

Chapter 4: Make-or-Buy Channel Analysis

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LEARNING OBJECTIVES

- Understand vertical integration as a continuum from make to buy rather than as a binary choice.
- Explain why channel players (manufacturers, wholesalers, retailers) often integrate forward or backward with great expectations, only to divest themselves within a few years.
- Frame vertical integration decisions according to whether owning the channel, or some of its functions, improves long-term returns on investment.
- Recognize why outsourcing should be the base case for a market channel, rather than vertical integration.
- Define six categories of company-specific capabilities.

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INTRODUCTION

- *Should a firm vertically integrate by performing both upstream and downstream functions?*
- *In other words,*
 - *Who should perform different channel functions?*
 - *Should it be a single organization (manufacturer, agent, distributor, retailer—all rolled into one)?*
 - *Should distribution functions be outsourced (upstream looking down)?*
 - *Should production be outsourced (downstream looking up), or neither, such that manufacturers and downstream channel members remain separate entities?*

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INTRODUCTION

- When the manufacturer integrates a distribution function, (making sales, fulfilling orders, offering credit), its employees do the work, and manufacturer has integrated forward or downstream from the point of production.
- Vertical integration also can begin from a downstream position, thereby integrates backward.
- Whether the manufacturer integrates forward or the downstream channel member integrates backward, the result is that one organization does all the work, and *the channel is vertically integrated.*

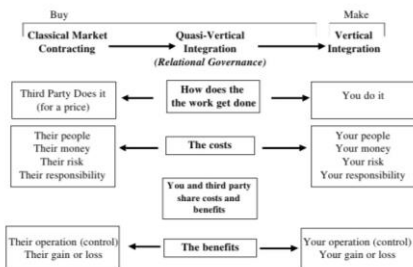
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INTRODUCTION

- Managers need a structured way to analyze their make-or-buy issues that provides them with a coherent, comprehensive, easily communicated rationale for their decisions.

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Degrees of Vertical Integration



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Example of institutions performing channel functions

Function	Classical Market Contracting	Quasi-vertical Integration	Vertical Integration
1) Selling (only)	Manufacturers' Representatives	"Captive" or Exclusive Sales Agency*	Producer Sales Force (direct sales force)
2) Wholesale Distribution	Independent Wholesaler	Distribution Joint Venture	Distribution Arm of Producer
3) Retail Distribution	Independent (3rd party)	Franchise Store	Company Store

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Costs and Benefits of Make-or-Buy Channels

- Distribution **costs**: personnel, transportation, warehousing, and so on
- The **risk** of the distribution operation and
- The **responsibility** for all actions in the channel
- Desire to **control** the operation
- Improve **economic profits**

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Payment Options for Buying Marketing Channels

- Price might be expressed as a margin (i.e., the difference between the price ultimately paid and the reseller's "cost of goods sold"), a commission (fraction of the resale price), or a royalty (percentage of the reseller's business).
 - A flat fee or lump sum, or else get reimbursed for its expenses, such as through a functional *discount*.
 - *Future consideration*

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MAKE-OR-BUY CHANNEL OPTIONS: THE BUYING PERSPECTIVE

- The fundamental rationale holds that, under normal circumstances *in developed economies*, markets for distribution services are efficient
- The efficient markets argument also does not mean that all manufacturers receive the same downstream services.

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Six Reasons to Outsource Distribution

1. Motivation
2. Specialization
3. Survival of the economically fittest
4. Economies of scale
5. Heavier market coverage
6. Independence from any single manufacturer

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MAKE-OR-BUY CHANNEL OPTIONS: THE MAKING PERSPECTIVE

- First, vertical integration always entails substantial set-up costs and overhead.
- Second, vertical integration is only worth considering if the firm is prosperous enough to muster the necessary.

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Six Company-Specific Distribution Capabilities

Six major forms:

1. Idiosyncratic knowledge
2. Relationships
3. Brand equip- derived from the channel partner's activities
4. Customized physical facilities
5. Dedicated capacity
6. Site specificity

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THE END!

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