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THE MIDDLE MARKET

In Collaboration With

Competing with the Gloves On

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Suppliers that compete with their wholesale customers can't dish it out, but they should take it

E-commerce is transforming the straightforward transactional relationship between wholesalers and retailers into a diplomatic dance. Increasingly, manufacturers compete with their wholesale customers to get everything from ice cream to televisions into the hands of consumers. No longer pure cooperative partners, the parties cannot simply agree on marketing and pricing strategies that maximize sales for both. As boundaries blur between vertical suppliers and horizontal competitors, each must weigh whether to support or attack the other.

Of course, suppliers have competed with their wholesale customers for as long as there have been catalogs. Factory outlet stores—originally intended to unload excess or damaged inventory—began dotting the landscape around the 1930s. Company-owned franchises compete with independent franchises, although franchisors may grant exclusive territories to protect the independents' sales. But it was the Internet with its who-needs-middlemen ethos that over the last 15 years has dramatically ratcheted up the threat to traditional retailers. If you can make it then you can sell it to anyone, anywhere.

The dual-distribution model—whereby suppliers sell both direct and through retailers—is a logical one for middle-market companies. Small businesses may rely almost entirely on independent distribution because they lack the means to reach many customers on their own. Large corporations are more likely to be wholly vertically integrated and to control an entire channel. Middle-market companies leverage hybrid distribution models as they transition from the small business to the large-corporate state. Using the Web, they can reach new customers in an environment free of rival brands that jostle for consumers' attention on retailers' shelves.

As they launch these new channels, suppliers exhibit a variety of attitudes ranging from arrogance to accommodation. When FedEx acquired Kinko's and created FedExKinkos.com to sell ballpoints, printer paper and desk chairs online, it wasn't notably solicitous of the feelings of office-supply retailers that used its services, according to a report in the New York Times. By contrast, Mattel anticipated toy merchants' distress over its online Barbie and Fisher-Price stores. It promised such efforts would account for less than 1% of those brands' sales and accommodated retailers by setting online prices higher and keeping some popular items off the Web site altogether, the Wall Street Journal wrote at the time.

Retailers, in general, are less divided. Their understandable hostility toward suppliers invading their space is captured by a commonly used term: “encroachment.”

Critical language aside, our research demonstrates dual-distribution relationships can be at once adversarial and advantageous. Suppliers and retailers both win when suppliers reduce wholesale prices to increase retailers' purchase of their products. They also win when both invest in positive brand marketing. However negative marketing about specific channels is a more complicated proposition. Obviously, suppliers would never denigrate their retailers: they want consumers in those stores. But how should suppliers respond when retailers assail the poor shopping experience of the direct channel? The surprising answer: they should sit back and take it.

IF YOU CAN'T SAY SOMETHING NICE

Companies invest in advertising to expand demand for their products. About two-thirds of advertising is positive: companies promoting themselves, their offerings, and sometimes the retailers that sell their offerings. Companies may also promote entire categories—particularly when those categories are new and unfamiliar to consumers. Sharp, for example, aggressively marketed LCD technology for flat-panel TVs, a campaign that also benefited its rivals Sony and Samsung.

Approximately one-third of advertising is negative: designed to put down the other guy. Tylenol's ads alerted consumers that ibuprofen can cause stomach problems. Apple embodied the PC as a be-suited and bespectacled John Hodgman, consigning it to the dustbin of uncool.

From Macy's and Gimble's to Microsoft and Google, when pure rivals advertise it's every business for itself. When wholesalers and retailers both collaborate and compete, however, their marketing stances are complicated.

The supplier uses its pricing power to charge more than cost to its retail rival in wholesale trade. So every unit that retailer sells translates into a wholesale markup for the supplier. Does the supplier want the retailer to order more units and do what it takes to sell them through to consumers? Absolutely. Does the supplier want to sell to consumers through its own Web site or catalog or company stores, a process that can't help but undercut its retail customer? Absolutely. But the supplier's incentive to boost retailers' demand means it should invest in the kinds of positive, cross-promotional efforts that send customers into the other guy's stores.

The retailer, for its part, will cheerfully stand beneath the supplier's promotional umbrella. Even if it resents the new competition, denigrating the brand would be a self-destructive act. But if retailers won't take on the brand, often they will take on the channel. Their message: Buy that TV from us and you can take it home today. We'll come hook it up and walk you through the features. We'll help if you run into problems. Our return process is a snap. Try getting that kind of service from the manufacturer. To them you're nothing more than a shopping basket. Log onto their site and let the aggravation begin.

Were the supplier and the retailer pure competitors, the supplier might be wise to strike back. But understanding the cost of its encroachment into the retailer's market, the supplier should instead take a more cooperative approach. The hit to the supplier's direct-sales profits caused by the retailer's negative advertising is balanced by the wholesale profits gained by the retailer's increased demand. By focusing on promoting the brand while the retailer promotes its own channel, the supplier makes a concession that encourages the retailer to stock its brand in the first place.

Retail customers can demonize the supplier's online sales channel all they want. So long as they say nothing bad about the brand—and invest in promoting their own channel as a place to buy the brand—everybody wins. The supplier should continue to promote its own channel and otherwise remain mute.

SOFTENING THE BLOW

Letting retailers' fighting words go unanswered is just one way that suppliers demonstrate a more collaborative approach. Pure competitors delight in driving up one another's operating costs. Supplier-competitors are in a perfect position to do so by raising wholesale prices. But eager to increase retailers' demand for their goods, and aware that those retailers may be more sensitive to wholesale prices increases (after all, they're battling a powerful new competitor), suppliers may choose to lower wholesale prices instead.

Suppliers can also accommodate retailers by creating different products for the direct sales channel, setting higher prices on some products sold online, and keeping some products off the Web site altogether. Another tactic, whose effect we are currently studying, inverts the traditional notion of a first-to-market advantage. Movie studios juggle the interests of multiple channels through tiered releases for theater, pay-per-view, premium-cable and so on down the distribution totem pole. Similarly, giving retail partners a window for exclusive distribution of a potentially hot new product can make them more comfortable with the supplier's competitive posture.

Retailers also benefit because suppliers with their own distribution channels tend to invest more in positive marketing overall. Provided enough customers prefer a traditional shopping experience, both parties can increase sales thanks to the supplier's expanded reach.

When suppliers encroach on retail markets, retailers can be expected to react defensively, as they would to any new competition. So suppliers would be wise to combine their new ventures with increased investment in marketing, changes in pricing, and other measures meant to cushion the blow. Even then, retailers may sling barbed words at the new channel. In that case, suppliers should turn a deaf ear and talk even louder about the brand.