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Manage Consolidation in the Distribution Channel

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Manufacturers have four strategic options when facing the dynamics of consolidating channels.

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In almost every business-to-business industry, companies are facing increasingly powerful intermediaries in their distribution channel. Industry consolidation is replacing a multitude of small "mom and pop" distributors with a handful of national, professionally managed, publicly traded corporations. Seeking to eliminate channel costs, these distributors make new demands on manufacturers and multiply service requirements. As distributors prune their supply base, market access for manufacturers is no longer guaranteed.

Traditional channel-management approaches rightly call for a manufacturer to identify strategies to maintain market position as value migrates down the channel. Consolidation complicates this effort, however, by creating uncertainty about the investments required to gain position if the channel structure changes. Which distributors will emerge as the winners? Which channel system will customers prefer? How should manufacturers manage relationships and investments during the transition period? How can these companies ensure that they will continue to be major players in the competitive landscape?

In this article, we provide a strategic primer on wholesale distributor consolidation for manufacturers. Our goal is to help man-

agers understand the dynamics of consolidation and the strategic options available to them. A company may be facing various stages of consolidation. Perhaps managers already realize that consolidation will soon overtake their channel. Or a manufacturer might find itself in a channel environment that is gradually moving from fragmentation to a few large players. Since much is known about channel relationships when there is a dominant intermediary, we focus our attention on the implications for manufacturers of the fragmentation-to-consolidation transition in the distribution channel.

We begin our discussion by describing consolidation and its drivers, which indicate when consolidation is impending. We contend that the dynamics of consolidating distribution channels call for manufacturers to rethink their approach to the trade. Drawing on more than a decade of research, interviews, industry case studies, and our own consulting experiences, we examine four strategic options available for a manufacturer facing the prospect of consolidation. Next we look at postconsolidation conditions, focusing on two critical challenges associated with the emergence of larger, more sophisticated distributors — supplier consolidation and increased service requirements. We conclude with some strategic questions for manufacturers and use an industry example to illustrate how companies make use of the strategic options.

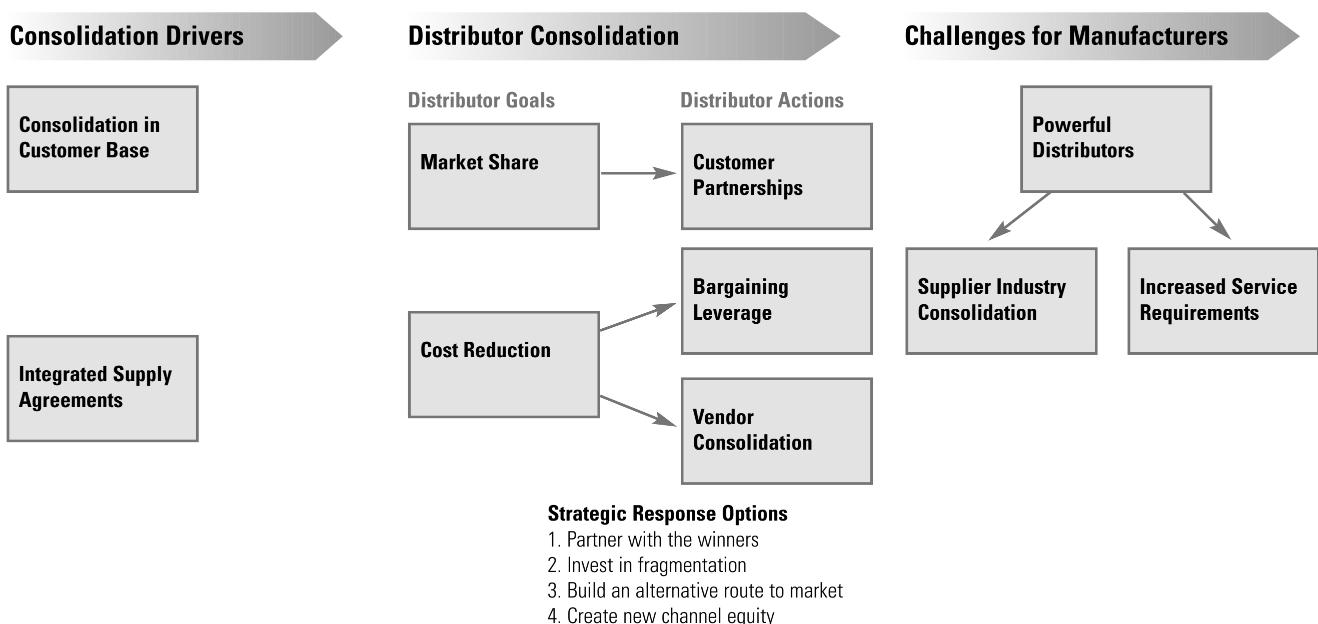
Consolidation in the Distribution Channel

Industry consolidation occurs when a small number of companies grow to control a majority of the market share in an industry within a compressed time period, transforming a fragmented market structure into a concentrated one (see *Figure 1* for an overview of the consolidation process). A rule of thumb is that an industry is not yet consolidated when the largest four firms have less than a 40 percent combined market share.[1] A sign of growing consolidation is faster sales growth among the largest companies than among small or midsized companies.

Today, industry consolidation in wholesale distribution is being led by consolidators that use sequential buy-and-build acquisition strategies to replace small mom-and-pop companies with a large corporation. Well-known consolidators include Arrow Electronics (electronic components), Airgas (industrial, medical, and specialty gases), Bergen Brunswig (pharmaceuticals), U.S. Office Products (contract stationers), MSC Industrial (industrial products), and Hughes Supply (construction supplies), to name just a few. Wholesale distribution was the second-most active industry in the United States for merger and acquisition activity in 1997.[2]

Consolidators in wholesale distribution follow a standard strategy — build a national network, leverage

Figure 1
Consolidation in the Distribution Channel



buying power with manufacturers, and reinvest profits to meet the emerging requirements of larger customers and manufacturers. With their size comes the financial clout to make operating decisions about product assortment and geographic territories independently from manufacturers. Geographic expansion by distributors, for example, has forced many manufacturers to unwind territory exclusivity agreements and has reduced the ability of manufacturers to enforce limits on carrying competing product lines (see *Figure 2* for a summary of changes in the distribution channel as it moves from a fragmented to a consolidated industry structure).

Interest in industry consolidation investments is bringing enormous amounts of financial capital into distribution. Many private equity firms now actively finance industry consolidations. For example, Golder Thoma Cressey Rauner, a prominent Chicago firm that partners with executives to consolidate service industries, recently formed American Sanitary to consolidate the distribution of janitorial and sanitary supplies. Consolidation Capital Corporation, a public corporation, raised more than $500 million on the New York Stock Exchange in November 1997 to, as their SEC filing put it, "become the leading consolidator of distribution companies and service providers in one or more fragmented industries." It was striking that Consolidation Capital did not specify which industries it intended to consolidate at the time of the public offering, indicating the strong interest in consolidation as an investment concept. Distribution consolidation stocks had strongly outperformed the market indices until August 1998. Since then, distribution consolidators have been out of favor due to implementation failures at the roll-ups, the performance of technology stocks, and the perceived impact of the Internet.

Consolidation in the Customer Base

Consolidation among downstream customers has been the most important trigger of consolidation in the distribution channel.[3] Customer consolidation occurs with the emergence of a few dominant customers, the exit of small companies that form the traditional distribution customer base, or the banding together of customer organizations into cooperative purchasing groups. These changes create the necessary conditions for distributor consolidation by providing incentives for a distributor to grow geographically and exploit the benefits of operating in multiple regions.

Customers, including large national manufacturers, multiunit retailers, and national purchasing groups, welcome the mix of broad geographic coverage and wide brand availability. It is more efficient for them to deal with distributors that can provide access to multiple manufacturers across multiple geographic regions. In addition, industrial purchasers that operate many regional manufacturing facilities, but use local or regional wholesaler-distributors in each area, provide an opportunity for a national distributor. Customer consolidation limits the business prospects for distributors that cannot provide the geographic reach or the level of service required by large customers.

Figure 2
How Consolidation Changes Distribution Channels

Transition

	Fragmented	Consolidated
Distributors	• Small, privately held "mom and pop" companies • Local market focus • Fragmented national sales (although some distributors may dominate a local or regional market) • Low entry barriers • Gross margins: 15% to 25%	• National sales and distribution networks • Number of independent distributors declines by 60% to 80% (primarily by acquisition) • Majority of industry sales go through two to four national, professionally managed, publicly traded corporations • High entry barriers • Gross margins: 10% to 15%
Customers	• Geographically dispersed • Complex purchasing decision • Brand preferences strong • Use local distributors for availability and convenience	• Customer consolidation • Centralized purchasing decision • Value ability to switch brands without switching supply sources • Seek broad geographic coverage from distribution channel

Distribution consolidators embark on growth-by-acquisition strategies to react quickly to the changes in customer purchasing patterns. For example, changes in customer buying practices were the primary driver of the rapid and intense consolidation among periodical and magazine wholesalers. Retailers put their contracts up for competitive bid, encouraging wholesalers to cross previously exclusive geographic boundaries. The contract-winning companies rapidly acquired former competitors in an effort to cover larger territories and service larger accounts. Smaller, regional wholesalers that did not (or could not) react were forced to sell out or dissolve. As a result, the number of wholesalers dropped from nearly 182 companies in 1990 to fewer than 50 companies in 1999. The largest five wholesalers now control an estimated 65 percent of the national market. Similar changes in the customer base drove consolidation in industries as diverse as drug wholesaling,[4] electronic components distribution, and food distribution. Many industrial products distributors now face similar pressures.[5]

Integrated Supply Agreements

Integrated supply, a new type of customer-distributor relationship, is also changing the face of wholesale distribution. Under an integrated-supply arrangement, a customer gives a single distributor (or a selected group of distributors) all its business in a particular product category or categories. In exchange, the distributor agrees to provide a high level of service on the entire product mix at set prices. Alternatively, the distributor may agree to cost-plus product pricing in combination with a service management fee. Other activities between the firms range from straightforward optimization of supply-chain logistics to more complex collaborations in new product development and value-added services. In 1997, integrated supply agreements made up 12 percent of large plants' procurement of industrial products, a 50 percent increase from 1996.[6]

Unlike supply-chain solutions that are imposed from above, such as the Efficient Consumer Response movement in the grocery industry, these arrangements have sprung up organically among firms acting in their own best interests. Larger customers face enormous organizational costs for purchasing the lowest-cost, most frequently used items. These customers seek to outsource the procurement function to the wholesale distribution channel. They are attempting to minimize their purchasing costs by reducing the supplier base, shrinking internal purchasing staffs, and applying supply-chain management technologies, such as electronic data interchange, to reduce inventory. In essence, customers in these channels value the efficiency with which a product moves through the channel as much (or more than) the features and benefits of the product itself.

Consolidating downstream customers, the rise in integrated supply agreements, and the resulting increase in distributor consolidation activity should serve as a wake-up call for manufacturers.

Consolidated distributors are positioned to benefit from this shift in customer preferences because they can take a global view of vendors, products, and application opportunities. They are positioning themselves to manage the entire supply chain for customers by aggregating the products from multiple industries. For example, in 1997, VWR Scientific Products, one of the largest distributors of laboratory supplies, entered into an alliance with W.W. Grainger, a nationwide distributor of industrial products. The alliance enables VWR and Grainger to service consolidated customer orders. Other distributors, such as MSC Industrial, are acquiring distributors from other lines of trade to meet the integrated supply needs of customers.

Four Strategic Responses

Consolidating downstream customers, the rise in integrated supply agreements, and the resulting increase in distributor consolidation activity should serve as a wake-up call for manufacturers. These are indicators that channel consolidation may be imminent. Successful survivors of consolidation use a mix of anticipation, preparation, and strategic savvy to deal with the uncertainties created by a possible consolidation. A manufacturer facing a potentially consolidated channel has four basic strategic options:

1. Partner with the winners.
2. Invest in fragmentation.
3. Build an alternative route to market.
4. Create new channel equity.

When the winners are easy to spot, the first strategy is the appropriate response. In many industries, however, the success of a consolidator can be highly uncertain, and existing channel conditions override any possibility of forming a strategic partnership. Ultimately, manufacturers need a channel design that can handle new products and services and incorporate emerging channel forms.[7] Strategies two through four reflect these concerns. In the next section, we describe the four strategies and consider the advantages and disadvantages of each.

1. Partner with the Winners

In many industries, manufacturers respond to uncertainties by forming partnering relationships with the distributors that they predict will be the winners of the consolidation transition. Developing partnerships can be a source of long-term strategic advantage in a consolidating industry. Partnering can virtually ensure a manufacturer's position as a key supplier, create large orders, and provide first exposure to strategic opportunities that will increase the dominance of the value chain relative to the competition. On the downside, partnering carries risk as channel consolidation accelerates. Manufacturers that select the wrong partner face the prospect of lost sales, reduced market access, and a missed opportunity to have built a close relationship with a consolidation winner. The wrong choice can lead to a forced exit for the manufacturer.

Successful manufacturers adopt a two-step approach to partnering in consolidating environments: (1) "pick the winners"[8] of the consolidation through effective partner selection, and (2) build strong partnerships that motivate distributor investments to support their products. Monsanto's Solaris division (which was recently sold to Scott's) pursued this approach when it selected lawn-and-garden consolidator Central Garden & Pet to be the master distributor for Solaris products. Central maintains a nationwide network of subdistributors carrying Solaris products and provides services to Solaris retailers, including logistics, order processing and fulfillment, inventory distribution, and merchandising.

Selecting Partners. Conventional channel wisdom dictates that manufacturers keep options open by developing relationships with many distributors. Maintaining distribution options, the thinking goes, avoids dependence on any single intermediary while simultaneously allowing manufacturers to reach as many customers as possible. However, in a consolidating industry, manufacturers lose options. By developing partnerships with the probable survivors of a consolidation, manufacturers can better leverage their resources, guarantee their future existence, and meet the needs of an increasingly demanding channel.

We have identified four basic types of distributors that are most likely to survive consolidation:

- Highly specialized distributors with routines and capabilities attuned to the technical and market conditions required to survive and prosper after a consolidation.

- Large general-line distributors that stress viability over efficiency in the preconsolidation period. The benefits of adaptability to multiple environments at the cost of short-term inefficiency outweigh the benefits of specialization to one set of conditions.

- Distributors that delay entry until the consolidation is nearly over. These firms then move into the specialized market niches where entry barriers are not high.

- Catalyst firms that trigger consolidation through a rapid acquisition and roll-up.

Research underscores the importance of choosing a trustworthy channel partner whose goals and competencies complement those of the manufacturer.

Manufacturers should take a portfolio approach by ensuring that each type of potential winner is represented among its distributors. Furthermore, our research underscores the importance of choosing a trustworthy channel partner whose goals and competencies complement those of the manufacturer.[9] Mutual goals may include efficient distribution, flexible pricing, innovations in information and product management technology, or tailored approaches to regional markets. If the distributor does not value the same goals as the manufacturer, then it may be tempted to pursue its own agenda at the expense of the manufacturer. The distributor is unlikely to exploit the relationship when the manufacturer understands the distributor's motives, can reliably predict its actions, and knows that it has similar goals. The sense of trust that grows from having common goals is criti-

cal in motivating firms to expend the effort "to step outside the box" and develop a partnering relationship.

Another important factor to look for is complementary competencies. A good partner brings something to the table — a critical competency that enables the partnership to expand the pie of potential benefits between them. For example, a company whose product is in heavy demand by a large number of end-users should look for a partner with strong distribution and placement skills. This does not simply mean market coverage, since market coverage is a benefit that a manufacturer would expect from any distributor. The manufacturer should seek a partner that has market coverage and a valuable long-term skill, such as the ability to keep at the forefront of knowledge in distribution. This partner, for example, might be open to innovative ways to approach the customer, use technology, and implement the resulting changes. In this way, partnerships do more than just provide market coverage; they pave the way for the achievement of sustained competitive advantage.

Surprisingly, partnering can make sense in consolidating channels. Manufacturers need not view the prospect of an increasingly powerful distribution channel with dismay. The dynamic, uncertain environment that consolidation brings provides an opportunity for manufacturers to band with distributors to create a powerful channel to the end customer. By understanding the need for trust, similar goals, and complementary competencies in partner selection, manufacturers can exploit changing channel structures and reap long-term benefits.

Building Effective Partnerships. One challenge of building and maintaining partner relationships is conflict management. Of course, manufacturers need to recognize that conflict between partners in a distribution channel is sometimes healthy. It can be a spur to action, a check against complacency. Ideally, conflict motivates companies to grow, change, and adapt. But if conflict becomes destructive, then manufacturers and distributors cannot work together to build a more cost-effective, competitive distribution channel. Ultimately, the entire industry suffers and becomes less competitive if partners do not fight for the future.

How should partners manage conflict? Many managers believe that conflict management in these close relationships is just like conflict management in any other distribution relationship. Our research demonstrates, however, that effective conflict management in partnerships differs from that in transactiona arrangements, or arm's-length negotiations.[10] For example, giving in on some issues helps build the trust, satisfaction, and expectations that move a transactional relationship toward a partnership; accommodating the distributor's needs helps to work through the areas of conflict, thus contributing toward a better relationship between the firms. However, once the parties are in a partnership, regular accommodation of the distributor can have a negative impact on relationship quality. In this context, accommodating signals premature closure on the issue causing the conflict and discourages the distributor from looking for a better solution. Hence, accommodating on a regular basis in a partnership can be a dysfunctional way to manage conflict.

A better approach to managing conflict in a partnership is to *collaborate* — to look for a novel, win-win solution that satisfies the needs and concerns of both firms. This may take some time, effort, and energy to discover and may involve some level of vulnerability. The partners may have to share sensitive information about their strategic concerns and needs in order to discover the solution that serves both parties best. This is precisely the reason why a collaborative approach does not always build trust, satisfaction, and long-term expectations into transactional relationships. In transactional relationships, each party's commitment is slight, and the temptation to take advantage of the other firm's sensitive information is great. But against the backdrop of a close partnering relationship, the payoffs from this approach in terms of the overall quality of the relationship are much greater than in transactional relationships. All this shows that "the old way of doing business" just won't work in partnering relationships.

Manufacturers can also partner with consolidators through "preferred supplier agreements." Under these agreements, the distributor is expected to provide additional or preferred support to the brands of partner suppliers. At the limit, a distributor may refrain from carrying brands of competing manufacturers in a specific product category. In exchange for this commitment, the manufacturer offers better pricing and extra marketing support or agrees to limit its network of distributors.

Weaker or second-tier manufacturers have the most to gain through this type of partnering. Manufacturers with low sales, nondifferentiated brands, and little

While successful collaborations can bring huge benefits, some manufacturers are slow to recognize the need for strategic partnerships in a consolidating channel environment.

market presence face the greatest hurdles in a consolidating market environment. Through preferred supplier agreements, they can improve their relative position in the channel by gaining market access and coverage. In turn, consolidating distributors may welcome the chance to offset the power of well-known branded alternatives.

While successful collaborations can bring huge benefits, some manufacturers are slow to recognize the need for strategic partnerships in a consolidating channel environment. For example, the largest Japanese automakers have tried to legally block dealership acquisitions by Republic Industries, H. Wayne Huizenga's venture, to consolidate the retail auto channel. Both Honda and Toyota settled out of court, allowing Republic to continue building a national, publicly traded car retailer. Currently, Nissan is still trying to halt the sale of its dealerships to Republic. While it is still too early to forecast the ultimate success of Republic Industries, the Japanese automakers are clearly betting against that success — a potentially dangerous strategy if they prove to be wrong.

2. Invest in Fragmentation

Manufacturers that do not want to risk a partnering relationship or want to avoid doing business with a powerful consolidator may choose to maintain a network of independent distributors in the channel. Typically, many small distributors do not want to be left behind as the distribution channel is restructured, yet they are reluctant to sell out to a consolidator, creating an opportunity for a manufacturer investing in a fragmentation strategy. Manufacturers that pursue this strategy must design a channel that meets the challenges of consolidation and integrated supply without unified legal ownership.

One approach is to help independent distributors create a credible alternative to the consolidators. In 1991, Parker Hannifin, an industrial products manufacturer, anticipated consolidation in its distribution channel. Parker did not believe that its independent distributors, which represent more than two-thirds of North American sales volume, would be able to compete with consolidators for integrated supply contracts. So Parker built a franchised alliance system called the iPower Distribution Group in the territories of its distributors. These distributors then helped recruit distributors in ten complementary product segments. Each franchise is formed as a separate company in which each member distributor holds an equal ownership interest and one seat on the board. Distributors must meet a variety of minimum business requirements, such as the ability to handle electronic data interchange transactions.

In this way, Parker has encouraged smaller distributors to band together and simulate some of the benefits of larger distributors. Most important, iPower members cannot sell any products that compete with Parker Hannifin's products, thereby eliminating the threat of reduced market access posed by consolidation.

Another approach is to develop relationships with horizontal alliances of smaller independents. These relationships are just beginning to permeate the world of distribution. In a horizontal alliance, distributors pool resources to create a new, separate organization for joint action. They differ from the vertical alliance system described above in that they are formed among similar firms that create a separate organization to manage the alliance. Horizontal alliances of distributors range from formal, but limited, cooperative buying groups to highly integrated marketing consortia. The largest four alliances in the industrial distribution channel — Affiliated Distributors, iPower Distribution Group, IMARK Group, and I.D. ONE — represent distributors with combined sales of $32 billion. With the exception of Parker Hannifin's iPower alliance, these alliances are created and funded entirely by distributors.

As part of an alliance, smaller independent distributors can bid for national or multiregional contracts, offering the same geographic reach as a large consolidator. Furthermore, the groups can take advantage of volume purchasing opportunities from manufacturers. Alliances can open the door to national customer accounts, lower the investments needed to play the integrated supply game, and build learning relationships with other distributors that offer complementary capabilities. At the same time, alliance members

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retain operational autonomy, enabling them to maintain high levels of service for local customers.

Manufacturers that choose to invest in industry fragmentation benefit from the inherent instability of these alliances relative to consolidators. But while alliances usually cannot undertake the unified actions of a consolidator, they also create risks for manufacturer partners that desire stability in their channel. These alliances are fully independent business organizations as well as affiliated groups of distributors. The multitude of stakeholders in an alliance creates an environment in which effective strategic planning processes can be hijacked by organizational politics. Furthermore, member distributors in an alliance face conflict between conformity with alliance strategies, such as working with the alliance's preferred suppliers, and differentiation by pursuing an independent strategy, such as choosing an assortment of products. Most independent distributors have historically pursued the latter strategy.

3. Build an Alternative Route to Market

Manufacturers can reassert themselves in the distribution channel by bringing the functions of an independent distributor in-house. A strategy of integrating forward toward the customer — wholly owning the channel — shifts the functions being performed by an independent distributor to the manufacturer. In addition, a manufacturer might consider the Internet as an alternate channel for going to market.

Forward Integration. Buying into the distribution channel gives a manufacturer absolute control over marketing activities and can help prevent market foreclosure. This strategy requires significant financial outlays and managerial attention. Vertical integration is a logical strategy for a manufacturer under specific, interrelated conditions.[11] Many manufacturers, however, do not anticipate its potential downside. Distribution is a very different business from manufacturing. The three biggest difficulties involved in creating a direct channel to market are:

1. Loss of marketing efficiency. The sales base for any one manufacturer may be too small to generate the same scale economies as an independent distributor.

2. Dulled incentives. An in-house operation has a captive source of supply, instead of having to compete for business with another company. Lack of competition may lead to unproductive investments in corporate overhead associated with a manufacturer-owned distribution business unit. Furthermore, quality is generally lower due to differences between manufacturing functions and a service business such as distribution.

3. Changing customer preferences. Integrated supply agreements can limit the potential gains from forward integration. Many larger customers, for example, are reducing their supplier base as a result of these agreements and may not be interested in adding a new direct sales vendor.

4. Competition with the existing channel. Vertical integration is likely to put a manufacturer in direct competition with independent distributors, which can lead to a sharp drop in sales during the transition period. In a consolidating environment, the supplier also faces the prospect of competing with the consolidators for viable acquisition targets.

A more feasible option may be to purchase minority shares in multiple independent distributors and then allow the companies to continue independent operation. Carrier Corporation, a leading manufacturer of heating and ventilation equipment, is facing distribution consolidators such as Watsco as well as consolidating customers. In response, Carrier has purchased a 49 percent interest in Carleton-Stuart, a regional distributor with $140 million in sales that has been distributing Carrier products for more than fifty years.

Internet as Alternate Channel. The Internet offers a potential alternative to either vertical integration or independent distributors. The Gartner Group, an information technology advisory company, has outlined two scenarios for ways in which the Internet will shift power to manufacturers.[12] In the first scenario, manufacturers post their products on the Internet in a bulletin board system, letting customers search and source globally using on-line search engines. In the second scenario, manufacturers use the Internet to gain direct access to customers, taking on functions now being performed by distributors.

Large industrial buyers have already begun to experiment with dynamically priced open sourcing over the Internet. For example, FreeMarkets Online, a Pittsburgh-based startup, has already brokered $103 million in goods through Internet-based auctions for clients such as Caterpillar, United Technologies, and General Motors. Polymerland, Inc., a subsidiary of General Electric, lets engineers search its on-line database of polymers to find the resin that has the exact qualities of heat and shrink resistance needed in a new laptop or toaster. Similar consumer-oriented services use Internet buying agent utilities to compare prices among competing on-line retailers. Companies like NECX, an on-line computer retailer, even let customers compare prices of identical items on competitors' sites without forcing them to leave the NECX site.[13]

Despite predictions of disintermediation, manufacturers must run hard to keep pace with sophisticated intermediaries that recognize the threat of electronic commerce. Channel consolidation has created smarter, stronger companies that will not be displaced easily. Some distributors have already begun to use Internet information-sharing capabilities to share forecasts, order information, inventory levels, and shipment status with their customers. For example, Marshall Industries was one of the first distributors to put its entire product catalogue on the Internet. Marshall offers customers the ability to access the status of their orders electronically by linking into Marshall's internal databases.

Wholesale distribution is also thriving in industries with on-line retail intermediaries. These on-line retail intermediaries are creating an electronic interface with end consumers in place of a physical store location. These companies outsource order fulfillment to large, consolidated distributors that already have a physical warehouse and shipping infrastructure in place. Examples of on-line retailer or distributor relationships include Amazon.com and Ingram Books for books, CDNow and Valley Media for music compact disks, and PlanetRx and McKesson in pharmaceuticals.

4. Create New Channel Equity

Manufacturers, like their brands, possess some level of equity in the channel, as evidenced by their ability to push products into the marketplace through the channel. As the distributor's power and influence grow in consolidating channels, a manufacturer must consider how to preserve this equity and make itself more attractive to the channel, regardless of what consolidation brings.[14]

Most manufacturers emphasize their brand equity. From the distributor's perspective, the possibility of being supplanted by a manufacturer is heightened when the manufacturer's brand name is strong or the product has special attributes that make it hard to replace. When customers have little brand preference, they will give greater weight to a distributor's reputation and service quality. Manufacturers should think about additional ways to make themselves more attractive to the channel. A broad product line, for example, can help a manufacturer build countervailing power in the channel and enable it to provide package discounts and linked promotion.

Avery International's acquisition of Dennison Manufacturing in 1990 provides an example of how a manufacturing organization can build equity in its channel. The formation of Avery Dennison was a direct response to consolidation pressures in the office-supply distribution channel. In the mid-1980s, office-supply superstores like Staples and OfficeMax began to take over the retail market from the small and medium-sized office products dealers. As the channel narrowed, manufacturers were forced to supply very high volume to a shrinking number of resellers and distributors. Manufacturers also needed to supply a national distribution channel, hurting small, regional manufacturers that could not match the economies of scale of national manufacturers or make the necessary investments in information technology or supply-chain innovation. Research and development costs grew because of advancing workplace technology.

Dennison was strong in the northeastern United States and Europe, while Avery was stronger in the western United States. The combined company has eliminated duplicate activities, blended identical product lines, and consolidated R&D activities to one location. Overlapping and complementary product lines helped to build assortment clout. The sales forces were consolidated by industry group in recognition of the changing number of intermediaries. Finally, Avery Dennison made itself more attractive to the distribution channel by emphasizing customer care. It set a goal of being the fastest supplier to its intermediary customers. For office products, the company installed new forecasting and logistics planning systems to streamline order processing, which result-

ed in less time for order taking and reduced distributor inventory volume.

Postconsolidation Realities

Consolidation changes the balance of power in channel relationships.[15] Power is the ability of one channel member to get another channel member to do what it otherwise would not have done.[16] In practice, power is obtained when one channel member (the manufacturer or the distributor) controls resources that are valued by the other company. In the grocery industry, one survey found that 72 percent of retail managers and 86 percent of manufacturing executives believe that power is shifting to retailers and away from manufacturers.[17]

Power is being exercised in attempts to shift margin from manufacturers to intermediaries. These attempts range from straightforward volume rebates to upfront payments and stocking allowances. Large national distributors often demand common pricing in all served geographic regions, which plays havoc with current channel relationships that rely on regional price-discrimination strategies.

In the laboratory products channel, which is now dominated by VWR Scientific Products and Fisher Scientific, a survey revealed that only one-fifth of the manufacturers believe that they now have substantial bargaining power in the channel.[18] As one manufacturer of precision instruments in the laboratory products channel told us, "I feel that the distributors have more clout now. They are asking me to pick up more freight costs and pay for catalogue space. That never would have happened ten years ago."

With the emergence of consolidated distributors, manufacturers face two critical challenges — vendor consolidation and increased service requirements — that demand effective strategic responses.

Vendor Consolidation

Vendor consolidation is a means by which distributors can meet customer demands for a more cost-efficient channel. Rather than stocking a proliferation of equally excellent, "me too" products, a distributor that implements vendor consolidation reduces the number of brands and stock-keeping units carried, which increases a distributor's bargaining power with manufacturers and makes its internal operations more efficient. Customers now expect distributors to use that leverage to negotiate better pricing from manufacturers. This shift in business-to-business channels mirrors changes that have already occurred in retail channels, such as consumer-electronics discounter Best Buy's decision to reduce its mix in every category.

Customers are also driving vendor consolidation. One laboratory products distributor told us about a large pharmaceutical company that went from purchasing 23,000 SKUs to 7,500 SKUs. Vendor consolidation leads to diminished business prospects for manufacturers that lack differentiated products and have poor relationships with distributors. By crafting partnerships with distributors, manufacturers can better ensure that they will not become the victims of a supply-base consolidation.

Another critical resource controlled by large distributors is access to customers. The majority of manufacturers are unable to duplicate or imitate this resource cost-effectively. For example, larger customers have traditionally been handled as direct accounts because of the high dollar volume of purchases and need for technical product information and support.[19] Integrated supply agreements between distributors and customers limit the possibility of direct contact between manufacturers and customers. The power of the distributor increases when the customer relies on the distributor for information or other value-added and transactional services to make a purchase decision. A manufacturer is less able to bypass the distributor and is more affected by the distributor's efforts (or lack thereof) to generate brand demands.

To understand the threat of vendor consolidation, a manufacturer must consider what the other downstream industry participants (distributors, buyers, or end users) would lose if supplier consolidation disappeared.[20] For instance, in examining the uniqueness and strength of its products, a manufacturer seeking

Assessing a Product's Value in the Marketplace

Can you answer "yes" to these questions?
- Is our product truly unique?
- Do we face fewer than three direct competitors?
- Are customers for our products price-sensitive?
- Do we have a larger installed base of users than any of our direct competitors?
- Is our product's quality measurably better than that of our competitors in the eyes of a customer?
- Do customers insist on our brand when ordering?

to demonstrate high added value should be able to answer "yes" to the questions listed in the *sidebar*. (These questions can be answered from the perspective of a single product or of an entire product line.) This exercise provides insights into the manufacturer's relative position in the industry because it highlights situations in which a proliferation of me-too products has created manufacturers that add little value.

Consider the pharmaceutical wholesale industry, which has consolidated from more than 200 wholesalers to fewer than 40 in 1999. Two-thirds of all pharmaceuticals sold in the United States go through just four wholesalers. In the midst of the consolidation, an executive at McKesson, the largest drug wholesaler, was quoted as saying: "What we do is look for opportunities to work with manufacturers who understand the new ability of the distributor to influence demand . . . and shift market share at the retail setting."[21] Concerns over market power led the Federal Trade Commission to block mergers among the largest four wholesalers.

Increased Service Requirements

In integrated supply relationships between large customers and distributors, customers expect distributors to go beyond simply eliminating redundancies to reconfiguring the entire supply-chain process. One way that distributors can do this is by using improved inventory, logistics, and information management techniques to redesign supply-chain processes. The intent is to eliminate costs, not simply shift them from one level of the channel to another. This redesign puts pressure on manufacturers to improve their ability to implement supply-chain solutions. To develop creative solutions, manufacturers need an intimate understanding of the distributor's needs, preferences, and demands. This knowledge is not available outside the context of a partnering relationship because distributors would be reluctant to share such sensitive information without a strong commitment from a manufacturer.

Conclusion

Responding to consolidation is a large task, and our understanding of how to do it successfully is still in progress. Using the framework that we present, a manufacturer should be in a better position to answer the following questions:

1. Will consolidation occur in our distribution channel?
2. How will larger distributors use their new power in the channel?
3. How can we balance the requirements of consolidators with our existing channel structure?
4. Will distributor consolidation lead to supplier consolidation? Does this help or hurt us?

Every company is different and faces a unique set of organizational and competitive challenges. For some firms, any one of the four strategic options described here would be sufficient. For others, a multipronged approach that blends aspects of each strategy could be optimal. Consider the $2.5 billion premium pet food market, where we find examples of different strategic responses in action.

Two superstores, Petco and PETsMART, have been rapidly consolidating the distribution channel and now control more than 900 retail locations. Like power retailers in other markets, both companies have a prominent position in the channel, demanding better pricing and direct distribution. At the same time, Central Garden & Pet has been actively consolidating the independent distributors that service the 11,000 surviving independent pet shops. Managers at pet-supply companies face a strategic dilemma: Should they partner with the fast-growing consolidators — Petco, PETsMART, and Central Garden & Pet, or should they continue to support the independent channel that represents the majority of their sales?

Iams, the market-share supply leader, requires the superstores to purchase through its franchised distributor network. By using its brand power from the preconsolidation era, Iams hopes to support the fragmented distribution channel. In contrast, Hill's supplies both independent pet shops and chain stores through its wholly owned distribution network, maintaining a company-controlled route to market. Other companies, such as the Pro-Visions division of Ralston Purina, serve retailers through a hybrid channel that relies on a mix of direct distribution and independent distributors, maintaining options by building relationships with multiple possible winners. Manufacturers must also evaluate their marketing channel strategy as new on-line entrants such as Petopia.com, Pets.com, and Petstore.com begin operations. For example, Petopia.com has an exclusive contract with distributor Loveland Pet Products, which will fill all orders via United Parcel Service from St. Louis, and has received funding from retail consolidator Petco.

Thoughtful managers will evaluate and anticipate the dynamics of distribution and follow a strategy that enables them to manage consolidation — before it manages them.

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