

Chapter 6

DESIGNING THE MARKETING CHANNEL

Chapter Objectives

Channel design refers to those decisions involving the development of new marketing channels where none had existed before or to the modification of existing channels. Channel design is a seven-step process of which six steps are covered in this chapter and the seventh or final step is covered in Chapter 7.

Learning objectives

- 1) Understand the definition of channel design and the key distinguishing points associated with it.
- 2) Realize that channel design is a complex process.
- 3) Know the sequence of the channel design paradigm and understand the underlying logic of the sequence.
- 4) Recognize a variety of situations that might call for a channel design decision.
- 5) Be familiar with the concept of distribution objectives and the need for congruency with marketing and corporate objectives and strategies.
- 6) Be able to specify distribution tasks.
- 7) Recognize the three dimensions of channel structure and the strategic significance of each dimension.
- 8) Delineate and define the six basic categories of variables affecting channel structure.
- 9) Understand the concept of a heuristic in terms of its benefits and limitations in channel design.
- 10) Recognize the limitations of the channel manager's ability to choose an optimal channel structure in the strictest sense.
- 11) Be familiar with the major approaches for choosing a channel structure.
- 12) Have an appreciation for the value of judgmental-heuristic approaches for choosing channel structures in the real world.

Chapter Topics

- 1) What is Channel Design?
- 2) Who Engages in Channel Design?
- 3) A Paradigm of the Channel Design Decision
- 4) Phase 1: Recognizing the Need for a Channel Design Decision
- 5) Phase 2: Setting and Coordinating Distribution Objectives
- 6) Phase 3: Specifying the Distribution Tasks
- 7) Phase 4: Developing Possible Alternative Channel Structures
- 8) Phase 5: Evaluating the Variables Affecting Channel Structure
- 9) Phase 6: Choosing the "Best" Channel Structure

Chapter Outline

What is Channel Design?

Key Term and Definition

- Channel design: Those decisions involving the development of new marketing channels where none had existed before, or the modification of existing channels.

Channel design is presented as a decision faced by the marketer, and it includes either setting up channels from scratch or modifying existing channels. This is sometimes referred to as *reengineering* the channel and in practice is more common than setting up channels from scratch.

The term design implies that the marketer is consciously and actively allocating the distribution tasks to develop an efficient channel, and the term selection means the actual selection of channel members.

Finally, channel design has a strategic connotation, as it will be used as a strategic tool for gaining a differential advantage.

Who Engages in Channel Design?

Producers and manufacturers, wholesalers, and retailers all face channel design decisions. Producers and manufacturers “look down” the channel. Retailers “look up” the channel while wholesaler intermediaries face channel design from both perspectives. In this chapter, we will be concerned only from the perspective of producers and manufacturers.

A Paradigm of the Channel Design Decision

The channel design decision can be broken down into seven phases or steps. These are:

1. Recognizing the need for a channel design decision
2. Setting and coordinating distribution objectives
3. Specifying the distribution tasks
4. Developing possible alternative channel structures
5. Evaluating the variable affecting channel structure
6. Choosing the “best” channel structure
7. Selecting the channel members

Phase 1: Recognizing the Need for a Channel Design Decision

Many situations can indicate the need for a channel design decision. Among them are:

1. Developing a new product or product line
2. Aiming an existing product to a new target market
3. Making a major change in some other component of the marketing mix
4. Establishing a new firm
5. Adapting to changing intermediary policies
6. Dealing with changes in availability of particular kinds of intermediaries
7. Opening up new geographic marketing areas
8. Facing the occurrence of major environmental changes
9. Meeting the challenge of conflict or other behavioral problems
10. Reviewing and evaluating

Phase 2: Setting and Coordinating Distribution Objectives

In order to set distribution objectives that are well coordinated with other marketing and firm objectives and strategies, the channel manager needs to perform three tasks:

1. Become familiar with the objectives and strategies in the other marketing mix areas and any other relevant objectives and strategies of the firm.
2. Set distribution objectives and state them explicitly.
3. Check to see if the distribution objectives set are congruent with marketing and the other general objectives and strategies of the firm.

1) Become Familiar with Objectives and Strategies

Whoever is responsible for setting distribution objectives should also make an effort to learn which existing objectives and strategies in the firm may impinge of the distribution objectives. In practice, often the same individual(s) who set(s) objectives for other components of the marketing mix will do so for distribution.

2) Setting Explicit Distribution Objectives

Distribution objectives are essentially statements describing the part that distribution in *expected to play* in achieving the firm's overall marketing objectives.

3) Checking for Congruency

A congruency check verifies that the distribution objectives do not conflict with the other areas of the marketing mix.

Phase 3: Specifying the Distribution Tasks

The job of the channel manager in outlining distribution functions or tasks is a much more specific and situationally dependent one. The kinds of tasks required to meet specific distribution objectives must be precisely stated.

In specifying distribution tasks, it is especially important not to underestimate what is involved in making products and services conveniently available to final consumers.

Phase 4: Developing Possible Alternative Channel Structures

The channel manager should consider alternative ways of allocating distribution objectives to achieve their distribution tasks. Often, the channel manager will choose more than one channel structure in order to reach the target markets effectively and efficiently.

Whether single – or multiple – channel structures are chosen, the allocation alternatives (possible channel structures) should be evaluated in terms of the following three dimensions: (1) number of levels in the channel, (2) intensity at the various levels, (3) type of intermediaries at each level.

1) Number of Levels

The number of levels in a channel can range from two levels – which is the most direct – up to five levels and occasionally even higher.

2) Intensity at the Various Levels

Intensity refers to the number of intermediaries at each level of the marketing channel.

- Intensive: sometimes called saturation means that as many outlets as possible are used at each level of the channel.
- Selective: means that not all possible intermediaries are used, but rather those included in the channel have been carefully chosen.
- Exclusive: a way of referring to a very highly selective pattern of distribution.

The intensity of distribution dimension is a very important aspect of channel structure because it is often a key factor in the firm's basic marketing strategy and will reflect the firm's overall corporate objectives and strategies.

3) Types of Intermediaries

The third dimension of channel structure deals with the particular types of intermediaries to be used (if any) at the various levels of the channel.

The channel manager should not overlook new types of intermediaries that are emerging such as Internet companies.

4) Number of Possible Channel Structure Alternatives

Given that the channel manager should consider all three structural dimensions (level, intensity, and type of intermediaries) in developing channel structures, there are, in theory, a high number of possibilities.

Fortunately, in practice, the number of feasible alternatives for each dimension is often limited due to industry or the number of current channel members.

Phase 5: Evaluating the Variables Affecting Channel Structure

Having laid out alternative channel structures, the channel manager should then evaluate a number of variables to determine how they are likely to influence various channel structures.

These six basic categories are most important:

1. Market variables
2. Product variables
3. Company variables
4. Intermediary variables
5. Environmental variables
6. Behavioral variables

1) Market Variables

Market variables are the most fundamental variables to consider when designing a marketing channel.

Four basic subcategories of market variables are particularly important in influencing channel structure. They are (A) market geography, (B) market size, (C) market density, and (D) market behavior.

A) Market Geography

Market geography refers to the geographical size of the markets and their physical location and distance from the producer and manufacturer.

A popular heuristic (rule of thumb) for relating market geography to channel design is:

“The greater the distance between the manufacturer and its markets, the higher the probability that the use of intermediaries will be less expensive than direct distribution.”

B) Market Size

The number of customers making up a market (consumer or industrial) determines the market size.

From a channel design standpoint, the larger the number of individual customers, the larger the market size.

A heuristic about market size relative to channel structure is:

“If the market is large, the use of intermediaries is more likely to be needed because of the high transaction costs of serving large numbers of individual customers. Conversely, if the market is small, a firm is more likely to be able to avoid the use of intermediaries.”

C) Market Density

The number of buying units per unit of land area determines the density of the market. In general, the less dense the market, the more difficult and expensive is distribution.

A heuristic for market density and channel structure is as follows:

“The less dense the market, the more likely it is that intermediaries will be used. Stated conversely, the greater the density of the market, the higher the likelihood of eliminating intermediaries.”

D) Market Behavior

Market behavior refers to the following four types of buying behaviors:

- 1) How customers buy
- 2) When customers buy
- 3) Where customers buy
- 4) Who does the buying

Each of these patterns of buying behavior may have a significant effect on channel structure.

2) Product Variables

Product variables such as bulk and weight, perishability, unit value, degree of standardization (custom-made versus standardized), technical versus nontechnical, and newness affect alternative channel structures.

A) Bulk and Weight

Heavy and bulky products have very high handling and shipping costs relative to their value. Therefore, a producer should attempt to minimize these costs by shipping only in large lots to the fewest possible points.

Consequently, the channel structure should be as short as possible usually from producer to user.

B) Perishability

Products subject to rapid physical deterioration and those of rapid fashion obsolescence require rapid movement from production to consumption.

The following heuristic is appropriate in these situations:

“ When products are highly perishable, channel structures should be designed to provide for rapid delivery from producers to consumers.”

C) Unit Value

The lower the unit value of the product, the longer the channel should be. This is because low unit value leaves a small margin for distribution costs.

When the unit value is high relative to its size and weight, direct distribution is feasible because the handling and transportation costs are low relative to the product’s value.

D) Degree of Standardization

Custom-made products should go from producer to consumer while more standardized products allow opportunity to lengthen the channel.

E) Technical versus Nontechnical

In the industrial market, a highly technical product will generally be distributed through a direct channel. This is because the manufacturer may need sales and service people capable of communicating the product’s technical features to the user.

In the consumer market, relatively technical products are usually distributed through short channels for the same reasons.

F) Newness

New products, both industrial and consumer, require extensive and aggressive promotion in the introductory stage to build demand. Usually, the longer the channel of distribution the more difficult it is to achieve this kind of promotional effort from all channel members.

Therefore, a shorter channel is generally viewed as an advantage for new products as a carefully selected group of intermediaries is more likely to provide aggressive promotion.

3) Company Variables

The most important company variables affecting channel design are (A) size, (B) financial capacity, (C) managerial expertise, and (D) objectives and strategies.

A) Size

In general, the range of options for different channel structures is a positive function of a firm’s size. Larger firms have more options available to them than smaller firms do.

B) Financial Capacity

Generally, the greater the capital available to a company, the lower its dependence on intermediaries.

C) Managerial Expertise

For firms lacking in the managerial skills necessary to perform distribution tasks, channel design must of necessity include the services of intermediaries who have this expertise. Over time, as the firm's management gains experience, it may be feasible to change the structure to reduce the amount of reliance on intermediaries.

D) Objectives and Strategies

The firm's marketing and general objectives and strategies, such as the desire to exercise a high degree of control over the product, may limit the use of intermediaries.

Strategies emphasizing aggressive promotion and rapid reaction to changing markets will constrain the types of channel structures available to those firms employing such strategies.

4) Intermediary Variables

The key intermediary variables related to channel structure are (A) availability, (B) costs, and (C) the services offered.

A) Availability

The availability (number of and competencies of) adequate intermediaries will influence channel structure.

B) Cost

The cost of using intermediaries is always a consideration in choosing a channel structure. If the cost of using intermediaries is too high for the services performed, then the channel structure is likely to minimize the use of intermediaries.

C) Services

This involves evaluating the services offered by particular intermediaries to see which ones can perform them most effectively at the lowest cost.

5) Environmental Variables

Economic, sociocultural, competitive, technological, and legal environmental forces can have a significant impact on channel structure.

6) Behavioral Variables

The channel manager should review the behavioral variables discussed in Chapter 4. Moreover, by keeping in mind the power bases available, the channel manager ensures a realistic basis for influencing the channel members.

Phase 6: Choosing the “Best” Channel Structure

In theory, the channel manager should choose an optimal structure that would offer the desired level of effectiveness in performing the distribution tasks at the lowest possible cost. In reality, choosing an optimal structure is not possible.

Why? First, as we pointed out in the section on Phase 4, management is not capable of knowing all of the possible alternatives available to them.

Second, even it were possible to specify all possible channel structures, precise methods do not exist for calculating the exact payoffs associated with each alternative.

Some pioneering attempts at developing methods that are more exacting do appear in literature and we will discuss these in brief.

A) “Characteristics of Goods and Parallel Systems” Approach

First laid out in the 1950s by Aspinwall, the main emphasis for choosing a channel structure should be based upon product variables. Each product characteristic is identified with a particular color on the spectrum. These variables are:

1. Replacement rate
2. Gross margin
3. Adjustment
4. Time of consumption
5. Searching time

▪ Using Aspinwall’s Approach

This approach offers the channel manager a neat way of describing and relating a number of heuristics about how product characteristics might affect channel structure.

The major problem with this method is that it puts too much emphasis on product characteristics as the determinant of channel structure.

B) Financial Approach

Lambert offers another approach, which argues that the most important variables for choosing a channel structure are financial. Basically, this decision involves comparing estimated earnings on capital resulting from alternative channel structures in light of the cost of capital to determine the most profitable channel.

▪ Using the Financial Approach

By viewing the channel as a long-term investment that must more than cover the cost of capital invested in it and provide a better return than other alternative uses for capital, the criteria for choosing a channel structure is more rigorous.

The major problem with Lambert’s approach lies in the difficulty of making it operational in a channel decision-making context.

C) Transaction Cost Analysis (TCA) Approach

Based on the work of Williamson, TCA addresses the choice of marketing channel structure only in the most general case situation of choosing between the manufacturer performing all of the distribution tasks itself through vertical integration versus using independent intermediaries to perform some or most of the distribution tasks. It is based upon opportunistic behaviors of channel members.

The main focus of TCA is on the cost of conducting the transactions necessary for a firm to accomplish its distribution tasks.

In order for transactions to take place, *transaction-specific assets* are needed. These are the set of unique assets, both tangible and intangible, required to perform the distribution tasks.

▪ Using the TCA approach

TCA has some substantial limitations from the standpoint of managerial usefulness.

First, it deals only with the most general channel structure dichotomy of vertical integration versus use of independent channel members.

Second, the assumption of opportunistic behavior may not be an accurate reflection of behavior in marketing channels.

Third, no real distinction is made between long-term and short-term issues in channel structure relationships.

Fourth, the concept of asset specificity (transaction-specific assets) is very difficult to operationalize.

Finally, TCA is one-dimensional, overly simplistic and neglects other relevant variables in channel choice.

D) Management Science Approaches

It would certainly be desirable if the channel manager could take all possible channel structures, along with all the relevant variables, and “plug” these into a set of equations, which would then yield the optimal channel structure.

The work of Balderston and Hoggatt, Artle and Berglund, Alderson and Green, Baligh, Rangan, Moorthy, Menezes, Maier, and Atwong and Rosenbloom have pioneered some quantitative work in this area.

▪ Using Management Science Approaches

These approaches still need much more development before they are likely to find widespread application to channel choice.

E) Judgmental-Heuristic Approaches

These approaches rely heavily on managerial judgment and heuristics for decisions. Some attempt to formalize the decision-making process whereas others attempt to incorporate cost and revenue data.

▪ **Straight Qualitative Judgment Approach**

The qualitative approach is the crudest but, in practice, the most commonly used approach for choosing channel structures. The various alternative channel structures that have been generated are evaluated by management in terms of decision factors that are thought to be important. These factors may include short- and long-run cost and profit considerations, channel control issues, long-term growth potential, and many others.

▪ **Weighted Factor Score Approach**

A more refined version of the straight qualitative approach to choosing among channel alternatives is the *weighted factor approach* suggested by Kotler.

This approach forces management to *structure and quantify* its judgments in choosing a channel alternative and consists of four basic steps:

1. The decision factors must be stated explicitly.
2. Weights are assigned to each of the decision factors to reflect relative importance precisely in percentage terms.
3. Each channel alternative is rated on each decision factor, on a scale of 1 to 10.
4. The overall weighted factor score (total score) is computed for each channel alternative by multiplying the factor weight (A) by the factor score (B).

▪ **Distribution Costing Approach**

Under this approach, estimates of costs and revenues for different channel alternatives are made, and the figures are compared to see how each alternative compares to another.

Regardless of how elaborate or detailed the analysis, the basic theme of this approach stresses managerial judgment and estimations about what the costs and revenues of various channel structure alternatives are likely to be.

▪ **Using Judgmental-Heuristic Approaches**

Regardless of which judgmental-heuristic approach is used, large doses of judgment, estimation, and even “guesstimation” are virtually unavoidable.

This is not to say that the so-called judgmental-heuristic approaches are totally subjective. Coupled with good empirical data, highly satisfactory (though not optimal) channel choice decisions may be made using these approaches.

Judgmental-heuristic approaches also enable the channel manager to readily incorporate nonfinancial criteria into channel choices. Such nonfinancial criteria as goodwill or the degree of control over the channel members may be of real importance to a firm.