

Fortune 1 Case Study: Channel Development In China

Our client has requested that their name and the names of their partners not be mentioned in this case study. The industry is small enough that we have also chosen to eliminate reference to the specific sector. What follows is a “cleaned” summary of our client’s experience in setting up sales channels in China.

Background

A U.S. based \$80 million manufacturer of relatively hi-tech refrigeration and incubation equipment, used in research and industrial applications presented Fortune 1 with the following scenario...

International sales accounted for 35% of the company’s revenues. This roughly broke down as Europe 60%, Asia 25%, and Latin America 15%.

Our client had increased international sales from \$20 million to almost \$30 million dollars over the previous 3 years.

The company had a single master distributor based in Europe, who was responsible for managing second tier distribution in all EU countries. This partner also provided Europe-wide technical service and training.

Our client had encouraged the Master Distributor to set up distribution in Asian markets 3 years earlier. Whereas in Europe our client’s Master Distributor sold products under only one brand name, in Asia it was permitted to use all brand names – this was 3 different brand names for 3 identical product lines.

The increase in international sales was a welcome addition to revenue, but our client began to get phone calls directly from 2nd tier distributors in China complaining of non-service from the Master Distributor. Soon after, a few determined end users also from China wrote or called our client complaining about product failures.

Our client’s Master Distributor assured our client that all was OK, and that all service issues were being followed up on, albeit service in Asia was more difficult to manage.

Our client hired Fortune 1 to help guide a group of 7 people over to China, order to assess what appeared to be escalating problems in China. This was to be the first of three trips planned for Asia; this trip focusing only on China.

Mission Definition

In our meetings with the client, we laid out the following objectives of the trip:

- Visit each customer who had taken the time to call or write
- Tour the top end users in China
- Meet all distributors actively representing the company's products in China
- Make first and second level assessments of these distributors
- Begin assessing the Chinese market: market size, growth rate, and product needs

In addition to these objectives, we convinced our client to cut the number of people going on the trip back to four: the CEO, the Vice President of Sales & Marketing, Director of Technical Service, and the President of the Master Distributor. This would make logistics and the whole trip run more smoothly and cost far less.

What We Found

The trip to Asia was both encouraging and disappointing. After all, our client had a foothold, and had working distributors who were interested and motivated, with ideas on how to move forward in the Chinese market. That said, the daily reality of the company's products sitting idle in dark and dirty hallways, and the client's end users consistently pointing to a non-working piece of equipment and complaining about a complete lack of service for more than 6 months, threw cold water on most of the positives we witnessed.

At this time in China, foreign companies needed to use a domestic Chinese agent for both importing into China and marketing within China, and only those trading companies authorized by the central government to handle exports and imports were permitted to sign import and export contracts.¹ Following from this, the market was more or less overwhelmed with representatives of our client's products. There were seven agents representing the products in Beijing alone, and five more in Shanghai. Three of these agents had been signed up because of their relationship with the one import/export company that the Master Distributor had connected with; the other four agents worked via their own import/export relationships. There had been no review, not even a cursory one, of the agents' operations or their people. In four cases, the agent's distribution agreement had been reached in a single meeting that took place in a hotel – neither our client, nor its Master Distributor had even visited the agents' offices. Most of the distributors were split according to the brand name they represented. However, two agents had set up their own 2nd and 3rd tier distribution relationships, and one ambitious group had even created his own private label of our client's products (unknown to both our client and his Master Distributor).

Each distributor pointed the finger at the other for lack of service operations and unhappy customers. At the same time, every distributor admitted that service had to be included in the price of the equipment, but none were prepared to offer technical service to the end-users. The price competition and different brands for identical products across multiple distributors created a messy and unprofessional mix in the eyes of customers – who typically delayed purchases while four or five distributors fought it out in terms of price and who the account belonged to.

¹ This is has changed somewhat with the increasingly popularity of WFOE – Wholly Foreign Owned Enterprises; and will continue to liberalize with China's entry into the WTO in December 2001.

Two of the distributors had been trained in technical service by the Master Distributor, but neither of the individuals trained had a technical background. In fact, they were PhDs in biochemistry and physics that had been unable to get work elsewhere.

Essentially, to drive sales into Asia our client had offered its Master Distributor big bonuses for sales revenue achieved. To earn these bonuses, the Master Distributor made a full court press into China and the ASEAN countries, offering distributorships for all three brands using competing agents. The one authorized China export/import company the Master Distributor had signed up was specialized in electronic components, but not in capital equipment. This Chinese export/import group in turn had signed up three agents to sell our client's products. Technical service produced no real revenue, and there were no bonuses paid for service, so although the Master Distributor knew its importance, our client had simply not stressed it as a need-to-have in the region. Hence, technical service had simply had not made it high up on the China priority list at the time of our visit.

What We Did

Our first and primary recommendation was to trim distributors and brands. The Chinese market was small enough that the major accounts were easily identifiable, and at this juncture our client had no reason to pursue the multi-brand multi-channel approach, which he used in the U.S. market. Our client needed to clean up the mess and make an impressive push forward in order not to lose the market share it had just invested a great deal of time, money, and brand equity into.

China can be divided roughly into five major regions: Guangzhou (South), Shanghai (East), Beijing and Tianjin (North Central), West China, and Northeast China. The first three were the most important in terms of research and industrial customers for our client's products.

We cut back distributors from 12 to 2. One distributor was made responsible for Guangzhou and Shanghai (South and East), and the other was made responsible for Beijing and Tianjin (North and Central). The Beijing export/import company was retained, and we insisted the agent in charge of Beijing and Tianjin work only through this export/import group. We were lucky this sales agent already had an existing relationship with the export/import company. The agent assigned to Shanghai and Guangzhou had a government authorized export/import group based in Shanghai whom he worked with. We immediately headed to Shanghai to meet and get to know this important player in our client's China equation.

The brands were trimmed according to total number of units that had been shipped. One of our client's brands, with minimal sales, was completely eliminated. Brand X was trimmed back to a single product, and Brand Y was used for two product lines.

Each Distributor was told to hire a Service Manager. Our client agreed to subsidize this Service Manager for three years. The distributor's Service Manger subsidy would decrease according to any percentage decrease in sales. Our client's Director of Technical Service had 1) veto power over the distributors' choices of Service Managers and 2) was made personally responsible for training these new Service Managers.

The territory assignments were enforced by a simple rule: Agent A was responsible for any product shipped into southern and eastern China, and Agent B was responsible for any product shipped into central or northern China. Any piece of equipment bound for China

was shipped only to the export/import company and the agent we had designated for that region, regardless of which agent placed the order with our client. Furthermore, each end-user we visited had been given the contact details of our client’s CEO, VP of Sales & Marketing, and Director of Technical Service. The end-users were given explicit instructions whom to buy from, and to contact our client with any problems concerning sales or service. Our client set up a simple score card system to track complaints about Agents A and B.

Possibly the most difficult decision was to remove our client’s Master Distributor from the Asian market. The Master Distributor had established the foothold, and was of course planning to reap the benefits in cash flows and control of a larger region. However, the Master Distributor was also responsible for having created what was essentially becoming a huge disaster. We executed this in a generous and fair, but very firm way. Our client compensated the Master Distributor for one year of estimated margin on Asian sales. This solution was not presented as an option. It was presented as, “this is what we are doing.” We pushed this deal through with the Master distributor by promising him Eastern Europe and Russian markets after specific sales volume hurdles were reached in Italy and France – these two countries lagged behind in market penetration compared to other European markets that which the Master Distributor was in charge of.

To add more backbone to the Chinese sales operations, we helped our client hire a Managing Director for China. This was a Chinese gentleman who had recently retired from one of the biggest end user companies in China. He was given direct access to our client, and made part of the President’s executive staff. The Managing Director’s mission was to oversee the two Chinese distributors, and to act as mentor for our client’s organization in terms of the China market. The VP of Sales and Marketing and the Director of Technical Service were required to travel together to China, three times per year to meet with distributors, inspect units in the field, and meet with end-users. As well, they each chose a person from their respective teams to have responsibility for China inside the client’s organization.

In terms of assessing the Chinese market, using the input from our meetings with end users and distributors, our first level analysis of Chinese government spending, we were able to size the market in terms of units being purchased annually and the growth rate. As well, our analysis of the market identified a clinical sector, which our client was not yet servicing. The total Chinese market was a \$13.4 million opportunity with an attractive growth rate that promised to pick up based on the Chinese Government’s plans to aggressively fund scientific research.

PRODUCT 1	Research	Industrial	Clinical
Units	325	175	85
CAGR	10%	7%	8%
Estimated \$ Value	\$6,350,000	\$965,000	\$425,000

Table 1

PRODUCT 2	Research	Industrial	Clinical
Units	730	525	265
CAGR	8%	8%	5%
Estimated \$ Value	\$2,560,000	\$1,450,000	\$725,000

Table 2

PRODUCT 3	Research	Industrial	Clinical
Units	191	135	56
CAGR	6%	6%	3%
Estimated \$ Value	\$475,000	\$300,000	\$125,000

Table 3

OPPORTUNITY	Research	Industrial	Clinical
Estimated \$ Value	\$9,385,000	\$2,715,000	\$1,275,000
Total Market	\$13,375,000		

Table 4

As for the products being sold into China, our tour of end-users' facilities were enough to convince everyone that our client's products were not built for the Chinese market. Our client's products were built for the U.S. market, where end-user environments were generally very well maintained, with clean facilities, and in-house service technicians trained to maintain the equipment. The reality in China was the complete opposite. Our client's products were relegated to small, cramped, and dirty areas, with little or no maintenance. Using the feedback from end-users and our own observations, we worked with our client's Director of Technical Service and VP of Engineering, to identify some quick hits to improve the products for the Chinese market.

Improvement	Importance	Time Frame
Larger and more robust motors	B	3 months
Increased ventilation around the motors	A	3 months
A designated preventative maintenance schedule specific to China	A	Immediate
An improved built-in lock	C	1 month
Thinner and shorter dimensions	A	1 year

Table 5

Loose Lips

In our dealings with both the client and the Master Distributor, it became obvious that for roughly two years, there had been constant “chatter” and overtures made about our client acquiring the Master Distributor. This was mostly coming from the VP of Sales and Marketing, who felt acquiring the Master Distributor was the only way to ultimately get control of international distribution.

Whereas we agreed the Master Distributor was a bull in the china shop, this is not necessarily a bad thing. A quick assessment of the relationship and the non-existence of international talent within our client's organization, made it obvious that the Master Distributor was there to stay, and indeed added a great deal of value to our client.

Our client and his entire organization had grown to over-rely on the Master Distributor for everything international. This included sales, pricing, advertising plans, trade show organization and so on. Most importantly, the sales and distribution relationships in Europe were those of the Master Distributor. No executive manager from our client had ever met one of the 2nd tier distributors in Europe. Hence, if our client did acquire the Master Distributor, our client would be forced to continue using current management at the Master Distributor, for at least the first two to three years. Fortune 1's standing advice – quite simply – is never use management who have already cashed out. As hard working and as smart as they may be, a person's motivations and interests change once they have real money in their pocket.

We raised this sensitive issue first with our client and his VP of Sales and Marketing. Once all of us around the table agreed that buying the Master Distributor was not an option, at least in the foreseeable future, we agreed to put an end to the acquisition talk. In follow up, our client met privately with the Master Distributor to 1) reaffirm the relationship and the promises for Eastern Europe, and 2) bring the acquisition rumors to a halt.

When rumors circulate, especially takeover rumors, it is rarely a good thing for any organization. Whereas mergers and acquisitions are exciting stuff for senior management to think about and strategize over, your bread and butter frontline people are usually transfixed by what the change will mean to them. If a deal is not really on the table, idle chatter does more harm than good.

Conclusions

We all came out of this with more than a few lessons learned in terms of managing the behavior of international channels, and especially in terms of a master distributor partner.

Ensure your master distributor sticks to his knitting, and do not encourage him to expand into new areas, before you are happy with his market penetration and service in his primary market. Do not help them morph into a worldwide distributor. Very few distributors have what it takes to effectively cover that kind of area, and ultimately you are diluting your control, not increasing it.

Your executive management must be managing, especially in terms of international sales. They must travel, they must meet distributors, and they must meet and speak with end-users. Otherwise you will quickly create over reliance on your master distributor. Your company must be informed, experienced, and have its own relationships with anyone and

everyone touching your products. Not wanting to make a distributor angry, for fear of wrecking a personal relationship or fear of experiencing a dip in sales, is one of the worst reasons to not enforce your chief role and your rights and obligations as the manufacturer or creator of the goods and services. Do not let a master distributor steam role you into being ignorant of your markets.

Know your channel partners before you reach a distribution agreement. You must know their company, its history, its source of start-up and ongoing funding. You must understand their other distribution relationships. You must assess their management, their organizational approach, and their use of technology. You must perform a level of due diligence that is consistent with what you hope to achieve. There is nothing worse than not knowing who is representing you.

A focused, rifle shot approach is best. Unless your resources are unlimited, an evolutionary approach is far better in terms of entering international markets. Start small. Get your feel. Understand who you are working with and who you are selling to. Then grow it.

Excessive sales goals, with big bonuses attached to them, and hands-off management, drives bad behavior. You may see some initial sales, but this momentum is not sustainable, and in fact the extra \$25,000 per month you are seeing may actually be eroding the base you think you are building, and ultimately ruining your good name in a big market.

Sales are nothing without service. Any company expanding sales must think hand-in-hand with service. In most cases, it is best that your company keep control of technical service, and that you work to establish a strong base and expectations before surrendering this critical part of your business over to your sales channel, if ever.

Epilogue

For our client this was just the beginning. Similar situations existed in all the Asian countries, including: Taiwan, Singapore, Thailand, Malaysia, and South Korea. Fortune 1 worked with our client in each of these countries to create sales channels and a management structure similar to the one we set up in China.

Two years later, our client was able to move regional management for ASEAN countries to Singapore. Based on our input, and the success of the China organization, the client left in place the Managing Director for China, who was ultimately given responsibility for Hong Kong and also for Taiwan.

The Technical Service subsidy given to the agents was ultimately abandoned, and our client created a China based Technical Service group to service China, and to train agents and service groups in the ASEAN countries. Ultimately, the ASEAN Managing Director created his own service organization based in Singapore.

Most importantly, our client has firmly established an international management structure both inside their U.S. operation as well the respective managing directors for China and ASEAN countries. This has resulted in increased knowledge and understanding across the client's organization, and has helped make our client reactive to end-users, and ultimately more successful in the marketplace.

Although, pressure in China continues to come from an aggressive Japanese competitor and from our client's main U.S. rival, sales have continued to grow in China. Market share has grown from 10% to an estimated 40%, roughly in line with our client's U.S. market share.