Channel Structure and Strategic Choice in Distribution Channels

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Abstract

Though marketing in general has adopted a strategic orientation, little attention has been given to strategy choices within distribution channels. The importance of marketing channel strategy decisions is highlighted by 1) their inherent long-term consequences and 2) the constraints and opportunities that they represent. The present paper incorporates strategic management theory into marketing channels literatures to examine the impact of different channel structures on the choice of a generic channels strategy. Specifically, the contingent effects of channel power/control and the degree of vertical integration are examined as they affect the choice between the generic strategies of overall cost-leadership, differentiation, focus, and combination strategies. Propositions are developed to stimulate interest in this area.

Keywords: Distribution channels, strategic choice, competitive strategy

During the late 1970s and early 1980s, the position of marketing within most firms was eroded or displaced by developments in strategic planning (Day and Wensley 1983). The cause of much of this deterioration can be attributed to multiple factors, including: marketing's short-run orientation, a fixation on the brand-unit level of analysis, lack of rigorous competitive analysis, and the lack of an integrated strategic framework (Anderson 1982; Day and Wensley 1983; Wind and Robertson 1983). The advent of the 80s has required a significant evolution in planning practices that presented an opportunity for marketing to reassert itself as an important influence in organizational development (Gluck, Kaufman, and Walleck 1980). The emergence of this opportunity is due in part to marketing's adoption of a strategic management perspective.

The essence of the strategic management perspective is an integrated organizational emphasis on securing and sustaining a competitive advantage (Day and Wensley 1983). Researchers in the marketing discipline have begun to adopt this perspective, as evidenced by the emergence of research on environmental management (Zeithaml and Zeithaml 1984), strategic planning (Anderson 1982), competitive advantage (Day and Wensley 1988), the implementation of business strategies (Ruekert and Walker 1987), and strategy-performance relationships (McDaniel and Kolari 1987; McKee, Varadarajan and Pride 1989). This growing body of research suggests that the field of marketing is starting to realize its strategic role in ensuring the long-run success of firms.

Though the field of marketing, in general, has adopted a strategic perspective, one particular area, distribution channels, has been relatively slow to embrace this perspective. Besides research on the manipulation of power and influence attempts, little attention has been given to the study of channel strategies. The importance of marketing channel strategy decisions is highlighted by 1) their inherent long-term consequences and 2) the constraints and opportunities that they represent (Dwyer and Welsh 1985). The development of relationships in a marketing channel often takes a great deal of time and effort. Therefore, any decisions made concerning these relations take on added strategic importance. Given this, the incorporation of strategic management theory is

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very relevant to the study of distribution channels.

The intent of the present paper is to examine how one strategy concept, choice of a generic strategy, can be applied in a channel context. This will be accomplished by examining the contingent relationship between channel structure (e.g., transactional and bureaucratic form) and subsequent choice of a generic strategy. The basis of the discussion of strategy will be Porter's (1980) strategy typology, though supporting literature will also be used. It is hoped that the propositions developed within the paper will stimulate interest in applying strategy concepts in this complex area. The paper will first provide a brief discussion of the literature on channel structure. Next, an introduction to Porter's generic types, as well as a "combination" strategy, which has emerged within the management literature, is also provided. Then propositions are developed, based on relevant theoretical considerations and the implications of the study are discussed.

Development of Channel Structure

The marketing channels literature has given considerable attention to the study of channel structure. Early researchers discussed channel structure in terms of the functions performed by channel members (Mallen 1973). The basic idea was that these functions could be allocated in different mixes among the various channel members depending on the characteristics of the channel. As structure research evolved, several common elements emerged, which were seen as varying across different channels, including: the number of channel levels (i.e., number of intermediaries involved), the intensity at the various levels (the number of intermediaries at each level of distribution), and the types of intermediaries at each level (i.e., retailers, wholesalers, distributors) (Rosenbloom 1987). Thus, channel structure was essentially treated at a micro level, rather than examining the more macro issues such as: how firms decide who will perform what activities, the costs and trade-offs involved in using various channel strategies, and various extraneous factors affecting channel relations.

More recent research in channel structure examines both macro and micro issues. The majority of the current research on channel structure focuses on one of two broad operationalizations of structure: transactional form or bureaucratic form. Though it could be argued that the degree of relationalism also reflects the structure of the relationship, transactional form and bureaucratic form are the most widely accepted.

Transactional Form

Transactional form research flows from work done in the transaction costs analysis (TCA) area. Largely attributed to work done by Williamson (1979, 1981), this research is concerned with appropriate governance structures and whether particular activities should be performed internally or externally. For example, part of Stern and Reve's (1980) political economy paradigm examined the internal economic structure of the channel. This operationalization was concerned with decisions about the level of vertical integration present in a channel relationship. Several researchers have examined the costs and benefits of using vertically integrated channels (cf. Dwyer and Oh 1988; Heide and John 1988; Noordewier, *et al.* 1990). These researchers have shown that external (market) transactions are superior to internal (relational) ones when: (i) environmental uncertainty is low, (ii) there are low levels of transaction-specific assets required, (iii) there is a large numbers bargaining condition, and (iv) when performance assessment is straightforward (Reukert, Walker, and Roering 1985; Dwyer and Oh 1988; Heide and John 1988; Noordewier, *et al.* 1990).

Bureaucratic Form

The second commonly used operationalization of structure involves the examination of the bureaucratic form of the channel. Developed from Weber's (1974) notion of bureaucracy, this perspective examines such structural dimensions as centralization, formalization, and specialization/ differentiation as they relate to the performance of the channel (Reukert, Walker, and Roering 1985; Dwyer and Oh 1988; Stern and Reve 1980). The

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focus of this approach is on the power, authority, and control of the channel. It is generally hypothesized that the effectiveness, efficiency, and adaptiveness of the channel can be improved by increasing centralization, formalization, and specialization, respectively. Centralization refers to the extent to which decisions are shared within the channel system. Formalization involves the degree to which activities and social relationships are governed by rules, procedures, and contracts. Specialization/differentiation represents the degree to which tasks are divided into unique elements (Reukert, Walker, and Roering 1985).

Though this discussion of channel structure has presented each perspective separately, the most useful research effectively combines both perspectives (cf., Stern and Reve 1980; Dwyer and Oh 1988; and Reukert, Walker, and Roering 1985). Though this research is generally more explanatory in nature, it provides greater understanding of channel structure. Thus, the present paper will utilize aspects of both perspectives in developing propositions. Specifically, I will be concerned with how varying levels of vertical integration and power/control within the channel affect the choice of a generic strategy. Before developing propositions, I first need to provide a brief review of the strategy framework to be utilized.

The Strategic Framework

The work by Porter (1980, 1985) defines three generic strategies which firms might choose to pursue in order to establish a competitive advantage: overall low-cost leader (OLC), differentiation and focus. Competitive advantages accrue from a combination of firm strengths, industry structure, and the firm's ability to cope with five competitive forces (threat of new entrants, threat of substitutes, bargaining power of suppliers, bargaining power of buyers, and/or rivalry among existing firms). According to Porter (1985), a firm's competitive advantage combines with its scope of activities (competitive scope) to determine which of the three generic strategies the firm will choose. The generic strategy, will, in turn affect the performance of the firm.

Overall Low-Cost Leader

The OLC strategy stresses economies of scale, proprietary knowledge, preferential access to raw materials, aggressive pricing policies, cost minimization, stable product lines and other factors which lead the firm to become "the" low-cost producer or supplier in its industry (Porter 1980). Low-cost leaders tend to "concentrate on standard, no-frills products and place considerable emphasis on reaping scale or absolute cost advantages from all sources" (Porter 1985, p. 13).

Differentiation

Firms stressing the differentiation strategy seek to be unique in their industry along some dimensions that are widely valued by buyers (Porter 1985). The means of differentiation might include such things as emphasis on quality, product durability, service, and/or product or brand image. Firms, which often succeed at differentiation, are able to charge premium prices, thus becoming an above average performer within the industry.

Focus

The focus strategy rests on the choice of a narrow competitive scope within an industry (Porter 1985). The firm following this strategy selects a segment or subsection of an industry and sets a strategy to serve it better than anyone else in the industry. This focus on serving a particular segment well often come at the expense of not serving other segments. Thus, by exploiting a narrow segment of the industry, the firm must sacrifice potential earnings from the balance of the industry.

Combination Strategies

Porter (1985) states that each of his strategies is a "fundamentally different approach to creating and sustaining a competitive advantage". He also states that firms must choose between pursuing the overall low-cost strategy and the differentiation strategy because the two are generally incompatible. More recently, there has been a good deal of research concerning the potential for a combination

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strategy (e.g., Hall 1980; Phillips, Chang, and Buzzell 1983; Wright, Kroll, Tu, and Helms 1991a). This emergent research suggests that the OLC and differentiation strategies may not be incompatible, but rather synergistic.

Hall (1980) observed that in certain cases (though very rarely), the most successful firms simultaneously pursued both a differentiation and an OLC strategy. This study was supported by Phillips, Chang, and Buzzell (1983). These researchers found that stressing quality (a differentiation strategy) is not inconsistent with low costs. In fact, as quality increases, the firm may lower costs either through improved efficiency or through achieving economies of scale. Further support for a combination strategy is found in Wright, *et al.* (1991a). These authors examined the performance of firms stressing either differentiation, OLC, or some combination of the two. They found that when firms attempted a low-cost strategy and were unsuccessful, they tended to have the lowest performance. Interestingly, the firms with the highest performance followed a combination strategy. It appears that following a combination strategy allows firms to cope with changes in the industry better than those who focus on a single strategy.

The literature just discussed provides evidence that organizations may pursue more than one strategy at a time, thus allowing for a combination strategy. Therefore, the current paper will include four potential strategies from which firms might choose: OLC, differentiation, focus, and combination. The following section will develop propositions, which identify contingent channel conditions (differing structural issues), which affect the choice of a generic strategy.

Development of Propositions

A number of management researchers have put forth contingency approaches, identifying under what conditions each generic strategy is appropriate. For example, researchers have examined the contingent effects of industry type (Hambrick 1983; Hill 1988), firm size within an industry (Wright 1987), and ability to differentiate products (Hill 1988) on the success of a chosen strategy. Many of these articles provide support for the propositions developed here.

Vertical Integration and Strategy

As mentioned earlier, the decision of whether to perform tasks internally or externally is central to the development of channel structure. Here, it is argued that this decision is also crucial to the selection of a generic strategy. Research has shown that an external focus (i.e., low vertical integration) will be chosen when there is low environmental uncertainty, low levels of transaction-specific assets, and when performance assessment is straightforward (Dwyer and Oh 1988; Heide and John 1988; Noordewier, *et al.* 1990; Reukert, *et al.* 1985). It is felt that under these circumstances, the external orientation allows for more flexibility and efficiency, with minimal risk. However, when the environment is highly volatile and more prone to asset risk from things such as opportunism (Williamson 1979), the literature suggests that firms will become more internally oriented. The rationale for this is that risks can be reduced or offset by taking control of as many processes as possible. For example, by vertically integrating, firms can reduce the risk of resource shortages.

Research from the strategic management area can provide insight into what this means in terms of strategic choice. Wright, Kroll, Chan, and Hamel (1991b) view organizational strategy as a spectrum ranging from internal orientation to external orientation. On the internal end, are cost minimization, low cost leader, and defender strategies, consistent with the vertically integrated firm? At the other end of the continuum are maximizing, prospecting, and differentiating strategies, consistent with the nonintegrated firm. This research indicates that when firms are internally focused, they incur lower costs due to the emphasis on stable technologies and efficient operations (Wright, *et al.* 1991b; Segev 1989). The emphasis on lower costs allows the firm to establish itself as the low-cost leader in the industry. Thus, internally focused (highly

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integrated) firms are more likely to exhibit characteristics of a low-cost leader.

On the other hand, firms, which are externally focused, tend to be more technologically active, with higher costs and more innovative outputs (Wright, *et al.* 1991b; Segev 1989). This emphasis on technological advancement and innovative outputs allows a firm to position itself in many different ways. Firms might choose to differentiate themselves in terms of high quality, premium features, technological leadership, etc. When the firm achieves this sort of differentiation, it is better able to attain higher returns. Thus, firms, which are externally focused, are better able to concentrate on differentiating themselves from the rest of the industry.

In terms of a combination strategy, there is evidence to suggest that firms, which generate high growth and high profits, are better equipped to use both a differentiation and an OLC strategy (Hambrick 1983; Hill 1988). For example, Wright (1987) suggests that larger firms in an industry are in a better position to choose between OLC and differentiation strategies. In other words, both OLC and differentiation strategies are available to firms with high profitability and market share (Wright 1987). If we look at this in relation to the degree of vertical integration, one would expect that firms, which are moderately integrated, would be better able to implement a combination strategy than firms at either extreme. The reason is that firms, which have the low cost focus of an integrated firm and the ability of the nonintegrated firm to differentiate, are able to reap synergistic benefits (Phillips, *et al.* 1983). Research suggests that firms stressing high quality are able to minimize costs through improved efficiency, while simultaneously differentiating themselves as a premium product company. When combined, these strategies produce enhanced economies of scale and improved ROI. The end result being stronger market positions. Thus, firms which are moderately integrated are better able to implement a combination strategy. On the basis of this discussion, the following propositions are developed:

P1: Firms which are highly vertical integrated are more likely to choose an OLC strategy.

P2: Firms with low levels of integration are more likely to choose a differentiation strategy.

P3: Firms which are moderately integrated are better able to choose a combination strategy.

Power/Control and Strategy

The phenomenon of power and control is one of the most frequently examined topics in the marketing channels literature. Researchers have long sought to understand how different relationships and power structures within the marketing channel affect the decisions of channel members (cf. Bucklin 1973; Gaski 1984; Pondy 1967). Power is generally seen as the ability of one channel member to change another's behavior, thereby controlling the decision variables of the other member (Gaski 1984; Stern and El-Ansary 1977). Some researchers take the position that power is necessarily a negative aspect in that, those who possess it will attempt to influence exchange partners by use of coercive influence strategies (Frazier and Summers 1986; Robicheaux and El-Ansary 1975). Other researchers stress that power can be a good thing in that it creates natural divisions and coordination among channel members (Frazier and Summers 1986).

It is clear from a review of the literature that the distribution of power in the channel is seldom symmetrical. It is generally the case that one side of the exchange possesses some degree of power or control over the other. This power rests explicitly on the fact that the partners are not always equally dependent on one another. Although the partners are mutually dependent to some degree, one partner will generally be more dependent than the other. When this asymmetrical situation arises, the decisions of both the parties will be affected.

Porter (1980) suggests that when buyers have power over suppliers (as in the case of retailing giant Wal-Mart over its suppliers), they will attempt to play suppliers against each other, inducing price

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competition. When suppliers have no alternative outlet for their products (e.g., transaction-specific assets), Williamson (1979) says that buyers will take advantage and seek maximal personal gain. When this occurs, the supplier has two alternatives: focus or differentiation.

If the firm chooses a focus strategy, it will attempt to "own" a particular market segment either through price leadership or differentiation (Porter 1980). If the firm chooses to focus on price, it will attempt to offer the lowest prices for a specific segment. If the supplier chooses a differentiated focus, it will attempt to serve a particular segment especially well (e.g., service quality). The second alternative is to attempt an industry-wide differentiation strategy. Here the firm would attempt to position itself as a premium product relative to competition by emphasizing such value enhancing factors as quality, service, innovation, and/or brand image. The difference between this strategy and the focus strategy is the fact that focus concentrates on a particular segment, while this strategy is industry-wide.

The choice between these two strategies is likely to depend on the scope of the supplier's activities (Davis, Robinson, and Pearce 1991a). Small firms which are essentially regional in competitive (market) scope will have a hard time creating any sort of differentiation for themselves on a national level. For example, a small aerospace firm may be unable to differentiate itself in such a large, capital-intensive industry. However, it can do quite well as a supplier of high quality, precision machine work to national suppliers. Davis, *et al.* (1991a) suggests that these firms should follow an OCL strategy in order to facilitate growth, eventually leading to the ability to compete on a national basis. In other words, due to lack of breadth and the inability to achieve economies of scale, small firms will be more effective at concentrating on a particular segment of the industry.

Supplier firms with a national competitive scope, on the other hand, will be much better able to differentiate themselves in the overall market. Due to their ability to achieve economies of scale, they will be able to compete on the basis of differentiation (Davis, *et al.* 1991a). While these firms are able to compete on an OLC strategy, there is not much incentive to do so. The reason is that, with rare exception, most of the firms, which compete on a national level in a given market, are equally capable of competing on price. However, firms are generally reluctant to undercut the competition due to the fact that any gains realized will be short-lived due to counter actions by competitors. When competing firms counter the low cost leader strategy, firms must eventually turn to some form of differentiation or suffer long-run consequences for the industry (the "cola wars" are an excellent example of this). Thus, once meeting some minimum level of price competition, firms will choose a differentiation strategy. For example, in the highly competitive market for military aircraft, price is usually fairly close for all suppliers. Therefore, the only way that a large supplier of military aircraft can combat the power of military buyers is by differentiating itself on the basis of technology. Given this logic, the following propositions are developed:

P4: When faced with the superior power of buyers, suppliers with a national competitive scope will attempt to combat the power of buyers by choosing a differentiation strategy.

P5: When faced with the superior power of buyers, suppliers with a regional competitive scope will attempt to combat the power of buyers by choosing a focus strategy.

In asymmetrical power settings, it is also possible for suppliers to have control over buyers, as in the case of suppliers of scarce natural resources to buyers. This power is based on the supplier's ability to charge higher prices, reduce service, and/or govern contracts. When buyers have no alternative sources for the resources mediated by suppliers or when asset-specific investments make switching costs prohibitively high (Williamson 1979), buyer dependency on the supplier is increased. Thus, buyer dependency leads to enhanced supplier control.

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Davis, Schul, and Hartline (1991b) suggest that firms dealing with high supplier power tend to look toward vertical integration, elimination of switching costs, and maximization of throughput in order to reduce the dependency on specific suppliers. Research on the reduction of opportunism in Distribution channels supports this contention (Dwyer and Oh 1988; John 1984; Williamson 1979). The general consensus is that a firm must either vertically integrate or make offsetting investments in order to protect itself from the opportunistic behavior (such as price gouging) by exchange partners.

As discussed in the section on vertical integration, the pursuit of tactics such as integration, cost reductions, and reliance on standardization of practices, is consistent with an overall low-cost leader strategy. In fact, Davis, *et al.* (1991b) and Jackson (1985) both suggest that by standardizing inputs, the cost leader can substantially reduce its switching costs and thus, reduce its dependency on a particular supplier (Davis, *et al.* 1991b; Jackson 1985). However, it would seem impossible to implement a low-cost leadership strategy while being subject to potential supplier pressures in terms of price gouging and restriction of supply. In other words, if suppliers charge high prices there is no way for buyers to pursue a low-cost strategy and remain profitable.

A more feasible alternative for buyers is to make themselves more desirable to suppliers. The channel literature suggests that the superior power of suppliers can be offset when there are munificent (rich) markets (Dwyer and Oh 1987). The reason for this is that in high growth markets, with high profit potential, suppliers see dealers as a means of enhancing their own performance, and are willing to work more closely with dealers to reap greater rewards. Additional support for this contention is provided by Heide and John (1988). These authors suggest that when vertical integration is not feasible, firms can offset the risk of opportunism by developing relational ties with the stronger firm. When such offsetting investments are used, power becomes more symmetrical. Based on these considerations, it seems that the best alternative for weak buyers would be to focus on creating a munificent market to serve. The only way to do this would be through a differentiated focus strategy. Dwyer and Oh (1988) suggest that small firms (analogous here to weak buyers) are relatively incapable of vertical integration and price competition on a national basis. However, these firms can focus on the development of highly profitable market niches. Based on the findings of Dwyer and Oh (1987), creation of these high profit niches should then make the buyer more desirable to suppliers, thereby offsetting the power imbalance. Based on this logic, the following proposition is developed.

P6: When faced with high levels of supplier power, buying firms will emphasize on a differentiated focus strategy.

Conclusions

The literature on marketing channels has given a good deal of time and effort to understanding the many interrelationships, which develop between channel members. In this effort, topics such as channel structure, power/conflict, environmental issues, and relational dimensions have been studied thoroughly. However, the concept of channel strategy has received little attention. This paper has attempted to show how the concepts developed in strategic management can be used in a distribution channels context. In this endeavor, relevant channel structural issues, which affect the generic strategy choices of channel members, have been discussed. Specifically, the contingent effects of channel power/control and the degree of vertical integration have been examined as they affect the choice between the generic strategies of overall cost-leadership, differentiation, focus, and combination strategies.

The development of contingent propositions is meant to show the interrelationship of channel structure and subsequent channel strategies. The implication to be drawn from this paper is that firms will choose different strategies under different channel conditions. Though this appears fairly intuitive, it has not been addressed in the

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channels literature. This is unfortunate because it might hold insight as to why firms within the same channel behave differently. The choice of a generic competitive strategy could offer additional understanding in this area. Though this paper is only a starting point in the merger of channels and strategic management, I hope that the paper has provided some degree of progress towards its intended purpose.

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