Shorey Consulting, Inc.

Achieving Competitive Advantage Through Sales and Distribution Strategy

Situation

Selecting a sales and distribution approach is a key element of a successful business model. The sales approach, or more broadly the overall process of selling and delivering products to customers, at once encompasses both a company's connection to its customers and a significant portion of its total costs. Traditionally, companies selected from a defined, limited set of options (i.e. direct sales, manufacturers representatives, distributors, dealers) and most firms in an industry made similar choices. Recently, the number of options has expanded greatly and the breadth of choices by competitors has proliferated in parallel, creating potential instability in competitive positions for current leaders and areas of opportunity for others. To make matters more uncertain, some of the traditional options no longer offer the same balance of services and costs and now cease to achieve the desired results. Therefore, many companies are forced to rethink their approaches to sales and distribution.

Structuring an analysis of sales and distribution channel options is based on the fundamental logic underlying channel selection:

- How do sales and distribution channel choices fit into an overall business model?
- What is the history of creating competitive advantage with sales and distribution channels?
- What were traditional channel options and why did they meet supplier and customer needs?
- How are the underlying characteristics of sales and distribution channels changing?
- What are new options open to suppliers and how should suppliers evaluate those options?
- How can suppliers mange transitions between channel choices?

This paper will provide an overview of the changing nature of sales and distribution channels.[1] It is the first in a series; subsequent ones will address each of the topics in greater detail.

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[1] The discussion here on sales and distribution channels applies largely to the US. Sales channels operate very differently in Europe, while the issues of gaining market access in developing countries have other constraints and ramifications. These topics are increasingly critical for many companies, but are outside the scope of this discussion. In addition, sales to highly concentrated OEM customers (e.g. auto parts) work with unique dynamics and requirements and do not always follow the patterns described here.

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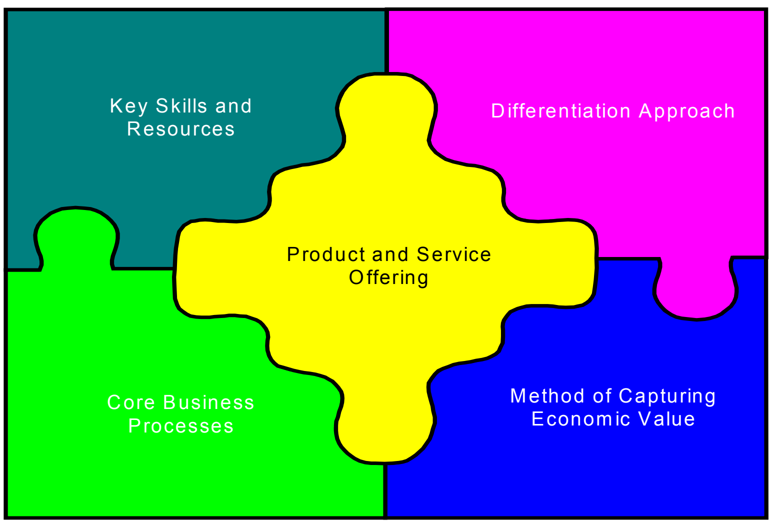
Sales and Distribution as a Path to Competitive Advantage

Many companies have built lasting competitive advantage through their choice of sales and distribution channels coupled with their ability to integrate that choice into a coherent, well executed business model. On its own, no approach to sales or product distribution is sufficient for competitive success. Rather, a complete business model (Figure 1) includes sales and distribution as one of the Core Business Processes in concert with Product/Service Offering, Differentiation Approach, Method of Capturing Economic Value and Key Skills/Resources. These choices are linked; once a company picks a sales and distribution channel, it limits its options on how it can achieve differentiation and where it can capitalize on profit opportunities. For example, if a company sells through distribution, it may have ceded any potential service business to the distributor.

Figure 1: Elements of an Integrated Business Model



The list of companies which have used sales and distribution channels to create competitive advantage includes most of the leaders in non-consumer, non-OEM (and many consumer) products. Andersen in residential windows and Carrier in residential and light commercial air conditioners based a major element of their competitive strength on a sales and distribution strategy anchored by the largest and strongest local distributors. Honeywell in control parts and Square D in non-industrial electrical equipment achieved strong competitive positions from their ubiquitous presence at the leading parts and electrical equipment wholesalers. Allen Bradley in motor controls and the Trane Company in commercial air conditioners built networks of independent sales representatives with the best connected and best known local sales sources in their individual local markets. Snap-On Tools in automotive tools and Hilti in construction fasteners are, at heart, distribution companies, creating their competitive advantage through direct sales from delivery trucks. During its most successful period, IBM had the best network of direct sales employees, each of whom had close relationships with corporate information technology managers.

The strong positions achieved by the industry leaders in the sales and distribution channel create consuming challenges for other competitors. For example, Group Schneider from France had unsuccessfully attempted to build a position in the US electrical equipment market for over a decade prior to purchasing Square D. The acquisition was logical because it provided Schneider with access to Square D's channel. The difficulty of achieving sufficient, high quality distribution and channel access is further illustrated by the number of developers of new technologies which sell their businesses or create alliances with industry leaders in order to gain distribution access.

Many management teams are now facing new questions on their sales and distribution approaches. How can companies create competitive advantage in the future using sales and distribution channel strategies? Is the window now closed for this path to advantage? Are the current leaders endowed with permanent strength, while second-tier companies are consigned to perennially weak positions? The strategic issues of sales and distribution channel selection and management have become more complex over the past decade because the answer to each of these questions is, increasingly, *no*. New options are ever more available to dislodge traditional leaders. Overreliance on current strengths has caused more than one company to ignore changing customer needs, industry economics, and technology options, with the result that they were surprised by innovative, new competitors who restructured industries using new sales and distribution approaches.

Traditional Sales and Distribution Channel Options

The process of creating future competitive advantage through sales and distribution channels begins with an understanding of how the current situation has evolved. The preferred sales and distribution channels within an industry have often been clear because certain channel types have met the basic needs of an industry better than others did. In industries where the optimal channel approach is already controlled by an entrenched competitor, other suppliers typically focus their efforts on duplicating the skills and capabilities of the leader's channel. This competitive dynamic tends to result in stable positions. Unless a leader makes a serious mistake, it can remain in a strong competitive position indefinitely while the other firms continue to struggle.

The residential whole-house air conditioning and heating industry provides an example of a typical set of distribution and competitive relationships. Heating and air conditioning equipment is sold to local contractors who, in turn, sell installed systems to builders and homeowners. The first challenge for manufacturers is the size of the customer base: over 10,000 small, under-capitalized, local contractors in the US. Second, there is a major logistics requirement in the sales and distribution process, since many local contractors need equipment delivered in one or two days in order to make emergency replacements during the height of the heating or cooling seasons. Finally, whenever heating or cooling technology changes, local contractors need to be trained in how to select and then install the new system, creating a need for the sales channel to convey information and technical assistance on a regular basis.

Given the nature of the cost and performance characteristics of the various channel options, heating and air conditioning manufacturers have gravitated to sales and distribution through distributors or wholesalers[2]. Carrier, the traditional industry leader, built relationships with many of the better capitalized, more skilled distributors in the early period of industry growth. It locked-up the best available channel partners. Later entrants were forced to find other approaches which met as many of the functional requirements of serving local contractors as they could. Rheem/Ruud, and a host of smaller companies, gravitated to heating supply wholesalers because these wholesalers would agree to take on additional product lines. The companies using wholesalers solve two of the three sales channel needs: access to many small contractors and delivery from local stocks. Unfortunately, most wholesalers carry multiple, competing products so that they do not provide strong sales and technical support for any individual supplier. Another competitor, Lennox, decided on a different balance. It opened its own, more limited network of local branches, sacrificing breadth of coverage for better sales and technical support. The exception to the predominant industry focus on distributors/wholesalers was GE, which used a business model concentrating on new construction sales by packaging air conditioners and heating equipment with home appliances. Ultimately, this model addressed too small a market segment and GE sold its residential heating and air conditioning business.

Over time, the products sold by most established heating and air conditioning manufacturers have becomes more and more similar. Without product differentiation, strength in the sales and distribution channel has reinforced the competitive and market share positions of industry leaders. Sales and distribution channel strategy became a key element for competitive success. For nearly twenty years, there was minimal change in relative positions among the residential heating and air conditioning industry leaders; changes tended to occur when stronger competitors acquired weaker ones.

In this example, the major participants each attempted to solve a similar distribution challenge by adopting distributors or by recreating the functions of a distributor in the best way still available. The heating and air conditioning industry is coalescing around a single sales and distribution structure, driven by the requirements for serving the contractor customer base and the cost/performance characteristics of sales and distribution options. Many other industries follow similar patterns with a preferred approach to sales and distribution. Traditional industry leaders have developed strong positions while other competitors struggle to gain adequate presence in similar channels. Competitive activities take place on the margins of this structure, with few firms successfully challenging the sales and distribution *status quo*.

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[2] The terms *Distributor* and *Wholesales* 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 *Wholesaler* will carry a complete range of products, including multiple lines of wines and spirits.

Disrupting Competitive Positions by Changing Sales and Distribution Channels

Increasingly, we see examples of companies which disrupted apparently stable industry structures by making major changes in a traditional industry sales and distribution channel process. Two models of this trend have relevance as examples for most industrial and other business-to-business product situations:

- Dell Computer built a strong position in PCs by replacing traditional distribution with telephone-based sales and ordering.
- Home Depot is consolidating the building materials retailing industry and, therefore, changing the competitive dynamics in its supplier industries.

In one instance, a manufacturer took an innovative approach and created a position of strength. In the other, manufacturers are finding their traditional channel changing, which radically shifted power, profits and shareholder value from the manufacturers to the distribution channel.

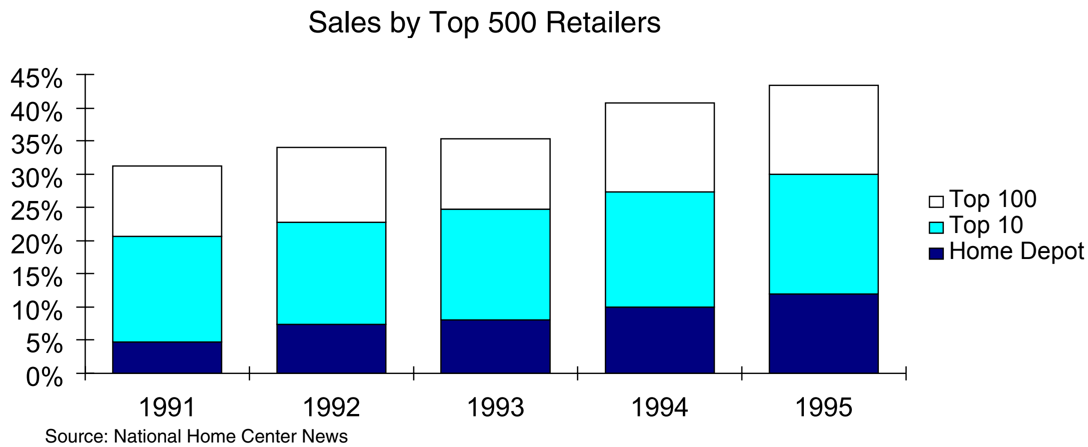
Dell entered the PC industry at a time when most companies sold through small, specialized, high-cost dealers which provided customers with support on both how to purchase and how to use computers. This high-cost channel was quickly obsolete and most PC suppliers switched to large, megastore retail chains (CompUSA, Computer City, etc.).

While the other suppliers were struggling with retail channel evolution, Dell took a radically different path by finding a means to sell products which normally required both significant customer assistance and local stocking without a dealer or distributor network. Dell created a new channel option by bringing new technology to traditional roles played by the distribution channel. Dell takes orders over the telephone, it allows purchasers to customize products to their own needs, it assembles products largely to order, and it achieves rapid delivery. The combination provides a high degree of customer service at a previously unattainable cost structure. With this distribution change as a major element of its strategy, Dell grew to a profitable $7.8 billion business at the time when many larger computer companies were giving up on the PC market.

Dell shows how a company can meet most of the same end customer needs as its competitors through a radically different distribution approach. As enabling technologies (telephone communications, call centers, shipping logistics, etc.) evolve, more suppliers will supplant traditional sales and distribution approaches and, therefore, gain competitive advantage. However, simply copying a model which has worked once is not a guaranteed path to success. No other “mail order” computer company has managed to match Dell’s growth in sales and profits. Dell built a strong overall business model and established its position before others had a chance to copy the model.

Home Depot has caused consolidation of building material retailers and, in the process, has generated both enthusiasm and concern among its suppliers. For the suppliers, the volumes are attractive, but the profits are not. By changing the economics of its retailing industry, Home Depot has managed to offer competitive prices to consumers, coupled with broad selection and relatively high levels of service. It has doubled its share in a slow-growing market by displacing many of the second-tier lumber and building materials retailers (Figure 2). Similar patterns occurred with Wal-Mart before it and now are spreading with the anticipated consolidation of office supplies distribution

Figure 2: Trends in Building Materials Retailers



Home Depot’s transformation of building materials sales and distribution channel is causing suppliers to rethink their own strategies. Some have chosen to work closely with Home Depot. In the late 1980s and early 1990s, selling to Home Depot led to major shipment and revenue growth for those suppliers. Recently, Home Depot (like Wal-Mart before it) has exercised greater bargaining power over its suppliers, forcing down prices and gaining other concessions. Many suppliers are now beginning to consider channel alternatives to Home Depot. The overall disruption of traditional sales and distribution channels is creating strategic uncertainty for most lumber and building materials companies, even those which had not sold to Home Depot but which had supplied the other, weaker home centers that are now threatened. Suppliers’ strategies are now driven not only by change in their own industries, but also by developments at the retailers, the manufacturers’ customers in the distribution channel.

What Should Companies Do About Channel Choices?

If Dell and Home Depot can disrupt the traditional sales and distribution channels in both an emerging industry and a relatively stable one, no business is immune from dramatic shifts in the structure of its sales channel. All businesses need to ask themselves: will change occur in my own industry and how quickly? Who will benefit? What are the major new directions open for strategic advantage? Companies can understand and find competitive advantage in the future evolution of sales and distribution channels for their industries through an analysis of:

- End customer needs - Who does the channel serve and what are the emerging needs of that customer group?
- Channel economics - What functions are performed by the channel and which ones are valuable to customers? Are the costs and value in balance?
- Alternative approaches - What is happening in analogous channels? Where are the best models of behavior? Dell and its approach may have great applicability well outside the computer industry. Who are the other 'Dell' examples?
- Emerging competitors - Who is appearing on the periphery of an industry? What alternative approaches are they offering? Do important groups of customers seem to be buying from firms using that new approach?

Understanding the situation and the alternatives for selecting a sales and distribution channel requires careful thought, data gathering, and analysis in the context of a coherent business model. As difficult as it may seem to create a new channel strategy, the prospect of actually changing any existing approach can appear even more formidable. In order to be successful, a company recognizing changing sales and distribution requirements in its marketplace must be committed to re-examining, and potentially changing, many aspects of the way it does business. Reassessment and change of this kind typically has ramifications throughout the organization, including:

- Questioning the concepts underlying past success
- Requiring new skills and capabilities
- Threatening loyalties and relationships built up over many years between current management and the existing channel participants
- Initiating a messy transition period

The only reason that companies chose to undertake such a re-examination is that the results can be dramatic. Early introduction of a new business model which meets better the current and future needs of customers creates substantial economic value as shown by Dell. Conversely, as IBM found, failure to move can rapidly destroy value.

What Follows

The remaining papers in this series on sales and distribution channel choice will describe the fundamentals of gaining competitive advantage using sales and distribution channels as one element in a new business model. In addition, the papers will also highlight successes and failures in making the transition to new models. They will serve as a guide for managers who are facing strategic decisions driven by new channel requirements.

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.