

Choose the Channel that Matches Your Product

As products mature, their market profiles change — and so should your route to customers

BY SUNIL CHOPRA

OVER THE LAST YEAR DELL'S STOCK PRICE HAS FALLEN by more than 30 percent while its rival, Hewlett-Packard (HP), has enjoyed a much healthier market performance. Does this mean that the direct sales model made famous by Dell is in decline?

The answer is yes and no. Dell still derives significant competitive advantage from customizing products and selling direct to buyers. On the other hand, this market is shrinking and the beneficiaries are companies like HP that sell through third-party channels such as retail chains.

This shift has occurred because customer needs and associated supply chain costs — elements that are aligned in a successful go-to-market strategy — have changed in the mature PC business. A hybrid model that embraces both direct and reseller channels now looks to be a better option for Dell. For all companies, generally the lesson is that your choice of sales channel should depend on the type of product you are selling and its level of maturity.

Channel trade-offs

Retail stores are effective at responding quickly to customer needs since product that is in stock is instantly available and backed up with sales support. However, retailers find it much more difficult to carry a wide variety of products in inventory because of the high costs involved. Stores have high facility and inventory costs but usually lower transportation costs because deliveries to outlets can be aggregated.

In contrast, the direct channel, with its more centralized storage of inventories, has different strengths and weaknesses. For example, Amazon.com cannot provide a book as quickly as a neighborhood Borders store, but it offers access to a richer selection of books. Centralized storage allows Amazon to have much lower facility and inventory costs than Borders (Amazon turns its inventories about 12-14 times per year, whereas Borders turns its inventory around twice a year) but Amazon also incurs much higher transportation costs.

Clearly, the direct online channel is most appropriate when facility and inventory costs are important and the customer values variety. Stores excel when the customer wants responsiveness, and inventory costs are less significant than transportation costs.

The key point is that both customer needs and supply chain costs are influenced by the type of product being

sold and its position along its life cycle. Thus, companies cannot select one channel and expect it to always be successful. Success only follows if the strengths of the channel and the product and market characteristics are appropriately aligned.

PC market dynamics

Applying the above logic to the PC and consumer electronics industry in the context of Dell sheds light on the computer maker's current market predicament.

Moore's law, based on an empirical observation made by Gordon Moore, a cofounder of Intel, states that the "complexity of integrated circuits, with respect to minimum component cost, doubles every 24 months." This prediction has become a self-fulfilling prophecy, and industry roadmaps (as of 2001) have predicted that Moore's law will remain valid for several generations of semiconductors.

What has changed during the last five to 10 years is the relative value that customers derive from this steady increase in computing speed. Here, it is important to think in terms of the Pareto principle, which implies that 80 percent of the benefits from Moore's law result from the first 20 percent of the development. From a user's perspective, this certainly seems to be true in the electronics industry. Ten years ago a doubling of chip speed allowed a typical user to significantly enhance the applications he or she could use, but today's PCs allow most users to handle all common applications. In fact, it can be argued that most everyday business applications such as Microsoft Office do not require the latest model PC and can be run quite adequately on a 3-year-old machine.

The above trend has fundamentally changed the relative importance of variety and inventory in hardware configuration. In the past, the ability to customize was highly prized by customers, and any surplus inventory quickly

[Key Takeaways]

- » Recent falls in Dell's stock price reflect a market shift that supports a hybrid go-to-market strategy involving direct and reseller sales channels, and puts the company at a crossroads.
- » The experience of Dell and other computer makers underlines the importance of product type and lifecycle when deciding which sales channel to use.

lost value as newer components became available. This created a business model based on the centralized storage of inventory that was assembled to order much more effectively than a model where pre-configured PCs were sold through retail stores. Clearly, Dell's direct approach was ideally suited to such a scenario and enjoyed a significant cost advantage over HP and Compaq.

Today, however, most customers are happy to choose from a few standardized, off-the-shelf PC models. Demand is no longer splintered by multiple computer configurations, but instead is concentrated around a much smaller group of standardized offerings. Also, a few years ago demand was typically low for each product variant; now each standardized model enjoys relatively high demand. Finally, the price of PCs has dropped significantly. As a result, inventory of standardized models now moves fast and is less of a factor in the profitability of the PC business.

This shift in emphasis changes the viability of the centralized direct channel relative to selling PCs through stores. The power of the direct channel to deliver customization is less relevant in today's more standardized market. This is why Dell's competitive edge is being eroded by players such as HP that sell through retail stores.

Moreover, Dell's problems are exacerbated by the company's expansion into consumer electronics. LCD televisions, for instance, have moved from the initial product life cycle stage to a more mature phase. Given the unstable demand in the early days, Dell's centralized model was well suited because it lowered inventory costs. As these products mature, however, demand is increasing and retail stores are becoming a more effective channel. Also, these products are not amenable to customization.

The inevitable conclusion is that Dell will be forced to consider the retail channel as it moves forward. The success of Apple reinforces this view. Even though Apple is considered to be on the cutting edge of design and innovation, its success has come with relatively little product variety. Excluding accessories, an Apple store probably sells less than 25 SKUs, with each SKU having high demand.

Two-tone model

That is not to say that the centralized channel has no role to play. A hybrid business model that combines the complementary strengths of the two channels will likely be the most effective in this evolving business. Eighty percent of the market that is satisfied with standard models is best served through retail stores. The other 20 percent that values customization is better served through the centralized channel.

Further evidence for the emergence of such a hybrid approach comes from the mistakes of another direct-sell PC manufacturer: Gateway. When the company first

opened Gateway Country Stores in 1996, it targeted customers who were less tech-savvy and valued the sales support that these outlets offered. Buyers could try out display models of Gateway computers at the stores, but could not make a purchase since the machines had to be ordered for home delivery later on. The problem was that although Gateway harnessed the channel's support strength, the company did not exploit the supply chain capability to deliver fast-moving products like standardized PCs. Most Gateway store customers were satisfied with one of the standardized models, but were disappointed that they could not leave a store with their chosen PC. Gateway would have been better served by stocking the standardized models with high demand at its stores, while supplying customized configurations through its centralized model. This way it could have combined the strengths of respective channels. By having two channels but only one mode of delivery, the company missed this opportunity.

In-store customization

Another possible structure when customers place a high premium on customization is for stores to complete the final product configuration. This is done in India, where stores assemble PCs to customers' orders. Such an approach decreases inventory costs because inventories are kept in component form, but increases the cost of assembly capacity, which is now decentralized. Such a structure makes sense when the cost of capacity is low relative to the cost of inventory. This is the case in India, where technicians are relatively cheap to employ. The structure is also appropriate for high-end electronics components where inventory is expensive and customers want it customized to their specifications.

The bottom line is that channel choice must be related to customer needs and product characteristics. This leaves Dell, in particular, at a crossroads. The company's products and markets have evolved to a point where certain fast-moving units may be better sold through retail stores. Going forward, a hybrid model that augments the strengths of the centralized channel for high variety with the strengths of the retail channel for fast movers is a better option for Dell. Do not be surprised if you see the familiar Dell logo in Costco outlets or in your neighborhood computer store. ♦

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