MODEL OF VERTICAL MARKETING SYSTEM IN RETAIL DISTRIBUTION

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Abstract

Fierce market competition among leading retailers asserts different models of market appearance and cooperation with suppliers. Vertical integration, as a kind of cooperation could range from one-hand transactions to mutual investments in specific assets. From a theoretical point of view the stages of integration at the end of distribution channel reflect on retailer's power and his need for resources. The importance of the paper is set by contemplation on integration factors by the modeling method. The factors like costs, responsibility, risk, margin, and function performance in the channel will be examined. The position of the partner that can be settled in the model could range from conventional contracting to full vertical integration, depending on the volume of the execution of marketing activities.
The contribution of descriptive model could be a kind of recommendation to leading retailers in a way to introduce more proper forms of cooperation with suppliers.

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1. Introduction

The differences between business subjects that have the same market goals but are not a direct competitor to each other represents an extremely interesting field for observation. It is necessary to analyze retail distribution and the distribution channel, as well as to identify the theoretical results that would facilitate the further investigation of the retail development, distribution and the vertical marketing models in general.

Vertical integration in a distribution channel places into focus the factors of cooperation such as the distribution of income among partners, the distribution of risk depending on the marketing functions and activities assumed, as well as margin increase through the cost reduction. The problem is to identify the model which is, from a theoretical point of view, based on gradation of integration and the retailers' power. This paper explains the position of a mediator and retailer in the distribution channel, and clarifies the state which can occur on the market if a retailer gains a more favorable negotiating position with respect to the other participants in the distribution channel.

The contribution refers to the modeling of the factors of the vertical marketing system, where, at the same time, the approach to the development of the model is adjusted to the retail environment, i.e. to the very end of the distribution channel.

2. The starting point of the retail distribution

From the distribution point of view, retail is a channel for approaching the end users, and another thing which makes it specific is the fact that in this channel, the final economic value of the product, which is generally a market standard, is determined. The very position in the market channel and the contact with end users gives the retailers a certain power which other participants in the distribution have to respect. That power is reflected in a revenue through margin, the range of marketing activities which a retailer transfers to the others, the risk of demand and the costs the retailer is prepared to bear.

On the market, there are numerous potential mediators whose sole purpose is to make it easier for the suppliers and the manufacturers to distribute their products to end users. Bearing in mind a large number of transactions among the subjects that participate in the exchange, some mediators have only specialized in specific ways of distribution and they do it more efficiently than others, for example, through retail sale, wholesale trade, catalogue sale, etc. The greater the number of the mediator types, the more diverse the types of the distribution channel.

When we talk about retail distribution, we refer to the range of those activities and functions on whose completion the product supply and distribution on the very end of the distribution channel, where the retailer has the final say, depend. All the activities and the functions together represent a model which is shaped by certain factors, such as revenue, expenses and risk. Kent & Omar (2003; 72) consider that what retailers thinks about in general, before deciding to go into business with a supplier, is how to satisfy his own needs. The negotiating abilities of the retailer to impose his rules and conditions play a significant role in the way the cooperation with the supplier will go.

For efficient retail, it is necessary to adjust the retailer's and the supplier's distribution models, and this homogenous structure represents a unique model of cooperation between the suppliers and the retailers, which will be discussed here. Dent (2008; 32) says there are two basic functions that suppliers or mediators perform, them being the satisfaction of supply and demand. Other functions can be divided into the exchange of the market information, the presentation of suppliers to the market, technical back-up and help with product selling to the end user.

The development of retail with the purpose of forming the best possible cooperation among the participants in the distribution, places into focus the question what has to be improved, in what way the mutual cooperation should be modeled and in what way does a retailer influence the physical flow of the goods through the channel. There is a need for considering the mutual relationships among the distribution channel participants, i.e. the business subjects which distribute products and provide services with an emphasis on the cooperation of a retailer with other participants. The greater the income of the retailer, the greater their influence on the distribution channels and the greater their control over the flow of the goods and services, without taking the ownership of the channel. Retail management controls the suppliers, who, then, have to increase the level of their services, take over more marketing functions and activities, reduce the price and improve assortment in stores.

3. Some practical issues of partnership

The efficiency and the productivity of the modern retail come down to the economy of the volume and massiveness of the market space. The more is sold in a store, the greater the flow of the supplies and the more times will the retailer earn his margin. The changes in the sale volume result in the changes of the relations among the partners in the distribution channel, and the conditions of cooperation are no longer the same. Thus, a retailer whose value or volume of sale, as well as that of the supply is increasing, will, accordingly, ask for greater discounts from a supplier. Regarding the growth of the competition in retail business, a number of great retailers are becoming a category for themselves. The big retailers charge even the shelf position to their suppliers, among other services which they couldn't have benefited on before, because the suppliers are more and more dependent on the retailers and their sale now. Actually, a partnership changes in that the suppliers lose power in the distribution and are forced to pay the retailer for the privilege that their products be exhibited in the places with a great number of visitors and potential buyers. In the stores which are restricted to 'four walls’, with a strictly determined number and the capacity of shelves which serve for exhibiting the products, a retailer carefully arranges certain products (category-mix, category management) on the shelves, where the relationship between the retailer and the supplier plays an important role.

According to Dent (2008; 379), in order to strengthen their market position, retailers try to build as many stores as possible. This kind of a plan asks for greater efforts in organizing the sale program, a more efficient marketing and a narrow range of management. In other words, the increase of sale in a store, as an indicator of successfulness, represents a real test for the retail strategy and the managing structure.

4. The structure of the vertical marketing system

There is no doubt that in different stages of the distribution chain and the chain of value, there is a striving towards connecting of the subjects - holders of the marketing activities. The vertical marketing system is an interorganizational structure which is based on contracts or trust, where each subject has a limited control over this mutual relationship (Klein, Crawford & Alchian 1978; 297). The purpose of the vertical marketing system is to connect, to a certain level, the marketing advantages of two or more separate organizational units which have different marketing interests and owners. The difference between the distribution channels are manifested in a different range of marketing functions, each with its own expenses, which especially come into focus if we are talking about outscoring marketing activities. If two or more levels of the distribution channel merge into one unit which is supervised and managed by a single managing structure, in that case we have vertical integration (Grossman & Hart, 1986; 711). These two authors link vertical integration with control and ownership. They also claim that in the case of vertical integration, we have the transfer of control over one’s assets to another subject, while the first subject still keeps the ownership over that assets.

According to Williamson (1971; 113), vertical integration occurs whenever some marketing activity is taken over or transferred to another subject in the channel for a longer period of time. According to Tipurić (1993; 34), the economic reasons for the vertical system lie in a potentially greater efficiency of the exchange, which is, in its final dimension, manifested in lower costs and higher quality in the distribution process. Vertical integration is, above all, a type of business cooperation which is reflected in the levels of the integration of marketing functions.

In case of a conventional exchange between a supplier and retailer, we are not merely talking about the transfer of the ownership, but this exchange, as a rule, encompasses a number of logistic and other activities. The very proximity of the adjacent participants in the channel implies that we are dealing with some complementary activities, which are, rarely present with more distant participants. Segetlija (2006; 448), gives a contribution to vertical integration by stating that the new trend of trade cooperation development is verticalization which involves shortening of the distribution channel 'on the basis of connecting wholesale trade and retail'.

4.1. Identification of the model

The analysis of the distribution channel has shown that vertical, compared to traditional channels, have considerably greater dynamics, development opportunities and give a better background for a specialization of the marketing functions. With vertical marketing systems, we have a limited independence of the participants, and, under the pressure from the competition, 'looking down on the partners' transforms into a closer relationship with the leader. The existence of traditional channels comes down to the benefits from a transaction and not from a cooperation which can be more profitable and advantageous in the long run. A vertical marketing channel provides a systematic view of the issue, which was not the case with conventional contracting in that they only dealt with the issue of the contact and the agreement between an end user and a supplier.

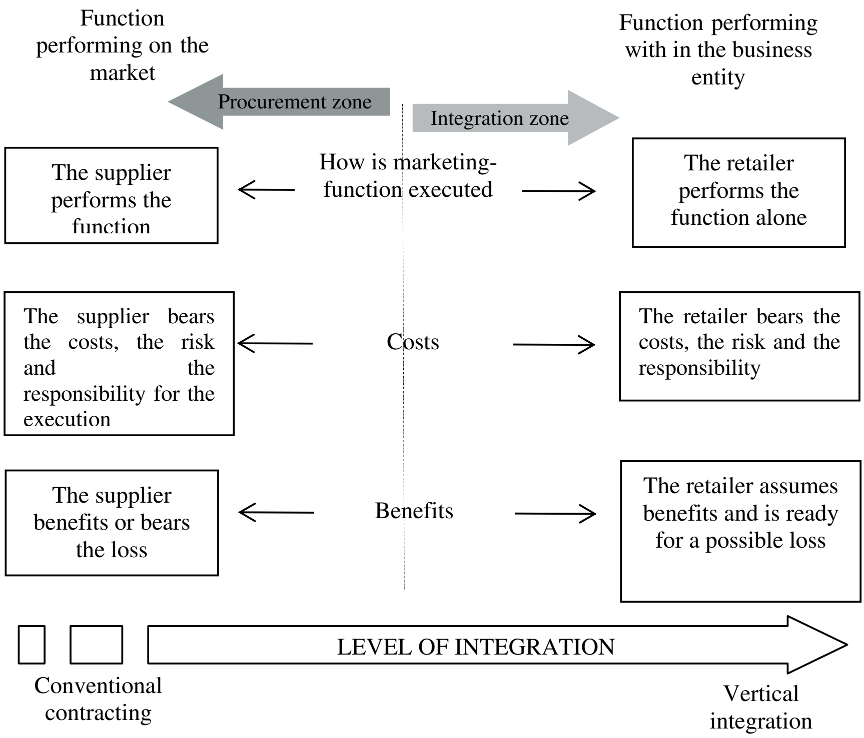
The analysis of the vertical connection or integration is about considering the 'make-or-buy' decision, where 'make' stands for an activity that one performs by themselves, and 'buy' stands for having somebody else to perform it. That decision implies the subject facing all the functions of the channel, at the same time examining what would be the costs and benefits from the execution of that function as well as, how great is the responsibility[1] for its execution. The request for the introduction of this new function, by all means, enriches the channel and facilitates its development; however, with the introduction of a new participant that would be the bearer of this new or specialized transferred function (outscoring), the channel widens and the antagonism within it increases. Vertical marketing channel is another descriptive, theoretical model of the distribution chain which, as opposed to the Porter's theoretical model (Porter;1985,85), emphasizes the role of the participant that would order and carry out the necessary functions. Verticalization stands for the process of unification of all the market levels within the channel, where each level is represented by independent business subjects which transfer their result to the next level that is closer to the consumer. What makes the vertical integration specific is the fact that the distribution of marketing activities is based on an agreement, on condition that all participants retain their identity and independence.

[1] Tyagi (1999; 511) mentions the responsibility within the context of temporal, spatial and informational frameworks. That would mean that the executor of the function carries the responsibility for the time and place of the function execution, and for the information that will occur as a consequence of that execution.

The point of reference for the vertical integration, or the reason for its forming is contained in the 'make-or-buy' decision. Based on the theoretical assumption of the value chain, and during the process of decision-making, we have to consider two things, a) what are the costs and the risks of performing the function and b) what is the expected benefit from the function. The negotiation between two interested participants in the channel, for example a retailer and a supplier, leads to a mutual agreement, whose purpose is to determine the share of the costs for both parties, what is the risk they have to take and what kind of benefits they can expect.

The performance of marketing functions in the channel depends on the following factors: costs, expected benefits and risks (Figure 1). If a retailer is equipped to an extent where he is able to perform certain marketing functions using his own resources, he bears the risk and the costs of performing that function. For example, owning a vehicle for transferring goods means that the retailer has, in terms of transport, opted for the 'make' decision, and, therefore, bears the transportation costs, but, at the same time, expects to make a profit on the difference between these costs and the costs that he would have if the transportation were provided by a supplier. However, transportation includes the coordination of the transportation facilities and human resources, which creates certain restrictions and the level of risk in conducting the business. This kind of 'make' decision by a retailer, as a result of specialization and under the pressure by the competition, can change, which means the turn towards the procurement zone, which is shown in Figure 1. The purpose of this picture is to identify the connection of the verticalization of marketing functions in the channel with the limitations, in terms of costs, risks and benefits. The more flexible and looser the verticalization, the more bearing of the costs, the risk and more freedom will be transferred to the other negotiating party. The only phenomenon that can influence the distortion of a dotted line in Figure 1 is the moment of power within the channel. A powerful player puts the pressure on weaker suppliers in that he tries, through their resources, to achieve greater profit by reducing the risk and costs.

Figure 1 Vertical integration model factors.

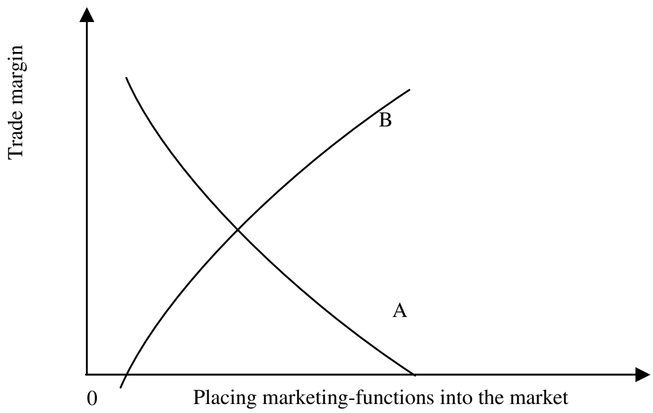


Source: Author's analysis

The conclusion of the analysis is that a graded distribution of benefits, risks and costs among the subjects over the course of the performance of the marketing functions is what all the participants in the channel are striving to. The stages are manifested through adopting the position between conventional contracting and a complete vertical integration. In general, every distribution channel can be set within the scope of the procurement zone and the integration zone, as a function of the vertical cooperation and one-time basis transactions. The retail distribution model is, thus, a result of an agreed distribution of benefits, risks and costs among the partners in the channel, and this agreed distribution is determined by cooperation.

The development of the retail distribution implies the development of the marketing channel structure, in which a graded vertical integration will rule. The structure will be the consequence of the proportion of the economic and negotiating power between the manufacturers and distributors, and they will mutually reflect this structure through vertical cooperation. Graph 1 show that the involvement in a greater number of marketing functions can influence in which direction the margin will go.

Graph 1 The relation of trade margin and marketing functions in the cases of weaker (curve A) and stronger (curve B) power of a retailer in the channel



Source: Author's analysis

The course of power depends on a certain subject's power which is observed in the channel. There are always two directions that the cooperation in the channel can take, for it is always the case that one more powerful and one less powerful subject meet. Bearing this in mind, Graph 1 indicates the relation between two curves, curve B represents the character of the powerful partner, and the curve A represents the less powerful ones. In the case of the curve A we witness the internalization of functions, where a retailer is trying to include as many as possible marketing functions within his own organization, which secures him a higher margin, and all that, of course, on condition that he performs the functions with competitive costs. The curve B represents the powerful participant, and he, inversely, gains a higher margin through the externalization of marketing functions. The place where the curves meet represents the place where the economic and negotiating power is, from a theoretical point of view, approximately the same and so is the distribution of the margin. If the characters of both partners are on the right-hand side with regard to the place where the curves meet, then we have a channel where B is the leader. However, if the characters are positioned on the left-hand side, that indicates that the more powerful subject is not specialized enough and that he needs to externalize more marketing functions to the other, less powerful subjects on the market.

4.2. The influence of power on vertical system modeling

The development in the channel manifests itself in the change of relationships within vertical integration, and this occurs if a retailer becomes the holder of a higher value margin in the market economy. The prerequisite for strengthening of a retailer’s position is, above all, the investment in financial assets. This investment is a result of the strategic goals of management and ownership with the purpose of using the acquired means for gaining new resources which should secure higher value margin and the profit in the long run. From the economic point of view the return to the invested amount means that the capital of a business subject has provided the profit, and is used rationally and economically. Apart from that, Anderson et al (2005; 341) emphasize that the 'return on the capital is a relevant measure for comparing the shift towards, or, away from the integration'. So, viewed from a broader perspective, we must notice the connection of this financial category with the model of vertical integration. The retailers that get return on the invested capital, make an efficient use of strategic resources, or, in other words, the managing structure integrates and classifies those resources and activities which are profitable and executable.

In the relations between suppliers and mediators, or, generally, between the participants in the distribution channel, power is a factor that is always present in the cooperation. El-Ansary & Stern (1972; 48) show that the proportion of power and influence is always present in the distribution channel. Organizations which perform transactions, especially mediators, are dependent on, both, the participants which provide goods and the participants to whom the goods are sold, i.e., on those that come before and those that come later in the distribution chain. A retailer that can obtain goods for a price lower than the one he pays to the mediator becomes more powerful than the mediator and vice versa. Thus, it can be said that the power determines the way and the type of cooperation.
The comprehension of power refers to putting one party’s interests before the interests of the other, in which case the latter one is unable to change this. Theoretically speaking, power is manifested in the ability of a business subject to, through his behavior and activities influence the course of cooperation and the behavior of other participants whom he interacts with. Since the purpose of cooperation is to make a bigger profit for the organization and the participants, individual striving towards this additional profit that the organization would not otherwise achieve, is always present. The goals of interorganizational cooperation are set through negotiation, so it is only natural to conclude that what we are dealing with here is the negotiating power or the ability to influence the outcome of the negotiation.

The power ratio in the distribution channel is a complex issue for it is difficult to determine the influence of every participant on the behavior of the others. In order to identify the power, every holder in the channel of goods and service distribution plays an important role.

Anderson et al (2005; 197) define power as 'the ability of one partner to force other partners to do what they otherwise would not do.' Power, therefore, means that the weaker partner conforms to the requests of the more powerful one, i.e., that way he loses a portion of the expected profit from their mutual cooperation. Power should be viewed as a tool for value acquiring and taking over the advantage from the others, in a way that is desired by the more powerful party. Tipurić (1993; 178) proves that power is especially important for examining interorganizational relations, because it is a means for influencing the behavior of other participants. The proportion of influence of a single participant in a certain group will lead to a more desirable amount of profit from transactions (Frazier & Kersi; 1995). Partners find influence extremely important since, as Grossman and Hart (1986; 711) have shown on their model, the ideal distribution of the profit from a transaction among partners in the distribution channel is closely related to the level of coordination in the channel. The one that coordinates the partner relationship according to his interest expects the largest portion of the profit.

Power is present when a business subject follows the direction desired by another organization. However, if the first organization would go its own direction regardless of the wishes of the second one, then we cannot talk about that as a result of power of one organization over the other. A supplier has an opportunity to test their own power in a partnership with a retailer by asking that the retail price of his product be lowered.

5. Conclusion

The influence of retailers on the participants in the distribution channel is ever greater. By means of vertical integration model, the factors which shape the functioning of the relations between a supplier and retailer are identified in this paper. Also, the explanations are given for the consequences of the transfer of marketing functions and activities to suppliers in order to reduce the pressure created by the costs on the trading margin, i.e. the profit of a retail subject. Negotiating power has a great influence on all aspects, from the modeling of the vertical marketing system to the very way of arrangement of the products on the shelves, and that power comes from the volume economy and the growth of the sales potential.

The cooperation at the very end of the channel for the distribution of goods and services will, in the future time, be ever more controlled by a retailer, while the others, manufacturers and mediators will be forced to accept their rules. The key resources for selling the product to the end user will be, even to a greater extent, under the dominance and the management of retail.
Further investigation concerning the possibility of change in distribution channel is required in order to achieve the best possible results for both parties, as well as to achieve the highest possible effectiveness of the distribution.

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