The Customer Trap

How to Avoid the Biggest Mistake in Business

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PART

I

Setting Up for Failure

Thomas Edison could have been talking about the Customer Trap when he observed, "many of life's failures are people who did not realize how close they were when they gave up."

For companies who initially pour all that they have into building great products, services, and brands, nothing is more depressing than watching them fail when it comes to the critical next step. Still, falling into a dysfunctional relationship with a Mega-Customer is not something that just happens, but is an intentional strategy.

CHAPTER

1

The Biggest Business Mistake

When you find yourself in the majority, pause and reflect.

—Mark Twain

Many of the people who lead companies, from huge multinationals to brand-new startups, think that if they can just get their product or service into the hands of a Mega-Customer, all their problems will somehow magically disappear. The thinking goes like this: "If we can make enough sales, profits will rise, business will grow, and we will be unimaginably successful. The trick is to find ever-bigger customers who can buy increasingly larger quantities of what we produce."

One of the most influential developments since the turn of the century has been the rise of large-scale customers across the business spectrum. We call these *Mega-Customers*. The temptation to search out Mega-Customers is almost irresistible. After all, they exist in every sector of the economy. In consumer retail, it is the big boxes: Walmart, The Home Depot, and all the rest. Online it is Amazon.com. AutoNation and Penske Corporation that drive a great deal of the automotive industry in America. Boeing and Airbus dominate aviation, as do AT&T and Verizon in telecom. In flowers it's FTD Companies, Teleflora, and 1-800-Flowers.com. And, of course, at the top sits the US federal government, with the nearly $1 trillion it spends in the private

sector each year. Uncle Sam is the single largest buyer of everything from paper clips to pharmaceuticals, trucks, cell phones, airline tickets, legal services, energy, hotel rooms, medical care, and information technology.

The perceived benefits of selling to a Mega-Customer are compelling, to be sure. Broader exposure to a wider expanse of the marketplace results—it is assumed—in substantial increases in sales. It also promises the chance to streamline customer management; to have only a few customers instead of hundreds or thousands. Both benefits are attractive, particularly in an era of relentless competition and disruption. Who wouldn't want to bring a few Megas on board?

However, this kind of thinking is shallow and dangerous. Ideas and the decisions we make around them have consequences. The risk is that once the decision has been made to go with the Mega-Customer, there is no turning back, as forces beyond the control of the producing firm quickly and inexorably takes over.

We're reminded of one of our former students, Sam. He was the kind of kid who you just knew was going to do well in business. He asked the right questions and was always exploring the best way to do things. His attention to detail was astounding. During college, Sam ran a pretty successful landscaping / snow removal company. He had two trucks, eight employees, and around 200 residential and commercial customers. Business was good and growing at a steady, sustainable pace. After he graduated, Sam continued to add crews each year, along with more and more customers. He made it through the Great Recession and even picked up accounts from competitors who couldn't survive. He was celebrated by the local media and named an emerging business leader. Eventually Sam's firm was one of the fastest growing landscaping companies in the region. He was well on his way.

One day Sam called one of this book's authors, Andrew, and said he was facing a tough decision. The biggest bank in the region had sent out a request for bid to handle the mowing, planting, landscape maintenance, and snow removal for its nearly 100 branches and offices. It was an 18-month contract. Sam said getting the contract would likely double his overall business, and he wanted to know if he should submit a bid. Andrew told him to be careful, and to not allow the bank to swallow up what had become a successful business. Dishearteningly, what Sam was really looking for was validation. He had already made up his mind to chase the big whale.

Not surprisingly, given his reputation in the marketplace, Sam won the bid. The bank instantly became 50 percent of his entire revenue stream, which meant that he had to immediately lease more equipment and trucks, and he had to hire a lot more people. Money flowed in, and money flowed out. Inevitably, internal resources—most important, Sam's famous attention to detail—were steered away from his original client base and toward the new

Mega-Customer. Service to the "originals" suffered, and many left. Still, it was, overall, a winning proposition. For the next year and a half, Sam was well on his way to becoming a very young millionaire. He bought a new home in a high-end neighborhood, a new Porsche Cayenne, and a new boat.

And then, 18 months later, the bank did what the bank had always done: it issued a new request for bid. Sam assumed that since he had performed so well for them, his contract would automatically be renewed. He was shocked, however, when he learned that the new bid asked for a price 20 percent less than the one Sam had negotiated 18 months earlier. That 20 percent was his margin!

Not without dismay, Sam "sharpened his pencil" and submitted a new bid, knowing that he was going to have to dramatically cut costs to stay ahead. He won the contract again, but he had to pay his employees less. Many of the best people left and went to work for his competitors. Service further suffered. More original customers departed. In 2011, fuel prices spiked, further hurting Sam's business.

By the end of the second 18-month contract, Sam was struggling to make payroll and the lease payments on his equipment. (He also quietly sold the new home, the Porsche, and the boat.) Needless to say, Sam didn't submit a third bid when the bank announced it was looking for a new supplier once again.

With the weight of the Mega-Customer off his back, Sam believed that he could start over with a wide base of residential and commercial customers. The problem was that his brand had become tarnished over the past three years. Word-of-mouth had spread about the poor service that Sam's business was now providing. Most of his old customers had moved on: snow, rain, and sunshine were not waiting for Sam to figure things out. There were driveways to clear and grass to shorten, and somebody else would be doing it. Sam is now selling cars at a local dealership.

It's a Common Story

Before you think this is merely the story of a young kid who did not know the ways of the world, we would like to remind you that similar cases over the past few decades have played out tens of thousands of times inside companies that were exponentially bigger than Sam's. What's more, they had experienced leaders who should have known better.

Let's look at another story, this time from a nationally recognized company that also fell into the Customer Trap. You might remember David Oreck, the founder of the vacuum cleaner company that bears his name. Television commercials featuring Mr. Oreck with a bowling ball over his head being held in place by one of his vacuum cleaners became cult favorites.

For 40 years his company was the kind of example that business students and emerging entrepreneurs were taught to emulate: the innovative, domestic manufacturer—supported by a direct sales strategy—that kept control of its products and brands.

We even once met Mr. Oreck when he spoke at our university. He was rightfully proud of what he had spent a lifetime to build. Hardworking Americans were paid a good day's wage making his products in Louisiana and Tennessee. He shunned the big-box stores at every turn—even calling Walmart "China Mart."

Exclusive franchises and corporate-owned stores kept the brand equity high. They sold only Oreck products. They were, along with the company's web site and call centers, the only places where somebody could buy an Oreck product. Many models cost over $1,000 and carried a 25-year warranty—something unheard of anywhere else in the household goods industry. The business grew. The brand got stronger. Franchisees and consumers were true believers, and the product attained an almost mystical status.

And, then, Mr. Oreck decided to sell the company. He sold it in 2003 to American Securities Capital Partners, a private-equity firm that proceeded to suck the life out of the business and left others "holding a big, ol' dusty bag full of debt."[1] The private-equity geniuses proceeded to wreck the company almost overnight by deciding to sell through Target. The exclusive franchisees, many of them loyal for more than 30 years, were pushed aside in favor of the new, bigger-volume Mega-Customer. The solid customer relationships Mr. Oreck had built over decades were immediately cannibalized. No one would pay $1,000 anymore for a vacuum cleaner that was now sold like a bag of bricks or any other commodity at a big-box retailer. The brand was ruined. The Oreck fanatics were thrown aside, sacrificed at the altar of big volume.

Remarkably, as the company predictably fell into bankruptcy, the new leaders of the firm had the chutzpah to blame the company's demise on not selling out to the big boxes fast enough. They said the transition in how they sold and distributed vacuum cleaners—by selling through large retailers instead of directly to customers—took longer than expected.[2] So, if we follow the logic here, the company was ruined because they couldn't destroy it fast enough.

You can't make this stuff up.

[1] Al Lewis, "Sucking a Business Dry," *The Wall Street Journal*, May 18, 2013, p. 2.
[2] Katy Stech, "Oreck Family Left in the Dust," *The Wall Street Journal*, July 9, 2013, p. B.4.

So What, Exactly, Is a Mega-Customer?

Simply put, a *Mega-Customer* is a customer that accounts for more than 10 percent of the total amount of sales. Why 10 percent? Is this some arbitrary number? Where does it come from?

Part of the explanation is intuitive. Putting a lot of eggs in one—or even a few—baskets can prove wonderful so long as those big customers stay profitable and loyal. However, change in business, as in life, is inevitable. The minute big customers change their minds, leave, or threaten to do so unless dramatic concessions are met, catastrophic situations can arise. Most of us would remember if we had a major account that announced it was taking its business somewhere else unless it got a dramatic price reduction. Such moments can cause grave harm, or even threaten the entire future of a company.

A more substantive reason for not exceeding 10 percent comes from the practice of managerial accounting. In 1974, the Financial Accounting Standards Board (FASB) established financial accounting standards for financial reporting by nongovernmental organizations. These standards are recognized as authoritative by the American institute of Certified Public Accountants and that Securities and Exchange Commission (SEC).[3]

The FASB has codified the language of accounting in its Statement[s] of Financial Accounting Standards (SFAS). These formal documents detail standards and guidance on selected accounting policies. The FASB issues these standards with the expectation that all reporting companies listed on US stock exchanges will adhere to them. Such standards are created to ensure a higher level of corporate transparency. In other words, this is all designed to provide outsiders a better look at what is going on inside a publicly traded company.

For our purposes, we are interested in SFAS 131:

> An enterprise shall provide information about the extent of its reliance on its major customers. If revenues from transactions with a single external customer amount *to 10 percent or more* of an enterprise's revenues, the enterprise shall disclose that fact, the total amount of revenues from each such customer, and the identity of the segment or segments reporting the revenues.[4]

In layperson speak, this means that under the accepted financial accounting standards of the United States, a publicly traded company must disclose if a customer is more than 10 percent of its total sales. Why? Because according to the accepted standards, a customer that represents more than 10 percent of total sales is a potential risk to the firm that outsiders should be made aware of.

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[3]Financial Accounting Standards Board, "Facts About FASB," www.fasb.org/jsp/FASB/Page/LandingPage&cid=1175805317407, accessed July 22, 2014.
[4]Financial Accounting Standards Board, "Statement of Financial Accounting Standards No. 131," www.fasb.org/resources/ccurl/699/632/fas131.pdf, accessed October 10, 2014.

The 10 Percent Rule

So why would the accountants come up with 10 percent as the benchmark for disclosure? We believe that it is because the 10 Percent Rule just makes sense.

As the Greek philosopher Heraclitus rightly put it, "Nothing endures but change." Customers come—and they go. For example, if a company has ten customers, and they are each about 10 percent of the total sales, and one or two of them fall away, the company will most likely survive. It might be tough sailing for a while. Nevertheless, replacing the two lost customers and their 20 percent of revenue is by no means impossible.

But what about a company that has ten customers, nine of which are 60 percent of the business, plus one—a Mega-Customer—that is responsible for 40 percent of all its revenue? What happens to that company when the Mega-Customer makes unrealistic demands, gets sold, goes out of business, or something else occurs? Replacing 40 percent of sales is a tough proposition, even on a good day. And what about a customer that is more than 40 percent of the business?

The same can be true if a significant portion of a company's revenue is connected to one industry. For example, how many companies were nearly wiped out when their customers in the travel and tourism sector were crippled after the September 11 attacks? In short, overdependency on one Mega-Customer, or one industry, can be devastating.

Something else regularly happens when a company violates the 10 Percent Rule: the Mega-Customer starts to tamper with the supplier's operations, ultimately forcing the supplier to accept and do things that would not have otherwise been considered. Of course, these activities are all designed to increase the profitability of the Mega-Customer, frequently at the expense of the supplier. A few common examples include the following:

- Changing payment terms. ("Now that we are so important to you, we are going to take more time to pay you.")
- Requiring suppliers to buy, learn, and use completely new information technology systems. ("Your systems are OK, yet to do business with us, you need to invest in a new system, bought through our own provider.")
- Charging for every little thing. ("Your truck was 10 minutes late; we will charge you X. We didn't sell all of the inventory we ordered, so we are charging you Y to have you move it out of our warehouse.")

- Providing access to the innovator's formulas and trade secrets. This is usually done under the guise of "quality assurance." And, of course, once that knowledge gets out, it doesn't go back into the tube.
- Holding hostage vital information about how the product or service takes its path to market. ("Since we are the customer, we have the right to not share information about your product with you.")

At the core of the Customer Trap is the promise of incredible wealth. Every supplier who gets a product or service accepted by the dominant player in their industry gets rich, right? Nothing could be further from the truth. The trap is sprung when Fortune 500 companies—or mom-and-pop stores—make the conscious decision to seek out a relationship with a Mega-Customer.

By the time the supplier figures out that a new reality is taking over, it has already entered the Customer Trap. The outcomes are predictable and heartbreaking. Product life cycles are dramatically reduced, turning hard-fought innovations into commodities. Long-standing brands and whole sectors are wiped out and become a shell of their former selves. Domestic operations are shuttered in favor of the low-cost advantages of outsourcing and offshoring. And despite strenuous efforts to continually reduce costs, profits cannot be found.

But It's Not the Mega-Customer's Fault!

Before we go any further, and you think this is merely another book pointing a finger at the giant retailors of the world for the ills they bring to local communities, let us be clear: we do not blame Megas for the problem of the Customer Trap and what it leads to. We believe that the true responsibility for a company's products and services lies with that same company. Nobody at FTD, Walmart, Amazon, the federal government, or any other potential Mega-Customer forces a supplier to come knocking on its door.

Whether it is out of naïveté, arrogance, or greed, companies that expect a Mega-Customer to treat them kindly—and to respect their brands, products, and services—are tragically misguided. What business leaders do not know, what they forget, or what they ignore, is that a strategy based on pursuing the Mega-Customer is inherently flawed.

And, yet, this is exactly what has happened repeatedly during the past decades. The shift occurred when marketing began to adopt the objectives of supply-chain management, where scale and efficiency dominate. While producers focused on perfecting their internal capabilities, Mega-Customers, operating under the radar of most business-school professors, management consultants,

and the business press, came to dominate every sector of the economy. The message to producers was clear: "Your job is to be 'lean' and 'efficient' and—at the same time—continuously deliver 'customer value' to the marketplace."

On the production and operations side, Six Sigma and other industry certifications are undoubtedly critical components of efficiency that need to be part of a company's DNA. But what about the customer side of the enterprise? This is where the delusion enters in. For example, how many companies believe that outsourcing a customer call center to India, in the name of efficiency and lower costs, is a good idea? We already know the answer.

Let's use Walmart as an example. It has around 125,000 suppliers. Because of its size, the retailer is the largest customer for the vast majority of these vendors. In the lexicon of efficiency, it makes sense to deal with just one customer like Walmart. Still, ask most of those suppliers how their profits stack up next to Walmart, year after year, and you'll likely hear anything but nice words.

Walmart's inevitable price cuts force manufacturers to lower costs, which may mean sending production offshore to China, designing quality *out* of a product, limiting research and development (R&D), and outsourcing service and repair. The result is the erosion of value for the consumer, as cost-cutting measures forced upon the producer by the Mega diminish the very attributes that attracted buyers to the product in the first place. It is difficult to make a lasting compromise between efficiency and value, because the quest for greater efficiency is by far the more powerful force and continually encroaches on customer value through repeated compromises.

Here's an example: Jones Soda used to be a hip, niche producer whose initial sales and distribution strategy was built around selling through unique complementors including tattoo parlors and snowboarding shops. The company had a small sales force that sought to grow the brand through its unique distribution channel. It was a solid model: an innovative manufacturer selling through loyal distributors, and eventually to Panera Bread and Barnes & Noble.

Then the CEO at the time got a brilliant idea: to expand sales and distribution further by selling through Target and other Mega-Customers. It was a tipping point, if you will. Sales volume surged, but profits evaporated. The company hemorrhaged money and has never really earned a profit since. Fast-forward to today: the stock is stuck at around 35 cents a share.[5] Another CEO is brought in. What is the new strategy? To sell in 3,600 Walmart stores, so as to increase sales volume. Wow.

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[5]On December 27, 2014, the company's share value was 0.34. It peaked in April 2008 at around $28.22 per share, just prior to the deal with Target.

Who Is Responsible?

To be fair, business leaders who drank the elixir of the Mega-Customer were players in a drama that began in the United States in the 1980s and has since spread around the world. Innovative companies and the people who led them were responding to what management theorists were saying at the time. These business gurus talked about organizational transformation—emphasizing core competencies, resources, capabilities, innovation, technology, and operational effectiveness. Methodologies such as total quality management, lean manufacturing, and Six Sigma were just some of the solutions preached by the business elites to companies of all sizes.

The Megas are both the by-products and the cause of a contagion that has spread across American business and is now being exported to the rest of the world. Beginning in the early 1980s, US manufacturers and service providers moved aggressively away from vertical integration and began to outsource many of their business activities. The concept of *core competence*, which is a mainstay of management education, was given as the primary rationale for jettisoning sales and distribution.

The idea was that the leaders of an organization should identify those areas where they excelled—where they brought true value to the marketplace—and dump everything else. Why manage a string of small customers, dealers, or franchisees when your core competency—your basis of differentiation—is in R&D, innovation, or manufacturing? Taking this advice, companies divested themselves of activities that were not perceived as value-added, and they pushed sales and distribution aside. Thousands of businesses that had previously been in control of all aspects of their innovative development began to lose interest in sales and distribution, preferring instead that specialists take over this "business function." Ironically, this created a marketplace vacuum that the Megas rapidly filled. Soon, the very companies that had taken over these noncore activities began to exert control at the core level, highjacking the strategic direction of the producing companies that had given them life in the first place. This, combined with a rash of international mergers and acquisitions, takeovers, and consolidations in the early 2000s, fueled the evolution of massive distributors in every industry, which became the driving force behind the sales and distribution of innovative products and services in the United States and around the world.

Today, most products and services are controlled by entities other than the ones that created these products and services. We find that, overwhelmingly, the ability of companies to get their innovations into the hands of consumers is blocked, thwarted, and controlled by Mega-Customers. Manufacturers do not even have control over the prices they can charge. This is evidenced by mandates from Mega-Customers who, year after year, impose price reductions while insisting that their suppliers maintain high standards of quality. This is the Customer Trap in action.

Still, in the end, the responsibility and, ultimately, the accountability for the rise of Mega-Customers sits squarely on the shoulders of those executives who decided to outsource their sales and distribution to the Megas in the first place. It was their call and their decision. It is critical to understand that when we talk about responsibility and accountability, it is individuals who must be held to account, not intangible things like corporations.

For every important responsibility, such as developing a sales and distribution strategy, there is accountability. It is the obligation of each person to answer for the discharge of responsibilities that affect others. Accountability includes being responsible for intentions as well as results. Whenever someone has an important obligation, they must answer to stakeholders for their decisions. What we find far too often is that executives, who at one time bought into the temptation of doing business with a Mega-Customer and now realize that they are caught in the Customer Trap, engage in the blame game. They say things like, "Well, we didn't know that this was going to happen to us." Or, "We didn't think that this was going to be the end result."

But, as your parents used to say, those you associate with define you. If you decide to travel to Bentonville, for example, and sit across the table from Walmart's buyers, and you then allow Walmart or any other Mega-Customer into your company, you have to fully accept the consequences of that action.

Mega-Customers are everywhere. They do not lie about who they are. Contrary to the conventional wisdom—and as we make clear in this book—they are not the only option. And they are most certainly not the best one. Doing business with Mega-Customers is not inevitable, nor a fait accompli. It is only when companies decide to search out and do business with a Mega-Customer that the Customer Trap becomes a reality. To provide you a clearer understanding of this all-too-common business mistake, we'll spend the next four chapters laying it out. A warning: this is not for the faint of heart.

CHAPTER

2

The Customer Trap and Brand Destruction

Nobody ever did, or ever will, escape the consequences of his choices.

—Alfred A. Montapert

The Customer Trap can lead to the destruction of many vital parts of a business. The power that a Mega-Customer is able to wield simply overwhelms the strategic toolkit of its supplier. As the Mega-Customer gains leverage, the producing firm loses control over its destiny and is soon nothing more than a colony serving the needs and wants of its colonial master. Once this happens, it is almost impossible to regain control. This is probably nowhere more easily seen than in the area of branding. The scope and magnitude of a deal with a Mega-Customer can quickly erode the brand equity of individual products and services. Ultimately, it will ruin the overall brand image of a company.

Whether your company is a small manufacturer, local retailer, or a Fortune 500 conglomerate, the quality and resonance of your brands is imperative.

What is a *brand*? It is an intangible set of perceptions that represents the essence of a company and the products and services it offers. This is supported by the rational, functional, and emotional attributes those products and services stand for. And, as the saying goes, "Perception often is reality."

The moment Oreck placed its products alongside the cheap, Chinese-made vacuums stacked against the nondescript walls of Target stores, for example, perceptions about the brand were incontrovertibly altered. Consumers now think about the brand in a fundamentally different way; the premium luster has been tarnished. Oreck is damaged goods.

The same is true when businesses such as restaurants, spas, dance studios, dermatologists, and automotive repair shops offer deals through Groupon, LivingSocial, Amazon Local, and similar web sites. These intermediaries can quickly become Mega-Customers to the providers. Producers are too easily persuaded that any losses incurred by lowering their prices will be more than offset by gains in sales volume. And rather than having to build relationships and market to a wide variety of clients (something that is both time-consuming and expensive), the Mega-Customer will take care of it for them.

The thinking goes like this: "We might be giving a spa treatment for 30 percent less through our Groupon special, but think of how many more spa treatments we'll be able to sell. And we won't have to worry about advertising and marketing because Groupon is doing that for us!"

This back-of-the-envelope approach to business strategy is more than dangerous. It fails to take into account the other costs associated with discounting through a Mega-Customer. An unintended but real consequence is the diminution of the brand. Once consumers see the brand associated with these kinds of deals, they will wait until the next round of deals are offered before considering a purchase. This puts the service provider into a downward spiral of constantly having to offer better deals in order to meet or beat their competitors, who are themselves selling through the Mega-Customer. These kinds of sites do not offer exclusivity. Instead, they pit producers directly against one another. Moreover, consumers will not develop loyalty to the service provider, but instead to the intermediary. Customer loyalty becomes based on the deal of the day, rather than the value provided by the product or service.

In this chapter, we'll take an in-depth look at two long-standing brands that have been effectively ruined by the Customer Trap. The harm caused to both Levi Strauss & Co. and Goodyear at the hands of their Mega-Customers provides an object lesson in the dangers of seeking to maximize volume at all other costs.

Levi Strauss Gives It Away

If there was ever such a thing as an iconic American brand, it was Levi Strauss & Co. Their jeans, ubiquitous for more than a century, were at the very center of American culture. Cowboys and aspiring cowboys strapped oversized belt buckles to their Levi's in rural Wyoming; hippies and their cultural progeny

put on prefaded versions; and almost everyone in between wore the jeans in some fashion. Levi's were the stuff of legend. James Dean wore them in *Rebel Without a Cause*. They even played a role in the Cold War. *Time* magazine reported in 1962 that bureaucrats in the former Soviet Union opposed their corrupting influence. "There is even a blue-jean fad to the anger of militant party stalwarts, who note acidly the blue denim must have been smuggled in from abroad since it is not even manufactured in the Soviet Union."[1] Smuggling jeans into Russia during the dark days of communism financed many European adventures for young Americans.

Levi Strauss is named after its founder, who created the rugged jeans for the miners of the California Gold Rush of the 1850s. Strauss hired a tailor to make pants out of the brown canvas he had carried across the country to San Francisco. After he ran out of material, he was able to source a new supply from the town of Nimes, France. This material, known there as *serge de Nimes*, was anglicized into the simpler word "denim." Strauss colored the fabric blue, and then he and his successors scrambled for a century to keep up with sales. The company had revenues of $2.4 million in 1880. Innovations such as fastening seams with rivets and branding (the kind involved with a hot iron) with numbers—the first was the now famous 501—followed.

During the first half of the 20th century, the firm struggled against both adversarial economic conditions and a lack of visionary leadership. Nonetheless, circumstances helped the company to break out of its regional market. Visits to western dude ranches by easterners during the 1930s, coupled with the appearance of blue jeans in hundreds of Hollywood westerns, created a mystique around this unique product.

During World War II, the US government declared Levi's to be essential to the war effort and made them exclusively available to defense workers. Pent-up consumer demand after the war created an ongoing product shortage. With only five factories, Levi Strauss was forced to implement a distribution program that favored the intermediaries and retailers that it had worked with during the preceding decades. In 1948, company profits were more than $1 million on the sale of 4 million pairs of jeans.

In the 1950s, noticing that America was in the midst of a baby boom, the company shifted its attention in the direction of the youth market, emphasizing that its pants were for play, not just work. The firm's sales force became national in scope, focusing more on urban than rural stores. New innovations followed, including zippers instead of the five-button fly, preshrunk denim jeans, stretch denim, corduroys, and permanent press. The firm grew at an

[1]Time, "Russia: The Liberal Life," http://content.time.com/time/magazine/article/0,9171,829038,00.html, February 16, 1962.

outstanding pace. From 1963 to 1966, sales doubled to $152 million. In 1968, Levi Strauss had sales of $200 million. It had become the sixth-largest clothing producer in the United States. Still, it was unable to keep up with demand. Despite domestic and international challenges in the 1970s, sales topped $1 billion in 1974 and then doubled four years later.

In the early 1980s, the demand for denim jeans slowed, prompting Levi Strauss to make its initial foray into the mass market. Deals were struck with Mega-Customers J.C. Penney and Sears. However, earnings dropped by 25 percent, and in 1982 the company shuttered nine plants and eliminated 2,000 jobs. Despite beefed-up advertising alliances with the high-end fashion market, and an Olympic tie-in in 1984, profits were down 50 percent by the middle of the decade.

Still, Levi Strauss was able to dig itself out of the hole through the introduction of new products, including Dockers and stonewashed jeans. Sales and distribution in the 1990s was extended to upscale stores like Macy's, as well as company-operated, stand-alone Dockers and Levi's stores. By 1996, the firm was debt free, had robust operations across Europe, was expanding into emerging markets such as India and China, and produced strong earnings.[2]

And, then, seemingly almost overnight, everything changed. In an SEC filing in 2000, the company outlined its precarious financial condition. A mere four years earlier, it had been on a solid footing with strong profits and a sustainable business model in place. In just that short time, however, the company closed 29 plants, eliminated 18,500 jobs, and watched profits shrink from $411.5 million in 1997 to just $5.5 million by 1999.

The root of the Levi Strauss implosion was attributed to a massive accumulation of debt incurred in 1985, when it went private in a leveraged buyout. Things were further complicated by the derailment of a highly touted employee incentive plan that was introduced during the peak year of 1996. The idea was to reward employees with a one-time bonus that would be equal to one-year's pay. The cost was $750 million.[3]

Compounding the company's difficulties was the altered competitive landscape. Levi's products were positioned above low-end alternatives sold by Sears and J.C. Penney. Yet they were below newer upscale brands produced by Calvin Klein and Tommy Hilfiger. Describing the conundrum facing Levi's, Peter Sealey, a former Coca-Cola executive and instructor at the University

[2]Funding Universe, "Levi Strauss & Co.," www.fundinguniverse.com/company-histories/levi-strauss-co-history/, March 4, 2015.
[3]Andrea Orr, "Levi Must Work Out of Tight Fit: Wal-Mart Deal May End Slide in Revenues," *Houston Chronicle*, September 18, 2003, p. 4.

of California, Berkeley, told the *Los Angeles Times*, "They've allowed the brand image to become something that's not relevant anymore. The worst thing you can do is to get caught in the middle."[4]

A 2003 article in the *Houston Chronicle* said of Levi Strauss, "Revenues have been falling for the last six years, and pressure is mounting for the company to produce results or risk becoming a statistic in another American institution—bankruptcy."[5] David Bergen, Levi's vice president, stated that the company was caught "in the jaws of death."[6] Finally, that same year, Levi Strauss relented and made a deal with Walmart. After years of resisting, the company felt as if it had no other choice but to throw its lot in with the giant retailer. The potential upside, of course, was the increase in volume that was sure to follow. Kurt Barnard, publisher of the *Retail Forecasting* newsletter, said,

> The company has been in grave, grave danger for five or six years, and they finally did the one thing—which, I believe, spells survival. That was the deal with Walmart. . . . Where else do you get access to 100 million new customers? The exposure is absolutely unparalleled.[7]

Harry Bernard, an executive at the retail-consulting firm Colton Bernard, summed it up, "They'll get the volume they need to survive."[8] Levi's launched its Signature line of jeans at Walmart on July 22, 2003, and by December jeans were also placed in Target stores. The Signature line did not have Levi's traditional insignias—the distinctive Red Tab, Two Horse leather patch, or stitching on the pocket. The jeans retailed for $23 with a rollback price of around $19.50.[9]

Given that the average off-brand price of jeans at Walmart was around $15, the Signature line was a premium product for the discount market segment. Levi Strauss hoped that the scaled-down product, along with the absence of the Red Tab, would adequately differentiate Signature from Levi's core products. Levi president and chief executive officer Phil Marineau acknowledged the concern of the company's traditional retail customers when he said that they were "worried about cannibalization of Levi's core product, particularly from Signature" and, as a result, was "managing Levi's and Dockers' orders and inventory very conservatively."[10]

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[4]Greg Johnson, "Troubles at Levi Strauss Revealed in SEC Filing," *Los Angeles Times*, May 5, 2000, p. C-1.
[5]Orr, "Levi Must Work Out of Tight Fit."
[6]Kim Girard, "Supply Chain Parnerships: How Levi's Got Its Jeans into Wal-Mart," *CIO*, www.cio.com/article/2439956/supply-chain-management/supply-chain-partnerships--how-levi-s-got-its-jeans-into-wal-mart.html, July 15, 2003.
[7]Orr, "Levi Must Work Out of Tight Fit."
[8]Girard, "Supply Chain Partnerships."
[9]Katherine Bowersne, "Levi's Hits Mass," *Women's Wear Daily*, December 9, 2003, p. 17.
[10]Ibid.

Levi Strauss & Co. completely reengineered its supply chain to fulfill the needs of Walmart. The company was forced to adopt sophisticated forecasting and product-tracking technologies. Using a "dashboard" that sits on the desks of executives, managers could track a specific product from the factory, to the distribution center, to the individual store. Said one Levi's executive, "When I first got here, I didn't see anything. . . . Now I can drill down to the product level."[11] Levi Strauss also expanded its distribution, adding three "pool points" that facilitated product dispersal to Walmart distribution centers and super-centers. In addition, the firm implemented technology to facilitate electronic data interchange, as well as other collaborative communication software. A cross-functional team was put together to ensure that those logistics efforts worked properly.

Levi's presence at Walmart gave a big boost to the Mega's efforts to bring name brands into the store. "They do like the name," said consultant Walter Loeb.[12] "They like to be able to say they carry the Levi's brand because it gives credibility to their business."[13] Still, Levi's Signature brand had a sluggish start. Walmart complained that the inventory turn was slower than anticipated. After three months, the disgruntled Mega slashed the price of men's jeans from $23 to $19.[14]

In 2003, Signature represented 8 percent of all Levi's sales in the United States and 6 percent worldwide. In 2004 it jumped to 14.5 percent and 9.7 percent. Walmart executives were pleased with the results. Levi's, now positioned as a mass-market premium brand, represented the high end of the retailer's denim offerings. Walmart also sold Wrangler jeans for $15–$18, and its own private-label jeans for $9.99. The Levi's cachet helped to pull people into the stacks of denim produced by the three different companies.[15] By 2006, it was Dockers, not Signature, that was the bright spot for Levi Strauss & Co. This was ironic, given previous attempts to jettison this line.[16]

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[11]Ibid.

[12]E. Clark, "Changing Retail Market: Vendors Eye Discounters to Bolster Bottom Line," *Women's Wear Daily*, March 16, 2005, p. 1–10.

[13]"Fitting In: In Bow to Retailers' New Clout, Levi Strauss Makes Alterations," *Wall Street Journal*, June 17, 2004, p. A-1.

[14]Sally Beatty, "At Levi Strauss Trouble Comes from all Angles," *The Wall Street Journal*, October 10, 2003, p. B1.

[15]Ray A. Smith, "At Levi Strauss, Dockers Are In: Rise in Sales Is Bright Spot, as Company Tries to Mend Its Jeans," *The Wall Street Journal*, February 14, 2007, p. A.14.

[16]SEC filing, "Form 10-K," 2006, p. 14.

At the beginning of 2006, Walmart decided to use shelf space in its apparel section for its own proprietary brands. Never mind that Levi's had to reconfigure its entire supply chain to create a new brand for Walmart. Levi's 2006 filing with the SEC stated the following:

> Our ability to maintain retail floor space, market share, and sales in these channels depends on our ability to offer differentiated and exclusive products and to increase retailer profitability on our products, which could have an adverse impact on our margins. In addition, recent efforts by mass channel retailers in the United States to expand their private label offerings may reduce floor space devoted to our Levi Strauss Signature products, which can have an adverse impact on our sales. For example, we experienced such impacts in 2006 as a result of actions taken by Walmart to increase its private-label women's business.[17]

The Signature brand was not doing well. The company stopped selling the products in Europe because of the insufficiency of mass-market channels. The 2007 Annual Financial Report of Levi Strauss stated:

> The Signature brand by Levi Strauss and Company had a difficult year, as expected. The brand is being overhauled to align with our mass retail customer's evolving apparel merchandising strategies. The plans we have developed with them will give the brand a fresh look and a new presence at retail for fall 2008.[18]

Third-quarter results for 2008 were revealing: "Higher net revenues reflected growth in each of the company's three regions. The increase in net revenues was primarily driven by currency, the addition of brand-dedicated retail stores worldwide, and sales growth at existing stores."[19] In their corporate filing for 2009, Levi Strauss stated that it might not be able to increase sales for the mass market because of private-label competition and because, in the mass-market channel, there was a reduction "in fixture spaces and purchases of brands that do not meet their mass-market requirements."[20] Ironically, it had been the mass market that was supposed to save the company. During the years that ensued, the situation only got worse. The 2013 annual report

[17]Levi Strauss & Co., "2007 Annual Report."
[18]Levi Strauss & Co., "Levi Strauss & Co. Announces Third-Quarter 2008 Financial Results (press release)," 2008.
[19]SEC filing, "Form 10-K," 2009, p. 12.
[20]Michael Appel, "Levi Strauss Signature: The Birth or Demise of a Brand?" *Retail Merchandiser* 44, no. 5 (2004), p. 58.

noted that its Signature brand, along with the newer Denizen brand, which was introduced into Target stores in 2011, accounted for less than 4 percent of net sales. An article in *The Irish Times* summarized the strategic miscalculation that tipped Levi Strauss off its perch:

> Up until the mid-1990s Levi's jeans were seen as an essential fashion item. But then the industry underwent a seismic shift, as denim came to be seen as a luxury item with brands such as 7 for All Mankind and True Religion selling their jeans for up to six times what a pair of Levi's cost and distributing them through luxury boutiques and department stores. Instead of jumping on the bandwagon, Levi's failed to respond to changing consumer tastes and suffered. It clung firmly to its position as a midprice manufacturer, despite the fact that the denim business was becoming polarized between the luxury and the discount end. In fact, Levi's did not introduce its own premium denim line—Capital E—until 2006, long after the luxury trend had first emerged.

Chip Bergh, who became CEO in 2011, had this to say about the predicament of Levi Strauss:

> We are working to make Levi Strauss & Co. (LS&Co.) great, again. Our aspiration is to be and be seen as the world's best apparel company and one of the best-performing companies in any industry. It's an ambitious goal, but it wasn't too long ago that this company held that spot, and I believe we can reclaim it.[21]

Mega-Customers often demonstrate a phenomenal ability to dominate businesses and transform entire industries. Unfortunately, this domination and transformation has left many of America's producers in subservient positions, weakened relative to large-scale Mega-Customers. Like Levi Strauss, the story of Goodyear illustrates the diminishing aura of once-dominant brands, overwhelmed as they are by the shadows cast by Mega-Customers in so many sectors of the economy.

Goodyear: The Rubber Hits the Parking Lot

Perhaps no other company is as emblematic of American industrial might as the Goodyear Tire & Rubber Company. With ubiquitous dealerships, highly visible blimps, and widely respected products and brands, Goodyear dominated the tire market for most of the 20th century. It is difficult to fathom that this icon of American manufacturing has been undone in recent years

[21]Levi Strauss & Co., "2013 Annual Report: Forging the Path of Progress," p. 3.

by its negligent embrace of the Megas—a negligence including the rejection of decades of carefully nurturing, maintaining, and expanding one of the most successful dealer networks in American business history.

The Goodyear Tire & Rubber Company, *the* pioneer US tire company and the industry leader for nearly 100 years, pushed itself into the hands of the Mega-Customers in the mid-1990s. For years, the firm cautiously managed an extensive and effective sales network, consisting of more than 5,000 authorized dealers. Then, in the mid-1990s, as part of a reorganization effort, the company abandoned its dealers and began to sell through Sears, Walmart, and Montgomery Ward.

Predictably, the dealers did not take this sitting down and instead linked their fortunes to other brands, such as Michelin and Pirelli. As a result, Goodyear began to lose a global network of faithful, committed dealers, and ended up selling a product perceived by consumers as just another tire sold at discount stores.

Bob Davis, a former Goodyear dealer in New Hampshire, stated, "You'd buy a tire from them one month; in the next month the price would be 20 percent lower or higher. . . . It was just too hard to do business with Goodyear."[22]

The Goodyear Tire & Rubber Company was founded in 1898, when Frank A. Seiberling borrowed $3,500 to buy a former strawboard factory in Akron, Ohio. Named after Charles Goodyear, the inventor of the rubber vulcanization process, the firm grew to 30,000 employees and had a pre-depression production high of 837,000 tires in April 1920. By 1930, despite depression-era challenges, the company had sales of $250 million and operations in 145 countries.[23] Goodyear's contemporary use of mass distributors was presaged during the early years when it entered into a distribution agreement with Sears, Roebuck & Company. The deal was simple: Goodyear charged Sears for the cost of producing tires plus a profit margin of 6 percent.

In what was to become a famous antitrust case, the tire maker was accused in 1936 of violating the Clayton Act, an antitrust law enacted in 1914. Unlike the Sherman Antitrust Act, which was concerned with attempts to monopolize commerce, the Clayton Act focused on practices deemed to interfere with fair competition. Section 2 of the act stated, "It shall be unlawful for any person engaged in interstate commerce to discriminate in price between different purchasers . . . where the effect of such discrimination may be to substantially lessen competition or to create a monopoly in an area of interstate commerce."[24]

[22]Kevin Kelleher, "Giving Dealers a Raw Deal," CNNMoney.com, December 1, 2004.
[23]Goodyear, "Corporate History by Year," www.goodyear.com/corporate/history/history_byyear.html, March 4, 2015.
[24]Breck P. McAllister, "Sales Policies and Price Discrimination under the Clayton Act." *Yale Law Journal* 41, no. 4, 1932, p. 519.

In 1936, the Federal Trade Commission issued an order forcing the tire company to end its arrangement with Sears. Although Goodyear appealed, it decided to terminate the relationship with the retailer. The laws and regulations passed at this time, which reflected government efforts to deal with the ravages of the Great Depression through statist policies, had at best, ambiguous economic outcomes.[25] But government meddling did have one unambiguous result for Goodyear: the company's use of mass-market distributors would not be revived until the 1980s, when it once again began selling its tires through Sears. Ironically, the appeal that the tire company filed came out in its favor in 1939.

The failure of the Sears deal meant that Goodyear had to develop its own marketing channels. As a result, the tire maker spent decades in control of its own sales and distribution. At its peak in the 1980s, the firm operated more than 1,000 company-owned stores, which produced 27 percent of sales; 600 franchised dealers that generated 23 percent of sales; and 4,400 independent dealers that produced 50 percent of sales. Franchisee dealers were simply new Goodyear dealers that graduated to independent status after completing three years of training by the company in the areas of business, finance, and operations.

Goodyear built its multimillion-dollar enterprise by creating the most effective dealership network in the United States. For most of its history, a dealer sold only Goodyear tires. The agreement went something like this: "You sell only Goodyear tires, and we'll take care of you. As long as your performance is satisfactory, we will provide you with an exclusive sales territory. If you are the Goodyear dealer in North Platte, Nebraska, we will sell tires only through you. If your performance is off, we'll talk to you about how to fix things before we open either a company-owned store or a separate dealership." In 1989, 70 percent of the dealers sold only Goodyear tires.

However, by 1991, the number had dropped to 50 percent. The other brands carried by dealers were typically lower-priced alternatives. Still, the Goodyear tire network was so loyal to the company that when the British financier James Goldsmith attempted a hostile takeover in 1986, the dealers were his most vocal opponents. The company was able to beat off the takeover attempt due to the combined efforts of the dealers and the citizenry of Akron, where Goodyear is headquartered. Several Goodyear blimps literally buzzed the city like bombers on the lookout for invaders. The high debt load resulting

[25]Jonathan J. Bean, *Beyond the Broker State: Federal Policies toward Small Business, 1936–1961*, (Chapel Hill, NC: The University of North Carolina Press, 1996).

from the battle with Goldsmith was used as the reason behind Goodyear's decision to begin selling to Sears in 1992. This decision was followed by deals with Walmart and Sam's Club.[26]

In June 1991, Stan Gault, the former CEO of Rubbermaid and a Goodyear board member, took over the battered tire giant. Gault had experienced fabulous career success. Touted as a miracle man on Wall Street, he was popular in the investment community because of his career history. During his 11 years at Rubbermaid, the company had quadrupled in size with earnings growing sixfold. "He was a real tough cookie when it comes to costs," a former associate reported.[27]

Sears had been attempting to get Goodyear to supply them with tires since 1989. Concern about the dealer network forestalled action until the Gault ascendancy. With his marketing background and previous experience selling through Mega-Customers, Gault provided about 20 percent of Sears' tire inventory almost overnight. To emphasize the newly adopted mass-market approach, he personally sold a set of ties to a pilot while flying to Chicago to join Sears executives for a press conference announcing the agreement. The next deal was with Walmart, which began selling a line called Viva in 1994.[28] Discounter Montgomery Ward followed, with the latter selling two exclusive tire lines. Gault stated at the time that the arrangement with Montgomery Ward was an attempt to expand distribution to new customers.[29]

The company implemented a number of cost-cutting measures and strategic initiatives, but the decision to begin selling tires on the mass market was the one with the most far-reaching consequences. Abandonment of the dealers did not come about as the result of analysis, executive discussions, or boardroom debate. Rather, the decision was simply made in the immediate aftermath of the decision to supply Sears. Goodyear's market share increased to 16 percent, reflecting the inventory buildup at Sears. Initially, dealers responded to Goodyear's embrace of the mass-market with despair. One dealer said, "We went with them through thick and thin and now they're going to drown us."[30]

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[26]Kelleher, "Giving Dealers a Raw Deal."
[27]Zachary Schiller, "Goodyear's Miracle Man?" *Business Week*, June 17, 1991, `www.bloomberg.com/bw/stories/1991-06-16/goodyears-miracle-man`. accessed March 3, 2015.
[28]Kelleher, "Giving Dealers a Raw Deal."
[29]"Goodyear to Sell Tires at 350 Montgomery Ward & Co. Outlets," *The Wall Street Journal*, June 14, 1995, p. A6.
[30]Dana Milbank, "Independent Goodyear Dealers Rebel: Decision to Sell through Sears Proves Unpopular," *The Wall Street Journal*, July 8, 1992, p. B2.

Not only did the dealers now have to contend with new competitors, but the high-velocity, lower-priced approach of the Megas meant that they also had to lower their prices, resulting in lower margins for everyone.[31] The dealers did not sit idly by as the rug was pulled out from under them. According to Manny Dracakis, former Goodyear dealer and the owner of All American Tire and Service in Cincinnati, "After someone punches you in the face a few times, you say enough is enough."[32]

With the delicate relationship between Goodyear and its dealer network violated, the dealers soon found other suitors. Instead of selling Goodyear tires exclusively, they began to carry multiple brands. Pam Fitzgerald, the vice president of a large dealership in Florida, was quoted in *The Wall Street Journal* as saying, "We will sell what we think will give the customer the best value, and that's no longer necessarily Goodyear."[33] The adoption of new brands by this dealership reduced the sales of Goodyear tires by 20 percent.

For its part, Sears used Goodyear tires as an inducement to attract customers, but then pushed its own store brand, RoadHandler, as well as other private labels.

In 2000, Nashville-based Bridgestone Americas' tire operations recalled millions of original equipment and replacement tires that had been identified as potentially unsafe by the National Transportation Safety Board. It appeared as if the very survival of the company was at stake. Yet two years later, Bridgestone reported a $135 million operating profit due to the increased sales of both Bridgestone/Firestone tires. During the same time, Goodyear suffered a 12 percent decline in North American sales and a dramatic drop in operating earnings, from $80 million down to only $10 million. According to an editorial in the industry journal *Tire Business*, the divergence in fortunes was attributable to the difference in how the companies had managed their dealer networks. Bridgestone, and its predecessor Firestone, worked hard to create a loyal dealer network, so that when the bad times came, the dealers would stick with the company. In contrast, Goodyear dealers felt they had

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[31]Lloyd Stoyer, "A Juggling Act: Dealer/Supplier Relationships Take Work as Other Parties Look Out for Their Own Best Interests," *Modern Tire Dealer*, April 1998, `http://www.moderntiredealer.com/article/story/2008/04/a-juggling-act.aspx`. accessed March 3, 2015.

[32]Kelleher, "Giving Dealers a Raw Deal."

[33]Milbank, "Independent Goodyear Dealers Rebel."

been stiffed by the manufacturer and, as a result, felt no loyalty. The editorial went on to say this:

> Many Goodyear dealers are angry with the company and don't feel the loyalty they once did to the tire maker. But there is no reason why Goodyear, which once enjoyed a dealer following second to none, can't regain that loyalty. It must again make independent dealers its number one priority. Ever since the Akron-based tire maker began years ago to expand sales and distribution beyond its own company stores and independent dealers, it has been losing momentum. Goodyear's independent tire dealers are one of the tire company's greatest assets. They stand on the front lines and more often than not determine what the retail tire customer buys. They can help reenergize the company. The sooner Goodyear recognizes this, the better."[34]

Despite the recommendations of industry observers, Goodyear continued to push product to its Mega-Customers. By 2003, it had lost control of its sales and distribution and was offering what was widely perceived to be a commodity product for the mass market. The new CEO, who replaced Gault, promised to make up with the dealers. That is something that has yet to happen.

What about the other tire manufacturers? Did they fall prey to the Customer Trap? Bridgestone still has a loyal dealer network. Michelin works closely with dealers and also sells on the mass market, but because their tires are positioned as premium products in the marketplace, Mega-Customers are less able to squeeze them on margins. Research undertaken by Michelin indicates that the customers who buy either Michelin or BFGoodrich brands spend an average of $388 when purchasing tires. That is 30 percent more than the average spent on other brands.[35]

And what of the tire dealers? During the years since Goodyear ditched its dealer network, the tire retail business has gone through a massive industry consolidation, with the top 100 tire dealerships operating an average of 58 stores while carrying more than 10 brands.[36] With connection between manufacturer and loyal dealer severed by Goodyear, many independent dealers have reaped big benefits with the new arrangement.

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[34]Editorial, *Tire Business*, November 11, 2002, www.tirebusiness.com/article/20021111/ISSUE/311119980/dealers-can-aid-goodyear-recovery&template=printart. Accessed March 4, 2015.

[35]Bruce Davis, "Michelin Unit Attempts to Satisfy Dealer Complaints," *Rubber and Plastic News* 36, no. 12, 2007, www.rubbernews.com/article/20070108/NEWS/301089959/michelin-unit-attempts-to-satisfy-dealer-complaints. accessed March 4, 2015.

[36]Bruce Davis, "Dealership Snapshot," *Tire Business*, 20(15), October 22, 2012, p. 21.

By 2001, Goodyear was in the red and has stayed there for most of the last 14 years. During this time, it has had one of the worst-performing stocks on the Standard & Poor's Financial Services S&P 500 index. While many factors contributed to the breakdown of the company, the jettisoning of a loyal distribution network surely played a large role. Goodyear lost control of its sales and distribution and will likely never recover.[37]

The stories of Levi Strauss and Goodyear demonstrate the peril companies face when they abrogate control over the distribution of their products to outside forces. Rather than dirtying their hands with dusty notions of sales and distribution, companies often think that they can innovate their way to success while leaving to others the tawdry details of bringing products into the marketplace. In the next chapter, we'll explore the limits of such an approach.

[37]Goodyear Tire & Rubber Co., Financial Statement, http://moneycentral.msn.com/investor, March 4, 2015; Ann and Elizabeth Harrow, "Worst 10-Year Performers: The Goodyear Tire & Rubber Company Skids Out," http://moneycentral.msn.com/investor/invsub/results/staemnt.aspx?Symbol=gt&1stStatement=10YearSummary&stmtView, July 26, 2008; www.bloggingstocks.com, available at www.bloggingstocks.com/2008/07/26/worst-10year-performers-the-goodyear-tie-and-rubber-company-ski.

CHAPTER

3

Turning Your Innovations into Commodities

Control your destiny, or somebody else will.

—Anonymous

Management gurus, consultants, the business press, politicians, educators, and so many others are hell-bent on getting as many people as possible to buy into the idea that innovation is *the* answer. At one level, such passion makes a lot of sense. For capitalism to flourish, growth is needed. Growth is fueled by new processes, products, and services, which challenge the status quo. Theoretically, this is all good: the economy expands, and innovative companies thrive. Competition forces the laggards to catch up or they go out of business. And the cycle starts anew.

However, in reality, something must be amiss when more than 75 percent of new ideas and inventions fail to gain traction in the marketplace. It seems that with so much attention focused squarely on creation, a critical component of the innovation formula is lost. That is, who is this innovation for?

In our experience, companies far too often assume that their amazing new inventions will almost metaphysically end up in the hands of the right customers—customers who will appreciate and value the innovation almost as much as they do. But what if those customers don't really care about the unique contribution the product makes to the marketplace, but are concerned

only about extracting price concessions in order to build market share? In other words, how is an innovation out there sold to existing customers who only want to render it into a commodity that they can capture, control, and then discard at will?

Innovation has been all the rage in popular and academic circles for a long time. Recently, educators have been developing and implementing curricula that emphasize science and math for the purpose of keeping the United States at the top of the innovation ladder. At universities, new master of business administration (MBA) programs and executive education courses focused on integrating innovation within the corporate culture are incredibly popular. Companies of all sizes have introduced innovation departments or divisions. The position of chief innovation officer (CIO) has become an increasingly fashionable job title. A recent search on the Monster web site revealed 19,000 management positions with the word "innovation" in the title. Technology transfer is sold as the link between academia and the private sector. Best-selling books by management gurus are in lockstep agreement that innovation is the hope for most companies as firms seek to avoid commoditization and stay ahead of the competition.

The conventional wisdom holds that innovation is essential for many companies that seek sustainable competitive advantage. The argument is that globalization, homogeneous markets, hypercompetition, and lower costs can rapidly turn many innovative products and services into commodities, thereby disallowing companies time to recoup the cost of bringing the innovation to market. In response, innovation is pushed from all corners as the best way for companies to stay ahead of the competition and deliver high value to customers. However, the practice of innovation often comes up short.

The problem is not a lack of innovative ideas (277,835 patents for inventions were granted in the United States in 2013), nor is it spending on R&D. After the 2008 recession, it took only a few years for R&D to rebound, with the pace of growth exceeding gross domestic product in 2011 and 2012, just as it had in the eight years preceding the economic downturn.[1] For many business leaders, innovation is viewed as the best way to ensure growth once market conditions begin to improve. Examples of companies creating great innovations during turbulent economic times include DuPont's invention of

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[1]Mark Boroush, "U.S. R&D Resumes Growth in 2011 and 2012, Ahead of the Pace of the Gross Domestic Product," National Center for Science and Engineering Statistics, 2013. http://www.nsf.gov/statistics/infbrief/nsf14307/nsf14307.pdf

V. Kasturi Rangan, *Transforming Your Go-to-Market Strategy* (Boston, MA: Harvard Business School Press, 2006).

shatterproof plastic and its creation of nylons, and Kraft Foods' introduction of macaroni-and-cheese dinners and formulation of Miracle Whip. These products were developed during the Great Depression. During the recession of 2001, Apple introduced the iPod.[2]

Why do so many innovations fail? While there are many possibilities, one explanation is that developing an innovation is simply the first step in a two-step process, and if the second step is missed, all the blood, sweat, tears, and money that were poured into the product in the first place are likely to be wasted. Dishearteningly, many firms simply do not demonstrate much interest in capturing the real value of their innovations, especially as they move into the second step—the sale and distribution of their products. Instead of reaping rewards for their efforts, companies have allowed Mega-Customers to take over the second step, thereby accelerating the process of commoditization.

With the dream of huge sales and a bigger market, innovative firms lose control as their innovations move out of the laboratory or factory and into the marketplace. The misstep of neglecting sales and distribution accelerates the path of commoditization for the innovation. Many companies that, at one time, built innovative products that could command high prices have abandoned this strategy, instead adopting the "volume at all costs" approach. This has occurred through a systematic process by which the Megas use their disproportionate size and buying power to disable the strategic imperatives of the innovative companies that do business with them.

As discussed earlier, the origins of the current arrangement began several decades ago, when business owners and managers lost interest in managing sales and distribution in favor of a new managerial paradigm that emphasized core competencies (innovation, technology, operational effectiveness, and outsourcing). By identifying and exploring their internal capabilities, businesses believed they would be able to focus more effectively on creating better innovations for new markets—resulting in significant benefits for customers. It was assumed that new innovations produced at a lower cost would be the ultimate result for companies that pursued this strategy. By catering to the mass market, however, innovative companies have allowed Mega-Customers to capture the value of their products and services, even as the Megas imposed costs and changes in strategic direction and operational control. Too often, the innovations of producers pass from their ownership and control into a form of property held, for all practical purposes, in the hands of the Megas.

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[2]Justin Scheck and Paul Glader, "Big Companies Invest in R&D to Grab Sales in Recovery," *The Wall Street Journal*, April 6, 2009, p. A. 1.

Innovations sold by the Megas can create a great deal of brand exposure, the influx of numerous customers, and enormous revenue generation. As products become successful and new facilities (and debt) are created to keep up with demand, the Mega-Customers insist on greater price reductions and, in the end, companies end up working like dogs to keep up with the dictates of their "partners"—all the while watching their innovations being treated more and more like commodities.

The Example from Detroit

For decades, Detroit's Big Three dominated hundreds of small and geographically isolated car dealerships. Dealers functioned in restricted areas and were not allowed to sell competing brands. Beginning in the late 1970s, to boost lagging sales, the Big Three grew their number of dealers and permitted existing ones to sell other brands of automobiles if those brands did not constitute direct competition with Ford Motor Company, General Motors Company (GM), or Chrysler Group LLC. For example, Ford dealers could sell GMC trucks, and Chrysler dealers could sell Pontiacs. Over time, the ability of manufacturers to exert control over their now multibrand dealers began to erode because everyone was selling everything. The manufacturers, companies that prided themselves on new designs with each model year rollout, did not intervene because they were afraid of losing short-term sales and alienating long-term customers. The shift of power away from the manufacturer/innovator to the dealers was now underway. The inevitable outcome was that, instead of an exclusive, dedicated dealer who sold only one line of vehicles, dealerships were now able to evolve into superstores, selling multiple brands. The biggest auto dealer in the country today is AutoNation, which sells almost every brand that is available in the United States.

When Detroit opened up the Pandora's box of multibrand dealerships, it was left with only two potential options that would allow it to regain control over distribution. First, it could drop unruly dealers and create a completely new sales and distribution network. While straightforward from a business point of view, the Big Three were unable to do this because of state laws and regulations designed to maintain the manufacturer-dealer agreements. Harvard business professor V. Kasturi Rangan summarizes the situation this way:

> By the end of the 1980s, dealers had gained a huge degree of independence from US manufacturers. Dealers could add imported car brands that were, in some cases, stronger than their corresponding US nameplates, and dealers had made headway in creating state laws to protect them from heavy-handed franchising practices, including the termination of dealers. The automakers had significant clout at the federal level, but at the state level, the dealers held significant sway. Automobile dealers

> accounted for only 1 to 2 percent of all retail outlets, but on average, they contributed 20 percent of states' retail revenues and consequently 3 percent of all state tax revenues.[3]

In small-town America, car dealerships are often the largest business in a given legislative district. State representatives were not interested in allowing Detroit to dismantle these local sources of employment and tax revenue.

The second option was to create more dealerships, often near the territories of existing dealers. This ultimately led to lower profitability for dealerships as they competed with each other for the same market share as well as increased costs for Detroit because of the need to supply and support underperforming outlets. As multibrand dealerships proliferated, the Big Three thought that the solution to their distribution problems might be the emergence of e-commerce as a viable channel. However, the political clout of the dealers was not about to be bypassed. By May 2000, 33 states had laws prohibiting or restricting manufacturers from selling cars online.[4]

The third option for manufacturers was to learn to get along with the new power structure and see their innovative products become commoditized year after year. Detroit had to retain its existing dealer network, and logically, the evolution of multibrand dealers continued because firms such as AutoNation were able to sell an array of models from different manufacturers. For AutoNation, a Mega-distributor that represents multiple manufacturers in many states, the only brand that matters is the one serving its purposes at a particular moment. Because dealers such as AutoNation manage a portfolio of brands, they are able to quickly adapt and respond to changes in the marketplace. If there is a new model change at Ford that the buying public does not like, or if Ford's innovations are good but not as good as their competitors, AutoNation can seamlessly shift to selling more-popular Chevrolets, Dodges, Hyundais, or Kias. Their customers will still buy, revenues will still come into the Mega-distributor, and the dealership will continue to grow.

Ganley Auto Group is the largest auto dealer in Ohio and one of the top ten in the entire United States. The brands the company sells include BMW, Honda, Hyundai, Isuzu, Mercedes-Benz, Nissan, Subaru, Scion, Suzuki, Toyota, Volkswagen, Chevrolet, Chrysler, Dodge, Ford, Jeep, Lincoln, and Mercury.[5] Is Ganley married to any one brand? No way. The only brand that matters to Ganley is the one that is serving its needs at any particular moment. Ganley can seamlessly shift to selling "better" brands and models at any point.

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[3]Andrea Orr, "Levi Must Work Out of Tight Fit: Wal-Mart Deal May End Slide in Revenues," *Houston Chronicle*, September 18, 2003, p. 4.
[4]Paul A. Greenberg, "Cars Online: Miles to Go Before They Sell," *E-Commerce Times,* `www.ecommercetimes.com/story/7119.html`, January 31, 2001.
[5]Ganley Auto Stores, `www.ganleyautogroup.com`, accessed September 24, 2014.

Ford has spent billions of dollars catching up with the technological lead of Toyota and Nissan. But what happens when the buying public is not excited about Ford products? What can it do? Ford produces and sells only Ford-brand automobiles and trucks. The company has borne most, if not all, of the risk—it has dealt with the lawyers and government safety inspectors, spent tens of millions of dollars on market research, sourced new parts from suppliers, and retooled its manufacturing processes—to bring innovative new products to market. All of this was done in the name of innovation, but because Ford can barely influence its biggest customers such as AutoNation in any meaningful way, it is always under the gun to cut costs, pressure suppliers, and when necessary, send jobs offshore. US automakers average a net of 5 percent on sales, with profitability ranging from –2.5 to 10 percent.[6] For example, in the third quarter of 2014, Chrysler reported net income of $611 million on $20.7 billion in sales and a modified operating profit of 8.7 percent of $946 million.[7]

Only after government bailouts and bankruptcy proceedings were automakers able to gain some control over the sale of their products. In the spring of 2009, with assurances from bankruptcy courts and government bodies, each company cut out nearly 1,000 dealers from its network.

Rubbermaid Abrogates Control

Another example of a company falling into the Customer Trap is Rubbermaid. For years, this firm was admired because it produced a wide range of high-quality storage and related products. The company was directly plugged into customer needs like few other consumer product companies. Ellen Spong, a stay-at-home mom from Canton, Ohio, said, "I remember when Rubbermaid called and asked to spend some time in my house. Two researchers spent the afternoon in the kids' bedroom, looking at how things were packed into the closets and asking questions about possible solutions to all of the kids' stuff."[8] Such attention to understanding how people might use Rubbermaid's products created an industry with a name brand that was admired and respected throughout America. However, by 2008, the company, which had been acquired by Newell ten years before, was firmly ensconced in the commodity business.

[6]Rangan, op. cit.

[7]Mark Clothier, "Chrysler's Net Income Rises 32% on Jeep and Pickup Sales," Bloomberg News, November 5, 2014. http://www.bloomberg.com/news/articles/2014-11-05/chrysler-s-net-income-rises-32-on-jeep-and-pickup-sales

[8]Interview with authors, September 2014.

Rubbermaid got its start in 1933, when James R. Caldwell and his wife invented 29 products based on deficiencies they experienced in their own kitchen. Caldwell "rang 10 doorbells and sold nine dustpans." Buoyed by his success, he was soon making use of department stores to market soap dishes, sink plugs, and drain board mats throughout New England. The new firm merged with Wooster Rubber Company, a struggling Ohio enterprise that had formed in 1920. Wooster Rubber Company, with only $80,000 in sales in 1935, was rejuvenated by the merger, and in 1941, the newly constituted Rubbermaid had sales of $450,000. By this time, Caldwell had succeeded in marketing 27 of the 29 products he and his wife had envisioned.[9]

Like many businesses during World War II, Rubbermaid switched from producing consumer products to contributing items needed for the war effort. After the war, the company introduced automotive accessories, such as rubber floor mats and cup holders, as well as its previous line of products. But it was not until 1955 that the business began to make products out of plastic, with the introduction of a plastic dishpan in 1956. Soon Rubbermaid marketed industrial and commercial items to restaurants, hotels, and other businesses.

Caldwell retired in the late 1950s. The next major leader of Rubbermaid was Donald E. Noble, a man of amazing vision and managerial abilities. Noble arranged for company stock to be sold on the New York Stock Exchange, pushed for a goal of doubling earnings on a six-year basis (which he was able to pull off), and based the firm's future on its ability to innovate. Product development was the key to this new effort. By 1968, the goal was to have 30 percent of annual sales originate from products introduced in the five previous years.

Like many companies in the 1970s, Rubbermaid began to get into unrelated businesses. It unsuccessfully marketed recreational goods such as snow sleds and motorboats. "We bombed," the vice president of marketing said to a reporter at *The Wall Street Journal* at the time. Other troubles followed, including problems with the Federal Trade Commission in the 1970s.

Donald Noble retired in 1980. He was replaced by none other than Stan Gault, who would later go on to lead Goodyear into the Customer Trap during the 1990s. Gault cut his teeth at General Electric (GE), where he had been in charge of the appliance division. A Wooster native, he made his way through college by working at Rubbermaid during the summers. Gault set out to quadruple sales by 1990, and he acted quickly. Operations were streamlined. Factories in the Netherlands were closed, the party-plan business (similar to Tupperware) was abandoned, and the automotive division was sold. Eleven percent of management was fired, and half of the company's middle-management positions were eliminated. Gault brought in people from GE to fill the top spots in the firm.

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[9]Funding Universe, "Little Tikes Company History," www.fundinguniverse.com/company-histories/Little-Tikes-Company-Company-History.html, accessed September 24, 2014.

A period of aggressive acquisition followed, which included the purchase of MicroComputer Accessories, a computer accessory company, and the Gott Corporation, a producer of insulated coolers and beverage holders. Rubbermaid also entered into joint ventures with Allibert, a producer of outdoor furniture, and DSM N.V., a Dutch chemical manufacturer. In 1989, sales stood at $1.45 billion, four times what they were in 1981 ($350 million).[10] Gault had exceeded his initial goal of quadrupling sales. How did he do this? Two major factors contributed to Rubbermaid's astonishing growth—acquisitions and innovations. The most noteworthy of these was the acquisition of Little Tikes Company.

Little Tikes

Little Tikes was an innovative company par excellence. In 1970, Thomas G. Murdough was unhappy with what he perceived to be the cheap and poorly made toys that flooded the market during the decade. In response, he founded the Little Tikes Company, based on a technology called rotational molding, which was used to produce large agricultural and chemical containers. Murdough found that molded plastic toys made using this methodology were more durable than the products then on the market.

The firm used its technology to invent outdoor play equipment in many styles using a large variety of shapes. The rotational molding process facilitated the creation of large surface areas that were durable and had comparatively few parts. As impressive as Murdough's product and process innovations were, his understanding of sales and distribution was even more remarkable.

Murdough believed that he could avoid the deep discounting and low product quality of other toy manufacturers by keeping tight control over distribution. During the 1960s, the strategy of large retailers, such as Kmart, was to draw parents into their stores by marketing the most popular toys as loss leaders. As a result, smaller stores were forced to lower their own prices and suffer from low profit margins. These small stores then put pressure on wholesalers, who pushed manufacturers to lower their own prices. The manufacturers managed to do this by compromising on quality. Younger baby boomers can attest to the steady decline in toy quality that occurred during the late 1960s through the 1970s. Compare what this generation says about toys with those who went to grade school in the 1950s.

[10]C. E. Helfat, *Dynamic Capabilities: Understanding Strategic Change in Organizations* (New York, NY: Wiley and Sons, 2007), p. 49.

Murdough was not drawn into the downward quality spiral because he simply refused to do business with large discounters. Instead, he focused on manufacturing innovative products, creating word-of-mouth "buzz" among parents, and building an effective network of independent distributors. The strategy of innovation, in concert with control over sales and distribution, was a phenomenal success.

Murdough sold his company to Rubbermaid for $50 million in 1984, stayed on as president for five years, and then resigned in frustration. He quit because Rubbermaid officials placed unrelenting pressure on him to distribute Little Tikes products through Kmart and Ames. Murdough objected, arguing that heavy promotion in the mass market could lead to short product life cycles. "You saturate the marketplace. . . . That's a big part of the reason the toy industry is flat on its back."[11]

Murdough wanted to "eliminate overkill distribution." A history of Little Tikes describes what happened: "Mr. Gault resisted, Mr. Murdough says, partly because these same mass merchants devote considerable shelf space to Rubbermaid's vast line of houseware products. 'Rubbermaid wants to distribute to every nook and cranny,' he [Murdough] says. A decade later, Murdough told *Forbes*, 'It turns out we never needed Rubbermaid's money. . . . I was spending all my time just keeping them [Rubbermaid executives] out of my hair.'"[12]

With Murdough's departure, Gault predicted that Little Tikes would have "its best year ever."[13] Little Tikes began innovating for the mass market. Five additional manufacturing plants were opened, a new 6,000-square-foot customer service center was built, and the firm unfurled new distribution agreements with customers including Kmart, Toys "R" Us, and Walmart.

The Acceleration of Commoditization

Rubbermaid had a great reputation. For 14 years, it was ranked number one in its industry group by *Fortune*, which also named Rubbermaid America's Most Admired Company in 1993. Wolfgang Schmitt took over the business two years after Stan Gault retired in 1991. To say that Schmitt, who had worked for the company since 1966, was proud of Rubbermaid would be a gross understatement. An essay by Schmitt in a popular 1990s business book brims with displays of self-assurance, hubris, and confidence regarding

[11]Alecia Swasy, "Corporate Focus: Rubbermaid Moves Beyond the Kitchen," *The Wall Street Journal*, February 3, 1989, p. 1.
[12]Funding Universe, "Little Tikes Company History," www.fundinguniverse.com/company-histories/Little-Tikes-Company-Company-History.html, accessed September 24, 2014.
[13]Ibid.

the company's course. Consider the following quotes from the former chief executive officer:

- "Our brands continue to prevail because of our persistent, consistently clever product innovation."[14]
- "Each of our products reflects several generations of innovation, and innovation is what distinguishes Rubbermaid from a sea of competitors."[15]
- "Whatever turns out to be our next breakthrough, I can guarantee that it will reflect changing trends, providing a one-to-one solution for the consumer."[16]

At its peak, Rubbermaid offered 5,000 different items, producing nearly 400 new products each year. A puff piece in *Fortune*, in 1994, credited the firm's creativity to Schmitt's uncanny abilities—he is "thinking, always thinking"[17]—as well as 21 development teams consisting of people from marketing, finance, manufacturing, R&D, and sales. The result of these efforts was the creation of some truly impressive products, from the heat-resistant spatula (one of Schmitt's ideas) to the Hip-Hugger laundry basket.

The Dye is Cast

In addition to Schmitt's passion for innovation, the company was equally committed to continuing Gault's strategy of selling through the Megas. Explaining the role of the mass discounters to Rubbermaid's future, Schmitt said, "It's typically the bigger suppliers that can form the sort of close partnerships that retailing's behemoths are increasingly demanding. The goal is to boost sales and reduce costs for both sides by slashing inventories, shortening lead times, and eliminating error: There is a healthy independence between us and people like Walmart. We need them; they need us."[18]

The new decade proved to be disastrous for Rubbermaid. As its commitment to the mass marketers increased, so too did the demands by Mega-Customers for lower prices. At first, Rubbermaid treated pressure from the

[14]Wolfgang Schmitt, "Technology Paves the Way to Perpetual Innovation," in *Innovation: Breakthrough Ideas at 3M, DuPont, GE, Pfizer, and Rubbermaid,* ed. Rosabeth Moss Kanter, John Kao, and Fred Wiersma (New York, NY: HarperCollins, 1997), p. 150.
[15]Ibid., p. 151.
[16]Ibid., p. 163.
[17]Marshall Loeb, "How to Grow a New Product Every Day: Wolf Schmitt's formula is to learn from Mother Nature, borrow from Cleopatra, and continually rub up against the customers." Fortune Magazine. November 14, 1994. http://archive.fortune.com/magazines/fortune/fortune_archive/1994/11/14/79932/index.htm. Accesses March 3, 2015.
[18]Zachary Schiller, Wendy Zellner, Ron Stodghill II, and Mark Maremont, "Clout," *Business Week*, www.businessweek.com/stories/1992-12-20/clout, December 21, 1992.

big-box stores with scorn. For years, it had been able to easily pass along price increases to its distributors, who simply charged customers more. However, expectations were rapidly changing.

The ubiquity of Walmart, The Home Depot, Lowe's, and other potential Mega-Customers, coupled with an inflation rate that hung around 2 or 3 percent for most of the decade, had created an expectation that prices would rise only slowly, if at all. Walmart accounted for about 14 percent of Rubbermaid's business when, in 1994, disaster struck.

The key component of Rubbermaid's products is polymer-based resins, which make up about one-third of the cost of any given item. The price of resins had been stable for years, but in spring 1994, costs shot up because of new global demand and a supply shortage resulting from problems at key refineries. Within 18 months, the price of resins nearly doubled, adding $200 million to Rubbermaid's costs.[19] Focused as always on earnings growth, the company increased its prices by what Schmitt claimed averaged, at the most, six percent.[20] Rubbermaid's price increases were met with derision by the Megas. The giant retailers objected to monthly price increases and complained that Rubbermaid was unresponsive to the realities of the market. Competitor products were available. Sterilite, a privately held company based in Massachusetts, and Tucker Housewares, a division of Mobil Oil, were ready to fill shelf space at Walmart with much cheaper items. The Megas were ready to jettison Rubbermaid. The problem was termed the "premium gap."

"We let the premium gap get too big in the early Nineties," Schmitt told *Fortune* magazine.[21] The article explained the dilemma this way:

> An experienced householder knows that she should have to pay no more than $10 for a reliable 32-gallon garbage can. When she spots an $8.99 Rubbermaid can next to a competitor's $5 can, Rubbermaid is not concerned. 'It's probably thin and breakable, and the customer knows that,' says Schmitt. What worries Rubbermaid is a competitor's $7.99 can, because it's probably pretty good. Yet the price is low enough to fall below the 10 percent premium gap. Thus, Rubbermaid not only loses a sale but may also have convinced the shopper that it is overcharging.[22]

[19]Claudia H. Deutsch, "A Giant Awakens, to Yawns," The *New York Times*, December 22, 1996 http://www.nytimes.com/1996/12/22/business/a-giant-awakens-to-yawns.html
[20]Tim Carvel and Joe McGowan, "Rubbermaid Goes Thump, *Fortune*, http://archive.fortune.com/magazines/fortune/fortune_archive/1995/10/02/206543/index.htm, October 2, 1995.
[21]Ibid.
[22]Ibid.

Initially, Schmitt thought that Rubbermaid would be able to weather the resin-based price increase better than its competitors. However, Tucker avoided the resin problem with product designs based on recycled plastics and cedar inserts for storage bins and trash cans. Sterilite was a privately held company that did not share Rubbermaid's aggressive profit goals and was not under the same kind of profit pressure brought to bear by Wall Street.[23]

As the company's innovations became increasingly commoditized, Schmitt attempted to lower costs and increase sales to offset the loss of value. But it was too late. The pressure to create innovative products had often resulted in superficial, cosmetic changes that "created manufacturing complexity and retail confusion" and that resulted in no increase in sales.[24]

Their Mega-Customers demonstrated only scorn for Rubbermaid, and they reacted with glee as the former wonder company began its downward slide. Said a Kmart official, "Retailers warned Rubbermaid, 'You will kill your business if you don't do something about your prices.'"[25] Another said, "They've been such lousy shippers. Not on time, terrible fill rates, and their products cost too much. They show you a new product line and then tell you they can ship only a third of what you want."[26] Walmart, frustrated with the price increases, emptied shelves of Rubbermaid's Little Tikes, and turned the space over to Fisher Price.[27]

Left with no other real option, Rubbermaid felt compelled to change gears. In 1994, it began to compete aggressively on the basis of price, offering steep discounts to its Mega-Customers. Its margins quickly eroded, and cost-cutting measures were enacted, including the elimination of 1,170 jobs and the closure of nine plants. The company purged 6,000 color and size variations and cut the total number of products by 45 percent.[28] These efforts produced only temporary relief. Rubbermaid was acquired by Newell in 1998 for $6 billion in stock.

And what of Little Tikes? The problems that afflicted Rubbermaid in the 1990s—slowing demand and high material costs—also challenged Little Tikes. The firm responded with increased R&D, new product displays, and more product launches. When Newell bought out Rubbermaid, Little Tikes began to invest heavily in consumer research, resulting in original products designed to stimulate the imagination of children. The firm also used innovative weather-resistant technology to produce electronic toys that could be left outside.

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[23]Ibid.

[24]Deutsch, op. cit.

[25]Ibid.

[26]Geoffrey Colvin, "How Rubbermaid Managed to Fall from Most Admired to Just Acquired, *Fortune*, http://archive.fortune.com/magazines/fortune/fortune_archive/1998/11/23/251411/index.htm, November 23, 1998.

[27]Constance E. Helfat et al, *Understanding Strategic Change in Organizations* (Malden, MA: Blackwell Publishing, 2007).

[28]Deutsch, op. cit.

Little Tikes was tenacious in its attempts to innovate its way around challenges posed by its competitors, distributors, and new owners.

Despite these efforts, sales continued to slide. In 2001, Toys "R" Us, its largest distributor, began cutting back its Little Tikes inventory to increase sales per square foot. In 2005, Little Tikes generated sales of $250 million—$20 million less than in 1989. Ultimately, the Little Tikes name came to be associated with deeply discounted toys sold on the mass market. In 2006, Newell Rubbermaid sold Little Tikes to MGA Entertainment.

Innovation may be necessary, but it is clearly not enough. This becomes crystal clear in the case of Amazon.com, which in many ways has perfected the Customer Trap.

Perfecting the Customer Trap

To those of us on the outside, Amazon was a bit of an enigma until Brad Stone's book, T*he Everything Store*, pulled open the door and let observers see how its founder, Jeff Bezos, organized the shelves and dealt with the merchandise. Bezos, a man of incredible vision, drive, and ambition, may be a true business genius. One thing is for sure: he viscerally understands the Customer Trap. Bezos is the world's foremost expert on how to make it work.

Bezos understood the power of scale from the earliest days of Amazon.com. In 1996, during one of their occasional walks around downtown Seattle, Bezos explained to his colleague Shel Kaphan why he was determined to rapidly expand Amazon. "When you are small, someone else that is bigger can always come along and take away what you have. We have to level the playing field in terms of purchasing power with the established booksellers."[29]

This intuition became policy in 1998, when in his first letter to shareholders, Bezos explained that Amazon would measure its success not by profitability, but by market leadership, defined as growing its market share. The letter, which became "holy scripture" inside the company and is re-released each year with the annual report, shapes the company's strategy up to the present day:

> We believe that a fundamental measure of our success will be the shareholder value we create over the long term. This value will be a direct result of our ability to extend and solidify our current market leadership position. The stronger our market leadership, the more powerful our economic model. Market leadership can translate directly to higher revenue, higher profitability, greater capital velocity, and correspondingly stronger returns on invested capital.

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[29]Brad Stone, *The Everything Store: Jeff Bezos and the Age of Amazon* (New York, NY: Little, Brown and Company, 2013), p. 52.

> Our decisions have consistently reflected this focus. We first measure ourselves in terms of the metrics most indicative of our market leadership: customer and revenue growth, the degree to which our customers continue to purchase from us on a repeat basis, and the strength of our brand. We have invested and will continue to invest aggressively to expand and leverage our customer base, brand, and infrastructure as we move to establish an enduring franchise.[30]

Even as Amazon embraced the role of market leadership, its vendors began to have second thoughts about putting all of their products in the Amazon shopping cart. Wall Street analyst Ravi Suria wrote a series of widely read reports in 2000 that predicted impending disaster for the company. These reports coincided with the high point of the dot.bomb crisis, and along with negative news reports touting e-commerce as only a passing fad, prompted droves of investors to abandon Amazon's stock. Vendors panicked. John Ingram, the president of Ingram, told Amazon executives, "But if you go down, we go down. If we're wrong about you, it's not 'oh, shucks.' We have such a concentration of our receivables from Amazon that we will be in trouble too."[31] As it turned out, the problem wasn't that Amazon was going down, but that Ingram and so many of Amazon's suppliers had placed so much of their business in Amazon's hands in the first place.

At the turn of the century, the Customer Trap was just one weapon in Amazon's strategic armory. The company's munitions consisted of many items, including numerous acquisitions, logistical expertise, and cutting-edge technology. Soon Amazon was experimenting with different calibrations of the Customer Trap.

Amazon found just the right setting in a 2002 dispute with United Parcel Service (UPS), when the world's largest logistics company balked at Amazon's request for price breaks on package delivery. In response, Amazon took the next six months to integrate its systems with FedEx and to increase its volume of shipments, as well as make more frequent use of the United States Postal Service. When UPS called what it considered to be Amazon's bluff at a September negotiation, the Mega literally quit shipping with the company. Seventy-two hours later, UPS folded and agreed to give Amazon discounted shipping rates.[32] In the years since, Amazon has effectively pitted UPS and FedEx against each other to obtain more-favorable pricing. It has made aggressive use of the Customer Trap, placing the trap in front of these two companies at every pickup site, intersection, and screen door. In the winter of 2014,

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[30] 1997 Letter to Shareholders. Reprinted in 2013 Letter to Shareholders. Amazon.com Annual Report. http://phx.corporate-ir.net/phoenix.zhtml?c=97664&p=irol-reportsannual, accessed March 6, 2015.
[31] Stone, op. cit., p. 105.
[32] Ibid., p. 181.

Amazon reduced its volume to FedEx by an annual rate of 50 to 60 million packages, resulting in an 8 percent decline in FedEx's entire volume. At the same time, UPS trucks were up to one-third full of Amazon's two-day-delivery "Prime" packages. One former senior FedEx executive said, "I'd be amazed if they are making 5 percent" profit on Amazon's Prime shipments.[33]

The upshot for UPS is booming net income and flat profit margins. The numbers tell the story. Amazon's sales increased fourfold, from $19.17 billion in 2008, to $74.45 billion in 2013. During the same time period, UPS revenues rose only 9 percent, to $34.07 billion. However, a 2013 net income of $4.37 billion at UPS dwarfed Amazon's paltry net of $274 million. But remarkably, "unprofitable" Amazon is clearly in the driver's seat. Despite its loss-making business model, it is able to call the shots with UPS and FedEx. The "strategic" response of UPS—the response always given by companies in the Customer Trap—is to become more efficient. According to CEO David Abney, e-commerce "has challenged some of our traditional ways of doing business," forcing the company to wring costs out of its system in order to advance its position. In the second quarter of 2014, UPS's average delivery cost slipped 1.7 percent from the year before, but its revenue fell 2 percent. The upshot is that for UPS, the Customer Trap looks like one of those big brown trucks circling the block, over and over, looking for an address. Ironically, Uncle Sam has recently been testing out the Customer Trap. Lured by the prospect of becoming one of the enablers of Amazon's "free" delivery, the US Postal Service has begun to slash prices to get a piece of the action.[34]

But it has been in the book category that Amazon's use of the Customer Trap can most clearly be observed. In its early years, it obtained books from the same distributors that all of the other booksellers used. In 2004, Amazon began to aggressively deal with large publishers by demanding significant discounts on bulk purchases, shipping arrangements that leveraged its "reinvigorated" UPS relationship, and an extended period to pay its bills.

The company played hardball with publishers that didn't go along by threatening to decrease the visibility of book titles on its web site. Having experienced success with this tactic, Bezos initiated the Gazelle Project, based on the notion that Amazon should approach small publishers "the way a cheetah would pursue a sickly gazelle."[35] The tactic consisted of categorizing publishers on the basis of their dependency on Amazon, and then putting the squeeze on the companies that were the most vulnerable. This ruthless approach horrified publishers. One book distributor described it "like dinner with the Godfather."[36]

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[33]Laura Stevens, "At UPS, E-Commerce Boom Proves a Heavy Lift," *The Wall Street Journal*, September 12, 2014, p. A1.
[34]*Ibid*.
[35]Stone, op. cit., p. 242.
[36]George Packer. "Cheap Words: Amazon is Good for Customers. But is it Good for Books?" *The New Yorker,* February 17, 2014.

In 2005, Randy Miller, who had helped found Amazon's jewelry business, took over publisher relations. According to author Brad Stone, "Miller took an almost sadistic delight in pressuring book publishers to give Amazon more-favorable financial terms," by ranking publishers according to sales and profit margins, and then threatening to decrease promotion of laggards who did not go along with the new terms. Speaking of Random House, Hachette, and Bloomsbury Publishing, Miller stated, "I did everything I could to screw with their performance," including removing books from Amazon's recommendation listings and promoting competitors' books. This prompted authors, who compulsively track sales on Amazon's Author Central web site, to put the heat on their publishers. According to Miller, "We would constantly meet with authors, so we'd know who would be watching their rankings. I knew these people would be on their phones the second they saw their sales numbers drop."[37]

Amazon's relationship with publishers became even more brutal in the wake of Kindle, as the Mega priced books so low that it threatened the $26 hardcovers that were the bread and butter of Barnes & Noble and Borders. Literary agent Andrew Wylie states, "What Bezos wants is to drag the retail price down as low as he can get it—a dollar-ninety-nine, even ninety-nine cents. That's the Apple play—'What we want is traffic through our device, and we'll do anything to get there.'"[38]

Bezos had decided that every book must be available through digital delivery for $9.99, and Amazon would be tough with publishers who did not digitize their catalogs fast enough. There was no business model behind this pricing, just a firm belief by Amazon that this was the right price. Knowing that the publishers would object, the company kept its plans secret until the launch of the first Kindle in 2007. While Amazon's pugnacity was agonizing for publishers, it paid off in a big way for Amazon, which completely outmaneuvered competitors such as Barnes & Noble and the now shuttered Borders Group.[39]

Playing "nice" with its "partners" is simply not part of Amazon's business DNA. Rather, its double helix appears to consist of a core of hostility combined with a kindly tertiary structure that maneuvers companies into the Customer Trap. In 2004, Amazon was sued in federal court by Toys "R" Us, which argued that it had broken an agreement in which Toys was to be the exclusive seller of the most popular toys sold by the company. In ruling in favor of Toys "R" Us, Judge Margaret Mary McVeigh gave the clear impression that she was less than impressed with the credibility of Bezos and the other Amazon employees who testified. In her ruling she states, "Amazon's conduct has not been consistent with the drafters' [of the agreement between

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[37] Stone, op. cit., p. 242–243.
[38] Packer, op. cit.
[39] Ibid., p. 253–254; 276.

the two firms] intent in reaching the Agreement. . . . The language as drafted whether intentional or inartful gave Amazon the words to play the game their way." Toys "R" Us prevailed in the case.[40]

Toys "R" Us had the resources to take Amazon to court. But what of the small players that become victims of Amazon's carefully calibrated Customer Trap? Technology has enabled individual creative artists to produce their own book projects and market directly to the public. For these people, Amazon's tactics can be crushing. An internationally renowned photographer related his experience to us:

> The book I published was not a small project. It was a photography book, shot over a six-month period. I drove over 20,000 miles to get to various locations. Photography books are expensive to print. They're also heavy. This was a big deal and it was costly in both time and money. Using their online resources, I researched Amazon as much as I possibly could. Their guides were confusing and often contradictory, but I thought I had a pretty good understanding of their process.
>
> The first warning came when my books arrived at Amazon's warehouses. I complied with their rules. Every pallet and box was individually labeled, but now with my books onsite they insisted that each book needed to be labeled as well (beyond the bar code). I patiently explained to my not-so-helpful Amazon liaison that this was not a requirement according to their own site. She replied that I could authorize them to label the books (at a cost) or I could tell her where I'd like them to ship the books (at another cost).
>
> A few months later the other shoe dropped. The yearly storage fee that Amazon bills me for every book, which is in addition to the monthly storage fee they've already collected, had been increased. Instead of a nominal fee of less than $100, the new fee would be over $2,000. I'm not sure how you charge twice for the same exact space that has been occupied at the same exact time, but that's probably an issue best explained by quantum physics. I shudder to imagine what your average slumlord would do with this information.

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[40]Toys R.Us.Com.LLC vs. Amazon.com, C-96-04 (Superior Court of New Jersey, 2009).

> Suddenly my book had become a lot less profitable. A new, but still-not-helpful Amazon liaison seemed delighted when he informed me I could pay the fee, or I could tell him where to ship the books. The fact that this policy was changed without my consent, and nullified the original agreement I'd made, was somewhat frustrating. Being that as an Amazon Associate I'm required to have a credit card on file meant they could charge me whatever and whenever they wanted to was somewhat infuriating.
>
> The first year I paid the monthly fee plus the yearly $2,000 storage fee. What choice did I have? You have to sell these things, and Amazon was an essential element of my distribution model. The second year, facing a new bill of over $1,200, I did the unthinkable. I was forced to pulp about 600 books. And yes, there's a charge for that too.

Individual creative artists like the one who wrote this note may be the greatest victims of Amazon's Customer Trap, but in the end, almost everyone "partnering" with Amazon is burned in one way or another. Sadly, the "value" created by Amazon is not even captured by Amazon itself. In January 2002, Amazon posted a net income of $5 million, the first profitable quarter in its history.[41] In 2013, the company lost $41 million for the year. Shockingly, in the third quarter of 2014, the company lost $437 million, all the while sales jumped 20 percent to $20.58 billion. In comparison, ExxonMobil makes more profits in two-and-a-half weeks than Amazon has made in its entire existence.[42] However, a high stock price propped up by cultic, true-believer investors has generated a great deal of wealth for many people—all at the expense of the producers of goods and services that the company sells.

In today's world of business, the accelerating commoditization of innovations occurs so regularly that no one seems to notice. Yet, the damage left behind when this happens is starkly apparent. Still, nothing seems to really change. As we'll see next, a lot of this intransigence has to do with who controls the information.

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[41]Ibid., p. 134.

[42]Greg McFarland, "Amazon Never Makes Money But No One Cares," *Invetopedia*, September 2, 2014. http://www.investopedia.com/stock-analysis/031414/amazon-never-makes-money-no-one-cares-amzn-aapl-wag-azo.aspx

CHAPTER

4

When Sales Channels Get Hijacked

I had nothing to offer anybody except my own confusion.

—Jack Kerouac

It was not until Amazon's Jeff Bezos met the "Yoda" of the Customer Trap that he learned how to deal ruthlessly with suppliers. In early 2001, Bezos's intuition that a key to business success is to gain leverage over suppliers became *the* fundamental business strategy of Amazon. What had been only a gut feeling was transformed into an operating paradigm through a conversation over coffee with Jim Sinegal, the founder of Costco Wholesale Corporation. The Costco model is based on customer loyalty garnered by offering a limited selection of products at rock-bottom prices. Costco buys in bulk and uses a standard markup of 14 percent. Most of its profit is realized from an annual membership fee. It has the ability to create huge sales volume through low prices, and thereby demand low prices from its suppliers.

As Sinegal related to Bezos, sometimes vendors resist Costco's way of doing business. "You can fill Safeco Field with the people that don't want to sell to us. But over a period of time, we generate enough business and prove we are a good customer and pay our bills and keep our promises.

"Then they [suppliers] say, 'Why the hell am I not doing business with these guys? I gotta be stupid. They are a great form of distribution.'"

Bezos "took the lessons he learned during that coffee in 2001 and applied them with a vengeance." The following Monday he told his executive staff that henceforth Amazon would have "everyday low prices" like Walmart and Costco. The company would benchmark its prices against large retailers and match their lowest prices every time. In July that year, Amazon cut its prices on books, videos, and music from 20 to 30 percent.[1]

The desire of potential Mega-Customers like Costco and Amazon to dominate their suppliers becomes even more obvious when it is stated on national television. Every few months, the business news channel CNBC takes a look into a particular company. In 2012 the news staff explored Costco, and as in most of these 1-hour documentaries, spent the bulk of the time with the CEO. Not surprisingly, the documentary seemed more like an infomercial than anything else. It gave Sinegal a big stage to tout all of the wonderful things about Costco. About 16 minutes into the episode, Sinegal said almost exactly the same thing in front of the camera that he told Bezos over coffee in 2001.

Carl Quintanilla, the CNBC anchor, asked Sinegal "Are there companies' brands that won't sell to you?"

Sinegal shot right back. "Sure. You could fill Yankee Stadium with the companies that don't want to sell to us at one point or another.... If the supplier is refusing to sell to us, there's only one reason why they're refusing to sell to us. And that's because of the price that we bring the goods to market."

Then Sinegal stated matter-of-factly, "Eventually we end up getting their products and selling their products."

How Costco is able to "end up getting their products and selling their products" borders on the unseemly. During the CNBC interview, Sinegal happily admitted that Costco regularly buys in the *gray market*. In this controversial practice, retailers circumvent manufacturers and buy products through third-party distributors.

There are two main types of gray markets. The first one seeks out imported manufactured goods that would normally be unavailable or more expensive in a certain country. This often happens with the tacit approval of the manufacturer, and is viewed as a way to manage inventory and global distribution more efficiently.

The second type, which Costco and others frequently engage in, effectively punishes those companies that won't sell through a Mega because they refuse to enter the Customer Trap. In an effort to reign in these "outliers," a Mega will purchase at full retail price a large quantity of products through the manufacturer's traditional sales and distribution channel. Then the Mega places the

[1]Brad Stone, *The Everything Store*, (New York City, New York, Little, Brown and Company, First Edition, 2013) p. 123–125.

manufacturer's products on its shelves at a much lower price than anywhere else. Of course, the Mega loses money on the sales. But profit is not the Mega's goal. Instead, it is to send a warning shot across the bow of any recalcitrant manufacturers: "Do business with us on our terms. If you don't, we will mess up your channels by forcing your distributors to lower their prices to match ours. Of course, if they do that they won't make any money and will discontinue buying your product…."

When asked by CNBC's Quintanilla if he had any qualms about buying and selling products through the gray market, Sinegal was unabashed. "What's wrong with it is when people try to manipulate the market so that they can control prices and keep prices artificially high. That's wrong."[2]

So, let's break this down: Here we have the CEO of one of the biggest retailers in the United States stating unequivocally that when a manufacturer tries to maintain the integrity of its prices and avoid the Customer Trap, "that's wrong." From Sinegal's perspective, it is *his* responsibility to save the buying public from the manipulative behavior of companies that make the investment to create and develop new products—even if that means Costco has to engage in manipulative and dubious behavior!

In the minds of many Mega-Customers, it is the distributor who is the most important player in capitalism. Innovators, creators, and builders are really nothing more than pawns in a business system that *they* have created. And while the Megas neither invented anything—nor took the huge risks to bring a new product to market—it is their sheer size that gives them unquestionable moral authority. They know what's best for the rest of us.

The hubris is beyond stupefying.

A Step Back Before Moving Forward

As we've stated earlier, the fundamental reality of the Customer Trap is the wholesale takeover of an innovator's business by a Mega-Customer. When the 10 Percent Rule gets broken, control gets wrestled away and power inexorably shifts toward the reseller and distributor. The growing dependency on a single customer dramatically reduces the ability of the innovating company to influence what happens to its products in the value chain.

Still—and this is an important point—resellers, intermediaries, and distributors are *not* by nature hostile and to be avoided at all costs. When properly managed, resellers, intermediaries, and distributors serve critical functions in helping to build the brands of their suppliers. If a customer continues to

[2]You can watch CNBC's documentary "The Costco Craze" and hear Sinegal's comments at www.cnbc.com/id/46603589#. It originally aired on April 9, 2012.

represent 10 percent or less of a company's total revenue—even if it is one of the big boxes, or the dominant player in another sector of the economy—the power balance remains tipped in the favor of the innovator, which is the way capitalism is supposed to work. The biggest gains should go to those who take the biggest risks. Other partners should benefit as well—if they add value. Nevertheless, the largest share of profits should go to those with the most skin in the game. The Customer Trap occurs when this principle is violated, and those who have invested little capture the lion's share.

Holding Data Hostage

The Customer Trap can be observed in the realm of data sharing and information transparency. Over the past quarter century, one of the most important features of business has involved the acquisition and control of information. The adage "if you can't measure it, you can't manage it" rings truer than ever. Since the advent of the information age, corporate leaders have sought to acquire additional and better information about every aspect of their businesses, so that they can manage more effectively.

No one worth his or her salt today would question the importance of organizing and understanding data. Business schools around the world have been outdoing each other to launch new MBA programs and courses in business analytics. Consulting firms are touting "big data" as the next phase in the advancement of the knowledge economy. Articles appear every day in the business press underscoring the benefits of harnessing information.

Of course, to accomplish this, information needs to flow both upstream and downstream, as well as inside and outside the company. The frequency of the information flow, as well the degree of the information's transparency, combine to determine the quality of the data that will be used in decision making.

The underlying assumption is that this information, melded with constant improvements in data-collection software, better analytical tools, and the seemingly ubiquitous "cloud," will unleash a new era, in which information will empower leaders in ways never dreamed of. Like most assumptions, however, it works only when it works.

In what can aptly be described as a true paradox, despite the widespread availability of data in business today, the presence of Mega-Customers has blocked the ability of many innovative companies to get access to the information they desperately need. While the data exists, it is simply not made accessible by many Mega-Customers to their suppliers.

Many companies are simply flying blind when it comes to what happens to their innovations after entering sales and distribution channels. The ability to acquire information about what is happening to the innovation gets thwarted

by the Mega-Customer. In consumer retail goods, for example, brick-and-mortar Megas—Walmart, Target, The Home Depot, and so forth—can hold hostage the data of their suppliers' products. When it is convenient for the Mega, it will release some information to the supplier. But this is done only when it serves the Mega's interest.

Even more depressing, many suppliers in this sector of the economy have thrown in the towel about ever getting data about the innovations from their Mega-Customers. They assume that lack of access to data is normal, merely "the way things have always been done." The customer is always right, right? If the Mega-Customer won't voluntarily share information about our products, then who are we to ask? As a result, American companies are often shooting in the dark when it comes to managing their enterprises. Table 4-1 shows the major challenges related to channel data associated with various functional areas of business.

Table 4-1. Primary Business Functions and Challenges[3]

Functional Area	Major Challenge without Channel Data Transparency
Marketing	Harder-to-recognize barriers to entry and new market opportunities
Sales & Distribution	Greater difficulty in anticipating customers' needs and providing effective channel incentives
Supply Chain	Increased complexity in managing product flows
Information Technology	Lack of actionable intelligence to analyze
Human Resources	Weakness in forecasting changes that will require new employees and/or current staff retraining
Finance	Reluctance to pursue new financing options
Risk Management	Inability to identify all the risks to the enterprise
Innovation	Inordinate fear of wasting R&D resources
Strategy	Decision making driven primarily by guesswork

In the area of marketing, for example, one wonders how a company can determine what the market thinks about its brands and products when it may not know who end users and final customers even are. This lack of understanding makes it harder to recognize obstacles standing in the way of getting a product to market, and it blocks the view as to what opportunities might be found on the other side of the intermediary.

[3]This was developed jointly between Zyme Solutions and the authors.

An illustration of how this lack of information transparency plays out is in the area of sales and distribution. As former distributors and manufacturers ourselves, the term "channel incentives" sends painful pulses down our spines. In order to enhance their product's visibility within a clogged or confused channel and drive sales, many manufacturers seek to increase the incentives offered downstream. Historically, the belief has been that by enticing channel partners with tangible financial rewards, attention by those partners will be refocused on a specific product or line. And, while the notion of providing an inducement is rooted in a rational theory about human behavior, things in reality are far more complicated. It reminds us of Yogi Berra's dictum: "In theory, there is no difference between practice and theory. In practice, there *is* a difference."

When we dig deeper into the effectiveness of channel incentives, for example, we find that a huge hole exists when it comes to the billions of dollars that are simply unaccounted for. Inefficiency, it seems, is the operative term. We estimate that approximately $1 trillion of sales in the high-tech sector, around 20 percent, is paid back through performance incentives to channel partners. This includes rebates, discounts, SPIFs, and the like to dealers, resellers, distributors, and other partners. This totals close to $200 billion. We have found that around 10 percent of that amount is either overclaimed or paid to the wrong entity. This is in the neighborhood of $20 billion!

In addition, another $200 billion in current inventory is being held at any time within high-tech distribution channels. It is estimated that 30 to 40 percent is at risk of being written off, discounted, or being deemed obsolete; and, of that number, 10 to 20 percent is simply not available due to channel inefficiency. This means another $6 billion to $16 billion has been misallocated.

Believe it or not, little or no research on this problem is occurring within the $2.5 trillion industrial sector. If we assume, for a moment, that the numbers from the high-tech sector are somewhat applicable to the industrial side, we are somewhere, conservatively, around $50 billion in the misallocation of channel incentives and loss in inventory value.

Managing supply chains on a good day, when there is transparency of information, is challenging enough. Keeping track of where things are, and where they are going, requires access to a constant flow of good data. Take it away, and everything becomes Alice in Wonderland, where down is up and left is right.

Information technology can be a wonderful asset to a company, so long as the inputted data is of high quality and reliability. Remove that data stream, however, and even the best analytics team is left shooting in the dark about what is really going on out there.

The same rings true on the human side of the enterprise. Being able to identify changes in the marketplace that will require additional employees *before* the competition does is a proven method to recruit the best talent. Of course,

staying a step ahead in recruiting is far easier when one can anticipate how the needs of the marketplace are changing. The same is true when retaining the best talent. Keeping top employees knowledgeable about emerging best practices is a way to maintain and build loyalty. Each of these requires a strong recognition of what is really happening. If a Mega-Customer is hijacking critical data about a company's products and services, it is nearly impossible to remain the kind of proactive employer many top performers want to work for.

The wide range of financing instruments available to a company today is truly impressive. Despite much of the bad rap attached to recent financial innovations—a lot of it deserved—there has been an exponential rise in the number, quality, and availability of commercial financing options. To weigh the value of any of these, it is critical for a company to possess the requisite information about itself before jumping in. How can this assessment be done if Mega-Customers are not providing the data needed? Risk management faces the same constraints. To paraphrase former U.S. Secretary of Defense Donald Rumsfeld, unknown unknowns are impossible to assess because we don't know about them.

A significant amount of new product failure is rooted here. Innovators go to market with one arm tied behind their backs. They simply don't possess the necessary information to manage in an increasingly complex world. If—by hard work, blood, sweat, and tears—they have done things right and introduced something of real value into the marketplace, without the data from their sales and distribution channels, innovators are left merely wishing for a better tomorrow. They can only go with their guts and hope, like a child at Christmas, that something magical will occur when they make the next uninformed decision.

Certainly having all the data available is no guarantee of success. Business is hard enough, even when we can know what is going on. But operating without the data is a recipe for disaster. What a tragic waste of scarce R&D resources, incentives, and human creativity! It doesn't have to be this way. Still, too often, it is.

In the end, the lack of information transparency enables power-hungry entities and perhaps even nefarious individuals and groups to hijack the hard-fought innovations of so many companies. Ceding too much control to a Mega-Customer has nothing but downside risks. If you think it can't get any worse, read on.

CHAPTER

5

Living the Outsourcing Compulsion

I don't pay good wages because I have a lot of money; I have a lot of money because I pay good wages.

—Robert Bosch

The conventional wisdom in government, business schools, and much of industry is that companies choose to close their costly domestic operations in favor of better prospects and profits in other countries. The ability to manufacture a product for 30 percent to 50 percent less than it would cost at home is widely considered to be the reason that American firms have flocked overseas in recent years. Thus far, the outsourcing (or, more properly, "offshoring") conversation has pitted shrinking transaction costs, enhanced efficiencies, and fat profits against job loss, societal disruption, and a sense of economic angst as industries restructure themselves to conform to the new realities of the digitized, global age.[1]

[1]This chapter is based in part on "The Outsourcing Compulsion," by Andrew R. Thomas and Timothy J. Wilkinson, *MIT Sloan Management Review*, Fall 2006, p. 10–14, by permission of publisher. Copyright © by Massachusetts Institute of Technology. All rights reserved.

Often unrecognized in the outsourcing-offshoring discussion is the strategic dimension. In fact, the compulsive embrace of overseas outsourcing—particularly the outsourcing rush, first to India, then Mexico, and later China, and now to even lower-cost locations such as Bangladesh and Vietnam—has less to do with international business than it has to do with how products are bought and sold in the domestic, American marketplace. The offshoring phenomenon is really about the purposeful weakening of America's industrial structure brought about as a business strategy by Mega-Customers. The move of American producers overseas is not so much an effort to seek new markets and new opportunities as it is a defensive response to power tactics the Megas employ here at home.

The underlying reality is that it is not corporate avarice that is driving large percentages of manufacturing out of the United States. What is forcing thousands of companies to close US operations and lay off workers is the imbalance in the sales and distribution model described in the previous chapters. The compulsive embrace of offshoring by US firms is not a function of internally generated goals and objectives, but it is, instead, driven by the sheer demands of corporate survival.

Globalization: A Mostly Necessary Evil

Unlike much of the rest of the world, globalization for most US companies has been often a tangential afterthought. Growth opportunities *do* abound for American companies outside the domestic market, where around 70 percent of *all* business activity takes place. Certainly the rise of emerging markets in recent years has provided opportunities to engage new middle-class consumers. US firms have long known that the power of American brands resonates across the globe. Apple, The Coca Cola Company, Caterpillar, and Google, among others, are as well known in Astana or Asuncion as they are in Akron. Nevertheless, the vast majority of US companies have still remained focused on servicing the massive internal consumer market—around $419 billion in consumer goods alone.[2] While China, for example, has the world's largest population at around 1.4 billion, the number of Chinese who live a Western middle-class lifestyle today is only around 70 million–not much more than the combined populations of Argentina and Peru. In the end, much of American business, including outsourcing and offshoring, remains squarely focused on what happens at home.

[2]SelectUSA, "The Consumer Goods Industry in the USA," http://selectusa.commerce.gov/industry-snapshots/consumer-goods-industry-united-states, accessed February 13, 2015.

Since the end of the Civil War, the US market has been far and away the biggest single prize for all sorts of businesses. The unparalleled combination of a secure continental island, almost unlimited natural resources, a small and unobtrusive government relative to its size, a dynamic system of capital creation and allocation, and a culture of entrepreneurship have made the United States unique in human history. These forces have blended in such a way that providence appears to be behind it all. For each of the past *15 decades*, despite recessions, depressions, crashes, and bubbles, the US economy was richer at the end of the decade than it was at the beginning.[3] In fact, the rise of the United States as the dominant global economic force has been *the* business story for the past 150 years. As John Steele Gordon observed, the United States became over a century ago—and remains today—"An Empire of Wealth."

By the end of World War II, the United States emerged as more than just an economic superpower. The US Navy reigned supreme on the sea and had the greatest fleet ever to sail. America's aircraft patrolled the skies without any interference, having already shown the nation's capacity and willingness to both build and deploy the atom bomb—twice. Hollywood entertained the world. More than half of all the capital on planet Earth was in American hands. No country in history was ever so powerful. Maybe God really did "shed His grace on thee."

Then, with all of this power in its hands, America did something unique in the course of human events. Instead of going back to the antiquities-old playbook of subjecting newly vulnerable peoples to vengeful punishments, the Americans truly shocked the world. Starting at the Bretton Woods Conference in July 1944, the United States reached out to its weakened allies and vanquished enemies and made an unbelievable offer: we will give you the needed capital to start rebuilding your countries and will carry the burden of protecting you from the aggressions of those who threaten you. In exchange, the United States asked for support in expanding American-style capitalism around the world. Further, to sweeten the deal—if it wasn't already sweet enough—the Americans declared that under the banner of free trade, foreign products and companies would have almost unrestricted access to the massive US market.

When the Americans laid out this deal, no one could believe their ears. Here was the most dominant nation in history saying that its strategic vision for the future was a world built on consumers and producers. And, incredibly, nearly all the costs and burdens of securing that vision would be borne not by the losers; rather, the winners of the war would do the heavy lifting for years to come. It all seemed to good be true. Yet, it *was* true.

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[3]The National Bureau of Economic Research, "Tables from *The American Business Cycle*," www.nber.org/data/abc/, accessed December 26, 2014.

Without having to contend with Soviet aggression or worry about centuries-long rivalries with their neighbors, countries like the United Kingdom, France, Germany, Japan, Taiwan, and South Korea could focus exclusively on rebuilding their economies. The security blanket provided by the United States ensured that business could be done without interference from others seeking to intrude on their growth. The stimulus provided by American capital through programs like the Marshall Plan jump-started much of Western Europe and Eastern Asia. Later, a significant portion of their prosperity would come from exporting to the United States. The eventual integration of China into the global economy initiated by President Nixon in 1972, and the collapse of the Soviet Union in 1990, assured for the foreseeable future that the dominant global idea would be capitalism as practiced in America.

To understand how that American-style capitalism evolved in the United States, particularly as it related to sales and distribution, requires a look back to the 19th and early 20th centuries.

Sales and Distribution: A Look Back

In the middle of the 19th century, sales and distribution was a haphazard proposition. As the United States spread westward, settlers were served by itinerant peddlers who sold goods obtained from Eastern cities or from isolated Western outposts. Shopkeepers in remote areas filled their inventories through semiannual shopping trips to large cities. The development of the railroad and the telegraph—innovations that make today's Internet pale by comparison—transformed the way business was done.

The initial beneficiary of the new technologies were wholesalers, also known as "jobbers." These individuals took title to goods purchased directly from producers through big buying networks, and sold to general stores on the frontier through large-scale (for the times) marketing organizations. The speed and predictability of the railroad, coupled with the ability to order goods through the telegraph, expanded the distribution capacity of jobbers, thereby reducing unit costs, which in turn led to higher profits. Just as the convenience of the new system allowed shopkeepers to concentrate on their local businesses, manufacturers benefited by receiving immediate payment rather than having to wait for their goods to be sold.

With the end of the Civil War, the country store of the Midwest spread throughout the South, supplied by full-service wholesaling firms that dominated distribution during the second half of the century. Supported by a legion of salesmen who travelled by train and carriage, wholesalers were able to help shopkeepers upgrade operations, improve accounting practices, and enhance merchandise presentation. In addition, they developed sophisticated purchasing operations. The activity of these buyers varied greatly because each product line required specific expertise and a specialized approach to the market.

In some instances, goods were sourced directly from manufacturers overseas. Circumstances sometimes required that private brands be developed for the wholesalers. At other moments, a wholesaler would become the sole distributor for a manufacturer's product. While backward integration into manufacturing occurred on occasion, most wholesalers focused on buying and selling rather than producing.

The wholesaler was largely an organizer of economic activity. Functional areas typically included the "traffic" department, which dealt with scheduling shipments from manufacturers, to warehouses, to retailers. As the system developed, a measure of performance evolved that is still with us today. Stock-turn was defined as "the number of times stock on hand was sold and replaced within a specified time period, usually annually."[4] Stock-turn measured the velocity of distribution. High stock-turn indicated that products were spending less time sitting on storeroom shelves, which meant lower unit costs and higher output per worker. It was the development of the telegraph and the railroad that made high stock-turn an achievable objective and created the possibility of mass marketing.

Emergence of Mass Retailing

By 1880, wholesalers began to be surpassed by either mass retailers, who bought directly from producers and sold through their own stores, or by manufacturers who built their own wholesale operations. In both instances, the activities of the previously dominant wholesalers were taken over, creating greater operational efficiencies. Retailers prevailed because they were able to achieve increases in economies of scale (lower costs associated with the volume of a product) and scope (lower costs associated with marketing different types of products) than wholesalers.

The new mass retailers came in four forms: department stores, mail-order houses, retail chains, and vertically integrated firms.

Department Stores

Department stores were an urban phenomenon. Retail operations that sold clothing or dry goods became department stores when they added furniture, glassware, jewelry, and other new product lines. Macy's and Bloomingdale's followed this course, as did Nieman-Marcus and Marshall Field's. The impetus behind the department store was the burgeoning of city populations in the decades following the Civil War. As the cities swelled with people, new lines

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[4]Alfred Chandler, *The Visible Hand: The Managerial Revolution in American Business* (New York, NY: Belknap Press, 1977), p. 223.

were added—carpets, upholstered goods, furs, men's and women's clothing, hats, shoes, toys—to satisfy the demands of a new, urban consumer class. The strategy of these stores was fairly uniform:

> They were aimed at maintaining the high-volume, high-turnover flow of business by selling at low prices and low margins. Profits were to be made on volume, not markup. . . . Above all, the mass retailers concentrated on maintaining a high level of stock-turn. This they did by marking down slow-moving lines, by extensive local advertising, and by creating a clearly defined management structure.[5]

Department stores were managed as decentralized holding companies, where the department head was king, free to make nearly all decisions about buying and selling goods, accountable to the central organization only for his financial performance. The head of a shoe department, for example, would make all of the decisions about where to buy shoes, how to price shoes, and even how advertising copy would read in the store's shoe ads.

Occasionally, department stores would integrate backward into manufacturing to produce a limited selection of products, such as clothing or upholstery. However, this was fairly rare, and management usually avoided controlling or managing the activities of their suppliers. Instead, as mentioned earlier, the strategy of the early department stores was based on stock-turn (velocity). For example, Marshall Field's had a stock-turn of 5 for most of the 20th century, while Macy's had a stock-turn of 12 for the year 1887. High stock-turns led to the ability to make more money with lower margins by selling at lower prices. Small retailers, complaining bitterly about this new, unfair competition, demanded state legislation that would protect them from the lower prices of the department stores.

Mail-Order Houses

The telegraph and railroad also paved the way for the first direct marketers. Though present in a limited form before the Civil War, mail-order houses came into full bloom in the years that followed. The first organization to sell a wide variety of products exclusively through catalog sales was Montgomery Ward, with catalogs in excess of 500 pages listing about 24,000 products. Sears, Roebuck & Company followed, and by 1895 it sold practically every consumer product that was then available through a 532-page catalog. Items included shoes, wagons, fishing tackle, stoves, china, saddles, firearms, buggies, glassware,

[5] Ibid., p. 227.

and musical instruments. Sales of $400,000 in 1893 nearly doubled two years later.[6] Like the department stores of the day, each merchandising department was fully autonomous; the buyer was in complete control of volume, catalog pricing, and the prices paid to vendors. The geometric growth in sales volume experienced by the mail-order houses prompted them to integrate backward into manufacturing. By 1906, Sears operated 16 manufacturing plants in order to maintain a steady supply of items for its numerous product lines. Its sophisticated system of logistics allowed it to surpass the retail volume of the department stores.

The ability of Sears and Montgomery Ward to increase profits through lower prices based on velocity (high stock-turn) and lower margins created a political fracas during the first decade of the 20th century. Smaller retailers and wholesalers railed against perceived unfair competition just as they had against department stores during previous decades. Despite protests, a bill extending parcel post service into rural areas was passed in 1912. Mass retailing was not stymied by entrenched, local interests. In fact, it was fostered by governmental action.

Chain Stores

Chain stores came to the fore in American retailing at the beginning of the new century. By the 1920s, they were under the same sort of political attack that had landed upon the department stores and mail-order houses years before. Chain stores differed from department stores in two ways: First, they consisted of multiple stores carrying similar merchandise spread out over a geographical area. Second, unlike the department stores and mail-order houses, they were centrally managed. Whereas buyers at the other forms of retail enterprise operated departments as independent principalities, managers of chain stores took their orders from the central office.

Referring to chain stores, one writer from the 1920s stated, "Some are centrally owned but independently operated. Some are centrally controlled and operated—this being the prevailing and most successful type."[7] Buyers consisted of specialists at the chain's headquarters. Hiring and firing was

[6]Sears Archives, www.searsarchives.com, accessed December 26, 2014.
[7]W.D. Darby, *Story of the Chain Store* (New York, NY: Dry Good Economist, n.d.), p. 9, quoted in John Perkins and Craig Freedman, "Organizational Form and Retailing Development: The Department and the Chain Store, 1860-1940," *Services Industries Journal* (1999), p. 129.

controlled by personnel departments. Store managers were likened to engineers operating locomotives. The key was standardization:

> The process of standardization is extended to almost every phase of chain activity; the stores are alike in appearance; the interior equipment is the same; the stock and position of the stock on the shelves of one store corresponds to that of any other store in the chain; the instructions given for running the stores are identical. Each manager has to fill out the same forms daily, to carry out the same routine of caring for cash, of locking up for the night, of all the detailed minutiae of storekeeping.[8]

F.W. Woolworth operated seven stores in Pennsylvania in the early 1880s. By the turn of the century it had sales of $5 million, and by 1909 it operated 318 stores throughout the United States. Similar to other retailers, success was based on stock-turn. In the mid-1920s, Sears and Montgomery Ward began chain stores of their own; a similar course was followed by large department stores in the 1930s.

During this period, producer-retailer relationships were under stress largely due to the power exercised by manufacturers coupled with the lack of interdependency among production and distribution activities. For most of the century, communications were carried out through the mail or through expensive "long-distance" phone calls. Computers, which didn't become commercially available until the 1960s, were expensive, difficult to use, and could not "talk" to each other. Industry leader Walmart didn't begin using information technology to coordinate with its vendors until 1987, and e-mail was not widely used until the mid-1990s. The ability to communicate, which we take for granted today, was a more complicated undertaking in years past.

Vertically Integrated Firms

Throughout most of the 20th century, the exception to the middleman situation existed in the vertically integrated firm, which combined manufacturing along with the sales and distribution function. By coordinating business activities within the firm rather than through external markets, producing companies could control all aspects of distribution, avoid dealing with intermediaries, and eliminate the need to negotiate with sales entities. Manufacturers developed distribution capacity, including sales, service, financing, installation and other appropriate ancillary activities.

[8]W.S. Hayward and P. White, *Chain Stores: Their Management and Operation*, Third ed. (New York, NY: McGraw-Hill, 1928), p. 8, quoted in Perkins and Freedman, "Organizational Form and Retailing Development," p. 130.

By owning their own retail outlets, these firms were able to monitor customer desires, better understand markets, and more carefully plan how best to approach buyer segments. National Cash Register, Remington Typewriter Company, Eastman Kodak Company, and Pabst Brewing Company are examples of producers that operated their own retail outlets during this period.

Arrival of the Megas

Although telecommunications, rails, and, eventually, trucking provided the means through which mass distribution expanded during the 20th century, relationships between producers and end users were limited. Transactions were overwhelmingly "arm's length," wherein manufacturers exploited economies of scale to lower costs, maximize production, and "push" their products onto the marketplace with little understanding of how much consumer demand really existed.

The need to coordinate supply and demand was filled by wholesalers, dealers, and distributors—middlemen—that stood between manufacturers and retailers. By managing huge inventories, these intermediaries served as buffers between producers and sellers, thereby limiting the need for coordination between the two.[9] Later technological advances created new tools that changed the dynamics between manufacturers and consumers.

The business historian Alfred Chandler explains the underlying economic logic of the wholesalers and new mass-market retailers, along with the emergence of the Megas:

> The intermediaries' cost advantage had resulted from exploiting the economies of both scale and scope. Because they handled the products of many manufacturers, they achieved a greater volume and lower costs per unit than did any one manufacturer in the marketing and distribution of a *single* line of products (scale). Moreover, they increased this advantage by the broader scope of their operation—that is, by handling a number of related product lines through a single set of activities (*scope*).[10]

Velocity was king. Economies of scale and scope ruled. What Chandler calls "managerial capitalism" was based on the idea that managers coordinated production and distribution activities within huge firms because it was more efficient than allowing the market to handle transactions through the "invisible hand." In fact, Chandler titled one of his books on the topic

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[9]Nirmalya Kumar and Jan-Benedict EM Steenkamp, "Retailing: Why Private Labels Succeed," www.rediff.com/money/2007/may/04retail.htm, May 4, 2007.
[10]Alfred Chandler, *Scale and Scope* (New York, NY: Belknap Press, 1990), p. 28.

The Visible Hand, implying that the invisible hand of the marketplace had been displaced by the visible hand of managerial activity. He states that, "The mass-marketers replaced merchants as distributors of goods in the American economy because they internalized a high volume of market transactions within a single large modern enterprise."[11]

Increasing stock-turn by growing volume, adding new lines of products, and opening new outlets allowed the mass marketers to price their products below that of smaller retailers who relied upon wholesalers, and to still be more profitable than those wholesalers. The mass-market retailers who benefited from this process—Gimbels, Hartfords, Woolworths, Kresges, and so forth—became phenomenally wealthy.

"Strategic Thinking"

In the early 1970s, manufacturers began to respond to the exhortations of management theorists who preached a doctrine of business transformation that emphasized resources, capabilities, innovation, technology, and operational effectiveness. Companies that had once been in control of all aspects of product development, sales, and service were slowly convinced by "leading" business thinkers to focus exclusively on "core competencies" and to get rid of everything else. Consequently, big companies began to divest themselves of activities that were not perceived as "value adding," while, at the same time, embracing operational paradigms that emphasized total quality management, material requirement planning, just-in-time inventory control, and lean manufacturing.

Eventually, efforts to "stick to the knitting" paid off, and firm boundaries underwent dramatic changes. Companies that previously had exercised power over their value chains were now outsourcing almost everything except those activities that they considered to be unique to their bases of sustainable competitive advantage. With rising pressure from perceived higher-quality Japanese companies, American manufacturers ended up spinning off not only business functions unrelated to their core resources and competencies, but also valuable distribution and sales capabilities.

By the end of decade, technological advances accelerated the amount of inefficiency that could be squeezed out of the retail sector. Today it is difficult to imagine a time when checkers manually entered numbers into a cash register and counted back change correctly, or when an individual standing in line waited patiently while the person in front of him slowly wrote out a check. Supply chain management, data mining and analytics, along with sophisticated logistics and inventory controls helped lead to the rise of the Megas.

[11]Chandler, op. cit., *The Visible Hand*, p. 336.

The big change came in 1987, heralded by a new approach based on the relationship between Proctor & Gamble (P&G) and Walmart. A former Walmart executive explains what happened:

> We both decided that the entire relationship between vendor and retailer was at issue. Both had focused on the end user—the customer—but each did it independently of the other. No sharing of information, no planning together, no systems coordination. We were simply two giant entities going our separate ways, oblivious to the excess costs created by the obsolete system. We were communicating, in effect, by slipping notes under the door. . . . Following the P&G/Walmart partnership, many other companies began to view the supplier as an important partner.[12]

Improvements in manufacturing processes and technology were making it possible for suppliers to the new Megas to customize products according the requirements of the end user. The need for extensive inventories diminished as the "marketing concept" became widespread and producers developed the capability to tailor-make products with short production runs through just-in-time manufacturing and other methods.

The Current American System

In previous eras, international business looked much different than it does today. The vast majority of American businesses focused on meeting the needs and aspirations of the ever-expanding domestic market through local production, sales, and distribution. Sourcing of raw materials from abroad was always an option and one that US companies engaged in when it made sense. Still, most products from US firms were sold to Americans, and nearly all services were of American origin.

At the same time, foreign companies benefited immensely from low entry barriers into the American market and were able to access the huge domestic consumer base. These included Japan's Honda Motor Company, Panasonic Corporation, and Sony Corporation; and Germany's Bosch, Siemens, and Volkswagen. While an exporting strategy was the initial way foreign firms entered the US market, long-term success was later found in locating entire operations in the country. Honda's Marysville, Ohio, plant first opened in 1978 to build motorcycles. Just a few years later, right next door, the Japanese company launched its first automotive plant in the United States. Being as close as possible to the American customer was the goal.

[12]Sam Walton, *Sam Walton: Made in America, My Story* (New York, NY: Doubleday, 1992), p. 222.

Presently, businesses in sales and distribution networks are reliant upon the products and services offered by other firms. Increasing population, hyper-competition, technology, globalization, specialization, and the ability to "unbundle" the value-adding activities of the companies involved in producing and distributing products has created an environment in which the "invisible hand" of the market seems to rule once again. Business historian Richard Langlois of the University of Connecticut explains as follows:

> In many respects, the structure of this new model looks more like that of the antebellum era than like that of the era of managerial capitalism. Production takes place in numerous distinct firms, whose outputs are coordinated through market exchange broadly understood. . . . Vertical disintegration and specialization is perhaps the most significant organizational development of the late 20th century.[13]

In the new global environment, in which companies find sourcing through the marketplace to be more efficient than building in-house, outsourcing and offshoring is a way of life. Globalization created a situation whereby these efficiencies were sought not only in the domestic market, but throughout the world. To see how globalization has become a major weapon in the Mega's arsenal, you must look carefully at what is meant when people refer to "foreign direct investment."

Foreign Direct Investment

Academic theories suggest that companies engage in foreign direct investment (FDI) overseas in order to acquire customers and new markets, to access raw materials, or to garner cheap labor. Recent investment in China, for example, has been explained in a number of ways. With 1.4 billion people, it is the world's largest potential market. Firms rushed in, hoping to capitalize on an emerging middle class that is expected to grow exponentially in coming years.[14] Until recently, the average manufacturing pay was less than $1 an hour, which also made it an attractive option for firms desiring lower wage rates. Finally, in some industries, China offers distinctive skills and expertise that are superior to those found in the United States. For example, Chinese engineers are on the cutting edge of developing technologies in the wireless chip and software industries, and they display formidable product and logistics skills

[13]Richard Langlois, "Chandler in a Larger Frame: Markets, Transactional Costs, and Organizational Form in History," *Enterprise & Society* 5:3, 2004, p. 365.

[14]Dominic Barton, "Half a Billion: China's Middle-Class Consumers," http://thediplomat.com/2013/05/half-a-billion-chinas-middle-class-consumers, May 20, 2103.

in auto-part manufacturing. [15] Each of these situations results from different motives for engaging in foreign direct investment.

FDI takes place when a company from one country makes an investment in another. It is distinguished from portfolio investment in that by definition, FDI involves both ownership and control. Examples of FDI include McDonald's opening one of its restaurants in Moscow in 1990, Timken's acquiring roller bearing manufacturing facilities in Romania in 1997, and Lenovo's acquisition of IBM's x86 server business in 2014. Each of these was an instance in which the parent company invested in foreign countries in order to access customers. This "market-seeking" FDI is typically what we see in the United States when firms from abroad build auto plants (for example, Toyota), buy our iconic firms (for example, Anheuser-Busch), or work with American companies on joint-venture projects (Électricité de France and Constellation Energy). The other type of foreign direct investment is called "factor seeking FDI." This occurs when firms are in search of factors of production, such as raw materials or cheap labor. But what is not considered in theories of FDI is the fact that many US companies have been pushed into outsourcing production, using joint ventures, or contract manufacturing—forced to close domestic factories and hire overseas companies to manufacturer their products—whether they want to or not.

In China, which opened up for business in 1979, western managers initially thought in terms of the huge Chinese market. A billion people are a lot of potential customers, especially considering what is likely to be considerable pent-up consumer demand. However, the FDI that flows into countries in the early stages of economic development tends to go to infrastructure projects, not consumer products. The Chinese government cherry-picked FDI, bringing in businesses needed for modernization, and firms that were export oriented. It did not allow foreigners to buy Chinese companies or set up their own subsidiaries. Until the mid-1990s, foreign firms operating in China were required to work with a Chinese joint-venture firm.

But if American businesses were unable to take immediate advantage of Chinese markets in order to produce gross profit, they quickly learned that an abundance of cheap Chinese labor could add to their bottom-line growth. It wasn't until the 1990s that the Chinese government allowed foreign firms to manufacture and sell consumer products in the domestic market. By that time, the pattern had been set and China was utilized as a manufacturing platform for the purpose of producing in-country, in order to sell offshore.

The intent of the Chinese government was to maximize the opportunity to learn from international partners and secure foreign capital. The Chinese

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[15] Committee on Comparative National Innovation Policies, *Rising to the Challenge: U.S. Innovation Policy for the Global Economy* (Washington, DC: National Academies Press, 2012).

feared that unless foreign companies were forced to team up with local partners, they would become little more than an export platform—an assembler of components that were invented and understood only in the advanced industrial world. Instead, a joint-venture strategy was pursued, and today, China is heavily engaged in R&D and new product development within the context of a large, but still emerging, economy.

Forced joint ventures come at a cost, however, and what was appealing to the Chinese government was often unappealing to American firms. Intellectual property infringement, operational and logistical difficulties, and the entire panoply of challenges that accompany large-scale operations in cross-cultural settings served to mute the joint-venture enthusiasm of US firms. Still, relentless pressure from their Mega-Customers at home forced countless American firms to swallow the bitter pill and outsource abroad. They really had no other choice.

The opening of China could not have come at a better time for the Megas. Information technology, particularly the rapid adoption of the Internet as a means of information sharing, eased difficulties associated with overseas manufacturing. The Megas, encumbered by mature market environments, hyper-competition, and unrelenting price pressures, were forced to look at the efficiency of operations in order to meet performance expectations. They were met halfway by their vendors, who had been fixated on a raft of management theories for 20 years or more. Instead of thinking about connections between production and distribution, manufacturers were thinking only about how to become more efficient. Let's take a closer look at an example of one retailer's forays into China and its impact on the US economy.

Walmart in China

Sam Walton had an early interest in sourcing from China, and by the mid-1980s, the company was importing a significant amount of merchandise. Concerned about America's growing trade deficit, he launched the "Bring It Home to the U.S.A." program in 1985. For several years, sourcing from Asia was managed through an organization created by Walmart—the Pacific Resources Export Limited. Walton wanted to buy from American companies, but only if domestic firms could compete with overseas suppliers.

After a period of stagnation following Walton's death in 1992, the company expanded its own in-house brands by working through unbranded suppliers in China.[16] Indifference to human rights issues by the Clinton administration, and the entrance of the country into the World Trade Organization in 2001, further legitimized China as the major supplier of products sold at Walmart.

[16]Sam Hornblower, "Walmart and China: A Joint Venture," *Frontline*, www.pbs.org/wgbh/pages/frontline/shows/walmart/secrets/wmchina.html, accessed February 13, 2015.

Pressed to lower their prices, Walmart suppliers repeatedly have made the discovery that their only option is to shift production overseas. Lakewood Engineering & Manufacturing Company is a case in point. For years, this electric fan manufacturer sold its 20-inch box fan for $20. Responding to Walmart's downward price pressure, the company opened a factory in Shenzhen in 2000, where labor costs averaged $.25 per hour compared with $13 per hour in Chicago. By 2003, the fan was sold at the Megas for $10.

In 2008, employees of Lakewood protested, alongside local labor organizations, the company's decision to close its electric heater operations and move production to China. Walmart bought 80 to 90 percent of the company's heaters. Lakewood claimed that its hands were tied because it was heavily mortgaged to Wells Fargo Bank, which refused to lend it more money. The company's relationship with the Mega resulted in the layoff of 220 workers and the outsourcing of production. The company went into involuntary bankruptcy in 2009 and was sold to Sunbeam Products.[17] Who was making money in this deal? Clearly not the manufacturer. [18]

Lakewood Engineering & Manufacturing is not the exception. Seventy percent of the products sold at Walmart either originate from China or have components manufactured in China.[19] If Walmart was a country, it would be the 27th largest economy in the world.[20] A commentary in *Forbes* sums it up:

> Walmart's decision to outsource manufacturing to China was one of the reasons behind the hollowing out of US manufacturing, especially at the low end. According to the Economic Policy Institute, Walmart's imports helped to destroy 200,000 US manufacturing jobs. It also helped China become a world power. Walmart now wants to bring manufacturing back to the US and is creating a $10 million fund to support US manufacturing. . . . But a $10 million fund is a proverbial flea going out to war with an elephant.[21]

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[17]Joseph Celentino, "Bankruptcy Circuit Split May Go to Supreme Court," www.courthousenews.com/2012/07/11/48286.htm, July 11, 2012.

[18]United States: Sunbeam Products, Inc. vs. Chicago American Manufacturing, LLC. No. 11-3920, (United States Court of Appeals, Seventh Circuit). http://caselaw.findlaw.com/us-7th-circuit/1605632.html, assessed March 10, 2015.

[19]Anita Chan, *Walmart in China* (Ithaca, NY: Cornell University Press, 2011).

[20]Dina Spector, "18 Facts About Walmart That Will Blow Your Mind," www.businessinsider.com/crazy-facts-about-walmart-2012-11, accessed January 21, 2015.

[21]Dileep Rao, "Walmart's $10 Million Plan Is a Good Start," www.forbes.com/sites/dileeprao/2014/02/17/walmarts-10-million-plan-is-a-good-start/, February 17, 2014.

And the Others Soon Follow

In fact, outsourcing to China has been a phenomenon. The most famous outsourcing center is the Foxconn "campus" in Shenzhen where iPads, Macs, and iPhones are made, as well as Sony's PlayStation 3, Amazon's Kindle Fire, and the Nintendo Wii. The Taiwanese company is the major assembler for Hewlett-Packard, Dell, and Acer, and manufactures all of the game consoles for Nintendo, Sony, and Microsoft. It employs 1.2 million Chinese, 220,000 in Shenzhen.[22] A *Frontline* documentary on Walmart sums it up:

> By now, many manufacturers . . . have little choice but to redefine themselves as "branded distributors" for overseas goods. In other words, instead of making their own products, they use their own brand names to market Chinese-made goods to retailers. They eke out profits by outsourcing production and marketing that production. The process is virtually the final step in the surrender to the Walmart/China joint venture.[23]

As a result of the Megas rush to source from China, other retailers have been forced to follow suit to stay competitive. The mail-order catalog company L.L. Bean was for decades the epitome of Yankee independence and all things American. In the 1990s, it was pressed by the raft of new mail-order companies that had appeared on the scene as well as price pressures from the Megas. By 1998, the company was ready to outsource. Chris McCormick of L.L. Bean said this:

> I don't want to overstate it, but we were lagging in our sourcing competencies. I'm guessing 60 to 70 percent of our items were probably sourced in the [United States] then. Maybe a little bit less than that but not much. What the consultants pointed out is that the world had moved offshore. Yes, it would be nice if we could keep sourcing products in the [United States] but, realistically, all those jobs were going offshore anyway. The competencies were leaving

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[22]James Fallows, "Inside Foxconn," www.theatlantic.com/international/archive/2012/10/inside-foxconn/263791/, October 18, 2012.
Michael, Kan, "Foxconn Builds Products for Many Vendors, but Its Mud Sticks to Apple," www.computerworld.com/article/2492795/it-careers/foxconn-builds-products-for-many-vendors--but-its-mud-sticks-to-apple.html, October 24, 2012.
[23]Sam Hornblower, "Wal-Mart and China: A Joint Venture," http://webcache.googleusercontent.com/search?q=cache:g62Ba3jRHhUJ:www.pbs.org/wgbh/pages/frontline/shows/walmart/secrets/wmchina.html+&cd=1&hl=en&ct=clnk&gl=us. Accessed March 6, 2015.

> this country and, from a competitive standpoint, we really had no choice. The quality, by the way, would be just as good if not better than the [United States]. So we created the sourcing department and gave them marching orders to improve our margins and reduce our cost of goods sold.[24]

In 2000, the outsourcing initiative resulted in $30 million in savings, making it a very good year for the company, McCormick said, "It wasn't so much sales growth that drove the performance of that year; it was improving margins that improved profitability of that year.[25] By 2006, only about 20 percent of its items were produced in the United States. Despite this decision, L.L. Bean still trumpets the Made in America tune by pointing out on its website that its factory in Brunswick, Maine, employs 450 people that " continue to make iconic products such as the Maine Hunting Shoe, L.L.Bean Boots, Boat and Tote Bags, dog bed liners and small leather goods." But in bragging about its Made in America products, the company also makes this sad point, " We're one of the last multichannel US merchants to still own and operate a US manufacturing facility."[26]

In fact, today innovators are hard-pressed to find companies in the United States with the ability to manufacture their products. Consider the Marshmallow Fun Company, which designs and sells toys that shoot spongy, sweet "marshmallow ammo" long distances. An article in *The Wall Street Journal* stated the following:

> So far, . . . the Dallas-based company has been unable to hit one of its targets: making at least some of its "blasters" in the United States rather than relying exclusively on contract manufacturers in China. "I salute anybody who's making goods in the U.S.A.," said Beaver Raymond, chief executive of the 10-year-old toy maker, whose products retail for about $20 to $28, "but it isn't so easy." Mr. Raymond and other American entrepreneurs eager to bring manufacturing back to the US often run up against an obstacle: unlike China, the US has few contract manufacturers geared up to make consumer products on a large scale.[27]

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[24]Leon Gorman, *L.L. Bean: The Making of an American Icon* (Boston, MA: Harvard Business School Press, 2006), p. 253.
[25]Ibid., p. 264.
[26]L.L. Bean, "Product Sourcing and Labor Rights," www.llbean.com/customerService/aboutLLBean/sourcing_and_labor_rights.html, accessed January 21, 2015.
[27]Hagerty, James R, "It's No Fun Making Toys or Toasters in the USA—With Few Contract Manufacturers in US, Many Businessmen Turn to China's Expertise and Scale, *The Wall Street Journal*, February 10, 2015, p. B1.

In contrast, contract manufacturers in China can make anything. According to Stephen Mauer of Shanghai-based AlixPartners, "You can find a specialist in any product. . . . You want a toaster oven? There are a dozen contract manufacturers that make toaster ovens. That kind of contract manufacturing just doesn't exist anyplace else."[28]

Mexico: The New (Old?) China

China, India, and other Asian nations are not the only destinations for American companies forced into outsourcing. In recent years, wage inflation in China has made Mexico's proximity more attractive. For example, auto workers in Mexico are paid about $26 dollars for a day's work, one-tenth of their counterparts north of the border.[29] Today, the average monthly income of a production worker in Mexico in is $353. Given the logistical challenges of operating in China, it is no wonder that American companies have been shifting production to Mexico as Chinese wages have increased in recent years.[30] Even the Chinese themselves have moved operations to Mexico. Foxconn now has a manufacturing center in Ciudad Juarez that mass-produces products during the introduction phase as well as later stages of the product life cycle.[31] Tremendous savings related to shipping are also being realized. For example, all Dell computers are manufactured at Foxconn's location in Juarez, which has the capacity to ship 1 million computers a month.[32]

The Outsourcing Compulsion

Presently, far too many US companies view outsourcing as their only option when it comes to "growing" their businesses. They are locked out of opportunities at home because of abnormal relationships with Mega-Customers that not only control the delivery of their products to consumers, but also wield tremendous power over their internal processes. Cut off from the ability to control distribution and sales, these firms can grow

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[28]Ibid.

[29]Bloomberg News, "GM, Ford Boost Mexico Output With $26-a-Day Workers" www.bloomberg.com/news/articles/2010-06-09/gm-ford-to-accelerate-growth-at-mexico-plants-where-workers-get-26-a-day. June 9, 2010.

[30]Tim Johnson, "As China's Wages Climb, Mexico Stands to Win New Manufacturing Business," www.mcclatchydc.com/2012/09/10/167930, September 10, 2012.

[31]John Hadjimarcou, Lance E. Brouthers, Jason P. McNicol, and Donale E. Michie, "Maquiladoras in the 21st Century: Six Strategies for Success," *Business Horizons* 56, 2013, p. 207–217.

[32]Brook Stockberger, "Foxconn plant may boost Santa Teresa," www.elpasotimes.com/ci_21203328/foxconn-plant-may-boost-santa-teresa, August 1, 2012.

only by cutting costs at the other end of the value chain. They must chase the cheapest inputs, particularly labor, to generate adequate margins and maintain shareholder value.

Equally debilitating is the fact that many of the efforts manufacturers make to invest overseas fail miserably. Because they feel compelled to relocate some or all of their operations offshore, they may not accurately assess the inherent risks in doing business in less-developed countries. In China, for example, an overwhelmed infrastructure, competition for scarcer and scarcer resources, a government that frequently protects local interests over those of foreign firms, and an impending currency correction are critical elements that manufacturers often do not, or seemingly cannot, consider. Such factors must be heavily weighed when looking at overseas locations. However, the perils of doing business in emerging markets are often glossed over as the demands of the Mega-Customers compel manufacturers to embrace what appears to be their only strategic option.

Yes, it is a fact that American firms are being pulled overseas by the allure of potential profits and cheap labor. The ability to hire software engineers in India at less than half the cost of their American counterparts, and the impressive, though inexpensive, capabilities of China's flexible manufacturing facilities, produce a siren-like enchantment to Western managers. The underlying reality remains: it is not corporate avarice that is driving large percentages of manufacturing out of the United States. Nor is it the desire for the cheapest price on the part of consumers. This coercive push is being driven by something more proximate to our domestic environment than the desire for new markets, lower labor costs, or greater efficiencies in sourcing. What is forcing thousands of companies to close US operations and lay off workers is the imbalance in the domestic sales and distribution model described in the previous chapters. The compulsive embrace of offshoring by US firms is not a function of internally generated goals and objectives, but is instead driven by the sheer demands of corporate survival for those companies in The Customer Trap.

PART II

Avoiding the Trap

Criticism simply for the sake of criticism is the purview of only a select few. Those who critique books, movies, plays, and restaurants, for example, do so knowing full well that their criticism goes only as far as their personal tastes.

In business, such an approach to criticism is anathema. If someone seeks to disparage a particular business practice, they should have a viable alternative. If they do not, they better step aside.

If the Customer Trap has taught us anything, it is that much of the thinking around sales and distribution is gravely flawed. Part I of this book is our critique. In Part II, we show how a company can avoid the Customer Trap in the first place.

CHAPTER

6

The STIHL Story

Few things are harder to put up with than the annoyance of a good example.

—Mark Twain

Fred Whyte, president of US-based STIHL, speaks about the outdoor power equipment produced by STIHL with the same kind of care and deliberation you would expect from someone who was clearing trees with one of the firm's legendary chain saws. He has been with the company for 42 years—the last 25 as president of US operations. Before that, he was the president of STIHL Canada for 10 years. Whyte remains a Canadian citizen, a fact concealed by a Midwestern accent that avoids even the occasional "eh." When we met with him, we started with this question: "Was there ever a moment that you were tempted to sell through the big-box stores?" He paused for a moment and then followed with an emphatic, "Unequivocally, no." And then he said, "You can't be all things to all people. You have to know who you are and what you are going to be when you grow up."[1]

In the United States, STIHL markets its products through 12 regional distributors and 8,500 servicing dealers, more than 50 percent of which sell only STIHL-branded handheld products. You cannot buy STIHL chain saws, blowers, trimmers, or brush cutters at Lowe's, The Home Depot, or Walmart. This is not because there have not been huge efforts to get STIHL products into the Megas. Sales presentations have been made, performance standards have been guaranteed, and huge profits have been projected. However, the efforts to strike a deal have been undertaken by the Megas—not STIHL. Fred Whyte states, "For quite a period of time, we had Lowe's and The Home Depot representatives flying in here on their private planes, sitting down with us, doing their PowerPoints."

[1]All quotes from the president of STIHL, Fred Whyte, come from an interview originally held on February 10, 2009. Subsequently, we have had several discussions with Mr. Whyte and his senior management team. Any facts were most recently updated in 2014.

The story of STIHL is a story of invention, creativity, and quality coupled with service, loyalty, and vision. It is the last of these, a remarkable clarity of vision, that has kept the firm out of the Customer Trap. The company has simply never given the mass-market discounters even one moment of serious consideration. This vision and intelligence, which pervades the company, was instilled by the firm's founder from the very beginning.

Origins

Andreas Stihl liked to figure things out, to know how things worked. Born in Zurich in 1896 and raised by relatives in Germany, he was sent to the front lines in World War I, where he received severe injuries leading to a medical discharge in 1917. With his military service behind him, he studied mechanical engineering at the technical institute in Eisenach and spent three years working for large companies, one of which built steam engines for sawmills. It was during this time that he perceived a problem and began to formulate a solution that would revolutionize the forest products industry throughout the world.

The problem he identified was that trees had to be brought down by stationary saws or axes and then transported whole to sawmills before being cut up into manageable pieces. This required moving heavy timber over many miles. Working out of a small workshop, Stihl designed and built the first-ever electric chain saw in 1926—a two-man 140-pound "cross-cutting chain saw." In 1929, he introduced the company's first gasoline-powered chain saw. Although it also required two men for operation, its portability revolutionized the wood products industry.

It was at this time that a particular aspect of Stihl's personality would ensure decades of postwar success and ultimately would protect the company from mass-market retailers: Stihl truly believed in serving the customer. Employees were trained to instruct buyers in how to use and maintain products purchased from the company. In addition, the company insisted that whoever sold STIHL products had to have the ability to service and repair those products. One early employee stated, "It won't do to sell saws to people without teaching, assisting, and offering good service to users later."

Like any innovation, the chain saw had its share of critics. Loggers, afraid the new technology would put them out of work, vigorously opposed the new technology and even attacked STIHL's salesmen. Stihl dealt with opposition through education and training. In 1937, he introduced chain-saw training courses at logging camps throughout Germany, and during a trip to the United States in 1939, he conducted seminars in power-saw technology. These efforts were used to overcome resistance and to introduce potential customers to his revolutionary new product.

Chain-saw training was a lengthy affair that is difficult for us to imagine today. A history written for the company provides the following account from 1939:

> The inhabitants of health resort Langenbrand near Bad Liebenzell in the Black Forest were very surprised when about ten chain saws sputtered to life in the yard of Hotel Ochsen. It was a feast for the eyes of the instructors to see how the district foresters with their chief fellers and forest workers practiced starting the chain saws and sometimes opened the throttle far more than necessary. There were one or two very funny incidents during the first exercise, i.e., starting and cross-cutting, which showed the men were really children at heart.
>
> From the second day of the course, the participants sang their way into the woods, where they were able to practice felling and bucking as long as they wanted. In this process, some of the men were so enthusiastic that they forgot that their colleagues also wanted to try out the machines and learn something.
>
> The chief forester in charge, who came into the woods every day on horseback with his head held high, took the course participants under his wing and looked after them. The course continued with lectures, explanations, and practical work until its successful conclusion was celebrated in a festive mood on Friday evening. Chief state forester Evers and Mr. Stihl, with several gentlemen from the company, joined them, and the foundation for more chain-saw training courses was laid while talking shop, telling jokes, and drinking beer. It should be mentioned that two pigs were slaughtered to provide food aplenty for all. Saturday after lunch, the course participants proudly and happily set off home with new energy and the machines they had bought.[2]

During this time, Stihl continued to improve his saw, creating a lighter weight and more reliable product.

Allied bombing raids during World War II destroyed the STIHL manufacturing facilities in Stuttgart-Bad Cannstatt , and production was relocated to Waiblingen. In 1945, Stihl was arrested by French troops and turned over to the Americans. Like all of Europe, the company languished during the immediate postwar period, but by 1948, Stihl was released from custody and eventually returned to the helm of his enterprise.

[2]Waldemar Schafer, *STIHL: From an Idea to a World Brand* (Stuttgart: Schaffer-Poeschel Verlag, 2006), p. 26.

The major breakthrough for the company occurred in 1950, when STIHL introduced the first one-man saw. An improved version brought to market in 1954, at 31 pounds, was the first chain saw that was truly portable. New products and innovations followed, including the Contra introduced in 1959 (with its direct drive and diaphragm carburetor) and a saw with an antivibration system in 1965. Constant improvement and innovation characterized the company's products throughout the period.

STIHL's innovations stimulated demand for chain saws and, between 1963 and 1965, output doubled from 65,000 to 130,000 saws. By this time, the business had 50 percent of the German market share and a 16 percent share worldwide. Within a decade, the company's 2,000 employees were producing 340,000 saws annually.

Andreas Stihl died in 1973 at the age of 76. Despite two world wars, raging inflation, crippling poverty, tough competition, and many other obstacles, the inventive mechanical engineer had managed to build a company with 2,500 employees producing the world's leading brand of chain saw. The following year, STIHL opened a 20,000-square-foot facility in Virginia Beach operated by fewer than 50 employees to facilitate its exports into the US market.

By 1960, Stihl's four children had become limited partners in the company, and because of careful planning, the transition to new leadership went smoothly. Hans Peter Stihl was designated as the successor to Andreas in 1972. The company weathered the economic slump of the 1970s and the global recession of the 1980s. In 1986, it began to offer complementary products, including safety glasses, gloves, boots, helmets, and hearing protectors. New products were also introduced, including trimmers and leaf blowers, as well as specialized clearing saws.

Until the 1990s, STIHL produced chain saws strictly for professional use in the forest and lumber industries. This left 50 percent of the market untouched by the company. Ongoing innovations, including design innovations that reduced the weight of the product to 20 pounds, prompted the company to move aggressively into the small-saw market. In 1994, STIHL shifted the production of all small saws to the United States and, as of 2014, the Virginia Beach operation consisted of a manufacturing and administrative facility of more than 1 million square feet, with approximately 2,100 employees. In 1973, another manufacturing facility was established in Brazil. A sales office was set up in China in 1995, followed by manufacturing operations in 2005.

STIHL became the market leader in the chain-saw segment in 1992, eclipsing both Homelite and the McCulloch Corporation. The STIHL Group today employs more than 13,800 people around the world and manufactures more than 275 model variations of chain saws, trimmers, leaf blowers, mini cultivators, and other related products.

In a 2008 speech given to employees of one of its American regional distributors (Bryan Equipment Sales in Loveland, Ohio), Hans Peter Stihl attributed the success of the company to four strategies:

> First, product innovation and quality. This is the lifeblood of any manufacturing concern. This is especially true for STIHL because of the high expectations our customers have for our products. Whether it is the introduction of new engine technologies that lead our industry by meeting or exceeding strict Environmental Protection Agency emission standards, or the advanced manufacturing processes that you will find in our Virginia Beach facilities, our customers ultimately experience dynamic products and features that are the hallmark of our brand.
>
> Second, the high level of in-house production. Unlike many other companies, we have not increased our outsourcing of component manufacturing. Actually, we have taken additional processes in-house to maximize quality while minimizing material cost increases and achieving delivery deadlines.
>
> Third, establishing an international manufacturing network. As you are aware, products produced at STIHL Incorporated are distributed across North America and shipped to (more than 90) different countries around the world. A significant portion of the annual production at Virginia Beach is for the export market, and STIHL Incorporated can be proud of its achievements in this regard.
>
> Fourth, and perhaps most importantly, the success of STIHL is based on unique marketing strategies. Virtually all of our primary competitors have compromised their retail distribution strategies to accommodate mass merchants and home centers. While this approach may offer some near-term advantages by way of increased sales distribution, the long-term effect can be a loss of identity and competitive uniqueness. This is not the STIHL way. Instead, we rely on our distribution associates, like Bryan Equipment Sales, to build and maintain relationships with our servicing dealers who serve our customers. And, like STIHL, Bryan Equipment is family owned, and I am pleased to now see the third generation of the Bryan family entering into the leadership position within this highly successful organization.[3]

[3]Speech by Hans Peter Stihl, Bryan Equipment Sales, Loveland, Ohio, 2008.

Service

Further into the preceding speech, Hans Peter Stihl summed up the company's service philosophy: "These big boxes are not able to give service. . . . No service, no sale." Fred Whyte, president of the US-based STIHL, said that STIHL has never been tempted to sell to the Megas because service was a key ingredient of the value proposition from the beginning. "Who likes to buy a new car without driving it around the block?" he asked. "The first challenge for STIHL dealers is to explain why their chain saws may sometimes cost $50 to $100 more than those of competitors." A price-based shopper—and most Americans are fixated on price—will not know that a STIHL chain saw has a unique chain brake, a higher-grade chain, an automatic gear-driven oiler, and a chrome-impregnated cylinder with superior heat-transfer capabilities and greater durability. A knowledgeable salesperson is required to communicate the superior quality of STIHL products. According to Eric Bolling, the manager of a STIHL dealership in Virginia, a customer will buy a higher-quality product that costs more, "if you can actually show the person what they're paying for."

STIHL dealers "qualify" customers by asking a series of questions so that they can make sure that they get the right product into the customer's hands. They instruct buyers in how to properly use and maintain the equipment they sell, and they offer protective clothing, such as chain-saw protective chaps, and eye and hearing protectors. STIHL's effort to get protective gear into customers' hands is not just a matter of "plus-selling." Although no one knows for sure, estimates are that around 20,000 accidents a year occur involving chain saws. In an article published in *The Wall Street Journal*, reporter Gwendolyn Bounds stated that she "discovered finding critical safety equipment at some big-box retailers can be hit or miss. The Home Depot and Sears, for example, carry some eight brands of saws between them, but spokespeople for both stores say that chaps aren't an item they choose to stock at this time. Lowe's, by contrast, does stock chaps and offers dedicated how-to-clinics in regions where chain saws are in high demand."[4]

STIHL dealers also operate full service centers at their retail stores. The goal is to establish a relationship with customers while making a "complete sale." By providing a dealer who is an expert, the customer not only is prepared to properly operate what can be a dangerous piece of machinery, but also can view the dealer as the authority when it comes to ancillary products, whether or not they are produced by STIHL (for example, lawn mowers, garden tractors, fertilizers, and so on).

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[4]Gwendolyn Bounds, "Did It Myself: Joining the Chain Saw Gang," *The Wall Street Journal*, February 4, 2006, p. 5.

It has never made sense at STIHL for a premium piece of machinery to be sold in a box without interaction with the customer. For this reason, you cannot buy a product from STIHL on the Internet and have it shipped to your home. STIHL in the United States, however, has shortened the shopping convenience bridge between its dealers and prospects via its online shopping program, STIHL Express. Through this program, a customer can reserve a STIHL product online and then pick it up at the dealer, who can provide expert advice and a fully assembled product, fueled and ready to go. According to the company, selling unassembled products that come in a box, with little or no protective equipment, and without a reliable dealer who can knowledgeably service the product is the opposite of building a relationship with a customer and is contrary to the STIHL business model. The nonservice sales approach ultimately results in low profitability over time.

The Dealer's Perspective

STIHL believes that its dealers are the lifeblood of the company and that the most critical point in its distribution channel is the counter space bringing servicing dealers to their customers. For decades, a conscious effort has been made to help dealers understand that they are a vital part of the firm's operations. An internal company history records the approach that STIHL has taken with its dealers:

> "Groups of dealers from all over the world are regularly invited to [the] head office, so that we could show them our factory and they could see how STIHL saws are made," explains Reinhold Guhl. In the evenings, Andreas Stihl, while he was still healthy, as well as Hans Peter Stihl, the export boss, and a number of other staff sit down with the dealers to talk things over in a relaxed atmosphere.
>
> Two things are very important at the meetings, stresses Guhl. First, it is necessary to keep underscoring the company's loyalty to servicing dealers because many of them fear that STIHL, as it grows in size, might terminate their agreements at some time. After all, the main competitors switched from specialist dealers to the big chains during the eighties and thereafter.
>
> Second, the photo session is an important part of the meeting with independent dealers. Everyone has a photograph taken with Stihl senior or junior, or both. The pictures are meticulously set up by the company's photographers, with warm handshakes and friendly smiles all around.

> Such pictures are soon hanging on the walls of showrooms all over the world. And dealers point out proudly: "As you can see, I know Mr. Stihl personally. I visited the place where the STIHL saws are built." And long stories are probably told in many places about the great factory and the pleasant evening spent drinking Swabian wine with "my friends Andreas and Hans Peter" and many others. This very personal approach in taking care of independent dealers is largely responsible for the good reputation of the company and the Stihl family among servicing dealers.[5]

STIHL dealers are nearly uniform in their praise of the company. Billings Hardware sits at the far end of Grand Avenue in Billings, Montana. If you walk in the front door and make an immediate turn to the left, you will see a huge display of STIHL products. Dan Thomas, a soft-spoken, articulate man who looks like he is in his mid-50s, is in charge of service at the store. "I've been in outdoor power equipment since 1979, and I've owned two dealerships of my own. I've worked at almost every level—including manufacturer's representative, service technician, sales, and management. I've done everything there is to do in this industry." Between fielding phone calls, Thomas explained that the industry has changed dramatically since he was in business with his father in the 1980s. "A lot of manufacturers were enticed by big chains and big-box stores to increase their numbers as far as sales go. That changed the industry—probably forever. A lot of manufacturers did not survive."[6]

One consequence of manufacturers moving toward the big-box stores was that they lost their relationship with independent dealers. The dealers could not compete with the price points offered by the Megas, so they discontinued the product lines that had been introduced in the big-box stores and sought out high-end manufacturers. Without the independent dealers, no one was around to service or repair units that had been sold. Thomas pointed out that there are exceptions. In Billings, Husqvarna equipment, which is sold at Lowe's, can be serviced at some Big R stores. But if you buy a Homelite or Poulan chain saw, "You are on your own." For purchasers,

[5]Schafer, *STIHL*, p. 91.
[6]Interview with Dan Thomas, Billings Hardware, February 23, 2009.

product reliability is a hit-or-miss proposition. Thomas described the quality issue in this way:

> The outdoor power equipment that's carried in big chains is generally not as good or as high quality as that carried by the independent dealer. That's strictly because the mass merchants want to market something at a lower price. Before the mass merchants became predominant in power equipment, most manufacturers had some good products. Once the manufacturers started getting into great big numbers, their quality went down for two reasons. First, they had to produce more units much more quickly. Second, the retail outlets were demanding a much less expensive unit, so they put less quality into it and cut corners in their manufacturing. At least as far as chain saws go, [Names three brands] were all fairly decent manufacturers back before that huge change in the industry. All of those units in this market are now of lower quality and are sold on the basis of price.

STIHL is viewed positively by Thomas. He stated that the company has a very good brand name and a high-quality product that is "the best-quality machine on the market right now." Husqvarna and ECHO are two other nationally known brands that Thomas considers to be "the next best machines." However, when they are purchased at the Megas, customers may or may not end up with a product that is appropriate for a particular job. Thomas explained his approach:

> The first thing I want to do is ask the customer what he is going to use the unit for and how he is going to use it. The worst thing you can do is sell somebody a piece of equipment that's not heavy-duty enough to do the job. He simply will not get satisfaction out of that machine. That is true for every line of equipment that is sold. You must get the customer to buy the unit that he wants to use in a certain application.

Thomas has the highest level of technical training offered by STIHL, which he acquired at the company's manufacturing facility in Virginia. He observed, "Big-box stores generally do not have qualified sales people on the floor that can help customers. There are some individuals who have some knowledge in those places, but not very many."

An entry on Arboristsite.com is representative of the perspective of many dealers:

My distributor was Mid-Atlantic STIHL in Hillsborough, NC. Never have I dealt with a finer organization—their customer service was excellent and their parts fill rate was even better . . . STIHL suggests a retail price—that

allows a dealer to make a certain amount of profit—but a dealer is free to sell for more or less. I always sold parts and whole goods for retail price (certain exceptions were made for high volume sales customers.) . . . Dealer profit is essential—otherwise there won't be any dealers. STIHL also has no minimum-order policies. There are incentives such as a minimum size order (it used to be $2,500 but may be higher now) to get free freight. . . . Many times, a customer needed a part . . . STIHL would ship it that same day and I'd sell it and pass along the freight. Customer and dealer happy."[7]

This testimonial demonstrates the kind of respect that STIHL has for it servicing-dealers. Fundamentally, the company understands that its business involves more than manufacturing the best outdoor power equipment in the world. It understands that small business owners and individual technicians operating across the globe are the key to its success.

Avoiding the Customer Trap

Peter Burton, STIHL's former vice president of marketing and sales, said, "The category killers are tempting. It's easy to get caught up in the adrenaline rush when they come calling. The kind of volume they say they can deliver, it's huge." The mass-discounter temptation is tempered by STIHL's vision of its place in the market and by an awareness of what happens to companies when they do business with the Megas. The downward spiral caused by the Customer Trap is well understood at STIHL. President Whyte presented it as a kind of parable:

> The big-box store people say, "Andrew, you are our most important supplier; a great guy, and we love you to death, and this is a fantastic product you have been giving us." So what does Andrew do? He goes home, sits down with his wife and says, "Honey, I added a Mega account; we're on easy street now. We're going to buy that new boat, and we get to buy the bigger house, and we get the Mercedes." Andrew then hires 20 people and builds a new building. The second year, Andrew comes back and sits down with his customer, and the same scenario is repeated, "Andrew, you're one of our preeminent suppliers, but we are going to have to double our volume with you this year with such a successful product." Andrew goes home, sits down with the wife. He gets a bigger boat, he buys a bigger house, he hires more people, he obtains more machinery, he buys bigger buildings. The third year, Andrew sits down with his Mega-Customer, who says, "Andrew we've had a great relationship with you, we love you to death, but this guy Terry Kelley, representing the Chinese company, can sell us the same

[7]Available at http://www.arboristsite.com/community/threads/do-stihl-dealers-not-like-to-sell-saw-builders-parts.90103/page-3. Accessed October 27, 2014.

> product for half the price." Now, what is Andrew going to do? Andrew doesn't go home and tell his wife he's selling the boat and laying people off. No, he looks at his chain saw and says, well, you know, we don't have to put chrome on that chain, we don't have to put ball bearings in the engines, we could put in bushings, instead. We don't need a gear-driven automatic oiler, we can put in one that takes a little pressure off the crank case that's manual. And those antivibration mounts, well, we can just put a bushing in there too. So over time, the quality of the product becomes eroded to meet a price; then you know what happens to the brand after that.

Whyte's parable is not idle talk. He watched it unfold with his company's once-great competitors. McCulloch Motors Corporation, founded in 1943, produced chain saws that were lighter than STIHL's through an assembly-line process that was, at the time, more advanced than the German firm's. Renamed McCulloch Corporation, it began to sell through J.C. Penney in the 1970s and was subsequently acquired by Black & Decker in 1988. Black & Decker had also pursued the mass market, and so diminished their brand image in the eyes of professional contractors, such that they had to reinvent their brand with the launching of DeWALT in 1992.

Today McCulloch is owned by Husqvarna, having passed through the hands of Jenn Feng Industrial Co. after filing for Chapter 11 bankruptcy in 1999. Jenn Feng paid a mere $7.5 million for its share of the company in 1999, in part because McCulloch had stopped supplying tools two years before, and its market share had been taken over by the competition. David Jong, the chief executive officer of the Jenn Feng Group, said that the company's initial strategy was to use the McCulloch brand to market its portfolio of lawn care products through The Home Depot, Kmart, Lowe's, and Sears. He said that when they first acquired the company, they thought that America's huge retailers would help them quickly boost market share. That did not happen, and McCulloch's share remained small even after two years of aggressively pushing the brand to the Megas. Why did the strategy fail? Jong explained it this way:

> You can't count on huge retailers to help you realize your dream because they have so many suppliers and usually pick a few big players as their long-term sources. If you are not one of their favored suppliers, they only buy in small quantities from you, and when your products sell out, you often find that the shelf space has been given over to the products of your rivals. Most of all, they shop for price, so there is constant pressure to discount. Or they import products from your rivals.[8]

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[8]Cens.com, "Interview with David Jong, CEO Jenn Feng Group," July 11, 2003. http://www.cens.com/cens/html/en/news/news_inner_12252.html

In 2003, Jenn Feng stopped dealing with the Megas, and, instead, according to Jong, intended to focus on supplying gas engines for handheld garden tools for US-based MTD Products. In 2008, Jenn Feng was acquired by Husqvarna.

A similar fate befell Homelite, which, when it was a division of Textron, ramped up sales on the mass market. By 1978, it had sold 1 million chain saws in a 12-month period. The company was sold to John Deere in 1994 and sold again in 2001 to the Hong Kong firm Techtronic Industries after losing $70 million in 2000 and $30 million in the first nine months of 2001. Ken Golden, the public relations manager at the time, stated, "Despite the very best efforts of many employees, Homelite has not been profitable."[9] Homelite chain saws are now available only at The Home Depot. The Homelite website prominently features a product recall required by the Consumer Product Safety Commission. If you Google *Homelite*, you will be bombarded with consumer complaints and recall information.

Speaking to business students at Northwestern's Kellogg School of Management, STIHL's former vice president of sales and marketing, Peter Burton, summarized the problem with the Megas:

> The big boxes are . . . intimidating. They dictate guarantees and shift costly operational activities off their own backs and onto suppliers. And they expect their suppliers not just to hold down their prices but to consistently drop them annually. In short, the supplier is left helpless and increasingly profitless. If you sleep beside the 8,000-pound gorilla, you don't want to be caught underneath when it rolls over.[10]

The management of STIHL views selling to the Megas as a "vicious circle." Firms are forced to lower their prices to be competitive and then reduce costs to remain profitable, which in turn leads to diminished product quality, and, ultimately, a brand that has been tarnished, sometimes irreparably. Hans Peter Stihl stated, "We remain true to our distribution philosophy of selling exclusively through servicing dealers because mass merchandisers are not in a position to provide optimal advice and handle technical service and parts support.[11]

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[9]"Deere & Co. Abandons Homelite Line," *American Nurseryman*, October 15, 2001.
[10]Steve Farwell. All quotes from Peter Burton come from "Thinking Outside the Box Stores: Suhl VP Talks Channel Strategy with Kellogg Students," February 13, 2008, available at www.kellogg.northwestern.edu/New?Articles/2008/Peterburton.aspx.
[11]"What Is Your Special Formula for Success, Mr. Stihl?" *Blick Ins Werk*, no. 1 (2007), quoted in Marketing Channels by Bert Rosenbloom, Cengage Learning, Nov 9, 2011. p. 15.

The Advertising Campaign

STIHL not only eschews the Megas, but also lets the world know about it. In 2006, it began placing some very provocative ads in *The Wall Street Journal, USA Today, The New York Times,* and other national, regional, and local newspapers. A picture of a STIHL chain saw sits under the caption, "Why is the world's number one selling brand of chain saw not sold at Lowe's or The Home Depot?" Another ad reads, "Why it is that some Father's Day gifts can't be found in a big box?" Explanations of the service and maintenance aspects follow in smaller print. The ads were intended not only to reinforce the "aura of exclusivity" that surrounds STIHL products but also to educate potential buyers about where they might find STIHL products. Research conducted by STIHL had indicated that more than 50 percent of survey respondents thought that the company's products could be purchased at Lowe's and The Home Depot. Whyte explained, "Generation X and Generation Y visit Home Depot and expect to be able to find everything there." Indeed, the local gas station has disappeared from small-town America as has the corner grocery store. The appliance stores that used to be front and center in small-town America have been replaced with the likes of tattoo parlors, T-shirt shops, and boutiques specializing in hemp. The younger generations, having no memory of local, specialty stores, think that everything can be found in the big-box stores. STIHL's advertising campaign has been aimed at undermining this perspective.

The impetus behind the *Journal* ads came from the company's dealers, who began to constantly challenge the corporation's stated commitment to sell only through the dealer service network. The thinking was simple: everybody sells through The Home Depot, so of course STIHL would eventually sell there as well. The idea for full-page ads came to Fred Whyte over a beer with Peter Burton. "We decided that we were going to put our dedication to our servicing dealers in print. We swallowed really hard, but we knew it was the right thing to do." Hans Peter Stihl liked the idea. "You can put it in print," he said. "As long as I own the company, we will only sell to servicing dealers."

STIHL's marketing efforts, as illustrated in Figure 6-1, have engendered tremendous enthusiasm from its dealer network. The campaign caused a stir when the ads initially appeared in the *The Wall Street Journal*. When asked about the ads, The Home Depot spokesperson, Jean Osta Niemi, said, "Those vendors who are selling their products at The Home Depot realize the benefit of 2,060 store locations and 1.3 billion customer transactions a year, and they, too, are committed to providing the best product at the best value." Ravjiv Lal, a Harvard Business School professor who specializes in retailing, was paraphrased in the same article as saying that it was a risky strategy because it implied that consumers who shop at big-box stores do not appreciate quality. "You can offend a bunch of people," he said, "but those probably

aren't your customers anyway." STIHL has become enormously successful by ignoring these kinds of suggestions while sticking to its core vision of quality and customer service.[12]

Figure 6-1. STIHL advertisement

[12]Timothy Aeppel, "Too Good for Lowe's and Home Depot?" *The Wall Street Journal*, July 24, 2006. B.1.

Seeking Out New Retailers

STIHL has not spurned all of the companies that have approached them. In July 2008, the manufacturer reached an agreement with John Deere, which made it the preferred provider of handheld power equipment at Deere dealers across the United States and Canada. Executives at STIHL "thought long and hard" when John Deere informed them that it had decided to exit the handheld market. Deere proposed that STIHL become the preferred brand of handheld products offered through Deere's network of dealers. "It was the first time a nongreen product went into the Deere stores with the blessing of their corporate office," said Whyte. He continued:

> They are a very well-recognized, national brand. They were obviously going to sell some kind of handheld product, so it was pretty amazing when they came to us and said, "Look, we have exited the handheld market, and you guys have been so successful that we want you to fill the void."

The complementary nature of the products sold through John Deere makes this distribution arrangement particularly attractive. Deere sells a variety of consumer and professional lawn and garden products, as well as tractors and heavy equipment used on farms and ranches, and STIHL does not compete with John Deere in any major product category now that Deere has exited the handheld category.[13] The relationship between the two remains strong and sound today.

While the deal with John Deere expands the reach of STIHL, distributing through suppliers of farm and power equipment is still somewhat limiting. Many people simply do not place themselves in that kind of environment. One of the reasons that The Home Depot and Lowe's have been so successful is that they reinvented the hardware store and lumberyard categories. For many people, going to the lumber store or hardware store was a less-than-pleasant shopping experience. Employees who were great at cutting boards and mixing paint were often socially ill equipped to deal with people who did not know much about fixing things. Such customers often felt foolish in the lumberyard environment. As much as anything, this created the multi-billion-dollar do-it-yourself home improvement category. STIHL executives recognize that many potential customers simply will not walk into the metallic atmosphere of a tractor of power equipment store. This, plus the proliferation of mass discounters, has pushed STIHL to continually search for new distribution opportunities that fit with its service and maintenance philosophy.

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[13]Information about the John Deere-STIHL deal was obtained from "John Deere and STIHL Announce Agreement to Expand Retail Relationships" (STIHL press release), July 29, 2008, and "John Deere & STIHL, Reach Handheld Equipment Deals," August 2008, available at `www.landscapemanagement.net`.

STIHL executives see hardware stores as a natural outlet for its products. Whyte especially likes Ace Hardware, Do It Best, and True Value.

> They are good business people, generally located in metropolitan areas, on nice pieces of real estate. They are open longer hours, whereas our traditional retailer is not open on Sunday and closes at six o'clock during the week. These stores are convenient. Ace, True Value, and Do It Best people are pretty sophisticated. They have shown their retailers that the average sale per square foot for STIHL products is something like 10 times what they are accustomed to in their stores. This is because they are selling a premium product. Even though they have access through their national buying programs for items made by Poulan and Weed Eater, the hardware owner also wants to be able to offer a premium product. We added dozens of Ace dealers in the last year. That is some very significant business. Again, the point is to segment potential customers—the customer who is more comfortable in that retail environment than going into a power equipment shop or even a John Deere dealership.

STIHL continues to look for opportunities to expand its distribution throughout North America and around the world. It is amenable to evaluating options when it comes to getting its products into the hands of customers. However, it is uninterested in the Megas or in branding the products to be sold under a different name. In the early 1990s, STIHL acquired VIKING, a European company started in 1984 that manufactures lawn mowers and garden equipment. You will not buy one of these lawn mowers in the United States because 80 percent of the walk-behind lawn mowers are sold through the big boxes. STIHL refused to allow its products to become commoditized, even when those products are sold under a completely different brand name.

Several years ago, as Fred Whyte got on a plane after attending a trade conference in San Diego, the chief executive of a well-known national brand that competes with STIHL turned to him and said, "Well, the good news is that I'm on my way to Atlanta to see my biggest customer, and the bad news is that I'm on my way to Atlanta to see my biggest customer." Because STIHL is determined to control the destiny of its products, its executives do not have to face this good news/bad news scenario.

While STIHL is one of the best examples of avoiding the Customer Trap, other companies have stayed clear of this mistake as well. Let's see next how some of them maintain control over their innovations.

CHAPTER

7

Innovation's Second Step

Things are not always what they seem; the first appearance deceives many; the intelligence of a few perceives what has been carefully hidden.

—Phaedrus, Roman poet

According to the textbooks, sales and distribution should be approached from the perspective of customer needs.[1] An individual or company simply wants the product to be available at a certain time and place, in the correct quantity and at the right price.[2] While unassailable from the customer's point of view, this perspective ignores the interests of innovating companies, which often conflict with those of the customer, particularly as innovators move through the vulnerable scaling-up process and the "customer" becomes more than 10 percent of total revenue.

The problem is that smaller, innovative firms are particularly vulnerable to the unidirectional power of large Mega-Customers. Rapid growth for many smaller businesses often takes place when they "make it big" by entering into a deal with large-scale customers. Small companies typically have a limited number of resources. As a result, pressure to fill huge orders can quickly become unmanageable because Mega-Customers require products that absolutely must be delivered according to specifications and absolutely *on time*.

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[1]This chapter is based on "Innovation's Second Step," by Timothy J. Wilkinson and Andrew R. Thomas, *Thunderbird International Review*, 56 (3), May/June 2014.
[2]Nigel Piercy, *Market-Led Strategic Change, 4th ed.* (London: Elsevier Butterworth-Heinemann, 2008).

Referring to company operations, former Office Depot Vice President Scott Koerner states, "We have a machine that operates with every element needing to work like clockwork for us to be effective. I've seen a lot of small companies grow quickly who can't meet that challenge."[3]

For many suppliers, the time needed for new product development and ongoing service to existing accounts is sacrificed to the endless paperwork and negotiations that make up the fabric of managing Mega-Customers. This is what happened to our student Sam and his landscaping business. He became so fixated on serving the needs of his Mega-Customer that he didn't have any more time for his other clients.

Often the process of scaling up has more to do with the urgency of the moment than it does with strategic decision making. As a result, sales and distribution channels tend to develop in an ad hoc manner. When a Mega-Customer takes on an innovative product, the product "takes off," and the producing firm is left scurrying to keep up with new demand and the day-to-day managerial challenge of meeting that demand. Such urgency leaves producers vulnerable to the long-term strategies of their "partners" who have the experience, knowledge, and strategic vision needed to dominate enthusiastic but resource-constrained innovators.

The power of Mega-Customers has been enhanced by the onset of the Internet. High costs are no longer associated with communicating, gathering information, and accomplishing transactions. Mega-Customers can demand that their suppliers are transparent in their operations because technology has made transparency easy and relatively cheap. As Michael Porter states, "Internet technology provides buyers with easier access to information about products and suppliers, thus bolstering buyer bargaining power."[4]

Ultimately, innovative companies can face the problem of Mega-Customers who are able to capture a great deal of the value of the innovated product while forcing changes in the innovator's operations, value chain, and product. At the same time, the innovative company risks alienating its traditional distributors, stores, or other channel members. In addition, innovative companies are often driven to outsourcing production offshore in order to lower costs so that they can meet the price points of their retail partners.

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[3]Gwendolyn Bounds, "You Got a Big Break. Now What?" *The Wall Street Journal*, November 13, 2006, p. R1.
[4]Michael Porter, "Strategy and the Internet," *Harvard Business Review*, March 2001, p. 63–78.

Model of Innovator/Distributor Relationship

Empirical research suggests that from the perspective of channel members, the goal is to establish channels that maximize cooperation and customer satisfaction, while at the same time minimizing conflict. By eliminating inefficiencies in sales and distribution, and by focusing on the customer, an optimal path to the market can be achieved. However, in reality, channel members exist within the context of power relationships.

Power is defined as the ability of one channel participant to change the behavior of another channel member. Power can be positive, as is the case when one firm has a legitimate (legal) right to tell another firm what to do, or negative, as when a firm uses its advantage to coerce or manipulate another firm. An example of the latter case would be "fines" levied by Mega-Customers for product-labeling mistakes and shipment errors, or demands for free samples.[5]

As explained in Part I of the book, the general consensus and empirical evidence suggests that over the course of the past several decades, bargaining power has shifted from suppliers to buyers. This took place as producers abandoned vertical integration in favor of focusing on their internal core competencies.[6] The increased concentration of channel structures has adverse effects on suppliers' profitability. All the elements underlying buyers' power in Porter' five forces model—enhanced bargaining power, more-knowledgeable buyers, and credible threats of backward integration—favor the intermediaries or end buyers.[7]

Sources of Power for the Megas

Figure 7-1 displays the power configurations that provide the context for producer/distributor relationships based on Rangan.[8] The figure indicates that the sources of power for the Mega consist of the scale or size of the distributors, access to markets, and legal or institutional constraints.

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[5]Altan S. Erdem, "An Investigation of the Concept of Power and Power Taxonomy in Channels of Distribution: A Transaction Cost Analysis Perspective," *The Journal of Marketing—Theory and Practice*, 1993, p. 62–79.
Iyer Ganesh and J. Miguel Villas-Boas, "A Bargaining Theory of Distribution Channels," *Journal of Marketing Research*, February 2003, p. 80–100.
Brent M. Wren, "Channel Structure and Strategic Choice in Distribution Channels," *Journal of Management Research*, 2007, p. 78–86.
[6]Andrew Kakabadse and Nada Kakabasdse, "Outsourcing: Current and Future Trends," *Thunderbird International Business Review* 47, no. 2, March–April 2005, p. 183–204.
[7]Sertan Kabadayi, Nermin Eyuboglu, and Gloria P. Thomas, "The Performance Implications of Designing Multiple Channels to Fit with Strategy and Environment," *Journal of Marketing*, October 2007, p.195–211.
[8]V. Kasturi Rangan, *Transforming Your Go-to-Market Strategy* (Boston, MA: Harvard Business School Press, 2006), p. 100.

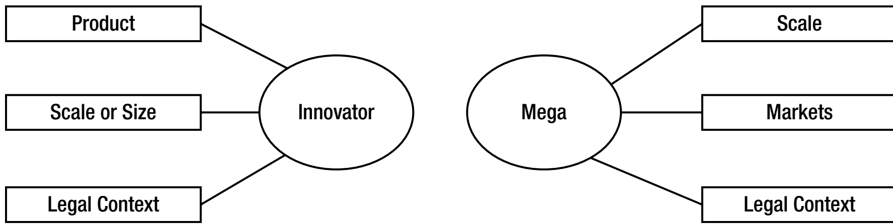

Figure 7-1. Power Structure

Scale

The most obvious, and perhaps the most determinative, variable in the power structure is the comparative scale of the producer and the distributor. Historically, big companies (with a few notable exceptions) have been able to dictate terms to retailers. With the rise of the Megas, few producers are in a position to stand on equal footing. As has been pointed out, not only are the large retailers able to cut into the margins of the producing company through systematic and forced renegotiations over pricing, but they are also able to shift the cost of traditional retailing activities onto manufacturers.

One of the most effective methods of managing suppliers is through what are called "category captains." Large retailers have learned that they can maximize their advantage by selecting a major supplier to manage a category of products—including those of competitors—so that the category maximizes the Mega's profitability. A category captain typically manages the merchandising of an aisle or section of the store and provides the retailer with information on category sales and trends, planning and merchandising advice, and suggestions for shelf space allotment. The captain's ideas are only recommendations, but they are taken seriously by retailers who cannot possibly have the same level of expertise as the category captain. Because category captains manage products other than those they produce, they must work closely with competitors.[9] As Barry C. Lynn put it in an article in *Harpers:*

> One obvious result is that a producer like Colgate-Palmolive will end up working intensively with firms it formerly competed with, such as Crest manufacturer P&G, to find the mix of products that will allow Walmart to earn the most it can from its shelf space. If Walmart discovers that a supplier promotes its own product at the expense of Walmart's revenue, the retailer may name a new captain in its stead.[10]

[9]Barry C. Lynn, *Cornered: The New Monopoly Capitalism and the Economics of Destruction* (Hoboken, NJ: John Wiley & Sons, 2010).

[10]Barry C. Lynn, "Breaking the Chain: The Anti-Trust Case Against Wal-Mart," www.harpers.org/archive/2006/07/0081115, July 2006.

Clearly, size and scale have their privileges, especially for distributors.

Markets

By definition, Megas have access to large numbers of customers, and as a result, they control access to markets. A series of articles in the *The Wall Street Journal* recount the impressive innovation of Colin Roche, the founder of PenAgain, who came up with a quirky wishbone-shaped pen design as a high school student in Palo Alto, California.[11] In 2001 he and a friend, Bobby Ronsee, contributed $5,000 each to form Pacific Writing Instruments, filed a patent, set up production, and put up a web site. The partners wanted to sell their pen on the mass market, but learned that in order to break into the big-box stores, they would first need to prove the value of their product among smaller retailers.

One early distributor was Fred Ebert, the owner of Edwards Luggage, who liked the pens and began to sell them at $12.95 each. Soon larger customers were on board, including Fred Myer and Hobby Lobby, as well as 200 Staples stores in Canada and 5,000 independent office-supply stores. By September 2005, PenAgain had sold 1.2 million units in Europe and had about $5,000 in web sales each month.

Roche and Ronsee were not satisfied with the dramatic development of their company. They were committed to making PenAgain a mass-market phenomenon. This meant that they needed to lower their costs and create economies of scale in order to be able to offer a low price to the mega-distributors that they planned to court. With financial backing from outside investors, Roche and Ronsee contracted with manufacturers in China. This allowed them to reduce the retail price on one model to $3.99.

Eventually, the PenAgain founders sat before a Walmart buyer in a small conference room in Bentonville. Ten months later, they received word that their supplier agreement was officially approved. Walmart would carry the pen in 500 stores for six weeks. PenAgain was expected to sell at least 85 percent of the product in order to receive permanent shelf space. The trial period with Walmart was deemed a success, and a reorder was issued.

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[11]Bounds, op. cit.
Gwendolyn Bounds, "Pen Maker's Trial," *The Wall Street Journal,* July 18, 2006, p. B1.
Gwendolyn Bounds, "One Month to Make It," *The Wall Street Journal,* May 30, 2006, p. B1.
Gwendolyn Bounds, "The Long Road to Wal-Mart," *The Wall Street Journal,* September 19, 2005, p. R1.

Hearing this news, Office Depot requested an expedited shipment of pens for all of its 1,049 stores. To fill the order, the partners had pens flown in from China, rather than having them transported by boat, the less-expensive and slower method. Home Depot sold the pens for $3.99, while Walmart priced them at $3.76. Surely, PenAgain now had market reach far beyond what would have been possible if the company had stuck with its independent distributors and online sales.

Success in entering the mass market presented the partners with several new challenges. First, the managers of their traditional "bread-and-butter retail accounts" were distressed to learn of the favorable pricing given to the Mega-Customers when they had been selling the pen for a premium price of over $7.00. Second, the Walmart placement created demand for the pen from other mass retailers. For example, in mid-July a call came in from the US drugstore chain Walgreens asking for 470,000 pens in time for the back-to-school rush. The challenge was to get half a million pens shipped from China while still filling the current orders of other customers. They accomplished this by delaying several orders for pens with special logos and bumping a large account for a client in Europe.

Third, the payment terms demanded by the Mega-Customers placed enormous stress on the firm's limited finances. To secure orders of 50,000 or more from the Chinese factory, the company was required to pay 30 percent up front, and the balance within 30 days of receipt of the goods. This placed them in a bind because the Megas typically don't pay their vendors until several months after receipt of goods. The partners addressed this concern by bringing a purchase-order financing company on board, which pays up-front costs in exchange for a hefty portion of the profits. Fourth, during this entire process the PenAgain staff consisted of the two founders, two full-time workers, and a handful of part-timers. There simply were not enough people to take care of all of the business that was pouring in.

In 2009, the international rights and patents for PenAgain were purchased by Propel-r Innovations. Company founder and director Aryeh Elbaz has this to say about the market power of the large-scale retailers:

> I think some entrepreneurs view big box the same way an actor views big Hollywood studios . . . the biggest stage for their art and the ticket to "success." These big-box stores wield so much leverage that entrepreneurs form their business model around their demands rather than around their end users. It's a dangerous play that escalates quickly and goes past the point of no return before anyone realizes it. Just my opinion.[12]

[12]Interview and correspondence with company spokesman Aryeh Elbaz, February 24, 2015.

But it's not only small innovators that are drawn to the market reach of the Megas; large firms are also attracted to the market power that the big retailers exhibit. Levi Strauss & Co., Goodyear, Proctor & Gamble, and the other firms discussed in this book all altered major components of their respective value chains in order to be able to sell through the mass discounters. The reach of the large-scale distributors is phenomenal, and their ability to capitalize on that reach is breathtaking.

Legal Context

The legal and regulatory environment places constraints on the relationships formed between producers and the Megas. Power was concentrated in the hands of producers for many years, but the legal environment eventually shifted so that today it favors distributors. A modest shift back toward manufacturers has only recently taken place.

One of the most obvious (and detrimental) placements of regulatory power is in the automobile industry. The Automobile Dealers Day in Court Act of 1956 and subsequent franchise laws have made it nearly impossible for automakers to manage how their cars were sold. The act reads as follows:

> An automobile dealer may bring suit against any automobile manufacturer engaged in commerce, in any district court of the United States in the district in which said manufacturer resides, or is found, or has an agent, without respect to the amount in controversy, and shall recover the damages by him sustained and the cost of suit by reason of the failure of said automobile manufacturer from and after August, 8, 1956, to act in good faith in performing or complying with any of the terms or provisions of the franchise, or in terminating, cancelling, or not renewing the franchise with said dealer. Provided that in any such suit the manufacturer shall not be barred from asserting in defense of any such action the failure of the dealer to act in good faith.[13]

A 2006 article in the *The New Yorker* describes the impact of the act:

> Car dealers, with their low-production-value TV commercials and glad-handing tactics, seem like the archetypal small businessmen, and it's hard to believe that they could sway the decisions of global corporations like GM and Ford. But, collectively, they have enormous leverage. Dealers are not employees of the car companies—they

[13]American Bar Association, *The Franchise and Dealership Termination Handbook,* (2004), p. 275.

> own local franchises, which, in every state, are protected by so-called "franchise laws." These laws do things like restrict GM's freedom to open a new Cadillac dealership a few miles away from an old one. More important, they also make it nearly impossible for an auto manufacturer to simply shut down a dealership. If GM decided to get rid of Pontiac and Buick, it couldn't just go to those dealers and say, "Nice doing business with you." It would have to get them to agree to close up shop, which in practice would mean buying them out. When, a few years ago, GM actually did eliminate one of its brands, Oldsmobile, it had to shell out around a billion dollars to pay dealers off—and it still ended up defending itself in court against myriad lawsuits. As a result, dropping a brand may very well cost more than it saves, since it's the dealers who end up with a hefty chunk of the intended savings.[14]

The American car makers are squeezed on both ends: unsustainably high union-enforced labor outlays coupled with huge legacy costs on one end, and a dealer-instigated stranglehold on the distribution of automobiles on the other. Defenders of the dealerships argued that dealer proliferation was irrelevant to GM because the dealers operated as independent businesses, purchasing cars and paying for their own operations. Said one letter published in the *The Wall Street Journal*, "So what if a dealership sells only 100 units a year? Each is a sale on which the manufacturer gets a monetary return."[15] An article published in the *The Denver Post* on June 2, 2009, one day after GM filed for bankruptcy, explained how the dealers helped to bring down the company:

> For years, critics of the company called for the elimination of the Oldsmobile division and the GMC truck division, which sold clonal versions of Chevy trucks. But GM found itself handcuffed to its obstreperous network of dealers who were protected by state franchise laws. It cost GM more than $1 billion to buy out Oldsmobile dealers when, at last, the division was closed in 2004.[16]

Even as GM plunged into bankruptcy and announced the closure of hundreds of dealerships, national and state politicians cried foul, demanding that the government step in and save the dealerships. Even after the goose is dead, the politicians were demanding that it keep on laying golden eggs. Today,

[14]James Surowiecki, "Dealer's Choice," www.newyorker.com/archive/2006/09/04/060904ta_talk_surowiecki, September 4, 2006.
[15]Jerry Briskin, letter to the editor, listed under "Are Dealers an Asset or a Burden?" *The Wall Street Journal*, June 9, 2009, p. 10.
[16]"As GM Goes, So Could the US," *The Denver Post*, June 2, 2009, p. 6A.

the same squawking can be heard in state legislatures as Tesla Motors attempts to sell through company-owned stores. Ricardo Reyes, Tesla's vice president of communications, put it this way:

> It is odd to me that the only thing consumers can't buy direct is booze and cars in this state. Imagine the Girl Scouts having to sell through a distributor network. Imagine Apple having to sell through a distributor network.[17]

Often people complain that the US Justice Department does not pursue antitrust violations with the Megas as they have with manufacturers like Microsoft, or service companies like Google. However, antitrust laws are set up to prevent firms from acting in a monopolistic fashion, for the ultimate purpose of increasing prices. The Megas, with their low-cost strategy and penchant for driving down prices, are not violating antitrust laws. Their business model, with its focus on low prices, does not act against the best interests of consumers. While the Federal Trade Commission demonstrated some interest in the area during the early years of the Obama administration, calls for breaking up monopolistic retailers have largely been ignored.[18]

Private-label offerings have been a great boon for the Megas. In category after category, large retailers have outsourced the production of copycat brands or knockoff products and have placed them on their shelves right next to branded products. The most audacious example of private-label offerings is Walmart's poaching of the White Cloud line of toilet paper, previously owned by P&G. The consumer products manufacturer, having decided to focus on Charmin, let its trademark for White Cloud expire in 1994. Walmart acquired the rights to license the brand from the company that picked it up after discovering P&G's lapse. Other product pick-ups, while not as obvious, have been every bit as successful and have been protected by the courts.

Another issue is *trade dress,* a legal term for the nonfunctional characteristics of a package or a product, including design elements. The boxes containing Apple's products, the packaging used for Wonder Bread, or the Happy Meal box used by McDonald's are examples of trade dress. The US Supreme Court has ruled that trade dress is not necessarily protected by US trademark law.

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[17]Bobby Blanchard, "Tesla Motors, Car Dealers Clash Over Franchise Law," www.texastribune.org/2015/01/28/tesla-motors-automobile-dealers-debate-franchise-l/#, January 28, 2015.
[18]Thomas Frank, "Free Markets Killed Capitalism: Ayn Rand, Ronald Reagan, Wal-Mart, Amazon and the 1 Percent's Sick Triumph Over Us All," www.salon.com/2014/06/29/free_markets_killed_capitalism_ayn_rand_ronald_reagan_wal_mart_amazon_and_the_1_percents_sick_triumph_over_us_all, June 29, 2014.

Circumstances prompting the court's decision are explained in a ruling in which Walmart prevailed over a garment company that had sued for trademark infringement:

> Petitioner Wal-Mart Stores, Inc., is one of the nation's best-known retailers, selling among other things children's clothing. In 1995, Walmart contracted with one of its suppliers, Judy-Philippine, Inc., to manufacture a line of children's outfits for sale in the 1996 spring/summer season. Walmart sent Judy-Philippine photographs of a number of garments from Samara's line, on which Judy-Philippine's garments were to be based; Judy-Philippine duly copied, with only minor modifications, 16 of Samara's garments, many of which contained copyrighted elements. In 1996, Walmart briskly sold the so-called knockoffs, generating more than $1.15 million in gross profits.[19]

Walmart's victory means that producers must now be able to prove that buyers perceive trade dress to be a marker of the company's branded products. If a company has not documented the connection between *trade dress* and its brand, much of what the company considers its brand can be legally copied and sold by its retail partner.

Power of Producers

Figure 7-1 also displays the power that producers have in their dealings with distributors. While sources of manufacturer power mirror that of Mega-Customers, the ability of producers to wield countervailing power equal to that of the Megas is becoming increasingly rare.

Product

The greatest source of power that a company has when dealing with the Megas is its products. Firms that sell truly differentiated innovations may be able to successfully distribute by using the mass-market distributors during the early phase of the product life cycle. A true innovation requires market space in which there are few, if any, real competitors, and sufficient lead time, created by patents, brand power, market reach, or some other delimiter that keeps competitors at bay. As soon as technological, legal, or operational vulnerabilities weaken an innovation's market position, the once-vaunted

[19]Wal-Mart Stores, Inc. vs. Samara Brothers, Inc. (99-150) 529 U.S. 205 (2000) 165 F.3d 120. United States Supreme Court

product can easily become just another brand sitting on the shelf next to a private-label version sold for half the price. In fact, marketing though the Megas almost ensures the unraveling of a product's power in the marketplace.

Mass-market distribution necessarily places a barrier between the manufacturer and the customer. While this does not matter for products that are already commodities, it makes a big difference for innovative products. For many companies, selling through the Megas removes the ability to effectively offer service and repair work. Defective products are sold, and then returned to the Mega without any opportunity on the part of the manufacturer to interact with the customer. The likelihood that products requiring servicing will be properly maintained is also greatly reduced. This reflects poorly on the producer, not on the distributor. Moreover, many products sold through the Megas require assembly by the purchaser, which often frustrates customers and further alienates them from the manufacturer.

Distributing through the Megas also robs the manufacturer of the opportunity to sell appropriate ancillary items. "Plus-selling" is left to sales associates who are unlikely to know about complementary products offered by the producer. For example, a John Deere riding mower can be outfitted with five variations of a "cargo mount" (for example, electric spreader, oscillating fan), eight kinds of bags, and four types of snow blowers. It is unlikely that a sales associate at The Home Depot or Lowes would have the knowledge to guide a customer through these options, even if all of these choices were available.

While the large-scale retailer is in charge of shelf allocation and the mix of merchandise sold, the producer has control over the innovation that has been created. An innovative product creates, by definition, potential space in the market. It is superior to, or different from, substitutes. Perhaps the product has features that are unavailable elsewhere, or is embedded with a degree of quality that makes it highly desirable. Five aspects of innovation influence the power of the producing firm vis-à-vis the large-scale distributor:

- Depth of innovation
- Differentiation
- Availability of substitutes
- Process innovation
- Brand awareness

Depth of Innovation

In their classic article, "The Core Competence of the Corporation," Prahalad and Hamel compare a firm to a large tree:

> The trunk and major limbs are core products, the smaller branches are business units; the leaves, flowers, and fruit are end products. The root system that provides nourishment, sustenance, and stability is the core competence. You can miss the strength of competitors by looking only at their end products, in the same way you miss the strength of a tree if you look only at its leaves.[20]

While these authors are speaking of the core competencies of firms, we believe what they are saying is also applicable to innovations. Companies that create at the root level, inventing core technologies with multiple applications, have what we call "deep innovations." For example, Floating Island International (FII) is a Montana-based company that has created what it calls the BioHaven. This floating island imitates the ecological function of swamplands, and can be used for environmental cleanup, water remediation, and the enhancement of wildlife habitat. The firm has identified more than 25 applications for its core technology.[21] Producers have more leverage when they possess deep innovations because, as the only game in town, they are able to forestall the Mega strategy of product substitution. Of course, this presumes that the innovators understand the market they are operating in, which is not always the case (see the story of PenAgain earlier in this chapter).

Differentiation

Michael Porter states, "A firm differentiates itself from its competitors when it provides something unique that is valuable to buyers beyond simply offering a low price.[22] According to Porter, such differentiation can take place anywhere in the value chain. Product differentiation is a minimal threshold for a producer if it has successfully scaled up into the mass-market environment while maintaining control over its product.

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[20]C.K. Prahalad and Gary Hamel, "The Core Competence of the Corporation," *Harvard Business Review* 68, no. 3, October 1990.
[21]Mary McNally and Timothy J. Wilkinson, "Floating Island International," *Journal of the International Academy for Case Studies* 17, no. 8, 2011, p. 57–61.
[22]Michael Porter, *Competitive Advantage*(New York, NY: The Free Press, 1985), p. 120.

Availability of Substitutes

Innovations are differentiated products that cannot be easily copied, whether because of patent and trademark protection or because they embody leading-edge technologies.

Process Innovation

Innovative processes consist of manufacturing methods that create the product. While greater efficiencies may be realized through process innovation, the economic value of those innovations may or may not be captured by the producing company.

Brand Awareness

The importance of branding has lessened as the mass retail environment has evolved into price-based competition involving private-label products and store brands. At the same time, it is critical for an innovation to become linked to a brand in the mind of the consumer, if that innovation is to be "owned" by the innovative company, and not by a competitor. Therefore, investment in marketing, patents, and trademarks is vital.

Once again, consider what happened to PenAgain after its experience with the Megas. The financial crises of 2008 forced its owners to rethink their distribution strategy. By 2009, they were largely out of the big-box stores and had entered into a distribution agreement with Atlanta-based Baumgartens, which provides global distribution of the product. By repositioning the pen as a writing aid to arthritis sufferers as well as those who experience pain when writing, the company developed a fiercely loyal customer base. Products are now sold through independent retailers and specialty stores for $4.99. PenAgain escaped the Customer Trap because it is a "sticky" innovation that simply must be in the market where its "end users need it rather than a trendy design where end users simply think it's cool."[23]

Scale or Size

Large manufacturers with well-known, sought-after products, have the best potential of going toe to toe with the Megas. A Harvard Business School case describes how P&G employee Tom Muccio moved to Bentonville in order to manage the company's relationship with Walmart. The two sides have been able to work together in order to overcome various challenges and disputes

[23]Interview and correspondence with company spokesman Aryeh Elbaz, February 24, 2015.

over the years. For example, it cost P&G $0.90 to sell a unit of Pampers to Walmart for $1.00 that Walmart wanted to sell for $0.83—a 17-cent loss per unit. This conflict was resolved by providing the retailer with a second, large-sized unit priced more favorably along with other joint efforts designed to increase sales. These efforts resulted in an increase in inventory turnover from 20 to 75 times annually.

What is clear from the case is that P&G has benefited from its relationship with Walmart. So far, it appears that P&G is simply too big to push around, even though around 15 percent of the company's sales are to Walmart. P&G claims that Walmart is the only retailer that it sells more than 10 percent of its product through. Clearly, both parties are vulnerable to any vagaries in the relationship; however, Walmart is not reluctant to pressure P&G as can be seen by its recent placement of German laundry soap Persil next to Tide.[24]

A Harvard Business School case disclosed that the real key to working with the Mega is to understand its culture and to be able to communicate concerns in a way that is understood by Walmart buyers. One of the key negotiation principles at the end of the case pretty much sums up the position of the smaller company "negotiating" with Walmart: "Don't spend time griping. Be problem solvers, instead. Approach Walmart by saying, 'Let's work together and drive costs down and produce it so much cheaper you don't have to replace me, because if you work with me I could do it better.'" Doesn't that sound just great?[25]

Legal Context

Numerous legal protections that are afforded producers can help manufacturers protect themselves from encroachment by the Megas. A US Supreme Court ruling in 2006 reinterpreted the Sherman Antitrust Act so that suppliers could prohibit retailers from advertising prices below that authorized by the producing firm. This policy of "minimum advertised price," or MAP for short, is intended to protect a brand's image from being harmed through discounting practices. Typically, MAP programs are tied into the producers' advertising policies so that retailers forgo advertising reimbursement from vendors if they advertised a price below the one that has been authorized.

[24]James Sebenius and Ellen Knebel, "Tom Muccio: Negotiating the P&G Relationship with Wal-Mart (A)," *Harvard Business School Press*, January 11, 2008.
Morgan Housel, "5 Things I Learned From Reading Procter & Gamble's Annual Report," www.fool.com/investing/general/2013/05/06/5-things-i-learned-from-reading-procter-gambles-an.aspx.
[25]James Sebenius and Ellen Knebel, "Sarah Talley and Frey Farms Produce: Negotiating with Wal-Mart (B)," November 8, 2006.

MAP assists producers in two ways. First, it helps protect smaller stores from price-based advertising carried out by the Megas. In order to bypass the major discounters and sell through independent distributors and specialty stores, smaller outlets have to exist. MAP helps level the playing field by making comparison shopping more difficult. Second, even though manufacturers cannot legally control the price charged by retailers, prohibitions against advertising a cheap price lessens the risk that the brand will deteriorate under a withering assault of big-store discounting. However, commoditization of the brand is still likely for other reasons discussed previously (for example, displaying quality products next to cheap knockoffs), and the fact that consumers are figuring out MAP and adjusting their shopping behavior accordingly. Plus, the ability of the Megas to offer unadvertised discounts to customers remains unimpeded. This means that companies that sell through the Megas may be compromising other channels for which a discounted price is not an option.[26]

Finally, not all manufacturers embrace the concept of MAP. Dave Roberts, the president of Comfort Solutions, the seventh largest bedding producer, states, "Manufacturers should not dictate the value and have control of prices. Manufacturers should be manufacturers, and retailers should be retailers." Comfort Solutions believes that retailers are in a better position to judge the value of products than are manufacturers. The company abandoned MAP in 2013. "Why do we deserve to exist?" Roberts asks. "We offer a strong alternative to what is being offered in the market."[27] Time will tell if Roberts is correct. Based on what we have observed with other companies, unilateral disarmament when dealing with the Megas is not a good business strategy.

Perhaps the most important legal protection that individual producers enjoy is patent protection. However, as pointed out previously, patents can take you only so far. While the liability of the Megas increases as they "work with" manufacturers on the production of low-end products, designing around patents is a normal practice and is encouraged by antitrust law as a way of spurring on innovation. Sometimes the Megas don't go far enough in their efforts to produce something that can stand up in court, and at other times they get it just right.

Manufacturers have successfully used institutional power in a broad array of circumstances. Efforts by auto manufacturers to persuade the US government to limit Japanese imports during the 1980s, the "Banana War" of the 1990s, and protectionist measures against foreign steel during the first terms

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[26]Quentin "Tim" Johnson, "Minimum Advertised Price Program," www.frelaw.com/articles/marketing/mark-0401-qtj.html, 2004.
[27]David Perry, "Comfort Solutions Drops Minimum Advertised Pricing," www.furnituretoday.com/article/427474-comfort-solutions-drops-minimum-advertised-pricing, January 7, 2013.

of George W. Bush all represent industry's ability to push Washington into helping American commercial interests. In contrast, manufacturers have yet to see the Megas as a threat to entire industries. Because the Megas are viewed simply as another link in the supply chain of the US economy, manufacturers have not used their trade associations or outer political platforms to alter the rules that govern their relationships with the mass-market discounters.

The Second Step

Despite the challenges posed by large-scale distributors and intermediaries, it *is* possible for producers to move from small to large-scale operations while maintaining control over their sales and distribution. The value of innovative products *can* be shared with channel members, and—this is a big one—as a result of the strategic design of the producing firm, rather than according to the sole preferences of Mega-Customers. Firms that have successfully managed to scale their businesses recognize the critical importance of controlling what happens to their innovated products throughout the sales and distribution chain. Notwithstanding the challenge presented by large distributors, it *is* possible to ensure that firms protect the created value they have placed in their products and processes.

The danger for innovators is that the firm may become fixated on moving its product into the marketplace with the expectation that its unique value proposition will make up for any hazards that might exist in whatever distribution channels are used. In such instances, the revenue generated by the innovation may be disproportionately captured by Mega-Customers that control the circumstances of the product's distribution.

Innovation's first step is the creation of a new and differentiated product or service. If that is all that happens, an innovation misstep takes place, and the creation, with all of its hope and promise, may never see the light or day or reach its full potential. The principle governing the second step of innovation is this: *An innovator must control the sales and distribution of its product.* While the created value of the innovation can be shared with distribution partners, control over decisions about how the product is to reach customers must be retained by the firm. Given the overriding principle of control, we suggest four paths to distribution that firms can take to retain power over sales and distribution (and their innovation's value) while they scale up. We refer to this as the "second step" in the innovation process.

Phase 1: Low Scale

Firms in phase 1 are too small to cope with the mass market without losing control of their product. Companies that successfully sell and distribute their innovations through Mega-Customers in this phase are likely to forfeit the opportunity to develop and control their products. In Phase 1, the best way for a firm to fully exploit an innovation may be to sell directly to customers or to use independent distributors.

Use Direct Marketing

As tools such as customer relationship management (CRM) software, database management programs, and web-based customer service aids become more affordable to businesses of all sizes, the possibility of directly targeting a company's micro market comes well within reach. Customer intimacy, loyalty, and word-of-mouth advertising are benefits that may be achieved with effective direct marketing.

Many small companies have successfully marketed their products by using only direct marketing. *Mental_floss*, a magazine specializing in trivia, makes full use of its web site to sell books, calendars, clothing, and other products centered on the revelation of quirky bits of information (for example, Teddy Roosevelt's White House dojo, or what you will be driving in 2020). By creating a fascinating web site that is a daily stop for thousands of people, the firm is able to sell its products directly to customers. Many other companies, from business satirists `Despair.com` to vintage clothes specialist American Vintage Classics, have built their entire businesses around the Web. We'll talk more about successfully implementing a direct-marketing approach in Chapter 8.

Use Independent Distributors

Alside, which invented aluminum siding in 1947, eventually became one of America's largest manufacturers of vinyl building surfaces and specialty windows. According to company cofounder Donald Kaufman, the principle of maintaining control over distribution was a core focus of the firm's strategy. Kaufman states, "If we had a good distributor in a local market, we wouldn't distribute the product in-house."[28] Instead, the firm would align the goals of the distributor with those of the firm and then manage the mutual dependency that resulted.

[28]Interview with Alside former CEO Donald Kaufman, July 25, 2008.

Alignment was kept simple. Alside sought market share, and its distributors wanted to make money by selling siding made of cutting-edge materials and designs. It was a classic shared-interest scenario, as both Alside and local distributors viewed the structure as serving both short-term and long-term objectives. The goal was to manage dealers so that they viewed themselves as partners, not merely as customers. Alside was able to avoid the high entry cost of establishing its own distribution center in a given market, with the requisite facilities and infrastructure being provided by the local partner. The local distributor had access to Alside's wide range of innovative products, business training, and inventory management control systems.

Phase 2: Low-to-Medium Scale

Phase 2 firms are large enough to carefully approach the mass market. But this approach should be indirect and/or limited. In this phase, most of the characteristics of the innovating company are optimal. Its innovation has deep roots, its products are highly differentiated, and the threat of substitutes is low. Process innovation and brand awareness may or may not be high in this phase.

In addition to serving the market directly and through independent distributors, we suggest that a firm may approach the mass market through a licensing arrangement. Licensing can help the innovator to set industry standards, enhance its reputation, and create learning opportunities. In addition, by licensing the production of a specific product or product line to another manufacturer, the innovator is free of product-fulfillment responsibilities and can pursue product applications in other markets.[29]

FII, mentioned earlier, has a licensing agreement with Savio Engineering, which manufactures and distributes smaller BioHavens through its subsidiary, Freedom Ponds. Similar arrangements are in place in the South Pacific and New Zealand. These companies manufacture and distribute BioHavens for landscaping installations and the small-pond market, thereby freeing FII to develop its product for other applications. By licensing the production of its consumer-based BioHavens to other companies, FII is free to move into other markets that are of more interest to the firm.

Another example is Timpko, a small-engine motorcycle manufacturer in southern China, which has licensed its products to several distributors of transport-related products across sub-Saharan Africa. Each distributor has specific, and often different, needs for the final version of the motorcycle.

[29]Ulrich Lichtenthaler, "The Drivers of Technology Licensing: An Industry Comparison," *California Management Review* 49, no. 4, Summer 2007, p. 67–89.

In Kenya, the primary use of the motorcycles is for delivery by local courier firms. At Timpko's plant, the Kenyan models are equipped with a secure cargo unit, which attaches to the rear of the motorcycle. For Ethiopia, where the product is primarily used by rural farmers, a special set of tires and a modified transmission are used to deal with the difficulties of the terrain. All of Timpko's units are developed in conjunction with the specifications of local distributors, and Timpko engineers frequently travel to Africa to see if any alterations need to be made.[30]

Phase 3: Medium-to-Large Scale

In Phase 3, innovative companies eventually have the scale to effectively work with the big distributors. Even though product-related characteristics are optimal, the innovator must still enter the mass market with care. In addition to the licensing arrangement discussed in Phase 2, we suggest that producers approach large distributors with either a limited number of products or items specifically designed for the mass market. Firms can enhance their control over distribution by allowing large retailers to sell only scaled-down, simplified product models or a limited selection from the firm's product line. By doing so, the firm has segmented the market according to channel of distribution.

For market segmentation by distribution channel to be effective, end customers must perceive a meaningful difference in products sold through different channels. For example, The Step2 Company, a manufacturer of outdoor play equipment, sells its newly innovated products exclusively through its web site, while promoting only standardized products on the mass market. This works because customers are willing to pay more for products sold directly by the company, recognizing these products as truly superior to mass-market offerings. Experience has shown that if a firm simply uses a multichannel approach with an undifferentiated product, it will be forced to lower its price across all channels as consumers become aware that the same item is being sold less expensively through the large-scale distributors.[31]

Phase 4: Large-to-Large-Plus Scale

For large-scale innovators that have positioned themselves properly in the marketplace, big retailers can be used to gain brand recognition and reach untapped customers. The mass market has the potential to rapidly create

[30]Andrew R. Thomas, Todd A. Finkle, and Timothy J. Wilkinson, "Timpko Export Management Company," *Journal of the International Academy for Case Studies* 16, no. 2, 2010, p. 61–73.
[31]Erin Anderson, George S. Day, and V. Kasturi Rangan, "Strategic Channel Design," *Sloan Management Review*, 1997, p. 59–69.

widespread brand awareness and deep market penetration. This is because the scale of mass distribution allows producers to introduce their innovations into the consciousness of consumers. Manufacturers may then be able to redirect consumers to the firms' preferred routes of distribution. At the same time, the producer can manage its mass-market products so that control is maintained.

Perhaps no other company in America epitomizes innovation more than Apple. This firm serves as the archetype of core competency–based innovation. Once viewed as a computer business, Apple has leveraged its capabilities to create previously unimagined markets through a succession of amazing products. Even so, the firm spent years languishing in the shadow of IBM and Microsoft. While Apple was successful as a niche player, it was unable to capitalize on its innovation capacity in the mass market.

The company's first truly mass-market success was the iPod, launched in 2001. This product, which revolutionized the music industry, has been sold at Target, Amazon.com, Best Buy, and many other retail outlets. One study estimated that for the $299 retail price for the fifth-generation iPod, the retail margin totaled $75, only $5 dollars less than an estimated $80 gross margin for Apple. Of course, Apple also collected the retail/distributor margin for products sold online and in its Apple stores. The iPod, which was responsible for 35 percent of the firm's revenue in 2007, but only 5 percent by 2012, is ubiquitous. This is largely due to the mass-marketing effort, which placed it on the shelves of big-box retailers. The massive success of the iPod reinvigorated the Apple brand and set the stage for the next step—the iPhone.

Unlike the iPod, distribution of the iPhone was tightly controlled. In entering an exclusive service and distribution agreement with Cingular Wireless in January 2007, Apple insisted on control over pricing and distribution decisions. This was a departure from the way it had allowed the iPod to be distributed. Moreover, when the product shipped in June 2007, it was sold exclusively through Apple's web site, company-owned stores, and Cingular's 2,100 branded stores and web site. By controlling distribution of the iPhone, Apple was able to capture margins previously shared with the mass marketers. However, this was accomplished in the wake of developing the "i" brand by selling iPods through the large-scale distributors.[32] It was only in December 2008, almost two years after it was introduced, that Apple began selling the iPhone through Walmart. Apple has been able to move between channels in a way that maximizes the value it retains through its innovative products.

[32]G. Linden, K.L. Kraemer, and J. Dedrick, "Who Captures Value in a Global Innovation System? The Case of Apple's iPod," Personal Computing Industry Center, The Paul Merage School of Business, UC Irvine, 2007.

Moreover, as of 2015 the company operates about 437 of its own retail stores worldwide, which are, according to a study by Morgan Stanley, a driving force in the company's growth.[33] This provides it with the kind of direct access to customers that can be used as leverage should major external channels (for example, Best Buy, AT&T, and Verizon) attempt to exert control over the relationship.[34]

Many other large-scale companies have opened their own stores as a means of gaining greater control, particularly when it comes to new product introductions, or as a means of repositioning its product or promoting a new message. Lego's 18 "concept stores" filled with 240 Lego bins, provide ample space for customers to interact with the product. Similarly, Bose uses its outlets, which have home-theater demonstration rooms, to display its audio components. Nike has used its stores to drive sales of shoes and clothes on the mass market, and apparel makers Puma and Lacoste have opened numerous stores in strategic locations throughout the United States.

Phase Summary

These phases and strategies are summarized in Table 7-1. Also in this table are suggested steps for implementation as well as possible risks.

[33]Philip Elmer-Dewitt, "The Magic of 285 Apple Stores," CNN Money, 2010.
[34]For an interesting explanation of Apple's retail strategy, see John Paczkowski's "Breaking Down Apple's Retail Distribution Strategy," `http://allthingsd.com/20121003/apple-stores-get-the-glory-but-retail-partners-shoulder-load/`, October 2, 2012.

Table 7-1. Key Considerations in the Distribution of Innovations

Strategy	Issues	Revisions to the Firm's Distribution Strategy	Steps for Implementation	Risks	Examples
Phase 1: Scale Low	Too small to cope with mass market	Direct marketing	1. Analyze the business environment. 2. Get your message out. 3. Develop database of prospects. 4. Pay attention to fulfillment and service.	Lack of expansion, revenues, and profits	Mental_floss Despair.com American Vintage Classics Red Ant Pants
		Independent distributors	1. Identify appropriate distributors. 2. Provide exclusive contracts on a regional basis. 3. Provide training and collateral sales materials. 4. Incentivize relationship.		
Phase 2: Scale Low to Medium	Mass market can be approached, but indirectly	Licensing	1. Differentiate product line. 2. Target appropriate consumer segment. 3. Train licensees. 4. Monitor licensees.	Lack of expansion, revenues, and profits Costs and monitoring	Floating Island International

Phase 3: Scale Medium to Large	Balancing multiple channels of distribution Retaining control vis-à-vis the large-scale distributor	Multiple channels including large-scale distributors Segmentation according to channel	1. Determine channel based on customer profiles. 2. Limit the amount of the product. sold through the large-scale retailers to 10%. 3. Do not let the retailer set the price. 4. Protect the innovation. 5. Stay close to the customer. 6. Implement channel stewardship.	Tarnishing brand image through use of inappropriate channel Succumbing to the allure of massive sales through large-scale retailers	Jones Soda Step2 Company
Phase 4: Scale Large to Large-Plus	Balancing multiple channels of distribution Retaining control vis-à-vis the large-scale distributor Expanding distribution	Create stores. Introduce new innovations through company owned outlets.	1. Create "showcase" stores. 2. Introduce new innovations through company-owned outlets.	Inadequate commitment to retail operations Channel conflict Expensive	Apple Lego Concept Stores Nike-town Hershey Puma Bose Coach

Large-scale distributors and customers dominate manufacturers when they can substitute the products of suppliers with those provided by other firms. Products that are perceived to be commodities are likely to be treated as commodities. When, "suppliers can be easily replaced, intermediaries are unlikely to be motivated to form strong relationships with them."[35] In this situation, the producing firm is in the unfortunate position of competing almost entirely on the basis of price.

The challenge for firms that are scaling up is to maintain control over sales and distribution without forgoing expansion opportunities that may result in superior long-term profitability. Strategic innovation is necessarily paired with the ability to sacrifice sales, market share, and short-term profits to retain control over the innovated product. While this does not necessarily mean a firm should sell its innovations through its own retail stores, it does mean that the firm must be determined to control distribution through each phase of the scaling-up process.

Controlling sales and distribution as a firm scales up is not a lockstep process that works the same way in every case. There is no formula that can be used to dictate when a company moves from one phase to the next and is ready to alter its channel configuration. Channel management consists of business decisions that managers must make based on circumstance and experience.

Moreover, successful companies operate strategically within the context of their values, mission, and culture. While one company may be strongly drawn to distribution through mass-market retail (for example, Dyson), another company may use its scale and presence in the mass market to engage in aggressive direct marketing or/and open its own stores (for example, Lego). Other companies may eschew mass-market retail altogether, preferring to deal with customers without any intermediaries being involved. For example, David Oreck, the founder of the Oreck Corporation, was strongly resistant to the notion of selling his product through large distributors. From the beginning, his goal was to create high-quality products sold at a premium price. For many years, he maintained that if the Oreck Corp. were to sell its XL Vacuum through the mass market, the product would sit on long shelves next to apparently similar machines. Customer comprehension of the XL's "top-fill" design, durable wheels, light weight, and "Microsweep" would be impaired as consumers compared the XL to the features of less-expensive competitors. Instead, the product was marketed online and through 300 plus Oreck stores throughout the United States. According to Oreck, "Any manufacturer who does not control distribution will eventually be controlled by the distribution channel."[36]

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[35]K. Kim and G. Grazier, "A Typology of Distribution Channel Systems: A Contextual Approach," *International Marketing Review* 3, no. 1, 1996, p. 19–32.
[36]Statement to the authors by David Oreck, June 17, 2005.

By avoiding large-scale distributors, David Oreck scaled up his business, and then chose *not* to distribute through the mass market. As a result, he protected his innovation, reserving profit margins for himself and his employees. Oreck introduced an innovation into a mature market through direct sales—initially to hotels and subsequently to the public. By doing so, the firm was able to avoid positioning its products as direct competitors to the mainstays of the industry. This happened because of the philosophy and vision of the company's founder. Dishearteningly, as you learned in Chapter 1, after Oreck sold the company and it was taken over by private equity technocrats, the approach to sales and distribution radically changed. And the rest is a sad history.

Table 7-1 summarizes the key considerations that managers should take into account as their firms move from small to large scale. Smaller firms are advised to be wary of premature engagement with the mass market, and it is recommended that medium and large firms approach big retailers with a great deal of caution. While we believe that the phase approach presented here can be used to guide distribution strategy as a company grows, we acknowledge that there are likely to be deviations from these sequential stages. For example, it is conceivable that a firm with breakthrough innovations could allow itself to become dependent on a mass-market strategy. Radical innovations, such as the iPod or the Dyson vacuum, allow producers to operate as the equals of large distributors because these products are highly differentiated and difficult to imitate due to patent protection, learning-curve effects, and proprietary technology.[37] Firms that create breakthrough innovations are in a potentially good negotiating position. For companies producing something other than disruptive innovations, a nuanced approach to channel entry is advisable.

As David Bryce and Jeffrey Dyer stated in *Harvard Business Review*:

> Smart newcomers refuse to challenge incumbents on the latter's terms and turf. They don't duplicate existing business models; they don't compete for crowded distribution channels; and they don't go after mainstream customers—at least not at first.[38]

Not only should the channel not be crowded, but the selected distributor should not have a history of opportunism or coercion. Firms that end up using the wrong mode of distribution, either because they made a mistake in conceptualizing how to configure the channel, or because of actions by their distributors, should realign their channel system incrementally to achieve a more acceptable outcome. [39]

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[37]Willow A. Sheremata, "Competing Through Innovation in Network Markets: Strategies For Challengers," *Academy of Management Review* 29, no. 3, 2004, p. 359–377.
[38]David J. Bryce and Jeffrey H. Dyer, "Strategies to Crack Well-Guarded Markets," `https://hbr.org/2007/05/strategies-to-crack-well-guarded-markets`, May 2007.
[39]Kenneth H. Wathne and Jan B. Heide, "Opportunism in Interfirm Relationships: Forms, Outcomes, and Solutions," *Journal of Marketing*, October 2000, p. 36–51.

The mass-market system of distribution has created conditions in which large retailers can easily dominate small, innovative companies. But just because it is easy doesn't mean it should be done. Many promising new products are now identified and controlled by mass marketers almost at will. We suggest that negative outcomes with distributors can be avoided if firms link their process and product innovations to sales and distribution strategies that serve the interests of the producing firm. Innovation simply for the sake of innovation does little to advance the interests of the company. Often managers assume their firm will automatically benefit from a technological or creative breakthrough. However, who a firm innovates for is often more important than the innovation itself. If the value of the innovation is captured by others, the new product or process represents wasted effort. Ultimately, the value of an innovation for a producer is largely determined by how that product is sold and distributed.[40]

To capitalize on its innovation, a firm must control distribution. Channel management should not be an afterthought for the innovative company. As firms move up in scale, managers should reevaluate their sales and distribution strategy in order to target profit-maximizing channels that do not jeopardize the firm's innovations.

[40]Andrew R. Thomas and Timothy J. Wilkinson, "The Outsourcing Compulsion: How the Colonization of Manufacturing by Distributors Has Pushed US Companies Overseas," *MIT Sloan Management Review*, 2006, p.10–14.

CHAPTER

8

Getting the Data and Doing Marketing Right

The number one benefit of information technology is that it empowers people to do what they want to do. It lets people be creative. It lets people be productive. It lets people learn things they didn't think they could learn before, and so in a sense it is all about potential.

—Steve Ballmer

Sarah Calhoun, the 30-something founder of Red Ant Pants, is a former Outward Bound instructor and wilderness enthusiast. She became so frustrated with ill-fitting work pants designed without the female figure in mind that she started her own company. It now sells 70 sizes of the double-knee, double-seat work pants with their lower-rise front and higher-rise backs. By importing 12-ounce cotton canvas from India, and having it cut and sewn by a factory in Seattle, Calhoun is free to sell the premium-priced pants ($129 a pair) to her target market—women who work for a living in agriculture, the construction trades, or any other job in the outdoors.

A 1964 Airstream trailer decorated with red ants was the initial marketing vehicle for the company, though now most sales are made online. Personal contacts gained through trade shows and conferences, such as the Women Building California Conference, and the International Society of Arboriculture, further extend her direct-marketing approach. Located in White Sulphur

Springs, a Montana ranching town, the company's big promotional event is a yearly music festival where people "dance their pants off" in a cow pasture while listening to top acts, including Lyle Lovett, Merle Haggard, and Emmylou Harris. After one of the concerts, the county sheriff congratulated Sarah on the festival with this text, "Great job, Sarah. I will never arrest you for anything." Making Red Ant Pants a successful venture hasn't been easy, but clearly it has involved lots of fun. "It's neat to show that we can do big things in small towns," she says.

Oh yes, the company uses Facebook, Twitter, and has placed homemade commercials on YouTube. Sarah has no interest in selling through the Megas, and has turned down several offers to go "national" with her brand. "We have a lot of people who do destination trips just to buy pants," she said, adding, "The really neat thing for me is that these pants really mean something to our customers."[1] Why has Sarah been able to tenaciously avoid doing business with the Megas? Her answer reflects the self-sufficient and neighborly ethic of Montana: "Staying independent and maintaining personal relationships is paramount to the values of our company."[2]

Another business that has avoided the Customer Trap is Alside, a pioneer in the aluminum siding industry. When you envision a product like aluminum siding, you are likely to imagine a commodity for which buying decisions are based on price. But when you listen to Donald Kaufman talk about the company he successfully ran as chief executive officer for a quarter of a century, you can observe clearly the difference between a leader who falls into the Customer Trap and one who consciously stays out of it.

Jerome Kaufman, Donald's brother, founded Alside in 1947 based on his invention of baked enamel aluminum siding that same year—a true innovation. In 1960, the company went public and was listed on the New York Stock Exchange (NYSE) the following year. From the beginning, this innovative manufacturer worked hard to control the sales and distribution of its products. Fundamental to the business was the close relationship the firm enjoyed with its customers. For three decades, Alside built and maintained a network of exclusive distributors across the country that worked directly with local contractors to install aluminum siding on millions of American homes.

When Donald took over in 1974, consolidation began to enter the aluminum siding industry, threatening the independent network of dealerships that had developed during the previous three decades. The commoditization race was

[1]Butch Larcombe, "Queen of the Pants," http://redantspants.com/our-story/meet-calhoun/ accessed 1/29/15, April 29, 2012; Laylee Walden, "How Sarah Calhoun Built Red Ants Pants from the Ground Up," www.bozemandailychronicle.com/business/do-it-yourself/article_9a768ede-433f-11e4-b3fc-4f6a90bf9241.html, September 23, 2014.

[2]Interview with the authors, February 25, 2015.

on. The temptation to Kaufman to cannibalize the Alside distribution network was very real. Alside's competitors were already abrogating control over their products to big-box retailers. It seemed almost inevitable that aluminum siding would go the way of so many other products and become a price-driven commodity, as the giant discounters swallowed up firms like Alside.

In the midst of the storm, Kaufman was faced with a defining moment. He could take the easy road and follow the crowd: shifting power to a few Mega-Customers while lining his own pockets as Wall Street rewarded the short-term rise in volume. Or he could dig in and face the threat head on, focusing on the long-term sustainability of the company. To his credit, Kaufman stood firm, which resulted in an enormously successful run for Alside under his leadership.

While women's work pants and aluminum siding may have little in common on the surface, the successful approach taken by both Sarah Calhoun and Donald Kaufman are the same side of the coin. Each leader aligned company capabilities with customers. They did this by adhering to the 10 Percent Rule—and by going directly to customers and building the kinds of long-term, sustainable, and profitable relationships that all companies need to succeed.

Not All Customers Are Equal

At its core, marketing is a means of delivering value to the customer. When we try to understand marketing in relation to the Customer Trap, we are trying to determine whom we really want as our customers, and whom we don't. Customers are not created equal, nor should they be treated the same. Most leaders we talk to seem to understand this at a basic level. Many, however, when faced with the daily rigors of setting and executing strategy in a hyper-competitive marketplace, let operational concerns obscure this fact.

Too frequently, they treat the biggest customers—the largest volume buyers of their products and services—as their best customers. Size seems to matter. The thinking, rooted in the relentless pursuit of volume, goes something like this: "The more that we sell to you, the customer, the more you are valued." As we have discussed, this is the bait at the entrance of the Customer Trap.

It is essential to determine whether, in fact, those big-volume customers are really the most profitable ones. Both Sarah Calhoun and Don Kaufman were aware of this pitfall, and constantly reminded themselves that it was profitability, not volume, that separated the good customers from marginal or downright bad ones.

Marketing is a two-way street. It involves a relationship between the supplier and the customer. In the mass-marketing paradigm that is characteristic of the Customer Trap, innovative companies become misaligned because their relationships end up out of balance. The customer becomes dominant, and the relationship becomes dysfunctional. A two-way relationship with a customer that is balanced means that needs are aligned between the two parties. These needs are based on the criteria of timeliness, loyalty, vision, and ultimately, profitability.

Typologies of Customers

As shown in Table 8-1, we lay out three general customer typologies: Transactional, Preferred, and Strategic. Obviously this is not the only way to categorize customers, but it does illustrate the broad scope of categories under which customers can fall. The Transactional are the least attractive type of customer, the Preferred are more attractive, while the most attractive are the Strategic customers. Strategic customers are the kinds of companies with which manufacturers would want to form strong bonds and alliances and that enable them to grow their products and services over time. These Strategic customers enable manufacturers to continue to deliver value and to maintain the inherent nature of their innovative products and services.

Table 8-1. Typologies of Customers[3]

Criteria	Transactional	Preferred	Strategic
Primary interest	Price-driven	Relationships over products	Long-term mutual dependence
Time frame	Short-term or no contracts	Longer-term	Integration of processes & systems
Focus	Focus is on transaction alone	Quality focus	Future (market) driven
Demands	Demands are not justifiable	Demands provide learning opportunities	Demands enhance common possibilities
Relationship approach	Us vs. Them	You and I	Together
Loyalty	Little or no loyalty	Moderately loyal	The most loyal
Profitability	Little profitability	Moderately profitable	The most profitable

[3]Andrew R. Thomas, "Analysis of Distribution Strategies of US Firms in Romania," PhD dissertation, Academia de Estudii Economice, Bucharest, Romania, 2008, p. 27.

Assessment Criteria

Volume is not a determining factor in assessing customer value. As we examine customer typologies, note that there is no criterion for how much the customer buys. As mentioned earlier, the profitless prosperity that so often exists when companies do business with a Mega-Customer permeates a company's performance when we look at it from a volume perspective.

In other words, say we are doing 60, 70, or 80 percent of our business with a Mega-Customer. If we are in the Customer Trap, an analysis will show that all we are really doing is simply turning money over, chasing slimmer and slimmer profits. All we are really doing is maintaining the product or service flow to the Mega-Customer.

Primary Interest

Primary interest is the first criterion. Transactional customers are price driven, and if anybody can recollect a time when they have dealt with a price-driven Mega, this criterion will be easy to understand. What separates the companies that can do business with a Mega from those that cannot is price. Can you deliver on price? And not simply can you deliver on price today, but can you meet the constant demands for reduced prices year after year? This is what so many innovative companies fail to realize. The challenge is not simply meeting the Mega's price the first day that you sit down to do business with them; but can you meet their price after the first year, the fifth year, the tenth year?

The inability to meet constant demands for lower price—transactional customers being price driven—is what compels innovators ultimately to offshore and outsource the production of their products and services.

Moving across Table 8-1, you will see Preferred customers as they relate to the primary interest criterion. These customers *do* value their relationships over products. They are not as price driven as Transactional customers. Price still plays a key role, but it is not the only role. When we get to the highest level of customer, the Strategic, the primary interest is a long-term mutual dependence. Strategic customers are looking for that two-way street, where "we need you as much as you need us."

Time Frame

Transactionals are based on the short term. If they do have contracts, they are month-to-month, quarter-to-quarter, or year-to-year. Preferred customers tend to have a longer-term perspective, while the time frame for Strategic customers tends to be much longer. This is because Strategic customers are relationship-driven – and good relationships take time to build. Yet that is OK from the point of view of Strategic customers, because time is something they are willing to commit to the relationship.

Focus

Not surprisingly, when it comes to focus, the Transactional customer is concerned with the price it wants to pay and the amount of product or service that it wants to buy. If everything aligns at that particular moment in time, a deal is struck. However, everything is based on that one transaction.

Preferred customers are willing to pay more because they see value coming from the quality of the product or service that they are acquiring from their supplier. At the top end, the Strategic customer is not only looking at what profits can be made today, but also at what an enhanced relationship with the supplier might mean over time.

Demands

Demands from Transactional customers are a problem and are simply not justifiable. Transactionals want everything: a lower price, better shipping terms, and plenty of credit. Far too often, companies that embrace the mass-marketing paradigm jump whenever asked to do something for a Transactional customer because many times these Transactional customers are by volume the biggest percent of their business. Yet, as we have seen, Transactional customers are not driven by anything except short-term results and the price.

The demands from Preferred customers might provide the supplier with learning opportunities about what they are doing both right and wrong. At the Strategic level, demands are a way to build common possibilities that strengthen the alignment between the two firms.

Relationship Approach

At the Transactional level, the approach to the relationship becomes very focused on "us versus them": "We're going to get the lowest price because we need to." This approach is confrontational and hostile. At the Preferred level, there tends to be more of a coming together, a mutuality of need, and a "you and I" relationship. At the Strategic level, you hear "together"—not simply today, but into the future as well. "We are going to do this. . . . We are going to make this happen." This collaboration can take place because of the long-term point of view that each party maintains.

Loyalty

At the Transactional level, so driven by price and short-term results, there is little or no loyalty. A moderate level of loyalty exists in a Preferred relationship. Perhaps it can become more, and if it does, it moves to the Strategic level, where the most loyal customers reside.

Profitability

Finally, and most important, we are in business to make profits over the long term and to sustain those profits. Transactional customers, although they may be the biggest group, are most often not the most profitable. Operational demands and the desire to beat up manufacturers over price, coupled with the negative approach that Transactional customers bring to the relationship, create a situation in which these customers are the least profitable. At the Preferred level, profits should be higher than at the Transactional level, and the Strategic customers would be the most profitable.

The Questions to Ask

It is important to ask questions when looking at my company in terms of the way we do our marketing. What is the direction that we are taking to bring value to the marketplace? Who are we doing it for and how are we doing it? Are we focused on Strategic customers? Are we building relationships with Strategic customers that align our two firms? Or are we focusing primarily at the Transactional level? Central to this notion of the different kinds of relationships that can exist with customers is not simply how the innovative company producing a product or service views its customers, but how those same customers look back at that innovative company.

If you are dealing with Walmart, for example, which has more than 125,000 suppliers, you might ask: How many of those suppliers does Walmart really need? How many of those suppliers would be viewed from a Strategic point of view in Walmart's eyes? There are certainly Strategic suppliers from Walmart's perspective; The Coca-Cola Company, Procter & Gamble, Johnson & Johnson, and maybe a few dozen, or, at the most, a few hundred others.

Walmart views most of its suppliers in a Transactional way. In other words, if it does not get the price that it wants, if it does not get its demands met, and, ultimately, if it cannot make enough money off those products or services that are purchased, then it simply will cut those suppliers loose. The dysfunctional nature of the Customer Trap takes over when the supplier, which Walmart probably views as Transactional, puts all or most of its eggs in the Walmart basket—mistakenly believing that Walmart is a Strategic customer.

These days, most Transactional, and even some Preferred, customer relationships are the result of a mass-marketing approach. Little or no profitability is provided by these customer types. If the Mega-Customer gets a better chance for lower prices, they are likely to walk away without a thought—unconcerned and even contemptuous of the idea of loyalty.

Consider Columbia Paint & Coatings, which was founded in 1947 by four entrepreneurs who a year earlier had started a company called the American Chemical Corporation.[4] This company built its strategy around creating relationships with the kinds of Strategic customers referred to earlier, while controlling critical aspects of production and distribution. Columbia began by obtaining zinc oxide from the American Smelting and Refining Company (ASARCO) in East Helena, Montana, and converting it to a pigment that was valuable for use in house paint as an extender pigment. Seeing that no one was manufacturing paints and coatings between Chicago and Seattle, the four men started a paint company. At that time, Helena had a population of about 15,000 people, and the state of Montana had a population of about 500,000, which was not a very large potential customer base.

The founders decided that in order to grow, expansion into neighboring states was necessary, and that the vehicle for expansion would be company-owned retail/wholesale stores; what the company referred to as "branches" or "distribution centers." These branches would in turn sell to all end users—homeowners, wholesalers, dealers, distributors, paint contractors, architects, property management companies, schools, and all forms of government. About 5 percent of Columbia's business comprised outside dealers or distributors typically consisting of hardware stores, privately owned lumberyards, and building material supply centers in cities that were too small for Columbia to operate a store of its own. By the time the company was sold to Sherwin-Williams in 2007, it operated 41 distribution centers in eight states in the Mountain West, Pacific Northwest, and Alaska.

When Columbia decided to start distributing through its own stores, the typical pattern for distribution in the coatings industry in the United States was for the manufacturer to sell to a distributor, who sold to a dealer, who then sold to the end users. Columbia was one of the first regional paint companies in the country to develop the concept of vertical integration, whereby it bought raw materials, formulated and manufactured the product, and sold to virtually all end users through its own distribution chain.

According to H.H. "Larry" Larison, the president of Columbia from 1976 to 2007, "the advantage of vertical integration and controlling your own distribution channel is that you can capture a much larger piece of market share." The three largest consumer segments for architectural paints and coatings are "do-it-yourself" homeowners, people who own property that are buying paint to maintain it, and painting contractors. Columbia stores were designed to be hospitable and to offer optimal service to those kinds of customers.

[4]The discussion of Columbia Paint & Coatings is based on an interview with H.H. "Larry" Larison that took place on October 23, 2014.

As a result, the company was able to capture market share in the range of 25 percent to 50 percent everywhere it was located. By the time Larry Larison sold Columbia, its total market share was approaching 35 percent.

Columbia never contacted Lowes or The Home Depot or considered using them as a distribution channel. Larison states:

> We were active in several industry associations. Through networking, we got to know some regional paint companies on the West Coast and East Coast who did establish relationships with Home Depot. Home Depot became a very significant consumer for those companies. As their business grew with Home Depot, and Home Depot became a major consuming resource for those companies, it put what they felt was undue pressure on them for price reductions. Home Depot and all the big major retailers, like Lowes and Costco, have a reputation for really working their suppliers hard to the point of unreasonableness and stretching profit margins to the point that it really isn't worth continuing the relationship.

Surprisingly, the Customer Trap has not been an attractive destination for most regional paint companies. Instead, the Megas source paint from large national companies that "specialize" in selling to them. For example, The Home Depot almost exclusively sells Behr paints, and Sherwin-Williams and Valspar have a variety of private labels that they sell through the mass-merchandise distribution channel. The mass-merchandising home centers have been unsuccessful in penetrating the paint-contractor market because regional companies as well as Sherwin-Williams, which operates its own stores throughout the country, are tailored to optimally service the painting contractor. The Megas, which are retail oriented, have not been able to present themselves as effectively to contractors. In addition, certain kinds of retail customers don't like big-box stores, but prefer the kind of individual attention and product expertise that they can get from stores that specialize in architectural paints and coatings as well as related surface preparation and application equipment. Larison states, "The fact that we were highly specialized attracted a certain kind of customer. The mass merchandisers never successfully pulled that kind of customer away from the manufacturer-owned store."

Similar to STIHL, Alside, and Red Ant Pants, the regional paint companies have been able to distinguish themselves from the Megas by offering specialized service. Vertical integration also gives these companies an edge. Within ten years of Colombia's founding, the Sherwin-Williams Company, which at that time was the largest manufacturer of architectural paints and coatings in the United States, changed the way it distributed its products. Previously, it had not operated as a vertically integrated organization and did not have paint-store operations selling to final customers at the end of their value chain. It was not until the 1950s that it began opening company-owned stores, which was

considered heresy at the time by the architectural coatings industry. Columbia and many other regional and national paint companies made this move and, within ten years, a large percentage of the industry followed course. Larry Larison explains how vertical integration helped Columbia compete:

> There were no middlemen involved. We were taking the product all the way from raw material to the end user through our distribution system. The only level of profitability involved was our own. Because our manufacturing plants operated as cost centers and sold to our stores at break even, we took all of our profit at the stores. We were the manufacturer, who was selling to a distributor, who then supplied to a dealer, who was then selling to the end user. Those are three or four levels of profit taking that we consolidated under our own roof. And in the paint and coatings industry today, the two most significant channels of distribution are the big-box store like Lowes, Home Depot, and any regional permutations of them, and the paint manufacturer–owned store. There are a significant number of regional manufacturers scattered around the US, and there are two national companies, Pittsburgh Paints PPG Industries and the Sherwin-Williams Company, that operate company-owned stores in the US, Canada, and Mexico.

One of the reasons that Larison embraced vertical integration was that it enabled Columbia to control sales to each category of consumer without relying on the effectiveness of a distributor or dealer to market its products:

> We marketed our products ourselves and we had a very disciplined approach to market. Each year our sales force developed a plan in which they had target accounts, accounts that they thought they could increase their sales to or accounts that they had never sold to that they hoped they could sell to in the future. We had a very aggressive and focused direct-sales effort. We employed effective, strategic pricing mechanisms that worked with each product group of manufactured products and nonmanufactured resale items. The resale items that we sold were application and surface preparation tools and equipment. About 30 percent of our sales were nonmanufactured items, and about 70 percent were manufactured items. The 80-20 rule generally applies in strategic pricing. The 20 percent of your products that make up 80 percent of your sales are very price sensitive. The rest aren't really price sensitive, so we would identify product groups that we could take stronger profit margins on and price them accordingly. So the high-volume paints and coatings items were less profitable per unit of sale, and the lower-volume items were more profitable because they were less price sensitive.

Smaller paint manufacturers can also participate in regional buying co-ops as a means of leveling the playing field. According to Larison, "A regional paint manufacturer can join an association where they pool their buying power, and are able to buy supplies from manufacturers at approximately the same price as a national paint and coatings company." Different associations focus on various products, such as the purchase of raw materials, containers, color systems, and merchandizing aids. "Buying co-ops are still very active and still very effective. This helps the regional paint and coatings company keep the playing field level with the big guy in terms of buying power," Larison states.

Larry Larison is not intimidated by the Customer Trap, but is instead optimistic about the current operating environment for smaller, regional manufacturers. He observes the following:

> When I was growing up, there was a brewery of every size that had branded beer. There was a meat-packing plant in every city of 30–40,000 people or more. They all disappeared because the "bigs" came along and absorbed their market, made them less cost-effective producers and marketers. But when you look at the rebirth of the small brewery, with the micro brews, they are all over the place. For example, the former Columbia Paint & Coatings manufacturing plant in Helena, Montana, is now the home of Lewis & Clark Brewery, a small brewery operation. With recent developments, affordable packaging equipment is now available, and it is affordable for a small brewer to buy aluminum cans and package with those cans on a short assembly line. Lewis & Clark's product on the shelf looks just as good as major brand-name beers. Another example: it is mechanically possible now to start a small meat-packing company and sell to a specialized customer base and make a profit.
>
> In the 1960s and '70s the most effective retailer of paint and coatings was Sears. That was before Home Depot and Lowes came along to do their thing. As specialized home-improvement centers, Sears and Kmart kind of remained in the old-fashioned mode of marketing, and they were all things to all consumers. They were eclipsed by Home Depot and Lowes on the home-improvement side, and by more-aggressive/sophisticated marketers like Shopko, Target, and Walmart on the general merchandise side. It's fascinating to watch the transition in almost every phase of product marketing, where trends change and market share shift happens.

Larry Larison sums it all up with this hopeful phrase: "Resourceful small business can still emerge and succeed."

An effective marketing vision is about focused, direct relationships with Strategic customers. Of course, it is essential to meet standards of excellence in business, but it must be done at the Strategic level, and to a lesser extent, at the Preferred level. To meet these standards, one has to get the data and "do" marketing the right way.

Getting the Data: The Foundation of Good Marketing

Many organizations find the changes in database management and communication technology to be so overwhelming that they do not know where to begin and how to compete.

For years, mass marketing was touted as the ultimate marketing fix, but as markets fragmented, marketing was aimed at smaller groupings called "segments" or "niches." Data-driven marketing is aimed at the individual market. The individual market is the Strategic customer. The dentist's office calls to remind you about your appointment. The closest grocery store asks for your card to record your purchases. You turn 50 and receive membership information from AARP. These are all examples of the impact of data-driven marketing in everyday life. Very quietly and often without much fanfare, the most visible applications of data-driven marketing have changed the way we go about living, and there is no evidence to suggest that the impact will lessen.

The Emergence of Channel Data Management

Chandran Sankaran is the founder and CEO of Zyme Solutions—the pioneer and leader in the emerging field of channel data management (CDM). Spending some time with Sankaran, it quickly becomes apparent that the world of information sharing does not work as many might expect.

Sankaran is one of those unique individuals who combines passion with reason, and possesses a rational optimism that challenges conventional wisdom. Sankaran recognized early on that manufacturers were more than willing to give away control over the sales and distribution of their innovations to Mega-Customers in exchange for greater volume. This, he observed, has frequently allowed the path to market to become muddied and transparency to be lacking. Sankaran wisely notes that the rise of dominant middlemen has

forced companies to explore how to connect to the true customer of their product:

> In the old school, you used to talk about routes to market, and it was, "How am I going to sell to Latin America?" In the new world, it's really "route to customer" and "how am I going to reach Bank of America? How am I going to reach the guy that has the need for that leaf blower? How do I reach the industrial maintenance department at the company next door?" It's "How do I actually reach out and touch those individual customers using that route to customer?"[5]

Sankaran recognizes the important roles that an intermediary can play, observing that few companies can become completely vertically integrated, where they control everything from product design and innovation to distribution and after-sales service. He states: "It makes sense for there to be a shared economy. And that's what a distribution channel is supposed to be, a shared economy for sales."

He points out that for most companies, it makes sense to have a shared infrastructure for marketing, distribution, and selling, as well as warehousing, customs clearance, taxes, and paying local transportation surcharges. "The real question," he asks, "is whether you can have a shared infrastructure, without giving up full ownership and transparency on your performance in that infrastructure, so that you can then make the right business decisions."[6]

Sankaran is quick to point out that giving control away to channel partners should not be an option: "While intermediaries can provide some economies of scale and access to markets, just because I work with an intermediary doesn't mean I have to go sit in a little cage somewhere and abrogate all my opportunities to them."

According to Sankaran, discrete manufacturing companies sell over $5 trillion each year through indirect sales channels—with little or no visibility into the operational analytics to make better business decisions in these channels. His company, Zyme Solutions, provides product companies with the operational data, visibility, and analytics they need in managing their sales channels globally. Zyme's network stands at 900,000 resellers/distributors around the world whose data they receive. Their customers are a growing breed of product companies gaining competitive market advantage by using data and analytics to drive business decisions.

[5]Interview with authors, January 5, 2015.
[6]Ibid.

Sankaran explains how innovators are waking up to the fact that data is fundamental to their businesses. And getting it from their channels is vital. Further, the benefits are not just one-way. Data sharing benefits both manufacturer and intermediary.

Channel visibility for manufacturers and brand owners is a relatively new phenomenon. In the past, on a regular basis, distributors would use various pretexts to refuse to provide sales information and visibility to their suppliers. Customers are now starting to show much greater resolve in demanding this transparency. They are more likely to say to a distributor who is reluctant to share data, "You know what, that's fine. The next quarter will be your last quarter as our partner in that market, because information transparency is central to how we're going to run our channels."[7] And their distributors quickly come into line.

Head, Torso, and Tail

Sankaran and Zyme believe in something they call the "Head, Torso, and Tail of the Distribution Channel" and feel that this is a central concept in CDM. This is a Pareto of partners, from the largest to the smallest, as illustrated in Figure 8-1.

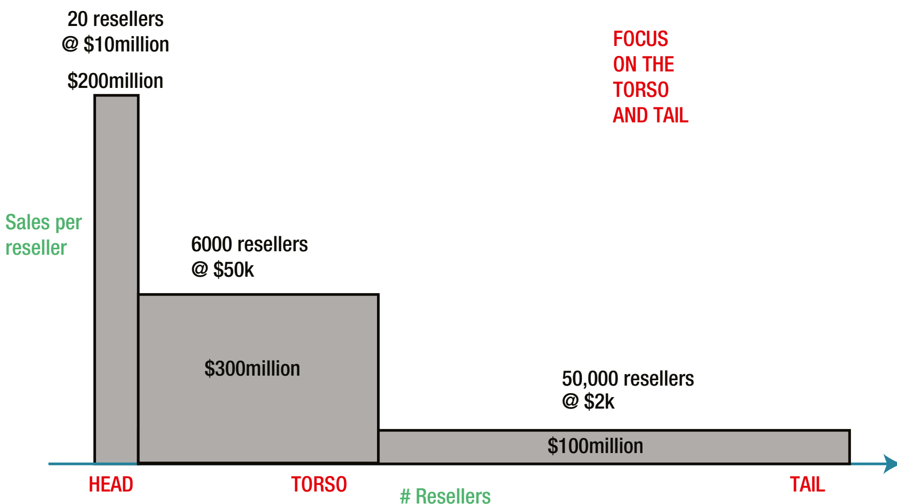

Figure 8-1. Head, torso, and tail of the distribution channel

[7]Ibid.

The Head consists of Mega-Customers, those large distributors and retailers in mature markets that have achieved significant market share. They move large volumes, and dictate commercial terms to their suppliers. These are usually not very profitable channels, but it's increasingly difficult for product companies to avoid doing business with the Head, however painful. The Torso represents the up-and-comers in mature markets and some of the larger established players in emerging markets. The Tail typically represents the bulk of the intermediaries in fast-growing, smaller markets.

Figure 8-1 illustrates how this might look for a company with $600 million in sales.

The power of CDM and better data, Sankaran says, is that it illuminates for the very first time the Torso and Tail of the sales and distribution channel, thereby allowing manufacturers to have a real alternative to the Head (Mega). The Torso and Tail players are scrappier, eager to do business with you, and when marshaled right and organized, they can represent a real source of competitive advantage and greater profitability than the Head. These players are harder to find and orchestrate at any scale, but with better data and transparency, the playing field is being leveled.

The 12 Steps

To implement a data-driven marketing strategy, the Taylor Institute for Direct Marketing at the University of Akron has developed 12 steps.[8] Why are there not 11 steps or 10 steps? Each of the 12 steps to a successful data-driven marketing program is vital and cannot be overlooked.

Skipping over and around steps in developing a direct-marketing strategy results in something like putting on your shoes before your socks. Each step provides information that refines and directs the strategy with the result that good direct marketing produces more results and less waste. Insight about the company, its products and services, and competitors are key pieces of knowledge that guide the final strategic initiative. Most important, this information enables a company to find and keep its best customers.

[8]The 12-step process is elaborated upon in Andrew R. Thomas, Dale M. Lewison, William J. Hauser, and Linda M. Foley, Eds. *Direct Marketing in Action: Cutting-Edge Strategies for Finding and Keeping the Best Customers* (Westport, CT: Praeger, 2006).

What Are the 12 Steps?

Figure 8-2 displays the following 12-step process.

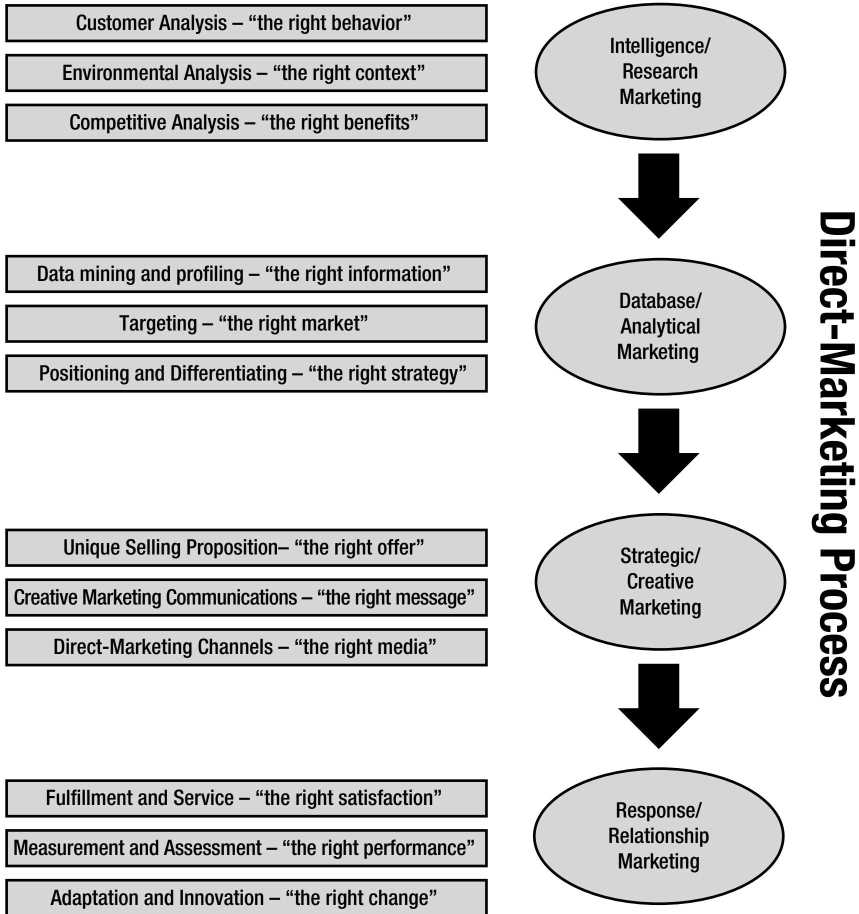

Figure 8-2. The 12-step process[9]

[9]Ibid.

Here's a brief look at each step:

1. *Customer analysis*: Profile your best customer's needs, motivation, and buying habits. Ask yourself, "What do they buy, and why do they buy it?"
2. *Environmental analysis*: Anticipate the need to proactively anticipate not only the internal needs of your customer's business, but also the next move of that customer's competition that could emerge.
3. *Competitive analysis*: Find out what your competitors are doing right and what they are doing wrong. This will be valuable help in developing your own message.
4. *Data mining and profiling*: Develop a database of prospects, and then extract and analyze as much pertinent information as possible to get the best possible read on your audience.
5. *Targeting*: Further refine your database to figure out your best prospects.
6. *Positioning and differentiating*: Develop the offer, or central selling point, in a three-step process:
    a. Identify the attributes of the offer and the characteristics that make it unique from your competitor's.
    b. Delineate the benefits your customers will receive upon acceptance of the offer.
    c. Make claims that are the promised benefits for taking advantage of the offer.
7. *Unique selling proposition*: Shape the statement that conveys an implicit promise of a perceived value: it will make you more desirable, healthier, wealthier, wiser, and so on.
8. *Creative marketing communications*: Determine how you will shape the message you have crafted. The message package includes each component of the media campaign, from the tone, to the type style, to the call to action.
9. *Direct-marketing channels*: Figure out how you will communicate your message. By mail? Newsletter? Phone call? Email? Choose a direct-marketing channel that will best get your pitch into the hearts and minds of your customers.

10. *Fulfillment and service*: Let's say your prospect bites. How are you going to fill the order or the request for a free sample or more information?
11. *Measurement and assessment*: Track results so you know what you did right and wrong. Your campaign worked only if it cost-effectively bridged the barrier between you and your prospects.
12. *Adaptation and innovation*: Revise, refine, relaunch. If you are not totally happy with the results, do not be afraid to tinker with the message, communications channel, or any other campaign element.

Many small companies are using the 12 steps to either bypass or compete with the Megas, even in sectors that appeared to be "owned" by the large operators.

A Bookstore Sets Itself Apart

The idea for a store focused on educational tools was hatched after church one Sunday by two couples who found themselves lamenting the absence of a place to buy sound educational gifts for their children and grandchildren. The result was the Launching Success Learning Store, located in Bellingham, Washington.

After researching the needs of area educators, the new business owners began to work closely with private schools, homeschooling parents, and public school teachers and principals. The store sells books, games, arts and crafts, and teaching resources. Dan Sanford, one of the founders, said that the enterprise was driven by developing relationships with customers based on offering expertise and excellent service.

Dan and his colleagues would take products to off-site events—such as teacher curriculum workshops, school parent nights, and school programs with parents and children, such as Math Night—where customers could interact with the products on location. Dan Sanford explains, "When people attend one of these events, bringing an interest in education with them, we try to be there with the products. Of course, it takes employee time and is nothing entirely new. Vendors have gone to site locations for decades, but in the educational materials industry, it is new to show up on location."[10]

[10]Dan Sanford interview, October 9, 2014.

The Launching Success Learning Store implemented strategies aligned with the 12 steps outlined previously. They know their customers personally, so they are able to understand customer needs, motivations, and buying habits. They are positioned in the marketplace to offer unique, highly differentiated products. For example, the store built up a large inventory for special-needs children after discovering an unmet demand in that area. Today it sells 30,000 products through its 5,600-square-foot building and its sophisticated and attractive web site. It has also formed alliances with other companies to extend its market reach. These include buying groups, homeschool materials producers, and a toy association. Most important, like STIHL (see Chapter 6), it imbeds its products into the context of its expertise so that customers are buying both the product and the service that goes with it.

The Launching Success Learning Store has been able to fend off competition in its category by going to great lengths to engage customers. It now holds curriculum in-store workshops designed to help parents evaluate and choose the best products. According to Sanford, "Curriculum workshops at a store is not a new idea. What is new are events where parents and children can practice using our materials under the guidance of our staff. Expertise is applied through what we call one-on-one 'personal shopping' with the customers. We provide a lot of instruction to parents on the uses of various curriculum and tools."

The Launching Success Learning Store also bundles the best enrichment materials. One key for the company has been its human capital, which it has extended by hiring seniors, graduate students in education, or teachers who are not currently in the classroom. Finally, the company has made a large investment in point-of-sales software to help it stay out of the Customer Trap. Through data management, they know who is buying how much of their product. Dan Sanford states, "We don't want to over-rely on big-school associations for sales. We figured this out early on when one of the largest customer groups turned to Amazon. We learned our lesson, and now measure our sales progress without lumping in the figures from those big buying groups. We don't want to become overly comfortable."

What happens when a company follows the 12 steps? The result is that the firm is bringing "good news" to its customers rather than aggravation and frustration. The result is that relationships are formed. The result is that customers do not feel that their time is wasted. The result is that you are partnering with customers, who then sing your praises to anyone who shows an interest. And the Customer Trap is avoided. Data-driven marketing provides one of the best ways to bring about that kind of difference.

Is the strategy of data-driven marketing right for your company? Indeed, it very well may be. Whether large or small, all companies can benefit from this approach. Smaller companies with fewer resources can ill afford to throw money to the wind, so using marketing dollars wisely is essential. Larger companies also have a bottom line for marketing costs, and in some cases, the marketing department will receive more funding when it has a proven strategy that works. Employing the 12 steps is current, proactive, and understandable.

If access to information is important in the domestic setting, you can imagine how vital it is when operating overseas. Cross-cultural differences are a good cover for the Customer Trap, and can turn the most rational-sounding decisions into lost opportunities or worse.

CHAPTER

9

Going Global and Keeping the Faith

The art of leadership is saying "no," not "yes." It is very easy to say "yes."

—Tony Blair

A few years back, a US firm that had a partnership in China manufacturing motorcycles went looking for new customers in Central America. Previously, the US firm had been relatively successful in South America and Africa, finding distributors for its line of basic transportation motorcycles. With an engine design based on a Honda model, the Chinese motorcycles were proven to be of acceptable quality and reliability. Most important, they were a lot cheaper—about half the cost of the competing Japanese models.[1]

The entry point in Central America was Cost Rica, which, along with Panama, was the most prosperous country in the region. In addition to a growing economy and political stability, other attractive conditions existed that might support strong sales, especially a rising lower-middle class that could now afford motorcycles for basic transportation needs.

[1]This chapter is adapted from "It's the Distribution, Stupid," by Andrew R. Thomas and Timothy J. Wilkinson, *Business Horizons* vol. 48, 2005, p. 125–134, by permission of publisher. Copyright © by Kelley School of Business, Indiana University. All rights reserved.

The American in charge of sales and distribution for the US firm was able to find two possible distributors in Costa Rica. Full of pride because of earlier success in other markets, he believed himself invincible when it came to identifying who would be the best distributor in Costa Rica.

The first candidate was a young entrepreneur whose primary business was in the agricultural sector—especially importing farm implements and fertilizers. He had built a network of sales agents across Costa Rica. He believed the Chinese motorcycles—designed for and often used by farmers—would complement the current product offerings.

The second possibility, on the surface, however, seemed to be a wiser choice. The other firm was owned by one of the wealthiest men in all of Costa Rica and was the exclusive agent of Honda cars, Scania trucks, and Komatsu heavy equipment. The father in this family business had previously represented Honda motorcycles, and the son was once again interested in lower-cost motorcycles. To the American, this option appeared to be the best one for the distributorship of his firm's products.

Market research revealed to the US firm that an annual sale of 250 motorcycles for each of the first three years was a reasonable expectation. This estimate was based on the total annual motorcycle imports for all of Costa Rica at around 2,700 units, with projected increases of 10 percent per year.

The American first sat down with the agricultural products distributor, who was very excited about the prospects of the Chinese motorcycles. Still, for the American, there was not a lot of satisfaction when the young man detailed his projections for only about 100 units annually. The young entrepreneur said it would take a long period of time for Costa Ricans to adopt to a Chinese model, but once it did happen, the potential would be enormous. Despite the enthusiasm, the American told his counterpart, "I will take your plan under advisement," and moved on.

A short time later, the American was entering the sparkling facilities of the Honda/Scania/Komatsu distributor. After an hour of discussion, the American offered the major player the exclusive dealership for the Chinese motorcycles. The infrastructure of his company was quite impressive; the sales organization, service facilities, financial capabilities, and history of distribution with motorcycles were all outstanding. Moreover, the initial order was to be 1,000 units—four times what the American believed he could sell in the first year. The only remaining step was to prepare an agreement ensuring the Costa Rican exclusive rights for the first five years. Then, as soon as the agreement was formalized, a revolving letter of credit would be opened to ship the motorcycles in 125-unit increments over the first year.

Once the document was legalized, notarized, and signed, the first units were dispatched from China to Cost Rica. Everything was off to a great start. Nevertheless, when time came for the second shipment, things began to go

bad. A document from the distributor to the confirming bank was required to reactivate the line of credit. It had not been sent. For several weeks, the American frantically tried to reach the Costa Rican distributor. He was always unavailable. When the American did reach one of the distributor's many secretaries, the responses were always the same: "He's out of town . . . unavailable . . . in a meeting." As the next shipment of 125 bikes sat at the Port of Shanghai and the other 700 were in production, stress was getting a bit high for the American.

Without telling anyone, the American flew to San Jose to find out what was happening. He grabbed a taxi from the airport and headed straight to the distributor's office, where he was stiffly informed that the distributor "was unavailable for the rest of the week." Distraught, the American was further frustrated to see none of the motorcycles nor promotional material for his bikes anywhere at the facilities.

With no other option, the American hailed a taxi. As he was headed to his hotel, he was shocked to witness many small motorcycles cruising the streets of San Jose—something that he had not seen the last time he was there. Most of the motorcycles were from his chief Taiwanese competitor.

After some time at the hotel bar to collect his thoughts, the American sucked it up and decided to call the first candidate—the one he turned down in favor of the rich guy. Absolutely uncertain what to expect, the American was blown away when the young man offered to meet for dinner. Clearly enjoying the moment, the Costa Rican showed some photographs of the American's motorcycles in their original crates, sitting in a bonded warehouse at the port of Limon. He then pulled out a recent newspaper article that stated that sales of Taiwanese-made motorcycles might exceed 500 units that year. As the American read the article, he discovered the last name of his exclusive distributor. It turns out his distributor's brother was bringing in the competition from Taiwan.

Exporting the Dysfunctional Model

It should not be surprising that many companies that are living the scourge of the Customer Trap at home do the same thing when they take their product overseas. This error is compounded by the fact that the most common option to enter into global markets is through distributors. Even a cursory look at almost any international business college-level textbook has a most glaring omission: the issue of distribution is often left out. When it is dealt with, it is often viewed as an issue of logistics. At best, the critical elements of selecting, bargaining with, and maintaining a strong relationship with a global distributor are relegated to a few paragraphs.

Blue Sky Beverage Company demonstrates the temptations of the Customer Trap at the international level. The Santa Fe–based firm is a small $1.8 million natural juice drink producer. After spending a lot of time and money looking for a distributor in Japan, Blue Sky president Richard Becker found Cheerio Kansai, a soft-drink manufacturer located in Osaka. The distribution with Blue Sky arranged with Kansai abrogated all of the control for the distribution of its product in Japan to the local agent.

As Megas often do at home, Cheerio ultimately redesigned Blue Sky's cans, ran ads that Blue Sky did not understand, paid 33 percent less than Blue Sky's American distributors did, and sold only two of the company's brands—ignoring everything else. Despite this maltreatment, Blue Sky justified the relationship under the guise that it could not afford its own office in Japan, had risked little, and, most important, had achieved an 8 percent increase in total sales as a result of Cheerio's first order.[2]

Fortunately for Blue Sky, things did not end tragically. Nevertheless, what is revealed is the seductive nature of distribution-manufacturer relationships in the industrial world. In emerging markets, which are less economically and politically sophisticated, such an abrogation of control can lead to corporate disaster.

Hope Outside the United States

The chance that American innovators will wrestle back control over the sales and distribution of their products at home is slim. The Megas in nearly every industry are fighting tooth and nail to maintain control. And while this may seem bleak—and it is bleak for those caught in the Customer Trap—there is hope. The opportunity exists for innovators to regain control over the sales and distribution of their products—not at home, but in emerging markets overseas. In these places, manufacturers still have the opportunity to directly influence what happens to their products. Certainly, the Megas are trying to make their mark in Mexico, China, and Eastern Europe, but so far they have made few inroads. In fact, in many markets, the Megas have not done well at all. The window of opportunity is still open for manufacturers to shape and mold the way distribution is handled in these markets. The questions are and remain: Will they do it? And how can it be done the right way?

[2]John B. Cullen, *Multinational Management: A Strategic Approach* (Cincinnati, OH: South-Western College Publishing, 1999), p. 156.

See It from the Distributor's Perspective

Academics who have looked at culture and international business always warn of the subconscious influence of self-reference criteria (SRC) on corporate behavior and actions. SRC is the unconscious tendency to interpret a particular business situation through the lens of one's own cultural experience and value system.[3] Many examples of SRC are cited in the business literature. For example, an American who equates formality with agreement and is put off by the gregarious nature of an Argentine customer is experiencing the effects of SRC.

SRC can play an important factor in selecting international distributors. In the Costa Rican case, the ultimate candidate was the exclusive distributor of Honda cars, Scania trucks, and Komatsu heavy equipment. This distributor had stated that his company had also represented Honda motorcycles in the past. In reality, however, he was involved in a directly competing venture. This information was deliberately withheld from the American because the Cost Rican saw the arrival of the American not as an opportunity, but as a threat that needed to be eliminated.

Most emerging markets are characterized by high risk and uncertainty. In these places, opportunity is constrained by turbulent events that can destabilize a life's work almost overnight. Needless to say, control and predictability are of critical importance. In Costa Rica, rather than seeing the entrance of low-end motorcycles from China as an opportunity to grow market share, the distributor saw the entry of a new product as a present danger. For distributors in emerging markets, the environment is always full of uncertainty. Therefore, it is often best to lock foreign firms and other potential destabilizers out of the market. By entering into an agreement for exclusive distributorship in Costa Rica, this individual was able to deftly eliminate what he perceived to be a problem.

Set Minimal and Ideal Criteria

To ensure the success of a distribution arrangement, both parties must bring something of value to the table.[4] The first question to be answered for the manufacturer is, "What kind of distributor do you want?" The answer to this

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[3]James S. Lee, "Cultural Analysis in Overseas Operations, *Harvard Business Review*, March–April 1966, p. 106–114.
[4]Steven E. Harbour, "Five Rules of Distribution Management," *Business Horizons* vol. 40, no. 3, 1997, p. 53–59.

question depends on circumstances and on what goals need to be achieved. For overseas markets, distributor selection criteria should include consideration of distribution outreach, functionality, appropriateness for products, cultural context, consumer-distributor interaction, and past performance.[5]

It is critical to set the qualities needed *before* undertaking the screening and selection process. Once the criteria have been established, it is vital to stick to your guns at all times. A new environment, the uncertainty that accompanies exporting, and the increased risk of operating in international markets all conspire to convince new exporters to take the easy way out, to look for a situation that feels good, in order to be comfortable with a distributor. Do not fall for that temptation.

The criteria are left to the innovator. However, whatever they end up being, you must be firm. Potential distributors should be held accountable to a range of minimum and maximum characteristics. One recommendation is to consider whether a potential distributor is involved with directly competitive products. In emerging markets, the selection of a distributor like this almost always leads to failure, especially for small- and medium-sized businesses.

Equally important, the innovator needs to look inward and decide which things are going to be brought to the table, such as exclusivity, patent and trademark protection, quality, favorable pricing, training, new and improved products, and periodic visits.

Focus on Potential Complementors

As with the domestic Customer Trap, far too many American companies get burned when they choose an international distributor who represents products similar to their own. The flawed logic of the US firm tends to go something like this:

> We need to capture as much market share as we can. Instead of investing all of the resources necessary to mentor a distributor who doesn't really understand our products and services, it's easier to locate an existing distributor who has a history of handling products similar to ours. We'll educate them on what needs to be done in a couple of weeks. And then all they have to do is put our product into their pipeline. Fast, efficient, and to the point—just like we do at home!

Nothing could be more wrong.

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[5]A. Coskun Samli, *Entering and Succeeding in Emerging Countries* (Mason, OH: South-Western Educational and Professional Publishing, 2004), p. 48.

The best choice for an innovator's products in a given market is typically what we call a "complementor." This consists of a local company that represents and distributes goods that do nothing except enhance the image and perception of the innovator's products. In the Costa Rican example, the best choice was clearly the agricultural products distributor. The products that this distributor sold complemented the image of the motorcycle as a basic transportation vehicle for workers and farmers and could have opened a whole new market.

In Trinidad and Tobago, outdoor cookouts are a way of life. With around 25 national holidays per year and many weeks of vacation for the average worker, residents make full use of their abundant free time to host massive gatherings with outdoor grilling as the centerpiece. Sensing a good opportunity, a US producer of innovative gas and propane grills decided to explore the Trinidad and Tobago market.

On the surface, the best potential distributor seemed to be Choice Mart, a San Diego–based Mega that rivals Walmart in Central America and the Caribbean. Choice Mart is the largest importer and distributor of grills in Trinidad and Tobago. And it is also the exclusive distributor for seven other brands of grills.

The US company decided it did not want its innovations thrown onto shelves next to its direct competitors. Instead, it looked for a complementor in the market. In Trinidad and Tobago, most natural gas and propane is sold at gas stations. Three main companies controlled the service center market, and the US company decided that such complementors would make an ideal distributor. In just a few short months, the US innovation was number two in the marketplace.

Loctite, a Connecticut-based company that specialized in adhesives, initially partnered with distributors who were well versed with the local market because these distributors carried competitors' products. After experiencing the negative consequences of having the market controlled the distributor, Loctite began to seek out complementors—firms that they called "company fit" rather than "market fit." According to one executive, "The closeness of the market fit can be a liability as well as an asset, because the distributors represent the market's status quo, and we are selling a replacement technology and attempting to change the market.[6] In contrast, company-fit partners, while unable to generate quick, short-term sales, are distributors who invest in the relationship in terms of time and are willing to be trained in the product.

[6]David Arnold, "Seven Rules of International Distribution," *Harvard Business Review*, November–December 2000, p. 135.

Explicitly Spell Out Responsibilities

As with children, responsibilities need to be defined and explained so that both parties have clear expectations. If not viewed correctly, a well-written distribution contract will give the false impression to a manufacturer that it really is in control. This is natural, given the detail and complexity of most agreements as well as the time, energy, and cost required to produce them. However, too often companies do not recognize the limitations of these legal instruments.

International distributor agreements falsely create the impression that the document itself has generated business. If an innovator wants to successfully sell and distribute its products in a new market, it will need more than merely a document prepared by and agreed to by lawyers. Distribution can be successful only if both parties are highly motivated. The key to selling and distributing products in a global market is not just a legal document, but the development of mutually beneficial relationships and a strong, effective business strategy.

Still, a well-crafted distributor agreement can and does provide a degree of security against badly intentioned individuals who are seeking to hurt the manufacturer and impede market entry. John Deere, like so many major US manufacturers attempting to enter the Middle East years ago, was being wooed into signing a blanket agreement that allowed a local distributor to operate with impunity. Large initial purchase orders were dangled in front of the company as a temptation to throw caution to the wind. John Deere, however, saw through the scheme and presented a 32-page distribution agreement that was so comprehensive and thorough, it scared off the potential "distributor." In this case, the agreement served as an instrument to better qualify and assess the credibility of a potential distributor.

Construct the Relationship

An international distributor agreement should be viewed as the starting point in an ongoing and evolving relationship. Unlike the United States and Western Europe, where a robust legal system ensures the relative integrity of business transactions, the legal infrastructure within emerging markets is usually unstable and unpredictable. In India and China, for example, contracts are often written with clever phrases, small print, and all manner of trickery. Such contractual aggression is made possible by poorly developed legal and regulatory regimes and court proceedings that require a great deal of time and money. Control or governance of foreign distributors is most effective when it is the result of relational norms developed and implemented by the manufacturer.

US manufacturers tend to complain that distributors do not know how to grow the market, are interested in only what is accessible, and underinvest

in the relationship. Distributors, in other words, are often viewed as lacking ambition and as not caring about the relationship. Conversely, US companies tend to view international distributors as only a temporary expediency that can be jettisoned after adequate market traction positions them to open up their own subsidiaries. However, owning subsidiaries is an expensive and time-intensive venture. Rather than viewing distributors as merely a quick way to enter a market, manufacturers should work carefully with their distributors to help them develop the business for the long term. David Arnold, who studied the relationships of 250 manufacturers and distributors, characterized success as follows:

> They acted as if they were business partners with the multinationals. They shared market information with the corporations; they initiated projects with distributors in neighboring countries; and they suggested initiatives in their own or nearby markets. These managers risked investing in areas such as training, information systems, and advertising and promotion in order to grow the multinationals' business.[7]

Constantly Scrutinize the Relationship

A number of standards exist that manufacturers can use to scrutinize the performance of a distributor. These standards include sales performance, inventory management, selling capabilities, attitudes, competition facing distributors, and general growth potential.

Again, it may seem foreign to a US company, but it is quite possible to have control over the sales and distribution of products in an emerging market. This is accomplished by exercising due diligence and staying on top of their distributor's performance in a timely fashion.

Manage Communication

Part of the due diligence of US firms must also include a communication plan that ensures the quality and quantity of interaction between parties. A successful communication strategy is twofold. The first part of the strategy should deal with operational components such as purchase orders, delivery, inventory, payments, and pricing. The second part should influence the distributor's behavior. Personal selling, advertising, sales promotions, and so on, are used to instill the corporate vision of the innovator into the distributor.

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[7]Ibid., p. 132.

Challenges should be expected between partners when it comes to effective communication. Physical separation, differences in size, organizational type, operating procedures, and native languages will enter in at one time or another. These challenges are further compounded because emerging market distributors forge their business relationships on a foundation of inherent distrust of even their closest associates.

Another issue that is often overlooked is confidentiality in communications. Stories abound of executives traveling overseas who have been offered the opportunity to purchase faxes or e-mails from or to their competitors by enterprising hotel clerks. In many markets, it is not uncommon for meeting rooms, mobile phones, cars, and hotel suites to be bugged by local distributors.

Incentivize the Relationship

In addition to monitoring, exporters can influence the behavior of distributors by offering appropriate incentives. Rather than providing standard operating procedures to control the behavior of the distributor, a laissez-faire approach focuses on outcomes by offering incentives and imposing penalties. The firm is compensated when and if sales occur, and it is penalized if sales do not occur.

PC Globe, a Tempe, Arizona-based software company, initially offered distributors exclusivity without establishing any standards of performance. Not surprisingly, its overseas sales were disappointing. Eventually, the firm changed its approach. In exchange for exclusivity, distributors must now order and prepay 20 percent of what they think they can sell in their first year. The exclusivity is guaranteed as long as they continue to order the same amount each quarter. According to company executives, these distributors "don't get exclusivity as much as the opportunity for exclusivity."[8]

You Get Only One Chance in a Market

Although its critical importance cannot be overstated, distribution is generally the most globally differentiated and least understood of all marketing mix components. It is also the component most likely to hinder success in foreign markets, especially for small- and mid-size companies. Proper distribution planning can ensure that the best available channels and distribution methods are in place to efficiently and economically move products and services to customers.

[8] Inc.com, "Exclusivity vs. Temporary Monopoly," http://pf.inc.com/articles/1995/01/11160.html, accessed March 10, 2015.

The process for establishing successful sales and distribution strategies in high-growth emerging markets is formidable. We recommend that managers analyze the situation from the perspective of the distributor, set clear criteria for distributor selection, search out and work with firms marketing complementary products, make sure that expectations are explicit and clear, build a long-term relationship with the distributor, monitor the relationship and, provide appropriate incentives to keep the relationship on track. Through the application of these strategies, manufacturers will be better able to maximize opportunities found in global markets.

In the case of the motorcycle manufacturer who was badly burned in Costa Rica, the lessons from that experience slowly found their way into the corporate culture of the organization. Although many mistakes persisted in recruiting and selecting foreign distributors, the American firm slowly began to realize the critical importance of breaking out of the dysfunctional domestic distribution model and establishing something new and much more dynamic.

Immediately after the Costa Rica debacle, mental checklists and queries among the staff preceded most discussions about new business. As the organization began to adjust its culture to the realities of global distribution, processes for distribution selection were formalized. Ultimately, minimally acceptable criteria were established. Three years later, the achieved distributor retention rate was well over 80 percent, and not surprisingly, sales and revenues were up more than 60 percent. The result was a series of mutually beneficial relationships in which the manufacturer was firmly in control of the sales and distribution of its products.

Globalization affords many opportunities and benefits to companies that get the sales and distribution of their products and services right. Not performing these critical business functions properly is a recipe for failure.

CHAPTER

10

Staying Local and Independent

Think outside the big box.

—Independent We Stand

Following the 10 Percent Rule and staying out of the Customer Trap requires a high level of discipline and awareness. It is even harder to stand one's ground when the conventional wisdom seems to be moving inexorably toward scale and efficiency when it comes to dealing with customers. Everyone who grew up in the 1970s—or before—can remember conversations in which people bragged about how much they paid for something. To have paid more for a product indicated that a higher-quality item had been purchased. It was a symbol of status that people would brag about. Not anymore. For many years, bragging rights have gone to the person who got a good price, a fabulous discount, a great deal.

This cultural shift is driven in part by the rise of cost-squeezing Mega-Customers. Clearly, the temptation to search out the Mega-Customer is almost irresistible. After all, Megas exist in every sector of the economy. And they offer the hope of big volume to the companies whose products and services they buy.

Many floral shops across the United States have gone through a maelstrom in recent years. The advent of e-commerce distributors including FTD, 1-800-Flowers.com, and Teleflora has reshaped the industry. Increasingly, these services have become Mega-Customers to a growing number of local florists. The owners of floral shops initially viewed these new sales channels as opportunities to find customers who otherwise wouldn't know about them.

It seemed a great way to add instant volume to the bottom line. Of course, as we've seen, everything comes with a cost.

Florists pay around 25 percent of every order in commission and marketing fees to one of the online Megas, plus another $200 or so in monthly membership charges. Shop owners can reject orders or ask for higher prices. However, rejecting orders carries another hidden cost, often $10–$100.

David Rohr, a florist in Cathedral City, California, knew right off the bat the costs of dealing with a Mega were too high. He quit Teleflora after Valentine's Day in 2002, when he lost more than $2,000 that day as business costs and network fees overtook his revenue from delivery orders.

"I was able to get new customers. But you can't make any money. They [the Megas] make all the money," Rohr said.[1]

Even worse, according to Betsy Hall, a florist just outside Atlanta, is what happens to folks who use the Megas to order flowers. Hall said photographs on major e-commerce websites are misleading and noted that bouquets looked fuller than they are in reality. She also said customers who use e-commerce sites pay more and receive less than if they would simply contact the local florist in the city where they want the flowers delivered.[2]

The Battle Is Joined

In the face of the onslaught by the Megas across every industry, one of the great business stories of the past decade has emerged: the rising pushback to the consolidation that has fueled the rise of The Customer Trap. "Buy local" and other independent movements have gained strength and momentum—providing innovators with viable and profitable channels through which to control the sales and distribution of their products.

One of the oldest American organizations promoting the principle that local is the way forward is the Institute for Local Self-Reliance (ILSR). ILSR contends that there is nothing inherently progressive or inevitable about globalization and that localism and regionalism, in the form of humanly scaled institutions, fosters community and a higher quality of life.

ILSR argues against the common view that "bigger is better, that separating the producer from the consumer, the banker from the depositor and lender,

[1]Jose Pagliery, "Florists Now Dread Valentine's Day," http://money.cnn.com/2013/02/14/smallbusiness/order-flowers/, February 14, 2013.
[2]Betsy Hall, "Because True Love Can't Be Googled," www.independentwestand.org/guest-blog-post-halls-flower-shop-because-true-love-cant-be-googled/, accessed February 3, 2015.

the worker from the owner is an inevitable outcome of modern economic development."[3] Surprisingly, little evidence supports this conventional wisdom. Rather, local economies have the potential to be efficient and dynamic.

In 1997 David Bolduc and Jeff Milchen decided to challenge the common view that the Megas—and their accompanying dysfunctionality—were inevitable fixtures of modern life. In cooperation with other business owners and concerned citizens, they created a strategy to help communities preserve local businesses and foster entrepreneurship. Today the American Independent Business Alliance (AMIBA) helps communities organize pro-local business activities, such as "buy independent, buy local" campaigns, pro-local public policy initiatives and other work to assist local businesses.[4]

Independent We Stand (IWS) is another organization that strengthens local businesses. Recognizing that many people prefer to buy locally produced products, IWS helps connect consumers with local sources of goods and services. In doing so, IWS fosters local economic development and keeps company profits working in the towns and cities where revenues are generated in the first place.[5] These organizations—and many others—are on the front lines of challenging the status quo. They are also demonstrating with clear, definitive insight that the current American business model is not only dysfunctional, but also unsustainable.

A Dying Idea

Despite the seemingly unstoppable rise of Megas in the current system, the cracks are starting to show. Consider the fact that costs are rising in low-wage locations as citizens begin to demand better living conditions.

China is no longer the manufacturing panacea that many thought it once was. Despite the slowdown in China's economy, labor costs have nearly doubled since 2005. Further, the ongoing deterioration of the environment is obvious to anyone who visits the country. The air in most cities is too dangerous to breathe, and the water deadly to drink in many places.

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[3]Institute for Local Self-Reliance at http://ilsr.org/, accessed March 10, 2015.
[4]You can learn more about the American Independent Business Alliance at www.amiba.net accessed February 2, 2015.
[5]http://www.independentwestand.org/ accessed March 10, 2015.

Churning out 6 percent of global supply, the Faun Textile mill in southern China is the largest producer of knit cotton in the world. Located on a 230-acre campus, it has spent the last 25 years producing the material that goes into inexpensive jeans, sneakers, and T-shirts for dozens of American retailers, including Walmart, Target, Eddie Bauer, Nike, and Lands' End. Fountain Set Holdings, a Hong Kong–based firm that places most of its effort into manufacturing the soft stretch cotton that goes into T-shirts and sweatshirts, owns the factory. The Megas typically work with Fountain Set to determine colors and seasonal fabric styles, though they usually buy the company's products through a third party that takes the material and turns it into clothing.

In the summer of 2006, people in Dongguan, the city where the Faun Textile mill is located, noticed that the Mao Zhou River running through their city had turned blood red. An investigation by local officials revealed that a pipe buried beneath the factory floor was dumping about 22,000 tons of contaminated water into the river each day. While this was noteworthy in Dongguan, it was of little interest downriver, where runoff from hundreds of manufacturing plants had created a river of thick, oily sludge, covered with plastic bags, electrical wires, shoes and other items. Said Li Changlin, a small businessman who works downstream from the Faun Textile mill, "We used to eat fish and crayfish out of this river . . . we swam in it. There were green plants on the banks, and the water was clear. After 1989, the factories came and the water turned black."[6] Unfortunately, the Faun Textile mill incident and the polluted Mao Zhou River are not isolated instances in China. Rather, the largest country in the world is also one of the most polluted.

For years, China's citizens demonstrated against the destruction of their environment. And just recently, the Communist Party started listening. In 2013, China's Ministry of Environmental Protection launched a nationwide cleanup campaign to tackle the nation's terrible air quality. By 2015, air quality had slightly improved, with only 8 out of 74 big cities managing to meet national standards on a series of pollution criteria, including sulfur dioxide levels.[7] Still, despite the slow progress, it is hard to imagine China falling back into the wanton devastation driven by unrestrained industrial expansion.

As the economics of offshoring become less advantageous, manufacturing will inevitably return to the U.S. And it must return. A former Nucor CEO states in his book, *American Made: Why Making Things Will Return Us to Greatness*, that

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[6]Jane Spencer, "Ravaged Rivers: China Pays Steep Price as Textile Exports Boom; Suppliers to US Stores Accused of Dumping Dyes to Slash their Costs," *The Wall Street Journal*, August 22, 2007, p. A1.

[7]Li Jeng, "Beijing's Neighbours Still Have Worst Smog in China, Despite Efforts to Tackle Air Pollution," www.scmp.com/news/china/article/1699403/beijing-region-still-has-worst-smog-china-despite-campaign-tackle-air, February 2, 2015.

we will need to create 30 million jobs by 2025 to turn around current unemployment. He says that this will not happen if "millions of college graduates are slinging hash or selling Chinese-made tennis shoes" or contributing to Wall Street's "malicious trading-room capitalism."[8]

Back to History

The rise of Megas across industry sectors does not align with most of American business history. The U.S. has always been a bastion of small business owners. And even with the temporary predominance of Megas today, the statistics bear this out:

- From 1997–2014, small businesses accounted for 65 percent of all net new jobs in the economy.
- Today, small businesses employ nearly 80 million Americans—more than one-quarter of the country's entire population!
- Residential neighborhoods served by a successful independent business district gain, on average, 50 percent more in home values than markets where Megas dominate.
- Independent retailers return more than three times as much money per dollar of sales than chain competitors.
- Independent restaurants return more than twice as much revenue per dollar of sales to the local economy than national restaurant chains do.
- For every square foot a local firm occupies, the local economy gains $179 vs. $105 for a chain store.[9]

People like Mike Massey, a third-generation retailer in the New Orleans area who owns a chain of specialty outdoor stores, are part of a growing wave of small business owners who are fighting back. Disillusioned with the predatory nature of the Megas, and their famous ability to squeeze the life out of suppliers, Massey and some friends decided to create another way for manufacturers to access their end users. It is called `Locally.com`.

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[8]Dan DiMicco, "We Built That," The Wall Street Journal, (March 4, 2015), A11.

[9]Sources: Small Business Administration; Intuit Small Business Innovation Study; American Express OPEN Independent Retail Index; Civic Economics/American Booksellers Assoc., US Dept. of Labor.

Massey says they realized, "there was a gap for shops who didn't have an online presence. There was also a gap for shoppers who couldn't explore their local shops using their Internet-connected devices. And there was a gap for manufacturers that wanted their range of products serviced by professionals."[10]

Locally.com doesn't sell products. It facilitates relationships between manufacturers, buyers, and local stores, charging a small monthly fee to the retailer and supplier. Using patent-pending technology, the platform aggregates product catalogs directly from the best brands and stock information from local merchants. It merges powerful web tools with local expertise and infrastructure to give shoppers access to every possible buying choice, online and off.

Locally.com automatically locates each shopper geographically upon entering the site. With that information, the site assembles a marketplace consisting of both local, nearby products and additional products that can be bought from their online partners. Their mantra is, "We don't sell products; we facilitate discovery." The idea seems to be gaining traction as more and more retailers and vendors come on board each month, seeking to stay both focused on their best customers and in control of their businesses.

Smaller Is Better

A significant portion of the rush into the Customer Trap lies in the misapplied approach to efficiency. The mistaken belief is that economies of scale will ultimately make up for any deficiencies or lapses when it comes to customers: size does matter—and bigger is better. As we've seen, this is simply not the case.

In 2008, shortly after graduating from college, Josh Neblett launched the online retail outlet GreenCupboards (now called etailz).[11] The business was the result of a business plan that he developed in a college course, under the tutelage of the instructor, serial entrepreneur Tom Simpson. During its first six months, the small startup had sales of $5,000; its top seller was a toilet bowl cleaner. By 2013 etailz had $24 million in sales and was one of the fastest-growing private companies in the country.

[10]Interview with authors, October 25, 2014.

[11]The material about etailz is based on an interview of Josh Neblett that took place on November 21, 2014, and an interview with Tom Simpson that took place on January 6, 2015.

This Spokane-based startup has been able to successfully partner with Amazon.com by using the Mega's marketing and logistical reach to extend its brand. It is a strategy that we believe Josh (he is known by all as Josh) has mastered, yet one that, he would be the first to tell you, constantly evolves. Initially, etailz operated a warehouse and was doing its own order fulfillment. However, Josh quickly realized that he was not interested in storing, packaging, and shipping inventory. This, plus his belief that Amazon is the best logistics and fulfillment operation in the world, made the decision to outsource to the company easy.

"The one thing that separates Amazon from all the other e-commerce companies that have been out there," he states, "is their two-day free shipping with laser-point accuracy." He points out that Amazon rarely makes errors of the "this didn't show up" variety, which truly sets it apart.

When asked how etailz interfaces with the Amazon website, Josh states that people will often make a purchase from Amazon without realizing who they are really buying from. Customers see the little add-to-cart button—the "buy box"—and think that the product is from Amazon. Josh explains:

> Many times you might have up to 100 people selling the exact product in the same listing. A lot of times you are buying from different merchants. We have positioned ourselves to find and locate these interesting, cool, unique products that are out there and tap into them. We aren't really interested in what we call the race to zero. That's when you have 100 companies selling the same product; you are going to get that race to zero. Whoever wants to make the least, wins. That's not a game we are really interested in playing. Instead, we rely on our efficiency. Our ability to grow has been technology driven; we really obsess about developing proprietary software and we obsess over how to do things better, faster, and more efficiently. Our process in identifying opportunities, setting up relationships, ordering the product, reordering the product, all of that stuff, as one, whole, streamlined flow is one of the things that helps separate us. We are really efficient.

Josh points out that there are rumors that at some point the merchants who sell through Amazon will be so effective that the online Mega will move out of the direct retail business altogether. He states, "I am a believer that it could head in that direction because every time we sell something, how much work does Amazon have to do? Essentially nothing." etailz takes advantage of the critical mass engendered by Amazon's huge base of customers. The Mega incurs only an extremely limited incremental cost each time it facilitates an etailz transaction. For example, assuming that Amazon charges a 10 percent commission, it has to do very little to make $10 on a $100 sale by etailz. Josh states, "We could argue that that model is more profitable than their Amazon

retail side of the model. I think they are evaluating which business model makes more sense for them."

Josh Neblett is not worried about the Customer Trap. When asked if Amazon can put the squeeze on etailz, he answers unhesitatingly, "Of course they can!" and then explains:

> They have flexibility but they would lose a lot of trust. If you look at businesses historically, like IBM, Microsoft, etc., they go through stages where they are king of the world, untouchable, and no one can do any wrong, but then someone comes in and takes over their market share. I don't think anyone right now is close to Amazon, but at some point there will be someone, whether it is eBay or Alibaba that emerges or someone else. Regardless of who it may be, we are positioned nicely to constantly pivot and evaluate all of the opportunities that are out there. My point is that if Amazon does do those kinds of things, we will look elsewhere. And we are getting to the point where we are big enough to have flexibility and leverage, whereas early on we didn't have that leverage.

The etailz strategy is focused on its suppliers. The company is constantly searching for great products with market potential. Tom Simpson explains, "One of the things we are very good at is our first-to-market initiative. We look for products that maybe have a write-up in *USA Today* or were on *Shark Tank*. We are looking for a new idea or product that people are applauding. There are products out there that people think sound cool but don't have any real distribution set up. We call up those companies and we tell them how we can optimize their sales on the Internet.

After recruiting suppliers with unique and interesting products, etailz focuses on doing well by them. Josh states, "The way we look at it is our obsession about the customer in the standard retail sense would apply to the supplier." He points out that business such as Amazon, Zappos, and eBay always talk about their obsession with the customer. etailz also obsesses over the consumer, but it is also obsessed with suppliers and how it can add value to them. He asks, "What can you do to help expand that supplier's pie?" and then answers rhetorically, "it is not always about selling more product." Tom adds, we can optimize their sales when they work solely with us online. If you have a unique product and you are just working with us, your product is being displayed with a single voice. No inconsistency, changes in pricing, or differences in service. The point is that we will make sure that your brand is enhanced by going through us rather than 15, 20, or 100 other people like us."

Such an arrangement, which requires a great deal of trust on the part of vendors, is built when etailz works with them to optimize product placement on Amazon with pictures, descriptions, key words, videos, and other marketing

efforts that help the supplier sell the product online. "It is one of the value-added benefits that we offer to them," Simpson says. In addition, etailz honors the pricing of its suppliers. He adds, "If they say not to sell it under $14.99, we won't sell if for less. A lot of other companies may not honor a supplier's price, but we do. Also, if you have a question, issue, or problem, you can call us and you get a person; you don't get an e-mail."

Josh points out that the online Megas obsess about the customer and the importance of the customer, while etailz has this very efficient fulfillment solution between the Mega and the customer. The result is that everyone is helping everyone else to achieve the end goal. He sees the entire process as a cooperative enterprise. For etailz, treating suppliers as if they were customers was a natural evolution. After hearing suppliers complain about their dealings with distributors—like not getting paid on time and experiencing poor customer service—the company began to address what they call "pain points" by treating their vendors as customers. Josh states, "I don't know when we had the ah-ha moment. I would say that realization and that emphasis is less than two years old. Since we did that, it has helped us exponentially grow." etailz lives out this supplier-as-customer strategy in ways that are both large and small. For example, when company representatives go to dinner with suppliers, they pick up the bill as if those suppliers were customers. Josh says that it is a small gesture, but that it communicates his company's magnanimity toward suppliers. The result is better performance:

> We get improved relationships; we get better support from their team. There's better collaboration on how we can help their brand grow. And if there's good collaboration between the manufacturer and the retailer, you can build something special. I think that has been the biggest emphasis, that it has been more open and transparent communication. Overall it creates more of a win-win dynamic that historically doesn't exist in the retail manufacturer relationship.

The Future Is Brighter Than Ever Before

In writing this book, we spent a lot of time with people like Josh Neblett and his partner, Tom Simpson. Their enthusiasm about the future is contagious. They see the world as full of opportunities, driven by radical technological change. The old rules don't apply to them. Yet, they are rational optimists. Access to data is empowering entrepreneurs and innovators in ways we couldn't have imagined even 10 years ago.

Chandran Sankaran of Zyme Solutions talks often about the "democratization" of business, where information transparency wins out, and the ability to turn an idea into a viable business is easier than ever before. The path to market for products and services is more open and visible than any time

we've ever seen. Entrepreneurship is now widely viewed as a smart life choice, rather than merely a hobby. Much of what is required to succeed in this new world is an alteration in how we approach the relationships with our best customers and suppliers. The days of big, arrogant Mega-Customers dominating the innovations of smaller risk takers are coming to an end.

Our Last Thought

In 2008, Jack Weil—the "Patriarch of Western clothing"—died. Mr. Weil was the inventor of the cowboy shirt. He was the one who put those snap-fasteners on western wear, ensuring that cattlemen wouldn't get snagged by cactus, sagebrush, or the horns of steers. Other adornments were added, including sawtooth flaps for pockets, a narrow fit to emphasize broad shoulders, and tight seams to show off the muscularity of the cowboy.

Mr. Weil manufactured and sold his shirts through his Denver-based Rockmount Ranch Wear. The shirts were manufactured in the United States. The idea of outsourcing to China or some other low-cost market was inconceivable to him. His obituary in *The Economist* stated:

> In his long, long life, Mr. Weil accumulated plenty of simple business sense. He knew J.C. Penney, and thought him smart. Levi Strauss was a nice fellow, but got too big for his britches; Sam Walton, founder of Walmart, was a "hillbilly son of a bitch . . ."

Walton constantly badgered him to supply Walmart with shirts, but Mr. Weil never wanted any customer to take more than 5 percent of his business. He felt he would lose control that way, and he considered discounters low-life in general. What mattered were two things: quality and knowing the customer.[12]

It seems that Mr. Weil intuitively understood the dangers of the Customer Trap. We can only hope that other innovators and entrepreneurs will similarly share his insight and recognize that controlling sales and distribution is fundamental to long-term profitability and success.

[12]"Jack Weil" obituary, *The Economist*, August 30, 2008. http://www.economist.com/node/12000749

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THE CUSTOMER TRAP

HOW TO AVOID THE BIGGEST MISTAKE IN BUSINESS

FIRST EDITION

BASED ON THE DISTRIBUTION TRAP,
WINNER OF THE BERRY-AMA BOOK PRIZE FOR
THE BEST MARKETING BOOK OF 2010

Andrew R. Thomas
Timothy J. Wilkinson

Apress®

The Customer Trap: How to Avoid the Biggest Mistake in Business

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The Apress Business Team

To Jackie, Paul Bryan, and Alana,
who make it all worthwhile

—Andrew R. Thomas

To N.P. "Van" Van Maren, banker emeritus of Wyoming, father-in-law, friend, and in memory of my father, Vernon Virgil Wilkinson

—Timothy J. Wilkinson

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—Timothy J. Wilkinson

Preface

American business is dysfunctional. Small and medium-sized companies, the backbone of capitalism, have been lured into a misconceived and dangerous operational model. It works like this:

> Step 1: Invest blood, sweat, tears, and money to start a new business or to innovate a new product or service.
>
> Step 2: Sell to the biggest customer possible.
>
> Step 3: Maximize the volume of sales to that big customer.
>
> Step 4: Deal with the inevitable customer demands that are sure to follow.
>
> Step 5: Try to keep quality and service at a high level while earning less and less.
>
> Step 6: Lose money.
>
> Step 7: Wonder what went wrong while trying to keep your head above water.

Much of what drives the high failure rates of businesses, along with the lack of success of so many new products and services, is rooted in this model. Business owners and managers are lured into selling most of their output to what we call "Mega-Customers" in the vain hope that somehow, someway, the added volume will translate into real profits.

Companies falsely believe that the efficiency gained by having one, or a few, big customers—rather than dozens, hundreds, or even thousands of small ones—will guarantee a positive bottom line. These companies also believe that this combination of higher volume and greater efficiency is the formula for their future success.

Let's lay it out right here: They couldn't be more wrong.

The Customer Trap becomes a reality when a company fails to follow "The 10 Percent Rule" by allowing a single customer to become more than 10 percent of its total revenue. While managing a large customer appears to have many positive benefits, the downside risks ultimately far outweigh any positives.

Simply by their size, Mega-Customers (those that represent more than 10 percent of total revenue) are able to possess an inordinate amount of control over their supplier's business. And while things may go well for a while, the distorted relationship between a company and a Mega-Customer will inexorably tilt in favor of the Mega.

There was a time, not that long ago, when companies controlled their products and services in a way that made sense for *them*. After all, the products and services were *theirs*. They had created them; done the testing; worked with and gotten approval from the myriad of lawyers, risk managers, insurance companies, and government regulators needed to bring them to market; and then developed the capacities to produce, promote, distribute, sell, and service. It was their skin in the game. It was *their* reputation; it was *their* future.

Customers were viewed then, as they are today, as vital to the success of the company. However—and this is important—customers were not supposed to become so big that they could take over the business of the supplier. Instead, customers were to be managed (remember the term "customer relationship management"?). The result would be that the value of the products and services could be shared. Not equally, mind you, but with the majority of the value returning to the company that originated the product or service. If you think about it, this makes complete sense. In the risk-and-reward environment that is capitalism, those who risk more should logically be rewarded more.

Yet, as we talk to business leaders around the world, it is clear that many of them realize that a fundamental shift has occurred. Power continues to transfer from those who create the products and services that fuel the economy to Mega-Customers who are controlling more and more of each sector of the global marketplace. Far too many companies mistakenly see deals with Mega-Customers as the way to boost their sales, market share, and profits.

In reality, a Mega-Customer, simply because of its size relative to the supplier, will logically use its leverage to demand price cuts and other concessions. Companies end up with thin or nonexistent profit margins, and their innovative products and services are often treated as little more than commodities. They may be "doing a lot of business," but real, tangible earnings are increasingly hard to come by. The outcome is profitless prosperity: a lot of business activity, with little or nothing to show for it.

Surprisingly, this tectonic transformation of the business landscape has occurred with little fanfare or real analysis. Under the banners of "scale," "leanness," "efficiency," and "core competencies" (whereby companies focus on the few things they are really good at and outsource the rest), the critical functions of sales and distribution have been largely abandoned to others. Hardly anyone has noticed what is happening. For many companies, it is too late.

What This Book Is About

The subtitle of this book, "How to Avoid the Biggest Mistake in Business," captures our intent to help you avoid falling into the Customer Trap. It is broken into two distinct parts.

Part I lays out the 10 Percent Rule and what constitutes the Customer Trap. It provides evidence as to why falling into the trap is the biggest blunder you can make in business. First, as you'll see, the scope and magnitude of a Mega-Customer can quickly consume the brand equity of individual products and services. Private labels, discounting, lack of service, and mass-market presentation have diluted the value of countless brands.

Second, selling through a Mega-Customer moves a company, especially an innovative company, further away from those who use their products. The ability to service and respond to the needs of consumers and endusers disappears when a Mega-Customer enters the mix and gains control over the bulk of the sales and distribution process. Even worse, the Megas create an environment in which innovations are commoditized too rapidly. In the natural course of events, today's innovations may very well become commodities in the next few years. Nevertheless, the product life cycle, while guaranteeing a downward trajectory of innovative value, does not assign a timetable to the decline of innovations. Deals with Mega-Customers compress the product life cycle and accelerate the commoditization process.

Next, we take a look at another rarely discussed, yet substantial problem that is rooted in the Customer Trap: the lack of information transparency. As power is increasingly gained and held by Mega-Customers, information about the route to the consumer and enduser is kept away from the innovative company. Critical sales and distribution data are held hostage, forcing the innovator to manage and make decisions "in the dark."

We finish Part I by exploring the outsourcing compulsion. The conventional wisdom in government, academia, and much of industry is that companies choose to close their costly domestic operations in favor of better prospects and profits in other countries. While it is certainly true that US companies have been pulled overseas by the allure of potential profits and cheap labor, the vast majority were pushed overseas by something that is much more proximate to the US domestic industrial structure than the desire for new markets, lower labor costs, or greater efficiencies in sourcing: the United States' dysfunctional sales and distribution system.

Fortunately, it is possible for a startup, a medium-sized firm, or even a large company to stay out of the vice of the Customer Trap. Part 2 looks at how to do just that. It is rationally optimistic. For companies that are not yet in the Trap and for those that have fallen into it, there are simple, yet powerful ways to build a long-term sustainable business with the right approach to selling products and services. We detail the following:

- How to control sales and distribution channels from the very beginning; from the origins of the product or service until purchased by the enduser
- How, through the acquisition and implementation of channel data, direct marketing can offer a low-cost and high-reward solution for companies that choose not to be tempted by Mega-Customers
- How, in an increasingly globalized business environment, it is possible to go global without having to engage Mega-Customers overseas
- How the consolidation of power and control within nearly every industry and business sector into the hands of a few Megas is simply not sustainable in the long run
- And how, around the world, governments, innovators, and customers are realizing that buying local and supporting independent businesses is a far better option

The benefits of the strategies and tactics described in this book can be immense—from the ability to retain operational control over your company, to higher profits and better sales, to keeping jobs in the United States. As you will see, you *can* take charge of your destiny and reap many benefits by staying out of the Customer Trap.

Ultimately, we believe that avoiding the Customer Trap is the best way to build a real, sustainable enterprise. With all the discussions about the decline of American ingenuity, scarcity of resources, global competition, uncertainty about the economic future, and doubts about the role of government, we know that controlling sales and distribution is the cornerstone of business success, as it always has been.

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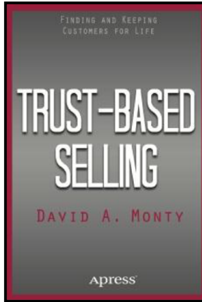

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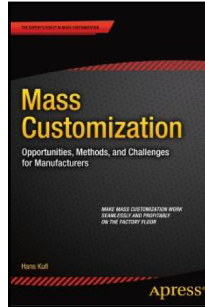

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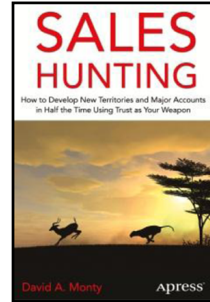

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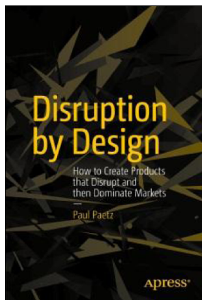

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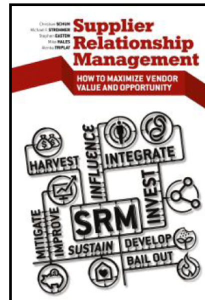

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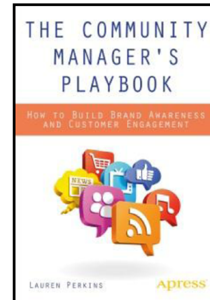

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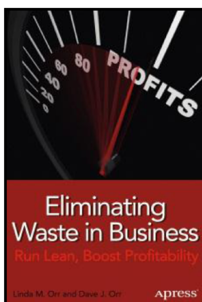

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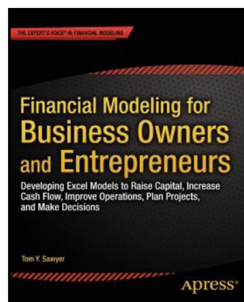

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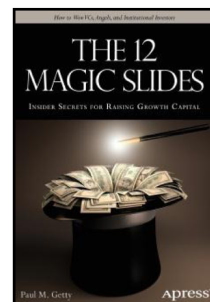

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