Strategic Channel Design

Erin Anderson • George S. Day • V. Kasturi Rangan

When choosing distribution channels, companies need to rely on design principles that are aligned with their overall competitive strategy and performance objectives.

Accelerating technological change, heightened marketplace demands, more aggressive global competition, and shifts in the workforce and population demographics are affecting distribution channels, forcing companies to reconsider fundamental assumptions about how they reach their markets. The magnitude of change demands a strategic perspective that views channel decisions as choices from a continually changing array of alternatives for achieving market coverage and competitive advantage — subject, of course, to the constraints of cost, investment, and flexibility. Tactical responses, based on maintaining power balances, managing conflicts, and minimizing transaction costs to pursue greater efficiency, will not suffice.

Changes in distribution channels come slowly, partly because the inherent complexity of the many links that connect value-adding functions in a channel obscures the need for change. Distribution channels are also dauntingly rigid and stable because of powerful, persistent inertia. Faint-hearted managers, unwilling to disrupt existing channels and incur predictable short-run costs for less certain gains from a new configuration or approach, may become discouraged, resulting in a growing mismatch between the firm's overall strategy and its means of distribution. Our main premise is that the pressures for change are overcoming the inertia in distribution channels. Customary and comfortable incremental approaches cannot cope.

Frequently, a firm's distribution method is an appendage to its strategy — the result of opportunistic, reactive, one-by-one decisions accumulated over time and frozen by perceived barriers. Instead, the firm's overall strategic direction must guide changes in channels. Therefore, we propose a process for incorporating a strategic perspective into decisions on the future configuration of channel functions, control of the functions, and resource commitments. This process requires firms to assess their current channels, identify alternatives based on creative combinations of value-adding channel functions, and evaluate the alternatives within a broad context that highlights potential competitive advantages.

First, we outline some forces for change in distribution channels. Next, we examine the implications of these changes for channels, including changing commitments, vertical compression, horizontal diversity, and the need to re-examine channel alliances. We also suggest how to design channels strategically.

Forces for Change

In the face of inertia, tradition, entrenched industry practice, and a lack of alternatives, most firms stayed with their established channels and seldom changed the way they exercised control.[1] Three forces are now changing the customary rules of channel management: (1) proliferation of customers' needs, (2) shifts in the balance of channel power, and (3) changing strategic priorities. Channels have become dynamic webs, comprising many direct and indirect ways to reach and serve customers.[2]

Proliferation of Customers' Needs

When markets are simple and stable, the appropriate

Erin Anderson is professor of marketing, INSEAD. George S. Day is the Geoffrey T. Boisi Professor of Marketing, Wharton School, University of Pennsylvania. V. Kasturi Rangan is the Eliot I. Snider and Family Professor of Business Administration, Harvard Business School.

channel configuration is usually evident. Firms will distribute directly when they want to closely control selling, serving, and pricing or have only a few readily identifiable customers. When the market requires a variety of related goods in small quantities, companies prefer to use intermediaries because of their wide coverage (due to economies of scope and scale), experience, and specialized distribution in their industries. Theoretically, the higher the required investments in specialized assets for servicing the end customer, the more appropriate are direct channels.[3] However, these guidelines for channel configurations are obscured when markets are fragmented into segments so diverse that many products are mass customized.[4] Three factors contribute to mass customization and, hence, market fragmentation:

Expanding capabilities for addressability and variety. Firms have greater ability to address individually each customer or small subsegment of their market with a combination of database technology[5] and flexible manufacturing.[6] Now firms can engage in a direct dialogue with their customers and appreciate the diversity of their needs.

Channel diversity. Increasingly, firms are shifting from centralized batch production to localized, one-at-a-time production. Meanwhile, distributors, not just manufacturers, are exploiting the generic capabilities for addressability and variety to automate many functions, such as order receipt, shipping, inventory management, and stock replenishment, so they can respond to orders more rapidly and cheaply and customize products.[7] The net result is continuing turmoil and channel diversity.[8]

Customer expectations. Customers have become accustomed to the benefits of customized products and greater services, ready availability through their preferred channel, and rapid order fulfillment.[9] Thus customers increasingly demand improved performance that is based on what they now know is possible.

In short, the new ability to address customers in small groups encourages channel diversity. Addressability and diversity together raise customer expectations. And these expectations put further strain on distribution channels.

Shifts in the Balance of Channel Power

Few businesses that reach their markets indirectly are exempt from intermediaries' seemingly inexorable gains in power and control. In retailing, this is evident in the growth of high-volume chain retailers (for example, Toys 'R' Us now controls 25 percent of the toy market in the United States), the consolidation among retailers that reduces the number of direct competitors, and the emergence of buying groups that permit small stores (notably in hardware) to improve their buying power. There have been comparable gains by large multilocation distribution firms at the expense of small, local distributors.[10]

The increased concentration of channel structures has adverse effects on suppliers' profitability. All the elements underlying buyers' power in the Porter industry-forces model — enhanced bargaining power, more knowledgeable buyers, and credible threats of backward integration — favor the intermediaries or end buyers.[11]

Enhanced bargaining power. When there are a few customers making large-volume purchases, the suppliers' ability to withstand pressures for discounts, price concessions, and costly services erodes quickly. The pressures mount when the retailers or distributors face slim profit margins relative to the suppliers. For example, in the United States, grocery retailers with margins of 1 to 2 percent are turning to manufacturers that have margins of 10 to 15 percent to bargain for some of that value. They not only have become more effective but also are designing their own merchandising programs and demanding supplier participation to underwrite these programs. They have also demanded that suppliers cater to the differences in their stores and in customer profiles.

The net result of power shifts is not always evident.[12] Although many observers believe that manufacturers have lost ground to suppliers, analysis reveals that both manufacturers and retailers have lost power to the consumer.

More knowledgeable buyers. A major determinant of marketing power has always been the agents' level of knowledge.[13] Big resellers enhance their relative power by increasing their knowledge of: (1) their suppliers' costs — because they may be negotiating to buy private-label products from these same suppliers, (2) their own operations — by taking advantage of transaction processing systems that can capture and interpret sales data about each item and merge it with cost informa-

tion, and (3) their customers' needs. For example, Merck purchased its pharmaceutical distributor, Medco Containment Services, Inc. In addition to wider product distribution, Merck management gained detailed information from Medco's databases, which link pharmacies, patients, physicians, third-party payers, and managed care organizations, that can guide research and help market new products.[11]

Credible threats of backward integration. Buyers and channel intermediaries can further enhance their power by threatening to take over some of their suppliers' activities or displacing them with their own products. The supplier knows the profit consequences of reduced capacity utilization and overhead coverage. Chain retailers' growth of private-label sales has forced the branded-goods makers to cut their prices, eliminate slow-moving brands altogether, and sharply rationalize their product lines.[13] Meanwhile, the increase in chain distributors' scale and scope permits them to take over more of their suppliers' activities, thereby strengthening their relationship with the end customer and creating a disadvantage for the supplier.

> Increasingly, companies are handing off noncritical activities or functions so they can concentrate on enhancing their competitive position.

Changing Strategic Priorities

Increasingly, companies are handing off noncritical activities or functions so they can concentrate on enhancing their competitive position. In rationalizing organizational and channel structures, firms are guided by:

1. An emphasis on understanding and responding to customers' real requirements in order to deliver superior value. When activities do not relate to these outcomes, a firm sees them as superfluous.
2. A willingness to cross artificial boundaries within the organization and challenge how all activities and processes that comprise value-adding processes, such as order fulfillment, are linked.[16] Can individual activities be combined, eliminated, done in parallel, or reordered? Applying the same logic to distribution means that a firm must make rationalization decisions at the individual channel function level — not at the higher level of the channel institution.[17]
3. An effort to perform activities where they make the most sense. Any activity that is not pivotal to the strategy can be performed better by another organization.[18]

Along with rationalizing their activities, firms are exploring new relationships and alliances with customers, suppliers, and intermediaries. The resulting networks or value-adding partnerships are like confederations of specialists. They are flexible, specialized, and emphasize interfirm relationships, with a pooling of complementary skills and resources to achieve shared goals.[19]

The resulting openness to partnering is producing new channel collaborations for the sharing of activities such as order fulfillment, inventory management, distribution, purchasing, and post-sales service.[20] The new linkages require relationship management skills and careful negotiations. Both participants must realize durable mutual benefits in financial terms (through increased revenues or lower costs) or hard-to-quantify benefits due to risk sharing or the pooling of expertise and market knowledge. Such mutual benefits are increasingly feasible because of advances in information technology that have sharply reduced the costs of coordinating and administering transactions between partners.

Implications for Channels

We can interpret the three forces for change — increasing customer needs, shifts in the balance of power, and changing strategic priorities — more fundamentally from the vantage points of recent developments in economic and organizational theory. Most distribution channels are subject to a combination of shifting patterns of commitment, vertical compression, horizontal diversity, and functional decomposition.

Shifting Patterns of Commitment

Fewer firms are committed to retaining their vertically integrated distribution systems. Instead, many firms have dismantled or downsized their corporate distribution arms and outsourced the functions to third

parties. But, rather than shifting to conventional arm's-length transactions with traditional distribution intermediaries (e.g. full-line, full-function distributors), many firms are experimenting with new arrangements.

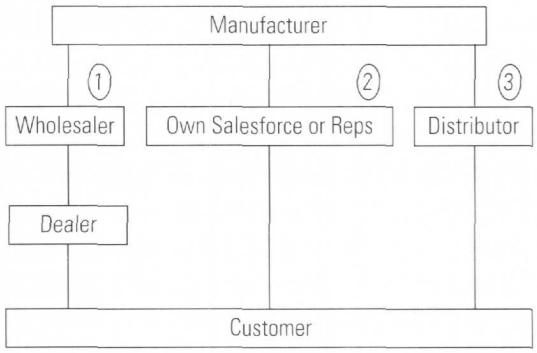
Some arrangements make relationships so close that a customer cannot see the seam between producer and distributor. Because these arrangements involve substantial, durable, and irreversible investments on both sides, they resemble strategic alliances.[21] At the same time, other suppliers have numerous third-party arrangements, thereby diversifying their channels to match the diverse needs in their markets.[22] The result is a complex collection of potentially overlapping outlets, with the potential for channel rivalry and conflict.

Greater turbulence and the attendant uncertainty erodes the inertial forces that hold firms to their established channel systems. Webster notes that the dramatic downsizing and personnel turnover that began in the 1980s accelerates internal change, simply because the defenders of the status quo no longer hold their old positions.[23] When ties among key personnel break, organizational arrangements may change because new decision makers have different opinions that are not "clouded by the continuity of experience."

Vertical Compression

In traditional vertical channels, firms transferred responsibility from one layer to the next, like passing the baton in a relay race. Thus a manufacturer sends a truckload shipment to a wholesaler, which then breaks it up and sells to a dealer, which, in turn, stocks the product and persuades the customer to buy (see Figure 1, option 1). If the product needs after-sales service, the customer takes it back to the dealer, which maintains and repairs the product in the field. Even though the product may pass through several layers in the distribution system, the customer relies solely on the dealer for the fulfillment of all channel functions, such as information, inventory, and repair.[24] Others in the vertical system have a support role. In this case, the wholesaler provides a wide assortment of products for the dealer's selection, but customers fulfill all their needs (assortment, lot sizes, information, and repair) through the dealer alone. Manufacturers can gain access to customers through alternate channel systems as well — directly or through representatives or one-step intermediaries such as distributors (options 2 and 3 in Figure 1). But no matter the system used, the customer fulfills its channel function requirements mainly from one source.

Figure 1 Traditional Channel Options



A small customer that buys through the dealer channel might prefer to get technical information directly from the manufacturer, but, because of the small lot size of its purchases, it would have to get product information as part of the local dealer's distribution support. The manufacturer would find it too costly to contact and provide this information directly, and the customer would find it costlier still to await product shipment from the factory. Even though the customer is not fully served by the manufacturer with regard to "information," overall, it is still better to get it from the dealer than not at all. (Of course, the dealer can also provide other relevant information about alternative products.)

Now, innovative IT, direct marketing, database marketing, and variations allow some manufacturers to contact far-flung, small customers for only a fraction of the cost of a direct sales call. Computer-aided quick-shipment systems enable transporters to schedule and dispatch less-than-truckload orders with about the same speed and efficiency as full loads. The small customer, therefore, may not suffer any inconvenience or product unavailability. Flexible manufacturing systems allow suppliers to produce small lots at only a marginally higher cost than scale-efficient large orders.

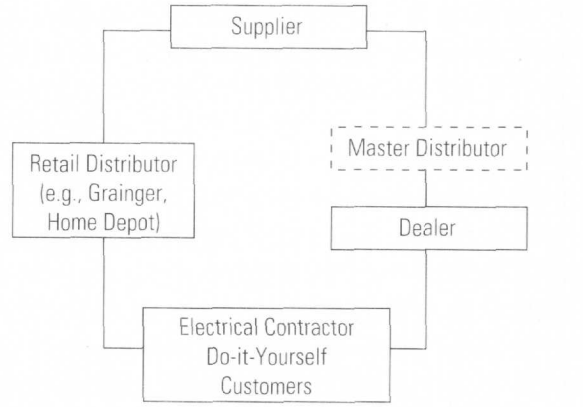
The roles of the intermediary, the distributor, and the dealer are all evolving. New forms of direct channels are emerging, and indirect channels are getting shorter with fewer intermediary layers. The role of the distributor as buffer between the manufacturer and the retail dealer is threatened in many markets.

As channels compress, the role of the master distributor or the wholesaler is most at risk (see Figure 2). With quick-shipment distribution logistics, retailers no longer lose time in ordering directly from the supplier. And, with the amount of information available to the supplier, tracking and responding to retail-level orders is vastly more manageable. IT and quick-shipment logistics have greatly diminished the need for dual inventories in the pipeline. In an intensely competitive environment, the extra margin saved at the master-distributor level can become a price advantage at the customer level — or can fund efforts to differentiate the retailer's offering.[25] For example, with more than 300 stores selling about 40,000 SKUs (stock-keeping units), W.W. Grainger has forced a reorientation in the electrical goods industry. Both the seller and the dealer see the master distributor as unwanted fat in the system. Home Depot in the construction industry and Terminix and Orkin in the pest-control industry are further examples.

Ironically, in many industries, manufacturers without the inventory-carrying capacity, the geographic reach, or the capability to fulfill small orders set up master distributors as the essential conduit to retail distribution. But retail dealers have become larger and more sophisticated in handling both suppliers and customers. For small retail dealers, which still need extra support in product assortment or credit, master distributors may be the only alternative. But only those that proactively use advances in information and logistics technology to their advantage and combine them with excellent servicing of small orders will survive.

Those suppliers that have successfully used a master-distributor channel in the past will find it hard to bypass this level. Master distributors perform inventory and credit functions and own the relationships with dealer accounts. Newer, more nimble competitors, however, may choose the cost-efficient alternative of eliminating the master distributor. Of course, the master distributor may make it difficult for an entrant to gain coverage, but if the entrant succeeds, the supplier with the master-distributor channel will lose revenue, share, and profits. Then the pressure to change will be tremendous. However, the long-established suppliers have entrenched relationships with the master distributors, and these channel partners will be willing to slice their margins or increase their channel efforts.

Figure 2 The Role of the Master Distributor



Horizontal Diversity

All channels drift out of alignment with supplier and customer needs over time, eventually leading to conflict, reevaluation, and change. Now these changes are occurring so swiftly that there is no time to determine whether an initial channel design is effective. Eisenhardt and Zbaracki refer to such an environment as "high velocity."[26]

How should a company manage in a high-velocity environment? New research in strategic decision making indicates that the traditional exhaustive and inclusive planning model doesn't work. Instead, more effective firms sacrifice thorough planning for experimental action by generating large numbers of options but *not* thoroughly analyzing most of them. An effective firm launches many small experiments or trials, carefully analyzes only a few options, and reacts quickly to feedback from the experiments. There is no time for exhaustive forecasting and analysis, and it is difficult to pin down means-ends relationships and forecast outcomes. Hence, organizations place many small "bets" and then enlarge those that seem to be most favorable. In distribution, this means experimenting with many different ways of reaching the market (e.g., direct mail, telemarketing, and more traditional resellers), often simultaneously.

Placing many small bets may seem indecisive and irrational, but it is now seen as the first step in a rational strategy of holding options.[27] A strategic option is a company's small investment in an operation that creates the right but not the obligation to take further action. Options theorists argue that many

seemingly small or half-hearted organizational commitments will actually amount to a lot if the commitment keeps a company in the game or is a learning experience. Because options buy time and knowledge, they are probes; although they may be costly, they prevent more expensive mistakes and indicate where to commit resources more heavily.

When is it worthwhile to purchase options? Theorists argue that options are best suited for highly uncertain environments, where investors have difficulty determining an asset's worth. Therefore, options become the best way to estimate the worth of a later, larger investment. Options are valuable in high-growth industries, in particular, because uncertainty suggests opportunity, which suggests making investments — but initial investment decisions are difficult to make rationally. Options are even more valuable when they can't be imitated quickly or easily and provide lead time over competitors.

Turbulent environments make it difficult to predict what type of channel is appropriate. As products eventually assume accepted configurations, as segments emerge, and as buyer behavior becomes predictable, a firm that invested in the wrong channel configuration will discover that it has miscalculated. Hence, while firms may find themselves trapped in an inappropriate delivery system, the best they can do is to alter their channel systems incrementally to align them with customer expectations.

Contrast this with the supplier who seeks channel diversity by generating many options and thoroughly evaluating a few. That is, the firm does business through many different distribution entities in many different ways, thereby creating many openings and gleaning varied information. As the market clarifies, the manufacturer can judiciously sell some options (e.g., sell out a distribution joint venture or liquidate an equity position in a distributor), fail to exercise some options (cease distributing through the channel entity), and call some options (invest in them more heavily by purchasing equity, injecting resources, or cultivating commitment). Because channel relationships are very difficult for competitors to duplicate or match, these options have substantial value.

• **Multiple Channels.** Multiple channels reflect the range of channel options available to buyers and suppliers. A buyer of personal computers, for example, could buy the same model from a direct-mail catalogue, a computer superstore, or a specialty store, each for a different price and service. Ideally, these different service levels reflect the needs of different buyers. A consumer who is price sensitive but very knowledgeable about product features and specifications would order from a direct-mail catalogue. But the customer who seeks a great deal of product information and education might prefer a computer specialty store. Additionally, this customer would need the reassurance, hand-holding, and local service of the specialty store.

As environments stabilize, distribution arrangements should become fewer, more substantial, and more stable, and reflect a coherent, articulated channel strategy.

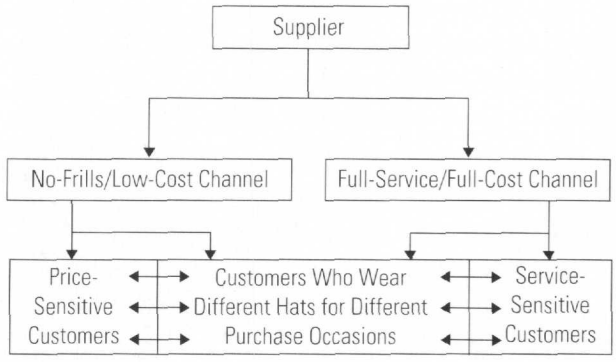
Unfortunately, consumers do not come neatly segmented into such airtight compartments. There is considerable movement between segments and across purchases. Moreover, with accelerating product life cycles, proliferation of products, and fragmentation of customer segments, multiple channel approaches are often the only way to provide market coverage. Different customers with different buying behaviors will seek channels that best serve their needs.

But options are not a perfect solution. Customers can infiltrate from the adjoining segments by patronizing both the full-service channel and the low-price channel (see Figure 3). As long as higher price fairly reflects higher service, customers will be loyal to a particular channel, but if the service is unnecessary or can be obtained at a lower cost, customers will cross to the low-price channel. In some businesses, presales service is a public good that customers can avail themselves of without making a purchase. For example, a customer can get a full-function demonstration at a computer specialty store and then buy the product from a low-cost mail-order retailer. The customer gets a free ride on the full-service channel.

In managing multiple channels, companies demar-

cate products and models by channels, thus minimizing direct comparison. The demarcations, of course, work only when there are meaningful differences among products. Sometimes, despite product differences, competing channels can offer similar problem-solving capabilities by patching or bundling products appropriately, for example, personal computers for workstations. In such cases, a company can render the patched solution uncompetitive in price. Other coordination mechanisms, such as joint incentives or customer partitioning, work only when one channel member is supplier-owned (e.g., has its own salesforce or captive distribution). The supplier-owned part of the channel can absorb the negative consequences of the mechanisms, if the systemwide results are worth the cost. But such mechanisms rarely work when all the multiple members are independent.

Figure 3 Multiple Channels



Multiple channels are most prevalent in fast-changing market environments. When the product-market matures slowly, the channel has time to adapt to changes in customer-buying patterns. Even if multiple channels are necessary to reflect market plurality, each channel is clearly specialized to serve a specific buying pattern. Crossovers are less common. Discount stores in the late 1970s and early 1980s were clearly targeted to the value-conscious shopper, and the service-conscious shopper continued to patronize the specialty stores. The two channels often stocked, displayed, and sold different brands and attracted a very different clientele. This does not occur in the more dynamic industries. Computer models that start out in specialty stores end up with the catalog retailers in less than six months. Early buyers may not face channel dissonance, but late-comers always do. While later buyers may seek the service of a specialty outlet, the price of a discount outlet is too tempting to pass up. Moreover, in dynamic environments, customers' shopping and buying behaviors, buying criteria, and segments change frequently.

In coping with turbulence, channel diversity pays, but only if the arrangements are treated as options. Further, they must decide what to do with options as the market stabilizes. Bowman and Hurry point out that a bundle of options allows a firm to persevere through hard times; their small investments can be carried while they serve their place-holding and learning function until the market improves.[28] A bundle of options also allows a firm to move faster, as it recognizes and seizes opportunities. Failing to realize option values means a firm is merely exploring; it does not develop ideas, realize opportunities, or develop a distinctive competence.[29] Thus manufacturers should not seek multiple coverage indefinitely. As environments stabilize, distribution arrangements should become fewer, more substantial, and more stable, and reflect a coherent, articulated channel strategy.

Functional Decomposition

Do high-velocity environments favor channel specialists at the expense of generalists? Specialists have few routines and narrow operations; generalists do more and cover more domains. For example, a value-added reseller of computer systems that focuses on architectural firms is a specialist. A computer chain selling a wide range of computer hardware and software for business and personal use is a generalist because it resells many products to wholesale and retail buyers.

In a high-velocity environment, it is unclear what to sell, how, and to whom. Specialists are probes of pieces of the environment; promising pieces warrant holding a specialist option. Yet, in many ways, the generalist appears well suited to a high-velocity environment. Because it does some of everything, it can hedge. In the language of organizational ecology, a generalist has slack or capacity that is not fully used, which can be redeployed.[30] Hence, in this type of environment, it is useful to have distribution options with both specialists and generalists.

What happens if and when the environment stabi-

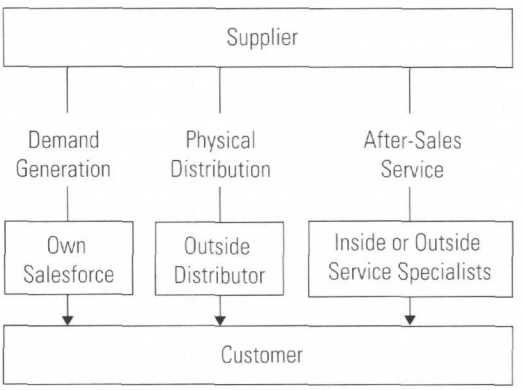
lizes? Population ecology theorists argue that the generalist, being a jack of many trades, becomes a master of none. Surrounded by swarms of varied specialists (a critical assumption), the generalist watches its market break into pieces, many of which gravitate to a suitable specialist. Many specialists, as well as the generalists, will prove unsuitable (Are architects an appropriate segment? Is value-added reselling an appropriate function?) and will exit. Population ecology does not predict *which* specialists will survive — only that the survivors tend to be specialists. When markets stabilize, most of those options with generalists and many of those with specialists will be less appropriate in the newly stable environment. A firm with a portfolio of options will be able to focus on the most suitable channels.

A firm does better in uncertain environments by dealing through many specialists because specialists tend to be focused and, hence, more nimble than the manufacturer. Further, the specialists have valuable local knowledge about small market niches. Bucklin suggests that when consumer demand is varied and complex, distribution channels will be varied as well.[31] The manufacturer cannot acquire as much market knowledge as many local entities can collectively. It will be overwhelmed by the task of integrating the information and making a decision. Hence, it will be better to deal through many entities and let the market sort out which are appropriate.

• **Composite Channels.** Organizational ecology theory explains both greater diversity and the increase in composite channels in which both the supplier and its channel partners divide up the execution of the channel functions. The supplier performs some functions such as sales negotiation and order generation, while its channel partners deliver physical distribution and order fulfillment. Other channel members might specialize in functions such as after-sales service. The members work together with certain members specializing in certain functions (see Figure 4). The difference between composite and conventional channels is the horizontal task allocation. A team of channel partners (including the supplier), each specializing in a few tasks, satisfies the customer's total needs. In the conventional channel, the hand-offs are vertical; each member performs the full channel functions that its immediate customers require.

As we suggested earlier, the trend toward functional specialization (and therefore horizontal channels) is driven by customers' desires to receive products and services in the most cost- and time-efficient manner. If channel functions have to be unbundled and sourced separately, customers, especially large ones, will be willing to do so.

Figure 4 Composite Channels



In the health care industry, there are many such composites. For example, Becton-Dickinson's Vacutainer Systems division negotiates directly with all large hospital buying groups for its blood-collection needles, syringes, and accessories.[32] When the deal is finalized, Becton-Dickinson signs a contract with the group and provides a list of authorized distributors. Becton-Dickinson's distributors effect the physical distribution — ordering, storing, and supplying products to the appropriate hospital at the desired time in required lots. It can do this cost efficiently, given the plethora of other products it already supplies the hospitals, so order entry and fulfillment costs are incremental. At the same time, the cost containment in the health care industry makes it attractive for buyers to negotiate directly on high-volume/high-value orders. The competitive environment gives suppliers better control on sales, profits, and market shares as well.

The computer industry also has a rich variety of composite channels. Value-added resellers (VARs) are able to tailor solutions for customers in niche markets (banking, retailing, CAD-CAM, etc.) While VARs provide the specific knowledge on the software, they work closely with computer vendors for hardware equipment and system configuration. Customers need the hardware and software to be integrated in order to

address their problems, but the channel expertise is such that it takes two members to find a perfect solution.

With new channel forms come new management challenges; the biggest is channel compensation. Because the channel member dealing with the customer no longer performs all channel functions, it cannot expect to receive a traditional margin or commission. Ideally, channel members under the new system are compensated only for the functions they perform. But herein lies a catch. All members in the hybrid system must adequately perform their functional responsibilities for the final sale to occur. If one member fails, the whole team suffers, unless another team member fills in. Free riders can abuse their position by cutting corners in their responsibilities, and the most valuable player often has to bear the cost. In the traditional vertical system, poor performance correlated directly with lower sales and therefore lower margins.

Because the channel member dealing with the customer no longer performs all channel functions, it cannot expect to receive a traditional margin or commission.

Composite channels are costly to monitor and administer and seem to work only in environments that can afford high channel margins. In low-margin industries, composite channels seem to work only for market leaders. Such suppliers usually use their market clout to influence their hybrid channel partners. Free-riding, for instance, is punishable by loss of orders. A leading industrial supply company, for example, calls on many of its accounts directly but routes all orders through its distribution network — a classic composite system. It will not choose a free-riding distributor, however. The company has multiple distributors in the same market area. Those not playing by the rules are not mentioned warmly by the salesforce when the order is written. Theoretically, the customer could still buy from the free-rider but will rarely do so because of the influence of the direct sales channel.

Unfortunately, for weaker suppliers, the coordination costs of the composite channel often exceed the benefits of its functional effectiveness. Such firms then trade off effectiveness for the simplicity and functional aggregation of the vertical arrangement. They may have to rely on full-function distributors to compete with the specialized composite channels of the market leaders.

Designing the Channel Strategy

The channel design process is similar to the steps followed in developing a competitive strategy.[33] The difference is that the channel supports the overall strategy: its prime requirement is to enhance effective delivery of the customer value proposition. In this support role, the channel must meet the requirements of:

1. Effectiveness — How closely does the channel design address customers' stated and unstated requirements?
2. Coverage — Can the customer find and appreciate the value in a firm's offering?
3. Cost-efficiency — Can the company justify a trade-off in cost-efficiency to gain greater strategic effectiveness and coverage because of the multiplier effect that distribution has on increasing the impact of the other marketing variables?
4. Long-run adaptability — Can the channel design handle possible new products and services and incorporate emergent channel forms?

Assessing the Company's Situation

The first step in channel design is to identify the threats, opportunities, strengths, and weaknesses that will influence channel performance and viability. A company should analyze competitor's shares of existing channels, the relative profitability of each channel, coverage of the market served, and the cost of each channel function. A company must consider likely changes in buying patterns, potential competitive entrants, long-run cost pressures, and new technologies such as the Internet or multimedia retail kiosks.

A company should assess what customers are seeking from channels by asking:[34]

- What service attributes do the target customers value?

• How can we use the differences in preferences to segment customers with similar needs?
• How well do the available channels meet the needs of the segments?

Selecting Alternatives

When a firm is confronted with myriad possibilities, how should it choose a channel arrangement? It should rely on strategic *design principles*, subject to the constraints of prior strategic commitments, resource availability, and rigidities. The principles are consistent with our theoretical analyses, while recognizing that the channel strategy must contribute to the business's overall performance objectives.

1. *Align channels with the overall competitive strategy, by:*
• Designing channels from the market back, so the channel activities meet the anticipated requirements of the target market.
• Creating barriers to competitive response. To do so, the firm may have to pay the price of locking itself into an internal operation or into close ties with selected channel partners, which usually obliges the partner to lock in a chosen supplier and lock out competing suppliers.
• Enhancing the delivery of superior customer value. The choice of a channel is also dictated by whether a firm elects to compete on operating excellence (e.g., by emphasizing reliability and competitive pricing of standard products and services), customer responsiveness (through some variant of mass customization or business partitioning), or superior performance. Each strategic thrust reflects the choice of a specific target segment, with distinct requirements and needs.

2. *Decompose and recompose channels into integrated collections of functions.* Channel functions are the basic building blocks of the design process. While functions cannot be eliminated, they can be combined creatively to reduce cost and to improve responsiveness and be dispersed among several different players. It is essential to take advantage of advancing IT capabilities to improve system coordination.

3. *Invest in learning.* Firms in high-velocity environments, where means-ends relationships are uncertain, should create a portfolio of options for coping with inevitable uncertainty. These options enable a firm to explore channel design by trial and error. Some experiments will fail. However, the costs incurred — even when there is a failure — should not be viewed as losses but as investments in learning how to understand and gain access to the market. As the market stabilizes, the firm should choose particular channels rather than continue to experiment.

4. *Translate strategic choices into programs, projects, and near-term plans and establish controls for monitoring channel performance.* These controls define the information collected, standards for performance, and ways to quickly and graphically compare expectations with results. Without this information, there is no basis for learning, correcting mistakes, and adjusting assumptions to better fit reality. Thus the end of this step signals the beginning of another cycle in the design process.

Conclusion

Many firms see distribution as peripheral to their competitive strategy. Increasingly, they have recognized that benign neglect is risky and wastes opportunities for competitive advantage. Under pressure from powerful market trends and technological changes, they are vigorously scrutinizing past practices, commitments, and relationships.

How should firms deal with external forces that disrupt once-stable patterns of channel commitment, compress vertical systems, proliferate horizontal alternatives, while decomposing channels into distinct functions that are reassembling into new patterns? A channel design process that follows sound design principles is needed to identify and select among the myriad of channel alternatives. Ultimately, a channel strategy is a series of trade-offs and compromises that align the company's resources with what it should do to satisfy its target customers and stay ahead of competitors. ◆

References

The authors are listed in alphabetical order. The authors thank Adam J. Fein for many helpful comments and Barton Weitz for sharing perspectives.

1. R.E. Corey, F.V. Cespedes, and V.K. Rangan, *Going to Market: Distribution Systems for Industrial Products* (Boston: Harvard Business School Press, 1989), pp. 43-59.
2. B.A. Weitz and S.D. Jap, "Relationship Marketing and Distribution Channels," *Journal of the Academy of Marketing Science*, volume 23, number 4, 1995, pp. 305-320.
3. O.E. Williamson, *The Economic Institutions of Capitalism* (New York: Free Press, 1985);

E. Anderson and B.A. Weitz, "Make-or-Buy Decisions: Vertical Integration and Marketing Productivity," *Sloan Management Review*, volume 27, Spring 1986, pp. 3-20; and
S. Klein, G.L. Frazier, and V.T. Roth, "A Transaction Cost Analysis Model of Channel Integration in International Markets," *Journal of Marketing Research*, volume 27, May 1990, pp. 196-208.
4. S. Davis, *Future Perfect* (Reading, Massachusetts: Addison-Wesley, 1987); and
J.B. Pine, *Mass Customization: The New Frontiers in Business Competition* (Boston: Harvard Business School Press, 1993).
5. R.C. Blattberg, and J. Deighton, "Interactive Marketing: Exploiting the Age of Addressability," *Sloan Management Review*, volume 33, Fall 1991, pp. 5-14.
6. G. Stalk, Jr., "Time — The Next Source of Competitive Advantage," *Harvard Business Review*, volume 66, July-August 1988, pp. 41-51.
7. F.V. Cespedes and E.R. Corey, "Managing Multiple Channels," *Business Horizons*, volume 35, July-August 1990, pp. 67-77.
8. Ibid.
9. A. Kumar and G. Sharman, "We Love Your Product But Where Is It?" *Sloan Management Review*, volume 33, Winter 1992, pp. 93-99.
10. Distribution Research and Education Foundation, *Facing the Forces of Change 2000* (Washington, D.C.: Distribution Research and Education Foundation, 1992).
11. M.E. Porter, *Competitive Strategy* (New York: Free Press, 1980).
12. P.R. Messinger and C. Narasimhan, "Has Power Shifted in the Grocery Channel?," *Marketing Science*, volume 14, Spring 1995, pp. 189-223.
13. R. Glazer, "Marketing in an Information-Intensive Environment: Strategic Implications of Knowledge as an Asset," *Journal of Marketing*, volume 55, October 1991, pp. 1-19.
14. B. O'Reilly, "Why Merck Married the Enemy," *Fortune*, 20 September 1993, pp. 60-64.
15. P. Sellers, "Brands: It's Thrive or Die," *Fortune*, 23 August 1993, pp. 52-55.
16. B.P. Shapiro, V.K. Rangan, and J.J. Sviokla, "Staple Yourself to an Order," *Harvard Business Review*, volume 70, July-August 1992, pp. 113-122.
17. V.K. Rangan, R.E. Corey, and F. Cespedes, "Transaction Cost Theory: Inferences from Field Research on Downstream Vertical Integration," *Organization Science*, volume 4, August 1993, pp. 454-477.
18. J.B. Quinn and F. Hilmer, "Strategic Outsourcing," *Sloan Management Review*, volume 35, Summer 1994, pp. 43-55.
19. R.S. Achrol, "Evolution of the Marketing Organization: New Forms for Turbulent Environments," *Journal of Marketing*, volume 55, October 1991, pp. 77-93; and
F.E. Webster, Jr., "The Changing Role of Marketing in the Corporation," *Journal of Marketing*, volume 56, October 1992, pp. 1-17.
20. J.C. Anderson and J.A. Narus, "Partnering as a Focused Market Strategy," *California Management Review*, volume 33, Spring 1991, pp. 95-113.
21. Anderson and Weitz (1986).
22. G.L. Frazier and K.D. Antia, "Exchange Relationships and Interfirm Power in Channels of Distribution," *Journal of the Academy of Marketing Science*, volume 23, Fall 1995, pp. 321-326.
23. F.E. Webster, Jr., "The Changing Role of Marketing in the Corporation," *Journal of Marketing*, volume 56, October 1992, pp. 1-17. For a counterargument, see:
M. Granovetter, "Economic Action and Social Structure: The Problem of Embeddedness," *American Journal of Sociology*, volume 91, number 3, 1985, pp. 481-510.
24. H.H. Baligh and L.E. Richartz, *Vertical Market Structures* (Boston: Allyn & Bacon, 1967); and
L.W. Stern, A.I. El-Ansary, and A.T. Coughlan, *Marketing Channels*, 5th edition (Englewood Cliffs, New Jersey: Prentice-Hall, 1996).
25. R. Lusch and D. Zizzo, *Competing for Customers: How Wholesaler-Distributors Can Meet the Power Retailer Challenge* (Washington, D.C.: Distribution Research and Education Foundation, 1995).
26. K.M. Eisenhardt and M.J. Zbaracki, "Strategic Decision Making," *Strategic Management Journal*, volume 13, Winter 1992, pp. 17-37.
27. B. Kogut, "Joint Ventures and the Option to Expand or Acquire," *Management Science*, volume 37, January 1991, pp. 19-33;
B. Kogut and N. Kulatilaka, "Options Thinking and Platform Investments: Investing in Opportunity," *California Management Review*, volume 36, Winter 1994, pp. 52-71;
E.H. Bowman and D. Hurry, "Strategy through the Option Lens: An Integrated View of Resource Investments and the Incremental-Choice Process, *Academy of Management Review*, volume 18, 1993, pp. 760-782.
28. Ibid.
29. H.A. Simon, "Bounded Rationality and Organizational Learning," *Organization Science*, volume 2, number 1, 1991, pp. 125-134.
30. M.T. Hannan and J. Freeman, "Structural Inertia and Organizational Change," *American Sociological Review*, volume 49, April 1984, pp. 149-164; and
M. Lambkin and G.S. Day, "Evolutionary Processes in Competitive Markets: Beyond the Product Life Cycle," *Journal of Marketing*, volume 53, July 1989, pp. 4-20.
31. L.P. Bucklin, *A Theory of Distribution Channel Structure* (Berkeley, California: IBER Special Publications, 1966).
32. Corey et al. (1989).
33. G.S. Day, *Market-Driven Strategy* (New York: Free Press, 1990).
34. L.W. Stern and F.D. Sturdivant, "Customer-Driven Distribution Channels," *Harvard Business Review*, volume 65, July-August 1987, pp. 34-37, 40-41; and
V.K. Rangan, M.A.J. Menezes, and E.P. Maier, "Channel Selection for New Industrial Products: A Framework, Method, and Application," *Journal of Marketing*, volume 56, July 1992, pp. 69-82.

Reprint 3845