Shorey Consulting, Inc.

Cost and Value in Sales and Distribution Channels

Situation

More and more companies are discovering that their accustomed approaches to selecting and managing sales and distribution channels no longer work. The channels cost too much and provide too little value. They meet neither the needs of the manufacturer nor the end customer. At the same time, competitors may be gaining position through innovative use of new channel options. Manufacturers need a new template to guide them to sales and distribution channel choices which better match channel costs with value and which offer the potential for competitive advantage.[1]

In most industries, sales and distribution channels have come as complete "packages"; manufacturers could choose among direct sales, manufacturers representatives, distributor, wholesalers, retailers, etc. Each package operates differently and a manufacturer has to select the one which seems most appropriate for its specific industry and situation. There has been little opportunity to disaggregate the sales and distribution process, so few manufacturers looked inside their chosen channel to understand the costs and value it brought. The clearest path for reaching such an understanding and for evaluating sales and distribution options emerges through analysis of the *activities* performed by the channel, assessing the costs of performing those activities, and matching the activities to customer needs and values. Based on an understanding of activities and their costs, manufacturers can evaluate whether the current channel is performing well and can assess whether new channel approaches are preferable.

Activities

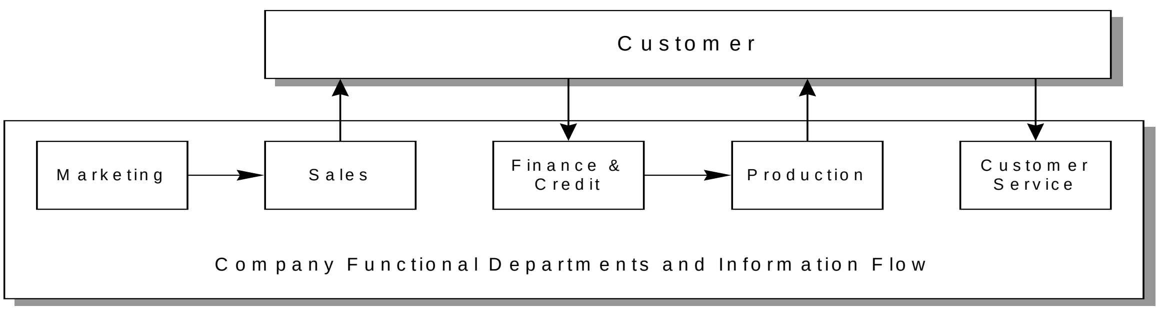
One of the most useful insights to emerge from the quality and process improvement movements is a focus on *activities*. Prior to the identification of activities, managers often viewed their businesses as a set of concentrated on functions (marketing, sales, manufacturing, etc.) or organizational units. The reorientation to activities puts the emphasis on *what* actually gets done, and only then on *who* does the work. Functional approaches, on the other hand, tend to concentrate more on *who* is responsible. Both approaches are important, but for the purpose of understanding and building new sales and distribution channels, starting first with an understanding of the key activities, and then turning to who does them, provides the most fruitful path.

[1] The previous article in this series, *Achieving Competitive Advantage Through Sales and Distribution Strategy*, describes the general evolution of sales and distribution channels.

A company with direct sales to end customers, such as a machine tool or other durable equipment supplier, provides a simple example of a sales and distribution process because the manufacturer performs all of the roles itself rather than having a distributor or some other party involved.

A common approach for a manufacturer using direct sales is a series of functional departments, each of which is partially responsible for the sales and distribution process. The sales group actually calls on customers, explains the benefits of the manufacturer's product and closes a sale. The sales force relies on leads and uses sales materials developed by the marketing department. Once a customer places an order, it is booked by the finance department and checked for credit limits. If the order is acceptable, it is then routed to manufacturing for production and shipment. If any follow-up is needed, the customer contacts customer service for help (Figure 1). All in all, at least five functional groups are involved in satisfying the customer and no single group has complete knowledge or control of the whole process.

Figure 1: Typical Direct Sales Approach to Customers



Looking at sales and distribution from an activity perspective, there are seven tasks (or activities) which are performed (Table 1). These activities start with finding new

Table 1: Sales and Distribution Channel Activities - Direct Sales

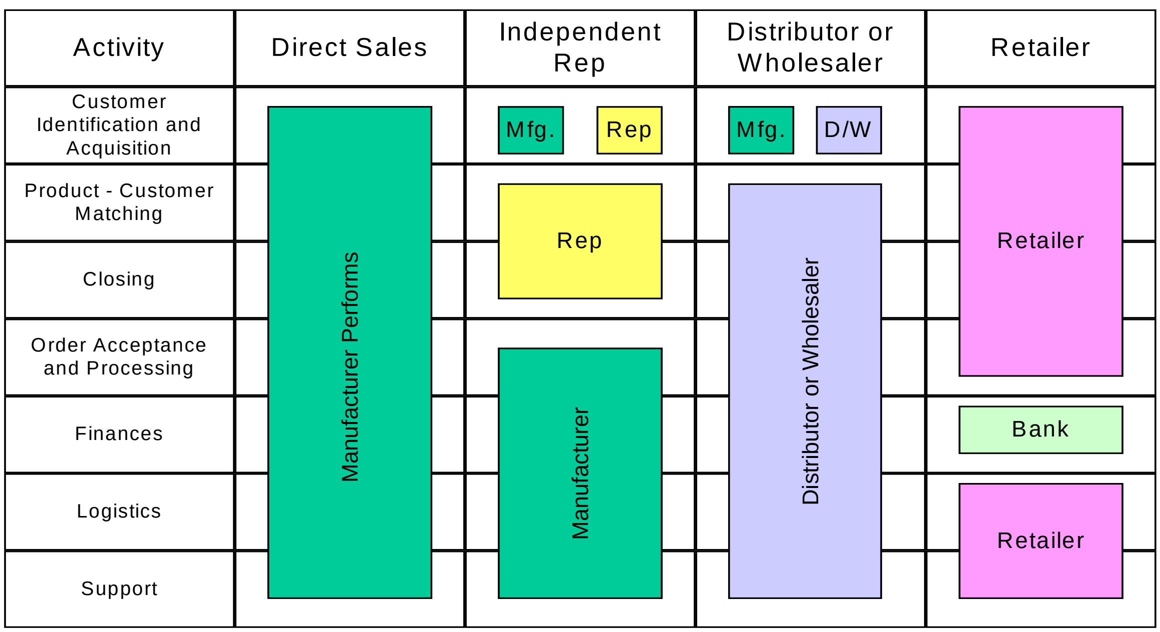
Activity	Description	Traditional Responsibility
Customer Identification and Acquisition	Finding new customers and then generating interest and inquiries	Marketing, Sales
Product/Customer Matching	Determining which products are most appropriate for the customer and explaining the unique benefits of the manufacturer's products	Sales, with tools from Marketing
Closing	Actually making a sale	Field Sales or Inside Telesales
Order Acceptance and Processing	Managing the paperwork involved in entering, shipping and billing for an order	Inside Telesales, Finance, Operations
Finances	Determining whether and under what circumstances to grant credit and collecting payment	Sales and/or Finance, Accounts Receivable
Logistics	Assuring timely delivery of the product including any necessary inventory management and shipping	Production, Distribution, Shipping
Support	After sales, warranty and other customer support	Sales, Customer Service

customers (*Customer Identification and Acquisition*), often a traditional marketing function, through the basic sales cycle (*Product/Customer Matching and Closing*) to the 'paperwork' processes of *Order Entry* and *Finance*. Once an order is accepted, the *Logistics* process assures that the product gets to the customer, while the *Support* process encompasses the activities to service and support a customer after product delivery. This approach to re-describing sales and distribution in terms of activities does not change the underlying process. Analytically, however, it can lead to a constructive strategic understanding. The power of reassessing the sales and distribution process emerges in using an activity framework to evaluate alternative sales and distribution options.

Channel Activities

Different sales and distribution channels exist because they allocate these seven basic activities in different ways between participants in the sales process (Figure 2). As

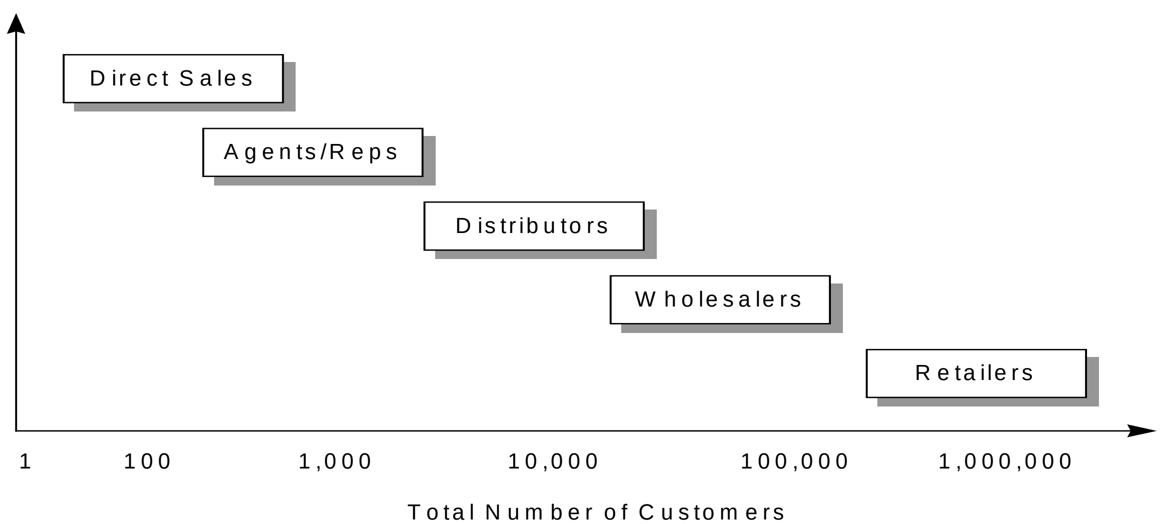
Figure 2: Activity Performance by Channel



described in the simple direct sales case illustrated in Table 1, a manufacturer engaging in direct sales to customers manages all of the activities itself. In other channel approaches, the distributor, wholesaler or retailer handles all customer-related activities. By selecting one of these channels, a manufacturer in essence "hires" a representative, a distributor, etc. to carry out some of the activities in selling and distributing products to end customers. Manufacturers "pay" the other channel participants by relinquishing some portion of the price paid by the end customer. Of course, in these more indirect channels, the manufacturer must still perform some of these activities itself in its dealings with its distributors, wholesalers or retailers (e.g. recruitment, credit decisions, logistics, etc.). The core question for a manufacturer is whether the channel partner provides sufficient value for the total price in terms of lost revenue from the customer and the cost to the manufacturer of the duplicated activities.

The decision to cede activities (and margin) to distributors, wholesalers or retailers has been driven, in large measure, by the need to support increasing numbers of customers. Generally, a manufacturer selling directly to end users has several hundred customers (Figure 3). In industries where there are often ten of thousands of customers such as small contractors, distributors or wholesalers are a common approach to sales and distribution. When customers are in the millions, such as small businesses or consumers, retailers, direct mail or other forms of mass merchandising are the common sales channel. Each channel organizes its activities to adapt to the number and geographic spread of the customer base.

Figure 3: Typical Distribution Channel by Number of Customers



Source: Shorey Consulting estimates

Direct Sales

When a manufacturer chooses to use a direct sales channel, it intends to focus intense sales efforts on a relatively small customer base. The power of a direct sales channel is in the two activities of *Product/Customer Matching* and *Closing*. A manufacturer with a direct sales organization is in a position to provide its sales force with the training, tools and motivation necessary to undertake complicated or long-cycle selling activities. Direct sales groups typically spend significant effort assisting customers with technical product selection, application engineering, demonstrations and other similar activities to assure the customer is selecting the most appropriate products. The sales organization may also write proposals, provide economic justifications and make multiple sales calls throughout the customer's organization in order to close the sale.

One challenge for companies using a direct sales approach is lead generation (*Customer Identification and Acquisition*). The limited size of most direct sales forces and their focus on in-person dealings with customers make them costly and inefficient at identifying new potential customers. Direct sales forces work well with geographically limited customer territories, where leads come from either established customer bases or broad marketing approaches.

In some industries, the overall sales and distribution process ends with product shipment and collection. For most manufacturers, though, post-sale activities (*Support*) are an increasingly important source of both customer loyalty and profit through sales of parts, service and follow-up for repeat purchases. In some instances, after-sales activities are the responsibility of the field sales organization. More and more, companies are raising the profile of the after-sales process and creating separate organizations of inside and outside groups to capture the full potential in this area.

Since the sales and distribution process cuts across several functional groups and budgets, companies rarely know its full cost. In a typical company, each functional group has its own separate budget built around head count and related expenses. From an expense control standpoint, budgets for functional groups are useful because managers who are close to the people doing the work can monitor and control costs. However, one certain consequence is that no one in the company has a clear understanding of how much it costs to sell and deliver products to a customer. Usually there is a well documented budget for the sales and marketing organizations, but the additional costs for the remaining activities are often buried in myriad other budgets. For equipment manufacturers or other companies which use direct sales, the total cost of this process can reach 20% of the end price to the customer[2] (Table 2), often twice the apparent cost of the sales and marketing functional budget.

Table 2: Cost Structure of Typical Direct Sales Process

Cost Category	**Per Cent of End Customer Price**
Selling (field sales force and sales management)	10%
Marketing (lead generation and support materials)	2%
Finance and Logistics	5%
After sales support (warranty, technical support, etc., excluding additional sales revenues)	3%

Source: Shorey Consulting estimates

Beyond the immediate operating expenses, a direct sales approach requires the greatest working capital investment for the manufacturer since the manufacturer maintains the required inventory and also retains all receivables and the associated credit risks of selling to end customers. At typical receivable and inventory levels, manufacturers can be forced to invest nearly 30%[3] of revenues in receivables and inventory (at an equivalent cost in interest of nearly 2% of revenues). Manufacturers without tight working capital

[2]All selling and distribution costs will be described as percentages of the price to the end customer. In this instance end price to the customer also equals manufacturer's revenue.
[3] Assuming 45 days of receivables and 4 inventory turns per year.

control can easily invest significantly more in working capital, causing a major cash and profit drain.

Manufacturers often believe that a direct sales approach is expensive in both operating expenses and working capital. Actually, this channel approach has a relatively low total cost for the entire process because there are no additional costs, or investments, beyond the manufacturer's. In addition, and from the manufacturer's perspective, the costs are principally fixed and have significant scale issues. Only sales commissions (5-7% of revenue at most) are truly variable, thus nearly three fourths of selling and distribution costs are fixed for a typical manufacturer. There is also a minimum scale for a direct sales force to cover the physical size and distances in the US, making direct sales a difficult choice for smaller companies or product lines.

Independent Sales Representatives

From an activity and total cost standpoint, the distinction between direct sales and independent sales representatives (manufacturers representatives, etc.) represents only a minor variation. The activities of *Product/Customer Matching* and *Closing* and much of *Customer Identification and Acquisition* are transferred from the manufacturer to the independent representative. This produces only a minor change in total costs because the manufacturer sheds only the cost of the sales force and the commissions paid to independent representatives equals the cost of a direct sales force.

Independent reps make sense in circumstances where a manufacturer cannot support a direct sales organization, or could not at the time the sales and distribution channel was created. Examples of common situations where independent representatives are useful include:

- Small companies or niche products which do not generate enough revenue to support a dedicated sales force.
- Accessory products which are easily sold in conjunction with a primary item and where secondary attention from the independent representative is not a significant issue.
- Entry into overseas markets where local knowledge and contacts are indispensable and where they are held by the independent representative, but not by the manufacturer.

Independent representatives serve principally to substitute variable costs for the fixed costs of the direct sales approach and to lower the minimum revenue level needed to support the sales and distribution channel. The fixed to variable cost trade-off is straightforward. Virtually all representatives are paid solely on commission so that approximately one-fourth the cost of sales and distribution channel management becomes variable. Scale effects occur because a manufacturer is only buying part of an independent representative's time and is, therefore, only paying part of the cost. At a given level of sales, a manufacturer can afford more "feet on the street" with independent reps than with its own sales force. Unfortunately, the manufacturer only buys partial attention and support from those feet.

The distinctions between a direct sales organization and independent representatives yield little effect on the investment requirements for the sales and distribution channel. Since the manufacturer still holds all of the inventory and the receivables, it still has a working capital requirement similar to a direct sales approach.

Distributors and Wholesalers

The principal reasons for manufacturers to use distributors and wholesalers[4] have been to shift the working capital responsibility from the manufacturer to a third party and to provide attention to many thousands of local customers. The primary emphasis in both the direct sales and the independent representative approaches is on the *Product-Customer Matching* and *Closing* activities. Distributors and wholesalers traditionally dedicate only a small portion of their efforts to these two activities; rather, they focus on the *Logistics* and *Finance* activities such as rapid delivery and credit decisions to small, local businesses.

A distributor or wholesaler maintains a local stock of product and provides either a counter for customer pickup or frequent delivery services to its customers. While most distributors or wholesalers have a sales organization, it is usually dedicated to finding customers and to maintaining relationships (*Customer Identification and Acquisition*). Some distributors have technically trained staff who can assist in *Product/Customer Matching*, but wholesalers rarely do. Wholesalers often have counter staff who can help the customer complete an order and who may answer some product related questions; few provide much real sales assistance.

In addition, distributors and wholesalers will generally provide credit lines to their customers (*Finance*). This is a critical element in the overall value provided by distributors and wholesalers because their customers are often small, undercapitalized firms who depend on free trade credit to finance their businesses. Deciding how much credit to provide and how long to ride with a troubled customer are functions where the local knowledge and business connections possessed by distributors and wholesalers create a strong basis for success. Many distributors and wholesalers have discovered that they are acting more like a bank than a sales or logistics organization.

While the distributor or wholesaler is providing many of the activities related directly to the end customer for the manufacturer, the manufacturer must replicate many of the activities in order to serve the distributor or wholesaler (Table 3):

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[4] The terms *Distributor* and *Wholesalers* are used synonymously in many industries. In most circumstances there are subtle differences between *distributors* and *wholesalers*. As used in this paper, *distributors* do not carry competing brands and *wholesalers* do. For example, a Coca Cola bottler is a *distributor* because it handles only Coca Cola beverages, products approved by Coca Cola, and supporting products. A liquor w*holesaler* will carry a complete range of products, including multiple lines of wines and spirits.

Table 3: Distributor or Wholesaler and Manufacturer Activities

Activity	Distributor - Wholesaler to End Customer	Manufacturer to Distributor - Wholesaler	Manufacturer to End Customer
Customer Identification and Acquisition	Outside Sales		End Customer Advertising, Coop Advertising
Product/Customer Matching	Limited Activity	Marketing Tools, Technical Support, Distributor - Wholesaler Training	
Closing	Counter Sales Or Phone/Fax Orders		
Order Acceptance and Processing	Accepts Orders From Customers	Accepts Distributor - Wholesaler Orders	
Finances	Credit Screening and End Customer Receivables	Distributor Receivables	
Logistics	Local Inventory and Delivery	Plant Inventory	
Support	Limited Activity	Warranties	

Manufacturers must support their distributors or wholesalers in two major areas for the overall channel to operate effectively. First, manufacturers must supply selling tools and related training in order for the distributor, or more rarely the wholesaler, to perform the *Customer/Product Matching* activity. Few distributors or wholesalers have the technical knowledge to develop their own programs to explain adequately and help customers select products appropriately. Secondly, manufacturers still need to perform *Finance* and *Logistics* functions in order to serve the distributors or wholesalers. The manufacturer must process orders and ship to the distributors or wholesalers and must make credit decisions on whom to finance and to what degree.

Post sales (*Support*) activities have emerged as a contentious issue in the relationship between manufacturers and the distributor or wholesaler channel. After-sale parts and service are often a key element in the lifecycle profitability of a product sale; distributors and wholesalers have traditionally controlled the after-market by virtue of their direct contact with the customer. As manufacturers have attempted to increase their own parts revenues and establish a service business, they have found themselves in conflict with their distributors or wholesalers, limiting the manufacturer's after-sale profit potential. The lost profit stream from after-sale parts and service raises the true cost of using distributors and wholesalers.

Because of the overlapping activities and the lost revenues, the total cost of a distributor or wholesaler sales and distribution channel is significantly higher than a direct sales or independent representative approach. The cost of the total channel with distributors or wholesalers can easily reach 35-40% of the price to the end customer versus approximately 20% for direct sales (Table 4). However, the magnitude of this overall cost structure is concealed from the manufacturer because *its* costs for sales and distribution decline from 20% to 15% of the *manufacturer's* selling price. The total system cost increases, while the costs apparent to the manufacturer decline because the added costs are buried in the distributor or wholesaler and, typically, in increased prices to the end customer.

Table 4: Distributor or Wholesaler Sales and Distribution Channel Cost Structure

Cost Category	Cost at End Customer Price	Cost at Manufacturer Selling Price
Distributor - Wholesaler		
Gross Margin	25%	33%
Manufacturer		
Selling and Marketing	6%	8%
Finance and Logistics	3%	4%
After Sales Support	2%	3%
Total Channel Participant	11%	15%
Grand Total	36%	48%

Source: Composite index of multi-location distributors and wholesalers and Shorey Consulting estimates

In addition to adding operating cost, distributors or wholesalers add significant working capital to the overall channel. A typical distributor or wholesaler maintains approximately 45 days of receivables and turns its inventory 4.5 times annually for a working capital investment at 25% of revenues. In order to support its distributors or wholesalers, a manufacturer can easily hold an additional 45 days in receivables and would do well to turn its inventory 6.5 times, thus yielding a 50% increase in total working capital in the distribution channel (Table 5). Because the manufacturer and its distributors or wholesalers are separate business entities, this higher cost level is rarely noticed or measured unless some change is occurring in the distribution channel. As long as most competitors use similar channels, neither the manufacturer, the distributor, the wholesaler nor the end customer have alternatives which highlight the added costs. When new competitors introduce new channel approaches, the added costs quickly, and acutely, become apparent.

Table 5: Working Capital by Sales and Distribution Channel Percent of End Customer Revenue

	Direct Sales Channel	Distributor - Wholesaler Channel
Distributor - Wholesaler		
Inventory		17%
Receivables		12%
Manufacturer		
Inventory	15%	7%
Receivables	12%	9%
Total	27%	45%

Source: Composite index of multi-location distributors and wholesalers and Shorey Consulting estimates

Many manufacturers have believed that the benefits from a distributor or wholesaler channel have offset the added costs. First, most manufacturers where not able to cover the broad US geographic territory themselves. Second, the distributor or wholesaler reduced the manufacturer's customers from several thousands to several hundred. Finally, the distributor or wholesaler added important local knowledge and judgment to the credit function.

Retailers

One of the major trends in sales and distribution channels is the emergence of retailers as an important channel for business-to-business product sales, exemplified by the role of the superstore like Home Depot, Staples or CompUSA. For retailers like Home Depot and CompUSA, the most visible aspects of their businesses focus on consumers, however selling to small (or not so small) contractors and other businesses is a more and more significant piece of the customer mix. Conversely, Staples was created with an orientation towards business customers. These retailers reduced the cost of the sales and distribution process by simplifying the *Logistics* activities and by reducing the working capital levels in the overall system relative to distributors and wholesalers. Staples has reduced sales and distribution costs 10% (2 points) by operating profitably on a 23% gross margin versus 25-26% for distributors and wholesalers. It has also managed to serve business customers with only fifteen days of receivables versus 45 days in typical distributor or wholesaler channels. Two of the most efficient retailers (Wal-Mart and Home Depot) achieve over five inventory turns per year versus 3.3 turns for W.W. Grainger, a wholesaler with significant size and comparable product line breadth. Clearly these companies have developed an increasingly successful, but new, approach to sales and distribution management.

Retailers achieve these results by cutting back even further than distributors and wholesalers on the *Product/Customer Matching* activity since most sales are self-service and most retailers offer little practical product advice. In exchange, the customer gets broad and deep product selection at low prices. Retailers serving business customers continue to provide *Logistics* support (delivery) and several offer simplified order entry and tracking (*Order Acceptance and Processing*). Bringing in new customers (*Customer Identification and Acquisition*) is accomplished through regional advertising rather than through any significant direct outside sales activity.

One of the most dramatic differences between retailers and distributors or wholesalers is in approaches to credit (*Finances*). Granting and managing credit policies is a function of great importance to the end customer and, therefore, high value to the manufacturer. Even the large retailers with a focus on business customers have restricted the use of traditional credit lines and open accounts. Rather they force many customers, especially the smaller and less creditworthy ones, to use bank credit cards for purchases. As a result, retailers can reduce receivables by over 25 days and pass-off the credit screening function to credit card issuing banks Retailers pay a steep (but largely hidden) price to eschew the credit activity in the form of a discount of 2-3% deducted from revenues on their credit transactions. Since granting trade credit is a major source of financing for many businesses, retail channels will need to meet this need in some form. Credit policies and practices will be a significant element in the competition between the distributor-wholesaler and retail channels as both seek to find solutions which meet customer needs and generate sufficient returns for the credit activities.

Observations and Future Directions

Distribution channels have traditionally been monolithic; most firms in an industry used the same approach. In a stable situation, a strategy of following the others is simple to conceive and implement. However, few industries still have this simplicity. Both new entrants and existing firms are experimenting with new sales and distribution approaches in order to create competitive advantage. The framework of activities and their costs provides a strategic perspective on the sales and distribution process, helping manufacturers understand and adapt to their changing environment.

Innovations in sales and distribution have emerged from many directions. Improved logistics and delivery times by FedEx and UPS are reducing the requirements for local warehousing. Broader acceptance of electronic data interchange to monitor sales and inventory levels throughout the total channel is reducing inventories and speeding response to changing customer requirements. Low cost computer power moves product information, specifications and selection directly to the end customer. The Internet is emerging as a means to serve large numbers of customers at much lower costs.

Shorey Consulting, Inc., is a strategy consulting practice dedicated to working interactively with clients in order to develop approaches for profitable growth in the face of change. It encourages thoughts, comments and additional examples of sales and distribution approaches as key elements in successful business models. Shorey Consulting can be reached at 617-850-6760 or at www.shoreyconsulting.com.

These new options create opportunities for manufacturers to restructure their sales and distribution approaches by performing activities in new ways which increase value to customers and reduce costs. Manufacturers can gain competitive advantage by:

- Determining which activities are valued by the end customers
- Identifying new ways to perform high value sales and distribution activities so that they increase customer satisfaction
- Assessing alternative approaches to sales and distribution which lower costs and working capital investments throughout the total channel

The next articles in this series will examine case studies of innovations in the sales and distribution process which created shareholder value.