

11.5: Organizing The Channel

Learning Objectives

After reading this section, students should be able to ...

- list the methods used in organizing channels
- outline the management of underlying behavioral dimensions present in most channels

ORGANIZING THE CHANNEL

Either through a planned process or through a natural evolution, channels of distribution reflect an observable organization structure. Three types are most common: conventional channels, vertical marketing systems, and horizontal channel systems.

Conventional channels

The *conventional channel* of distribution could be described as a group of independent businesses, each motivated by profit, and having little concern about any other member of the distribution sequence. There are no all-inclusive goals, and in many instances, the assignment of tasks and the evaluation process are totally informal. Consequently, channel frameworks might be working against one another, tasks may go undone, and ineffective channel member relationships may last for years. Despite these deficiencies, this type of channel structure remains most common, and there are numerous examples of such networks working.

Vertical marketing systems

Vertical marketing systems have emerged as a solution to the problems of conventional networks. A *vertical marketing system* (VMS) comes about when a member of the distribution channel (usually the manufacturer) assumes a leadership role and attempts to coordinate the efforts of the channel so that mutually beneficial goals can be attained. Three forms of vertical integration are now common.

Administered VMS

The *administered VMS* is very close to the conventional network, but differs in that it is informally guided by goals and programs developed by one or a limited number of firms in the existing channel. This framework is the source of the concept of a channel captain, in that administrative skills and the power of one individual may be the driving force of the channel. Often the dominant brands, as in the case of Xerox or Procter & Gamble, are able to manifest this cooperation.

Through the recognition of a channel leader, the distribution networks function better, sales and profits are higher, product exposure improves, inventory management systems are initiated, and the coordination of promotional activities becomes a reality. An administered system is not without its problems. Often, this effort is placed on the shoulders of a single individual. Another drawback is the tendency of polarizing channel members. Businesses either become part of the VMS or remain strongly independent. Eventually these independents may find themselves at a tremendous competitive disadvantage, and may even be deprived of certain channel benefits.

Contractual VMS

There are instances when channel members wish to formalize their relationship by employing a contractual agreement, known as a *contractual VMS*. This provides additional control, and either explicitly or implicitly spells out the marketing functions to be performed by all the members of the channel. This is the most popular form of vertical marketing arrangement.

Corporate VMS

When channel members on different levels are owned and operated by one organization, a *corporate vertical marketing system* is said to exist. Such integration can be forward or backward. A manufacturer who owns the various intermediaries in its channel network has engaged in *forward* integration. A retailer who takes over the wholesaling and manufacturing tasks is *backward* integrating. This process can entail either the organization's purchasing the institutions, or establishing its own facilities. Although partial forward or backward integration is most common, total integration is becoming more popular. Manufacturers who have recently integrated through to the retail level are Dannon Yogurt, Blue Bell Ice Cream, and Pepperidge Farms. Sears and Safeway stores are two retailers that have successfully integrated backward. American Hospital Supply Corporation is an example of a wholesaler that has integrated both backward and forward.

Horizontal channel systems

There are instances where two or more companies are unable to acquire the capital, or do not have the technical or production know-how, to effectively market their products alone. In such cases, these companies may establish a temporary or quasi-permanent relationship in order to work with each other, and create the channel mechanism required to reach their target markets. This arrangement has been labeled a *horizontal channel system*. For example, two small manufacturers might combine their shipments to common markets in order to gain full carload transportation rates that each could not obtain separately. Another common scenario is for a large retailer to buyout several competing small retailers in order to gain entry into certain markets or with certain customers.

THE CHANNEL MANAGEMENT PROCESS

Evidence suggests that a channel should be managed just like the product, promotion, and pricing functions.

This channel management process contains five steps.

Analyze the consumer

We begin the process of channel management by answering two questions. First, to whom shall we sell this merchandise immediately? Second, who are our ultimate users and buyers? Depending upon a host of factors, including the type of product, functions performed in the channel, and location in the channel, the immediate and ultimate customers may be identical or they may be quite separate. In both cases, some fundamental questions would apply. There is a need to know what the customer needs, where they buy, when they buy, why they buy from certain outlets, and how they buy.

It is best that we first identify the traits of the ultimate user, since the results of this evaluation might determine the other channel institutions we would use to meet these needs. For example, the buying characteristics of the purchaser of a high-quality VCR might be as follows:

- purchased only from a well-established, reputable dealer
- purchased only after considerable shopping to compare prices and merchandise characteristics
- purchaser willing to go to some inconvenience (time and distance) to locate the most acceptable brand
- purchased only after extended conversations involving all interested parties, including dealer, users, and purchasers
- purchase may be postponed
- purchased only from a dealer equipped to render prompt and reasonable product service

These buying specifications illustrate the kinds of requirements that the manufacturer must discover. In most cases, purchase specifications are fairly obvious and can be discovered without great difficulty. On the other hand, some are difficult to determine. For example, certain consumers will not dine at restaurants that serve alcohol; others will patronize only supermarkets that exhibit definite ethnic characteristics in their merchandising. Nonetheless, by careful and imaginative research, most of the critical factors that bear on consumer buying specifications can be determined.

Knowing the buying specifications of consumers, the channel planner can decide on the type or types of wholesaler or retailer through which a product should be sold. This requires that a manufacturer contemplating distribution through particular types of retailers become intimately familiar with the precise location and performance characteristics of those he is considering.

In much the same way that buying specifications of ultimate users are determined, the manufacturers must also discover buying specifications of resellers. Of particular importance is the question, “from whom do my retail outlets prefer to buy?” The answer to this question determines the types of wholesalers (if any) that the manufacturer should use. Although many retailers prefer to buy directly from the manufacturers, this is not always the case. Often, the exchange requirements of manufacturers (e.g. infrequent visit, large order requirements, and stringent credit terms) are the opposite of those desired by retailers. Such retailers would rather buy from local distributors who have lenient credit terms and offer a wide assortment of merchandise.

Establish the channel objectives

The channel plan is derived from channel objectives. They are based on the requirements of the purchasers and users, the overall marketing strategy, and the long-run goals of the corporation. However, in cases when a company is just getting started, or an older company is trying to carve out a new market niche, the channel objectives may be the dominant objectives. For example, a small manufacturer wants to expand outside the local market. An immediate obstacle is the limited shelf space available to this manufacturer. The addition of a new product to the shelves generally means that space previously assigned to competitive products must be obtained. Without this exposure, the product is doomed.

As one would expect, there is wide diversity of form that channel objectives can take. The following areas encompass the major categories:

- Growth in sales by reaching new markets, and/or increasing sales in existing markets.
- Maintenance or improvement of market share—educate or assist channel components in their efforts to increase the amount of product they handle.
- Achieve a pattern of distribution—structure the channel in order to achieve certain time, place, and form utilities.
- Create an efficient channel—improve channel performance by modifying various flow mechanisms.

Specify distribution tasks

After the distribution objectives are set, it is appropriate to determine the specific distribution tasks (functions) to be performed in that channel system. The channel manager must be far more specific in describing the tasks, and must define how these tasks will change depending upon the situation. An ability to do this requires the channel manager to evaluate all phases of the distribution network. Tasks must be identified fully, and costs must be assigned to these tasks. For example, a manufacturer might delineate the following tasks as being necessary in order to profitably reach the target market:

- provide delivery within 48 hours after order placement
- offer adequate storage space
- provide credit to other intermediaries
- facilitate a product return network
- provide readily available inventory (quantity and type)
- provide for absorption of size and grade obsolescence

Evaluate and select from channel alternatives

Determining the specific channel tasks is a prerequisite for the evaluation and selection process. There are four bases for channel alternatives: number of levels, intensity at the various levels, types of intermediaries at each level, and application of selection criterion to channel alternatives.

Number of levels

Channels can range in levels from two to several (five being typical). The two-level channel (producer to consumer) is a direct channel and is possible only if the producer or customer are willing to perform several of the tasks performed by intermediaries. The number of levels in a particular industry might be the same for all the companies simply because of tradition. In other industries, this dimension is more flexible and subject to rapid change.

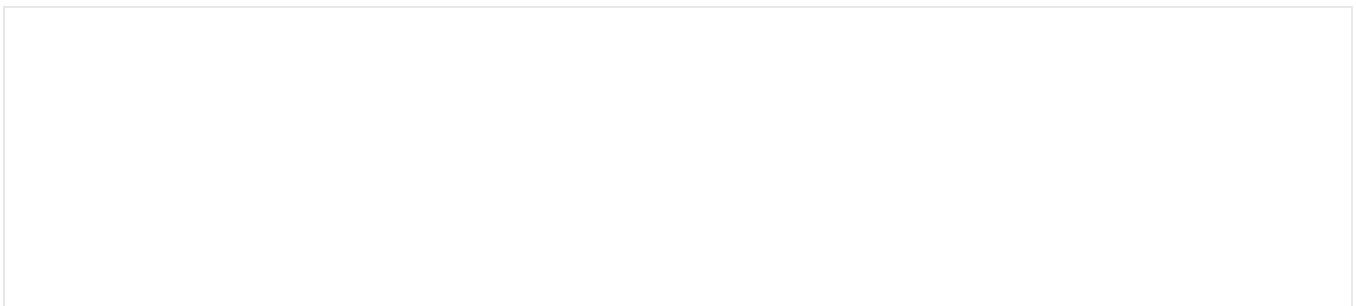
Intensity at each level

Once the number of levels has been decided, the channel manager needs to determine the actual number of channel components involved at each level. How many retailers in a particular market should be included in the distribution network? How many wholesalers? Although there are limitless possibilities, the categories shown in Table 10.2 describes the general alternatives.

The intensity decision is extremely critical, because it is an important part of the firm's overall marketing strategy. Companies such as Coca-Cola and Timex watches have achieved high levels of success through their intensive distribution strategy.

Types of intermediaries

As discussed earlier, there are several types of intermediaries that operate in a particular channel system. The objective is to gather enough information to have a general understanding of the distribution tasks these intermediaries perform. Based on this background information, several alternatives will be eliminated.



1. Exclusive distribution (such as Ethan Allen and Drexel Heritage Furniture)
 1. the use of a single or very few outlets
 2. creates high dealer loyalty and considerable sales support
 3. provides greater control
 4. limits potential sales volume
 5. success of the product is dependent upon the ability of a single intermediary
2. Intensive distribution (such as candy)—the manufacturer attempts to get as many intermediaries of a particular type as possible to carry the product
 1. provides for increased sales volume, wider consumer recognition, and considerable impulse purchasing
 2. low price, low margin, and small order sizes often result
 3. extremely difficult to stimulate and control this large number of intermediaries
3. Selective distribution (such as Baskin-Robbins)—an intermediary strategy, with the exact number of outlets in any given market dependent upon market potential, density of population, dispersion of sales, and competitors' distribution policies
 1. contains some of the strengths and weaknesses of the other two strategies
 2. it is difficult to determine the optimal number of intermediaries in each market

Table 10.2: Levels of channel intensity.

Having identified several possible alternative channel structures, the channel manager is now at a place where he or she can evaluate these alternatives with respect to some set of criteria. Company factors, environmental trends, reputation of the reseller, experience of reseller are just a few examples.

Who should lead

Regardless of the channel framework selected, channels usually perform better if someone is in charge, providing some level of leadership. Essentially, the purpose of this leadership is to coordinate the goals and efforts of channel institutions. The level of leadership can range from very passive to quite active-verging on dictatorial. The style may range from very negative, based on fear and punishment, to very positive, based on encouragement and reward. In a given situation, any of these leadership styles may prove effective.

Given the restrictions inherent in channel leadership, the final question is “who should lead the channel?” Two important trends are worth noting, since they influence the answer. First, if we look at the early years of marketing, i.e. pre-1920, the role of the wholesaler (to bring the producer and consumer together) was most vital. Consequently, during this period, the wholesaler led most channels. This is no longer true. A second trend is the apparent strategy of both manufacturers and retailers to exert power through size. In a type of business cold war, manufacturers and retailers are constantly trying to match each other's size. The result has been some serious warfare to gain channel superiority.

Under which conditions should the manufacturers lead? The wholesaler? The retailer? While the answer is contingent upon many factors, in general, the manufacturer should lead if control of the product (merchandising, repair) is critical and if the design and redesign of the channel is best done by the manufacturer. The wholesaler should lead where the manufacturers and retailers have remained small in size, large in number, relatively scattered geographically, are financially weak, and lack marketing expertise. The retailer should lead when product development and demand stimulation are relatively unimportant and when personal attention to the customer is important.

Evaluating channel member performance

The need to evaluate the performance level of the channel members is just as important as the evaluation of the other marketing functions. Clearly, the marketing mix is quite interdependent and the failure of one component can cause the failure of the whole. There is one important difference, with the exception of the corporate VMS; the channel member is dealing with independent business firms, rather than employees and activities under the control of the channel member, and their willingness to change is lacking.

Sales is the most popular performance criteria used in channel evaluation. Sales might further be subdivided into current sales compared with historical sales, comparisons of sales with other channel members, and comparisons of the channel member's sales with predetermined quotas. Other possible performance criteria are: maintenance of adequate inventory, selling capabilities, attitudes of channel intermediaries toward the product, competition from other intermediaries and from other product line carried by the manufacturers own channel members.

Correcting or modifying the channel

As a result of the evaluation process, or because of other factors such as new competition, technology, or market potential, changes will be made in the channel structure. Because channel relationships have tended to be longterm, and the channel decision has such a pervasive impact on the business, great care should be taken before changing the status quo.

Terminations of channel members not performing at minimum performance standards should be employed only as a last resort. Corrective actions are far less destructive and maintain the goodwill that is so crucial in channel relationships. This requires that the channel manager attempt to find out why these channel members have performed poorly and then implement a strategy to correct these deficiencies.

Sometimes a producer decides that an entirely new channel needs to be added, or an existing one deleted. A manufacturer of camera accessories might decide that he wants to reach the skilled amateur market in addition to the professional photographer market. This would mean designing a different channel, and learning about a different set of intermediaries.

THE HUMAN ASPECT OF DISTRIBUTION

A channel of distribution by its very nature is made up of people. Ideally, a channel member should coordinate his or her efforts with other members in such a way that the performance of the total distribution system to which he or she belongs is enhanced. This is rarely the case. Part of this lack of cooperation is due to the organization structure of many channels, which encourages a channel member to be concerned only with channel members immediately adjacent to them, from whom they buy and to whom they sell. A second reason is the tendency of channel members to exhibit their independence as separate business operations. It is difficult to gain cooperation under this arrangement. Four human dimensions have been incorporated into the study of channel behavior: roles, communication, conflict, and power. It is assumed that an understanding of these behavioral characteristics will increase the effectiveness of the channel.

Role

Most channel members participate in several channels. Establishing the *role* of a channel member means defining what the behavior of the channel member should be. For example, a basic role prescription of the manufacturer may be to maximize the sales of his or her particular brand of product. This connotes that the manufacturer is to actively compete for market share, and aggressively promote his or her brand. The role prescriptions of independent wholesalers, however, are likely to be quite different. Since wholesalers may represent several competing manufacturers, his or her role would be to build sales with whatever brands are most heavily demanded by retailers. Therefore, a major issue in channel management relates to defining the role prescriptions of the various participants in order to achieve desired results. This is accomplished through a careful appraisal of the tasks to be performed by each channel member and clear communication of these roles to the members.

Communication

Channel communication is sending and receiving information that is relevant to the operation of the channel. It is critical for the success of the channel member to work to create and foster an effective flow of information within the channel. Communication will take place only if the channel member is aware of the pitfalls that await. The channel manager should therefore try to detect any behavioral problems that tend to inhibit the effective flow of information through the channel and try to solve these problems before the communication process in the channel becomes seriously distorted.

Conflict

Anytime individuals or organizations must work together and rely on each other for personal success, conflict is inevitable. *Conflict*, unlike friendly competition, is personal and direct and often suggests a confrontation. Because it is so pervasive in distribution, a great deal of research has been conducted in attempts to identify its causes, outcomes, and solutions.

There is also a need to manage conflict in the channel. This consists of (a) establishing a mechanism for detecting conflict, (b) appraising the effects of the conflict, and (c) resolving the conflict. This last consideration is most difficult to implement. Techniques such as a channel committee, joint goal setting, and bringing in an arbitrator have all been used. There are even cases when conflict is necessary. Such is the case in the e-marketplace. For example, Eric Schmidt, Chairman and CEO of Google Inc., notes: "From my experience the most successful companies are the ones where there is enormous conflict. Conflict does not mean killing one another, but instead means there is a process by which there is a disagreement. It is okay to have different points of view and disagree, because tolerance of multiple opinions and people often leads to the right decision through some kind of process."

Power

Power is our willingness to use force in a relationship. It is often the means by which we are able to control or influence the behavior of another party. In the channel mechanism, *power* refers to the capacity of a particular channel member to control or influence the behavior of another channel member. For instance, a large retailer may want the manufacturer to modify the design of the product or perhaps be required to carry less inventory. Both parties may attempt to exert their power in an attempt to influence the other's behavior. The ability of either of the parties to achieve this outcome will depend upon the amount of power that each can bring to bear.

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Sources

Section 10.4 Organizing The Channel is adapted from chapter '10. Channel concepts: distributing the product' from the textbook 'Introducing Marketing, First Edition, 2011' authored by John Burnett – this book was published under The Global Text Project, funded by the Jacobs Foundation, Zurich, Switzerland.

The following changes were made to the most recent edition: Divided 'Chapter 10. Channel concepts: distributing the product' into three sections; Removed Created new title for Figure featuring Anderson ad.; Removed box titled 'In Practice' from wsj.com; Removed case application at the end of chapter; Added learning objectives.

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