

# Achieving Channel Excellence

*The “Ace Up Your Sleeve” in Sales and Marketing Programs*

## Overview

---

As more and more customers base their buying decisions on process benefits like convenience and service – and distribution intermediaries become increasingly consolidated and specialized – winning companies are finding that the effective design and management of their channel network is essential to achieving profitability growth goals.

Our work with clients has shown that leading companies can build a sales channel structure that addresses customer needs and takes advantage of market opportunities by engaging in a four-step process:

- Assess the true cost of working through third-party distributors.
- Understand the competitive benefits a distributor can provide.
- Design a channel network that uses incentives and support tools to maximize partner performance.
- Effectively manage the transition to the new channel network.

Successfully implemented, this process will create a capability and network that differentiates a company today and provides a basis for competitiveness well into the future.

---

---

Superior channel management is increasingly important in a wide range of industries. Companies that implement thoughtful channel management programs can reduce their costs and improve their ability to reach and effectively serve key customer groups. Those that fail to introduce new approaches may find themselves lagging behind the competition – and their own profitability goals – as new distribution challenges emerge.

Two challenges, in particular, are driving the need for better management of third-party partners. First, companies are finding that the “front end” of their business is increasingly a source of differentiation. As product technologies converge, customers are basing their buying decisions on process benefits, like convenience, customization, and support and service, which are beyond the factory’s direct control. Second, distribution markets are evolving rapidly. While the absolute number of intermediaries is declining, the number of different types of intermediaries is increasing. The first of these challenges has made superior performance in process functions, traditionally carried out by intermediaries, more important; the second has made it more possible.

In this new environment, there is a raging debate inside many of our clients. One group of managers wants to bring more activities in-house in order to “get better control and ensure strong service delivery.” A second group wants to “take advantage of the cost positions of new kinds of intermediaries.” The company’s top managers are left feeling that they must make a trade-off between the cost efficiency and reach of using a third-party channel and the higher levels of service and control that are available through direct contact. But this trade-off mentality is built on assumptions that are often false. Indeed, we have found that third-party channels cost

much more than most companies think and they can often provide advantages that are not fully appreciated.

In our experience, companies can provide process benefits, exploit the cost positions of new kinds of intermediaries, and take advantage of the new opportunities in the marketplace, if they focus on doing four things right:

- Assess the true costs of working with channel partners.
- Take into account the benefits provided by these relationships.
- Design a channel network that addresses customers' real needs, using a set of incentives and support tools that can maximize the performance of partners.
- Effectively manage the transition to the new model they have created.

### Recognize the true cost of working through third parties

Discussions about changes in channel design are often laced with emotion. Some managers believe that third parties receive outrageous sums of money for doing very little. Others fear that customers will be lost and costs will skyrocket if third parties are not used. A simple set of economics can typically shed light on the true costs and benefits of working through third parties in any market, and thus help resolve the debate.

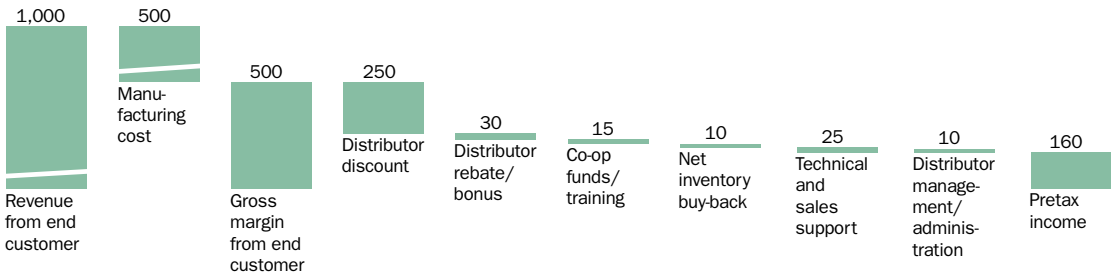
The key is to start with a holistic view of the market in any given geography or segment, and then model the revenue and cost implications of different distribution models for both the company and its distribution partners. Exhibit 1 illustrates a typical outcome of this type of analysis for a company debating whether or not to go direct. While it is clear that there are significant costs in working through third-party distribution, companies must also recognize that they will likely lose sales volume by going direct. In many cases the benefits of working through partners appear to outweigh the costs. The outcome of this analysis is highly dependent on a handful of market-specific factors:

## Exhibit 1 Costs and Benefits of Working Through Distribution

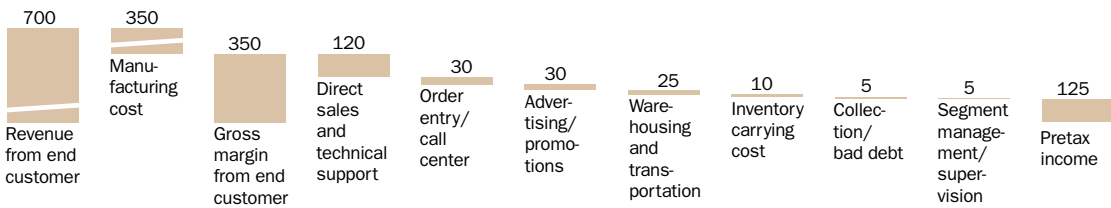
\$ Millions

Composite example

### Selling through distribution



### Selling direct



**Distributor discounts.** The largest, and often least well-tracked, cost of working through distribution is the difference between end-customer price and distributor price. In most industries, this amount will average somewhere between 20 and 30 percent of revenue. Some segments, however, may have over 50 percent margins, while others may have margins in the single digits. It is essential that any company considering changes in its distribution approach take the time to understand this price difference for all relevant segments.

**Rebates and special incentives.** In most industries, rebates and special incentives are less than 5 percent of revenue, but can rise significantly if they are the only means by which a manufacturer influences the behavior of its partners.

**Distributor support.** Promotional allowances, training credits, inventory buy-back programs and other forms of support can often add up to another 2 to 5 percent of revenue. Much of this money is distributed without measuring the resulting

return on the investment. However, since some of these funds are disbursed on a matching basis, there could be a multiplier effect that allows a company to build product awareness and availability at relatively little cost.

**Technical and sales support.** When building a third-party distribution system, many companies underestimate the amount of sales support required to retain shelf space and keep share of mind high at distributors. They may also lose sight of the fact that they will need to provide significant levels of technical support and service to end users, even if a distributor is involved in the sale.

Given all of the costs described above, many companies are tempted to cut out the middleman whenever they can. They have an “I can do anything better than you” attitude, and look to replicate what others do at lower costs. In some cases this approach makes sense, but in many cases it underestimates the unique capabilities of third parties and the high cost of trying to build what the third parties already have.

## Understand the distributor’s business model and competitive advantage in the market

Before taking steps to displace intermediaries or sign on new ones, companies must examine the complete economics involved. To do this well, they should understand how their partners make money and, in particular, ascertain the extent to which the third parties “own the end customer” or have advantaged cost positions. Some factors to assess include:

**Distributors’ success with their business model and the effectiveness of their value proposition.** In order to work most effectively with your channel partners, or to even consider displacing them, it is critical to understand how their business works. Do customers buy from your partners because they carry your products, or because of the after-sales support and service? What margins do the distributors make on your products versus what they make on financing the sale of the

product? Understanding your distributors' business models is critical to making your partners successful or – where it makes sense – successfully assuming their roles.

**Distributors' ability to drive more revenue out of a territory.** In many industries, intermediaries have served a given customer base for several generations. They know where all the potential customers are in a territory and can predict which ones will buy and which will not. In industries ranging from hydraulics to electrical products to heating oil, we have found that intermediaries “own” anywhere from 20 to 50 percent of the shared business. In other words, if the manufacturer drops a distributor and the distributor picks up another line, up to half the volume the manufacturer used to enjoy in that territory may move to a competitor. This degree of distributor ownership typically can be estimated by answering three related questions:

- **How much of the market values objectivity and one-stop shopping?** For some sets of customers nothing is more important than the broad and deep assortment that a distributor can provide. These customers value the fact that the distributor presents an objective picture of the entire supply market, and they do not feel that any single producer can give them the same value.
- **To what extent do the distributors have deep technical knowledge and strong, locally delivered service capabilities?** Manufacturers often overestimate their ability to replicate distributor skills and deliver them in a way that customers will find acceptable (e.g., through on-site representatives, at local distribution counters, during late-night panic attacks).
- **To what extent do the distributors have privileged relationships and special access to customers?** Manufacturers often do not know their end customers. Even if customers do not need one-stop shopping or special local services, it is often a challenge to find end customers' decision makers and convince them to change the way they buy. With careful

transition planning and strong field presence, the degree of loss can be minimized; but companies still need to assess and acknowledge the time and cost involved in trying to displace deep, trust-based relationships.

**Distributors' ability to absorb risk and keep the balance sheet clean.** Two of the biggest obstacles manufacturers face when they attempt to disintermediate the channel are increased inventory and additional credit risk. Few companies fully account for default risk when evaluating the cost of taking over account coverage of smaller customers. Furthermore, they often overreact to the first sign of defaults, instituting costly and cumbersome credit policies, or restricting credit unnecessarily, simply because they have no history with customers.

**The need to replicate sales, order entry, promotion, and warehouse costs.** In many cases, the manufacturer is more efficient than its distribution partners in some parts of the sales and delivery process. However, if the company takes on all of the functions that could be carried out by distributors, its margins shrink. On the other hand, selectively choosing the functions it takes over can result in a win for both the manufacturer and the distributor. The key to finding these opportunities is understanding the distributor's economics – as well as your own – and looking for functions where the distributor's variable/avoided costs are greater than the new costs you take on.

After completing a static look at the economic picture in the delivery chain, it is important to consider dynamic effects as well. Third-party networks help keep product makers lean – an important factor in cyclical businesses. Instead of being stuck with a costly sales and service infrastructure during down periods, costs fluctuate with demand.

Consequently, channel networks that include third parties often have the potential to be more flexible, more effective, and lower cost than a direct model. We have found that the ultimate performance of a mediated channel is highly dependent on the tools a company uses to capture this potential.

### Build a channel model that gets the most out of the third parties in your network

In order to capture the potential advantages of third parties, companies must adopt a new way of managing channel partners that advances their business objectives and market strategies. For several reasons, however, many companies are reluctant to take this step. To begin, they may view the channel as unmanageable or may fear that any change in approach will cause channel partners to look to the company's competitors for alternative sources of supply. And, in extreme cases, manufacturers may be anxious about potential legal action resulting from the termination of a relationship with a distributor. These concerns are sometimes compounded by ineffective talent in top channel management positions. The resulting channel "strategy" can fall short of a company's needs – it may work in static times, but it does little to prepare companies to take advantage of the opportunities and risks brought about by today's changing distribution landscape.

Over the course of our firm's work on 250 channel-related engagements in the last 2 years, we have observed five common characteristics that differentiate those companies who are leading the channel revolution from those who have been overwhelmed by it. To successfully build an effective third-party distribution network, you should:

- 1. Ground channel actions in a deep understanding of what it takes to meet end customers' needs.** Winners start by being explicit about the key drivers of end-customer value. They understand the purchase criteria of customer segments served through distribution, and then use this understanding

to anticipate changes required in the “front end” of their business.

For example, one manufacturer of air conditioners found that some of its independent dealers/installers offered superior post-sale service and support and were able to drive greater satisfaction and repurchase rates than anything directly controlled by the company. Performance, however, varied from one distribution partner to another. Rather than taking a hands-off approach to the channel, or attempting to provide service directly, the manufacturer defined a gold standard of service, and then influenced its channel partners to adopt this approach. The company routed more business to those partners who scored well on customer satisfaction surveys and moved away from those intermediaries who did not have the necessary skills or performance.

**2. Optimize end-to-end economics.** Best-practice channel managers do not let their channel partners control the end-to-end relationship. They typically build a deep understanding of the costs of the major steps involved in serving a given set of customers (e.g., providing design assistance, taking and processing orders, having the inventory and logistics capability needed to deliver within 24 hours of request) and assign those responsibilities accordingly. What they often find is that traditional distributors are very cost-effective at certain steps of the chain, but relatively inefficient at other steps. In some cases, these findings have prompted companies to offer new “direct ship” or “direct order” services for some customers to remove a costly step in the process. In other cases, the findings have led them to introduce a new kind of intermediary into the system (e.g., a consolidated logistics warehouse, or a credit or payment processing specialist) to serve as a support resource for all of the more traditional channel members. This functional “best-in-breed” approach can reduce costs by up to 20 percent, if the manufacturer can convince its traditional partners to shed the no-longer-needed costs.

**3. Set clear goals and engage in joint sales planning.** Changing channel responsibilities midcourse can be traumatic. As such, a more universally applicable – and often less disruptive – step that companies can take to improve performance is to engage more fully in planning with channel partners. Best-practice joint market planning goes well beyond setting overall quotas or volume targets for a distributor. It involves setting clear profit goals and growth objectives by segment, and then committing to actions to achieve those goals. Successful manufacturers are not afraid to ask their partners to gain share in attractive segments or to invest in necessary showrooms or demo equipment. In return, they are willing to listen and respond when third-party partners say they need product modifications or new warranty terms in order to achieve the shared objectives. The key is to reduce the managerial distance between the people directly interacting with the customer and those with the resources to make changes.

An electronic components supplier provides a good example of a company that has embraced a simple, but powerful, performance management model. On a quarterly basis it sets and monitors four goals that convey and make tangible the company's current set of priorities. The goals are as follows: 1) achievement of overall sales targets; 2) achievement of sales in certain target products; 3) achievement of pre-set activity targets (e.g., number of contacts per day or new accounts per sales rep); and 4) achievement of “intangible” targets (e.g., customer follow-ups, prospecting activities).

**4. Align performance and rewards through a range of “carrots and sticks.”** We see very few leaders who still have pure volume-based incentives. More frequently, winners have tiered approaches that vary financial rewards, as well as terms and conditions, based on the desired role and performance of any given intermediary. A few companies have gone to the point of rewarding intermediaries for the roles they play on specific transactions (e.g., getting a product specified or making a sale

## Exhibit 2 Tiered Distribution Structures – Aligning Pay and Support with Desired Activities and Outcomes

### Typical qualifying criteria

#### Products carried

- Full line
- Exclusive
- Complementary products

#### Recent sales performance

- Volume
- Growth
- Share position

#### Actions which reduce channel cost

- EDI/Internet link
- Minimum order sizes

#### Actions which relate to customer needs

- Store hours
- Minimum stock levels
- Certified reps
- Showrooms/configuration assistance
- Customization capability

#### Customer satisfaction

- Survey results

### Types of tiering

#### Good, better, best

Distributors with the best performance are designated “platinum” or “gold” and get the best support and prices

#### Segment- or product-specific qualification

All distributors receive a baseline level of support; some, with unique capabilities, then receive a special package to help them with a target segment or more advanced offering

### Typical benefits of being top tier

- Larger discounts/rebates
- Promotional allowances
- Extra support tools and literature
- Trips/rewards
- Early access to new products
- Disproportionate share of leads/orders or role in national accounts
- More joint sales time
- Voice on Distributor Council

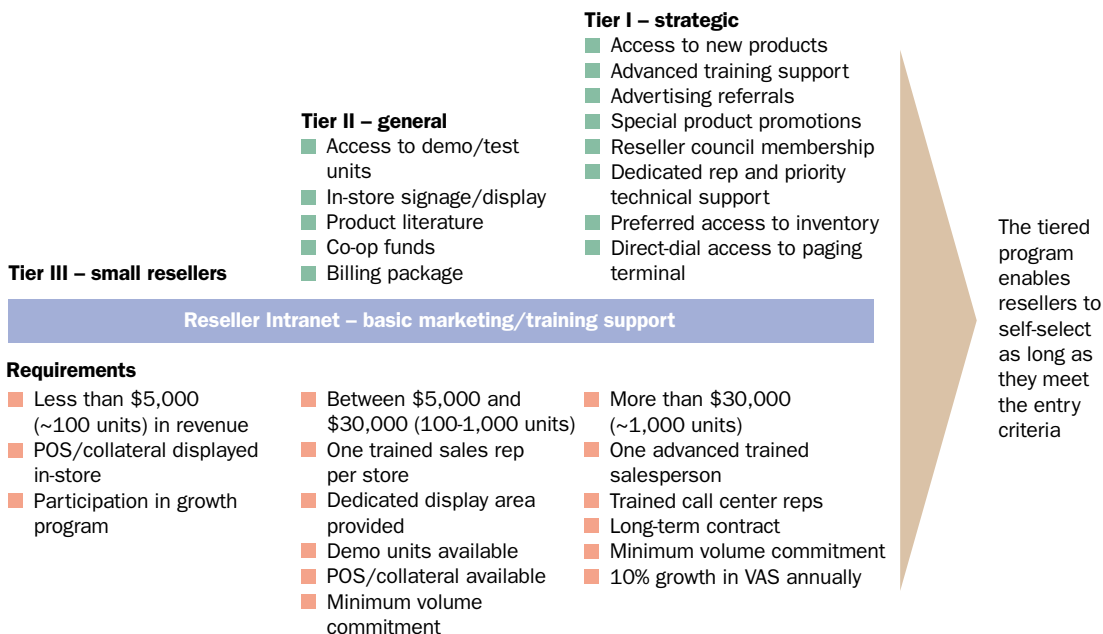
to a high-priority segment). Most companies do not want to be burdened by systems that require transaction-level tracking, so they give extra incentives, support, or discounts to third parties who exhibit the behaviors that tend to lead to success in target areas.

While tiered programs vary from company to company, the goal is always the same – to reward intermediary behavior that creates the most long-term value for a company. At times this is best done by rewarding actions that reduce overall channel cost (e.g., by adopting EDI links or more efficient ordering processes). More often, manufacturers designate third parties as “platinum-” or “gold-level” intermediaries, based on the extent to which they carry out the value proposition that the company intends for the target market (see Exhibit 2). Alignment with the value proposition can be estimated based on the products an intermediary carries, the actions they take to meet customer needs (e.g., training all salespeople on new products, making inventory visible to preferred customers via

the Internet), or superior results on end-customer satisfaction surveys. The intermediaries who take the necessary steps are rewarded with larger discounts, more promotional allowances, better support tools, and a disproportionate share of leads. Over time, this integrated system of expectations and rewards causes more business to be funneled through the best intermediaries, and therefore improves the company’s ability to deliver the value proposition it intends in a cost-effective way (see Exhibit 3).

Best-practice companies use sticks as well as carrots. They utilize a graduated series of tools to intervene when things are not going well. They will narrow the focus of struggling distributors (and reallocate responsibilities to other intermediaries) and/or encourage consolidation of weaker players so they do not always have to resort to outright cancellation – an act that often leads to mutual destruction.

**Exhibit 3 Managing Channel Performance – Paging Provider**



Source: Reseller interviews, company data, McKinsey team analysis

**5. Deliver necessary support tools.** Finally, best-practice companies treat their intermediaries as real business partners. They invest in the channel, and share tools and perspectives that manufacturers are uniquely able to provide. One company we recently worked with developed a pricing system to help its intermediaries optimize their margin and chance of success in different end markets. Another company shared findings on the effectiveness of different kinds of promotional campaigns with its preferred partners, and co-invested in the materials required to implement the best approach in each market. The most universal kind of support is access to the company's best people. Effective distribution managers are experienced coaches who can really help intermediaries improve their businesses.

### Actively manage transitions to the new model

Developing a vision of the ideal end state is often the easy part of channel efforts. The harder part is managing the transition to the new network. One client described it as having to “walk through the valley of death in order to reach the Promised Land.” Any time the roles of third parties are modified, there is a chance that their perceived interests and those of the company will become misaligned. Given all of the changes occurring in distribution, intermediaries are jittery. They are highly sensitive to signals that suggest they do not have a future with a given manufacturer and are quick to jump ship if they believe their future will be more secure if they switch to another source of supply. The keys to success are strong communication; deliberate, fact-based planning that takes into account the economic effects on both manufacturers and intermediaries; and rapid, decisive implementation.

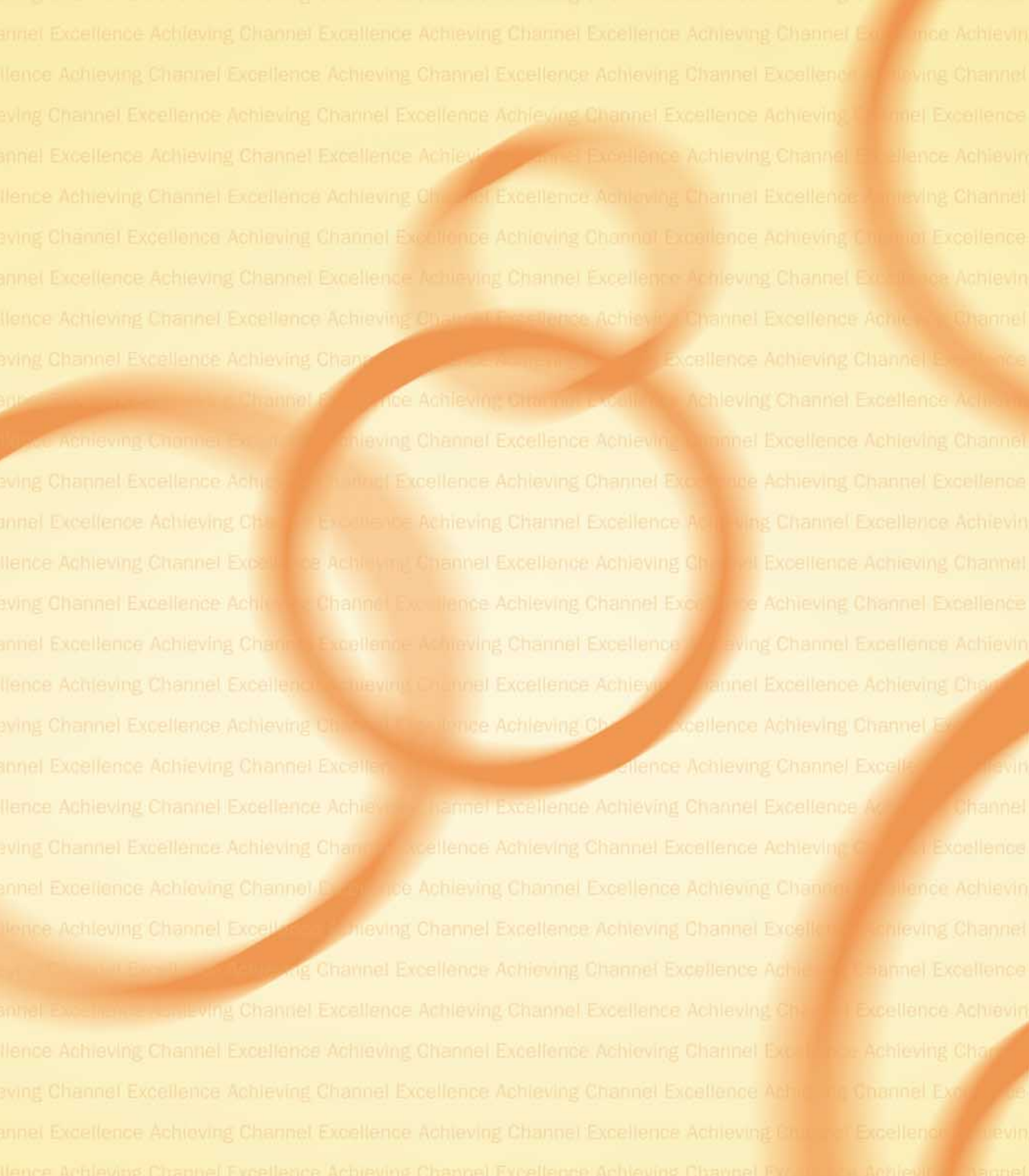
---

As more and more manufacturers migrate to new models for third-party distribution networks, companies that fail to keep pace will find themselves at a competitive disadvantage. The players who succeed will successfully identify the true cost of working with intermediaries, understand the distributor's competitive advantages in the marketplace, implement a model that integrates and optimizes their own strengths and those of their partners, and effectively manage the transition to the new model.

Implementing successful approaches is not easy. It takes time, talent, and hard work, but the rewards can be substantial. We have seen companies increase their sales and profits by double digits by adopting these tactics. Even more importantly, they have built a capability and a network that can serve them well into the future, as the basis for competition in many industries continues to shift from what you produce to how you deliver it.

*– Tanuja Randery is a Consultant in McKinsey's Marketing Practice. Bill Caesar is an Associate Principal in the firm's Atlanta Office. Mike Longman is a Principal in the Cleveland Office.*

For additional information or copies,  
please call (203) 977-6800 or e-mail  
[mckinsey\\_marketing\\_practice@mckinsey.com](mailto:mckinsey_marketing_practice@mckinsey.com)



Marketing Practice  
06.2002  
Designed by Arnold Saks Associates  
Copyright©McKinsey&Company  
<http://marketing.mckinsey.com>