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Understanding channel margins and sharing the cost of partnering

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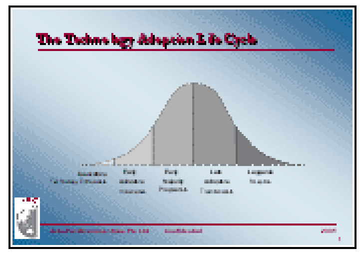
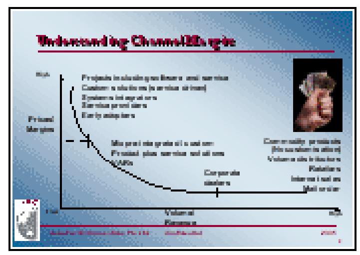
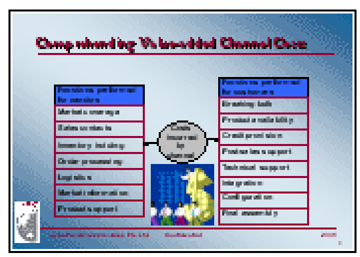
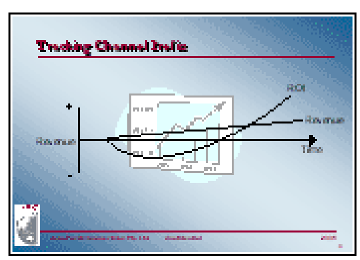
With the sharp rise of products being sold through channels today, coupled with ever-shrinking channel margins, vendors no longer have an option but to take an active interest in their channel partners' financial status.









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Reading a balance sheet or P&L report will only tell you half the story. What vendors really need to understand is how each partner's revenue is derived - by asking what percentage of revenue is obtained from hardware, software and value-added services, respectively. Since services typically fetch the greatest margin, the proportion of service revenue will tell you a lot about where this channel partner stacks up on the value-add chart and its potential to garner higher margins.

It is also essential to appreciate the correlation between the technology-adoption lifecycle and a product's related margin cycle - it can help vendors determine the best type of channel for each product at various vantage points.

According to the technology-adoption lifecycle, customers can typically be divided into five categories:

Innovators, technology enthusiasts
These buyers tend to be highly-intellectual, prepared to take risks, decisive, aggressive and first movers.

Early adopters, visionaries
These customers are market leaders who are prepared to take risks and respond to aggressive marketing, while they proactively search for new solutions.

Early majority, pragmatists
These users tend toward the status quo and mature technologies with a quality reputation from respected companies.

Late majority, traditionalists
These purchasers fear the new and are more cynical and reactive.

Laggards, sceptics
These shoppers are slow to change, buy "me-too" products and are price driven.

The majority of customers fall into the early or late majority categories. However, margins are strongest in the innovator and early adopter stages. These buyers will pay a premium for new and innovative solutions - so, though revenue will be low at this stage, it presents an opportunity for value-added partners. Over time, as volume builds with the early and late majority, both prices and margins will drop, so less value will be required from channel players. Once a product becomes a commodity and the laggards are on board, broad-based distributors and retailers are good channel bets. The last-stop on the channel train is a virtual channel that services customers via mail order and internet sales.

As competition intensifies with early majority customers rushing to buy mid-life products, there are higher barriers to market entry and an increased threat of substitution from existing competitors. Though bargaining power with suppliers may increase, at this point, customers will gain the upper hand when it comes to price. Savvy vendors will adapt their channel strategy and distribution models to suit each stage of a product's lifecycle.

To stay competitive, vendors must also track their channel partners' margins over time. There are basically two ways to increase channel revenue: sell more products in existing markets (gain market share) or open more markets. At the same time, there are two primary ways to reduce channel costs: reduce expenses and tighten inventory turns. To value the channel's total costs, you have to take into account actual costs, while factoring in all opportunity costs. The bottom line is that vendors ought to constantly pay attention to the total gross margin performance of each product in the channel.

Though channel revenue is relatively easy to map, channel costs are not always so obvious. Begin by comprehending all costs incurred by each channel partner relative to each vendor's products - including those costs performed on behalf of the vendor as well as those performed for customers. On behalf of vendors, channel partners:

- Build sales contacts
- Ensure appropriate market coverage
- Hold inventory
- Process orders
- Manage shipping
- Provide marketing and product support.

For customers, channels are expected to ensure product availability, extend credit, provide post-sales service, support, and training, and sometimes provide integration, configuration, final assembly or total solutions.

Next, chart the channel-profit timeline and you will see there is almost always an initial period when each channel partner invests before breaking even or gaining margin. Vendors should be sensitive to this and factor the channel partners' start-up costs into the launch equation. Remember success is a two-way street and to stay competitive, vendors must fund their channels' growth.

However, the single, largest investment that vendors make to ensure successful channel partnerships is a dedicated channel manager. This person has to be empowered by management to have sufficient time and authority to select and manage each channel partner. There is nothing more troublesome for channel partners than trying to negotiate with a vendor representative that does not have ample authority. In addition, this person ought to be:

- Knowledgeable about industry trends and market drivers
- Educated on the company's products and services
- Effective in implementing the company's channel policies and programs
- Committed to win-win channel partner relationships

In addition to a dedicated channel manager, vendors should also provide responsive contacts across all the necessary functions, including marketing, finance, operations/logistics (related to order shipments and RMAs), as well as technical support.

At the end of the day, vendors that make it a priority to understand their channels' margins and share in the cost of partnering are the ones that stand the greatest chance of building profitable and loyal channel relationships.

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