Frank Lynn & Associates, Inc.

How to Tell When Channel Conflict is Destructive
White Paper

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Channel Conflict in Brief

Multiple channel strategies are a way of life for manufacturers today. Whether you are managing a mix of direct and indirect channels or a spectrum of high-support to low-support resellers, the reality is that channel conflict will be an ongoing issue in your marketplace.

A limited amount of channel conflict is healthy. It indicates that you have adequate market coverage. However, once the balance between coverage and conflict is lost, destructive channel conflict can quickly undermine your channel strategy, market position and product line profitability.

Conflict can show up in the market in a variety of ways. A point of confusion for many manufacturers is whether problems are truly symptoms of destructive channel conflict or other marketing or channel strategy issues. When faced with potential indicators of destructive conflict, you should audit your market position to identify the true cause and then quickly act to address it.

Channel conflict is managed by a combination of economics and controls. Economic solutions compensate channels fairly for functions performed and help direct channels away from actions that create destructive conflict. Controls put structure around a channel strategy to limit the potential for undue destructive conflict.

What is Channel Conflict?

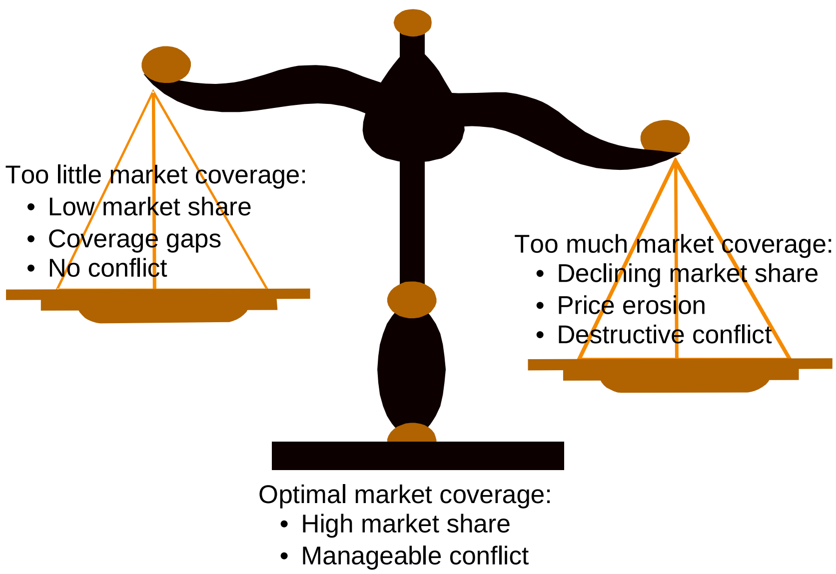
Channel conflict can be defined as any scenario where two different channels compete for the same sale with the same brand. Conflict can take the form of a direct sales force competing with an independent distributor, two different types of competing distributors, two like distributors competing for the same sale, or all of the above.

Most go-to-market strategies have an inherent level of channel conflict. This is necessary to manage share position as the market evolves and customers migrate to new channels. Some conflict is also necessary to assure full geographic coverage of your market. From our experience, there are a number of rules to help assure an appropriate balance between coverage and conflict:

- Lack of any channel conflict in a marketing strategy usually indicates gaps in market coverage
- Conflict cannot be eliminated. The goal of marketing management must be to optimize market coverage and manage channel conflict so that it does not become destructive

- Market share erosion and declining street prices are evidence that channel conflict is becoming destructive. Channels are responding to excessive competition by de-emphasizing the brand or by giving away too much in order to keep an account
- Every manufacturer will face channel conflict at some point. As markets evolve and mature, many manufacturers will be required to add new, lower-cost channels in order to cover all major market segments. Traditional channels, whether they are direct sales or reseller/agents, will feel threatened by any manufacturer's move toward more efficient channels

Exhibit I



When Channel Conflict Occurs

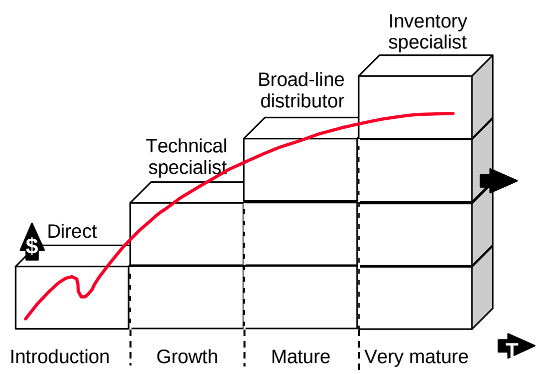
Maturation of a market over time is the primary reason all manufacturers inevitably face channel conflict. Because end-user needs differ considerably from introduction of a new technology to the maturity of a market, your channel strategy must evolve with the market. The primary sources of channel conflict are the transition points that occur when a market moves from one stage of the life cycle to the next, and you migrate to the new channel models that arise to serve your customers across these transition points.

When a technology is first introduced, the end user has little, if any, knowledge about how the technology works and how to use it best in his or her business. A key component of a successful sale is technical education of the end user, usually available only from the manufacturer. Direct sales are the norm here.

The transition from "introduction" to "growth" creates the potential for direct versus indirect channels to cover growing market segments. Applications surface that existing value-add or technically oriented resellers can take into their customer bases. Rather than invest in company-owned channels to cover an expanding and divergent market, most manufacturers choose to partner with indirect channels that already sell into specific markets. This leads to some measure of direct versus indirect conflict.

Growth levels off in a maturing market as potential buying segments and applications become saturated. Sophisticated end users internalize product knowledge, which decreases their need for technical support from the channels from which they purchase. Their channel preference often moves to low technical support (broad-line) channels.

Exhibit II



Broad-line channels exhibit a lower cost structure, can accept lower gross margins and offer a lower price than the technical channel. Manufacturers face conflict as they seek to maintain relationships with the technical channels, while establishing new relationships with broad-line channels. For many companies, technical channels still play an important role in introducing new products and supporting unsophisticated customers. More efficient channels are also needed, however, to meet expectations of the majority of customers in a mature market, creating an environment for conflict between two different indirect channel models.

Another reason manufacturers experience conflict is that too many of the same types of channels are deployed within a finite geographic market. Increasing market coverage in a mature market can also mean adding channel locations, until "like-channel" conflict is created.

Recognizing Destructive Channel Conflict

Changes in the level or intensity of conflict are potential indicators of destructive conflict. Noise always exists. Thus, it does not mean that your company is experiencing destructive channel conflict just because different internal factions or channel members are complaining about lack of manufacturer commitment or are uncomfortable with competition for some sales. Increasing levels of noise or evidence of declining channel support for your product line would be indicators to pay attention to. It is a tough call, however, since destructive conflict tends to creep into a channel system over time.

External Indicators of Channel Conflict

Border Wars

These occur when multiple members of the channel network compete for the same sale in the same account. A limited number of border wars should be expected and are, in fact, one indication that you have good market coverage. Generally, channels will begin to react to channel conflict when incidence of border wars exceeds 15% to 25% of that channel's total business with a manufacturer's products.

Emotion

Conflict increases the level of noise in direct and indirect channels. A necessary component of good channel management strategy is controlling a limited degree of emotion from the channel. However, as emotion builds, the channels will begin to react by reducing support of the product line or by switching out that line wherever possible. Emotion will often cause the channel to de-emphasize a brand even when it is not in the best interest of the channel. Emotion creates a bank of ill will within the channel, and the manufacturers face risk of a quick, wholesale switchout in the channel once leverage slips.

Customer Satisfaction

Conflict can erode customer satisfaction for two reasons:

- Customers will start to experience redundant buying costs when forced to deal with multiple channels offering essentially the same solutions in sales situations
- Competing channels focus on easy ways to win the sale in a conflict situation (such as dropping price) and begin to ignore less evident customer buying requirements

Internal Indicators of Channel Conflict

Destructive channel conflict backs into a business and starts to impact a number of internal measures of operating efficiency and business success. Look for changes in these factors to indicate a threat to market position.

Sales Force Productivity

When a conflict impacts a direct sales force, productivity slips. You might see:

- Increased management costs as sales managers are forced to manage by exception
- Increased turnover as sales reps react to conflict

- A decline in sales per rep as effort is focused toward conflict versus territory management

Channel Relationships

Destructive conflict causes an erosion in channel position. Initially, channels will ask for special pricing as margin erodes. They will begin to offer the conflicting brands for sale only when requested. Eventually, they will drop the brand entirely.

Customer Relationships

As conflict puts emphasis on price as a differentiation between conflicting channels, the basis for your competitive position can erode. This can lead to a fundamental shift in the way customers perceive and buy your products. Once your product line achieves commodity status, the cost of repositioning the line is enormous and the likelihood of regaining a premium position with an established line is relatively low. Therefore, the implications and cost of meeting new customer expectations can be tremendous.

Because these internal factors can produce declines in market share and profits, it is critical that you recognize them and react quickly and appropriately.

Channel Conflict Solutions

Channel conflict is an integral part of your channel strategy, and taking a closer look at the problem often reveals that the perceived channel conflict issue masks a larger channel strategy issue. Common challenges, often viewed as channel conflict problems, include:

- *Pricing strategy*—conflict results from a misaligned price/discount structure that creates an unlevel playing field because it promotes an economic advantage for one channel over another

- *End-user/channel segmentation*—as end-user needs evolve, defined segments change. Manufacturers that fail to recognize, understand and deliver the needs of these segments can create the same types of customer satisfaction issues found in instances of channel conflict

- *Channel support*—channel support requirements change as end-user needs change. Failure to meet these new support needs can erode a manufacturer's position in that channel

- *Market penetration*—manufacturers often consider channel conflict to be a barrier to market penetration, particularly for new product introductions. However, lack of market penetration can more often be traced to the components of the product launch plan, including definition of target end users, channel selection strategies, and marketing "pull-through" activities

- *Company politics*—preserving the status quo becomes a natural obstacle to adding new channels. Odds are that a company has a traditional channel, (e.g., direct sales force, VAR channel, specialty dealer) that has been successful in growing the business and has a powerful support base within the organization. Our experience is that many channel expansion battles are lost for "conflict" reasons when they are fought without both camps having a common understanding of how channels play different economic roles in the marketplace. The real issue might not be whether the company needs to add a new type of channel; it might be how to achieve this with minimal loss to the traditional base

Destructive channel conflict is managed through economics and structural controls. Economics motivate the channels to avoid conflict. Structural controls lay the ground rules within which conflict is managed. With each tactic, communication before conflict arises is critical.

Economic remedies to manage channel conflict require channel compensation techniques. The right economic solution is dictated by the type of conflict being faced, the manufacturer's market and channel position, and the company's strategic goals.

- *Dual compensation*—applied when conflict exists between direct and indirect channels. The goal is to move the indirect channel from a position of potential adversary for the direct sales force to one of "partner" for the direct sales force

- *Functional compensation or discount*—used to manage cross-channel conflict or conflict between channels of differing cost structures and capabilities. Functional discounts are applied by paying a channel a specific discount if it performs a measurable task or function. Functional discounts allow the "high-cost" channel to compete against "low-cost" channels for those customers who value the high support

- *Shared costs*—the key difference between this concept and functional discounts is that functional discounts compensate the channel for incremental tasks via a discount on product sold, while shared costs pay directly for the task

- *Compensation for market share*—usually applied to direct versus indirect conflict, the direct sales rep is compensated based on total market share in a territory. The goals of the sales rep are based on direct and indirect volume, thus motivating the direct rep to "partner" with indirect channels to maximize territory volume

Structural controls are only as effective as their enforcement. There is no value unless you are willing to clearly spell out the controls at the outset of the channel agreement and enforce the stated penalties to all channel members.

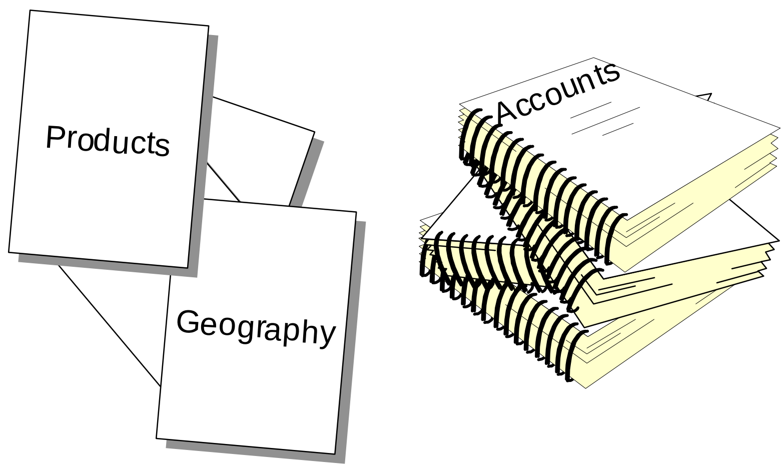
Controls are typically applied to:

- *Accounts*—you specify "named" or "house" accounts where indirect channels can expect to compete with your direct channels. Named accounts are usually specified based on end-user sourcing capabilities, channel ability to meet end-user buying requirements, and volume and strategic value

- *Products*—channels can qualify for franchising by product line/category across your company's offering. Product qualification is usually based on end-user product support needs, channel support capabilities, "fit" or positioning of the product category in the channel's overall business, and strategic considerations
- *Geography*—as a manufacturer, you can specify those geographies/account types in which you will provide sales support to the channel. These geographies are usually defined by granting the channel a primary area of responsibility

The successful marketer combines the elements of economic and control-related solutions that best address conflict challenges —framing them in an understanding of market position, channel position, and strategic goals.

Exhibit III
Controls = "Rules of the Game"



Is Channel Conflict a Strategic Issue in Your Business Today?

Take a moment to consider the following questions:

1. Have you recently seen your market move through a "transition" point (e.g., from introduction to growth, from growth to maturity)?
2. Have you made any recent changes to your channel strategy (e.g., adding channel members, adding new types of channels)?
3. Have requests from the direct sales force or channels for special prices increased significantly?
4. Have gross margins eroded significantly in any customer or channel segments?
5. Have you seen a decrease in dollar revenue per direct sales rep and/or dollar revenue per channel location?

6. Have you experienced significant loss of market share or declines in customer satisfaction in any customer segments?
7. Have you experienced a decrease in your number of channels as a result of channels dropping your line?

If you answered yes to two or fewer questions, conflict is not a strategic issue for you today.

If you answered yes to three or four questions, conflict could be impacting your business. Take this opportunity to "audit" your market position and enact strategies to manage destructive conflict.

If you answered yes to five or more questions, conflict might be undermining your channel strategy and must be managed now.

For more information on this topic, please contact our Client Services Coordinator at (312) 263-7888.