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Changing Channels to Market

How to anticipate and manage shifting channels

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Channels tend to evolve over many years. Sometimes they evolve so slowly that companies fail to see the change and don't adapt their strategies based on where the trends are heading -- often finding themselves in a position where they no longer control their market position. In the turbulent economic times that we are experiencing now, these trends are often accelerated as companies make hard choices about what to continue doing and to stop doing in order to survive. In our work with companies across a range of industries, we've developed some perspectives on how to stay ahead of changing channels.

The trick is to recognize these trends and proactively adjust your channel strategies before it's too late. It is especially difficult to see these trends given that channels can be a complicated jumble that varies widely across different industries and regions of the world.

For one company, which is in the building products market, the dominant channel to market shifted from local market value-added distributors to a few powerful manufacturer representative agencies over a twenty year period. Historically, the industry was supplied by a lot of relatively small manufacturers who utilized value-added distributors providing design services that complemented the wide range of products required for large building projects. Rep agencies handled relatively few product lines. As a result of the distributors' strong customer relationships and value-added services, they commanded rich margins typically over 20%.

But given this industry's building boom and bust cycles distributors often face cost pressures and, over time, they eliminated their design specialists. At the same time, manufacturer's reps were consolidating and began representing many more lines from a range of manufacturers. They in turn added the design staff that the distributors had relinquished.

In many local areas today, we see one or two rep agencies that dominate the market. These agents hold the customer relationships, provide value-added services and essentially dictate terms to the manufacturers and distributors. The role of distributors has diminished along with their profits as they are now limited to holding inventory and taking credit risk. The game changed for manufacturers as the balance of power shifted toward the large agents that play one manufacturer against another for the lowest price.

In the example above, some of the manufacturers are now in a reactive mode. Unless they want to live with ever slimmer margins, they must embark on aggressive plans to restore the balance of power -- in this case likely achieved by better understanding end-customer requirements then deploying products to broaden their offering (achieved through internal development but also through acquisition) coupled with channel management strategies to create and capture market value.

Companies that are looking for the right indicators can anticipate changes in their channels. The four major factors to look for are outlined below.

Customer or retailer consolidation The rise of big-box retailers in category after category has driven major changes in manufacturers channel strategies; not simply that they now have to recognize new retailers that want to buy direct instead of through traditional distributors, but the impact on the remaining channels to traditional retailers can also be dramatic. For one of our clients, the cost to serve the remaining independent retailers rose significantly while market coverage declined through their traditional channel forcing supplier to look for partners that carried a broader product range with unfortunately lower service levels that the manufacturer then had to supplement.

Supplier consolidation As suppliers consolidate, they too often want to take a step out of the distribution chain and go direct. Household appliances can be used here to illustrate a couple of different channel changes as manufacturers consolidated and took the business direct to retailers. In several cases major manufacturers acquired high-end appliance brands with a significant portion of expected synergies coming from sharing direct to retail sales and distribution capabilities. In many cases the high-end brands withered as the retail outlets and distribution behind them could not support the more demanding service requirements of these premium products -- an example of trying to change channels beyond their limits. While the majors were buying up other players, the remaining smaller high-end manufacturers saw their channel shrink and distributors in local markets going out of business. As larger suppliers consolidate, the smaller premium brands are forced to jockey for position with the relatively few high-service channel survivors -- changing to the right channel partner becomes critical.

Support services shifting to new players This can take several forms. The building products example above is a case where the control and profitability moved from one type of channel partner to another through the service offering. Often we see situations where distributors will add services to help their downstream customers fend off larger consolidators, usually in areas where the distributor's uses critical mass or scale to deliver the service efficiently.

Independent grocery stores have access to marketing programs, accounting and IT support, as well as sourcing of private label products just like the larger grocery chains because their distributors invest in these capabilities and spread the cost across a broader base of business than any individual store could.

Another example is when a group of distributors create a network of repair contractors or get into the repair business themselves so that local dealers (their customers) would have that additional capability to fight the big box retailers with their squads of repair technicians. These types of services can counter the cost advantages from consolidation and deliver higher levels of service to end consumers.

Category expansion As products start out in niche positions and grow to become major categories, we often see channels emerging and evolving as a result. In the early days of data networking equipment for the enterprise market, most of the business was sold directly from the manufacturers to the end customer, with only about 10% going through channel partners. As the business has grown, the proportion of business going through various kinds of channel partners (e.g., system integrators, value-added resellers, distributors, and local dealers) has inverted -- channel volume now accounts for 90% of the business.

In fact, channel partners providing customized local service have been major contributors to the explosive growth. In this type of situation, it's important to sequence your channel strategy properly to align with partners that suit your target end-customer segments, and be ready to adjust as the products and target customers change.

Some choose to ignore the complexities described above and simply view the channel as their customer rather than the true end-user in the market. Product plans, pricing schemes, terms and support resources are largely based on what their channel partners demand -- and demand they do as manufacturers lose touch with the ultimate customer. In the short-term, it can appear attractive to reduce cost by eliminating inbound marketing efforts to understand trends in customer requirements and competitive positions, as well as outbound marketing programs to maintain brand positions and generate demand through channels. In the long term though, these types of investments drive growth and profitability -- especially if most of your business goes through channel partners.

Channels Vary Widely

Channels are a complicated mix; they differ dramatically across industries and regions. Some variations are noted here:

- **Two-step versus one-step models.** These include, for example, master distributor and sub-distributor. Big box stores are one-step models; they deal directly with manufacturers and end-customers. However, the more complex or specialized the item, such as a high-end appliances, the more likely it will need a two-step channel.
- **Vast and diverse player mix.** These include local specialized dealers vs. national distributors vs. "online-only" distributors. Some markets feature local dealers, others rely on national distributors.
- **High-service vs. high-volume channels.** Channels can usually provide one or the other. Local hardware stores specialize in excellent service, while large chains like Home Depot can compete on price.
- **Consolidation vs. fragmentation.** Consolidation of the channel will typically occur in the largest portions of the market that require relatively low, consistent service levels.

So how do you stay ahead of changing channels so that you are in control of your strategy rather than being a victim? We would suggest the following steps:

1. Explicitly assess how your channels have evolved over the past several years. Gauge how much consolidation has occurred and understand how end-customer service associated with your products has changed or moved in the value chain.
2. Determine if your industry is ripe for some of the changes described above. This is best done by understanding trends in requirements from the end-customers' perspective and getting their views on how channel partners do or don't add value.
3. Realign your channel partners with target customer segments in anticipation of where things are heading. Don't get too comfortable with your current arrangements.
4. Adjust your service and channel programs to support evolving needs and capture value with appropriate pricing strategies. Don't let your business be commoditized as a result of avoiding or continuously cutting programs that can differentiate your offering.

During tough economic times you can expect channels to change at an accelerated rate. Making the required adjustments will pay-off as long as they are implemented with a clear sense of where the market is going and what your role is going to be relative to channel partners.

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