

Channel It

Channels of Distribution

A

So What

It's your grandparents' anniversary, and you've decided to make them a special dinner including some of their favorite foods. You'll be serving lobster and garlic mashed potatoes with a fresh fruit salad for dessert. The day of the dinner, you make a trip to the local grocery store to pick up all the ingredients you'll need. You might not realize it, but you've just greatly benefited from several channels of distribution. What if you'd needed to purchase each item directly from its producer? You might have had to travel to Maine to pick up the lobster, to Idaho for the potatoes, and to Florida or California for the fruit!

Channels of distribution make life easier for consumers and businesses every day. They save time and money, and they allow us to enjoy a variety of products from around the world. Find out more about channels of distribution—who participates in them, how they work, and the benefits they provide.

Channel Basics

Have you ever had to travel a considerable distance to purchase a product you wanted? Perhaps you found the perfect used car—it was the make and model you wanted, had low mileage, and was listed at an affordable price. The only trouble was that you had to drive 200 miles to pick it up. In this case, your time and effort were probably worth it since you only needed to deal with the hassle one time. But, what if this circumstance applied to all your needs? You would soon find that the goods and services you consume would be limited to those produced in your own geographic area. Fortunately, there are channels of distribution. Because of these channels and their participants, products from many different locations are available right where you live.

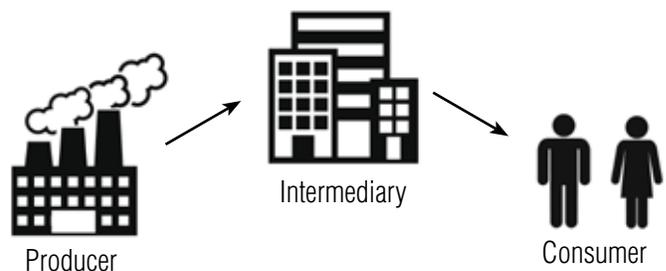
Getting the goods

Channels of distribution are the paths, or routes, that goods and services take from the producer to the ultimate consumer or industrial user. These paths aren't physical, however. Although goods do travel to their destinations along highways and railroads, the term channels of distribution doesn't refer to those types of routes. Instead, it refers to businesses or people who perform a variety of functions to enable products to be in the right places at the right times.

A channel of distribution begins with a producer and ends with an ultimate consumer or industrial user. A **producer** makes or provides goods and services. Examples of producers include Whirlpool, a manufacturer of household appliances, and Pfizer, a company that makes pharmaceuticals. Farmers are producers as well—they grow a variety of crops such as corn, wheat, and rice. Producers of services include actors and entertainers, teachers, and health care professionals. (For a look at some of the top producers in the U.S., see <http://www.industryweek.com/resources/iw50best/2014>.)

Objectives

- A Explain the importance of channels of distribution.
- B Describe types of channels of distribution.



An **ultimate consumer** is anyone who personally uses a good or service to satisfy her/his own needs or wants. We are all ultimate consumers of many different goods and services. If you've used one of its dishwashers, you are one of Whirlpool's ultimate consumers. If you've eaten corn on the cob, you are one of a farmer's ultimate consumers. If you've gotten your teeth cleaned, you are one of a dentist's ultimate consumers. Can you name three goods or services that you've consumed already today?

An **industrial user** is a business that buys materials, services, or goods that will be used to make other goods or used in the operation of the company. A construction company, for instance, must buy lumber, steel, and other materials needed to build homes and offices. An accounting firm will purchase computers, printers, and other office equipment necessary for its employees to perform their jobs.

All good things must come to an end

A channel of distribution ends, then, when the good or service has reached the ultimate consumer or industrial user. A channel also ends when changes are made to the form of the good. For example, the channels of distribution for the milk, flour, eggs, and sugar purchased by a bakery end when the items are combined to make doughnuts. However, a new channel of distribution for the doughnuts begins.

Intermediaries

Many products take paths that include channel members in addition to the producer and the ultimate consumer or industrial user. These channel members are known as **intermediaries** or **middlemen**. They operate between the producer and the consumer or user to help in the movement of goods and services. Let's take a look at the different types of intermediaries:

Retailers. Businesses that buy consumer goods and sell them to ultimate consumers are **retailers**. Retailers perform functions such as buying, selling, promoting, storing, and pricing goods. They may also provide customer services such as credit, installation, and repair. McDonald's, Macy's, and your neighborhood gas station are all examples of retailers. Can you name a few more?

Wholesalers. Businesses that buy goods from producers or agents and sell them to retailers are called **wholesalers**. Wholesalers buy a variety of goods from many producers and sell groups of related products to retailers. For instance, a wholesaler might purchase baseball bats from one producer, mitts from another, and baseballs from still another. A retailer would then be able to purchase all the baseball equipment from one source, rather than having to contact each producer. Important functions of wholesalers include packaging, transporting and storing, extending credit to retailers, and providing promotional and consulting services.

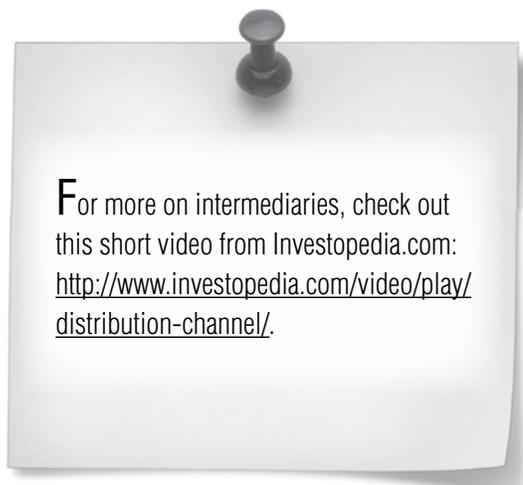
Agents. Businesses or individuals that assist in the sale and/or promotion of goods and services but do not buy them from the producer are known as **agents**. They do not take title to the products; in other words, they never actually own them. Instead, their job is to sell and promote a producer's goods and services. Agents usually handle a limited number of noncompeting products.

Importance of intermediaries

The primary objective of producers in distributing goods and services is to get them to consumers in the most effective and efficient manner possible. To do that, they must have products in the right places, at the right times, and at the least cost. In some cases, the most effective, efficient manner of distribution will be to sell directly to ultimate consumers or industrial users. In other cases, producers will use intermediaries to assist in getting products to consumers. Regardless of the methods used to distribute products, the functions involved will remain the same. These include buying, selling, pricing, financing, etc.



- ▲ Ultimate consumers personally use a good or service to satisfy their own needs or wants. You're one of a dentist's ultimate consumers when you get your teeth cleaned!



For more on intermediaries, check out this short video from Investopedia.com: <http://www.investopedia.com/video/play/distribution-channel/>.

When a producer chooses to sell goods and services directly to consumers, the producer must perform all the necessary functions and will incur all the costs of distribution. At the same time, however, the producer earns any and all income the products bring in. When producers use intermediaries to assist in distributing goods and services, costs can be passed on to other channel members. Producers' profits could decrease since income also has to be shared with intermediaries; however, producers' income might be higher if the intermediaries are able to sell more than the producers can sell on their own.

It is frequently not realistic for producers and consumers or industrial users to deal with each other directly. Likewise, it would not be practical for retailers to deal directly with producers all the time. Through the use of agents and wholesalers, retailers are able to reduce the number of contacts that they must make with producers.

Through the use of intermediaries, producers are able to match their production to the needs and wants of consumers or industrial users. This is possible because intermediaries:

Buy big and sell small. Intermediaries buy large quantities of goods from producers and sell smaller quantities to other intermediaries or consumers. For example, an intermediary might purchase 10,000 two-liter bottles of soda from a producer

and sell 100–200 at a time to a small retailer. By placing large orders with producers, intermediaries are able to reduce their per-unit cost for goods, allowing them to make a profit and/or pass some of the savings along to consumers.



- ▲ Intermediaries collect goods from a variety of producers and divide them into quantities and assortments that consumers will want. How does this apply to a makeup boutique?

Develop an assortment of goods. Since most producers are able to produce more than any consumer will purchase at one time, intermediaries collect goods from a variety of producers and divide them into quantities and assortments that consumers will want. Consumers are then conveniently able to obtain the desired amounts and types of goods and services. A makeup boutique, for instance, will develop an assortment of products for its customers—lipsticks, blush, mascaras, eyeshadows, etc.—in many different sizes and colors from several different producers.

Transport and store goods. Intermediaries transport and store goods so that they will be available to consumers or industrial users where and when they are wanted or needed. This enables goods to be on hand when consumers or industrial users are ready to buy them rather than only when they are produced.

Intermediaries can perform a variety of other functions as well. They can provide market information to producers. Since intermediaries have more contact with consumers, they may be able to provide up-to-date information about consumer buying habits, problems with products, etc. Intermediaries can also promote the sale of goods and services. Most often, they perform this function through sales staff. They may use other promotional techniques, such as advertising, as well. Extending credit, servicing sales, and providing management services are other ways that intermediaries make producers' jobs easier. Management services may include planning inventories and store layouts and helping to train employees.



For more on the pros (and cons!) of using channel intermediaries, see David Stewart's article "The Advantages and Disadvantages of Intermediary Distribution" at http://www.ehow.com/info_8560892_advantages-disadvantages-intermediary-distribution.html.

Summary

Channels of distribution are the paths, or routes, that goods and services take from the producer to the ultimate consumer or industrial user. Intermediaries, or middlemen, operate between the producer and the consumer or user to help in the movement of goods and services. They include retailers, wholesalers, and agents. Intermediaries are important because they perform many helpful functions, such as breaking down large quantities of goods, developing an assortment of goods, and transporting and storing goods.

TOTAL RECALL

1. What are channels of distribution?
2. What is a producer?
3. What is an ultimate consumer?
4. What is an industrial user?
5. When does a channel of distribution end?
6. What are intermediaries?
7. What are retailers?
8. What are wholesalers?
9. What are agents?
10. Why are intermediaries important?

THE GRAY ZONE

Although channels of distribution allow consumers and industrial users access to products from all over the world, they do not guarantee that consumers will be able to purchase anything they want, any time they want. Certain products may only be available in limited supplies. Because of supply and demand, channel members may be able to charge higher prices for coveted products. This may be fine for a designer handbag, but what if the product is more basic, like fresh water or medical supplies? Or, let's say there is a hurricane or tornado in a certain part of the country, and many people need to repair their homes and roofs. Is it OK for channel members to mark up hardware products during this time to make a bigger profit?



All Your Favorite Channels

Just as you can reach one city by many different routes, producers can reach consumers and industrial users through many different channels. Some routes are short, involving just the producer and the consumer or industrial user. These short routes are known as **direct channels** of distribution. Other routes are longer, involving the use of intermediaries. These routes are called **indirect channels** of distribution. Let's learn more about the most common routes for consumer goods, industrial goods, and services.

Channels for consumer goods

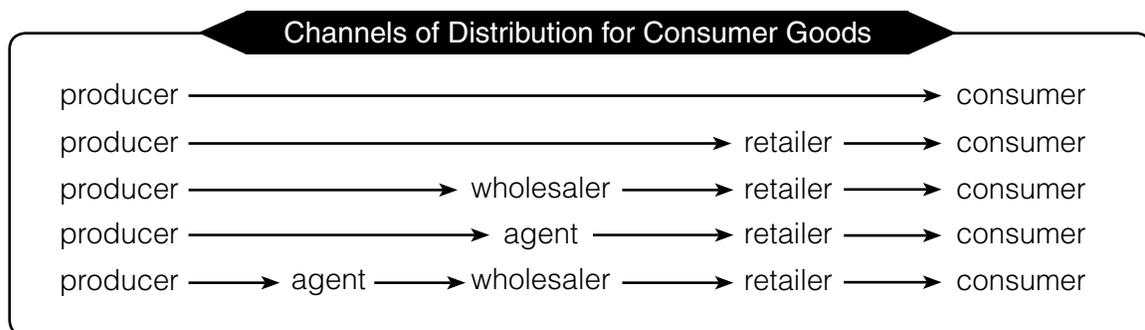
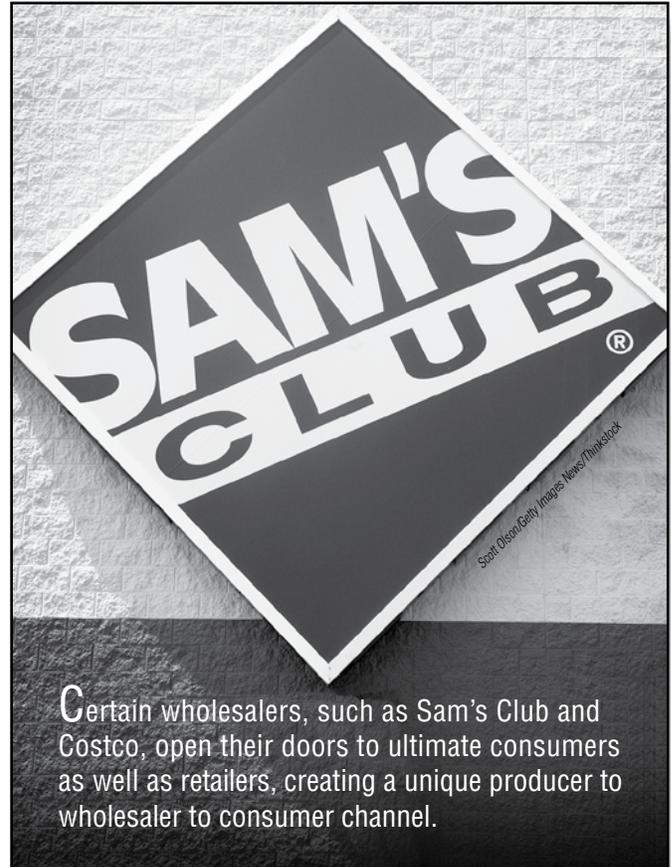
There are five basic channels of distribution for consumer goods. They are:

Producer to consumer. With this type of channel, goods move straight from the producer to the consumer (direct distribution). This is the simplest of all channels. It can take place where the good is produced—a pumpkin farm, for example. It can take place in warehouses or outlets owned by the producer. Or, it can take place through producers' catalogs or online sites. By selling goods directly to consumers, producers are able to maintain tight quality control of selling, installation, and servicing. However, the producer retains all distribution costs. For some more information on direct distribution, read Forest Time's article "What Is a Direct Channel of Distribution?" at <http://smallbusiness.chron.com/direct-channel-distribution-42213.html>.

Producer to retailer to consumer. When it is not possible for a producer to reach a large number of consumers on a direct basis, the producer will often decide to distribute products through intermediaries. Retailers can provide wide distribution of products to consumers and at lower costs than producers can on a direct basis. Most retailers who deal directly with producers buy in large quantities due to the size of their businesses and the great demand for products. Large department stores and retail chains are among those that usually deal directly with producers.

Producer to wholesaler to retailer to consumer. Since many producers cannot offer small shipments, they often require buyers to place large orders for goods. However, most retailers cannot buy the large quantities required. This is why producers use wholesalers to sell to smaller retailers. This is the most common channel of distribution for consumer goods.

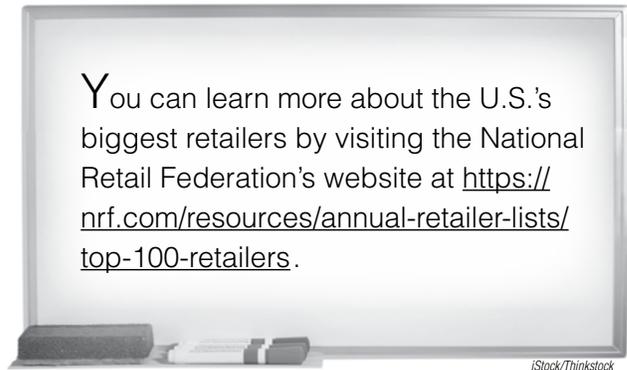
Wholesalers buy large quantities from producers and divide them into smaller units for sale to retailers. The wholesaler is able to provide the retailer with a variety of products from which to choose. This helps the producer as well because large, bulk sales can be made to a few wholesalers rather than to many retailers.





Producer to agent to retailer to consumer. Some producers do not want to take the responsibility or spend the time or money to sell their goods, but they are prepared to handle many other marketing functions. These producers contract with an agent to sell the goods to retailers. The agent's job is to bring buyer and seller together. Once the sales are made, the producer assumes responsibility for processing the goods to the retailers. This channel is frequently used by producers to reach large retailers.

Producer to agent to wholesaler to retailer to consumer. To reach small retailers, producers will contract with agents to sell their goods to wholesalers. Wholesalers, in turn, buy large quantities of the goods and sell smaller amounts to many small retailers. When using this channel, producers are able to share their responsibilities for distribution with a maximum number of intermediaries.



Channels for industrial goods

Goods that will be used to make other goods or services or that will be used in the operation of a business are known as **industrial goods**. They are consumed by industrial users.

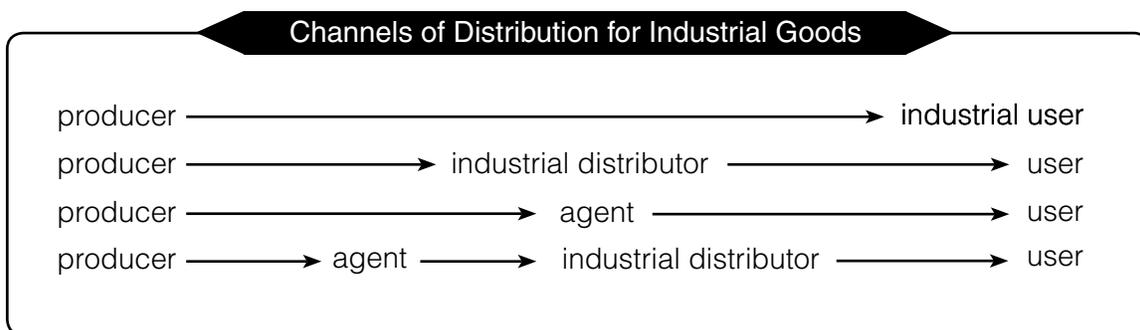
Channels of distribution for industrial goods are separate from those used for consumer goods, but they are quite similar. Retailers, however, do not appear in any of the channels for industrial goods. The most common routes for these goods to take from producer to user are:

Producer to industrial user. This is the direct distribution route for industrial goods. It is also the most common route for them to follow, since most large industrial goods, such as airplanes or manufacturing equipment, require installation or special servicing. Producers feel that they are best qualified to provide these special considerations.

Producer to industrial distributor to user. Industrial distributors function in much the same way as wholesalers for consumer goods. They buy large quantities of goods and raw materials from producers and sell small quantities to industrial users. Unlike wholesalers, however, they tend to specialize in selling a limited number of products. They frequently carry small, standardized parts and operating supplies that industrial users need on a continuous basis. By having supplies on hand, they are able to help industrial users obtain goods faster than they could from producers. Chemicals and machine parts often move through this channel.

Producer to agent to user. Producers who do not have their own sales forces contract with agents to promote and sell their goods to industrial users. Shipment of goods is direct from the producer to the industrial user since the agent does not take title to the goods. This channel is used frequently for construction equipment and other industrial goods with unit prices high enough to justify selling directly to industrial users.

Producer to agent to industrial distributor to user. When a good's unit cost is not high enough to justify selling directly to industrial users, industrial distributors will be added to the channel. The industrial distributor buys large quantities of a good from an agent and sells smaller quantities to industrial users. This route is often used by small producers of items such as building supplies.



Channels for services

Think about **services** for a minute. They are intangible activities that are performed by other people for money. They are productive acts that satisfy economic wants. Because services are intangible, producers aren't concerned about having to ship and store them. Usually, services are consumed when they are produced. Therefore, most services follow a direct channel of distribution—they move directly from the service provider to the consumer or user. For example, if you want to have your dog's hair cut, you take him to a dog groomer. The groomer performs the service directly on your dog. This service could not be handled through channel members. Can you name other services that move directly from the service provider to the consumer or industrial user?

Agents can assist with the distribution of services. This channel would begin with the service provider, move to the agent, and then to the consumer or user. An example of this indirect channel would be the services provided by entertainers who work with agents to promote and sell their skills. Travel agents, insurance agents, and stock brokers are also channel members involved in the distribution of specific services.



▲ Some services, like dog grooming, move directly from the service provider to the consumer.

Summary

A direct channel of distribution goes from the producer straight to the consumer or user. Indirect channels of distribution involve intermediaries. Channels for consumer goods and industrial goods are separate but similar. Channels for services are usually direct, but they can sometimes involve agents.

TOTAL RECALL

1. What is the difference between direct distribution and indirect distribution?
2. What are the five basic channels for consumer goods?
3. What are the four basic channels for industrial goods?
4. How are services distributed?

Make It Pay!

Think of five products you've used in the past week. Where were they produced? Who produced them? What channel members were involved in getting them to you? How would you have obtained these products without channels of distribution?