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DE-STRESS TO DELIVER

The Devolution Marketing

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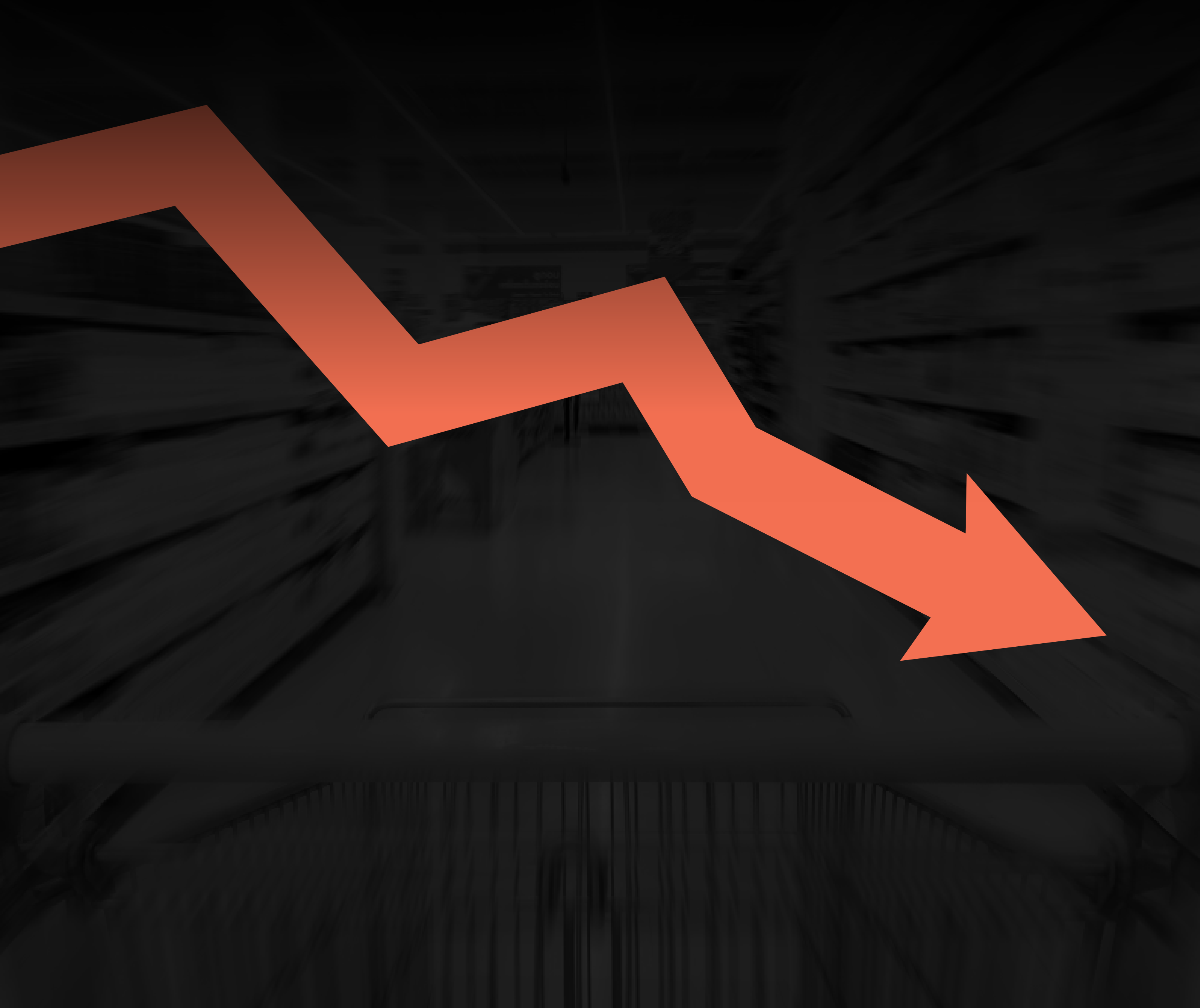


A large portion of what drove us into the Great Recession is rooted in this dysfunctional pattern of distribution. Sell more and more through a mega-distributor-with much of the profit split by distributors and overseas manufacturers. Earnings obtained by the latter are reinvested into the United States, and then are lent to consumers so they can continue to spend beyond their means-thereby propping up the global economy.

Discussions are abundant about out-of-control lending, consumer spending, the impact of outsourcing and the lack of sustainability. But little attention is paid to the harmful impact that the distribution strategies employed by mega-distributors have played-not only on innovators, but on the overall economy. As we talk to business leaders around the world, it is clear that many of them realize a fundamental shift has occurred: Power has transferred from those who create innovative products and services to mega-distributors, who are increasingly in control of the global marketplace.

Mistakenly, many marketing departments see deals with mega-distributors as the way to boost sales and market share. In reality, the Megas live by high volume and low prices. They use their powerful leverage to demand price cuts and other concessions from suppliers. Companies end up with razor thin or non-existent profit margins, even as their innovative products and services are treated like commodities by both the Megas and the buying public. Surprisingly, this transformation of the business landscape has occurred with little fanfare or real analysis.

The Blame Game

Before you think that this is merely another attempt to blame Wal-Mart Stores, Inc., GE Capital, AutoNation, The Home Depot and others for the ills of the world, let us be clear: We do not blame the Megas for the distribution trap and what it has caused. As far as we know, no one has ever been forced to sell their products or services to someone else. Megas rarely, if ever, travel to visit potential suppliers. They wait for would-be vendors to show up. And boy, do they in great numbers, each hoping to strike it rich! Beginning in the early 1980s, innovative firms permitted, either consciously or subconsciously, outsiders into their companies. They allowed these outsiders to gain increasing control over sales and distribution activities. Innovative firms and the people who led them were responding to what management theorists were saying at that time. The "business gurus" talked about organizational transformation emphasizing things like resources, capabilities, innovation, technology and operational effectiveness. "Total quality management," "lean manufacturing" and "zero defects" were just a few of the solutions preached by business elites to companies of all sizes.

Drinking this elixir, thousands of companies that once had been in control of all aspects of their innovative development began to lose interest in sales and distribution, preferring instead that other companies take over this ''business function.'' The concept of ''core competencies'' was provided as the justification for letting loose of control after the producing firm had exercised its unique set of value-adding activities. Why manage a string of dealers if your core competency-your basis of differentiation is in research and development or manufacturing? Taking this advice, companies divested themselves of activities that were not perceived as value added. Sales and distribution were pushed aside.

One of the people who understood the ramifications of the new transformational thinking was Sam Walton. He and a raft of imitators stepped in to fill the power vacuum that the strategy gurus had helped create. The result was the evolution of massive distributors, which ultimately drove the sales and distribution of innovative products and services in the United States.

The Distribution Trap

Numerous manufacturers have seen their profit margins squeezed and their brands eroded because they decided to sell through the Megas. Rubbermaid, Levi Strauss, Goodyear and many lesser-known companies have been literally trashed by the relentless pressure from the Megas to cut prices. Remember Jones Soda Co.? In 2006, this company showed profits of $39 million on $406 million in revenue. A distribution strategy initially based on selling through tattoo parlors and snowboarding shops morphed into one focused on Panera Bread, Barnes & Noble and Starbucks. But in 2007, Jones Soda began to sell to the Megas (including selling a limited selection to Wal-Mart), and ended up posting an $11.6 million loss for the year.

One website summed it up: "And just exactly what is Jones Soda doing for sale at Wal-Mart? Is Jones Soda now going to market itself as a value-priced soda, except with weird #avors?" (Source:http://www.bloggingstocks.com/2007/06/14/jones-soda-loses-its-fizz). In September 2010, after suffering from years of quarterly losses, the company went all-out in marketing to the Bentonville, Ark., giant, agreeing to sell 6-packs of its most popular sodas to the Mega's 3,800 stores. This served to only further debase what had at one time been a popular, upstart brand.

The scope and magnitude of a Mega can quickly consume the brand equity of individual products and services. Private labels, discounting, lack of service and mass-market presentation have diluted the value of American brands. The distribution trap has squeezed margins by making products that were once viewed with respect easily substituted with either store brands or inexpensive knock-offs. In fact, the Megas can be viewed as instruments of brand dilution. The very act of discounting, which is the business model of the Megas, under-mines the entire idea behind a manufacturer's brand.

In 1993, Rubbermaid, the long-time producer of high-quality storage products was named America's Most Admired Company by Fortune magazine. Rubbermaid offered 5,000 different items, producing nearly 400 new, innovative products each year. Most the company's history was defined by strong relationships with end-users through a network of independent distributors and dealers. However, beginning in the early 1990s, a new leadership team entered and committed to expanding sales through the Megas.

The CEO at the time, Wolfgang Schmitt, explained: "It's typically the bigger suppliers that can form the sort of close partnerships that retailing's behemoths are increasingly demanding. The goal is to boost sales and reduce costs or both sides by slashing inventories, shortening lead times and eliminating error: There is a healthy interdependence between us and people like Wal-Mart. We need them; they need us." Wal-Mart accounted for about 14 percent of Rubbermaid's business when, in 1994, disaster struck.

The key components of Rubbermaid products are polymer-based resins, which make up about one-third of the cost of any given product. The price of resins had been stable for years, but costs shot up in spring 1994 because of new global demand and a supply shortage resulting from problems at key refineries. Within 18 months, the price of resins nearly doubled-adding $200 million to Rubbermaid's costs. Focused as always on earnings growth, the company increased its prices. The price increases were met with derision by the Megas. The giant retailers objected to monthly price increases, and complained that Rubbermaid was unresponsive to the realities of the market. Wal-Mart, frustrated with the price increases, emptied shelves of Rubbermaid's "Little Tikes" line of toys, and turned the space over to Fisher-Price.

Left with no other real option, Rubbermaid felt compelled to change gears. In 1994, it began to compete aggressively on the basis of price, offering steep discounts to the Megas. Its margins quickly eroded, and cost-cutting measures were enacted, including the elimination of its dealer network, thousands of American jobs and the closure of nine plants. The company purged 6,000 color and size variations and cut the total number of products by 45 percent. These efforts produced only temporary relief. Rubbermaid was acquired by the Newell Corporation in 1998 for a mere $6 billion in stock.

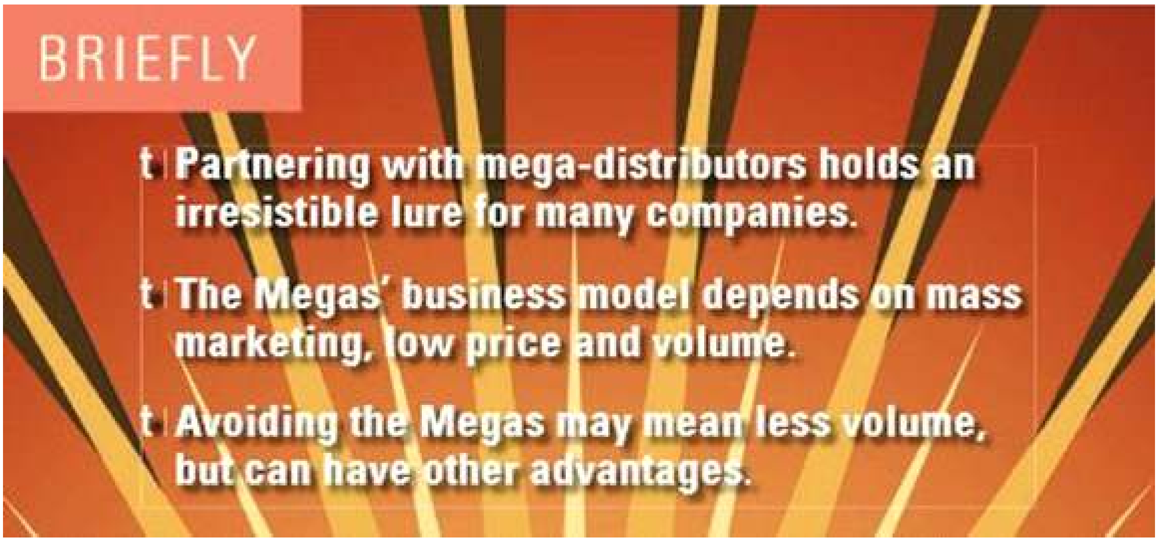
The Outsourcing Compulsion

Another consequence of the distribution trap is outsourcing and offshoring. While the academic literature is replete with theories about foreign direct investment (FDI), the real motivator for much of the 23 percent FDI that is "contracted-out" has been entirely ignored. Producers are being literally forced to invest in overseas manufacturing by their mega-distribution partners. Outsourcing is a coping mechanism in response to relentless price pressures from the Megas. Companies locked into the distribution trap can substantially lower costs by shuttering domestic manufacturing operations.

Lakewood Engineering & Manufacturing Co. is a case in point. For years, this electric fan manufacturer sold its 20-inch box fan for $20. Responding to Wal-Mart's downward price pressure, the company opened a factory in Shenzhen, China in 2000, where labor costs averaged $0.25 per hour compared with $13 per hour in Chicago. By 2003, the fan was sold at the Mega for $10. In 2008, Lakewood employees, alongside local labor organizations, protested the company's decision to close its electric heater operations and move production to China. Wal-Mart buys 80 to 90 percent of the company's heaters.

Lakewood claimed that its hands were tied because it was heavily mortgaged to Wells Fargo Bank, which refused to lend it more money. The company's relationship with the Mega resulted in the layoff of 220 workers and the outsourcing of production. All too often, the compulsive embrace of offshoring by U.S. firms is not a function of internally generated goals and objectives, but is instead driven by the sheer demands of corporate survival.

One of the consequences of the outsourcing compulsion is environmental degradation in the developing countries where distributor-forced outsourcing takes place. In manyemerging markets, environmental laws are lax or simply go un-enforced. These countries may be viewed favorably by multinationals, because they constitute ''pollution havens''-with the cost of pollution absorbed by the people living in those countries, not by the multinational corpora- tions or their customers. For example, China's industrial cities are so full of air pollution that their occupants rarely see the sun. The heavy reliance on coal has polluted the air with suspended particles of liquid or solids that float in the air. These particulates-and China has lots of them floating around-are associated with respiratory problems and heart disease. In the U.S., the growth of municipal waste has grown in tandem with the contribution of retail trade to the gross domestic product. According to the Environmental Protection Agency, 55 to 65 percent of municipal waste is classified as "residential waste": It is the product of the buying habits of individuals and families. This has taken place because during the last 25 years, as consumer prices have dropped and as consumption has increased, people have purchased increasing amounts of cheap stuff from the Megas-which quickly wears out and is then discarded.



The rush to the cheapest possible price has not yet factored in these costs of environmental degradation. When that inevitably happens, prices will have to rise. In short, the offshoring of production, driven by the mega-distributors, is not sustainable. China and other emerging economies have traded extremely high economic growth for polluted air, water and land. No country can pursue such a strategy indefinitely. In the coming decades, as emerging markets grow up, environmental concerns will outweigh the appetite for runaway growth, and the unreasonably low prices that Americans have come to expect as they make purchases from the Megas will end.

The Independent Solution

Falling into the distribution trap is not an inevitable out-come of American business practice. But companies like Red Ants Pants have prospered by avoiding the big-box stores and other mass-market retailers. Thirty-year-old company founder Sarah Calhoun became so frustrated with ill-fitting work pants, designed without the female figure in mind, that she started her own company. There are now 70 different sizes of the double-knee, double-seat work pants with their lower-rise front and higher-rise backs. By importing 12-ounce cotton canvas from India, and having it cut and sewn by a factory in Seattle, Calhoun is free to sell the premium priced pants ($119 a pair) to her target market: women who work for a living in the construction trades. A 1964 Airstream trailer decorated with red ants is the marketing vehicle of this small firm. Calhoun's Tour de Pants road trips allow her to make direct sales to groups of women at homes across the country. Personal contacts made through trade shows and conferences further extend her direct marketing approach.

Another example is STIHLInc., a manufacturer of outdoor power equipment that has never sold its products through mass merchants. Instead, the company sells itsinnovative products through thousands of independently owned servicing dealers across America and through-out the world. An industry global leader in both market share and profitability, STIHL continues to embrace its founding principle of only selling the company's products through servicing dealers.

The Current Landscape

The rise of the Megas has created a groundswell of community-based efforts to help local independent businesses compete effectively and prevent chains and online giants from displacing local entrepreneurs. More than 100 such groups have organized in North America since 2000, including 70 affiliated with the American Independent Business Alliance (AMIBA), a non-profit dedicated to supporting these com-munity efforts.

AMIBA facilitates group purchasing, cooperative promotions and advertising and other activities to help local businesses gain economies of scale. It also wages sophisticated "buy local" campaigns to promote the greater overall value local businesses often can provide to customers, as well as the vital economic, social and cultural role they play in communities. Lastly, these alliances are advocates for the interests of local entrepreneurs in their local government and media. As their ranks grow, AMIBA aims to shift state and national policies that favor larger corporations at the expense of smaller community enterprise. Another effort to support local business is Independent We Stand, sponsored in part by STIHL. Independent We Stand focuses on the money spent at locally owned companies and how it re-circulates throughout the community. Whether it is the taxes that are paid, the payroll of the workers or the businesses' own spending, the impact of local-driven commerce makes a community a far better place to live.

The battle lines are being drawn for a new showdown between locally focused groups like AMIBA and Independent We Stand and Wal-Mart. The mega-retailer recently announced that it is targeting urban areas with the idea of introducing smaller stores like the ones it already oper- ates across Latin America. In a recent Wall Street Journal article, Bill Simon, head of Wal-Mart's U.S. stores business, said that Wal-Mart hopes to open many of its "Neighborhood Markets" across the country. These stores will be like the smaller "bodegas" the company has set up across Latin America. According to Simon, Wal-Mart believes that the opportunity exists for "hundreds" of the smaller-sized out- lets, which will offer customer staples and produce.

The Reality Check

For many companies, the lure of partnering with a megadistributor is irresistible. These giants can put products in front of hundreds of millions of customers and potentially bring in huge gains in sales and market share. But behind these high hopes may be a faulty premise that can lead to disaster. Whether out of naiveté, arrogance or greed, innovative companies expect that the Megas will care about the success of their products and services as much as they do.

What companies forget, or ignore, is that the Megas' business model depends on mass marketing, low price and volume. Naturally, the Megas use their tremendous leverage to dictate tough terms to innovators. They insist on ever-greater price reductions and force companies to redesign products and services to better suit their needs. In the end, many producers discover that all the blood, sweat, tears and money they have poured into their products and services has been wasted: Their hard-won creations have been turned into commodities with razor-thin profit margins. From this perspective, the outcomes for the innovator are not surprising: the abandonment of brand integrity, the acceleration of the innovation into a commodity and the inevitable cost cuts that result from offshoring and outsourcing.

Having created the process and product, and invested time and money, why would companies turn the final stage of the operation over to a third party? Business leaders do it all the time. It is their choice, and they must bear responsibility for what happens.

To avoid the negative outcomes described, companies must control their own distribution. This may mean selling directly to customers online or through company-owned retail stores. Or, it may mean striking strong deals with distributors and avoiding partners who will not agree to stringent terms. Of course, avoiding the Megas may mean less volume, but the advantages of doing so are likely to make up for it. Companies that keep a tight rein on distribution have a greater ability to control pricing, customer service and after-sales service. They can also build stronger, longer-lasting relationships with their customers. And isn't that what every company ultimately needs?

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