



SUPPLY CHAIN AND CHANNEL MANAGEMENT

LEARNING OBJECTIVES

- L01** Understand the importance of marketing channels and supply chain management.
- L02** Understand the difference between direct and indirect marketing channels.
- L03** Describe how marketing channels are managed.
- L04** Describe the flow of information and merchandise in the marketing channel.

Already well established as an efficient shipper of orders, Amazon continues to seek to do even better. Currently, Amazon receives an order, labels and packages it, loads it onto a delivery truck (run by UPS or the U.S. Postal Service, depending on the day and delivery details), and waits

for confirmation that this third-party logistics provider has delivered the product directly to the customer's door. In this traditional process, the online retailer seeks to improve by adding more warehouses, can provide more customers with overnight or same-day delivery.



But two more striking innovations instead aim to reinvent the supply chain completely, to benefit both customers and itself. First, Amazon recently applied for and received a patent for its “anticipatory shipping” system, which starts reading packages for delivery before the customer even adds the item to his or her virtual cart.¹ With anticipatory shipping, Amazon boxes and ships out products that it expects customers will want, according to their previous purchases, in the belief that they are likely to order them soon. To determine what to ship, Amazon uses information from customers’ previous orders, product searches, shopping cart contents, and previous returns.

This innovation promises to be particularly beneficial for popular books, movies, and games, for which people clearly announce their desire to have the item in hand the very day it is released. If Amazon can get it to their homes

on that same day, it might discourage customers from visiting physical retail locations, because their wait times would be even lower than brick-and-mortar stores can offer. In this sense, Amazon is using Big Data to predict demand and thus edge out its rivals. However, critics caution that when Amazon’s algorithms are incorrect, the necessary returns could grow rapidly to become quite costly. In response, Amazon has suggested that it might simply convert any unwanted deliveries into gifts, thus building goodwill among customers who receive a desirable new order for no cost.

Second, Amazon has not limited its streamlining efforts to the retailer–customer link. Instead, it has created its Vendor Flex program, which seeks to lower overall transportation costs. Among the first partners in Amazon’s Vendor Flex program is Procter & Gamble (P&G), which agreed to allow Amazon to build fulfillment

centers within P&G's own warehouses. The cost savings accrue because the new system eliminates the costs of transporting P&G's products to Amazon's fulfillment centers.

Not everyone is excited about this innovative new partnership, though. Companies such as Target, which have enjoyed long-term relationships with P&G, are taking

notice and taking action. After learning of the Vendor Flex program between Amazon and P&G, Target reacted by moving all P&G products from prominent end-cap positions in its stores to less prestigious and less visible locations. Target also stopped using P&G as its primary source of advice for planning merchandising strategies within each category.

In this chapter, we discuss the third P, *place*, which includes all activities required to get the right product to the right customer when that customer wants it.² Specifically, as we noted in Chapter 1, **marketing channel management**, which also has been called **supply chain management**, refers to a set of approaches and techniques firms employ to efficiently and effectively integrate their suppliers, manufacturers, warehouses, stores, and transportation intermediaries into a seamless operation in which merchandise is produced and distributed in the right quantities, to the right locations, and at the right time, as well as to minimize systemwide costs while satisfying the service levels their customers require.³ Students of marketing often overlook or underestimate the importance of place in the marketing mix, simply because it happens behind the scenes. Yet marketing channel management adds value, say for Amazon's customers, because it gets the products to them efficiently, quickly, and at low cost.

LO1 Understand the importance of marketing channels and supply chain management.

THE IMPORTANCE OF MARKETING CHANNEL/SUPPLY CHAIN MANAGEMENT

So far in this book we have reviewed the methods companies use to conduct in-depth market research, gain insights into consumer and business behaviors, segment markets, select the best target markets, develop new products and services, and set prices that provide good value. But even if firms execute these activities flawlessly, unless they can secure the placement of products in appropriate outlets in sufficient quantities exactly when customers want them, they are likely to fail. Adding Value 16.1 examines how Goya Foods recognized it needed to do a better job at getting products into stores to satisfy customers' demands and what it did about it.

Convincing wholesalers and retailers to carry new products can be more difficult than you might think. **Wholesalers** are firms that buy products from manufacturers and resell them to retailers; retailers sell products directly to consumers. For example, PenAgain, a small California-based manufacturer of ergonomic pens and other writing instruments, wanted to put its offerings in Walmart stores, but first it had to get Walmart to buy what it was selling.⁴ After a tough selling session, Walmart agreed to give PenAgain a one-month trial in 500 stores, but only if it lowered its costs. PenAgain thus moved production overseas. Walmart provided no marketing support though, and PenAgain was too small to afford traditional print or television advertising, so it developed a

Adding Value 16.1

The Beans May Be Slow Cooked, but the Delivery Is Quick!

As Goya Foods celebrated its 75th year in business, its top managers were dealing with some very serious growing pains. Selling a wide variety of Hispanic and Latin foods, the company had achieved a dominant market share, was the largest Hispanic-owned company in the United States, and had annual sales of around \$1 billion. In specific local and regional markets, demand for its products was substantial—a great success that also came with a notable challenge.

That is, many of the markets that loved Goya products had slightly different preferences, reflecting the diversity of Hispanic consumers in the United States. People of Cuban heritage wanted items made somewhat differently than consumers whose families originated in Mexico, and so on. Thus, the number of unique inventory items or stock keeping units (SKUs) that Goya provided reached over 1,600. The supply chain network grew more complex. And in all the confusion, service levels, as measured by its in-stock availability, dropped. Quite simply, with all the complexity, buyers were spending too much time manually calculating and determining shipments and inventory levels, leaving them insufficient time or energy to think strategically. Making decisions without sophisticated analytics was not something that Goya could sustain anymore.

For Goya, the solution was to automate the transportation and inventory planning processes, using software that enabled it to keep track of demand, order fulfillment, and replenishment with minimal effort. By automating its ordering processes, Goya's buyers could work smarter. For



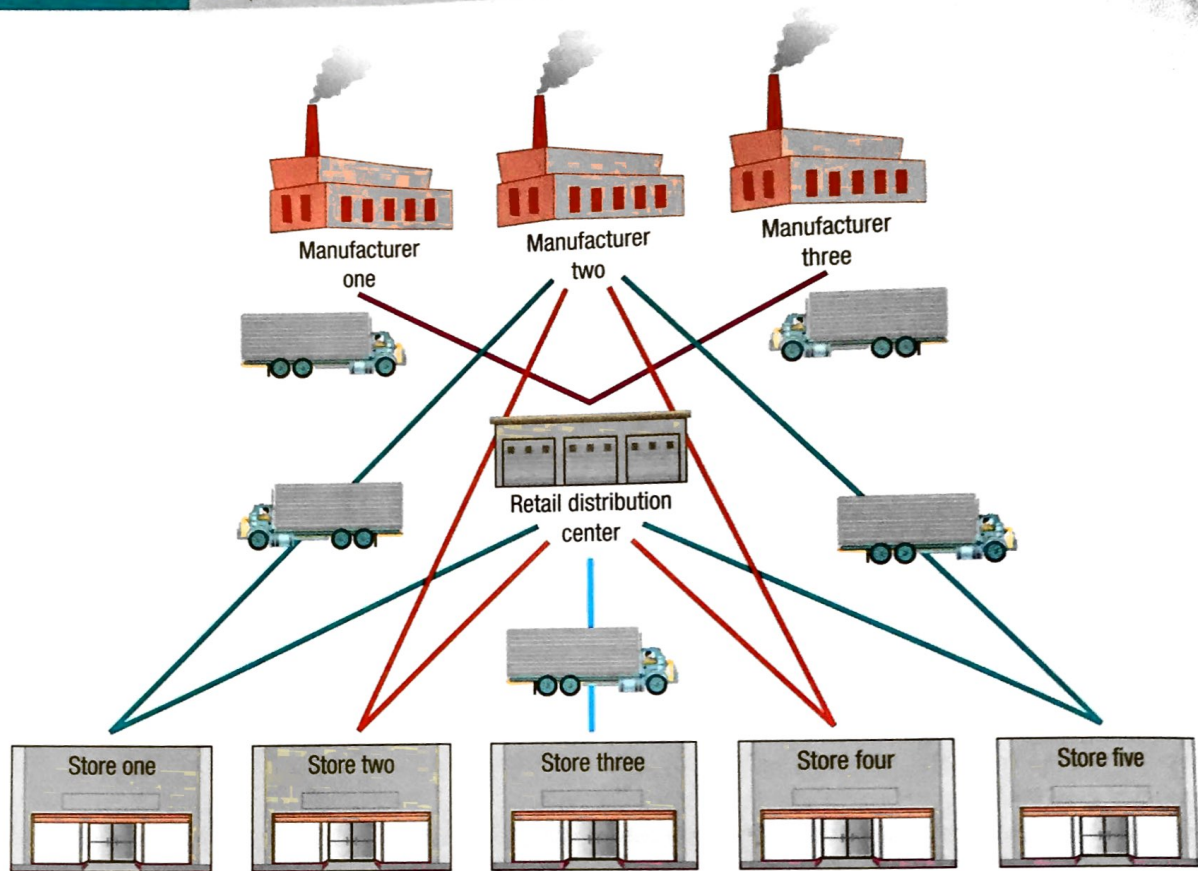
To satisfy its diverse market of Hispanic consumers, Goya expanded the number of unique inventory items it carried to 1,600. To keep service levels high, Goya implemented an automated transportation and inventory planning system.

example, making sure delivery trucks were more efficiently used resulted in millions of dollars in transportation savings. The new system also improved its in-stock availability to 98 percent, which resulted in a proportional increase in sales.

viral marketing program and produced displays to use in the stores. A **viral marketing program** is one that encourages people to pass along a marketing message to other potential consumers. To keep track of sales, it relied on Walmart's Internet-based Retail Link system, though it also hired a firm that sends representatives into stores to check out display placement and customer traffic. Finally, PenAgain agreed to adhere to strict packaging, labeling, and shipping requirements. And remember, for all this effort, its entry in stores was only a test, and a very expensive gamble! But if it could succeed in Walmart stores, PenAgain would be well on its way to prosperity.

In the simplified supply chain in Exhibit 16.1, manufacturers make products and sell them to retailers or wholesalers. The exhibit would be much more complicated if we had included the suppliers of materials to manufacturers and all the manufacturers, wholesalers, and stores in a typical marketing channel.

Exhibit 16.1 represents a typical flow of manufactured goods: Manufacturers ship to a wholesaler or to a retailer's distribution center (e.g., Manufacturer 1 and Manufacturer 3) or directly to stores (Manufacturer 2). In addition, many variations on this supply chain exist. Some retail chains, such as Home Depot or Costco, function as both retailers and wholesalers. They act as retailers when they sell to consumers directly and as wholesalers when they sell to other businesses such as building contractors or restaurant owners. When manufacturers such as Avon sell directly to consumers, they perform both production and retailing activities. When Dell sells computers to a university or business, it engages in a business-to-business



(B2B) transaction, but when it sells to students or employees individually, it is a B2C (business-to-consumer) operation.

Marketing Channels Add Value

Why do manufacturers use wholesalers or retailers? Don't these added channel members just cut into their profits? Wouldn't it be cheaper for consumers to buy directly from manufacturers? In a simple agrarian economy, the best supply chain likely does follow a direct route from manufacturer to consumer: The consumer goes to the farm and buys food directly from the farmer. Modern eat-local environmental campaigns suggest just such a process. But before the consumer can eat a fresh steak procured from a local farm, she needs to cook it. Assuming the consumer doesn't know how to make a stove and lacks the materials to do so, she must rely on a stove maker. The stove maker, which has the necessary knowledge, must buy raw materials and components from various suppliers, make the stove, and then make it available to the consumer. If the stove maker isn't located near the consumer, the stove must be transported to where the consumer has access to it. To make matters even more complicated, the consumer may want to view a choice of stoves, hear about all their features, and have the stove delivered and installed.

Each participant in the channel adds value.⁵ The components manufacturer helps the stove manufacturer by supplying parts and materials. The stove maker turns the components into the stove. The transportation company gets the stove to the retailer. The retailer stores the stove until the customer wants it, educates the customer about product features, and delivers and installs the stove. At each step the stove becomes more costly but also more valuable to the consumer.



How many companies are involved in making and getting a stove to your kitchen?

Marketing Channel Management Affects Other Aspects of Marketing

Every marketing decision is affected by and has an effect on marketing channels. When products are designed and manufactured, how and when the critical components reach the factory must be coordinated with production. The sales department must coordinate its delivery promises with the factory or distribution or fulfillment centers. A **distribution center**, a facility for the receipt, storage, and redistribution of goods to company stores, may be operated by retailers, manufacturers, or distribution specialists.⁶ Similar to a distribution center, instead of shipping to stores, **fulfillment centers** are used to ship directly to customers. Furthermore, advertising and promotion must be coordinated with those departments that control inventory and transportation. There is no faster way to lose credibility with customers than to promise deliveries or run a promotion and then not have the merchandise when the customer expects it.

DESIGNING MARKETING CHANNELS

LO2 Understand the difference between direct and indirect marketing channels.

When a firm is just starting out or entering a new market, it doesn't typically have the option of designing the best marketing channel structure—that is, choosing from whom it buys or to whom it sells. A new sporting goods retailer may not have the option of carrying all the manufacturer lines it wants because other competing retailers in its market area might carry the same products. On the other side, a small specialty sporting goods apparel manufacturer may not be able to place its products in major stores like Sports Authority because its line is unproven, and the products might duplicate lines that the retailer already carries. Chapter 17 discusses how manufacturers choose their retailer partners in more depth.

Although there are thus various constraints on marketing channel partners with regard to the design of the best channel structure, all marketing channels take the form of a direct channel, an indirect channel, or some combination thereof.

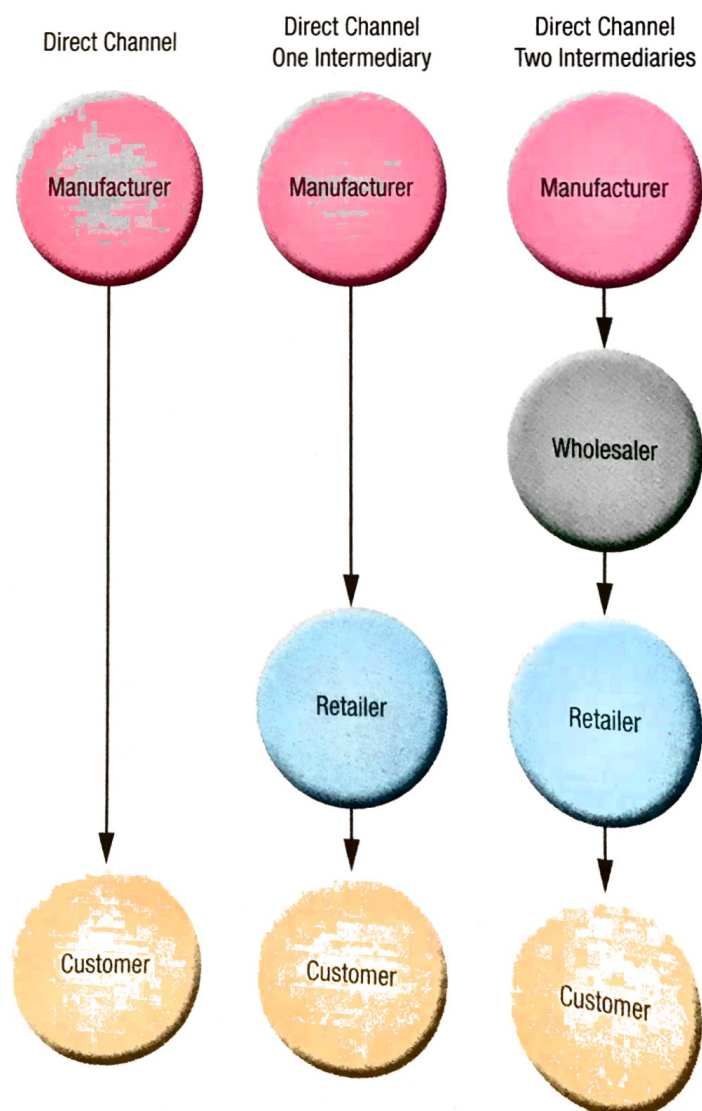
Direct Marketing Channel

As shown in Exhibit 16.2, there are no intermediaries between the buyer and seller in a **direct marketing channel**. Typically, the seller is a manufacturer, such as when a carpentry business sells bookcases through its own store and online to individual consumers. The seller also can be an individual, such as when a knitter sells blankets and scarves at craft fairs, on Etsy, and through eBay. (Recall our discussion of consumer-to-consumer [C2C] transactions in Chapter 1.) When the buyer is another business, such as when Boeing sells planes to JetBlue, the marketing channel still is direct, but in this case, the transaction is a business-to-business one (see Chapter 7).

Indirect Marketing Channel

In **indirect marketing channels**, one or more intermediaries work with manufacturers to provide goods and services to customers. In some cases,

EXHIBIT 16.2 Channel Strategies



only one intermediary might be involved. Automobile manufacturers such as Ford and General Motors often use indirect distribution, such that dealers act as retailers, as shown in the middle of Exhibit 16.2. The right side of Exhibit 16.2 reveals how wholesalers are more common when the company does not buy in sufficient quantities to make it cost effective for the manufacturer to deal directly with them—independent book sellers, wine merchants, or independent drug stores, for example. Wholesalers are also prevalent in less developed economies, in which large retailers are rare.

L03 Describe how marketing channels are managed.

MANAGING THE MARKETING CHANNEL AND SUPPLY CHAIN

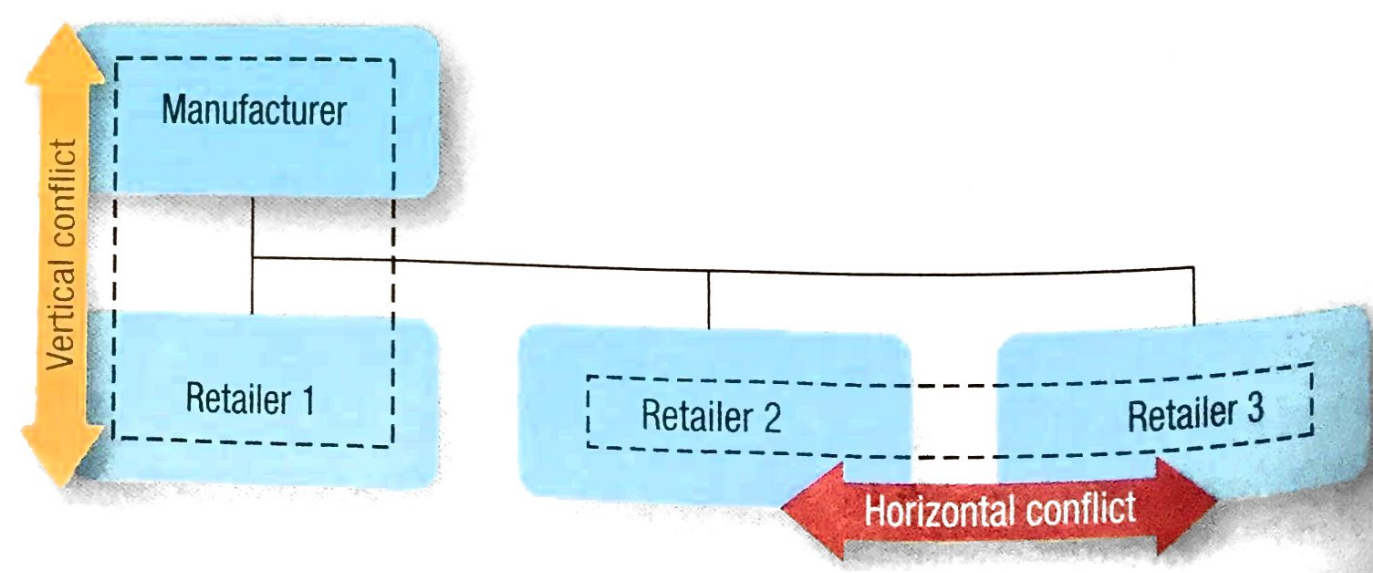
Marketing channels and supply chains comprise various buying entities, such as retailers and wholesalers; sellers, such as manufacturers or wholesalers; and facilitators of the exchange, such as transportation companies. Similar to interpersonal interactions, their relationships can range from close working partnerships to one-time arrangements. In almost all cases, though, interactions occur because the parties want something from each other: Home Depot wants hammers from Stanley Tool Company; Stanley wants an opportunity to sell its tools to the general public; both companies want UPS to deliver the merchandise.

Each member of the marketing channel also performs a specialized role. If one member believes that another has failed to do its job correctly or efficiently, it can replace that member. So, if Stanley isn't getting good service from UPS, it can switch to FedEx. If Home Depot believes its customers do not perceive Stanley tools as a good value, it may buy from another tool company. Home Depot even could decide to make its own tools or use its own trucks to pick up tools from Stanley. However, anytime a marketing channel member is replaced, the function it has performed remains, so someone needs to complete it.⁷

If a marketing channel is to run efficiently, the participating members must cooperate. Often, however, supply chain members have conflicting goals, and this may result in channel conflict (Exhibit 16.3). For instance, Stanley wants Home Depot to carry all its tools but not those of its competitors so that Stanley can maximize its sales. But Home Depot carries a mix of tool brands so it can maximize the sales in its tool category. When supply chain members that buy and sell to one another are not in agreement about their goals, roles, or rewards, **vertical channel conflict** or discord results.

Horizontal channel conflict can also occur when there is disagreement or discord among members at the same level in a marketing channel, such as two competing retailers or two competing manufacturers. As we mentioned in the opening vignette, Target experiences a conflict with Amazon because of its Vendor Flex program with Procter & Gamble (P&G). Amazon benefits from the program, which lowers its transportation costs, but Target believes that it gives its competitor an unfair advantage.

EXHIBIT 16.3 Vertical versus Horizontal Channel Conflict



GOING BACK TO REGULAR TOOLS
GOING BACK TO

WOULD BE LIKE
BLACK AND WHITE TV.



STANLEY

The Home Depot and Stanley Tool Company have a mutually beneficial partnership. The Home Depot buys tools from Stanley because their customers find value in Stanley products. Stanley sells tools to Home Depot because they have established an excellent market for its products.

Avoiding vertical channel conflicts demands open, honest communication. Buyers and vendors all must understand what drives the other party's business, their roles in the relationship, each firm's strategies, and any problems that might arise over the course of the relationship. Amazon and P&G recognize that it is in their common interest to remain profitable business partners. Amazon's customers demand and expect to find P&G products on its website; P&G needs the sales generated through Amazon. Amazon cannot demand prices so low that P&G cannot make money, and P&G must be flexible enough to accommodate the needs of this important customer. With a common goal, both firms then have the incentive to cooperate because they know that by doing so, each will boost its sales.

Common goals also help sustain the relationship when expected benefits fail to arise. If one P&G shipment fails to reach the Amazon section of one of its fulfillment centers, due to an uncontrollable event such as a demand forecasting miscalculation, Amazon does not suddenly call off the whole arrangement. Instead, it recognizes the incident as a simple, isolated mistake and maintains the good working relationship, because Amazon knows that both it and P&G are committed to the same goals in the long run.

In this sense, their partnership exhibits both of the non-mutually exclusive ways that exist to manage a marketing channel or supply chain: Coordinate the channel using a vertical marketing system and develop strong relationships with marketing channel partners—topics we now examine.

Managing the Marketing Channel and Supply Chain through Vertical Marketing Systems

Although conflict is likely in any marketing channel, it is generally more pronounced when the channel members are independent entities. Marketing channels that are more closely aligned, whether by contract or ownership, share common goals and therefore are less prone to conflict.

In an **independent** or **conventional marketing channel**, several independent members—a manufacturer, a wholesaler, and a retailer—attempt to satisfy their own



Amazon and Procter & Gamble recognize that it is in their common interest to remain profitable business partners.

Independent marketing channel



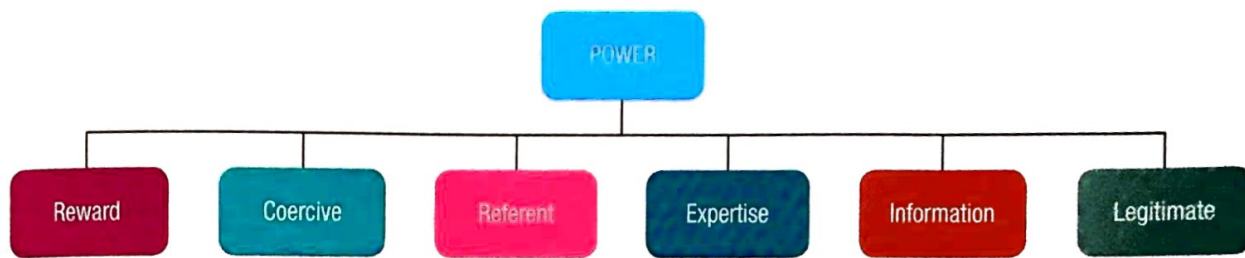
Vertical marketing channel



objectives and maximize their profits, often at the expense of the other members, as we portray in Exhibit 16.4 (left). None of the participants have any control over the others. Using our previous example, the first time Walmart purchases pens from PenAgain, both parties likely try to extract as much profit from the deal as possible. After the deal is consummated, neither party feels any responsibility to the other.

Over time, though, Walmart and PenAgain might develop a relationship marked by routinized, automatic transactions, such that Walmart's customers come to expect PenAgain products in stores, and PenAgain depends on Walmart to buy a good portion of its output. This scenario represents the first phase of a **vertical marketing system**, a marketing channel in which the members act as a unified system, as in Exhibit 16.4 (right). Three types of vertical marketing systems—administered, contractual, and corporate—reflect increasing phases of formalization and control. The more formal the vertical marketing system, the less likely conflict is to ensue.

Administered Vertical Marketing System The Walmart–PenAgain marketing channel relationship offers an example of an **administered vertical marketing system**: There is no common ownership or contractual relationships, but the dominant channel member controls or holds the balance of power. Because of its size and relative power, Walmart imposes controls on PenAgain. **Power** in a marketing channel exists when one firm has the means or ability to dictate the actions of another member at a different level of distribution (Exhibit 16.5). A retailer like Walmart exercises its power over suppliers in several ways. With its **reward power**, Walmart offers rewards, often a monetary incentive, if PenAgain will do what Walmart wants it to do. **Coercive power** arises when Walmart threatens to punish or punishes the other channel member for not undertaking certain tasks, such as if it were to delay payment to PenAgain for a late delivery. Walmart may also have **referent power** over PenAgain if the supplier desperately wants to be associated with Walmart, because being known as an important Walmart supplier enables PenAgain to attract other retailers' business. If Walmart exerts **expertise power** over PenAgain, it relies on its expertise with marketing pens. Because Walmart has vast information about the office supply and back-to-school markets, it can exert **information power** over PenAgain by providing or withholding such important market information. Finally, **legitimate power** is based on getting a channel member, such as PenAgain, to behave in a certain way because of a contractual agreement between the two firms. As Walmart deals with PenAgain and its other suppliers, it likely exerts multiple types of power to influence their

EXHIBIT 16.5 Bases of Power

behaviors. If either party dislikes the way the relationship is going though, it can simply walk away.

Contractual Vertical Marketing System Over time, Walmart and PenAgain may formalize their relationship by entering into contracts that dictate various terms, such as how much Walmart will buy each month and at what price, as well as the penalties for late deliveries. In **contractual vertical marketing systems** like this, independent firms at different levels of the marketing channel join through contracts to obtain economies of scale and coordination and to reduce conflict.⁸

Franchising is the most common type of contractual vertical marketing system. **Franchising** is a contractual agreement between a franchisor and a franchisee that allows the franchisee to operate a retail outlet using a name and format developed and supported by the franchisor. Exhibit 16.6 lists the United States'

EXHIBIT 16.6 Top 10 Franchises for 2014

Rank	Franchise Name	Number of U.S. Outlets	Startup Cost
1	Anytime Fitness Fitness Center	2,425	\$56.3K–353.9K
2	Hampton Hotels Midprice Hotels	1,942	\$3.7M–13.52M
3	Subway Subs, salads	41,121	\$85.69K–262.85K
4	Supercuts Hair Salon	2,324	\$108.75K–203.6K
5	Jimmy John's Gourmet Sandwiches Gourmet Sandwiches	1,872	\$300.5K–489.5K
6	7-Eleven Inc Convenience Stores	50,944	\$30.79K–163M
7	Servpro Insurance/disaster restoration and cleaning	1,614	\$134.8K–183.44K
8	Denny's Inc Family Restaurant	1,697	\$117M–2.4M
9	Pizza Hut Inc Pizza, pasta, wings	14,357	\$297K–2.1M
10	Dunkin' Donuts Coffee shop	10,862	\$294K–1.51M

Source: Entrepreneur's 2014 Franchise 500. www.entrepreneur.com



Anytime Fitness was ranked the number one franchise by Entrepreneur magazine in 2014.

top franchise opportunities. These rankings, determined by *Entrepreneur* magazine, are created using a number of objective measures such as financial strength, stability, growth rate, and size of the franchise system.⁹

In a franchise contract, the franchisee pays a lump sum plus a royalty on all sales in return for the right to operate a business in a specific location. The franchisee also agrees to operate the outlet in accordance with the procedures prescribed by the franchisor. The franchisor typically provides assistance in locating and building the business, developing the products or services sold, management training, and advertising. To maintain the franchisee's reputation, the franchisor also makes sure that all outlets provide the same quality of services and products.

A franchise system combines the entrepreneurial advantages of owning a business with the efficiencies of vertical marketing systems that function under single ownership (i.e., a corporate system, as we discuss next). Franchisees are motivated to make their stores successful because they receive the profits after they pay the royalty to the franchisor. The franchisor is motivated to develop new products, services, and systems and to promote the franchise because it receives royalties on all sales. Advertising, product development, and system development are all done efficiently by the franchisor, with costs shared by all franchisees.

Corporate Vertical Marketing System In a **corporate vertical marketing system**, the parent company has complete control and can dictate the priorities and objectives of the marketing channel because it owns multiple segments of the channel, such as manufacturing plants, warehouse facilities, and retail outlets. By virtue of its ownership and resulting control, potential conflict among segments of the channel is lessened.

American Apparel, a clothing manufacturer based in Los Angeles, California, represents a corporate vertical marketing system because it manufactures its own products rather than having contractual relationships with other firms, and it operates its own retail stores selling T-shirts and other men's and women's sportswear. With this corporate ownership structure, it is able to bring fashion-sensitive items from the idea stage to market in a very short time.

American Apparel represents a corporate vertical marketing system because it manufactures its own products and operates its own retail stores.

Managing Marketing Channels and Supply Chains through Strategic Relationships

There is more to managing marketing channels and supply chains than simply exercising power over other members in an administered system or establishing a contractual or corporate vertical marketing system. There is also a human side.

In a conventional marketing channel, relationships between members reflect their arguments over the split of the profit pie: If one party gets ahead, the other party falls behind. Sometimes this type of transaction is acceptable if the parties have no interest in a long-term relationship. If Walmart believes that PenAgain's ergonomic pens are just a short-term fad, it may only be interested in purchasing once. In that case, it might seek to get the best one-time price it can, even if doing so means that PenAgain will make very little money and therefore might not want to sell to Walmart again.



More frequently, firms seek a **strategic relationship**, also called a **partnering relationship**, in which the marketing channel members are committed to maintaining the relationship over the long term and investing in opportunities that are mutually beneficial. In a conventional or administered marketing channel, there are significant incentives to establish a strategic relationship, even without contracts or ownership relationships. Both parties benefit because the size of the profit pie has increased, so both the buyer and the seller increase their sales and profits. These strategic relationships are created explicitly to uncover and exploit joint opportunities, so members depend on and trust each other heavily; share goals and agree on how to accomplish those goals; and are willing to take risks, share confidential information, and make significant investments for the sake of the relationship. Successful strategic relationships require mutual trust, open communication, common goals, interdependence, and credible commitments.

Mutual Trust Mutual trust holds a strategic relationship together. Trust is the belief that a partner is honest (i.e., reliable, stands by its word, sincere, fulfills obligations) and benevolent (i.e., concerned about the other party's welfare). When vendors and buyers trust each other, they are more willing to share relevant ideas, clarify goals and problems, and communicate efficiently. Information shared between the parties, such as inventory positions in stores, thus becomes increasingly comprehensive, accurate, and timely.

With trust, there's also less need for the supply chain members to constantly monitor and check up on each other's actions, because each believes the other won't take advantage, even if given the opportunity. Although it is important in all relationships, monitoring supply chain members becomes particularly pertinent when suppliers are located in less developed countries, where issues such as the use of child labor, poor working conditions, and below-subsistence wages have become a shared responsibility. Ethical and Societal Dilemma 16.1 highlights how Apple has both stumbled in this responsibility and changed its practices to improve its dedication to ethical choices.

Open Communication To share information, develop sales forecasts together, and coordinate deliveries, Walmart and its suppliers maintain open and honest communication. This maintenance may sound easy in principle, but some businesses don't tend to share information with their business partners. But open, honest communication is a key to developing successful relationships because supply chain members need to understand what is driving each other's business, their roles in the relationship, each firm's strategies, and any problems that arise over the course of the relationship.

Common Goals Supply chain members must have common goals for a successful relationship to develop. Shared goals give both members of the relationship an incentive to pool their strengths and abilities and exploit potential opportunities together. Such commonality also offers an assurance that the other partner won't do anything to hinder the achievement of those goals within the relationship.

Walmart and its suppliers recognize that it is in their common interest to be strategic partners. Walmart needs its suppliers to satisfy its customers, and those manufacturers recognize that if they can keep Walmart happy, they will have more than enough business for years to come. With common goals, both firms have an incentive to cooperate, because they know that by doing so, both can boost sales. If Walmart needs a special production run of pens to meet demand for back-to-school buyers, PenAgain will work to meet the challenge. If PenAgain has difficulty financing its inventory, it is in Walmart's best interest to help it, because they are committed to the same goals in the long run.



An iPad user reading a recent issue of *The New York Times* on his or her tablet might have suffered a strange sense of guilt. The newspaper published reports of labor abuses that seemingly run rampant in the Chinese factories responsible for producing Apple's most popular products. These in-depth reports cataloged a long list of failures: the presence of child workers, more than 12-hour shifts, regular workweeks of longer than 60 hours, workers housed in tiny dormitories with approximately 20 people limited to three rooms, allegations of suicides, and lax safety standards that have led to fatal explosions.

The reports focus mostly on a Foxconn factory in Chengdu, in southwestern China, that manufactures iPhones and iPads. An explosion caused by insufficient ventilation of aluminum dust (created when the cases for the gadgets are polished) in May 2011 killed four workers. A similar explosion followed six months later at another factory. The ensuing investigations by *The New York Times* revealed multiple other violations of the code of conduct that Apple has established for its suppliers.

With this code of conduct, as well as the frequent audits it performs, Apple asserts that it is doing the best that it can to ensure its suppliers live up to reasonable standards and fair labor practices. An anonymous former Apple executive asserts, "There is a genuine, companywide commitment to the

code of conduct." Yet abuses continue, as Apple's own corporate responsibility reports reveal. Audits show that several supply companies continue to engage in labor practices that violate the code, with few punishments or changes to the supply chain.

Part of the reason stems from Apple's need for secrecy—once it finds a supply partner that can manufacture its high-tech gadgets, it wants to maintain that relationship to avoid any leakage of innovation information. So even if a supplier violates the code again and again, Apple is unlikely to switch.

Furthermore, Apple's focus on innovation means that it must work constantly to come up with new ideas and products, which it needs to produce quickly and in sufficient quantities to keep customers happy. This demanding supply chain leaves little room for flexibility. When Apple says it needs 1 million products, then its supplier is going to do whatever it takes to get those products ready in time. The code of conduct might ask that factory workers be limited to 60-hour workweeks, but in truth, Apple is asking the factories to keep running all day, every day, to make the order. In fact, an investigation by the Fair Labor Association in late 2013 found that while working conditions are improving, Foxconn facilities continue to require their workers to exceed the legal limits for overtime hours.

To keep its costs low, Apple also offers very slim profit margins to suppliers. In turn, these factories aim to reduce their own costs. Another Apple supplier thus began using a toxic chemical, instead of rubbing alcohol, to polish the screens of iPhones, because the chemical dries faster. But it exposes workers to the threat of paralysis and nerve damage.

The primary reason for these labor abuses may come only at the end of the supply chain—the consumer. A survey of Apple consumers showed that only 2 percent of them recognized labor issues as a concern. In a remarkably succinct summary of the challenge, another anonymous Apple executive asserted, "You can either manufacture in comfortable, worker-friendly factories, or you can reinvent the product every year, and make it better and faster and cheaper, which requires factories that seem harsh by American standards. And right now, customers care more about a new iPhone than working conditions in China."



Though Apple attempts to monitor its channel partners' behavior with regard to labor issues, sometimes abuses fall through the cracks.

Interdependence When supply chain members view their goals and ultimate success as intricately linked, they develop deeper long-term relationships. Interdependence between supply chain members that is based on mutual benefits is key to developing and sustaining the relationship.¹⁰ Walmart's suppliers recognize that without Walmart, their sales would be significantly less. Although certainly the more powerful member of the supply chain, Walmart also recognizes that it can depend on these suppliers to be a dependable source of supply, thus enabling it to have a very efficient marketing channel.

Credible Commitments Successful relationships develop because both parties make credible commitments to, or tangible investments in, the relationship. These commitments go beyond just making the hollow statement, “I want to be your partner”; they involve spending money to improve the products or services provided to the customer and on information technology to improve supply chain efficiency.¹¹ As our chapter opener described, Amazon and P&G have worked closely to set up their Vendor Flex program, enabling Amazon to operate fulfillment centers within P&G’s own warehouses and thereby lower transportation expenses.

Similar to many other elements of marketing, managing the marketing channel can seem like an easy task at first glance: Put the right merchandise in the right place at the right time. But the various elements and actors involved in a marketing channel create its unique and compelling complexities and require firms to work carefully to ensure they are achieving the most efficient and effective chain possible. We now turn our attention to how information and merchandise flow through marketing channels.

CHECK YOURSELF

1. What is the difference between an indirect and a direct marketing channel?
2. What are the differences among the three types of vertical marketing systems?
3. How do firms develop strong strategic partnerships with their marketing channel partners?



MAKING INFORMATION FLOW THROUGH MARKETING CHANNELS

L04 Describe the flow of information and merchandise in the marketing channel.

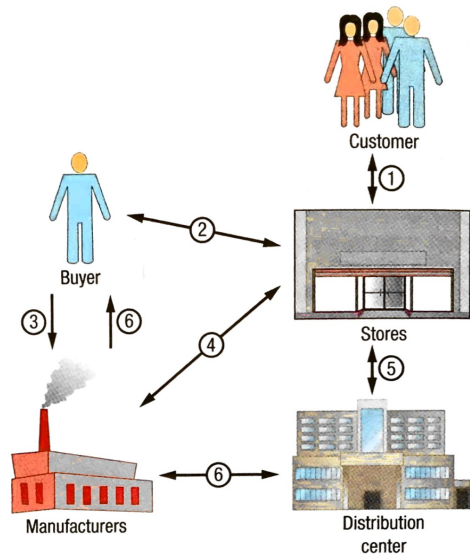
Information flows from the customer to stores, to and from distribution centers, possibly to and from wholesalers, to and from product manufacturers, and then on to the producers of any components and the suppliers of raw materials. To simplify our discussion—and because information flows are similar in other marketing channel links and B2B channels—we shorten the supply chain in this section to exclude wholesalers as well as the link from suppliers to manufacturers. Exhibit 16.7 illustrates the flow of information that starts when a customer buys a Sony HDTV at Best Buy. The flow follows these steps:

Flow 1 (Customer to Store): The sales associate at Best Buy scans the **Universal Product Code (UPC)** tag on the HDTV packaging, and the customer receives a receipt. The UPC tag is the black-and-white bar code found on most merchandise. It contains a 13-digit code that indicates the manufacturer of the item, a description of the item, information about special packaging, and special promotions.¹² In the future, RFID tags, discussed later in this chapter, may replace UPC tags.

Flow 2 (Store to Buyer): The point-of-sale (POS) terminal records the purchase information and electronically sends it to the buyer at Best Buy’s corporate office. The sales information is incorporated into an inventory management system and used to monitor and analyze sales and decide to reorder more HDTVs, change a price, or plan a promotion. Buyers also send information to stores about overall sales for the chain, ways to display the merchandise, upcoming promotions, and so on.

Flow 3 (Buyer to Manufacturer): The purchase information from each Best Buy store is typically aggregated by the retailer as a whole, which creates an order for new merchandise and sends it to Sony. The buyer at Best Buy may

EXHIBIT 16.7 Information Flows



also communicate directly with Sony to get information and negotiate prices, shipping dates, promotional events, or other merchandise-related issues.

Flow 4 (Store to Manufacturer): In some situations, the sales transaction data are sent directly from the store to the manufacturer, and the manufacturer decides when to ship more merchandise to the distribution centers and the stores. In other situations, especially when merchandise is reordered frequently, the ordering process is done automatically, bypassing the buyers. By working together, the retailer and manufacturer can better satisfy customer needs.



The flow of information starts when the UPC tag is scanned at the point-of-purchase.

Flow 5 (Store to Distribution Center): Stores also communicate with the Best Buy distribution center to coordinate deliveries and check inventory status. When the store inventory drops to a specified level, more HDTVs are shipped to the store, and the shipment information is sent to the Best Buy computer system.

Flow 6 (Manufacturer to Distribution Center and Buyer): When the manufacturer ships the HDTVs to the Best Buy distribution center, it sends an advanced shipping notice to the distribution centers. An **advanced shipping notice (ASN)** is an electronic document that the supplier sends the retailer in advance of a shipment to tell the retailer exactly what to expect in the shipment. The center then makes appointments for trucks to make the delivery at a specific time, date, and loading dock. When the shipment is received at the distribution center, the buyer is notified and authorizes payment to the vendor.

Data Warehouse

Purchase data collected at the point of sale (information flow 2 in Exhibit 16.7) goes into a huge database known as a data warehouse, similar to those described in Chapter 10. Using the data warehouse, the CEO can learn not only how the

corporation is generally doing but also look at the data aggregated by quarter for a merchandise division, a region of the country, or the total corporation. A buyer may be more interested in a particular manufacturer in a certain store on a particular day. Analysts from various levels of the retail operation extract information from the data warehouse to make a plethora of marketing decisions about developing and replenishing merchandise assortments.

In some cases, manufacturers also have access to this data warehouse. They communicate with retailers by using electronic data interchange (EDI) and supply chain systems known as vendor-managed inventory.

In information flows 3, 4, and 6 in Exhibit 16.7, the retailer and manufacturer exchange business documents through EDI. **Electronic data interchange (EDI)** is the computer-to-computer exchange of business documents from a retailer to a vendor and back. In addition to sales data, purchase orders, invoices, and data about returned merchandise can be transmitted back and forth. With EDI, vendors can transmit information about on-hand inventory status, vendor promotions, and cost changes to the retailer, as well as information about purchase order changes, order status, retail prices, and transportation routings. Thus EDI enables channel members to communicate more quickly and with fewer errors than in the past, ensuring that merchandise moves from vendors to retailers more quickly.

Vendor-managed inventory (VMI) is an approach for improving marketing channel efficiency in which the manufacturer is responsible for maintaining the retailer's inventory levels in each of its stores.¹³ By sharing the data in the retailer's data warehouse and communicating that information via EDI, the manufacturer automatically sends merchandise to the retailer's store or distribution or fulfillment center when the inventory at the store reaches a prespecified level.¹⁴

In ideal conditions, the manufacturer replenishes inventories in quantities that meet the retailer's immediate demand, reducing stockouts with minimal inventory. In addition to providing a better match between retail demand and supply, VMI can reduce the vendor's and the retailer's costs. Manufacturer salespeople no longer need to spend time generating orders on items that are already in the stores, and their role shifts to selling new items and maintaining relationships. Retail buyers and planners no longer need to monitor inventory levels and place orders.

CHECK YOURSELF

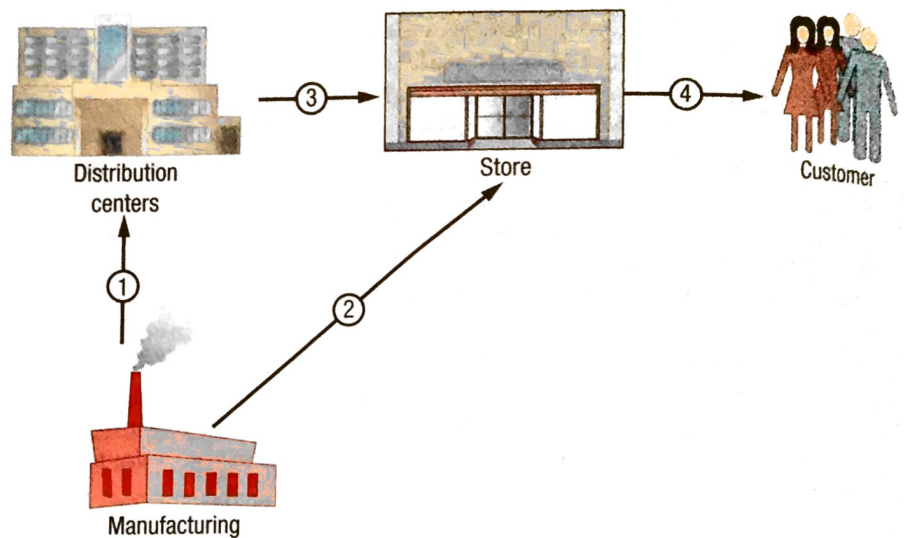
1. What are the marketing channel links associated with each information flow?
2. How do marketing channel members use data warehouses to make decisions?
3. What is EDI and how is it used?
4. Why do some marketing channels use VMI, while others do not?



MAKING MERCHANDISE FLOW THROUGH MARKETING CHANNELS

Exhibit 16.8 illustrates different types of merchandise flows:

1. Sony to Best Buy's distribution centers, or
2. Sony directly to stores.
3. If the merchandise goes through distribution centers, it is then shipped to stores,
4. and then to the customer.



Making merchandise flow involves first deciding whether the merchandise will go from the manufacturer to a retailer's distribution center or directly on to stores. Once in a distribution center, multiple activities take place before it is shipped on to a store.

Distribution Centers versus Direct Store Delivery

As indicated in Exhibit 16.8, manufacturers can ship merchandise directly to a retailer's stores—direct store delivery (flow 2)—or to their distribution centers (flow 1). Although manufacturers and retailers may collaborate, the ultimate decision is usually up to the retailer and depends on the characteristics of the merchandise and the nature of demand. To determine which distribution system—distribution centers or direct store delivery—is better, retailers consider the total cost associated with each alternative and the customer service criterion of having the right merchandise at the store when the customer wants to buy it.

There are several advantages to using a distribution center:

- More accurate sales forecasts are possible when retailers combine forecasts for many stores serviced by one distribution center rather than doing a forecast for each store. Consider a set of 50 Target stores, serviced by a single distribution center that each carries Michael Graves toasters. Each store normally stocks 5 units for a total of 250 units in the system. By carrying the item at each store, the retailer must develop individual forecasts, each with the possibility of errors that could result in either too much or too little merchandise. Alternatively, by delivering most of the inventory to a distribution center and feeding the stores merchandise as they need it, the effects of forecast errors for the individual stores are minimized, and less backup inventory is needed to prevent stockouts.
- Distribution centers enable the retailer to carry less merchandise in the individual stores, which results in lower inventory investments systemwide. If the stores get frequent deliveries from the distribution center, they need to carry relatively less extra merchandise as backup stock.
- It is easier to avoid running out of stock or having too much stock in any particular store because merchandise is ordered from the distribution center as needed.

- Retail store space is typically much more expensive than space at a distribution center, and distribution centers are better equipped than stores to prepare merchandise for sale. As a result, many retailers find it cost effective to store merchandise and get it ready for sale at a distribution center rather than in individual stores.

But distribution centers aren't appropriate for all retailers. If a retailer has only a few outlets, the expense of a distribution center is probably unwarranted. Also, if many outlets are concentrated in metropolitan areas, merchandise can be consolidated and delivered by the vendor directly to all the stores in one area economically. Direct store delivery gets merchandise to the stores faster and thus is used for perishable goods (meat and produce), items that help create the retailer's image of being the first to sell the latest product (e.g., video games), or fads. Finally, some manufacturers provide direct store delivery for retailers to ensure that their products are on the store's shelves, properly displayed, and fresh. For example, employees delivering Frito-Lay snacks directly to supermarkets replace products that have been on the shelf too long and are stale, replenish products that have been sold, and arrange products so they are neatly displayed.

Superior Service 16.1 explores how the two retail giants Amazon and Walmart are vying to win the same-day grocery delivery battle.

The Distribution (or Fulfillment) Center

The distribution center performs the following activities: management of inbound transportation; receiving and checking; storing, and cross-docking; getting merchandise floor ready; ticketing and marking; preparing to ship merchandise to store; and shipping merchandise to stores. Fulfillment centers perform the same functions, but because they deliver directly to customers, rather than to stores, they do not have to get merchandise floor ready. To illustrate these activities being undertaken in a distribution center, we'll continue our example of Sony HDTVs being shipped to a Best Buy distribution center.

Management of Inbound Transportation Traditionally, buyers focused their efforts, when working with vendors, on developing merchandise assortments, negotiating prices, and arranging joint promotions. Now, buyers and planners are much more involved in coordinating the physical flow of merchandise to stores. **Planners** are employees responsible for the financial planning and analysis of merchandise and its allocation to stores. The TV buyer has arranged for a truckload of HDTVs to be delivered to its Houston, Texas, distribution center on Monday between 1:00 and 3:00 p.m. The buyer also specifies how the merchandise should be placed on pallets for easy unloading.

The truck must arrive within the specified time because the distribution center has all of its 100 receiving docks allocated throughout the day, and much of the merchandise on this particular truck is going to be shipped to stores that evening. Unfortunately, the truck was delayed in a snowstorm. The **dispatcher**—the person who coordinates deliveries to the distribution center—reassigns the truck delivering the HDTVs to a Wednesday morning delivery slot and charges the firm several hundred dollars for missing its delivery time. Although many manufacturers pay transportation expenses, some retailers negotiate with their vendors to absorb this expense. These retailers believe they can lower their net merchandise cost and better control merchandise flow if they negotiate directly with trucking companies and consolidate shipments from many vendors.

Receiving and Checking Using UPC or RFID **Receiving** is the process of recording the receipt of merchandise as it arrives at a distribution center. **Checking** is the process of going through the goods upon receipt to make sure they arrived undamaged and that the merchandise ordered was the merchandise received.



Superior Service 16.1

Who Will Win the Same-Day Grocery Delivery War:
Amazon or Walmart?

Amazon has more than 89 fulfillment centers, with more to come. The complex machinery and supply chain mechanisms allow Amazon to ship out products in less than 2.5 hours from the time a customer clicks "Place Your Order." Yet, fulfillment center teams are always working to develop innovative ways to cut the time down even further. In addition to warehouse speed, these centers excel in proximity. Amazon has spent billions building centers closer and closer to customers.

Now Amazon is expanding its grocery delivery business, AmazonFresh. Previously available only in Seattle, Amazon sees AmazonFresh as the future of shopping. Customers can get whatever they want, whenever they want, wherever they want, and as fast as they demand it. During a recent launch in Los Angeles, customers enjoyed free trials of PrimeFresh, the upgraded version of Amazon Prime, including free shipping of products and free delivery of groceries for orders over \$35. In both Los Angeles and Seattle, Amazon maintains a fleet of Fresh trucks that deliver everything from full-course meals to chocolate from local merchants. As Amazon evolves into a same-day delivery service, its fleet could become yet another competitive advantage.

Yet AmazonFresh remains a challenge, mainly because of the differences associated with grocery products. It cannot ship milk the same way it ships diapers. Despite the tremendous logistical and economic hurdles to creating a same-day delivery service, Amazon hopes to expand its grocery customers and turn monthly customers to weekly or even twice weekly buyers.

In Mexico, Walmart has achieved the goal of same-day grocery delivery, where Superama, its high-end grocery chain, delivers groceries in as little as three hours. When Superama first began home delivery in 1993, managers would take orders by telephone or fax. As volume increased, it created a web page and then a mobile application that today accounts for approximately 20 percent of Superama's online orders. Such e-commerce has been a success, though Walmart also uses portable credit card terminals to limit customers' perceptions of the risk of typing in their card information online.



Walmart's Superama can profitably deliver groceries in Mexico, partly because the cost of doing so is much lower than in the United States

Much of this delivery success in Mexico is a result of the nation's densely populated urban areas. Demand is highest in Mexico City, which also accounts for much of Mexico's wealth. Due to traffic congestion and more dual-income families, demand for grocery deliveries is high, most of the deliveries are made by freelance drivers who get \$1.50 per delivery using their own transportation, rather than relying on a fleet of Walmart-owned trucks.

Walmart is betting big on the Mexican market as a "detonator for growth" and seeks to triple the number of stores offering grocery delivery in Mexico within a year. Superama's target market is households with income of \$3,000 a month, or 35 percent of the nation's population. As one of Walmart's largest foreign markets, Mexico contributes \$27 billion (or 6 percent) to the retailer's annual sales. Superama also has helped Walmart dominate the market (92 percent share) for online grocery shopping in Mexico.

Thus two retail giants have staked their claims, relying on their distinct capabilities. Considering the delivery cost advantages in Mexico and Amazon's head start in the United States, can Walmart catch its Internet-only rival in the U.S. same-day grocery delivery market? And just as important, how much does it need to do so?

In the past, checking merchandise was a very labor-intensive and time-consuming process. Today, however, many distribution systems using EDI are designed to minimize, if not eliminate, these processes. The advance shipping notice (ASN) tells the distribution center what should be in each carton. A UPC label or radio frequency identification (RFID) tag on the shipping carton that identifies the

carton's contents is scanned and automatically counted as it is being received and checked. **Radio frequency identification (RFID) tags** are tiny computer chips that automatically transmit to a special scanner all the information about a container's contents or individual products. Approximately as large as a pinhead, these RFID tags consist of an antenna and a chip that contains an electronic product code that stores far more information about a product than bar (UPC) codes can. The tags also act as passive tracking devices, signaling their presence over a radio frequency when they pass within a few yards of a special scanner. The tags have long been used in high-cost applications, such as automated highway toll systems and security identification badges. As the cost of the tags and implementation technology has decreased, their uses have become more prevalent in retail supply chain applications.



Walmart speeds merchandise from its distribution centers to stores.

Storing and Cross-Docking After the merchandise is received and checked, it is either stored or cross-docked. When merchandise is stored, the cartons are transported by a conveyor system and forklift trucks to racks that go from the distribution center's floor to its ceiling. Then, when the merchandise is needed in the stores, a forklift driver or a robot goes to the rack, picks up the carton, and places it on a conveyor system that routes the carton to the loading dock of a truck going to the store.

Using a **cross-docking distribution center**, merchandise cartons are prepackaged by the vendor for a specific store. The UPC or RFID labels on the carton indicate the store to which it is to be sent. The vendor also may affix price tags to each item in the carton. Because the merchandise is ready for sale, it is placed on a conveyor system that routes it from the unloading dock at which it was received to the loading dock for the truck going to the specific store—hence the name *cross-docked*. The cartons are routed on the conveyor system automatically by sensors that read the UPC or RFID label on the cartons. Cross-docked merchandise is in the distribution center only for a few hours before it is shipped to the stores.

Merchandise sales rate and degree of perishability or fashionability typically determine whether cartons are cross-docked or stored. For instance, because Sony's HDTVs sell so quickly, it is in Best Buy's interest not to store them in a distribution center. Similarly, cross-docking is preferable for fashion apparel or perishable meat or produce.

Getting Merchandise Floor-Ready For some merchandise, additional tasks are undertaken in the distribution center to make the merchandise floor-ready. **Floor-ready merchandise** is merchandise that is ready to be placed on the selling floor. Getting merchandise floor-ready entails ticketing, marking, and, in the case of some apparel, placing garments on hangers (or maybe attaching RFID chips). For the U.K.-based grocery chain Tesco, it is essential that products ship in ready-to-sell units so that it has little manipulation or sorting to do at the distribution center or in the stores. To move the store-ready merchandise it receives from suppliers quickly into the store, Tesco demands that products sit on roll cages rather than pallets. Then, store employees can easily wheel them onto the retail floor. The stores' backrooms only have two or three days' worth of backup inventory, and it is important to keep inventory levels low and receive lots of small, accurate deliveries from its suppliers—which also helps cut costs.¹⁵

Ticketing and marking refers to affixing price and identification labels to the merchandise. It is more efficient for a retailer to perform these activities at a distribution center than in its stores. In a distribution center, an area can be set aside and a process implemented to efficiently add labels and put apparel on hangers. Conversely, getting merchandise floor-ready in stores can block aisles and divert sales people's attention from their customers. An even better approach from the retailer's



Robots are often used to help prepare merchandise to be shipped to stores.

perspective is to get vendors to ship floor-ready merchandise, thus totally eliminating the expensive, time-consuming ticketing and marking process.

Preparing to Ship Merchandise to a Store At the beginning of the day, the computer system in the distribution center generates a list of items to be shipped to each store on that day. For each item, a pick ticket and shipping label is generated. The **pick ticket** is a document or display on a screen in a forklift truck indicating how much of each item to get from specific storage areas. The forklift driver goes to the storage area, picks up the number of cartons indicated on the pick ticket, places UPC shipping labels on the cartons that indicate the stores to which the items are to be shipped, and puts the cartons on the conveyor system, where they are automatically routed to the loading dock for the truck going to the stores. In some distribution and fulfillment centers, these functions are performed by robots.

Shipping Merchandise to Stores Shipping merchandise to stores from a distribution center has become increasingly complex. Most distribution centers run 50 to 100 outbound truck routes in one day. To handle this complex transportation problem, the centers use sophisticated routing and scheduling computer systems that consider the locations of the stores, road conditions, and transportation operating constraints to develop the most efficient routes possible. As a result, stores are provided with an accurate estimated time of arrival, and vehicle usage is maximized.

Inventory Management through Just-in-Time Inventory Systems

Marketing channel management offers the 21st century's answer to a host of distribution problems faced by firms. As recently as the early 1990s, even the most innovative firms needed 15 to 30 days—or even more—to fulfill an order from the warehouse to the customer. The typical order-to-delivery process had several steps: order creation, usually using a telephone, fax, or mail; order processing, using a manual system for credit authorization and assignment to a warehouse; and physical delivery. Things could, and often did, go wrong. Ordered goods were not available. Orders were lost or misplaced. Shipments were misdirected. These mistakes lengthened the time it took to get merchandise to customers and potentially made the entire process more expensive.

Faced with such predicaments, firms began stockpiling inventory at each level of the supply chain (retailers, wholesalers, and manufacturers), but keeping inventory where it is not needed becomes a huge and wasteful expense. If a manufacturer has a huge stock of items stuck in a warehouse, it not only is not earning profits by selling those items but also must pay to maintain and guard that warehouse.

Therefore, many firms, such as American Apparel, Zara, Mango, and Forever 21, have adopted a practice developed by Toyota in the 1950s (see the Zara case study at the end of this chapter). **Just-in-time (JIT) inventory systems**, also known as **quick response (QR) systems** in retailing, are inventory management systems that deliver less merchandise on a more frequent basis than traditional inventory systems. The firm gets the merchandise just in time for it to be used in



To reduce lead time, UPS works with adidas by providing it with special labeling, garments on hangers, and advanced shipping notices.

the manufacture of another product or for sale when the customer wants it. The benefits of a JIT system include reduced **lead time** (the amount of time between the recognition that an order needs to be placed and the arrival of the needed merchandise at the seller's store and is available for sale), increased product availability, and lower inventory investment.¹⁶

Reduced Lead Time By eliminating the need for paper transactions, the EDI in the JIT systems reduces lead time. Even better, the shorter lead times further reduce the need for inventory, because the shorter the lead time, the easier it is for the retailer to forecast its demand.

Increased Product Availability and Lower Inventory Investment In general, as a firm's ability to satisfy customer demand by having stock on hand increases, so does its inventory investment; that is, it needs to keep more backup inventory in stock. But with JIT, the ability to satisfy demand can actually increase while inventory decreases. Because a firm like American Apparel can make purchase commitments or produce merchandise closer to the time of sale, its own inventory investment is reduced. American Apparel needs less inventory because it's getting less merchandise in each order but receiving those shipments more often. Because firms using JIT order merchandise to cover shorter-term demand, their inventory is reduced even further.

The ability to satisfy customer demand by keeping merchandise in stock also increases in JIT systems as a result of the more frequent shipments. For instance, if an American Apparel store runs low on a medium-sized, red T-shirt, its JIT system ensures a shorter lead time than those of more traditional retailers. As a result, it is less likely that the American Apparel store will be out of stock for its customers before the next T-shirt shipment arrives.

Costs of a JIT System Although firms achieve great benefits from a JIT system, it is not without its costs. The distribution function becomes much more complicated with more frequent deliveries. With greater order frequency also come smaller orders, which are more expensive to transport and more difficult to coordinate. Therefore, JIT systems require a strong commitment by the firm and its vendors to cooperate, share data, and develop systems.

For more on JIT inventory systems, see the end-of-chapter case, "Zara Delivers Fast Fashion."

Quiz Yourself



- Which of the following is NOT one of the activities carried on in a distribution center?
 - Coordinating inbound transportation
 - Receiving, checking, storing, and cross-docking
 - Distributing paychecks and paystubs for retail employees
 - Getting merchandise floor ready
 - Coordinating outbound transportation
- When Cynthia's Boutique receives dresses, they already have price tags and are on hangers.

Cynthia's Boutique receives _____ merchandise.

- floor-ready
- repurposed
- just-in-time
- quick response
- horizontal channel

(Answers to these two questions can be found on page 652.)

Net Savvy

- Zappos.com, an online shoe seller, has received praise for its stellar supply chain management. Go to <http://about.zappos.com/zappos-story/fulfillment-facility>, read the "In the Beginning," "Looking Ahead," and "Customer Testimonial" sections, and see how a shoe ultimately reaches the customer. How does its fulfillment center enable Zappos to adhere to its marketing communications message and provide excellent customer service?
- The case study for this chapter examines how Zara International, a division of Inditex, successfully

manages its supply chain. Visit Inditex's website (<http://www.inditex.com>) and go to "Sustainability," then review the company's commitment to sustainable management, particularly the section that pertains to its Suppliers and the Code of Conduct for its suppliers. Considering the discussion in this chapter about strategic relationships, how does Inditex address the factors necessary for mutually beneficial partnerships, according to its code of conduct?

Chapter Case Study

ZARA DELIVERS FAST FASHION¹⁷

In the fast fashion retail business strategy, supply chain management processes serve to introduce fashionable merchandise rapidly, such that stores can respond immediately to customer demand for merchandise. This was pioneered by Zara, a global specialty apparel chain located in La Coruna, Spain, but it also has been adopted by other retailers, including American Apparel, H&M (headquartered in Sweden), TopShop (UK), and Forever 21 (United States).

The approach is particularly effective for specialty apparel retailers that target fashion-conscious consumers who simply must have the latest looks—but they want to do so on a very limited budget. These shoppers load up on new fast fashions every few weeks, instead of purchasing a few higher-priced basics every few months.

To fit with such short cycles and meet customers' demands, the fast fashion process starts with the receipt of timely information from store managers. At Zara, store managers always have their reporting devices literally in hand. These handheld devices, which are linked directly to the company's corporate office in Spain, enable daily reports on what customers are buying (or not) and what they are asking for but not finding.



Zara's competitive advantage in specialty apparel retailing is based on its efficient supply chain that delivers fashionable merchandise to its stores frequently.

For example, customers might want a purple version of a pink shirt that they see on the shop floor. Managers immediately pass the information on to the designers in Spain. Those designers then communicate electronically with the factory that produces fabric for shirts. This factory starts up its automated equipment, which is run by assemblers who live in close proximity to the factory. (The undyed fabric comes from Asia, where Zara finds inexpensive sources, and then bulk fabric ships to Spain and Portugal to be manufactured into apparel.) The robots in the company's 23 highly automated factories start cutting out shirts and mixing purple dye. For final construction, a network of 300 or so small assemblers, located near the factories in Galicia, Spain, and northern Portugal, take responsibility for making the final product. Finally, to ensure timely delivery, the shirts get shipped by truck to stores in Europe and by air express to stores in the rest of the world.

The Benefits of Fast Fashion for Zara

Zara's main advantage over its competitors, such as The Gap and H&M, has resulted from its highly responsive and tightly organized supply chain. Unlike these competitors, Zara selects factory locations that are in close geographic proximity to the company's headquarters in Spain. Although this approach increases labor costs, compared with outsourced production in lower-cost countries in Asia, it also improves communication, reduces shipping costs and time, and reduces the time before new fashions appear in stores. It also gives Zara the flexibility to modify its operations in one supply chain function to expedite processes in another, such as pricing or tagging. It might hang merchandise on racks in the warehouse so that store employees can move apparel directly from delivery to the sales floor. And it can do all this because it maintains complete control over the entire process.

Furthermore, instead of shipping new products a few times a season, as many of its competitors do, Zara makes deliveries to every one of its stores every few days. The purple shirts would be in stores in two weeks—compared with the

several months it would take for most department stores and other specialty apparel stores to accomplish the same feat. Because its fast fashion system also ensures shorter lead times, it's less likely that any Zara store will be out of stock before the next sweater shipment arrives. Limiting the stock in stores even can create a sense of scarcity among its customers. If they don't buy now, the item might not be available next time they visit the store. By producing and shipping in these small quantities, Zara can quickly recover from its (rare) fashion faux pas.

Finally, the efficiency of its supply chain means Zara rarely has to discount merchandise that is not selling. At Zara, the number of items that end up marked down is about half the industry average. Even with these results, Zara still manages to introduce around 10,000 new designs and 40,000 new SKUs each year.

Moving Too Fast? The Negative Effects of Fast Fashion

Despite some strong signals of success—including annual growth rates of approximately 20 percent in terms of sales and number of stores—Zara started to outgrow its own strategy. By their very nature, fashion trends change rapidly and constantly, and so must the merchandise on Zara's shop floors. Faced with disappointed customers, some sales managers ordered extra quantities of hot items, to avoid stockouts. Even with this attempt to circumvent the replenishment system, some stores still suffered from stockouts, because they received fewer units than they had ordered when overall demand exceeded inventory levels. For some items, Zara even confronted perhaps the most frustrating scenario in a supply chain: Inventory sat unused, eating up storage costs, at one location, even as another store desperately pleaded for the same inventory to meet its customers' demand.

As noted among the benefits, the company launches as many as 10,000 new styles annually, with a range of colors and sizes, resulting in hundreds of thousands of SKUs in the system. If we add in replenishment orders, which are received twice weekly, Zara's average shipping total reached nearly 2.5 million items per week, all coming from the company's distribution center. Its legendary supply chain efficiency thus was in danger of a clogged artery.

In response, Zara has adopted some new mathematical processes that turn human experience and mountains of data into actionable information. These models factor in store managers' unique requests for merchandise replenishments, together with historical trends in the sales of the same item. Merchandise display practices have been altered, such as removing all sizes of a garment from the sales floor if a popular size is not available. This practice helps reduce customer frustration, in that they never see an item that might not be available in their size. It also diminishes shipping; if the medium size is unavailable, the small and large sizes do not get shipped either. Instead, these remaining sizes head toward the stores that still have all sizes in stock, so they can be available to customers there.

Growth, costs, market demand, and technology advances all can push retail executives to rethink their business processes. But truly savvy managers search for ways to optimize operations, even when business is running smoothly. As Zara learned, current approaches will not necessarily work tomorrow. As the founder of Zara's corporate owner Inditex told the company's first deputy chair and CEO, "Once a month, come here thinking that we are near bankruptcy. You will find a lot of things to change."¹⁸

Questions

1. How does an individual firm like Zara manage a supply chain? How does it get new products from design to store so quickly?
2. What are some of the ways that Zara's supply chain management system has helped create value for its customers? Provide specific examples.
3. What challenges did Zara's focus on supply chain efficiency create? Are all such systems destined to suffer such "growing pains"?