

CHANNELS OF DISTRIBUTION

These notes will focus on **whether** or not a **producer** should **use wholesalers** in a channel of distribution. After presenting some background, the focus will be on advantages and disadvantages to a producer or manufacturer in a) **using** wholesalers vs. b) **bypassing** them.

USE OF WHOLESALERS BY PRODUCERS

I. Frequently used channels of distribution in **business** markets and in **consumer** markets

A. Overview

The primary purpose of the below discussion is to demonstrate that a key channel decision made, both by producers who target **business** customers and producers who target **consumers** involves whether to use wholesalers in the channel or whether to bypass these wholesalers.

Although a producer decides whether to use or bypass wholesalers, wholesalers also make decisions. If a producer approaches a wholesaler about using the wholesaler, the wholesaler decides whether or not to either **buy** from the producer (if it is a **merchant** wholesaler) or **represent** the producer (if it is an **agent** wholesaler). (By the way, the similarities and differences between merchant and agent wholesalers will be discussed shortly under “II.”) In many instances, better wholesalers decide **not** to buy or represent some producers, at least not under the conditions that the producer prefers. Putting this another way, producers need to consider that good wholesalers are actually **potential customers** who typically have more producers who approach them to purchase products or represent producers than the number of producers they will buy from or represent. Viewing wholesalers as **potential customers** means that a producer needs to figure out how to offer desirable products and either desirable selling or distribution **conditions** and **incentives** to wholesalers and also to retailers.

B. Description of frequently used channels in **Business** markets

Two common options exist and each is identified below.

1. Producer to Business customer (This is called a **direct** channel because there is **no intermediary** between the producer and the customer.)
2. Producer to **wholesaler** (or “dealer” or “distributor”) to business customer

Note that the only difference between the two above channels is that the first channel does not use a wholesaler while the second channel does use a wholesaler.

C. Channels used in **Consumer** markets –

The two most common channel options are identified below. As in business markets, note the only difference between the two options is that one uses wholesalers and the other one bypasses wholesalers.

1. Producer to retailer to consumer (similar to the first option above in business markets except that this one includes **retailers**)
2. Producer to **wholesaler** to retailer to consumer (similar to the second option above in business markets except that this one includes **retailers**)

D. Identification and explanation of the primary **difference** between channels used in **business** markets and those used in **consumer** markets

Based on a comparison of the above options with **business** markets to those with **consumer** markets, you will notice that the only **difference** between channels used in business markets and those used in consumer markets is that **retailers** usually are **not** used in **business** markets while they usually are used in **consumer** markets.

1. Why **retailers** usually are **not** used in **business** markets

Because business customers expect a lot of detailed information about the products they may purchase along with having the ability to negotiate prices and other terms of purchase, such as delivery dates and schedules, they prefer to deal with **personal salespeople** and retailers usually do not provide **this type** of personal selling. Although this is only a **preference** that producers do not necessarily **need** to honor, producers almost always will honor this preference of business customers because even smaller business customers usually are large enough potential customers that the potential revenue from honoring this preference to deal with salespeople is greater than the actual cost of using salespeople.

2. Why **retailers** usually are used in **consumer** markets

Because **consumers** need to **go to** sellers, rather than having the sellers **come to them** (Each household does not purchase enough for sellers to go to each household through personal selling.), **convenience of location** is very important to **consumers**. In addition, because consumers tend to purchase small quantities of **many** different products at a single point in time, they look to buy many different products at **one time**. Retailers tend to provide convenient locations and also tend to carry products from a lot of producers in order to provide a variety of product selection to consumers.

E. An important summary characteristic of wholesalers

You will note from the discussion of the four channels identified previously, that there is no channel involving true wholesalers selling to **consumers**. They either sell to a) **business** customers or b) **retailers**. Thus, organizations, such as Costco, which call themselves “wholesalers,” are not true wholesalers. Because many of their customers are **consumers**, Costco should be called a retailer rather than a wholesaler.

II. Similarities and Differences between **merchant** and **agent** wholesalers

Before getting started, realize that different types of agent wholesalers exist. Our focus will be on **manufacturers agents**, as this is the most common type of agent wholesaler used by producers, particularly in business markets. The similarities between merchant and agent wholesalers is discussed under “A” and the differences are discussed under “B.”

A. **Similarities** between merchant and agent wholesalers

1. Both merchant and agent wholesalers represent **multiple** producers.

Although both represent multiple producers, a difference exists in the **nature** of the producers represented by each type of wholesaler, as discussed below under C4.

2. Both merchant and agent wholesalers perform a **personal selling** function and have their own sales forces. In **consumer** markets, the wholesalers usually engage in personal selling with **retailers** and they engage in personal selling with **business customers** in **business** markets.
3. As mentioned at the very top of the page, **neither** type of wholesaler sells to **consumers**. They only sell to business customers in business markets and to retailers in consumer markets.

B. **Differences** between **merchant** and **agent** wholesalers

1. An Underlying difference

Merchant wholesalers **purchase** products from producers while **agent** wholesalers **do not purchase** products from producers.

This difference actually is not either an advantage or a disadvantage for either type of wholesaler. However, the major advantage to using merchant wholesalers and the major advantage to using agent wholesalers both **follow** from this difference, as discussed under 2 and 3 on the next page.

Although I will not list it as a second underlying difference, realize that merchant and agent wholesalers generate revenues in different ways because only **merchant** wholesalers actually **purchase** products from producers. **Merchant** wholesalers generate revenue by **reselling** the products they **purchase** from

producers while **agent** wholesalers generate revenues by **receiving commissions** from **producers**.

This underlying difference in the method of revenue generation is not as important as you might think it is, particularly if you assume that **agent** wholesalers, because they operate on **commission**, have a **stronger motivation** to sell than merchant wholesalers, who do not operate on commission, at least commissions paid by producers (Nothing prevents merchant wholesalers from paying their own salespeople commissions though, and they often do this.). The reality is that **both** agent and merchant wholesalers have a **strong motivation** to sell as neither receives any revenue unless and **until** they sell products. In fact, if anything, **merchant** wholesalers might even have a **slightly stronger general motivation** to sell **than agent** wholesalers because MWs will **lose** their **investment** in **inventory** if they do not sell off the inventory they purchase.

To qualify the above, having a strong **general** motivation to do effective personal selling does **not** translate into having a strong motivation to engage in aggressive personal selling with **each and every product** that a merchant or agent wholesaler carries. This is because some of the products they carry are direct or indirect **substitutes** for each other. In this case, they are compensated or gain revenue regardless of which specific product that business customers or retailers buy. This will be explained in more detail under the third disadvantage of wholesalers, which is less aggressive personal selling than what a manufacturer would receive if they had their own salesforce.

2. **Merchant** wholesalers often perform some **functions** in **addition** to **personal selling**. These functions include **warehousing** and **physical handling** of products, and **transportation** of products.

On the other hand, **agent** wholesalers **do not perform** these **additional functions**.

This is a **very important** difference, and basically results in an **advantage** for **merchant** wholesalers, as performing more functions is only a good thing. It reduces the burden on producers to perform these functions to the same degree, at least when they use merchant wholesalers.

Given that merchant wholesalers have this advantage over agent wholesalers, agent wholesalers had to come up with an advantage of their own to producers to compensate for the fact that they do not perform the range of functions that merchant wholesalers do. They came up with a way of offering more effective personal selling than merchant wholesalers, which is discussed below.

3. Merchant wholesalers often represent **directly competing** producers in the **same product category** (Contadina tomato paste and Hunts tomato paste, for example). This is not to say that **merchant** wholesalers only buy from producers in a **single** product category, as this is not the case at all. Merchant wholesalers buy multiple

brands within a product category but also buy brands from multiple product categories.

In contrast, agent wholesalers, at least manufacturers representatives/agents, will carry multiple product categories (as do merchant wholesalers) but will represent only **one** producer in a **product category**. Thus, if an agent wholesaler represents a producer in a product category, the producer does **not** need to **fear** that the agent wholesaler will try to sell a directly competing brand from another producer in the same product category. In contrast, this **fear** is a **realistic** one when merchant wholesalers are used.

III. Impact of use of **wholesalers** on a **producer's costs**

A. Description of **general conclusion** of the impact of a producer's use of wholesalers on the **producer's COSTS**.

The use of wholesalers influences a producer's cost **structure**. More specifically, a producer's costs tend to be **more VARIABLE** but **less FIXED** if wholesalers are used by a producer than if the producer bypasses wholesalers. This cost **STRUCTURE** difference results in both one important advantage and one important disadvantage.

Given that one type of cost to a producer tends to **increase** with the use of wholesalers (**variable** costs), while another type of cost, namely a producer's **fixed** costs, tends to decrease with the use of wholesalers, it is hard to make a simple generalization about how the use of wholesalers influences a producer's **total** costs

Let me provide explanations for each of these two general conclusions.

B. Explanation of how and why there is a consistent impact on a producer's **cost structure** when the producer uses wholesalers

1. Meaning of **cost structure** as used in these notes

A **cost structure** is defined by the percentage/ratio of **variable** (and also of **fixed**) costs to **total** costs.

Cost **structures** can be **mostly variable** (for example, 80% variable costs and 20% fixed costs), **mostly fixed** (for example, 20% variable costs and 80% fixed costs) or **roughly balanced** between variable and fixed costs (for example, 45% variable and 55% fixed costs).

2. Identification of the impact of the use of wholesalers by a producer on the producer's cost **structure**

As indicated under "A" above, the use of wholesalers will change a producer's cost structure to a **higher** percentage of **variable** costs to **total** costs than the percentage that exists if wholesalers are bypassed.

Saying this same thing the opposite way, **bypassing** wholesalers will **change** the cost **structure** of a producer to a **higher** percentage of **fixed** costs to total costs than the percentage that exists if wholesalers are used.

3. Explanation of why a producer's **variable** cost **percentage** of total costs will increase when it uses wholesalers.
 - a. Explanation of why a producer's **fixed** costs tend to **decrease** if it uses wholesalers

Let's start with what would happen to fixed costs if a producer **bypasses** wholesalers, which will **increase** some **fixed** costs of both **personal selling** and **warehousing**. If a producer bypassed wholesalers, it would need to maintain a large salesforce of its own. Many **fixed** costs of personal selling would exist if a producer relied **solely** on its own sales force (such as **administrative** costs, **support** costs, and **training** costs) even if the producer's salespeople were paid strictly on a commission, which is a variable cost. In addition, some distribution costs involved in warehousing inventory are **fixed** costs if a producer bypasses wholesalers and needs to have its own large network of warehouses, particularly in consumer markets, to allow refill of retailers' inventories quickly. (Realize that the reduction in fixed costs with warehousing occurs only if **merchant** wholesalers are used. As mentioned in the prior discussion of differences between merchant and agent wholesalers, the latter do not engage in the warehousing function.)

Although a producer still will need a **small** salesforce when selling and distributing to wholesalers, as well as needing a smaller network of warehouses to refill wholesaler's inventories quickly, the size of the salesforce (with both merchant and agent wholesalers) and the warehousing network will be a lot smaller (only with merchant wholesalers) if wholesalers are used, which obviously will reduce the fixed costs of personal selling and warehousing.

- b. Explanation of why a producer's **variable** costs tend to **increase** if it **uses wholesalers**

This reasoning is **easiest** to understand when we are talking about using **agent** wholesalers, as these wholesalers are paid by the producer strictly on a **commission** basis, which is a **variable** cost.

This reasoning is **harder** to understand when we are talking about **merchant** wholesalers. The problem here is that the producer does **not** actually pay the merchant wholesaler so there is no **direct** cost to the producer in using these merchant wholesalers. Here the cost is really an **opportunity cost** that is definitely a **variable** opportunity cost. The opportunity cost is that the producer makes **less revenue per unit sold** when a **merchant** wholesaler is

used than when this wholesaler is bypassed. The **reduction in unit** revenue is **equal** to the **merchant** wholesaler's **contribution margin**.

Let me give an example to demonstrate that the **opportunity** cost to a producer of using a merchant wholesaler is the MW's **contribution margin**, which definitely is a unit **variable** cost that increases in total with each and every unit sold. If a merchant wholesaler buys a product from a producer for \$1.00 a unit and sells the same product for \$2.00 to either a retailer (in a consumer market) or to a business organization (in a business market), then the producer's revenue has been reduced by \$1.00 a **unit** by using the merchant wholesaler. This is because the producer could have sold the product directly to the business customer or retailer for \$2.00 if it bypassed the wholesaler, while it sells the product for only \$1.00 to the merchant wholesaler.

The above explanation can be **reversed** to explain why a producer's **variable** costs tend to **decrease** if it **bypasses** wholesalers. By bypassing **merchant** wholesalers, there is **no wholesaler contribution margin** to eat into the producer's contribution margin. By bypassing **agent** wholesalers, the producer **avoids** having to pay a commission to the agent wholesaler. (You could argue that the producer would need to start paying commissions to its own sales force if it bypasses agent wholesalers, which, **on the surface**, would not reduce the producer's variable costs. It **appears** to be just substituting paying its own salesforce a commission versus paying an agent wholesaler a commission. However, this is not the way to view it, as a producer still needs a small salesforce to sell to agent wholesalers when agents are used and it needs to pay its own small salesforce a commission. Thus, using agent wholesalers means paying commissions to **both** its own salesforce and to agent wholesalers.

- C. Is it **better** for a producer to have a **STRUCTURE** that has a **higher ratio** of **VARIABLE** to total costs (which will tend to exist when a producer uses wholesalers) or is it better to have one that has a **higher ratio** of **FIXED** to total costs (which tends to exist when a producer bypasses wholesalers)?

Each cost structure has its advantages and its disadvantages so there is no simple answer to this question. The advantages of each cost structure, along with other advantages and disadvantages to a producer in using wholesalers are discussed below.

IV. **Advantages** to a **producer** in **using** wholesalers as opposed to bypassing wholesalers.

Both the advantages, discussed under IV below, and the disadvantages, which are discussed under V starting later, are organized into **categories**. The categories are the same with both the advantages and the disadvantages. **Three categories** are used in each instance and they are listed below. Knowing these categories will help you remember the advantages and disadvantages as well as give you a basic understanding of why each exists.

- Advantages (and disadvantages) resulting at least in part from impact of use of wholesalers on a producer's **cost structure** (The **advantages** are those that result from the **reduction** in a producer's **fixed** costs when wholesalers are used. The **disadvantages** are those that result from the **increase** in a producer's **variable** costs when wholesalers are used.)
 - Advantages (and disadvantages) resulting from the fact that wholesalers represent **MULTIPLE producers**
 - **Miscellaneous** advantages (and disadvantages).
- A. Advantages to a producer in using wholesalers that result **at least partly** from the cost **structure** difference identified previously

(To repeat this cost structure impact, the use of wholesalers will result in a producer's cost structure becoming **more variable** and **less fixed** in nature.)

Here, since we are looking at the **advantages** of this cost structure, our discussion will focus on the advantages resulting from having **lower FIXED** costs.

1. Less **downside risk** to a **producer** is involved in using wholesalers than in bypassing them (This advantage results **totally** from the lower fixed costs involved when using wholesalers.).
 - a. Explanation of this **lower downside risk** advantage and why it exists

Downside risk is the amount of money that can be lost by a producer with a product if **sales** are **less than expected**.

The amount of money that can be lost if sales are less than expected depends largely on **fixed costs** because these costs **cannot** be quickly adjusted **downward** if sales are less than expected. For example, if a producer had its own large salesforce, its administrative, support, and training costs would be just about as high if sales were less than expected.

In contrast there tends to be less downside risk with wholesalers even with the increase in variable costs involved. This is because some **variable** costs **automatically** adjust **downward** if **sales** are **less than expected** as is true with sales commissions paid by producers to agent wholesalers, as well as with the opportunity variable cost with merchant wholesalers. The amount of commissions paid by producers to agent wholesalers obviously goes down a lot when the agent wholesaler's sales unexpectedly decrease. The opportunity loss in revenue **per unit** (which was discussed starting at the bottom of page 6) involved in using merchant wholesalers goes down in **total** when the number of sales units of the producer's goods unexpectedly decreases.

- b. Explanation of **when** lower downside risk is an **important** advantage

In general, this is an important advantage when a lot of **sales uncertainty** exists. Instances in which this uncertainty exists are listed below.

- i. With a **new** product

Here, there is usually a **high** degree of **uncertainty** about the level of **sales**, even when test marketing is used. The **unstable** competitive environment along with the **lack** of any **prior sales history** lessen the ability to accurately forecast sales with new products.

- ii. With a brand in a product category where sales of the **product category** are quite **unstable**

This usually happens when **product category sales** are influenced substantially by **unstable environmental** factors, such as the **economy** and the **weather**.

This is true, for example, with **ski** resorts (where sales depend a great deal on **snow conditions**), with **automobiles** (where sales fluctuate a lot based on **economic** conditions), and with many other product categories. It is particularly true in **business** markets because demand in business markets tends to go up or down as demand for the **products sold by businesses** goes up or down. As an example, if automobile sales are quite unstable, then automobile **production** is quite **unstable**. This **production instability** creates a great deal of instability in sales of organizations selling **to** automotive companies, such as **tire companies**.

- c. Does this advantage of lower downside risk for a producer apply equally to **merchant** and **agent** wholesalers?

As a preview, this question is basically asked with each advantage, as well as with every disadvantage. Because this issue is frequently discussed, it is critical that you remember the prior discussion in the notes starting on page 3 which compared merchant to agent wholesalers.

No, it applies to a **greater** extent with **merchant** than with agent wholesalers. In other words, less downside risk exists with merchant wholesalers than with agent wholesalers.

The reason is that the **reduction** in **fixed** costs involved in using wholesalers is **greater** with **merchant** than with **agent** wholesalers. This is true because merchant wholesalers can reduce a producer's fixed costs of **both warehousing** and **personal selling** but the use of agent wholesalers reduces **only** the fixed costs of **personal selling** (since as mentioned in the earlier

discussion of merchant versus agent wholesalers under “2” on page 4, agent wholesalers are not involved in warehousing.

2. The use of wholesalers gives a producer **quicker access** to market than when bypassing wholesalers (This is the **second** advantage to producers in using wholesalers that results at least **in part** from the impact that the use of wholesalers has on a producer’s **cost structure**.)
 - a. Is this advantage **solely** a result of the **cost structure** difference (or as a result of **lower fixed** costs resulting from the use of wholesalers by a producer)?

The answer to this question is **no**. This advantage exists **partly** because of the lower producer fixed costs involved in using wholesalers. More specifically, “(ci)” below results from the lower fixed costs. However, both (cii) and (ciii) below have nothing to do with lower fixed costs involved in using wholesalers.

- b. **When** is quicker access to market an **important** advantage to a producer?

As was the case with the prior advantage involving less downside risk, this advantage is important mostly with **new** products, particularly with **startup** organizations or with **established** products entering **new** geographic markets.

It can be a **very important** advantage when getting the product accepted by retailers or business customers **quickly** can be a **long-term competitive** advantage. This will tend to be the case when a producer of a new product thinks that **competitors** will be able to come up with a similar product quickly and when the potential for **brand loyalty** is **high**. In this instance, getting a large base of **loyal** customers **quickly** can be a **long-run competitive** advantage.

- c. Reasons **why** the use of wholesalers provides producers with **quicker access** to **market**.
 - i. Many new products are introduced by **startups** with **limited financial resources**. If their **fixed** costs of personal selling and warehousing are high, they need to introduce the new product by **rolling it out**. Rolling it out is a **slow process**. Using wholesalers **reduces fixed costs** of personal selling (with both merchant and agent wholesalers), and warehousing (but only with merchant wholesalers), which can allow a startup, or small organization with limited resources the ability to do either a **larger-scale** rollout or else do a full-scale launch more quickly.
 - ii. If wholesalers were **not** used, a startup producer would need to hire and train its own sales force, which can take a number of months. This **time** can be saved by using wholesalers because they have **established sales forces** so no hiring or **basic** training is needed.

- iii. If wholesalers were **not** used, the producer's sales force, once hired and trained, would need to take time to establish **trust** and **credibility** with retailers and business customers. Trust and other aspects of **building relationships** with potential customers tend to be quite important in these situations. A wholesaler's salesforce already should have established these relationships, which can save a good deal of time.
- d. Does this advantage tend to apply to the same extent with agent wholesalers as with MWs?

It applies **more** to **merchant** wholesalers. More specifically, "ci" above applies **more** to **merchant** wholesalers than to agents. The **reduction in fixed costs** is greater with **merchants** because they perform both the **personal selling** and the warehousing functions. This was discussed in more detail under the first advantage dealing with reduced downside risk. However, "cii" and "ciii" above **only apply** to the personal **selling** function, which means that these two reasons for this advantage apply equally to agents as to merchant wholesalers (since both agents and merchant wholesalers perform the personal selling function for producers).

B. Advantages to a producer in using wholesalers that result from the fact that wholesalers represent **multiple** producers

- 1. Better producer access to **small** customers through wholesalers being able to obtain **sales pooling** across the multiple producers that a wholesaler represents.

An explanation of why this advantage exists is provided below. The explanation will start with an explanation in "a" of why it is **not** economically feasible for producers to even attempt to have its own salesforce contact **small** customers if it decides to bypass wholesalers. The explanation then proceeds to discuss why it is **more economically** feasible to attempt to sell to these **small** customers when wholesalers are used.

- a. Explanation of why it often is **not** financially feasible for a **producer's** salesperson to contact **small** business customers or **small** retailers

The **marginal** potential **sales revenue** of in contacting a **small** customer contact by a **producer's** salesperson (when wholesalers are bypassed) tends to be substantially **less** than the **marginal costs** for a sales contact to be made with these **small** customers.

Small customers usually purchase only a **small** amount, particularly from a **single** producer. Thus, **limited sales potential** exists here. This is particularly true with **retailers** in consumer markets because small retailers, such as a small "mom and pop" grocery store, usually carry products and brands from a **large number** of producers. Thus, they usually buy only a **small amount** at a time from any **single** producer.

For example, if the marginal **cost** of making a sales call is \$50 and the marginal **sales potential** to an **individual** producer of calling on the **small** potential customer is \$40, then it obviously would not be feasible for the producer's salesperson to try to contact the customer. Even if the contact is successful, a loss will occur.

- b. Explanation of why it often is **financially feasible** for a **wholesaler's** salesperson to contact **small** customers to sell a producer's brand or brands

The **marginal costs** are likely to be the same regardless of whether it is a salesperson that works for a wholesaler or for a producer. However, the **marginal sales potential** will be a lot **higher** with a **wholesaler's** salesperson than with a producer's salesperson. This is because the wholesaler salesperson represents **multiple producers** and can sell brands from these **multiple producers** in a **single** transaction.

Assume for example, that the wholesaler salesperson represents **four producers** in a consumer market where the salesperson contacts retailers. Here if the marginal **sales potential** of **each** producer is \$40 (which was less than the marginal sales of \$50 in our example above), then the **marginal sales potential** for the **wholesaler** is **\$160** (**\$40 for each producer times 4 producers**). With marginal sales potential of \$160 and marginal costs of \$50, it makes sense for the wholesaler's salesperson to contact the retailer. If the contact is successful, each producer gets sales revenue that they would not have received as well as the wholesaler getting some revenue. In other words, it is a **win-win** situation, at least if each producer gets some sales revenue.

- c. Does this advantage apply **equally** to **MWs** and **agent** wholesalers?
- i. **General** answer to the above question

As with the prior two advantages, this one also applies to a greater extent with merchant than with agent wholesalers, but for a different reason. The reason, going back to a key difference between merchant and agent wholesalers discussed under "3" starting on page 4 is that although both agent and merchant wholesalers represent multiple producers in different product categories, only merchant wholesalers represent multiple producers within each product category they carry. This gives merchant wholesalers a greater sales pooling impact, which is important with small customers, because they can pool sales of multiple producers both across product categories (which agents can do as well) and within product categories (which agents cannot do).

2. **Lower personal selling and warehousing costs** for the **entire** distribution **system** (The system includes multiple producers and multiple customers.) resulting from **less duplication of effort** if wholesalers are used than if

wholesalers are not used.

As a reminder of the outline format being used, this is the **second advantage** to a **producer** in using wholesalers that results from the fact that **wholesalers** represent **multiple producers**. The **first** advantage in this category was the above one dealing with **better producer access** to **smaller** customers resulting from **sales pooling**.

- a. General reason for this **less duplication** of effort in a distribution **system** when producers use wholesalers

I will use a very simple distribution system with four producers and four retailers, with each of the four producers selling and transporting to each of the four retailers and each of the four retailers buying from each of the four producers.

Let's start with what the distribution system would be if **none** of the producers used a wholesaler. Here each producer would a) have **their own** salesforce **separately** contact each customer, b) **separately** transport their own products, and c) **separately** warehouse their own products. Here there is a lot of **overlap** or **duplication** of effort. A similar example is driving alone (which is like bypassing wholesalers) to taking transit (which is similar to using wholesalers). Clearly for commuters as a whole, the amount of gas used is much greater if they all drive separately, resulting in a lot of duplication, than if they all took transit.

Looking only at personal selling, there would be a total of 16 personal selling contacts across the four producers and four retailers in only a single sales cycle, such as a week.

On the other hand, if the same producers were to use one wholesaler, the **wholesaler** would **reduce** the **duplication of effort and overlap**. Basically, one salesperson working for the wholesaler could do the job of four salespeople working separately for each producer. Putting it another way, there would be a reduction of 8 personal selling contacts for the **system** if wholesalers were not used (from 16 above when wholesalers were not used to 8 when a wholesaler is used). Here, each producer would need to contact the one wholesaler, which is 4 sales contacts, but then the one salesperson for the wholesaler can contact each of the four retailers. I will show a diagram of this in class that may make it clearer.

The **50% reduction** in the number of sales contacts for the system would be much greater in a **more realistic** system with a much larger number of customers and a larger number of producers. For example, if a wholesaler would represent 20 producers and contact 20 customers, then the number of sales contacts for the system **without** wholesalers would be **400** (20 times 20) while the number of sales contacts for these producers and customers if a

wholesaler is used would equal **40** (20 producers separately contacting the wholesaler plus the wholesaler separately contacting each of the 20 customers). Note here, that the reduction in sales contacts is much greater than 50%.

Fewer personal selling transactions for the **system** translate into lower personal selling costs for the system. More specifically, the total number of salespeople needed for the system will be reduced. This lowers the amount of personal selling compensation for the system, and also lowers the amount needed to hire, train, manage, and support the personal selling efforts for the system as a whole.

- b. Description of how **less duplication of effort** resulting from a wholesaler representing **multiple** producers can **lower transportation** and **warehousing** costs (As a reminder, this discussion applies only to merchant wholesalers as agent wholesalers are not involved in warehousing and transportation.)

The above discussion focuses only on how **personal selling** costs can be reduced for the distribution **system** when producers use wholesalers rather than bypassing them. **Transportation costs** also can be reduced for the system because the wholesaler can **pool** shipments from **different** producers into **one** shipment. This **increase** in the quantity shipped **at one time** almost certainly will result in a **quantity discount** in transportation costs.

There also is **reduction of overlap in warehousing** as a wholesaler can use one **larger** warehouse for a large number of the producers it represents rather than each producer having its own warehouse if they did not use merchant wholesalers.

- c. How and why do **producers** get some of the **system cost savings** created by using wholesalers?

In introducing this topic, realize that the cost savings are for the entire system and that each producer is only a small part of the system along with customers and the wholesaler. In fact, since it is the wholesaler who really is responsible for the system cost savings and efficiency, it might seem fair that the wholesaler get 100% of the cost savings for the system. However, as discussed below, the wholesaler has an incentive to pass some of the cost savings it generates for the system back to each producer it represents.

- i. Explanation of why wholesalers have an incentive to **pass** some of the cost savings for the entire system back to producers

Wholesalers have this incentive because they realize they need to give producers some **incentive** to use them rather than having the producers use other wholesalers or rather than having producers bypass

wholesalers. Sharing the cost savings with them is the major way of giving producers an incentive to use the wholesaler. It actually is a very important incentive since, as we will see relatively soon in looking at the disadvantages to a producer in using wholesalers, some very important disadvantages often exist. Reducing a producer's cost of distribution by sharing in the system cost savings is the main way of getting a producer to realize that the advantages in using wholesalers can outweigh the disadvantages.

- ii. Will the cost savings produced by the greater **system** efficiency in using wholesalers be distributed **equally** to all **producers**?

The answer to this question is no.

Producers that have more popular brands and who are large enough to bypass wholesalers tend to have more **bargaining leverage** in negotiating prices with merchant wholesalers and in negotiating commissions with agent wholesalers. This **greater bargaining leverage** tends to result in them getting a **larger share** of the system **cost savings** than producers with less bargaining leverage. More specifically, the greater bargaining leverage of some producers will allow them to pay lower commissions to agent wholesalers and sell their products at **higher** prices to merchant wholesalers.

- d. Does this advantage apply equally with **agent** wholesalers and **MWs**?

No, it applies **more** with **merchant** wholesalers than with agents. The primary reason is that **agent** wholesalers are **not** involved in **warehousing** and in **transportation**. Thus, the previously discussed system savings in transportation and warehousing due to less duplication of effort when wholesalers are used does **not** apply to **agent** wholesalers. However, the reduction of duplication for the system in **personal sales** effort will apply to agent wholesalers as well as to merchant wholesalers.

- C. A **miscellaneous advantage** to a producer in using wholesalers rather than bypassing wholesalers.

Some **small** retailers and business customers **prefer** to deal with a wholesaler rather than with each producer individually.

1. How is this an **advantage** for a **producer**?

It might seem that this is more of a disadvantage than an advantage for a producer in the sense that producers probably would prefer that its customers have no strong preferences regarding the use of wholesalers. If customers had no strong preferences, then producers would be free to make a decision about whether to use wholesalers based solely on their best interests without needing to worry

about how this decision will influence retailer satisfaction (or satisfaction of business customers in business markets). However, **realistically** the **preferences** of retailers and business customers need to be considered by a producer when making this decision.

2. Reasons why **small** retailers and business customers may **prefer** to buy from a **wholesaler** rather than from producers
 - a. It will save the customer **time** because it will need to deal with **fewer salespeople**.

This was demonstrated previously in the diagram that looked at the number of sales contacts. In this simple example, each customer had to deal with **four** producer salespeople if the producers **bypassed wholesalers** while each customer had to deal with only **one** wholesaler salesperson if the producers **used a wholesaler**.

Because these customers are business organizations (either business customers in business markets or retailers in consumer markets), this may **seem** to be an advantage to **all** customers rather than mostly to **small** customers. Yet, this advantage applies **more** to **small** customers because these small businesses or small retailers are less likely to have **purchasing departments** than larger organizations. For example, if a **small business owner** needs to deal with a lot of salespeople to decide what to purchase as well as having to deal with **other** aspects of managing the business, having to deal with fewer salespeople via wholesalers is an **important** advantage.

In contrast, with **larger** organizations, the **purchasing agents'** **sole** job is to interact with salespeople and they are given the time to do this with no conflicting responsibilities.

- b. Wholesaler salespeople provide more **objective** purchasing guidance than a producer's salesperson tends to provide.

The greater objectivity of wholesalers comes from the fact that they represent **multiple** producers and merchant wholesalers even represent multiple producers that are direct competitors. Thus, a wholesaler's sales rep does not really care which producer's brand or brands a customer buys as long as it is one that the wholesaler carries.

You might again think that this would be an advantage for **all** customers, not just **small** ones. However, it is more of an advantage to **smaller** customers because they again usually do not have **purchasing departments**. This means that the **smaller** customers have a **greater need** for the more **objective** purchasing guidance that wholesalers can provide.

In contrast, the **purchasing agents** in **larger** organizations are trained and

experienced to **carefully evaluate information** to determine its accuracy. Because if this, they do not need to rely heavily on getting objective information from each salesperson.

D. Summary of advantages to a producer in using wholesalers

Five different advantages have been presented. It might help to summarize them in one place, which I do below.

1. Identification of the five previously discussed advantages to a producer in using wholesalers
 - a. Less **downside risk** to a **producer** is involved in using wholesalers than in bypassing them.
 - b. The use of wholesalers gives a producer **quicker access** to market than when bypassing wholesalers.
 - c. Better producer access to **small** customers through wholesalers being able to obtain **sales pooling** across the multiple producers that a wholesaler represents.
 - d. **Lower personal selling and warehousing costs** for the **entire** distribution **system** (The system includes multiple producers and multiple customers.) resulting from **less duplication of effort** if wholesalers are used than if wholesalers are not used.

This is the biggest advantage by far, although we will see in the summary that it applies more to producers of consumer convenience goods than to producers of other types of consumer goods as well as producers selling mostly to business customers.
 - e. Some **small** retailers and business customers **prefer** to deal with a wholesaler rather than with each producer individually.
2. With the exception of the fifth advantage, the other four advantages apply more with merchant wholesalers than with agent wholesalers.

V. **Disadvantages** to a producer using wholesalers as opposed to bypassing wholesalers and using their own salesforce.

As a reminder, the discussion of the disadvantages, as was done with the previous discussion of the advantages, is organized into **three** categories; with the categories being the same here as with the advantages. The first category involves **cost structure** impact. The second category involves the impact of the characteristic of wholesalers representing **multiple** producers, and the third category is a **miscellaneous** one.

A. Disadvantages that follow from the **cost structure** impact of using wholesalers

The impact of using wholesalers on a producer's cost **structure** was discussed at the beginning of these notes under II. To quickly summarize, **using wholesalers** tends to **reduce** a producer's **fixed** costs but, at the same time, tends to increase a producer's **variable** costs. There are two producer advantages that exist, at least in part, from the reduction in fixed costs, which were discussed previously under IVA of these notes. At the same time two producer **disadvantages** result from the increase in **variable** costs that exist in using wholesalers. These two disadvantages are discussed below.

1. A producer has a **higher pricing floor** when it uses wholesalers compared to when it bypasses wholesalers. A producer with a higher pricing floor **loses** the **pricing** ability to both **undercut** the prices of competition and/or the ability to even match the low prices of competitors, particularly when the competitors **bypass** wholesalers.

- a. Explanation of why this disadvantage exists and results from the fact that a producer's unit variable costs increase when it uses wholesalers

The concept of **contribution margin**, which was discussed in class before the first exam, is the key explanatory concept here. As a reminder, contribution margin equals **unit price – unit variable costs**. Note that **fixed** costs have no bearing or impact on contribution margin. To continue, it is necessary to maintain a **positive** contribution margin, at least in the long run in order to have a chance of being profitable. A negative contribution margin guarantees a loss. The use of wholesalers will increase variable costs, which increases the price needed to generate a positive contribution margin. For example, if a merchant wholesaler will only buy a product from a producer if the producer charges a price that is \$1 less than what the retailer is willing to buy the product at, this really increases the producer's unit variable costs by \$1, which raises the minimum price that generates a positive contribution margin by \$1.

- b. How **important** is this disadvantage of having a higher pricing floor to a producer?

Its importance depends on the producer's market target, its **positioning** strategy, and the positioning strategy used by competitors. This disadvantage is **more** important when a producer is positioning a brand as a **lower priced** one and is targeting **more price sensitive** customers. Obviously, being able to match or beat competitive prices is more important in this situation than when positioning on higher quality and targeting less price sensitive customers.

2. A producer's profits will tend to be **lower** at sales levels **significantly above breakeven sales** when it uses wholesalers compared to when it bypasses wholesalers.

This is actually the flip side of the first advantage, which was less downside risk. Another way of saying less downside risk is that losses will be less when sales are below breakeven if wholesalers are used than if they are bypassed. Well, because tradeoffs usually exist, if losses tend to be less at sales volume below breakeven when wholesalers are used, then it is also true that profits will be less at high sales volumes if wholesalers are used.

a. Reasoning for this disadvantage

TOTAL variable costs of a producer, which increase when a wholesaler is used, will always **increase** as the **volume** produced and **sales increase**. Because using a wholesaler increases the producer's **variable costs**, this means that using a wholesaler will cause a producer's total costs to increase as sales volume increases.

In contrast, when wholesalers are bypassed, the producer tends to have higher **fixed** costs, which do **not increase** in **TOTAL** as the producer's **sales volume increases**.

I will draw a graph in class that will demonstrate and summarize what I have said in the prior two paragraphs. Basically this graph will show costs on the vertical axis and the volume produced and sold on the horizontal axis. Two cost functions will be plotted, one with fixed costs and the other with variable costs. The fixed cost function will start at a level well above 0 but remain flat at the level for all volume levels. The variable cost function will be one that consistently increases but starts at 0. At some point the variable cost function will intersect the fixed cost function. Above this volume, total costs are higher if the costs are variable than if they are fixed, which is the point being made namely that the use of wholesalers, because it increases variable costs, will be less profitable at high sales volume levels. (I encourage you to draw your own graph based on the verbal description I use in this paragraph. I know that some of you will be able to do so.)

b. How **substantial** is this disadvantage?

It is not that substantial. This is because the "fixed" costs involved in having the larger **producer** salesforce if wholesalers are not used is essentially a **SEMI-fixed** cost. These "fixed" personal selling costs of hiring, training, managing, and supporting a producer salesforce do not increase with each and every unit sold. However, once sales volume increases beyond a certain point, additional salespeople will need to be hired, trained, managed, and supported. Additional sales support people also will need to be hired and managed as the size of the producer's own salesforce increases. Using the graph I mentioned above and will draw in class to demonstrate this, The fixed cost curve will actually be a **series** of steps that are flat only within a certain range but then increase when the costs are **semi-fixed** costs. Most fixed costs, actually, tend to be semi-fixed rather than being totally the same across all sales volumes.

In summary, distribution and personal selling costs do increase at a faster rate when wholesalers are used, as this cost is entirely variable. However, these costs do increase as sales volume increases even when wholesalers are bypassed because the producer's own salesforce needs to increase in size as sales volume increases past a certain point or threshold.

- c. How **important** is this disadvantage to a producer?

It depends on the producer's basic strategy and targeting approach. If the producer is aggressively trying to increase its sales volume or target the **masses** through either a differentiated or an undifferentiated market target strategy, then it is expecting to have a large sales volume, which would make this disadvantage an important one.

However, if the producer is using a **concentrated** market target strategy with a **lower** sales volume objective, this disadvantage would be unimportant, or even would not even exist. In fact, **total** costs will tend to be **lower** with a cost structure with a **high** percentage of **variable** costs at the **lower** sales volumes associated with the use of wholesalers. (Again, the in-class graph will demonstrate this.) Thus, this disadvantage about the rate of increase in total costs will be very unimportant when a **concentrated** strategy is used.

B. **Disadvantages** to a producer in using wholesalers that result from wholesalers representing **multiple producers**

1. Wholesalers will provide **less aggressive personal selling** of a producer's brand or brands than would occur if the producer has its own sales force.
 - a. Reasoning behind this disadvantage of less aggressive personal selling when wholesalers are used

Two reasons exist for wholesalers providing less aggressive selling for a producer than the producer would get from its own sales force. Both reasons follow from the fact that wholesalers represent multiple producers.

First, a wholesaler's salesforce has to **spread its selling time** over a large number of producers. Thus, it has less time to devote to personal selling for any individual producer. For all practical purposes, less time to devote to selling for any one producer means less motivation to sell for the producer compared to the producer's own salesforce.

Second, although both agent and merchant wholesalers have a strong **general** motivation to sell, as discussed toward the beginning of these notes, neither type cares which **specific producers' brands** they sell, at least when the business and retail customers view the different producers' brands as **substitutes**, and here is where the lack of aggressiveness exists. Substitutes

can be either **direct** or **indirect** with **retailers** as discussed in the next two paragraphs, but there are only **direct** substitutes with **business** customers as explained in the **third** paragraph below.

For example, if a **merchant** wholesaler carries both Contadina tomato paste and Hunts tomato paste, and a retailer wants to buy Contadina rather than Hunts, the wholesaler would not try to persuade the retailer to buy more Hunts, as it will make revenue regardless of whether the retailer buys a) Contadina or b) Hunts tomato paste. Here, retailers tend allocate a certain amount of shelf space to the **product category** of tomato paste, meaning that the total amount of tomato paste bought is basically constant. Thus, the more of one brand they buy and stock, the purchase of other brands will lessen.

Using another example that looks at this **across product categories**, if a retailer wants to buy a lot of tomato paste and not very much prepared spaghetti sauce and the **agent** wholesaler carries the most popular brand in **both** product categories, the wholesaler again will not attempt to persuade the retailer to buy more spaghetti sauce and less tomato paste, because the **agent** wholesaler makes money as long as it sells either tomato sauce or spaghetti sauce.

The point in the previous paragraph of **indirect** substitutes **across product categories** applies to retailers as they have a **finite** amount of shelf space and facings for all product categories. Thus, the more facings for one product category, the fewer the facings for other product categories. However, business customers' purchasing of different product categories basically involves **unrelated** decisions. If General Motors buys more tires, this certainly does reduce the amount of steel that they need to buy.

- b. How **important** is this disadvantage of lack of aggressive personal selling by wholesaler salespeople?

The need for aggressive personal selling is **greater** with **new** products and when targeting **new** customers than when targeting current customers for repurchase. However, even in the **latter** situation **unless** customers are **extremely brand loyal** or **little competition** exists, some degree of aggressive personal selling often is needed.

A **lower** level of aggressive personal selling also is needed in consumer markets with **retailers** than with business customers. This is because once retailers first carry a brand, they will tend to repurchase it as long as the turnover rate does not decrease. Even if it decreases, the degree of aggressive personal selling is not likely to cause the retailer to change a decision to discontinue purchase of a slow-moving brand.

In summarizing the ideas in the prior two paragraphs, the lack of aggressive personal selling is particularly important in a) business markets and b)

consumer markets when it is tough to get retailers to make an initial commitment to purchasing a new and untested brand. The lack of aggressive personal selling is less important with established brands in consumer markets where retailers will continue to repurchase brands as long as they will continue to turnover and will stop purchasing them when turnover decreases. Their decisions here have little to do with how aggressive a personal selling effort is.

- c. Will this disadvantage of less aggressive wholesaler personal selling apply to the same degree with **agent** wholesalers as with **merchant** wholesalers?

The first reason for less aggressive sales effort from wholesaler sales people than from a producer's salesforce, namely less time to devote to selling for any one producer, applies equally to agent and merchant wholesalers.

The second reason for less aggressive sales effort applies to a **lesser** extent with **agent** than with **merchant** wholesalers, which means that personal sales effort will be more aggressive with agent than with merchant wholesalers (but still a lot less aggressive even with agent wholesalers than with a producer's own salesforce because agent wholesalers have less time to devote to a producer, as discussed in the previous paragraph).

The reasoning for agent wholesalers having more aggressive sales efforts for producers than merchant wholesalers is based largely on the **difference** in the **nature** of the **producers** represented by **agent** wholesalers in comparison with merchant wholesalers that was discussed at the beginning of these notes. More specifically, manufacturers' **agents** do not represent two or more **directly** competing producers. This means that if a customer needs a **specific product category**, which often is the case, particularly in business markets, a producer can be assured that the **agent** wholesaler will not try to substitute a competitor's brand for the producer's brand because the agent wholesaler will **not** represent any **direct** competitors.

- d. Summary of this disadvantage dealing with less aggressive personal selling from wholesalers than from a producer's own salesforce.

First, particularly in business markets, agent wholesalers will provide more aggressive personal selling for a producer than merchant wholesalers because agent wholesalers do not carry **directly** two or more competing brands or substitutes. They carry only one brand per product category. In contrast, merchant wholesalers carry directly competing brands, which reduces the aggressiveness of personal selling for each producer. The situation is somewhat different in consumer markets where these salespeople sell to **retailers**. Here there is a major problem even with agent wholesalers not providing much aggressive personal selling since they carry **indirect** substitutes. Indirect substitutes exist across product categories with retailers since they have a finite amount of shelf space. Thus, if they buy more of one

product category, they buy less of another one.

Of course a producer's own salesforce will provide more aggressive personal selling than agent wholesalers because they only represent the one producer.

This disadvantage is a very important one with new products in both business and consumer markets and also is a very important disadvantage with established products in business markets.

2. A wholesaler salesperson has a lot **less motivation** to both a) seek out information about producers marketing tactics and strategies and b) to **communicate** any information of this type that they receive to each producer they represent. Each producer would consider this information to be valuable **competitive intelligence** (and information that a producer's own salesforce would have a strong motivation to communicate to the producer).

- a. Background – Salesperson access to competitive intelligence

In **business** markets, salespeople, regardless of whether they work for a producer or represent multiple producers via a wholesaler, have **access** to a lot of information about **competitors** through their interactions with purchasing agents representing customers. Purchasing agents are more than willing to convey this information to either wholesaler salespeople or to a producer's salespeople. In addition, salespeople who visit retailers can directly **observe** what a wide range of producers are doing with possible price changes, sales promotion, and even changes in where retailers put producers' brands on the shelves.

Although salespeople will get access to a lot of this information about producers without even actively seeking it out, they also will tend to have access to some of this information if they ask relevant questions to purchasing agents representing retailers or business customers.

- b. Explanation of why a **wholesaler** salesperson has **less** motivation to **actively collect** and/or **pass** competitive information they receive back to producers they represent than the amount of motivation a producer's own salesforce would have to pass this intelligence and/or research to the producer's marketing department.

- i. **Wholesaler** sales people do not even perceive information about different **producers** they represent, even those in the same product category, to be **competitive** information.

A **wholesaler** perceives **competition** to be other **wholesalers**. On the other hand, wholesalers tend to perceive producers who are competitors to **one** of the producers they represent to be **clients** of the wholesaler who the wholesaler wants to **keep happy**. Wholesalers realize that they will **upset**

one producer they represent whenever they pass along information about **this** producer to **another competing** producer the wholesaler represents.

For example, if a merchant wholesaler sells both Hunts and Contadina, it will upset the Hunts if it passes information to Contadina about pricing changes made by Hunts. The wholesaler, thus, would be inclined to not communicate this information to Contadina.

- c. Will this disadvantage exist **equally** with **agent** as with merchant wholesalers?

This disadvantage of a producer receiving less competitive intelligence when they use wholesalers exists to a **lesser** extent with **agent** wholesalers than with **merchant** wholesalers. The reason is that agent wholesalers usually do not represent **directly** competing producers because they carry only **one** brand per product category. Thus, they usually do not need to worry about passing information about one producer they represent to another **competitive** producer they represent. For example, if a producer only represents Hunts tomato paste, they would have no reason to withhold information about Contadina from the producer of Hunts.

- d. How important is this disadvantage to a producer?

In general, this is **almost always a very important** disadvantage, as producers need to get accurate and **timely** information whenever any competitive **changes** occur.

C. **Miscellaneous** disadvantages to a producer in using a wholesalers

1. A producer has **less control** over **retail coverage** (meaning which specific retailers carry the producer's brand or brands and which ones do not carry the producer's brand or brands) if a wholesaler is used than if a producer's own salesforce is used. (This disadvantage is **only applicable** in **consumer** markets because retailers rarely are used in business markets, for reasons discussed at the beginning of these notes.)

This disadvantage is different than the prior ones as well as to the one remaining one in one important respect. This is a disadvantage that can be prevented as long as a producer is aware of how serious the problem can be if the producer does not take action to prevent this disadvantage from happening. Thus, most of the discussion of this disadvantage focuses on why it is a serious problem if nothing is done to prevent it from happening and the rest of the discussion will focus on what a producer can and should do to prevent this disadvantage from happening.

- a. Reason for this disadvantage existing when wholesalers are used in consumer markets.

Because **MWs purchase** brands from producers, they are **legally** entitled to sell them to whomever they please.

The loss of control over retail coverage does not **legally** exist with AWs because they do not take title to the producers' brands. However, the loss of control can **practically** exist with agent wholesalers, particularly if a producer does not take appropriate action to prevent agent wholesalers from selling to retailers that the producer does not want them to sell to. An agent wholesaler will want to sell to any retailer willing to buy so that they can get revenue through a commission.

- b. How important a disadvantage is this loss of **retail coverage**?

The loss of control over **retail** coverage can be a **very important** disadvantage to a producer when a producer offers **exclusive** or **selective** distribution to a retailer for the reasoning discussed below.

- i. Background information on what selective and exclusive distribution are and why producers might offer one of these options to retailers.

Selective or exclusive distribution exists when a producer promises a retailer that they will be the **only** one (with **exclusive** distribution) or one of the **few** retailers (with **selective** distribution) allowed to carry a producer's brand in a **given geographic market**. These types of distribution rarely are used with consumer **convenience** goods, where widespread availability is very important to consumers. However, these types of distribution are often used with higher involvement product categories where consumers are less concerned about widespread availability.

Selective or **exclusive** distribution may be used by a producer even though it makes the brand **less available** to consumers. It is done because **retailers** like such distribution rights and they are **willing to do more** for a **producer** who gives them such rights. They are more willing to advertise the producer's brands in the retailer's advertising, more willing to put up point of purchase displays for the producer, more likely to aggressively sell the producer's brands if they have exclusive distribution rights, and more likely to even agree to carry a producer's brands when they know that their **retail competitors** will not be carrying these same producer brands.

- ii. Will retailers promised exclusive or selective distribution rights be upset if a wholesaler, who did **not** make the **promise** in the first place, sells the producer's brands to other competing retailers?

I think you can answer this question yourselves. Yes, the retailers will tend to be upset in this situation. Retailers here are told that they will be given

exclusive or selective distribution and they agree to do certain things for a producer in return for being given exclusive or selective distribution. When they discover that they do not have these exclusive or selective distribution rights promised them, they almost certainly will be **very upset** that the promises were not honored, particularly if they lived up to their end of the promise.

- iii. To what extent will **retailers blame** the **producer** if **wholesalers** representing the producer do not follow the selective and exclusive distribution agreements made by a producer?

The producer is likely to be blamed even if it is the wholesaler who violates these agreements. Retailers expect, and have reason to expect, that producers communicate these agreements to wholesalers and make it clear to wholesalers that these agreements **made by the producer must be honored**.

- iv. How can producers prevent wholesalers from violating selective and exclusive distribution agreements made by a producer?

The basic point with this question is that once producers are aware of this **potential** disadvantage of the loss of control over retail coverage and are also aware of the significant consequences to them if wholesalers do not honor exclusive and selective distribution agreements made by the producer, the producer can and should take steps to prevent wholesalers from violating these agreements that producers make. The steps taken are discussed below.

First, producers need to maintain careful communication with wholesalers to inform them of these agreements and any changes made in them. They need to then find out whether the wholesalers will make a commitment to honoring these exclusive and selective distribution agreements. Wholesalers are unlikely to act inconsistently with such a commitment as they know the importance of having a reputation of living up to commitments made to producers. If a wholesaler does not agree to abide to such exclusive and selective distribution arrangements, the producer needs to fine another wholesaler who will do so.

Second, producers need to make it clear that they will **terminate** any **relationship** with a **wholesaler** who takes action inconsistent with these agreements. In other words, close to a **zero tolerance** approach should be used. With such an expressed policy, wholesalers are very likely to honor these selective and exclusive agreements.

2. **Large** customers often **pressure** producers to sell directly to them rather than through **MWs**. (This is the second **miscellaneous** disadvantage that a producer faces when deciding to use **wholesalers** in a channel of distribution.)

Note that this is the only disadvantage that applies solely to MWs.

- a. Reason for this pressure of **large** customers to encourage producers to sell directly to them and bypass merchant wholesalers

The **large** customers are motivated largely by thinking they can buy the product at a **lower** price **directly** from the producer than the price they would need to pay the **merchant** wholesaler because the wholesaler's **contribution margin** can be eliminated. For example, if a wholesaler's margin is \$.50 a unit, a large business customer or large retailer could purchase from the manufacturer for up to \$.50 less than from the merchant wholesaler.

Often, **large** customers will offer to **split** the wholesaler's contribution margin with the producer to give the producer something to gain by bypassing the merchant wholesaler.

- b. Wouldn't **smaller** customers have this same incentive or motivation to pay a lower price by pressuring a producer to sell direct while bypassing merchant wholesalers?

Yes, smaller customers probably would have this motivation, although smaller customers also have the **offsetting** motivations for using a wholesaler that were discussed previously under C starting on or about page 15 of these notes.

However, even when smaller customers have this motivation to pressure a producer to bypass merchant wholesalers, they do not have the **bargaining leverage** that **larger** customers have to **pressure producers to bypass** wholesalers.

- c. Why is this tendency of larger customers to pressure a producer to bypass wholesalers a **disadvantage**?

On the surface, this seems to be something that would not hurt the producer and would even help it, particularly if the customer is willing to split the MWs margin with the producer. However, a more careful analysis demonstrates that this is a very difficult dilemma for producers for a number of reasons and they would prefer to not be presented with this dilemma. First, although there are no costs to the **customer** in bypassing wholesalers, the **producer** does incur **extra** personal selling and distribution costs that the MWs would be assuming. Second, the MW, which the producer still would want to use for smaller customers, would be **very upset** with the producer and for very good reason. They might even decide to stop representing such a producer who does not support them and takes revenue of large customers away from them. On the other hand, if the producer refuses the request/demand of a large customer to sell directly to them, the customer may decide not to buy from the producer.

- d. One possible way of a producer resolving the above **dilemma** that the producer faces

The producer could approach the MW and indicate that it wants to continue to work with the MW and is even willing to sell to the MW at a lower price as a gesture of good faith, while also asking the MW to lower its price to the large customer by some agreed upon amount that the large customer is willing to accept. The basic point here is that compromises sometimes are necessary to maintain good relationships with MWs.

D. Summary of disadvantages to a producer in using wholesalers

As I did with the advantages, I will simply list each of the six disadvantages that have been discussed.

1. A producer has a **higher pricing floor** when it uses wholesalers compared to when it bypasses wholesalers. A producer with a higher pricing floor **loses** the **pricing** ability to both **undercut** the prices of competition and/or the ability to even match the low prices of competitors, particularly when the competitors **bypass** wholesalers.
2. A producer's profits will tend to be **lower** at sales levels **significantly above breakeven sales** when it uses wholesalers compared to when it bypasses wholesalers.
3. Wholesalers will provide **less aggressive personal selling** of a producer's brand or brands than would occur if the producer has its own sales force.

This disadvantage, and the next one, are the two most important disadvantages to a producer. Note that both of these most important disadvantages apply more to MWs than to agent wholesalers.

4. A wholesaler salesperson has a lot **less motivation** to both a) seek out information about producers marketing tactics and strategies and b) to **communicate** any information of this type that they receive to each producer they represent. Each producer would consider this information to be valuable **competitive intelligence** (and information that a producer's own salesforce would have a strong motivation to communicate to the producer).
5. A producer has **less control** over **retail coverage** (meaning which specific retailers carry the producer's brand or brands and which ones do not carry the producer's brand or brands) if a wholesaler is used than if a producer's own salesforce is used. (This disadvantage is **only applicable** in **consumer** markets because retailers rarely are used in business markets, for reasons discussed at the beginning of these notes.
6. **Large** customers often **pressure** producers to sell directly to them rather than through **MWs**.

VI. **Summary** of discussion of whether or not a producer should use wholesalers rather than bypassing them

- A. Based upon the discussion of the advantages and disadvantages in these notes, it should be clear that the decision a producer needs to make about whether or not to use wholesalers is a **difficult** decision.
- B. In making the decision on whether to use wholesalers, a producer must look at the **degree** to which each of the advantages and disadvantages exist in a **particular situation** along with the degree of **importance** of each of the advantages and disadvantages in a **particular situation**.

Factors that **influence** the **degree** of both the **size** and **importance** of advantages and disadvantages in using wholesalers are a) the **nature** of the **products** sold by producers, b) the **markets** sold to, and c) **characteristics** of the **PRODUCER**. The manner in which each of these three factors influence a producer's decision to use wholesalers is discussed below, with the **first two factors** discussed in **combination** with each other.

1. Description of the **combination** of **product and market** characteristics that influence the producer's decision concerning whether to use wholesalers

The approach used to discuss this impact involves identifying two different product/market combinations, which tend to be very different. Wholesalers would tend to be used with the first combination below (a) and bypassed with the second combination below (b).

- a. Extent that the **established** product is a **convenience** good in **consumer** markets

Wholesalers are more likely to be used with **convenience** goods than with **shopping goods**. This is because **three** of the **advantages** in using wholesalers are quite **important and large** in this situation and also because **two** of the **disadvantages** also tend to be **unimportant**.

One **important and large advantage** involves **system cost savings** due to the **reduction in duplication**. Because so **many** retailers are used in this situation because of **intensive** distribution being needed with **convenience** goods, a very large **reduction** in the number of **sales transactions** for the system will exist when wholesalers are used compared to when they are bypassed.

Both of the advantages dealing with **smaller** retailers also are quite important in this situation because it is important to get small, as well as larger retailers, to carry these products to achieve the **intensive** distribution with **convenience** goods described above.

One **unimportant disadvantage** is the one involving the lack of aggressive

personal selling when using wholesalers. Retailers generally decide whether to repurchase **established** convenience goods based almost entirely on inventory turnover statistics. Aggressive personal selling has no impact on these turnover statistics.

A second **unimportant disadvantage** involves the **loss of control** over **retail distribution**. As discussed earlier in these notes, this disadvantage is **important** when **selective** or **exclusive** is used at the retail level but **intensive** distribution is used at the retail level with **convenience** goods in **consumer** markets.

- b. Extent that established product is **expensive** and **complicated** in **business** markets

Merchant wholesalers tend to be **bypassed** in this product/market situation, with either agent wholesalers or a company's own salesforce being used (**Reasoning** for using agent wholesalers with this product/market combination is discussed under F starting on page 33). In this situation, which tends to be the **opposite** product/market combination from the one described above under a, **three** of the **advantages** in using wholesalers are **unimportant** and small and **two** of the **disadvantages** are **very important**.

The three **unimportant advantages** involve a) **better access** to **small** customers, b) **preferences** of **small** customers to use **wholesalers**, and c) **system cost savings** due to the reduction in duplication. The **first two** of these **advantages** are **unimportant** because most customers in **business** markets are **larger**. The **third above advantage** is **unimportant** because a **smaller** number of business customers tend to exist in most product categories, which means that a **limited amount of duplication** of **sales effort** will exist even when most producers **bypass wholesalers**.

The two **important disadvantages** in this product/market situation of complicated and expensive products in business markets are a) **less aggressive sales effort** from wholesalers, and b) **less** producer **access** to **competitive** and **intelligence**. **Aggressive** selling usually is needed in **business** markets because each possible customer tends to involve **high sales potential**. In addition, purchasing agents expect salespeople to spend a lot of time with them and as discussed with this disadvantage, a wholesaler's salesperson needs to spread their time over a larger number of producers. Because **each** business customer tends to have somewhat **unique needs and desires** and because a lot of **price competition** can exist, it is very **important** that producers in business markets get **good access** to **competitive** and **customer research** that salespeople have access to.

2. Description and discussion of **producer** characteristics that influence the producer's decision on whether to use or whether to bypass wholesalers

- a. Whether the organization is a **startup** with **limited financial resources** vs. a large and established organization with substantial financial resources

Even though some of the **disadvantages** in using wholesalers are very **important** with a **startup** organization with limited resources, such as a) the lack of aggressive personal selling, c) the lack of control over retail distribution (since selective distribution often needs to be provided to retailers to give them an incentive to carry the **new** brand even if it is a convenience good), and d) lack of producer access to competitive and customer research (which is important with a **new** brand), wholesalers still tend to be used because of the **savings in fixed costs** associated with using wholesalers. In other words, a startup producer rarely can afford to start off with its own sales force, at least in consumer markets with the large number of potential retailers that need to be contacted.

As discussed below under “D,” **missionary salespeople** tend to be used in this situation in **combination** with **wholesalers** because some of the disadvantages in using wholesalers are important while, at the same time, these producers cannot afford to use their own sales force.

- C. Realize that an **agent** wholesaler is a **compromise** between using a **merchant** wholesaler and **bypassing wholesalers entirely**

If you refer back to the previously discussed advantages and disadvantages in using wholesalers, you will note that I often discussed whether the advantages and disadvantages applied equally to **agent** wholesalers and to **merchant** wholesalers. To summarize this, I **usually** concluded that the **advantages** applied to a **greater** extent with **merchant** wholesalers than with agent wholesalers but I also usually concluded that the **disadvantages** applied to a **greater** extent with merchant than with agent wholesalers. Because **both** the advantages and disadvantages apply to a **lesser** extent with **agent** than with merchant wholesalers, then the use of **agent** wholesalers is a **compromise** between using merchant wholesalers and bypassing wholesalers all together.

- D. The producer can use **missionary salespeople** in **combination** with agent or merchant **wholesalers** when **start-up** organizations introduce **new** products.
1. What is a **missionary** salesperson?

A **missionary** salesperson works **only** for a specific producer. They also are used **only** with **new** products. These missionary people will make the **initial contact** with potential customers, sometimes accompanied by the wholesaler and sometimes not accompanied by the wholesaler. The wholesaler, usually a merchant wholesaler, assumes the transportation, warehousing, materials handling, inventory management, and even the **follow-up** sales function.

Based upon the above description, missionary salespeople often are only **temporarily** employed by a producer.

2. Why do **missionary** salespeople tend to be used primarily with **startups** introducing **new** products?

Selecting a distribution channel is very difficult with **new** products introduced by a **smaller** organization because **both** the **advantages** and **disadvantages** in using wholesalers tend to be quite **important** with in this situation. For example, the **advantages** of **reducing downside risk** and **gaining quick access to the market** are very important with many new products introduced by a **startup** organization. In addition, the **disadvantages** of **less aggressive personal selling** and **losing control over retail coverage** (at least with consumer products) tend to be very important disadvantages (**Selective** distribution often is used **initially** even with **convenience** products to give **retailers** an **incentive** to carry the **new** product.) The lack of producer access to competitive information also is a very important disadvantage here. This information is critical when a new product is being launched with a very uncertain and unstable competitive environment.

If **both** the advantages and disadvantages in using wholesalers tend to be **important** with **startups** introducing new products, then finding something that has some of the advantages without some of the disadvantages is very useful and this is what happens with the **combination** of **missionary** salespeople and merchant wholesalers. The **lower downside risk** advantage exists because **merchant** wholesalers still are used to perform functions such as warehousing that involve fixed costs. The wholesalers also are used to help the missionary salespeople **quickly build a relationship** with customers that already know the wholesalers. At the same time, the missionary salespeople, because they only represent the one producer, will **aggressively sell** for the producer and will **follow any selective distribution arrangements** the producer establishes for the same reason (which you should now realize are disadvantages to a producer in using wholesalers). They also will be eager to pass seek out and pass along competitive intelligence to the producer's marketing department.

- E. Producers should consider using a **hybrid** channel system or a **multichannel distribution system**

1. What is a **hybrid** distribution system?

A producer using a **hybrid** distribution system will **use** wholesalers for **some customers** and will **bypass** them with **other** customers in the same time frame.

2. Description of different ways of using a hybrid system with and without wholesalers
 - a. **Wholesalers** may be **used** with **smaller** customers but **bypassed** with **larger** customers.

The reasoning for this particular hybrid system has already been established. Go back and you will see that two of the **advantages** in using wholesalers discussed previously apply only to **smaller customers**. (the one dealing with better **access** to **smaller** customers and the one dealing with **smaller** customer **preferences** to purchase from wholesalers).

If some of the **advantages** of using wholesalers apply **only** to **small** customers, then it makes more sense to **use** wholesalers with **smaller** customers than with larger customers.

At the same time, **one** of the **disadvantages** of using wholesalers previously discussed applies only to **larger** customers (the one dealing with pressure of **larger** customers put on a producer to bypass wholesalers). Given that this **disadvantage** applies only to **larger** customers, it suggests that it may make sense for a producer to **bypass** wholesalers with **larger** customers (although a **DILEMMA** is involved in doing this and this dilemma was discussed under c and d starting at the bottom of page 28 of these notes.) Note that it was recommended there that producers try to avoid folding to this pressure and can sometimes reduce the pressure by working with the wholesaler to reduce both of their contribution margins to give the larger customer a lower price. If the price can be lowered significantly, the larger customer will be satisfied purchasing from the wholesaler.

- F. Agent wholesalers tend to be used more than merchant wholesalers in **business** markets

Two of the **disadvantages**, which will apply to a **lesser** extent with agent wholesalers than with merchant wholesalers (which means that these really are **advantages** of **agent** wholesalers compared to merchant wholesalers) tend to be very **important** in business markets (lack of aggressive personal selling, and less competitive intelligence and customer research) The fact these two important disadvantages apply to a lesser extent with agent than with merchant wholesalers suggest that it would make more sense to use agent than with merchant wholesalers. The reasons why these disadvantages are important in business markets were presented previously under 1b starting on page 30. It is essential that you review these reasons because a study guide question (second part of Q10) requires you to present this reasoning.

In addition, one of the advantages, which also applies to a **lesser** extent with agent than with merchant wholesalers, is **unimportant** in many **business** markets. This advantage is the one dealing with system cost savings due to reduction in duplication. Since this really is a **disadvantage** of **agent** wholesalers compared to merchant wholesalers, the fact that this is an **unimportant** disadvantage of agent wholesalers leads to the use of agent wholesalers. The reasoning for this advantage being unimportant in business markets also was discussed under 1b starting on page 30 and needs to be reviewed to answer the second part of study guide question 10.