they are part of a channel.

But like it or not, firms are interrelated, even if poorly, by their policies. So it makes sense to try to avoid channel conflicts by planning for channel relations. The channel captain arranges for the necessary functions to be performed in the most effective way.

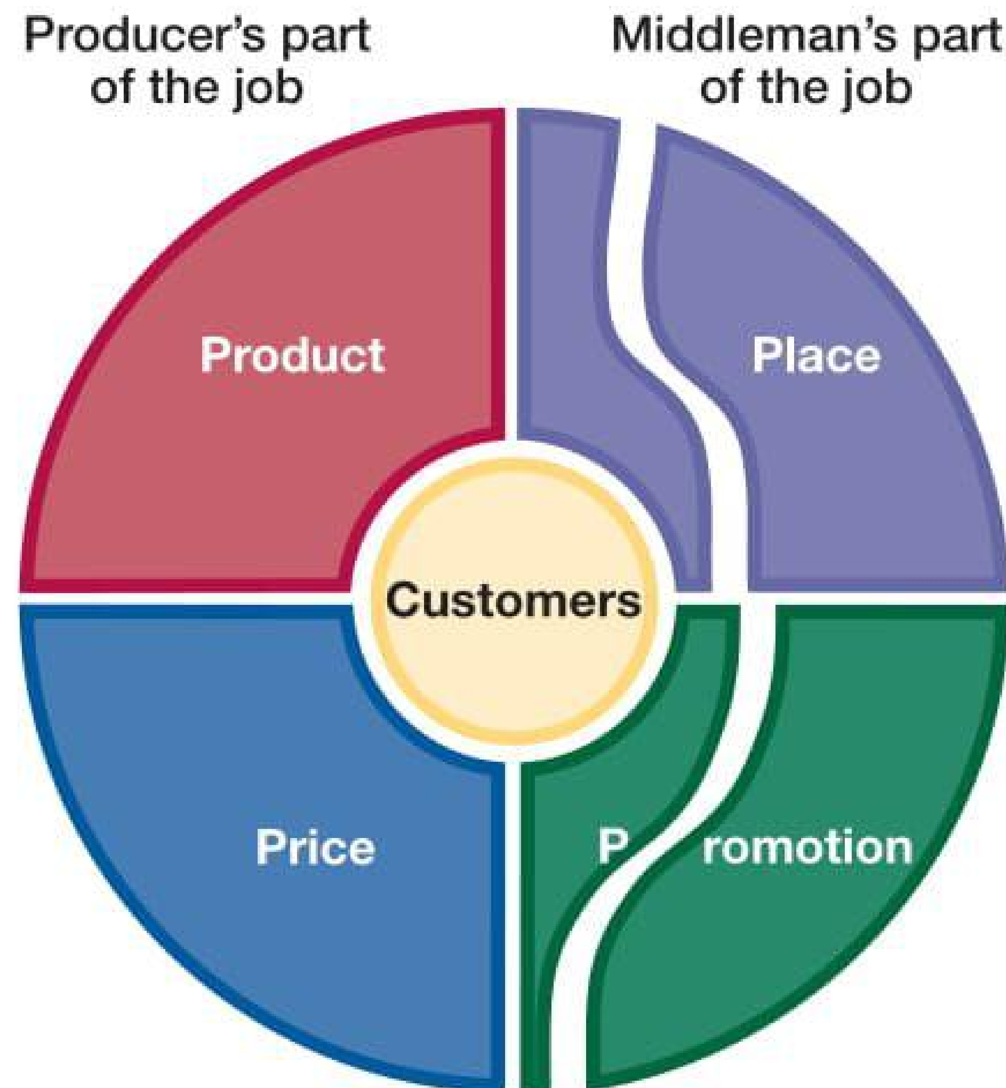
The situation faced by Goodyear is a good example. The Goodyear brand was sold almost exclusively through its own stores and its 2,500 independent tire dealers. But sales were falling. There were many reasons. France's Michelin and Japan's Bridgestone had aggressively expanded distribution in North America. The 850 Sears autocenters were selling one-tenth of all replacement tires. Moreover, many consumers were shopping at discount outlets and warehouse clubs. Goodyear decided it had no choice but to expand distribution beyond its independent dealer network. One of the first changes was to sell Goodyear tires to Sears, Kmart's Penske autocenters, and other big retail chains. To better reach the discount shoppers, Goodyear converted many of its company-owned autocenters to no-frills, quick-serve stores operated under the Just Tires name. However, to reduce the conflict that these changes caused with its independent dealers, Goodyear introduced new lines of premium tires—like the innovative Aquatred line and specialized lines for sports cars and 4-wheel drive vehicles. These were tires that appealed to the dealers' target market. Goodyear also increased advertising and promotion support to pull more customers into the dealers' stores, and offered training on how to build sales of related services. Goodyear also created the Gemini brand name to help promote service by Goodyear dealers. Because of this channel leadership, Goodyear's sales increased and so did the sales of its dealers.[14]

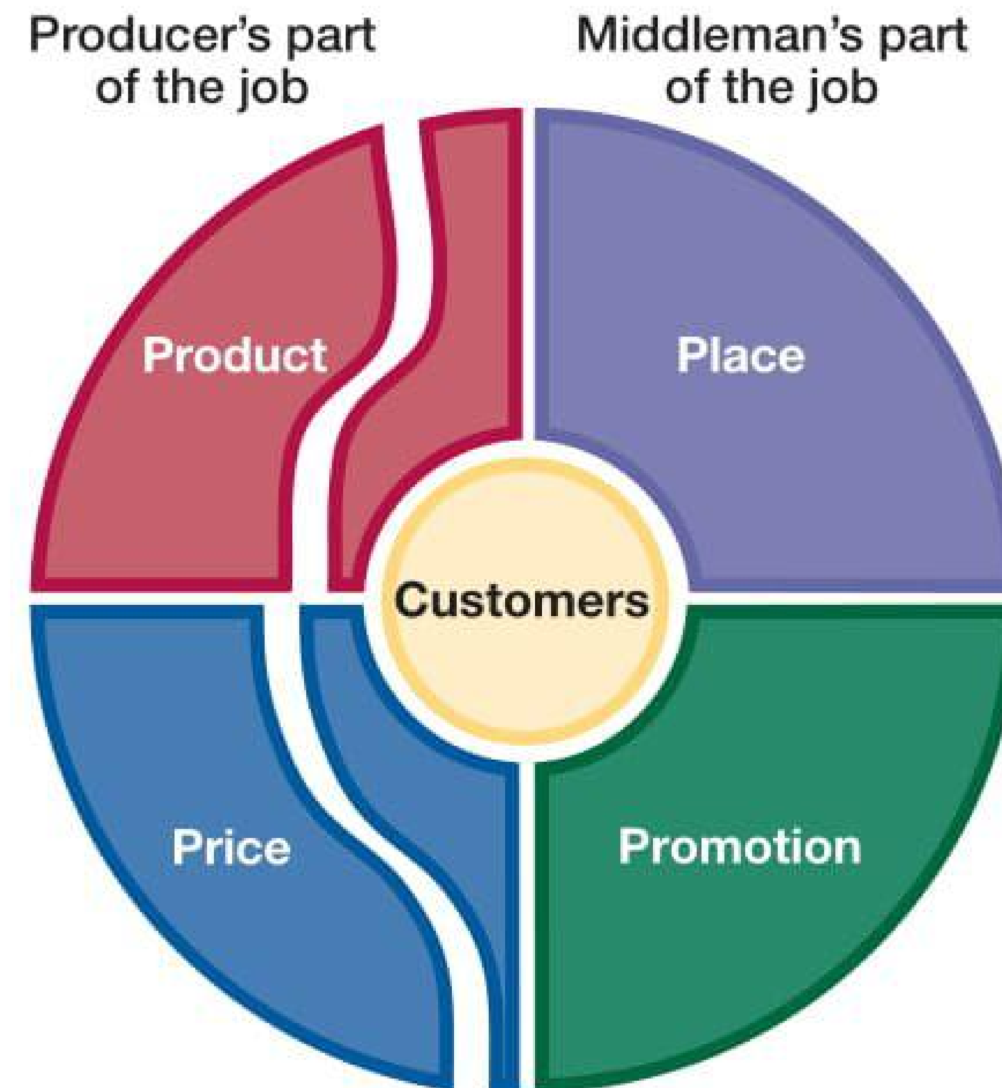
Some producers lead their channels

As the Goodyear case suggests, in the U.S. producers frequently take the lead in channel relations. Middlemen often wait to see what the producer intends to do and wants them to do. After marketing managers for Goodyear set Price, Promotion, and Place policies, wholesalers and retailers decide whether their roles will be profitable and whether they want to join in the channel effort.

Exhibit 11-2A shows this type of producer-led channel system. Here the producer has selected the target market and developed the Product, set the Price structure, done some consumer and channel Promotion, and developed the Place setup. Middlemen are then expected to finish the Promotion job in their respective places. Of course, in a retailer-dominated channel system, the marketing jobs would be handled in a different way.

Exhibit 11-2 How Channel Functions May Be Shifted and Shared in Different Channel Systems

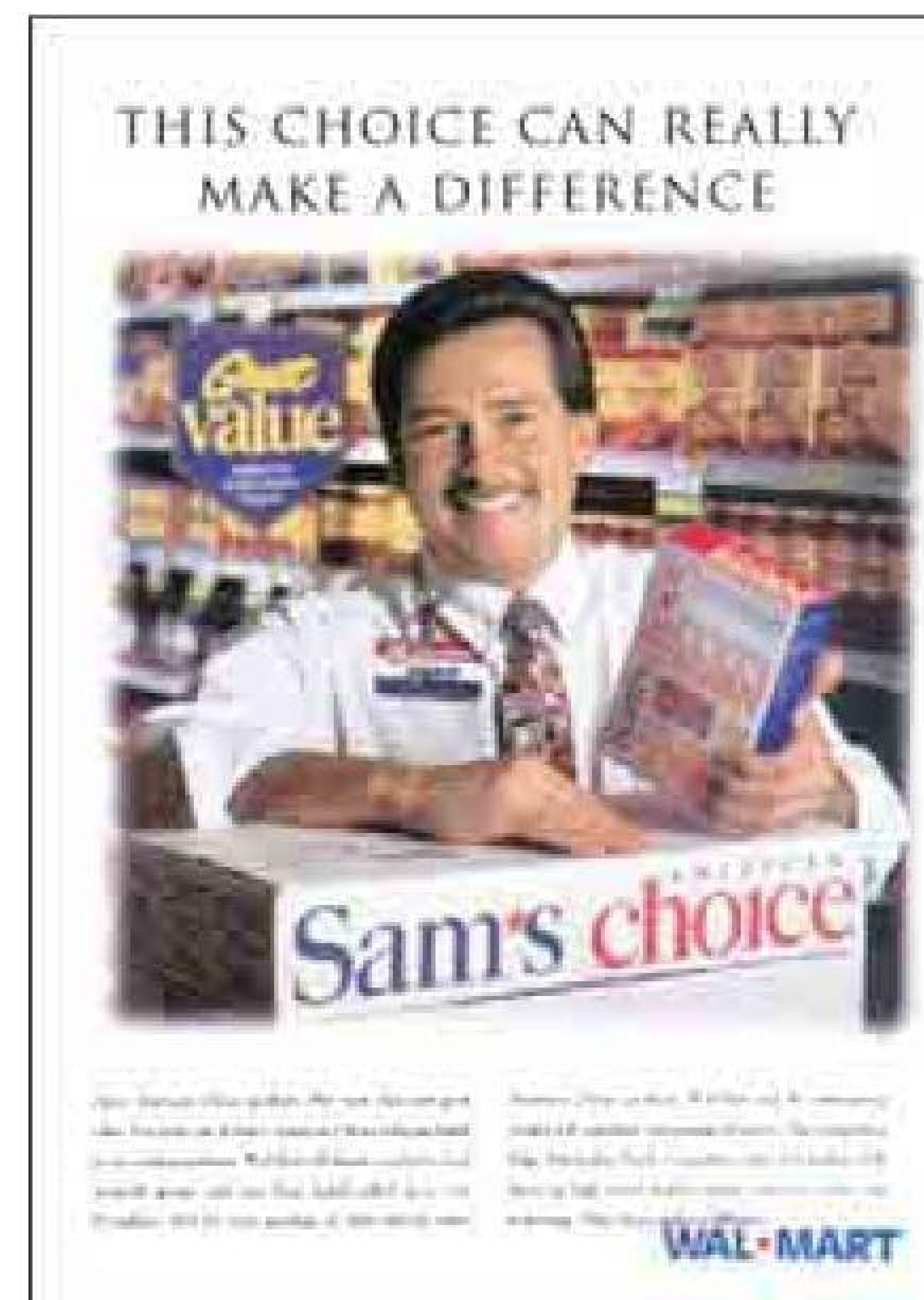




Some middlemen are channel captains

Sometimes large wholesalers or retailers do take the lead. These middlemen analyze the types of products their customers want and then seek out producers who can provide these products at reasonable prices. With the growth of powerful retail chains, like Target and Toys "R" Us, this is becoming more common in the United States. It is already typical in many foreign markets. In Japan, for example, very large wholesalers (trading companies) are often the channel captains.

Channel captains who are middlemen often develop their own dealer brands. Large retailers like Sears or Kmart and wholesalers like Ace Hardware in effect act like producers. They specify the whole marketing mix for a product and merely delegate production to a factory. Exhibit 11-2B shows how marketing strategy might be handled in this sort of retailer-led channel system.



The growing number of retailer-led channel systems is prompting growth of private label dealer brands in a wide variety of product categories.

Kimberly-Clark Boosts Bottom Line for Disposable Diapers

It's a messy problem when a busy parent makes a special trip to a Costco store to buy Huggies disposable diapers and they're out of stock. It can be costly too. The average retailer's loss from out-of-stocks on high-volume items, like diapers, is about 11 percent of annual sales. So what should a Costco manager do to avoid the problem? Nothing. That job is handled by Kimberly-Clark (KC), the firm that makes Huggies. Costco has a system that it calls "vendor managed inventory" in which key suppliers take over responsibility for managing a set of products, often a whole product category. Every day an analyst at KC's headquarters studies Costco's online data that details Huggies' sales and inventory at every Costco store. The analyst studies how much is sold of each item in each store in the average week. If inventory is getting low, a new order is placed and shipping is scheduled. It's also important not to order too much or too early. KC absorbs all of the inventory and delivery costs required to keep Huggies on the shelves at Costco. When KC does this job well, it makes more money and so does Costco. Costco is a powerful customer, but KC is the channel captain for this category. Costco could do the job itself, but it handles such a wide assortment of products that it would be costly to do all the work required in every high-volume category. Many large retailers use similar approaches. Smaller retailers, however, may find that vendors are not as eager to provide this kind of extra support. The benefits justify the costs when the vendor is more selective about where the service is provided.[15]

www.mhhe.com/fourps

Some strong middlemen use their power to control channel relationships. Wal-Mart, the largest retail chain, is constantly looking for ways to cut its own costs—and sometimes that means cutting costs in the channel. Buyers for Wal-Mart look at the value added by a wholesaler. If they think Wal-Mart can be more efficient without the wholesaler, they tell the producer that the chain will only buy direct—usually at a lower price than was paid to the wholesaler.

Middlemen are closer to the final user or consumer and are in an ideal position to assume the channel captain role. Middlemen, especially large retailers, may even dominate the marketing systems of the future.[16]

Many marketing managers accept the view that a coordinated channel system can help everyone in the channel. These managers are moving their firms away from traditional channel systems and instead developing or joining vertical market systems.

Vertical Marketing Systems Focus on Final Customers

In contrast to traditional channel systems are **vertical marketing systems**—channel systems in which the whole channel focuses on the same target market at the end of the channel. Such systems make sense, and are growing, because if the final customer doesn't buy the product, the whole channel suffers. There are three types of vertical marketing systems—corporate, administered, and contractual. Exhibit 11-3 summarizes some characteristics of these systems and compares them with traditional systems.

Corporate channel systems shorten channels

Some corporations develop their own vertical marketing systems by internal expansion and/or by buying other firms. With **corporate channel systems**—corporate ownership all along the channel—we might say the firm is going "direct." But actually the firm may be handling manufacturing, wholesaling, *and* retailing—so it's more accurate to think of the firm as a vertical marketing system.

Corporate channel systems develop by vertical integration

Corporate channel systems may develop by **vertical integration**—acquiring firms at different levels of channel activity. Bridgestone, for example, has rubber plantations in Liberia, tire plants in Ohio, and wholesale and retail outlets all over the

© The McGraw–Hill Companies, 2002

Exhibit 11-3 Characteristics of Traditional and Vertical Marketing Systems

	Type of Channel			
		Vertical Marketing Systems		
Characteristics	Traditional	Administered	Contractual	Corporate
Amount of cooperation	Little or none	Some to good	Fairly good to good	Complete
Control maintained by	None	Economic power and leadership	Contracts	Ownership by one company
Examples	Typical channel of "independents"	General Electric, Miller Beer, O.M. Scott & Sons (lawn products)	McDonald's, Holiday Inn, IGA, Ace Hardware, Super Valu, Coca-Cola, Chevrolet	Florsheim Shoes, Sherwin-Williams, Mothers Work

world. Sherwin-Williams produces paint, but it also operates 2,000 retail outlets. In England, most of the quaint local pubs are actually owned and operated by the large beer breweries.

Corporate channel systems are not always started by producers. A retailer might integrate into wholesaling and perhaps even manufacturing. Mothers Work is a good example. It started as a mail-order catalog specializing in maternity clothes. Now it sells more than a third of all maternity clothes in the U.S. Vertical integration has been a key factor in this growth and its ability to give its customers what they want when they want it. It has over 700 company-run stores, its own designers, fabric-cutting operations, warehouses, and information systems to tie them all together.[17]

Vertical integration has potential advantages—stability of operations, assurance of materials and supplies, better control of distribution, better quality control, larger research facilities, greater buying power, and lower executive overhead.

Provided that the discrepancies of quantity and assortment are not too great at each level in a channel—that is, that the firms fit together well—vertical integration can be efficient and profitable. However, many firms that have tried vertical integration have found it difficult to achieve these efficiencies. Some managers think it's hard to be really good at running manufacturing, wholesaling, and retailing businesses that are very different from each other. Instead, they try to be more efficient at what they do best and focus on ways to get cooperation in the channel for the other activities.

Administered and contractual systems may work well

Firms can often gain the advantages of vertical integration without building an expensive corporate channel. A firm can develop administered or contractual channel systems instead. In **administered channel systems,** the channel members informally agree to cooperate with each other. They can agree to routinize ordering, share inventory and sales information over computer networks, standardize accounting, and coordinate promotion efforts. In **contractual channel systems,** the channel members agree by contract to cooperate with each other. With both of these systems, the members achieve some of the advantages of corporate integration while retaining some of the flexibility of a traditional channel system. In fact, the opportunities to reduce costs, and provide customers with superior value, are growing in these systems as new information technologies help channel partners share data to make products flow more efficiently through the channel.

An appliance producer may develop an informal arrangement with the independent wholesalers in its administered channel system. It agrees to keep production and inventory levels in the system balanced—using sales data from the wholesalers. Every week, its managers do a thorough analysis of up to 130,000 major appliances located in the many warehouses operated by its 87 wholesalers. Because of this analysis, both the producer and the wholesalers can be sure that they have enough inventory but not the expense of too much. And the producer has better information to plan its manufacturing and marketing efforts.

Middlemen in many industries—like groceries, drugs, hardware, and books—develop and coordinate similar systems. Computerized checkout systems track sales. The information is sent to the wholesaler's computer, which enters orders automatically when needed. Shipping cartons with computer-readable bar codes track the status of shipments and reduce errors. This reduces buying and selling costs, inventory investment, and customer frustration with out-of-stock items throughout the channel.

Vertical marketing systems—new wave in the marketplace

Smoothly operating channel systems are more efficient and successful. In the consumer products field, corporate chains that are at least partially vertically integrated account for about 25 percent of total retail sales. Other vertical systems account for an additional 37.5 percent. Thus, vertical systems in the consumer products area have a healthy majority of retail sales and should continue to increase their share in the future. Vertical marketing systems are becoming the major competitive units in the U.S. distribution system—and they are growing rapidly in other parts of the world as well.[18]

Short-term alliances are also popular

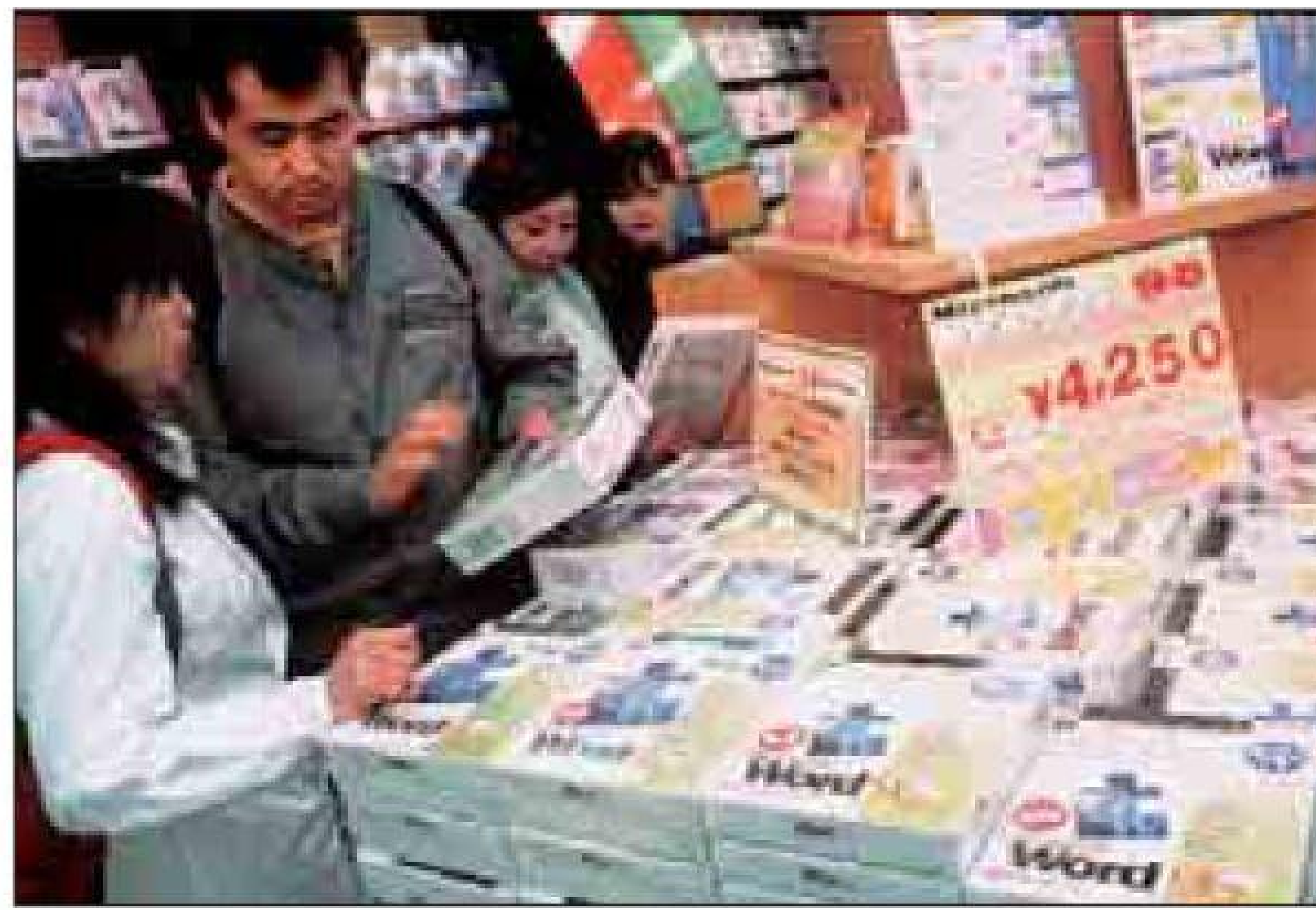
Firms that cooperate to build vertical marketing systems typically share a longer-term commitment. Sometimes, however, what a firm wants is a short-term collaboration to help it be more efficient in accomplishing a specific objective. This may lead to an alliance, a partnership (usually informal) among firms in which they agree to work together to achieve an objective. An alliance often involves two firms, but sometimes it involves a whole network of firms, who spin a web to catch more customers. The firms may be at the same level in the channel or at different levels. For example, a number of firms in the computer business have formed alliances to promote a market for the Linux operating system. Some of these firms produce hardware and some produce software, some focus on distribution, and some are even competitors (at least in some of their product-markets). Nevertheless, by forming a temporary alliance they increase their chances of reaching potential customers at the end of the channel. Without the alliance, it would be difficult for any one of these firms to compete with Microsoft or Intel.[19]

The Best Channel System Should Achieve Ideal Market Exposure

You may think that all marketing managers want their products to have maximum exposure to potential customers. This isn't true. Some product classes require much less market exposure than others. **Ideal market exposure** makes a product available widely enough to satisfy target customers' needs but not exceed them. Too much exposure only increases the total cost of marketing.

Ideal exposure may be intensive, selective, or exclusive

Intensive distribution is selling a product through all responsible and suitable wholesalers or retailers who will stock and/or sell the product. **Selective distribution** is selling through only those middlemen who will give the product special attention. **Exclusive distribution** is selling through only one middleman in a particular geographic area. As



As the percentage of people and firms adopting personal computers has increased, Microsoft has moved to more intensive distribution of its products worldwide.

we move from intensive to exclusive distribution, we give up exposure in return for some other advantage—including, but not limited to, lower cost.

In practice, this means that Wrigley's chewing gum is handled, through intensive distribution, by about a million U.S. outlets. Rolls Royces are handled, through exclusive distribution, by only a limited number of middlemen across the country.

Intensive distribution—sell it where they buy it

Intensive distribution is commonly needed for convenience products and business supplies—such as laser printer cartridges, ring binders, and copier paper—used by all offices. Customers want such products nearby.

The seller's intent is important here. Intensive distribution refers to the desire to sell through *all* responsible and suitable outlets. What this means depends on customer habits and preferences. If target customers normally buy a certain product at a certain type of outlet, ideally, you would specify this type of outlet in your Place policies. If customers preferred to buy Sharp portable TVs only at electronics stores, you would try to sell through all electronics stores to achieve intensive distribution. Today, however, many customers buy small portable TVs at a variety of convenient outlets—including Eckerd drugstores, a local Kmart, over the phone from the Sharper Image catalog, or perhaps from a website on the Internet. This means that an intensive distribution policy requires use of all these outlets, and more than one channel, to reach one target market.

Rayovac batteries were not selling well against Duracell and Energizer, even though the performance of the different batteries was very similar. Part of that may have been due to the heavier advertising for the Duracell and Energizer brands. But consumers usually don't go shopping for batteries—83 percent of the time they're purchased on impulse. So to get a larger share of the purchases, Rayovac had to be in more stores. It offered retailers a marketing mix with less advertising and a lower price. In a period of three years, the brand moved from being available in 36,000 stores to 82,000 stores—and that was enough to give sales a big charge.[20]

Selective distribution—sell it where it sells best

Selective distribution covers the broad area of market exposure between intensive and exclusive distribution. It may be suitable for all categories of products. Only the better middlemen are used here. Companies usually use selective distribution to gain some of the advantages of exclusive distribution—while still achieving fairly widespread market coverage.

Reduce costs and get better partners

A selective policy might be used to avoid selling to wholesalers or retailers who (1) place orders that are too small to justify making calls or providing service, (2) have a reputation for making too many returns or requesting too much service, (3) have a poor credit rating, or (4) are not in a position to do a satisfactory job.

Selective distribution is becoming more popular than intensive distribution as firms see that they don't need 100 percent coverage of a market to justify or support national advertising. Often the majority of sales come from relatively few customers—and the others buy too little compared to the cost of working with them; that is, they are unprofitable to serve. This is called the 80/20 rule—80 percent of a company's sales often come from only 20 percent of its customers *until it becomes more selective in choosing customers*.

Esprit—a producer of colorful, trendy clothing—was selling through about 4,000 department stores and specialty shops nationwide. But Esprit found that about half of the stores generated most of the sales. Sales analysis also showed that sales in Esprit's own stores were about 400 percent better than sales in other sales outlets. As a result, Esprit cut back to about 2,000 outlets and opened more of its own stores and a website—and profits increased.[21]

When producers use selective distribution, fewer sales contacts have to be made—and fewer wholesalers are needed. A producer may be able to contact selected retailers directly. Hanes sells men's underwear this way.

Get special effort from channel members

Selective distribution can produce greater profits not only for the producer but for all channel members—because of the closer cooperation among them. Wholesalers and retailers are more willing to promote products aggressively if they know they're going to obtain the majority of sales through their own efforts. They may carry more stock and wider lines, do more promotion, and provide more service—all of which lead to more sales.

Selective often moves to intensive as market grows

In the early part of the life cycle of a new unsought good, a producer's marketing manager may have to use selective distribution to encourage enough middlemen to handle the product. The manager wants to get the product out of the unsought category as soon as possible—but can't if it lacks distribution. Well-known middlemen may have the power to get such a product introduced but sometimes on their own terms—which often include limiting the number of competing wholesalers and retailers. The producer may be happy with such an arrangement at first but dislike it later when more retailers want to carry the product.

Exclusive distribution sometimes makes sense

Exclusive distribution is just an extreme case of selective distribution—the firm selects only one middleman in each geographic area. Besides the various advantages of selective distribution, producers may want to use exclusive distribution to help control prices and the service offered in a channel.

Retailers of shopping products and specialty products often try to get exclusive distribution rights in their territories. Fast-food franchises often have exclusive distribution—and that's one reason they're popular. Owners of McDonald's franchises pay a share of sales and follow McDonald's strategy to keep the exclusive right to a market.

Unlike selective distribution, exclusive distribution usually involves a verbal or written agreement stating that channel members will buy all or most of a given product from the seller. In return, these middlemen are granted the exclusive rights to that product in their territories. Some middlemen are so anxious to get a producer's exclusive franchise that they will do practically anything to satisfy the producer's demands.

When Honda introduced its Acura luxury car in the U.S., marketing managers decided to set up a completely new dealer system. In return for the right to sell the car, each new dealer agreed to focus exclusively on Acura and its target market. Acura also required its dealers to build expensive new showrooms. The cars sold well with this strategy, but after three years nearly half of Acura's dealers were still losing money or making only a small profit. Steady sales of a few models of just one make of car were not enough to offset the big investment in new facilities. To help

its troubled dealers, Acura increased its advertising, developed new models, and worked with dealers to identify ways to earn more profit from service and used cars.[22]

Is limiting market exposure legal?

Exclusive distribution is a vague area under U.S. antimonopoly laws. Courts currently focus on whether an exclusive distribution arrangement hurts competition.

Horizontal arrangements among competitors are illegal

Horizontal arrangements—among *competing* retailers, wholesalers, or producers—to limit sales by customer or territory have consistently been ruled illegal by the U.S. Supreme Court. Courts consider such arrangements obvious collusion that reduces competition and harms customers.

Vertical arrangements may or may not be legal

The legality of vertical arrangements—between producers and middlemen—is not as clear-cut. A 1977 Supreme Court decision (involving Sylvania and the distribution of TV sets) reversed an earlier ruling that it was always illegal to set up vertical relationships limiting territories or customers. Now courts can weigh the possible good effects against the possible restrictions on competition. They look at competition between whole channels rather than just focusing on competition at one level of distribution.

With a very small share of the overall market for television sets, Sylvania couldn't compete on price with bigger producers who sold through self-service stores. So Sylvania decided to target customers who saw TVs as a heterogeneous shopping product. These people preferred stores that specialized in TVs, had a good selection on hand, and provided advice before the purchase and repair service afterward. Such retailers faced added costs to provide these services. They didn't want customers to inspect their TV sets, get information at their stores, and then be able to buy the same sets somewhere else at a lower price. In other words, they didn't want other retailers to get a free ride on their investment in inventory and higher-paid sales help. So Sylvania gave exclusive sales territories to dealers who cooperated with its full-service strategy. Even though this approach tends to reduce competition at the retail level, Sylvania argued that it needed such exclusive sales territories to compete with other producers. The Supreme Court basically agreed.

The Sylvania decision does not mean that all vertical arrangements are legal. Rather, it says that a firm has to be able to legally justify any exclusive arrangements.[23]

Caution is suggested

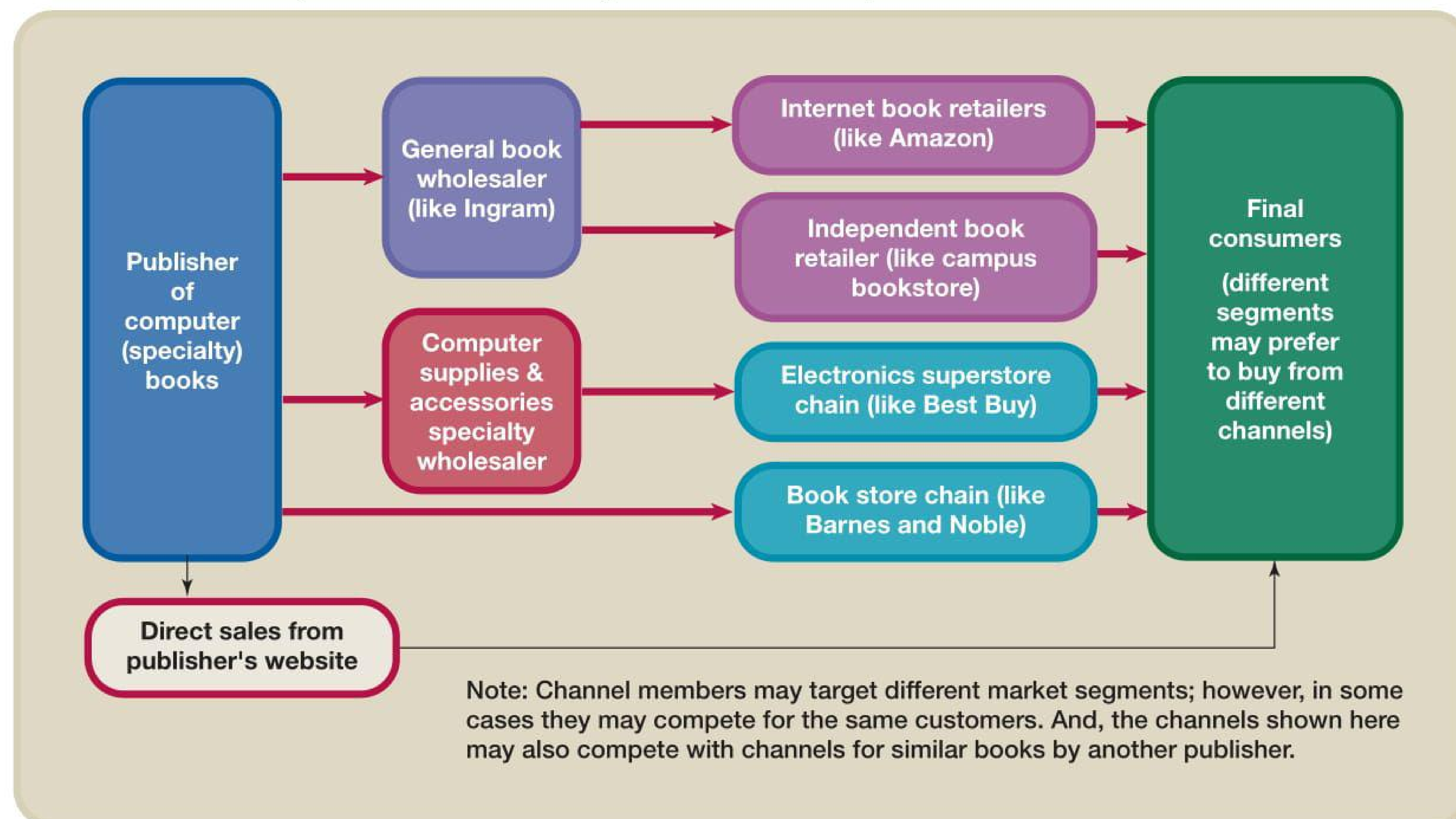
In spite of the 1977 Supreme Court ruling, firms should be extremely cautious about entering into *any* exclusive distribution arrangement. The antimonopoly rules still apply. The courts can force a change in relationships that were expensive to develop. And even worse, the courts can award triple damages if they rule that competition has been hurt.

The same cautions apply to selective distribution. Here, however, less formal arrangements are typical—and the possible impact on competition is more remote. It is now more acceptable to carefully select channel members when building a channel system. Refusing to sell to some middlemen, however, should be part of a logical plan with long-term benefits to consumers.

Channel Systems Can Be Complex

Trying to achieve the desired degree of market exposure can lead to complex channels of distribution. Firms may need different channels to reach different segments of a broad product-market or to be sure they reach each segment. Sometimes this results in competition between different channels.

Exhibit 11-4 An Example of Dual Distribution by a Publisher of Computer Books

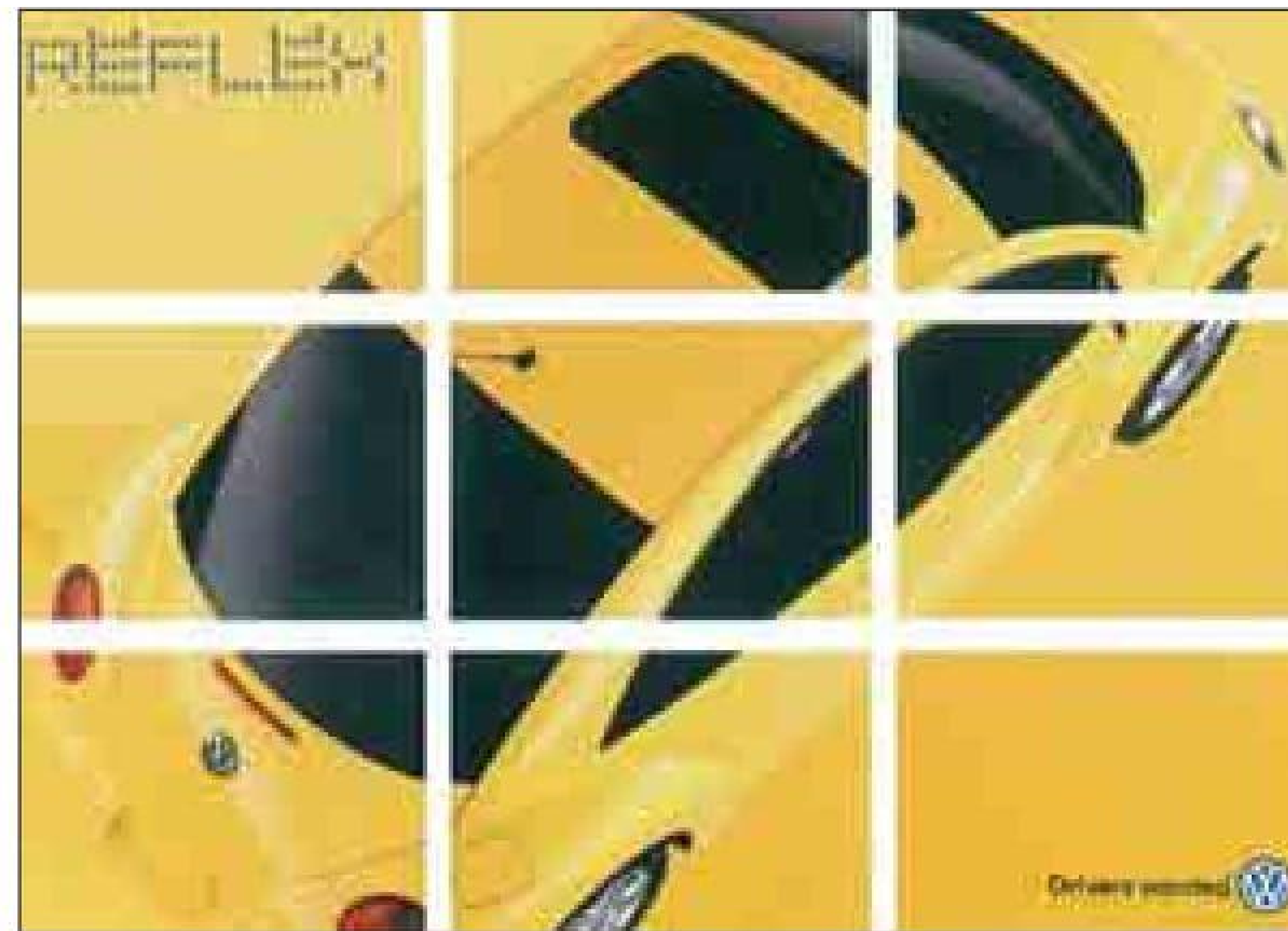


Consider the different channels used by a company that publishes computer books. See Exhibit 11-4. This publisher sells through a general book wholesaler who in turn sells to Internet book retailers and independent book retailers. The publisher may have some direct sales of its best-selling books to a large chain or even to consumers who order directly from its website. However, it might also sell through a computer supplies wholesaler that serves electronics superstores like Best Buy. This can cause problems because different wholesalers and retailers want different markups. It also increases competition, including price competition. And the competition among different middlemen may result in conflicts between the middlemen and the publisher.

Dual distribution systems may be needed

Dual distribution occurs when a producer uses several competing channels to reach the same target market—perhaps using several middlemen in addition to selling directly. Dual distribution is becoming more common. Big retail chains want to deal directly with producers. They want large quantities and low prices. The producer sells directly to retail chains and relies on wholesalers to sell to smaller accounts. Some established middlemen resent this because they don't appreciate *any* competition—especially price competition set up by their own suppliers.

Other times, producers are forced to use dual distribution because their present channels are doing a poor job or aren't reaching some potential customers. For example, Reebok International had been relying on local sporting goods stores to sell its shoes to high school and college athletic teams. But Reebok wasn't getting much of the business. When it set up its own team-sales department to sell directly to the schools, it got a 30,000-unit increase in sales. Of course, some of the stores weren't happy about their supplier also selling to their potential customers. However, they did get the message that Reebok wanted someone to reach that target market.[24]



Some special models of the Beetle could only be ordered online direct from VW's website. However, the customer was then directed to a VW dealer who completed the transaction—an arrangement that avoids conflict between VW and its dealers.

Ethical decisions may be required

A shared product-market commitment guides cooperative relationships among channel members as long as the channel system is competitive. However, if customers' Place requirements change, the current channel system may not be effective. The changes required to serve customer needs may hurt one or more members of the channel. The most difficult ethical dilemmas in the channels area arise in situations like this—because not everyone can win.

For example, wholesalers and the independent retailers that they serve in a channel of distribution may trust a producer channel-captain to develop marketing strategies that will work for the whole channel. However, the producer may conclude that everyone in the channel will ultimately fail if it continues exclusive distribution. It might decide that consumers, and its own business, are best served by a change (say, dropping current middlemen and selling directly to big retail chains). A move of this sort, if implemented immediately, may not give current middlemen-partners a chance to make adjustments of their own. The more dependent they are on the producer, the more severe the impact is likely to be. It's not easy to determine the best or most ethical solution in these situations. However, marketing managers must think carefully about the implications of strategy changes in the Place area—because they can have very severe consequences for other channel members. In channels, as in any business dealing, relationships of trust must be treated with care.[25]

Internet

Internet Exercise Avon sells cosmetics and other products through independent sales representatives (agents), in kiosks and stores, and also through a catalog (both online and printed). Review the Avon website (www.avon.com). Do you think that Avon's independent sales representatives would view the website as competing for their customers' purchases and a source of conflict, or would they think that it helps them promote the product and identify new prospects? Explain your thinking.

Reverse channels should be planned

Most firms focus on getting products to their customers. But some marketing managers must also plan for **reverse channels**—channels used to retrieve products that customers no longer want. The need for reverse channels may arise in a variety of different situations. Toy companies, automobile firms, drug companies, and others sometimes have to recall products because of safety problems. A producer that makes an error in completing an order may have to take returns from middlemen or other business customers. If a Viewsonic computer monitor breaks while it's still under warranty, someone needs to get it to the authorized repair center. Soft-drink

companies may need to recycle empty bottles. And of course, at some point or other, most consumers buy something in error and want to return it. For example, this is quite common with online purchases where consumers can't see, touch, or try the actual product before purchasing it.[26]

Another problem arises from products that are damaged in shipping or discontinued. Most manufacturers take them back. For example, until recently P&G had a reclamation center that took back thousands of products, ranging from damaged boxes of Tide to leaking bottles of Crisco Oil. A grocery products trade group says that the cost of such unsalable products, in total, may be as much as $4 billion a year. This has prompted P&G to change its policies. Now, P&G has adopted a no-returns policy and instead gives retailers a payment for damaged items. The system is designed to reduce the cost of returns to both P&G and retailers. Ultimately, that cost must be paid by consumers. Some retailers don't like P&G's policy, but it is important to see that it is a specific plan and part of an overall strategy.

When marketing managers don't plan for reverse channels, the firm's customers may be left to solve "their" problem. That usually doesn't make sense. So a complete plan for Place may need to consider an efficient way to return products—with policies that different channel members agree on. It may also require specialists who were not involved in getting the product to the consumer. But if that's what it takes to satisfy customers, it should be part of marketing strategy planning.[27]

Conclusion

In this chapter, we discussed the role of Place and noted that Place decisions are especially important because they may be difficult and expensive to change.

Marketing specialists, and channel systems, develop to adjust discrepancies of quantity and assortment. Their regrouping activities are basic in any economic system. And adjusting discrepancies provides opportunities for creative marketers.

Channel planning requires firms to decide on the degree of market exposure they want. The ideal level of exposure may be intensive, selective, or exclusive. They also need to consider the legality of limiting market exposure to avoid having to undo an expensively developed channel system or face steep fines.

The importance of planning channel systems was discussed—along with the role of a channel captain. We stressed that channel systems compete with each other and that vertical marketing systems seem to be winning.

In this broader context, the "battle of the brands" is only a skirmish in the battle between various channel systems. And we emphasized that producers aren't necessarily the channel captains. Often middlemen control or even dominate channels of distribution.

Questions and Problems

1. Review the case at the beginning of the chapter and explain why Amazon.com would use a wholesaler like Ingram.
2. Give two examples of service firms that work with other channel specialists to sell their products to final consumers. What marketing functions is the specialist providing in each case?
3. Discuss some reasons why a firm that produces installations might use direct distribution in its domestic market but use middlemen to reach overseas customers.
4. Explain discrepancies of quantity and assortment using the clothing business as an example. How does the application of these concepts change when selling steel to the automobile industry? What impact does this have on the number and kinds of marketing specialists required?
5. Explain the four regrouping activities with an example from the building supply industry (nails, paint, flooring, plumbing fixtures, etc.). Do you think that many specialists develop in this industry, or do

producers handle the job themselves? What kinds of marketing channels would you expect to find in this industry, and what functions would various channel members provide?

6. Insurance agents are middlemen who help other members of the channel by providing information and handling the selling function. Does it make sense for an insurance agent to specialize and work exclusively with one insurance provider? Why or why not?
7. Discuss the Place objectives and distribution arrangements that are appropriate for the following products (indicate any special assumptions you have to make to obtain an answer):
   a. A postal scale for products weighing up to 2 pounds.
   b. Children's toys: (1) radio-controlled model airplanes costing $80 or more, (2) small rubber balls.
   c. Heavy-duty, rechargeable, battery-powered nut tighteners for factory production lines.
   d. Fiberglass fabric used in making roofing shingles.
8. Give an example of a producer that uses two or more different channels of distribution. Briefly discuss what problems this might cause.
9. Explain how a channel captain can help traditional independent firms compete with a corporate (integrated) channel system.
10. Find an example of vertical integration within your city. Are there any particular advantages to this vertical integration? If so, what are they? If there are no such advantages, how do you explain the integration?
11. What would happen if retailer-organized channels (either formally integrated or administered) dominated consumer product marketing?
12. How does the nature of the product relate to the degree of market exposure desired?
13. Why would middlemen want to be exclusive distributors for a product? Why would producers want exclusive distribution? Would middlemen be equally anxious to get exclusive distribution for any type of product? Why or why not? Explain with reference to the following products: candy bars, batteries, golf clubs, golf balls, steak knives, televisions, and industrial woodworking machinery.
14. Explain the present legal status of exclusive distribution. Describe a situation where exclusive distribution is almost sure to be legal. Describe the nature and size of competitors and the industry, as well as the nature of the exclusive arrangement. Would this exclusive arrangement be of any value to the producer or middleman?
15. Discuss the promotion a new grocery products producer would need in order to develop appropriate channels and move products through those channels. Would the nature of this job change for a new producer of dresses? How about for a new, small producer of installations?

Suggested Cases

13. Paper Supplies Corporation
15. Modern Horizons, Inc.
16. Morgan Company
34. Aluminum Basics Co.

Computer-Aided Problem

11. Intensive versus Selective Distribution

Hydropump, Inc., produces and sells high-quality pumps to business customers. Its marketing research shows a growing market for a similar type of pump aimed at final consumers—for use with Jacuzzi-style tubs in home remodeling jobs. Hydropump will have to develop new channels of distribution to reach this target market because most consumers rely on a retailer for advice about the combination of tub, pump, heater, and related plumbing fixtures they need. Hydropump's marketing manager, Robert Black, is trying to decide between intensive and selective distribution. With intensive distribution, he would try to sell through all the plumbing supply, bathroom fixture, and hot-tub retailers who will carry the pump. He estimates that about 5,600 suitable retailers would be willing to carry a new pump. With

selective distribution, he would focus on about 280 of the best hot-tub dealers (2 or 3 in the 100 largest metropolitan areas).

Intensive distribution would require Hydropump to do more mass selling—primarily advertising in home renovation magazines—to help stimulate consumer familiarity with the brand and convince retailers that Hydropump equipment will sell. The price to the retailer might have to be lower too (to permit a bigger markup) so they will be motivated to sell Hydropump rather than some other brand offering a smaller markup.

With intensive distribution, each Hydropump sales rep could probably handle about 300 retailers effectively. With selective distribution, each sales rep could handle only about 70 retailers because more merchandising help would be necessary. Managing the smaller sales force and fewer retailers, with the selective approach, would require less manager overhead cost.

Going to all suitable and available retailers would make the pump available through about 20 times as many retailers and have the potential of reaching more customers. However, many customers shop at more than one retailer before making a final choice—so selective distribution would reach almost as many potential customers. Further, if Hydropump is using selective distribution, it would get more in-store sales attention for its pump and a larger share of pump purchases at each retailer.

Black has decided to use a spreadsheet to analyze the benefits and costs of intensive versus selective distribution.

a. *Based on the initial spreadsheet, which approach seems to be the most sensible for Hydropump? Why?*
b. *A consultant points out that even selective distribution needs national promotion. If Black has to increase advertising and spend a total of $100,000 on mass selling to be able to recruit the retailers he wants for selective distribution, would selective or intensive distribution be more profitable?*
c. *With intensive distribution, how large a share (percent) of the retailers' total unit sales would Hydropump have to capture to sell enough pumps to earn $200,000 profit?*

For additional questions related to this problem, see Exercise 11-3 in the *Learning Aid for Use with Basic Marketing*, 14th edition.

When You Finish This Chapter, You Should

1. Understand why logistics (physical distribution) is such an important part of Place *and* marketing strategy planning.

2. Understand why the physical distribution customer service level is a key marketing strategy variable.

3. Understand the physical distribution concept and why it requires coordination of storing, transporting, and related activities.

4. See how firms can cooperate and share logistics activities to improve value to the customer at the end of the channel.

5. Know about the advantages and disadvantages of the various transporting methods.

6. Know how inventory decisions and storing affect marketing strategy.

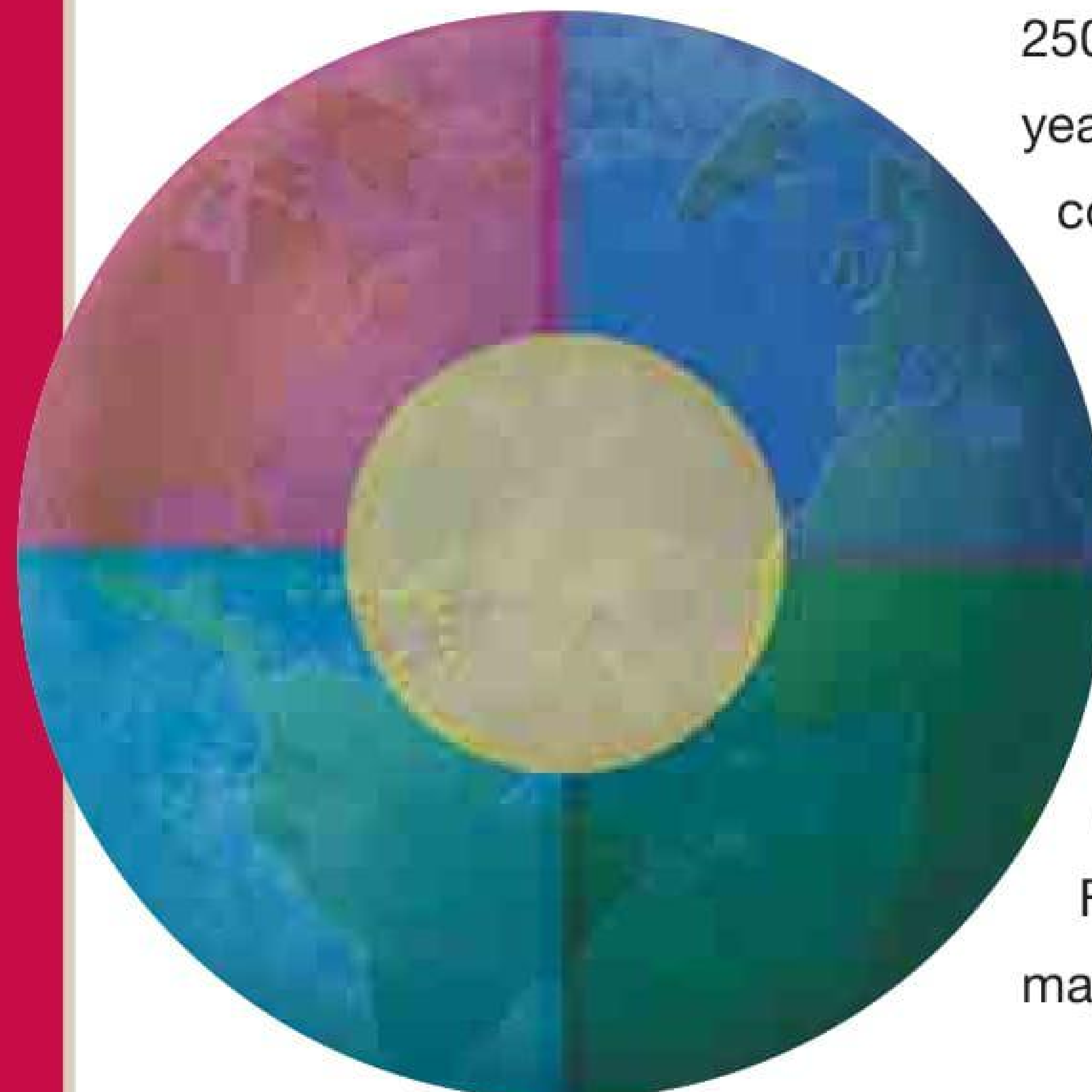
7. Understand the distribution center concept.

8. Understand the important new terms (shown in red).

Chapter Twelve

Distribution Customer Service and Logistics

If you want a Coca-Cola, there's usually one close by—no matter where you might be in the world. And that's no accident. An executive for the best-known brand name in the world stated the objective simply: "Make Coca-Cola available within an arm's reach of desire." To achieve that objective, Coke works with many different channels of distribution. But that's just the start. Think about what it takes for a bottle, can, or cup of Coke to be there whenever you're ready. In warehouses and distribution centers, on trucks, in gyms and sports arenas, and thousands of other retail outlets, Coke handles, stores, and transports over 250 billion servings of soft drink a year. Getting all of that product to consumers could be a logistical nightmare, but Coke does it effectively and at a low cost. Think about it: A can of Coke at the store costs only about 15 cents more that it costs you to have the post office deliver a letter.



Fast information about what the market needs helps keep Coke's

place

price

promotion

produc

distribution on target. In the United States, computer systems show Coke managers exactly what's selling in each market; that allows Coke to plan inventories and deliveries. Coke also operates a 24-hour-a-day communications center to respond to the two million requests it gets from channel members each year. Orders are processed instantly—so sales to consumers at the end of the channel aren't lost because of stock-outs. And Coke products move efficiently through the channel. In Cincinnati, for example, Coke built the beverage industry's first fully automated distribution center. Forklifts were replaced with automatically guided vehicles that speed up the product flow and reduce labor costs.

Coke's strategies in international markets rely on many of the same ideas. But the stage of market development varies in different countries, so Coke's emphasis varies as well. To increase sales in France, for example, Coke must first make more product available at retail stores; so Coke is installing thousands of soft-drink coolers in French supermarkets. In Great Britain, Coke is using multipacks because it wants to have more inventory at the point of consumption—in consumers' homes. In Japan, by contrast, single-unit vending machine sales are very important—so Coke uses an army of truck drivers to constantly restock its 870,000 vending machines, more per capita than anywhere else in the world. Coke is even testing vending machines that raise the price when it's hot or when few cans are left. In less-developed areas, the Place system is not always so sophisticated. In China, for example, the Communist Party won't let Coke control all of the details, but a local manager struck a deal. For some cash, the Communist Party keeps inventories in some of its local offices. Then retired party members use bicycle-powered pushcarts to sell the Coke inventory at densely populated housing projects.

www.mhhe.com/fourps www.mhhe.com/fourps

t place price promotion product

Coke is also working to increase fountain-drink sales in domestic and international markets. As part of that effort, Coke equips restaurants and food outlets with Coke dispensers. Once a Coke dispenser is installed, the retailer usually doesn't have room for a competitor's dispenser. And when a consumer wants a fountain drink, Coke isn't just "the real thing," it's the only thing. The number of fountain outlets has grown so rapidly that one Coke account rep serves as many as a 1,000 customers in a geographic area. That means that the little guys could get lost in the shuffle. However, to give them the service they need at a reasonable cost, Coke recently initiated Coke.net, a password-protected Web portal where fountain customers can access account managers online, track syrup orders, request equipment repairs, or download marketing support materials.

Of course, Pepsi is a tough competitor and isn't taking all of this sitting down. In recent years it has added more non-cola products, and its edgy ads for Mountain Dew and other products are helping it gain market share—which means it gets more shelf space and more Pepsi stocked at the point of purchase. Coke is pushing on new fronts as well. So the competition is becoming even more intense. It's not just the "Cola Wars" any more but rather the wars for cola, juice, water, sports drinks, tea, and many other beverages. And who wins customers and profits in this broader competition will depend on overall marketing programs—but clearly Place has an important role to play.[1]

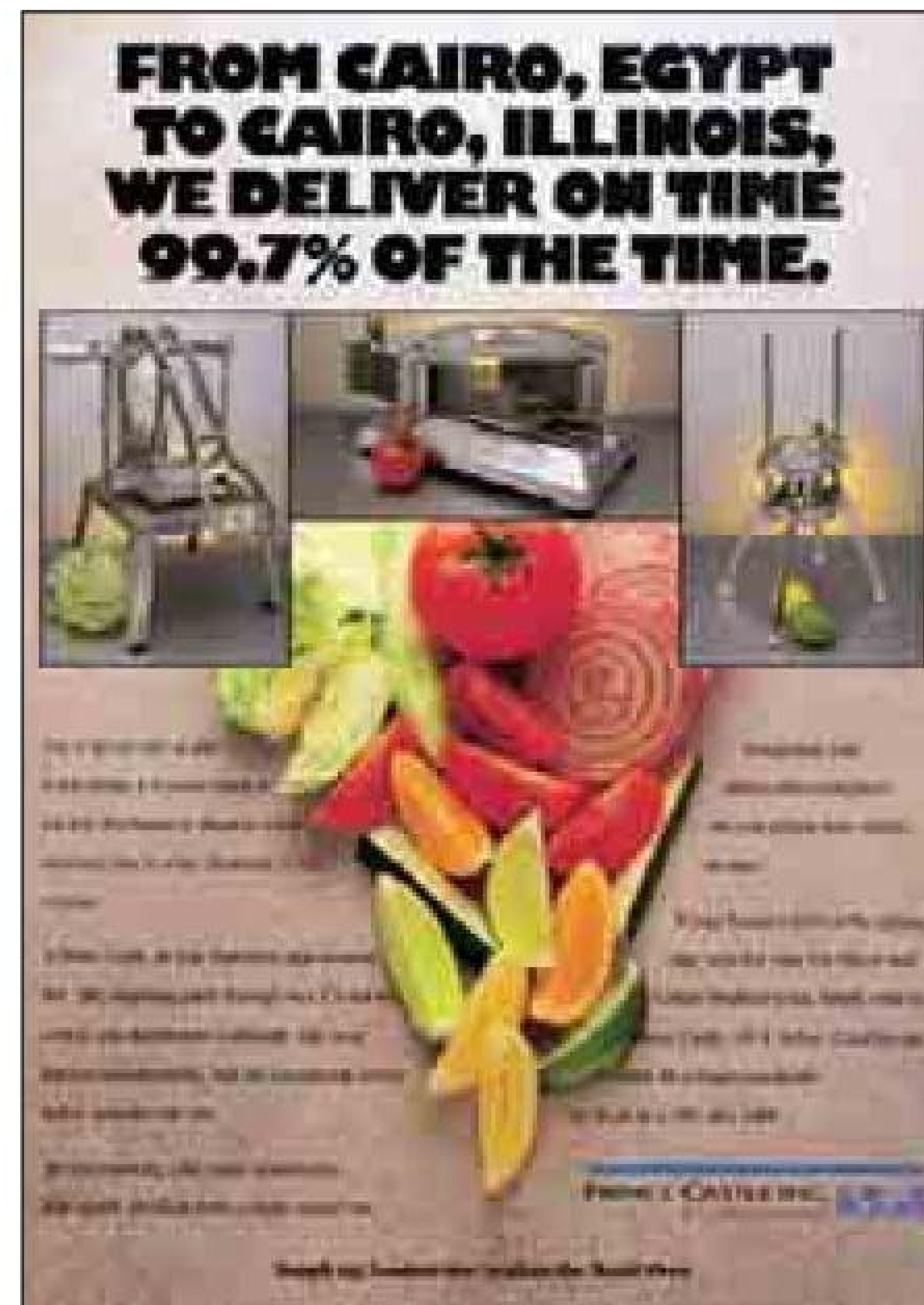
Physical Distribution Gets It to Customers

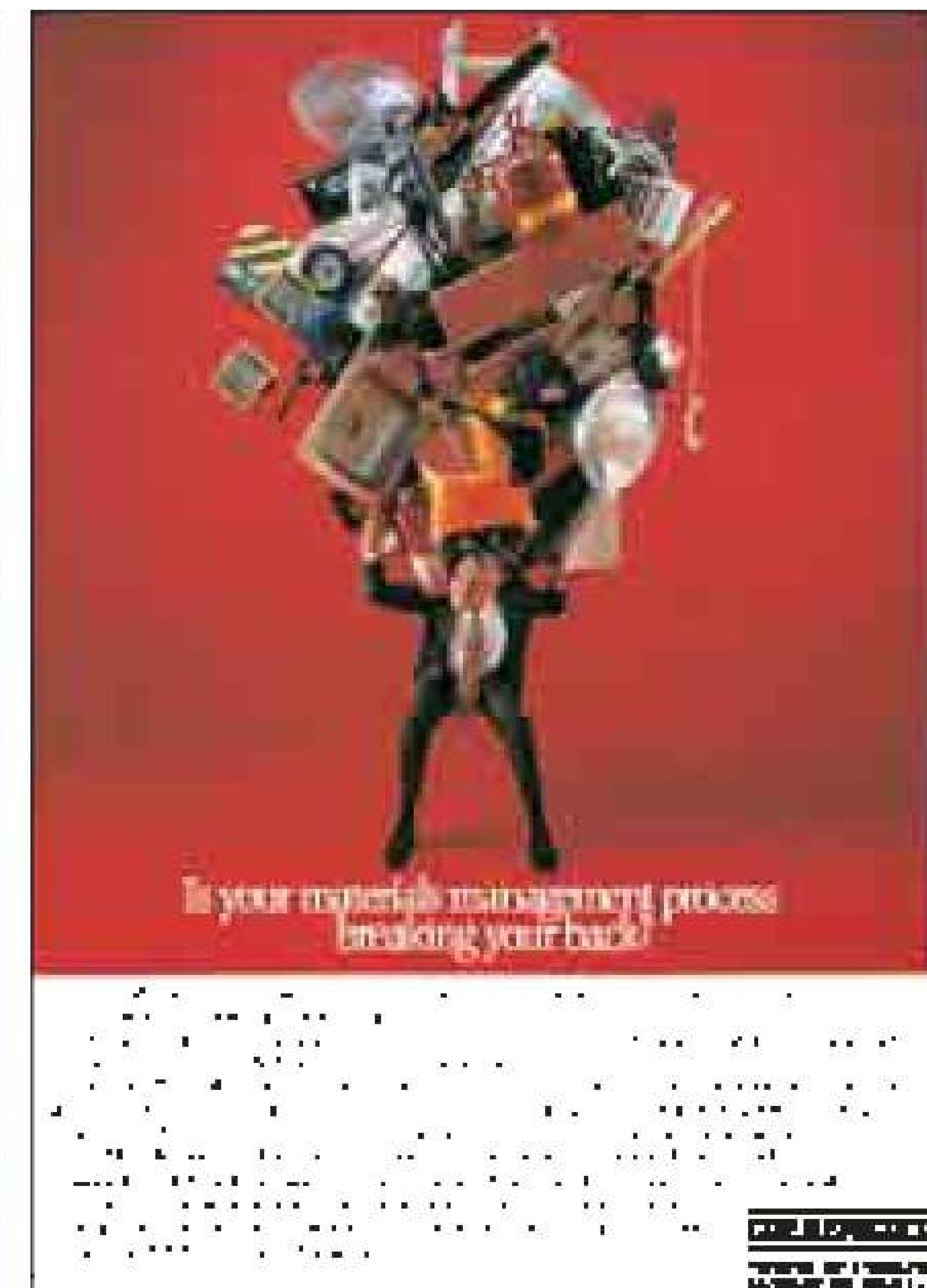
Choosing the right channel of distribution is crucial in getting products to the target market's Place. But as the Coke case shows, that alone is usually not enough to ensure that products are available at the right time and in the right quantities. Whenever the product includes a physical good, Place requires logistics decisions. **Logistics** is the transporting, storing, and handling of goods to match target customers' needs with a firm's marketing mix—both within individual firms and along a channel of distribution. **Physical distribution (PD)** is another common name for logistics.

PD provides time and place utility and makes possession utility possible. A marketing manager may have to make many decisions to ensure that the physical distribution system provides utility and meets customers' needs with an acceptable service level and cost.

Logistics costs are very important to both firms and consumers. These costs vary from firm to firm and, from a macro-marketing perspective, from country to country. However, for many physical goods, firms spend half or more of their total marketing dollars on physical distribution activities. The total amount of money involved is so large that even small improvements in this area can have a big effect on a whole macro-marketing system and consumers' quality of life. For example, during the past decade many supermarket chains and producers that supply them collaborated to create a system called Efficient Consumer Response (ECR) that cut grocers' costs, and prices, by about 11 percent. That translates to savings of about $30 *billion* a year for U.S. consumers! The basic idea of ECR involves paperless,

© The McGraw–Hill Companies, 2002





The physical distribution customer service level—including fast and reliable delivery of whatever assortment is needed—is critical to many business customers.

computerized links between grocers and their suppliers, which leads to more effective merchandise assortments and continuous replenishment of shelves based on what actually sells each day. Although the ECR movement started in the U.S. and Canada, it quickly spread across Europe and in other regions. Now, 50 consumer packaged goods companies have banned together to create Transora, a Web portal (www.transora.com), to bring more e-commerce benefits to the ECR concept. Obviously, far-reaching innovations like these don't transform everything overnight, but you can see that more effective approaches in the distribution area have the potential to save firms, and their customers, massive amounts of money.[2]

Physical Distribution Customer Service

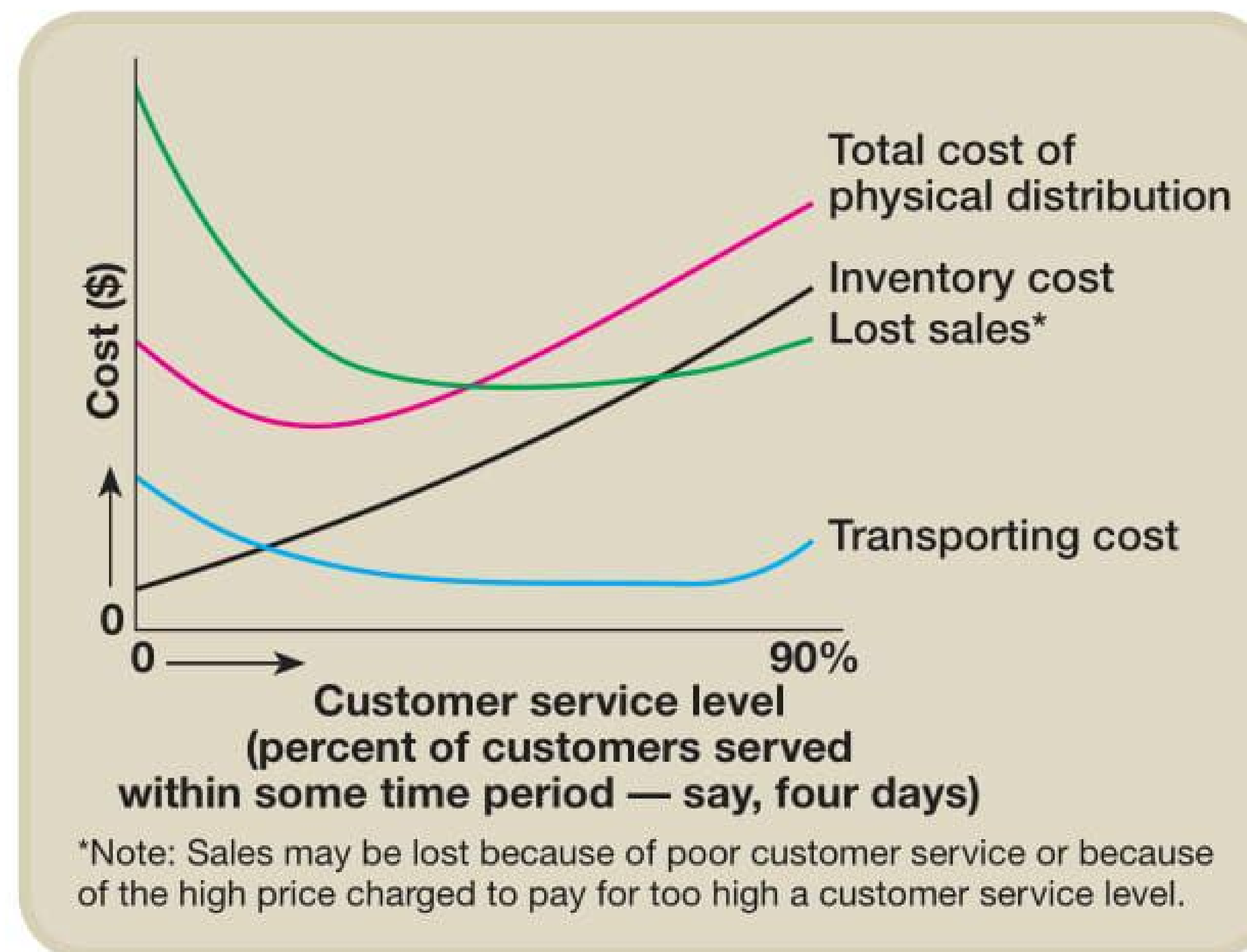
From the beginning, we've emphasized that marketing strategy planning is based on meeting customers' needs. Planning for logistics and Place is no exception. So let's start by looking at logistics through a customer's eyes.

Customers want products, not excuses

Customers don't care how a product was moved or stored or what some channel member had to do to provide it. Rather, customers think in terms of the physical distribution **customer service level**—how rapidly and dependably a firm can deliver what they, the customers, want. Marketing managers need to understand the customer's point of view.

What does this really mean? It means that Toyota wants to have enough windshields delivered to make cars *that* day—not late so production stops *or* early so there are a lot of extras to move around or store. In turn, it means that the Toyota dealer wants the car when it's due so that salespeople are not left making lame excuses to the customer who ordered it. It means that business executives who rent cars from Hertz want them to be ready when they get off their planes. It means that when you order a blue shirt at the Lands' End website you receive blue,

Exhibit 12-1
Trade-Offs among Physical Distribution Costs, Customer Service Level, and Sales



not pink. It means you want your Lay's Baked Potato Chips to be whole when you buy a bag at the snack bar—not crushed into crumbs from rough handling in a warehouse.

Physical distribution is invisible to most consumers

PD is, and should be, a part of marketing that is "invisible" to most consumers. It only gets their attention when something goes wrong. At that point, it may be too late to do anything that will keep them happy.

In countries where physical distribution systems are inefficient, consumers face shortages and inconvenient waits for the products they need. By contrast, most consumers in the United States and Canada don't think much about physical distribution. This probably means that these market-directed macro-marketing systems work pretty well—that a lot of individual marketing managers have made good decisions in this area. But it doesn't mean that the decisions are always clear-cut or simple. In fact, many trade-offs may be required.

Trade-offs of costs, service, and sales

Most customers would prefer very good service at a very low price. But that combination is hard to provide because it usually costs more to provide higher levels of service. So most physical distribution decisions involve trade-offs between costs, the customer service level, and sales.

If you want a new Compaq computer and the Best Buy store where you would like to buy it doesn't have it on hand, you're likely to buy it elsewhere; or if that model Compaq is hard to get you might just switch to some other brand. Perhaps the Best Buy store could keep your business by guaranteeing two-day delivery of your computer—by using airfreight from Compaq's factory. In this case, the manager is trading the cost of storing inventory for the extra cost of speedy delivery—assuming that the computer is available in inventory *somewhere* in the channel. In this example, missing one sale may not seem that important, but it all adds up. In fact, using Compaq Computer to illustrate this point is quite purposeful. A few years ago Compaq lost over $500 million in sales because its computers weren't available when and where customers were ready to buy them. With that kind of lesson in lost sales, you can see why Compaq worked hard to improve on the trade-off it was making.

Exhibit 12-1 illustrates trade-off relationships like those highlighted in the Compaq example. For example, faster but more expensive transportation may reduce the

need for a costly inventory of computers. There is also a trade-off between the service level and sales. If the service level is too low—if products are not available on a timely and dependable basis—customers will buy elsewhere, and sales will be lost. Alternatively, the supplier may hope that a higher service level will attract more customers or motivate them to pay a higher price. But if the service level is higher than customers want or are willing to pay for, sales will be lost to competitors who have figured out what kind of service customers value.

The important point is that many trade-offs must be made in the PD area. The trade-offs can be complicated. The lowest-cost approach may not be best—if customers aren't satisfied. A higher service level may make a better strategy. Further, if different channel members or target markets want different customer service levels, several different strategies may be needed.[3]

Many firms are trying to address these complications with e-commerce. Information technology can improve service levels and cut costs at the same time. As you'll see, better information flows make it easier to coordinate the different activities and cut inefficiency that doesn't add value for the customer.

Physical Distribution Concept Focuses on the Whole Distribution System

The physical distribution concept

The **physical distribution (PD) concept** says that all transporting, storing, and product-handling activities of a business and a whole channel system should be coordinated as one system that seeks to minimize the cost of distribution for a given customer service level. Both lower costs and better service help to increase customer value. It may be hard to see this as a startling development. But until just a few years ago, even the most progressive companies treated physical distribution functions as separate and unrelated activities.

Within a firm, responsibility for different distribution activities was spread among various departments—production, shipping, sales, warehousing, and others. No one person was responsible for coordinating storing and shipping decisions or seeing how they related to customer service levels. Some firms even failed to calculate the costs for these activities, so they never knew the total cost of physical distribution. If it was unusual for distribution to be coordinated within a firm, it was even rarer for different firms in the channel to collaborate. Each just did its own thing.[4]

Unfortunately, in too many firms old-fashioned ways persist—with a focus on individual functional activities rather than the whole physical distribution system. Trying to reduce the cost of individual functional activities may actually increase total distribution costs—not only for the firm, but also for the whole channel. It may also lead to the wrong customer service level. Well-run firms now avoid these problems by paying attention to the physical distribution concept.

Decide what service level to offer

With the physical distribution concept, firms work together to decide what aspects of service are most important to customers at the end of the channel and what specific service level to provide. Then they focus on finding the least expensive way to achieve the target level of service.

Exhibit 12-2 shows a variety of factors that may influence the customer service level (at each level in the channel). The most important aspects of customer service depend on target market needs. Xerox might focus on how long it takes to deliver copy machine repair parts once it receives an order. When a copier breaks down, customers want the repair "yesterday." The service level might be stated as

Exhibit 12-2
Examples of Factors that Affect PD Service Levels

- Advance information on product availability
- Time to enter and process orders
- Backorder procedures
- Where inventory is stored
- Accuracy in filling orders
- Damage in shipping, storing, and handing
- Online status information
- Advance information on delays
- Time needed to deliver an order
- Reliability in meeting delivery date
- Complying with customer's instructions
- Defect-free deliveries
- How needed adjustments are handled
- Procedures for handling returns

"we will deliver 90 percent of all emergency repair parts within 8 business hours and the remainder within 24 hours." Such a service level might require that almost all such parts be kept in inventory, that the most commonly needed parts be available on the service truck, that order processing be very fast and accurate, and that parts not available locally be sent by airfreight. If Xerox doesn't make the part, it would need to be sent directly from Xerox's supplier. Obviously, supplying this service level will affect the total cost of the PD system. But it may also beat competitors who don't provide this service level.

Increasing service levels may be very profitable in highly competitive situations where the firm has little else to differentiate its marketing mix. Marketing managers at Clorox, for example, must do everything they can to develop and keep strong partnerships with Clorox middlemen (supermarket chains, convenience stores, mass merchandisers, warehouse clubs, and wholesalers) and other business customers (ranging from white-tablecloth restaurants to the fast-service chains). Many other firms sell products with precisely the same ingredients as Clorox and are constantly trying to get orders from Clorox's 100,000 business customers worldwide. Yet Clorox's objective is to "maintain the highest standards for customer service" in the product-markets it serves because that helps it obtain a competitive advantage. For example, when the bleach buyer for a major retail chain went on vacation, the fill-in person was not familiar with the computerized reorder procedures. As a result, the chain's central distribution center almost ran out of Clorox liquid bleach. But Clorox's distribution people identified the problem themselves—because of a computer system that allowed Clorox to access the chain's inventory records and sales data for Clorox products. Clorox rearranged production to get a shipment out fast enough to prevent the chain, and Clorox, from losing sales at individual stores. In the future when some other bleach supplier tries to tell buyers for the chain that "bleach is bleach," they'll remember the distribution service Clorox provides.[5]

Find the lowest total cost for the right service level

In selecting a PD system, the **total cost approach** involves evaluating each possible PD system and identifying *all* of the costs of each alternative. This approach uses the tools of cost accounting and economics. Costs that otherwise might be ignored—like inventory carrying costs—are considered. The possible costs of lost sales due to a lower customer service level may also be considered. The following simple example clarifies why the total cost approach is important.

A cost comparison of alternative systems

The Good Earth Vegetable Company was shipping produce to distant markets by train. The cost of shipping a ton of vegetables by train averaged less than half the cost of airfreight so the company assumed that rail was the best method. But then Good Earth managers did a more complete analysis. To their surprise, they found the airfreight system was faster and cheaper.

Exhibit 12-3 compares the costs for the two distribution systems—airplane and railroad. Because shipping by train was slow, Good Earth had to keep a large

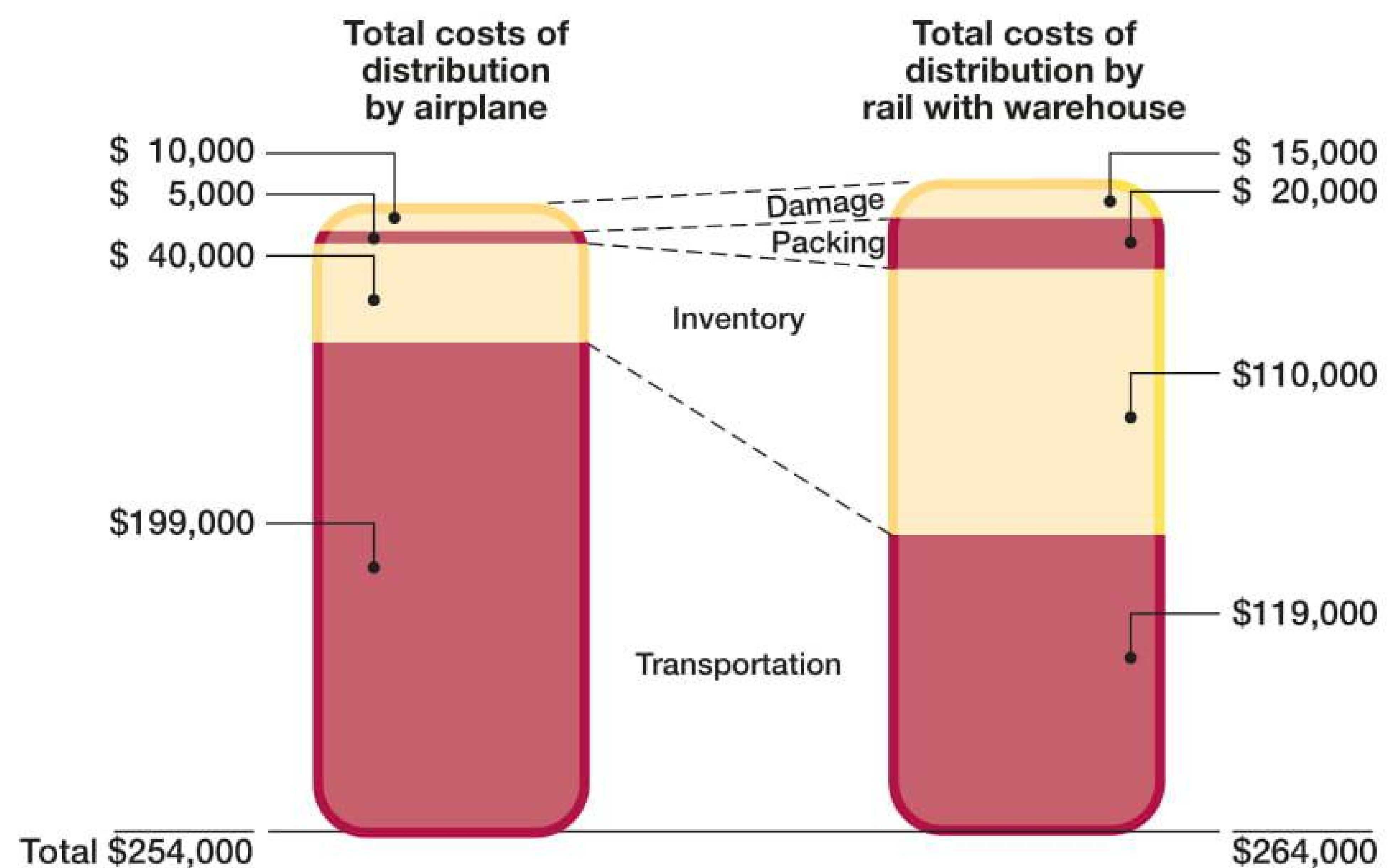
Both Business Objects and Sauder try to help customer firms do a better job of tracking the status of orders and making certain that products are where they are needed at the right time.

inventory in a warehouse to fill orders on time. And the company was also surprised at the extra cost of carrying the inventory in transit. Good Earth's managers also found that the cost of spoiled vegetables during shipment and storage in the warehouse was much higher when they used rail shipping.

In this case, total cost analyses showed that airfreight, while more costly by itself, provided better service than the conventional means—and at a lower total distribution cost. The case also illustrates why it is important to get beyond a focus on individual functional elements of PD and instead consider the costs and service level of a whole system. This broader focus should consider how the whole channel operates, not just individual firms.

Many firms are now applying this type of thinking to improve value to customers and profits. For example, after two years of work with the total cost approach,

Exhibit 12-3
Comparative Costs of Airplane versus Rail and Warehouse



National Semiconductor cut its standard delivery time in half, reduced distribution costs 2.5 percent, and increased sales by 34 percent. In the process it shut down six warehouses around the globe and started to airfreight microchips to its worldwide customers from a new 125,000-square-foot distribution center in Singapore. In advance of these changes, no one would have said that this was an obvious thing to do. But it proved to be the smart thing.

Identifying all the alternatives is sometimes difficult

It's important for firms to compare the costs and benefits of all practical PD alternatives, including how functions can be shared in the channel. Sometimes, however, there are so many possible combinations that it is difficult to study each one completely. For example, there may be hundreds of possible locations for a warehouse. And each location might require different combinations of transporting, storing, and handling costs. Some companies use computer simulation to compare the many possible alternatives. But typically, the straightforward total cost analysis discussed above is practical and will show whether there is need for a more sophisticated analytical approach.[6]

Coordinating Logistics Activities among Firms

Functions can be shifted and shared in the channel

As a marketing manager develops the Place part of a strategy, it is important to decide how physical distribution functions can and should be divided within the channel. Who will store, handle, and transport the goods—and who will pay for these services? Who will coordinate all of the PD activities?

There is no right sharing arrangement. Physical distribution can be varied endlessly in a marketing mix and in a channel system. And competitors may share these functions in different ways—with different costs and results.

How PD is shared affects the rest of a strategy

How the PD functions are shared affects the other three Ps—especially Price. The sharing arrangement can also make (or break) a strategy. Consider Channel Master, a firm that wanted to take advantage of the growing market for the dish-like antennas used to receive TV signals from satellites. The product looked like it could be a big success, but the small company didn't have the money to invest in a large inventory. So Channel Master decided to work only with wholesalers who were willing to buy (and pay for) several units—to be used for demonstrations and to ensure that buyers got immediate delivery.

In the first few months Channel Master earned $2 million in revenues—just by providing inventory for the channel. And the wholesalers paid the interest cost of carrying inventory—over $300,000 the first year. Here the wholesalers helped share the risk of the new venture—but it was a good decision for them too. They won many sales from a competing channel whose customers had to wait several months for delivery. And by getting off to a strong start, Channel Master became a market leader.

A coordinated effort reduces conflict

PD decisions interact with other Place decisions, the rest of the marketing mix, and the whole marketing strategy. As a result, if firms in the channel do not plan and coordinate how they will share PD activities, PD is likely to be a source of conflict rather than a basis for competitive advantage. Holly Farms' problems in introducing a new product illustrate this point.

Marketers at Holly Farms were encouraged when preroasted chicken performed well in a market test. But channel conflict surfaced when they moved to broader distribution. As with other perishable food products, the Holly Farm label indicated a date by which the chicken should be sold. Many grocers refused to buy the roast

chicken because they worried that they had only a few days after it was delivered to sell it. They didn't want it to spoil—at their expense—on the shelf. They also didn't want to sell their customers something that wasn't fresh.

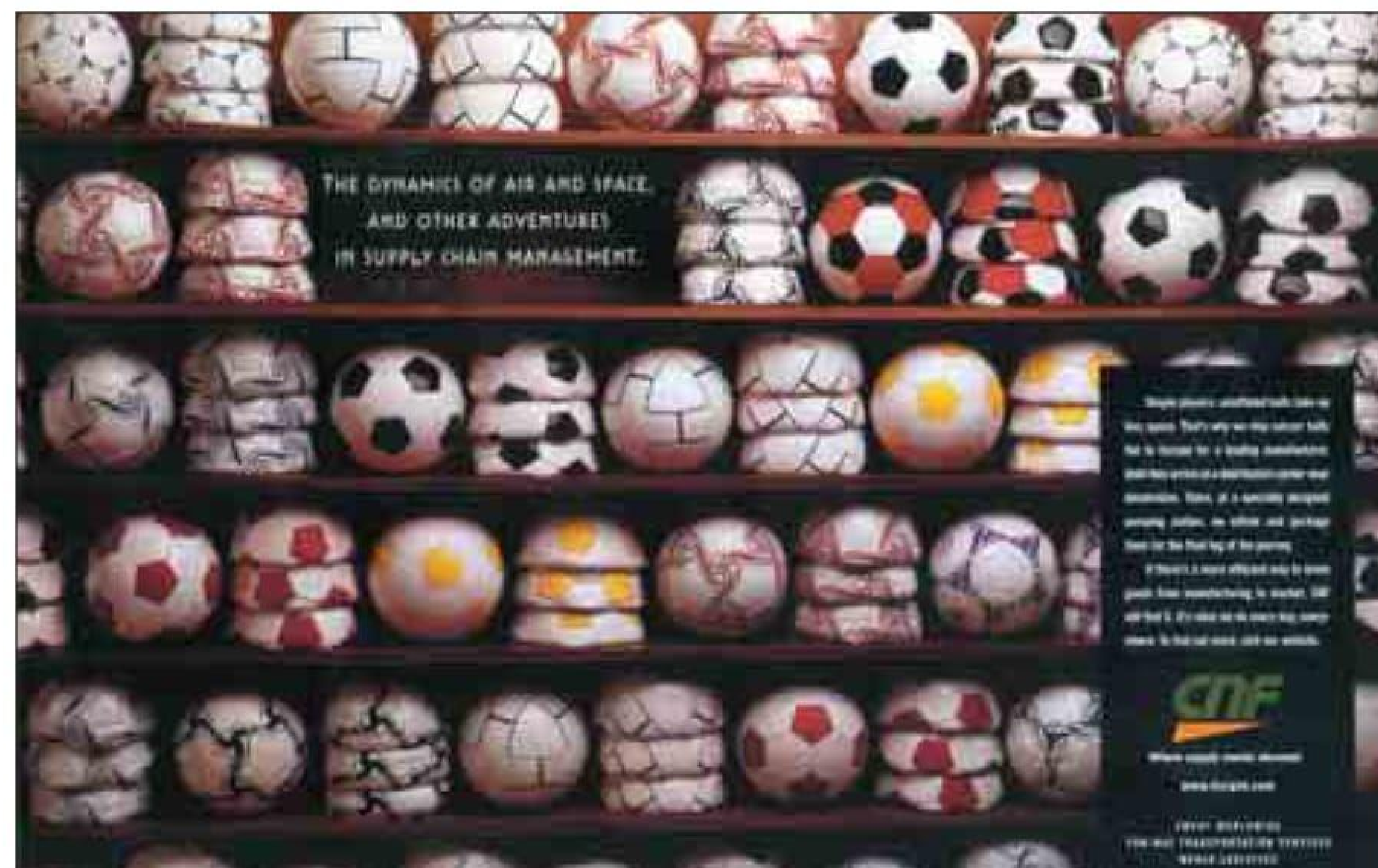
Shelf life had not been a problem with Holly Farms' raw chicken. It sold in higher volume and moved off shelves more quickly. The source of the problem with the roast chicken was that it took too long to ship from the plant to distant stores. Coupled with slow turnover, that didn't leave grocers enough selling time. To address the problem, Holly Farms changed its transportation arrangements. It also developed new packaging that allowed grocers to store the chicken longer. Holly Farms also shifted its promotion budget to put more emphasis on in-store promotions to speed up sales once the chicken arrived. With these changes, Holly Farms was able to win cooperation in the channel and establish its product in the market.[7]

JIT requires a close, cooperative relationship

We introduced the concept of just-in-time (JIT) delivery in Chapter 7. Now that you know more about PD alternatives, it's useful to consider some of the marketing strategy implications of this approach.

A key advantage of JIT for business customers is that it reduces their PD costs—especially storing and handling costs. However, if the customer doesn't have any backup inventory, there's no security blanket if something goes wrong. If a supplier's delivery truck gets stuck in traffic, if there's an error in what's shipped, or if there are any quality problems when the products arrive, the customer's business stops. Thus, a JIT system requires that a supplier have extremely high quality control in production and in every PD activity, including its PD service.

For example, to control the risk of transportation problems, JIT suppliers often locate their facilities close to important customers. Trucks may make smaller and more frequent deliveries—perhaps even several times a day. As this suggests, a JIT system usually requires a supplier to be able to respond to very short order lead times. In fact, a supplier's production often needs to be based on the customer's production schedule. Thus, e-commerce order systems and information sharing over computer networks are often required. However, if that isn't possible, the supplier must have adequate inventory to meet the customer's needs. Moreover, the supplier in turn may need better service from firms that it relies on, say, for raw materials or supplies.



To help a manufacturer of soccer balls reduce its logistics costs, CNF ships the balls to Europe uninflated and then pumps them up before the last leg of their journey to individual outlets.

You can see that the JIT system shifts greater responsibility for PD activities backward in the channel. If the supplier can be more efficient than the customer could be in controlling PD costs—and still provide the customer with the service level required—this approach can work well for everyone in the channel. However, it should be clear that JIT is not always the lowest-cost or best approach. It may be better for a supplier to produce and ship in larger, more economical quantities—if the savings offset the distribution system's total inventory and handling costs.

While not every firm can, or should, use a just-in-time approach, it is an important idea. It focuses attention on the need to coordinate the PD system throughout the channel. It also highlights the value of close working relationships and effective communication between marketers and their customers. Whether or not a firm uses the JIT approach, good information (and technology to share it quickly) is often the key to coordinating PD activities and improving the customer service level.[8]

Chain of supply may involve even more firms

In our discussion, we have taken the point of view of a marketing manager. This focuses on how logistics should be coordinated to meet the needs of customers at the end of the channel of distribution. Now, however, we should broaden the picture somewhat because the relationships within the distribution channel are sometimes part of a broader network of relationships in the **chain of supply**—the complete set of firms and facilities and logistics activities that are involved in procuring materials, transforming them into intermediate or finished products, and distributing them to customers. For example, Toyota not only works with dealers and customers further down its channel of distribution but also is coordinating with all of the supplier firms from which it buys parts, supplies, and raw materials. Those firms, in turn, are linked to other suppliers who come earlier in the chain of supply. What happens at each link along the chain can impact coordination further down the chain. If the firm that produces seats for Toyota doesn't get the fabric from its supplier on time, the seats will be delayed in route to Toyota and the car will be slow getting to the dealer and consumer.

Ideally, all of the firms in the chain of supply should work together to meet the needs of the customer at the very end of the chain. That way, at each link along the chain the shifting and sharing of logistics functions and costs are handled to result in maximum value for the final customer. Further, all of the firms in the whole chain of supply are able to do a better job of competing against competitors who are involved in other chains of supply.

The practical reality is that coordination across the whole chain of supply doesn't always happen. The customer service level that a marketing manager needs to compete may not be possible if firms earlier in the chain of supply can't or won't do what is needed. In these situations the purchasing and manufacturing departments can't be expected to do the impossible. Resolving this sort of problem requires strategic decisions by the firm's top management. For example, the CEO might decide that the firm needs to invest in costly new computer networks and software that will provide e-commerce order systems that also give suppliers information they need.

The challenges of coordinating logistics functions across the complete chain of supply have prompted some firms to put a high-level executive in charge of chain of supply decisions. This person works with people in marketing, procurement, manufacturing, and other areas to find the best ways to address problems that arise. Yet, it's still difficult for a manager in any one company to know what kind of logistics sharing arrangement will work best, or even be possible, in a whole series of other companies. Because of that, many firms turn to outside experts for help. For example, specialists have developed to design e-commerce computer systems that link all of the firms in a chain of supply. Similarly, there are consultants who use computer models to figure out the best locations for inventory or the best way to shift logistics functions among firms. In other cases, firms sometimes outsource the whole job of planning *and* implementing their logistics systems.[9]

Internet

Internet Exercise Large corporations often turn to other firms that specialize in logistics—transportation and warehousing services, consultants, developers of software for e-commerce, and the like—to help implement the physical distribution aspects of their marketing strategies. The website of the Virtual Logistics Directory (www.logisticdirectory.com) lists many logistics specialists and what they do. Go to the website and select the *Integrated Logistics* category. Review the descriptions of some of the firms listed, and then pick one. Explain why a large corporation with a logistics problem might seek its help rather than just trying to tackle the problem internally.

Better information helps coordinate PD

Coordinating all of the elements of PD has always been a challenge—even in a single firm. Trying to coordinate PD throughout the whole supply chain is even tougher. Keeping track of inventory levels, when to order, and where goods are when they move is complicated. The Internet is becoming more and more important in finding solutions to these challenges.

Many firms now continuously update their marketing information systems—so they can immediately find out what products have sold, the level of the current inventory, and when goods being transported will arrive. And coordination of physical distribution decisions throughout channels of distribution continues to improve as more firms are able to have their computers "talk to each other" directly and as managers can get information from a website whenever they need it.

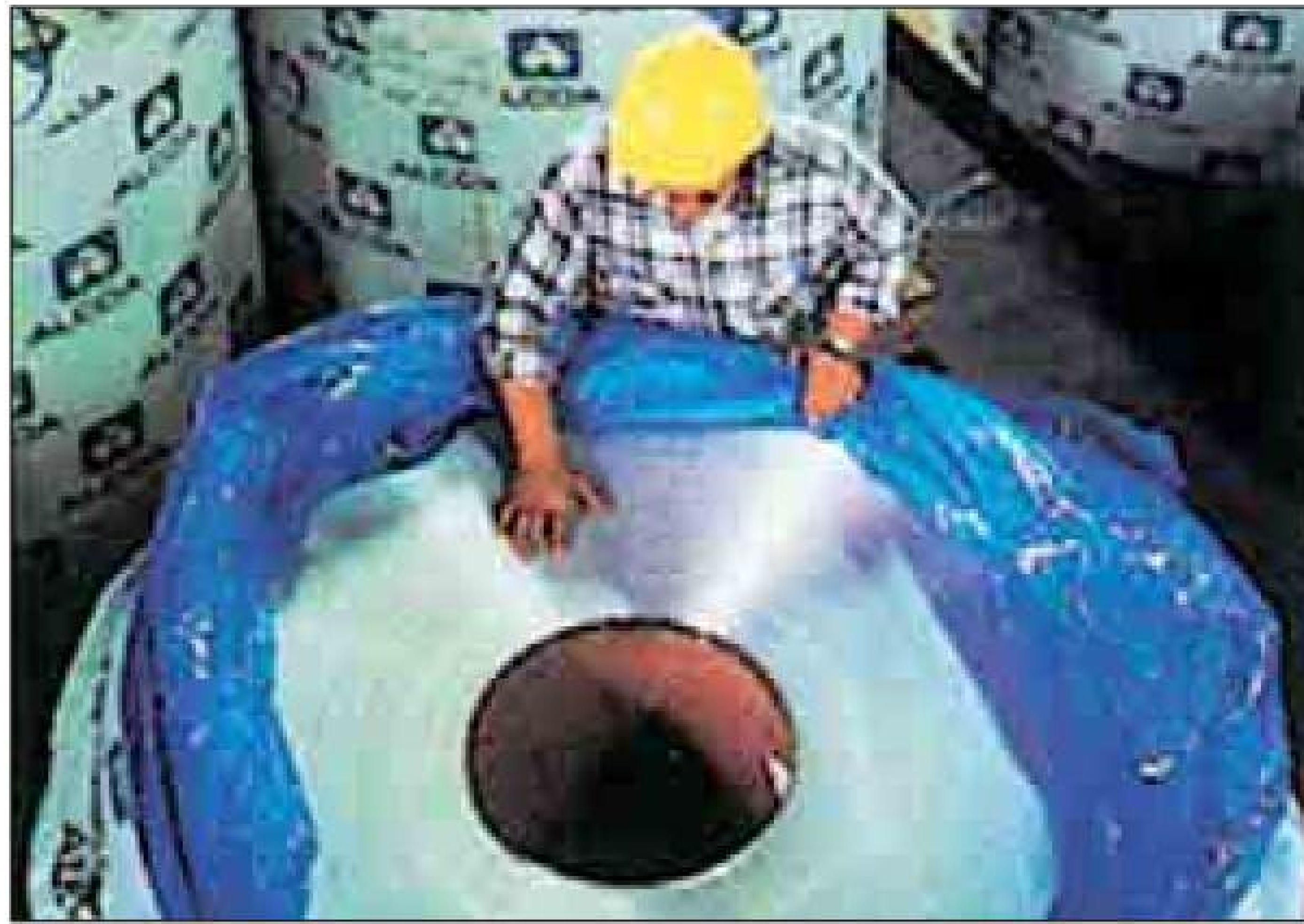
Electronic data interchange sets a standard

Until recently, differences in computer systems from one firm to another hampered the flow of information. Many firms attacked this problem by adopting **electronic data interchange (EDI)**—an approach that puts information in a standardized format easily shared between different computer systems. In many firms, purchase orders, shipping reports, and other paper documents were replaced with computerized EDI. With EDI, a customer transmits its order information directly to the supplier's computer. The supplier's computer immediately processes the order and schedules production, order assembly, and transportation. Inventory information is automatically updated, and status reports are available instantly. The supplier might then use EDI to send the updated information to the transportation provider's computer. This type of system is now very common. In fact, almost all international transportation firms rely on EDI links with their customers.

EDI systems were originally developed and popularized before the World Wide Web and Internet gained widespread use. Most traditional EDI systems are expensive to develop, rely on proprietary computer networks, and use specialized software to exchange data securely. Alternatives to this approach that rely on the Internet are gaining in popularity. However, there are still some obstacles. While it's easy for firms to share many types of information that use the standard HTML web-page format, HTML is not well suited for exchanging numerical data (like sku numbers, sales volume, purchase quantities, and the like) between software programs on different computers. However, a new standard format, called XML, is gaining popularity and fostering easier EDI-type data exchanges over the Internet.[10]

This improved information flow and coordination affects other PD activities too. Instantaneous order processing or using an EDI system or the Internet, for example, can have the same effect on the customer service level as faster, more expensive transportation. And knowing what a customer has sold or has in stock can improve a supplier's own production planning and reduce both inventory costs and stockouts in the whole channel.

Better coordination of PD activities is a key reason for the success of Pepperidge Farm's line of premium cookies. It was making the wrong products and delivering them too slowly to the wrong market. Poor information was the problem. Delivery truck drivers took orders from retailers, assembled them manually at regional offices,



Transporting costs can be a large part of the total cost for heavy products that are low in value, like sheet aluminum. But the cost of transportation adds little to the total cost of products—like pharmaceuticals—that are already valuable relative to their size and weight.

and then mailed them to Pepperidge Farm's bakeries. Now the company has instant networked data sharing between sales, delivery, inventory, and production. Many of the company's 2,200 drivers use hand-held computers to record the inventory at each stop along their routes. They use the Internet to transmit the information into a computer at the bakeries—so that cookies in short supply will be produced. The right assortment of fresh cookies is quickly shipped to local markets, and delivery trucks are loaded with what retailers need that day. Pepperidge Farm now moves cookies from its bakeries to store shelves in about three days; most cookie producers take about 10 days. That means fresher cookies for consumers and helps to support Pepperidge Farm's high-quality positioning and premium price.[11]

In summary, using computers to share information and coordinate activities is helping some firms and channels compete successfully for customers and increase their own profits.

Ethical issues may arise

Most of the ethical issues that arise in the PD area concern communications about product availability. For example, some critics say that Internet sellers too often take orders for products that are not available or which they cannot deliver as quickly as customers expect. Yet a marketing manager can't always know precisely how long it will take before a product will be available. It doesn't make sense for the marketer to lose a customer if it appears that he or she can satisfy the customer's needs. But the customer may be inconvenienced or face added cost if the marketer's best guess isn't accurate. Similarly, some critics say that stores too often run out of products that they promote to attract consumers to the store. Yet it may not be possible for the marketer to predict demand, or to know when placing an ad that deliveries won't arrive. Different people have different views about how a firm should handle such situations. Some retailers just offer rain checks.

Some suppliers criticize customers for abusing efforts to coordinate PD activities in the channel. For example, some retailers hedge against uncertain demand by telling suppliers that they plan to place an order, but then they don't confirm the order until the last minute. They want to be able to say that it wasn't an order in the first place—if sales in the store are slow. This shifts the uncertainty to the supplier and reduces the retailer's inventory costs. Is this unethical? Some think it is. However, a marketing manager should realize that the firm's order policies can reduce such problems—if the cost of providing the service customers want is higher than what they will pay. In other words, this may simply be another trade-off that the marketer must consider in setting up the PD system.[12]

© The McGraw–Hill Companies, 2002

Now that you see why the coordination of physical distribution activities is so important, let's take a closer look at some of the PD decision areas.

The Transporting Function Adds Value to a Marketing Strategy

Transporting aids economic development and exchange

Transporting is the marketing function of moving goods. Transportation provides time and place utilities—at a cost. But the cost is less than the value added to products by moving them or there is little reason to ship in the first place.

Transporting can help achieve economies of scale in production. If production costs can be reduced by producing larger quantities in one location, these savings may more than offset the added cost of transporting the finished products to customers. Without low-cost transportation, both within countries and internationally, there would be no mass distribution as we know it today.

Transporting can be costly

Transporting costs may limit the target markets a marketing manager can consider. Shipping costs increase delivered cost—and that's what really interests customers. Transport costs add little to the cost of products that are already valuable relative to their size and weight. A case of medicine, for example, might be shipped to a drugstore at low cost. But transporting costs can be a large part of the total cost for heavy products of low value—like many minerals and raw materials. You can imagine that shipping a massive roll of aluminum to a producer of soft-drink cans is an expensive proposition. Exhibit 12-4 shows transporting costs as a percent of total sales dollars for several products.[13]

Governments may influence transportation

Government often plays an important role in the development of a country's transportation system—including its roads, harbors, railroads, and airports. And different countries regulate transportation differently—although regulation has in general been decreasing.

For example, as part of their move toward unification, most European countries are reducing their transporting regulations. The construction of the tunnel under the English Channel is a dramatic example of the changes taking place. The "chunnel" allows trains to speed between England and the rest of Europe.

As regulations decreased in the U.S., competition in the transportation industry increased. As a result, a marketing manager generally has many carriers in one or more modes competing for the firm's transporting business. Or a firm can do its own transporting. So knowing about the different modes is important.[14]

Exhibit 12-4
Transporting Costs as a Percent of Selling Price for Different Products

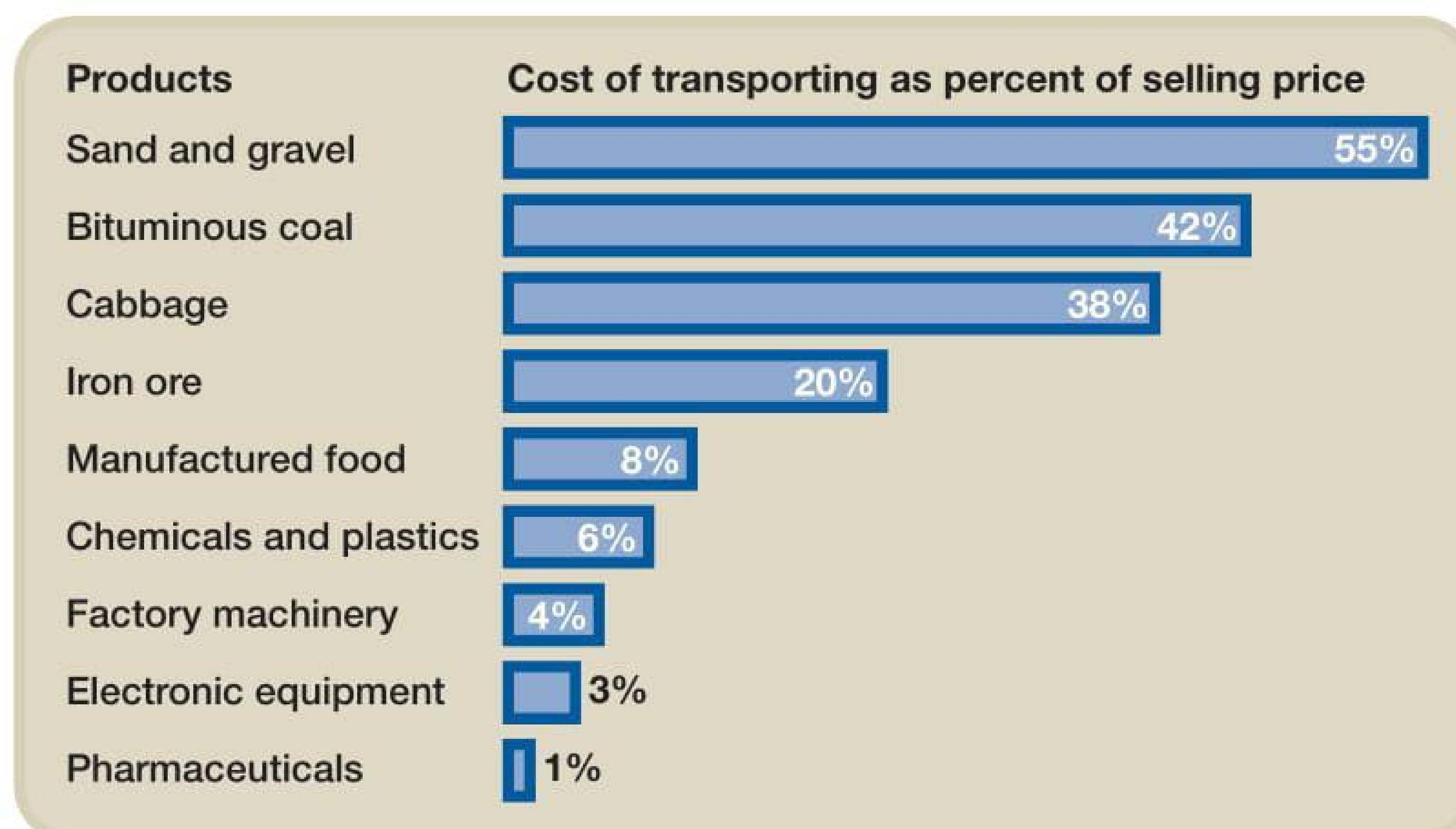


Exhibit 12-5 Benefits and Limitations of Different Transport Modes

	Transporting Features					
Mode	Cost	Delivery speed	Number of locations served	Ability to handle a variety of goods	Frequency of scheduled shipments	Dependability in meeting schedules
Truck	High	Fast	Very extensive	High	High	High
Rail	Medium	Average	Extensive	High	Low	Medium
Water	Very low	Very slow	Limited	Very high	Very low	Medium
Air	Very high	Very fast	Extensive	Limited	High	High
Pipeline	Low	Slow	Very limited	Very limited	Medium	High

Which Transporting Alternative Is Best?

Transporting function must fit the whole strategy

The transporting function should fit into the whole marketing strategy. But picking the best transporting alternative can be difficult. The "best" alternative depends on the product, other physical distribution decisions, and what service level the company wants to offer. The best alternative should not only be as low-cost as possible but also provide the level of service (for example, speed and dependability) required. Exhibit 12-5 shows that different modes of transportation have different strengths and weaknesses. You can find more detail at the website of the Bureau of Transportation Statistics (www.bts.gov). Low transporting cost is *not* the only criterion for selecting the best mode.[15]

Railroads—large loads moved at low cost

Railroads are still the workhorse of the U.S. transportation system. They carry more freight over more miles than any other mode. However, they account for less

Mercedes recently introduced a new, smaller truck that is designed to be more flexible in making deliveries in congested cities like Istanbul, where this ad appeared.

Babbages Changes the Rules to Win Game Lovers' Business

Winning the hearts, wallets, and loyalty of electronic game fanatics isn't easy, but Babbages' marketing strategy has done just that. Imagine, for instance, the week in which the folks at Babbages shipped 500,000 units of 73 different games by overnight delivery to 900 different stores. Or there was the time they filled tractor-trailer trucks at Nintendo's loading dock, at midnight, and then rushed to a chartered jet so that a highly anticipated game would be available in stores the same day it was released. Have they lost their minds? No, but some people think that their customers have. Big-spending game enthusiasts want to be the very first to get a new game when it comes out. So Babbages ships every new game for overnight delivery. While Wal-Mart and Best Buy stores can stock more at a lower price, it takes longer for games to work through their distribution centers and get to store shelves. By then, Babbages would like to be sold out. The shelf life of a new game is only about 15 weeks, and most sales are at the beginning. So gamers will drive across town to get a game sooner at Babbages, even if it's more pricey. That way, when someone asks their opinions about a new game, they will be in the know. In fact, game manufacturers like Nintendo know that avid gamers post reviews of a game on the Internet within 24 hours of when it gets to Babbages. If reviews say that a game is really hot, the manufacturer can ramp up production. That saves time because the factories are in Asia, and it takes about three weeks to reorder and get more product on shelves.[16]

www.mhhe.com/fourps

than 10 percent of transport revenues. In the United States, as in other countries, they carry heavy and bulky goods—such as raw materials, steel, chemicals, and coal—over long distances. By handling large quantities, the railroads are able to transport at relatively low cost. For example, in the United States the average cost to ship by rail runs about 2 to 3 cents a ton-mile. Because railroad freight moves more slowly than truck shipments, it is not as well suited for perishable items or those in urgent demand. Railroads are most efficient at handling full carloads of goods. Less-than-carload (LCL) shipments take a lot of handling and rehandling, which means they usually move more slowly and at a higher price per pound than carload shipments.[17]

Trucks are more expensive, but flexible and essential

The flexibility and speed of trucks make them better at moving small quantities of goods for shorter distances. They can travel on almost any road. They go where the rails can't. They are also reliable in meeting delivery schedules, which is an essential requirement for many of today's logistics systems that require rapid replenishment of inventory after a sale. In combination these factors explain why at least 75 percent of U.S. consumer products travel at least part of the way from producer to consumer by truck. And in countries with good highway systems, trucks can give extremely fast service. Trucks compete for high-value items. This is reflected in their rates, which average about 26 cents per ton-mile in the United States. Critics complain that trucks congest traffic and damage highways. But trucks are essential to our present macro-marketing system.[18]

Ship it overseas—but slowly

Water transportation is the slowest shipping mode—but usually the lowest-cost way of shipping heavy freight. Water transportation is very important for international shipments and often the only practical approach. This explains why port cities like Boston, New York City, Rotterdam, Osaka, and Singapore are important centers for international trade.

The growth of airfreight has made it easier and faster for firms to serve customers in foreign markets.

Inland waterways are important too

Inland waterways (such as the Mississippi River and Great Lakes in the United States and the Rhine and Danube in Europe) are also important, especially for bulky, nonperishable products such as iron ore, grain, steel, petroleum products, and gravel. However, when winter ice closes freshwater harbors, alternate transportation must be used. Some shippers—such as those moving iron ore—ship their total annual supply during the summer months and store it near their production facilities for winter use. Here low-cost transporting combined with storing reduces *total* cost.

Pipelines move oil and gas

Pipelines are used primarily by the petroleum industry to move oil and natural gas. So pipelines are important both in the oil-producing and oil-consuming countries. Only a few major cities in the United States, Canada, Mexico, and Latin America are more than 200 miles from a major pipeline system. Of course, the majority of the pipelines in the United States are located in the Southwest—connecting the oil fields and refineries. From there, the more flexible railroads, trucks, and ships usually take over—bringing refined and graded products to customers.

Airfreight is expensive but fast and growing

The most expensive cargo transporting mode is airplane—but it is fast! Airfreight rates are on average three times higher than trucking rates—but the greater speed may offset the added cost. Trucks took the cream of the railroads' traffic. Now airplanes are taking the cream of the cream.

High-value, low-weight goods—like high-fashion clothing and parts for the electronics and metal-working industries—are often shipped by air. Perishable products that previously could not be shipped are now being flown across continents and oceans. Flowers and bulbs from Holland, for example, now are jet-flown to points all over the world. And airfreight has become very important for small emergency deliveries—like repair parts, special orders, and business documents that must be somewhere the next day.

Internet

Internet Exercise A firm that is just starting to export to international markets may want help figuring out what shipping services are available. The North Carolina Ports Authority's website (www.ncports.com) helps provide such information. Go to the website, select *Ports Directory,* and review the different firms and agencies that might be able to provide you with help if you had to ship a large quantity of furniture to the Middle East. Identify an organization from those listed that you might want to contact first, and indicate why.

But airplanes may cut the total cost of distribution

An important advantage of using planes is that the cost of packing, unpacking, and preparing the goods for sale may be reduced or eliminated. Planes may help a firm reduce inventory costs by eliminating outlying warehouses. Valuable by-products of airfreight's speed are less spoilage, theft, and damage. Although the *transporting* cost of air shipments may be higher, the *total* cost of distribution may be lower. As more firms realize this, airfreight firms—like DHL Worldwide Express, FedEx, Airborne, and Emery Air Freight—have enjoyed rapid growth.

These firms play an especially important role in the growth of international business. While the bulk of international cargo moves on ships, the speed of airfreight opens up global markets for many businesses that previously had only domestic opportunities. For example, DHL Worldwide Express offers 24-hour delivery service from Tokyo to Los Angeles, New York to Rome, and London to Chicago. For a firm whose products are valuable relative to their weight and size, the cost of air deliveries may seem trivial when compared to the sales potential of competing in new markets.[19]

Put it in a container—and move between modes easily

Products often move by several different modes and carriers during their journey. This is especially common for international shipments. Japanese firms—like Sony—ship stereos to the United States, Canada, and Europe by boat. When they arrive at the dock, they are loaded on trains and sent across the country. Then the units are delivered to a wholesaler by truck or rail.

Loading and unloading goods several times used to be a real problem. Parts of a shipment would become separated, damaged, or even stolen. And handling the goods—perhaps many times—raised costs and slowed delivery. Many of these problems are reduced with **containerization**—grouping individual items into an economical shipping quantity and sealing them in protective containers for transit to the final destination. This protects the products and simplifies handling during shipping. Some containers are as large as truck bodies.

Piggyback—a ride on two or more modes

Piggyback service means loading truck trailers—or flatbed trailers carrying containers—on railcars to provide both speed and flexibility. Railroads now pick up truck trailers at the producer's location, load them onto specially designed rail flatcars, and haul them as close to the customer as rail lines run. The trailers are then hooked up to a truck tractor and delivered to the buyer's door. Similar services are offered on ocean-going ships—allowing door-to-door service between cities around the world.

To better coordinate the flow of products between modes, transportation companies like CSX offer customers a complete choice of different transportation modes. Then CSX, not the customer, figures out the best and lowest-cost way to shift and share transporting functions between the modes.[20]

Transportation choices affect environmental costs too

Marketing managers must be sensitive to the environmental effects of transportation decisions. Some say trucks cause air pollution in already crowded cities. People who live near airports suffer the consequences of noise pollution. A damaged pipeline can spew thousands of gallons of oil before it can be repaired. The Exxon *Valdez* oil spill in Alaska is a dramatic example of the kind of environmental disaster that can happen when a transportation accident occurs.

Many firms are taking steps to reduce these problems. For example, Conoco, a subsidiary of Du Pont, is building ships with double hulls to reduce the risk of leaks. Some trucking and railroad firms establish elaborate safety procedures for dealing with toxic cargo. Today, the public *expects* companies to manufacture, transport, sell, and dispose of products in an environmentally sound manner. If companies are environmentally unsafe, consumers will show their dissatisfaction through their market choices. However, these environmental efforts increase the cost of distribution.[21]

© The McGraw–Hill Companies, 2002

Economies of Scale in Transporting

Most transporting rates—the prices charged for transporting—are based on the idea that large quantities of a good can be shipped at a lower transport cost per pound than small quantities. Whether a furniture producer sends a truck to deliver one sofa or a full carload, the company still has to pay for the driver, the truck, the gas, and other expenses like insurance.

Transporters often give much lower rates for quantities that make efficient use of their transport facilities. Thus, transport costs per pound for less-than-full carloads or truckloads are often twice as high as for full loads. These quantity rate differences are one important reason for the development of some wholesalers. They buy in large quantities to get the advantage of economies of scale in transporting. Then they sell in the smaller quantities their customers need.

Freight forwarders accumulate economical shipping quantities

Freight forwarders combine the small shipments of many shippers into more economical shipping quantities. Freight forwarders do not own their own transporting facilities—except perhaps for delivery trucks. Rather, they wholesale air, ship, rail, and truck space. They accumulate small shipments from many shippers and reship in larger quantities to obtain lower transporting rates.

Freight forwarders are especially useful in arranging international shipping. They handle 75 percent of the general cargo shipped from U.S. ports to foreign countries. They are also very helpful for handling international airfreight. For example, Air Express International specializes in helping marketing managers find the most efficient air cargo firm to speed deliveries around the world.[22]

Should you do it yourself?

To cut transporting costs or get more control, some marketing managers do their own transporting rather than buy from specialists. Large producers, like Levi Strauss, often buy or lease their own truck fleets. Shell Oil and other large petroleum, iron ore, and gypsum rock producers have their own ships. Some firms now buy their own planes for airfreight.[23]

Both SunLite and GE provide logistics-related services that help firms reduce big inventories and improve customer service.

© The McGraw–Hill Companies, 2002

The Storing Function and Marketing Strategy

Store it and smooth out sales, increase profits and consumer satisfaction

Storing is the marketing function of holding goods. It provides time utility. **Inventory** is the amount of goods being stored.

Maintaining the right inventory level is difficult when it's hard to forecast likely demand. Even so, a firm that is stocked out when customers are ready to buy may not only lose the sale but may also damage the relationship and the possibility of future sales. Kmart ran into this problem. A number of consumers decided it was no longer a convenient place to shop when stores repeatedly ran out of basic staples that consumers expected to find.

Storing is necessary when production of goods doesn't match consumption. This is common with mass production. Nippon Steel, for example, might produce thousands of steel bars of one size before changing the machines to produce another size. Changing the production line can be costly and time-consuming. It's often cheaper to produce large quantities of one size, and store the unsold quantity, than to have shorter production runs. Thus, storing goods allows the producer to achieve economies of scale in production.

Some buyers purchase in large quantities to get quantity discounts from the producer or transporter. Then the extra goods must be stored until there is demand. And goods are sometimes stored as a hedge against future price rises, strikes, shipping interruptions, and other disruptions.

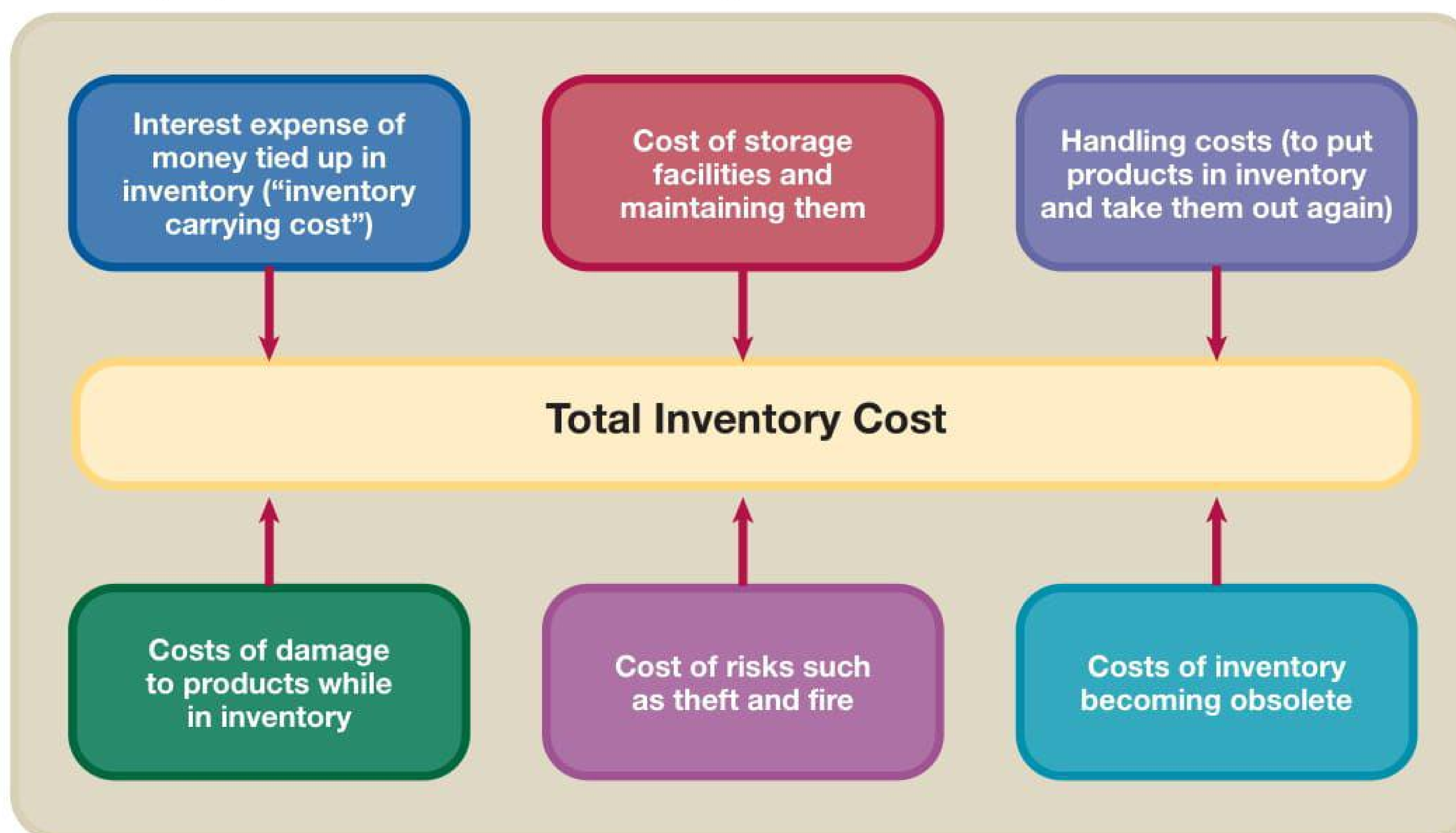
Storing varies the channel system

Storing allows producers and middlemen to keep stocks at convenient locations—ready to meet customers' needs. In fact, storing is one of the major activities of some middlemen.

Most channel members provide the storing function for some length of time. Even final consumers store some things for their future needs. Since storing can be provided anywhere along the channel, the storing function offers several ways to vary a firm's marketing mix and its channel system by (1) adjusting the time goods are held, (2) sharing the storing costs, and (3) delegating the job to a specialized storing facility. This latter variation would mean adding another member to the distribution channel.

When consumers buy in large quantities and keep the product inventory near the point of consumption they take over some of the inventory carrying costs—and they may consume more too.

Exhibit 12-6 Many Expenses Contribute to Total Inventory Cost



Which channel members store the product, and for how long, affects the behavior of all channel members. For example, the producer of Snapper lawn mowers tries to get wholesalers to inventory a wide selection of its machines. That way, retailers can carry smaller inventories since they can be sure of dependable local supplies. And they might decide to sell Snapper—rather than Toro or some other brand that they would have to store at their own expense.

If final customers "store" the product, more of it may be used or consumed. You saw this in the Coke case that introduces this chapter. Coke wants customers to buy six packs and 2-liter bottles. Then consumers have an "inventory" in the refrigerator when thirst hits. Of course, consumers aren't always willing or able to hold the inventory. In China, for example, Coke had little success until it gave up pushing 2-liter bottles and switched to single-serving 75 ml bottles. Only 1 out of 10 Chinese families has a refrigerator—so they didn't have a good way to store a bottle once it was open.

Goods are stored at a cost

Storing can increase the value of goods and make them more available when customers want them. But a manager must remember that *storing always involves costs* too. Different kinds of cost are involved. See Exhibit 12-6. Car dealers, for example, must store cars on their lots—waiting for the right customer. The interest expense of money tied up in the inventory is a major cost. In addition, if a new car on the lot is dented or scratched, there is a repair cost. If a car isn't sold before the new models come out, its value drops. There is also a risk of fire or theft—so the retailer must carry insurance. And, of course, dealers incur the cost of leasing or owning the display lot where they store the cars.

In today's competitive markets, most firms watch their inventories closely. Taken in total, the direct and indirect costs of unnecessary inventory can make the difference between a profitable strategy and a loser. Annually these costs are typically 20 to 40 percent of the average value of the inventory. As a result, well-run firms everywhere are trying to cut unnecessary stock and reduce the drain it puts on profits. On the other hand, a marketing manager must be very careful in making the distinction between unnecessary inventory and inventory needed to provide the distribution service customers expect.[24]

Rapid response cuts inventory costs

Many firms are finding that they can cut inventory costs and still provide the desired customer service—if they can reduce the time it takes to replace items that are sold. This is one important reason that the JIT and ECR approaches we discussed earlier in the chapter have been widely adopted. These approaches work because the firms involved use EDI, the Internet, and similar computerized approaches to share information and speed up the order cycle and delivery process.

Rapid replenishment of inventories is not the only reason that inventory costs have been reduced. By using the information from JIT and ECR systems, firms can see the benefit of dropping some of the items that they stock and sell. P&G is a vivid example. Between 1991 and 1996 it introduced many new products but cut its total number of skus (individual stock-keeping units) by 34 percent. P&G hasn't stopped selling bar soap, but it has cut the number of sizes and colors for some of its brands. After the cuts, sales of the remaining products went up and costs came down. With fewer products, P&G can put more marketing effort behind those it has. Its retailers are also more willing to push products that turn over quickly. Reducing the number of skus does reduce consumer choice, but there is a point where additional choice doesn't add enough value for consumers to justify the extra inventory.[25]

Specialized Storing Facilities May Be Required

New cars can be stored outside on the dealer's lot. Fuel oil can be stored in a specially designed tank. Coal and other raw materials can be stored in open pits. But most products must be stored inside protective buildings. Often, firms can choose among different types of specialized storing facilities. The right choice may reduce costs and serve customers better.

Private warehouses are common

Private warehouses are storing facilities owned or leased by companies for their own use. Most manufacturers, wholesalers, and retailers have some storing facilities either in their main buildings or in a separate location. A sales manager often is responsible for managing a manufacturer's finished-goods warehouse—especially if regional sales branches aren't near the factory. In retailing, storing is so closely tied to selling and available shelf space that buyers may control this function.

Firms use private warehouses when a large volume of goods must be stored regularly. Yet private warehouses can be expensive. If the need changes, the extra space may be hard, or impossible, to rent to others.

Public warehouses fill special needs

Public warehouses are independent storing facilities. They can provide all the services that a company's own warehouse can provide. A company might choose a public warehouse if it doesn't have a regular need for space. For example, Tonka Toys uses public warehouses because its business is seasonal. Tonka pays for the space only when it is used. Public warehouses are also useful for manufacturers who must maintain stocks in many locations—including foreign countries.

In most countries, public warehouses are located in all major metropolitan areas and many smaller cities. See Exhibit 12-7 for a comparison of private and public warehouses.[26]

Warehousing facilities cut handling costs too

The cost of physical handling is a major storing cost. Goods must be handled once when put into storage and again when removed to be sold. In old warehouse districts—located in big cities or at ports—traffic congestion, crowded storage areas, and slow elevators delay the process and increase the costs.

Exhibit 12-7
A Comparison of Private Warehouses and Public Warehouses

	Type of warehouse	
Characteristics	Private	Public
Fixed investment	Very high	No fixed investment
Unit cost	High if volume is low Very low if volume is very high	Low: charges are made only for space needed
Control	High	Low managerial control
Adequacy for product line	Highly adequate	May not be convenient
Flexibility	Low: fixed costs have already been committed	High: easy to end arrangement

Today, modern one-story buildings away from downtown traffic are replacing the old multistory warehouses. They eliminate the need for elevators and permit the use of power-operated lift trucks, battery-operated motor scooters, roller-skating order pickers, electric hoists for heavy items, and hydraulic ramps to speed loading and unloading. Most of these new warehouses use lift trucks and pallets (wooden trays that carry many cases) for vertical storage and better use of space. Bar codes and UPC (uniform product code) numbers make it easy for computers to monitor inventory, order needed stock, and track storing and shipping costs. Some warehouses have computer-controlled order-picking systems or conveyor belts that speed the process of locating and assembling the assortment required to fill an order.[27]

The Distribution Center—A Different Kind of Warehouse

Is storing really needed?

Discrepancies of assortment or quantity between one channel level and another are often adjusted at the place where goods are stored. It reduces handling costs to regroup and store at the same place—*if both functions are required.* But sometimes regrouping is required when storing isn't.

Don't store it, distribute it

A **distribution center** is a special kind of warehouse designed to speed the flow of goods and avoid unnecessary storing costs. Anchor Hocking moves over a million pounds of its housewares products through its distribution center each day. Faster inventory turnover and easier bulk-breaking reduce the cost of carrying inventory and lead to bigger profits.

Today, the distribution center concept is widely used by firms at all channel levels. Many products buzz through a distribution center without ever tarrying on a shelf; workers and equipment immediately sort the products as they come in and then move them to an outgoing loading dock and the vehicle that will take them to their next stop. While these "cross-docking" approaches have become more efficient, the basic benefits of the distribution center approach are still the same as they were over 25 years ago when the idea was pioneered. In fact, a good way to see how the distribution center works is to consider an early application.

Pillsbury's distribution system was overwhelmed by expanding product lines and sales

Pillsbury—the manufacturer of baking products—used to ship in carload quantities directly from its factories to large middlemen. Initially, plants were as close to customers as possible, and each plant produced the whole Pillsbury line. As lines expanded, however, no single plant could produce all the products. When customers began to ask for mixed carload shipments and faster delivery,

McKesson is a leading distributor of drugs, and effective use of technology has been a key reason for its success. The space-age gizmo on this man's arm combines a scanner, computer, and two-way radio—to speed up order assembly and delivery from McKesson's distribution center.

Pillsbury added warehouse space and started hauling goods from plant to plant. Over time, Pillsbury set up 100 branch warehouses—controlled by 33 sales offices. Accounting, credit, and other processing operations were duplicated in each sales office. PD costs were high, but the customer service level was still a problem. It took Pillsbury a week just to process an order. And the company had no effective control over its inventories. Pillsbury needed a change to distribution centers.

The distribution center brings it all together

Pillsbury first specialized production at each plant to a few product lines. Then Pillsbury sent carload shipments directly to the distribution centers—almost eliminating storing at the factories. The distribution centers were controlled by regional data processing centers, which quickly determined where and when goods were to be shipped. Centralized accounting got invoices to customers faster—resulting in quicker payment. Because each distribution center always had adequate inventory, it could ship orders the most economical way. And because the field sales organization no longer handled physical distribution or inventory, it could focus on sales. Pillsbury could guarantee customers delivery within three days.

There are many variations of the distribution center. The Pillsbury example shows it within an integrated operation. But public warehouses offer similar services.

Managers must be innovative to provide customers with superior value

Improved technology, coordination among firms, and efficient new distribution centers are bringing big improvements to the PD area. Yet the biggest challenges may be more basic. As we've emphasized here, physical distribution activities transcend departmental, corporate, and even national boundaries. So seeing and taking advantage of the opportunities for improvement often requires cooperation all along the channel system. Too often, such cooperation doesn't exist—and changing ingrained ways of doing things is hard. But marketing managers who push for innovations in these areas are likely to win customers away from firms and whole channel systems that are stuck doing things in the old way.[28]

Conclusion

This chapter deals with logistics activities and how they provide *time* and *place* utility to improve value to the customer. We looked at the customer service level and why it is important.

We emphasized the relation between customer service level, transporting, and storing. The physical distribution concept focuses on coordinating all the storing, transporting, and product handling activities into a smoothly working system—to deliver the desired service level and customer value at the lowest cost.

Marketing managers often want to improve service and may select a higher-cost alternative to improve their marketing mix. The total cost approach might reveal that it is possible *both* to reduce costs and to improve service—perhaps by identifying creative new distribution alternatives.

We discussed various modes of transporting and their advantages and disadvantages. We also discussed ways to reduce inventory costs. We explained why distribution centers are an important way to cut storing and handling costs, and we explained how computerized information links—within firms and among firms in the channel—are increasingly important in blending all of the activities into a smooth-running system.

Effective marketing managers make important strategy decisions about physical distribution. Creative strategy decisions may result in lower PD costs while maintaining or improving the customer service level. And production-oriented competitors may not even understand what is happening.

Questions and Problems

1. Explain how adjusting the customer service level could improve a marketing mix. Illustrate.
2. Briefly explain which aspects of customer service you think would be most important for a producer that sells fabric to a firm that manufactures furniture.
3. Briefly describe a purchase you made where the customer service level had an effect on the product you selected or where you purchased it.
4. Discuss the types of trade-offs involved in PD costs, service levels, and sales.
5. Give an example of why it is important for different firms in the chain of supply to coordinate logistics activities.
6. Discuss some of the ways computers are being used to improve PD decisions.
7. Explain why a just-in-time delivery system would require a supplier to pay attention to quality control. Give an example to illustrate your points.
8. Discuss the problems a supplier might encounter in using a just-in-time delivery system with a customer in a foreign country.
9. Review the list of factors that affect PD service level in Exhibit 12-2. Indicate which ones are most likely to be improved by EDI links between a supplier and its customers.
10. Explain the total cost approach and why it may cause conflicts in some firms. Give examples of how conflicts might occur between different departments.
11. Discuss the relative advantages and disadvantages of railroads, trucks, and airlines as transporting methods.
12. Discuss why economies of scale in transportation might encourage a producer to include a regional merchant wholesaler in the channel of distribution for its consumer product.
13. Discuss some of the ways that air transportation can change other aspects of a Place system.
14. Explain which transportation mode would probably be most suitable for shipping the following goods to a large Los Angeles department store:
    a. 300 pounds of Maine lobster.
    b. 15 pounds of screwdrivers from Ohio.
    c. Three dining room tables from High Point, North Carolina.
    d. 500 high-fashion dresses from the fashion district in Paris.
    e. A 10,000-pound shipment of exercise equipment from Germany.
    f. 600,000 pounds of various appliances from Evansville, Indiana.
15. Indicate the nearest location where you would expect to find large storage facilities. What kinds of products would be stored there? Why are they stored there instead of some other place?

16. When would a producer or middleman find it desirable to use a public warehouse rather than a private warehouse? Illustrate, using a specific product or situation.
17. Discuss the distribution center concept. Is this likely to eliminate the storing function of conventional wholesalers? Is it applicable to all products? If not, cite several examples.
18. Clearly differentiate between a warehouse and a distribution center. Explain how a specific product would be handled differently by each.
19. If a retailer operates only from a website and ships all orders by UPS, is it freed from the logistics issues that face traditional retailers? Explain your thinking.

Suggested Cases

16. Morgan Company

26. Rainbow Packers, Inc.

Computer-Aided Problem

12. **Total Distribution Cost**

Proto Company has been producing various items made of plastic. It recently added a line of plain plastic cards that other firms (such as banks and retail stores) will imprint to produce credit cards. Proto offers its customers the plastic cards in different colors, but they all sell for $40 per box of 1,000. Tom Phillips, Proto's product manager for this line, is considering two possible physical distribution systems. He estimates that if Proto uses airfreight, transportation costs will be $7.50 a box, and its cost of carrying inventory will be 5 percent of total annual sales dollars. Alternatively, Proto could ship by rail for $2 a box. But rail transport will require renting space at four regional warehouses—at $26,000 a year each. Inventory carrying cost with this system will be 10 percent of total annual sales dollars. Phillips prepared a spreadsheet to compare the cost of the two alternative physical distribution systems.

a. *If Proto Company expects to sell 20,000 boxes a year, what are the total physical distribution costs for each of the systems?*
b. *If Phillips can negotiate cheaper warehouse space for the rail option so that each warehouse costs only $20,000 per year, which physical distribution system has the lowest overall cost?*
c. *Proto's finance manager predicts that interest rates are likely to be lower during the next marketing plan year and suggests that Tom Phillips use inventory carrying costs of 4 percent for airfreight and 7.5 percent for railroads (with warehouse cost at $20,000 each). If interest rates are in fact lower, which alternative would you suggest? Why?*

For additional questions related to this problem, see Exercise 12-3 in the *Learning Aid for Use with Basic Marketing,* 14th edition.