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?

LO 15-4 Describe the flow of information and merchandise in the marketing channel.

MAKING INFORMATION FLOW THROUGH MARKETING CHANNELS

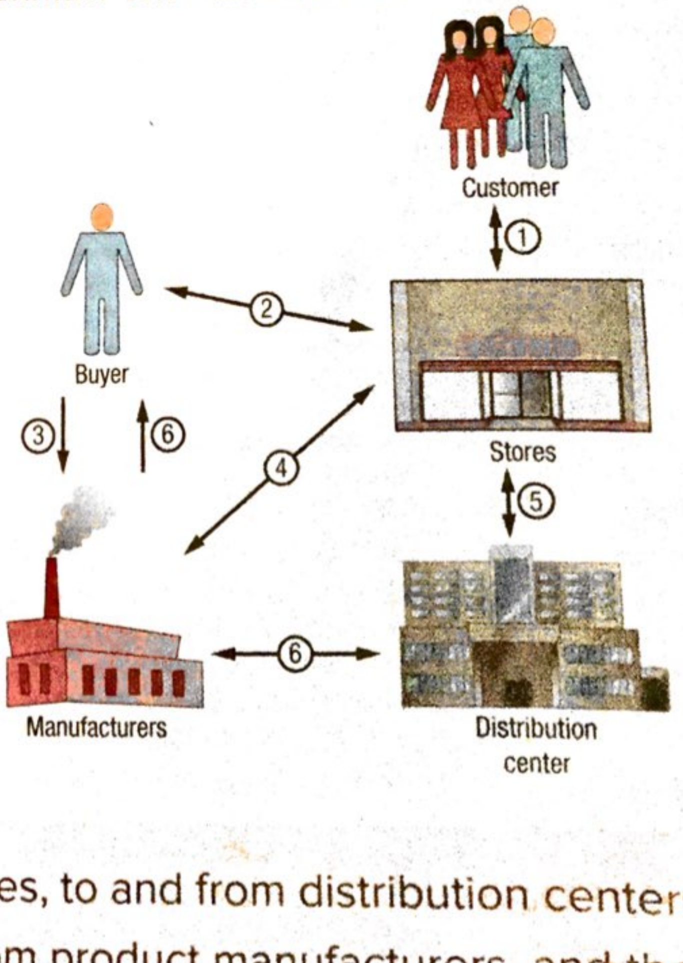
Information flows from the customer to stores, to and from distribution centers, possibly to and from wholesalers, to and from product manufacturers, and then on to the producers of any components and the suppliers of raw materials. To simplify our discussion—and because information flows are similar 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 15.7 illustrates the flow of information that starts when a customer buys a Sony HDTV at Best Buy. The flow follows these steps:

Universal Product Code (UPC) The black-and-white bar code found on most merchandise.

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.

▼ **EXHIBIT 15.7** Information Flows



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.

advanced shipping notice (ASN) 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.

electronic data interchange (EDI) The computer-to-computer exchange of business documents from a retailer to a vendor and back.

vendor-managed inventory (VMI) An approach for improving supply chain efficiency in which the manufacturer is responsible for maintaining the retailer's inventory levels in each of its stores.

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 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.

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 15.7) goes into a huge database known as a data warehouse, similar to those described in Chapter 10. Using the data warehouse, the CEO not only can learn how the corporation is generally doing but also can 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 15.7, 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]

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

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

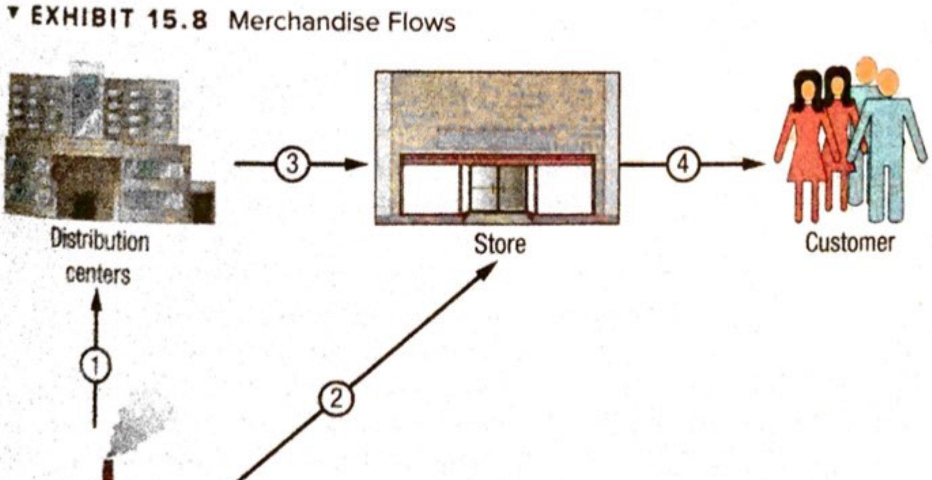
1. What are the marketing channel links associated with each information flow?
2. How do marketing channel members use data warehouses to make decisions?
3. What is EDI and how is it used?
4. Why do some marketing channels use VMI, while others do not?

MAKING MERCHANDISE FLOW THROUGH MARKETING CHANNELS

Exhibit 15.8 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.

EXHIBIT 15.8 Merchandise Flows



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 15.8, 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 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.

Some retail chains, such as Home Depot or Costco, function as both retailers and wholesalers.

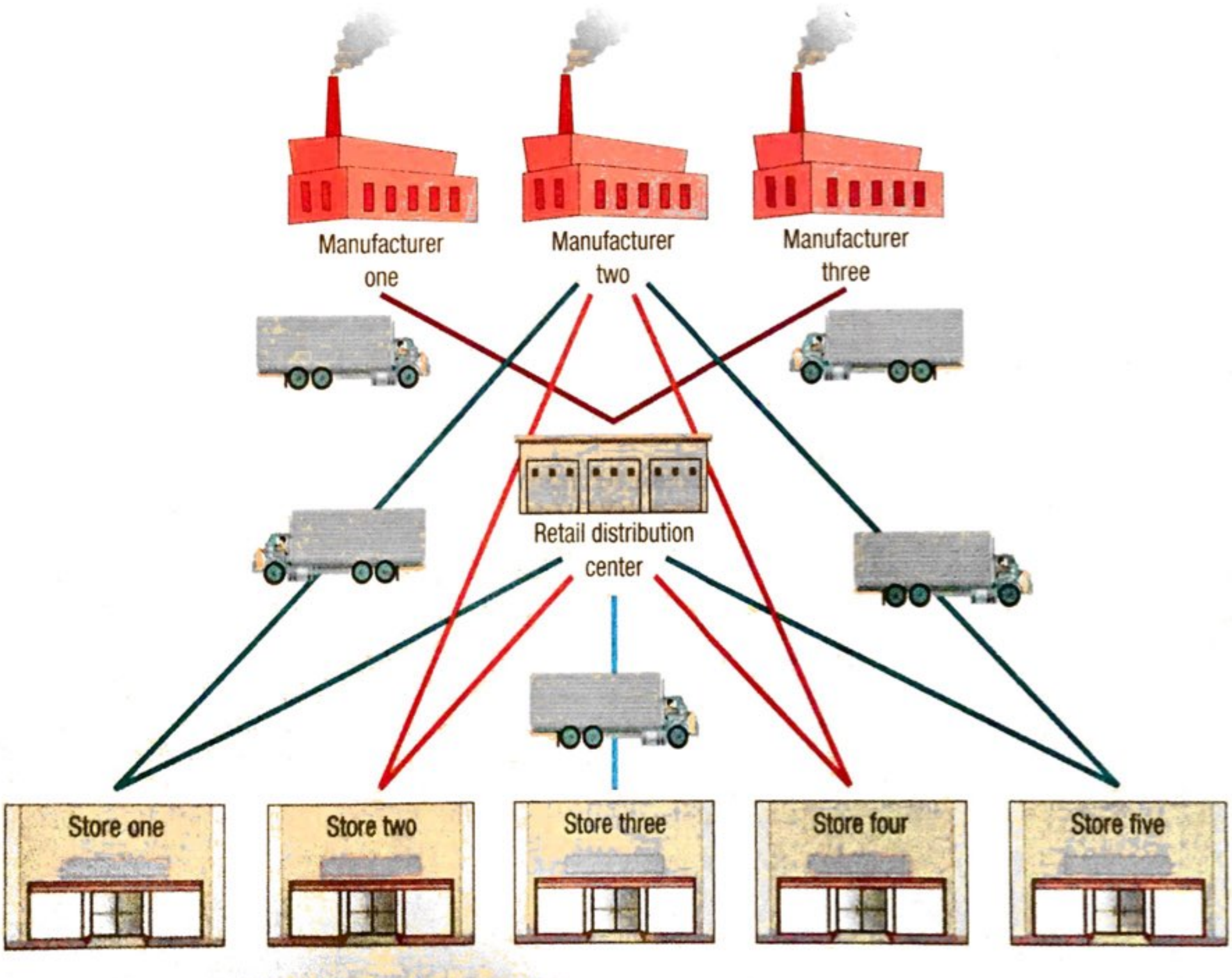
In the simplified supply chain in Exhibit 15.1, manufacturers make products and sell them to retailers or wholesalers. The exhibit would be much more complicated if we had included the suppliers of materials to manufacturers and all the manufacturers, wholesalers, and stores in a typical marketing channel.

Exhibit 15.1 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

▼ **EXHIBIT 15.1** Simplified Supply Chain



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

stock/Alamy RF

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.

A facility for the receipt, storage, and redistribution of goods to company stores or customers, may be operated by retailers, manufacturers, or distribution specialists.

fulfillment center
Warehouse facilities used to ship merchandise directly to customers.

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.

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.”

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

LO 15-2 Understand the difference between direct and indirect marketing channels.

DESIGNING 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

marketing channel The manufacturer sells directly to the buyer.

indirect marketing channel When one or more intermediaries work with manufacturers to provide goods and services to customers.

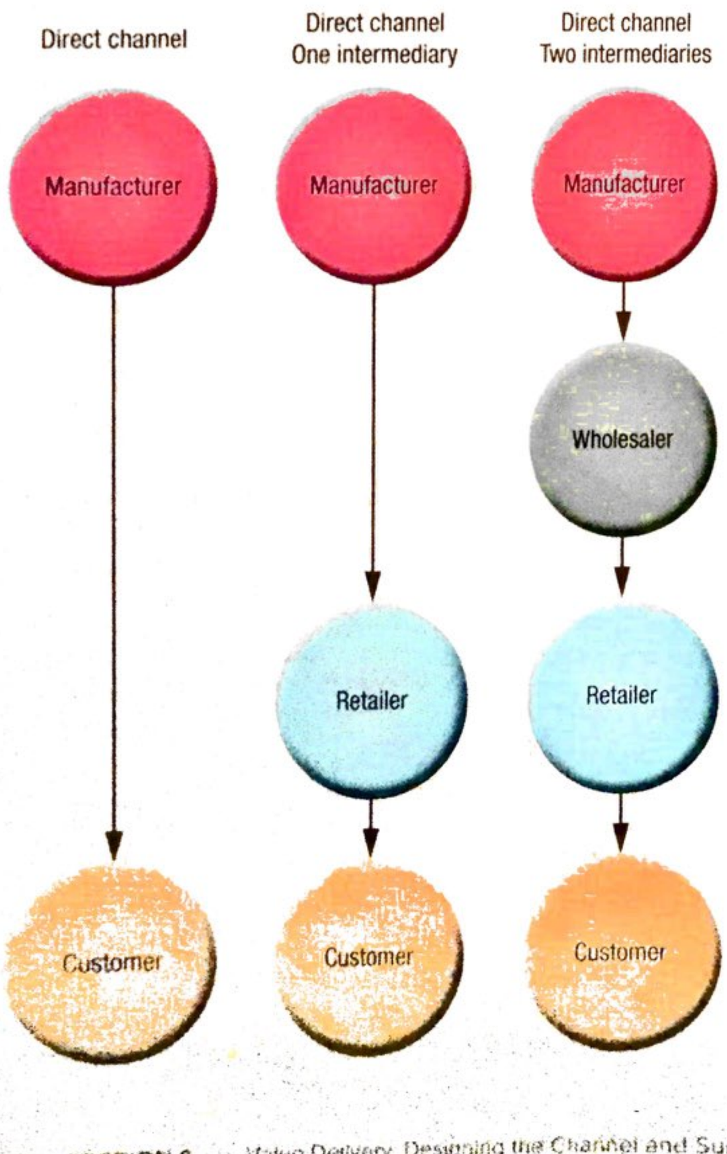
the option of carrying all the manufacturer lines it wants because other competing retailers in its market area might carry the same products. On the other side, a small specialty sporting goods apparel manufacturer may not be able to place its products in major stores like Sports Authority because its line is unproven, and the products might duplicate lines that the retailer already carries. Chapter 16 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 on the left side of Exhibit 15.2, 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).

▼ **EXHIBIT 15.2** Direct and Indirect Channel Strategies



Indirect Marketing Channel

In **indirect marketing channels**, one or more intermediaries work with manufacturers to provide goods and services to customers. In some cases, 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 15.2. The right side of Exhibit 15.2 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.

LO 15-3 Describe how marketing channels are managed.

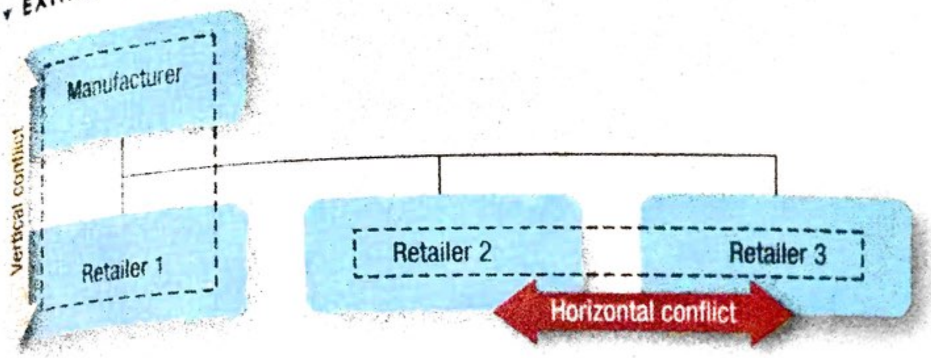
MANAGING THE MARKETING CHANNEL AND SUPPLY CHAIN

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

▼ EXHIBIT 15.3 Vertical versus Horizontal Channel Conflict



vertical channel conflict A type of channel conflict in which members of the same marketing channel, for example, manufacturers, wholesalers, and retailers, are in disagreement or discord.

horizontal channel conflict A type of channel conflict in which members at the same level of a marketing channel, for example, two competing retailers or two competing manufacturers, are in disagreement or discord, such as when they are in a price war.

have conflicting goals, and this may result in channel conflict (Exhibit 15.3). 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.

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 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 fulfilment 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.

With a common goal, both firms have the incentive to cooperate because they know that by doing so, each will boost its sales.

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

Courtesy The Stanley Works

independent (conventional) marketing channel A marketing channel in which several independent members—a manufacturer, a wholesaler, and a retailer—each attempts to satisfy its own objectives and maximize its profits, often at the expense of the other members.

vertical marketing system A supply chain in which the members act as a unified system; there are three types: *administered*, *contractual*, and *corporate*.

administered vertical marketing system A *supply chain* system in which there is no common ownership and no contractual relationships, but the dominant channel member controls the channel relationship.

power A situation that occurs in a marketing channel in which one member has the means or ability to have control over the actions of another member in a channel at a different level of distribution, such as if a retailer has power or control over a supplier.

reward power A type of marketing channel power that occurs when the channel member exerting the power offers rewards to gain power, often a monetary incentive, for getting another channel member to do what it wants it to do.

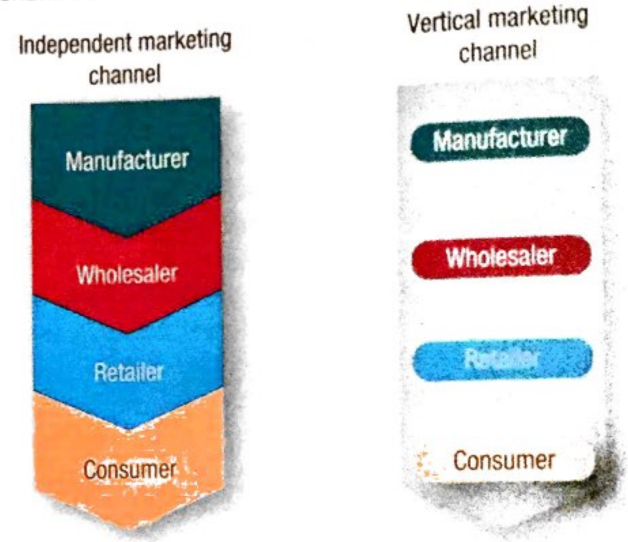
In this sense, their partnership exhibits both of the non–mutually exclusive ways that exist to manage a marketing channel or supply chain: Coordinate the channel using a vertical marketing system and develop strong relationships with marketing channel partners—topics we now examine.

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 objectives and maximize their profits, often at the expense of the other members, as we portray in Exhibit 15.4 (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.

▼ **EXHIBIT 15.4** Independent versus Vertical Marketing Channels



THE MORE FORMAL THE VERTICAL MARKETING SYSTEM, THE LESS LIKELY CONFLICT IS TO ENSUE.

Amazon and Procter & Gamble recognize that it is in their common interest to remain profitable business partners.
© Daniel Mihailescu/AFP/Getty Images

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 15.4 (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.

coercive power Threatening or punishing the other channel member for not undertaking certain tasks. Delaying payment for late delivery would be an example.

referent power A type of marketing channel power that occurs if one channel member wants to be associated with another channel member. The channel member with whom the others wish to be associated has the power and can get them to do what they want.

expertise power When a channel member uses its expertise as leverage to influence the actions of another channel member.

information power A type of marketing channel power within an administered vertical marketing system in which one party (e.g., the manufacturer) provides or withholds important information to influence the actions of another party (e.g., the retailer).

legitimate power A type of marketing channel power that occurs if the channel member exerting the power has a contractual agreement with the other channel member that requires the other channel member to behave in a certain way. This type of power occurs in an administered vertical marketing system.

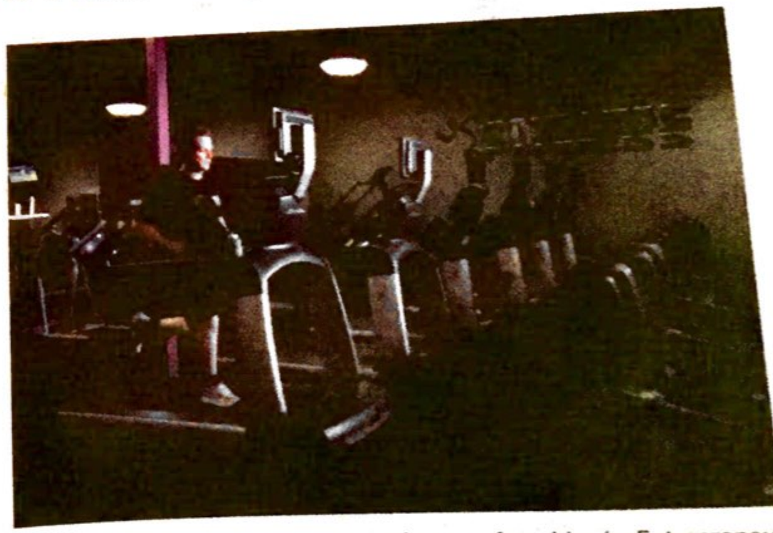
Administered Vertical Marketing System The Walmart–PenAgain marketing channel relationship offers an example of an **administered vertical marketing system**: There is no common ownership or contractual relationships, but the dominant channel member controls or holds the balance of power. Because of 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 15.5). 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 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

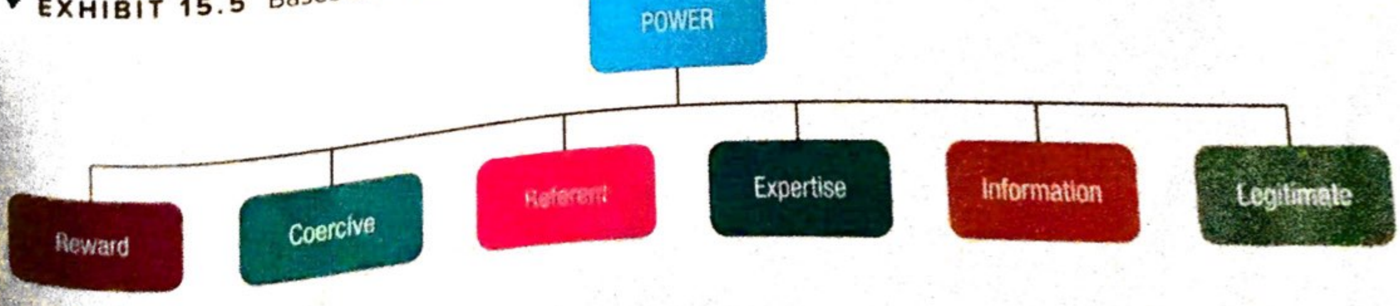
contractual vertical marketing system A system in which independent firms at different levels of the supply chain join together through contracts to obtain economies of scale and coordination and to reduce conflict.

franchising A contractual agreement between a *franchisor* and a *franchisee* that allows the franchisee to operate a business using a name and format developed and supported by the franchisor.



Anytime Fitness was ranked the number one franchise by Entrepreneur *magazine in 2014.*
© Bryan Mitchell/AP Photo

▼ **EXHIBIT 15.5** Bases of Power



corporate vertical marketing system ystem in which the ent company has nplete control and can tate the priorities and ectives of the supply ain; it may own facilities ch as manufacturing nts, warehouse facilities, ail outlets, and design dios.

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 15.6 lists the United States' 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.

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.

▼ EXHIBIT 15.6 Top 10 Franchises for 2014

Rank	Franchise Name	Number of U.S. Outlets	Start-Up Costs
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–1.63M
7	**Servpro** Insurance/disaster restoration and cleaning	1,614	$134.8K–183.44K
8	**Denny's Inc.** Family restaurant	1,697	$1.17M–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, http://www.entrepreneur.com.

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.

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 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.

marketing

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