WHITE PAPER

# The rise of the middle class channel

*When high volume channels tap out, look to grow profits with high margin, high-value mid-tier partners.*

ChannelWAVE

When the vice president for the "Bank of Change" is asked, in a satirical commercial on *Saturday Night Live*, "How do you make money?" his answer is simple:

"Volume."

What makes this funny is that a bank that makes change, but charges no fees for exchanging money, could never make a profit at any volume. Increasing sales volume, but finding that net margins are decreasing, zero, or negative is a familiar situation for many high-tech companies in today's tight, competitive market. These businesses are discovering that their highest volume sales channels are producing lower margins and limited growth in profits because of continuous pricing pressure and the extensive investment and support needed to nurture and manage these channels.

So where do you turn for the margin that you need to increase profits and improve your competitive position? Look to the middle class by automating repeatable, successful business processes and achieving a brand preference with the more fragmented second and third tier partners, innovative high-tech companies are increasing their scale and velocity through lower volume, but higher margin channels – and reaching more customers at a lower cost.

For example, PC component and peripherals manufacturers sell their motherboards, microprocessors, disk drives, monitors, and keyboards to original equipment manufacturers (OEMs) like Dell, IBM, and HP to achieve high volume sales. The three largest computer OEMs control for approximately 50 percent of new PC and server sales. Component makers find selling through these channels to be highly efficient and a high priority, because these sales account for a majority of revenue. But the large OEMs compete in an extremely price sensitive market. To reduce costs, they must use their consolidated buying power to negotiate with multiple competitive suppliers to create high volume, but low margin contracts with a few select suppliers.

White box manufacturers control 37 percent of the total PC market. Components and peripherals manufacturers can reduce their cost of sale and increase profits by using Partner Relationship Management (PRM) technology to establish new and higher margin channels.

## Fast Growing, High Margin Channels

Components and peripherals manufacturers find it increasingly difficult to maintain and increase margins with this small set of OEM partners, because competitive pressure and the reliance on volume contracts leads to long-term price reduction. Sales volume is dependent upon the success of the OEM's sales – not on initiatives that drive brand preference for the components. Applying additional channel management resources to increase sales through the major OEMs or to negotiate better contracts has reached a point of diminishing returns.

What about the other 50 percent of the computer market?

While 13 percent of PC sales occur through a short list of smaller OEMs, the majority of the market is highly fragmented. So-called "white box" manufacturers produce an aggregate 37 percent of all PC sales. This market includes more than 6,000 unique organizations with a wide range of services, skills and locations to serve specific markets. Collectively, this is the fastest growing segment of the PC market and produces more sales than any one manufacturer.

Because white box organizations are smaller, they have traditionally worked with distributors like Ingram Micro and had limited direct contact with components and peripherals manufacturers. Their pricing is not negotiated through large volume contracts, but is maintained at a higher margin through distribution.

Driving brand, messaging, programs and products through the fast-growing white box market represents a large, untapped source of new revenue and margins for high-tech manufacturers. However, effectively leveraging this broad, but fragmented network of Tier 2 partners is nearly impossible without the right tools. The manual effort required to establish a trusted partnership and create brand preference for specific components within this channel adds a new indirect cost to each sale, diminishing the potential advantages. Even if the gross margin on a white box sale is twice as high as for a sale through a major OEM, channel support costs for this lower-volume business can effectively wipe out the net margin.

### Automation and scale

To reduce the overall cost of managing each white box relationship, components and peripherals manufacturers are investing in Partner Relationship Management (PRM) technology to build scalable automation that reduces the cost of acquiring, ramping up and managing each partner relationship. PRM tools help vendors and their channel partners to sell more productively, without dedicating the additional resources and high-touch efforts that are required to support high-volume partners.

Manufacturers can achieve the necessary scale by establishing a partner database to track and reward performance, standardizing marketing and sales programs across channels and providing self-service technical support and training. Reducing the cost of supporting and managing the white box channel not only allows manufacturers to sell at a higher net margin, but also can drive long-term growth by increasing the percentage of overall sales through higher margin, but harder-to-reach channels.

Table 1: Without PRM, the net margin in the white box channel is narrow because of high management costs associated with marketing to the channel and maintaining a large staff to support relationships with the large number of white box partners.

### Margins without PRM

| Channel Segment | Total Annual Sales | % Sales | Gross Margin | Net Margin No PRM | Total Margin W/O PRM |
|---|---|---|---|---|---|
| T1 - OEM Computer (Dell, HP, IBM) | $500,000,000 | 50% | 6% | 5% | $25,000,000 |
| T2 - OEM Computer | $200,000,000 | 20% | 9% | 4% | $8,000,000 |
| White Box | $250,000,000 | 25% | 12% | 1% | $2,500,000 |
| Retail | $40,000,000 | 4% | 12% | 3% | $1,200,000 |
| Direct/Online | $10,000,000 | 1% | 25% | 17% | $1,700,000 |
| Total | $1,000,000,000 | 100% | N/A | N/A | $38,400,000 |

Table 2: PRM technology allows vendors to reduce their overall management costs per partner and achieve lower costs per transaction through the white box channel. Stronger execution also allows vendors to grow their overall revenue through the white box channel.

### Margins with PRM

| Channel Segment | Total Annual Sales | % Sales | Gross Margin | Net Margin With PRM | Total Margin With PRM |
|---|---|---|---|---|---|
| T1 - OEM Computer (Dell, HP, IBM) | $500,000,000 | 46.5% | 6% | 5% | $25,000,000 |
| T2 - OEM Computer | $200,000,000 | 18.6% | 9% | 6% | $12,000,000 |
| White Box | $325,000,000 | 30.2% | 12% | 7% | $22,750,000 |
| Retail | $40,000,000 | 3.7% | 12% | 3% | $1,200,000 |
| Direct/Online | $10,000,000 | 0.9% | 25% | 17% | $1,700,000 |
| Total | $1,075,000,000 | 100% | N/A | N/A | $62,650,000 |

Table 3: PRM generates a significant bottom-line return through the combination of higher margins per transaction and growth through the white box channel. In this representative case, a manufacturer increases profits from $38M to $62M by more effectively leveraging the white-box market.

### Margin Difference with PRM

| Channel Segment | Total Margin No PRM | Total Margin With PRM | Total Margin ROI |
|---|---|---|---|
| T1 - OEM Computer (Dell, HP, IBM) | $25,000,000 | $25,000,000 | $0 |
| T2 - OEM Computer | $8,000,000 | $12,000,000 | $4,000,000 |
| White Box | $2,500,000 | $22,750,000 | $20,250,000 |
| Retail | $1,200,000 | $1,200,000 | $0 |
| Direct/Online | $1,700,000 | $1,700,000 | $0 |
| Total | $38,400,000 | $62,650,000 | **$24,250,000** |

### Tier 2 channels are becoming critical in many vertical markets

The challenges facing components manufacturers are not unique to the technology industry. Other industries have profited from similar opportunities to scale third party partner relationships and reach customers that are not served by traditional channels, as markets continue to diversify and mature. The telecommunications industry went through a major shift with the rise of the Internet and wireless technology, coupled with government deregulation to create competitive carriers in multiple markets.

As a result, telecommunications carriers partnered with master agents who delivered access to networks of individual independent agents. As margins for broadband and wireless services dropped, it became more important to build meaningful relationships with the independent agents to drive margins in an increasingly competitive environment.

Mutual funds and banks have seen a similar shift to target the smaller volume channels of independent brokers, as instability in the stock market has led many investors to work with financial advisors and the number of mutual funds is too large to support long-term growth. Deregulation and diversification of utilities is driving a first wave of master agents to resell energy services through independent agents that will likely evolve quickly into a model similar the telecommunications industry.

***Case Study: Maxtor Corporation***

*Maxtor sells its award-winning storage solutions through a global network of distributors, resellers, systems integrators and consultants with businesses in consumer electronics, enterprise storage, home entertainment and dozens of vertical applications.*

*Maxtor selected ChannelWave as a global, multi-channel sales and marketing platform, with integrated commerce, to deliver targeted communications, programs, training and business resources to thousands of channel partners around the world. The PRM system will automate channel partner recruitment, profiling and program management, create and drive targeted marketing campaigns, manage sales opportunities and measure channel performance.*

*"ChannelWave gives Maxtor an integrated, global command and control center that provides unprecedented visibility and strategic capabilities into all of our sales channels," said Stephen DiFranco, vice president of corporate marketing and branding at Maxtor.*

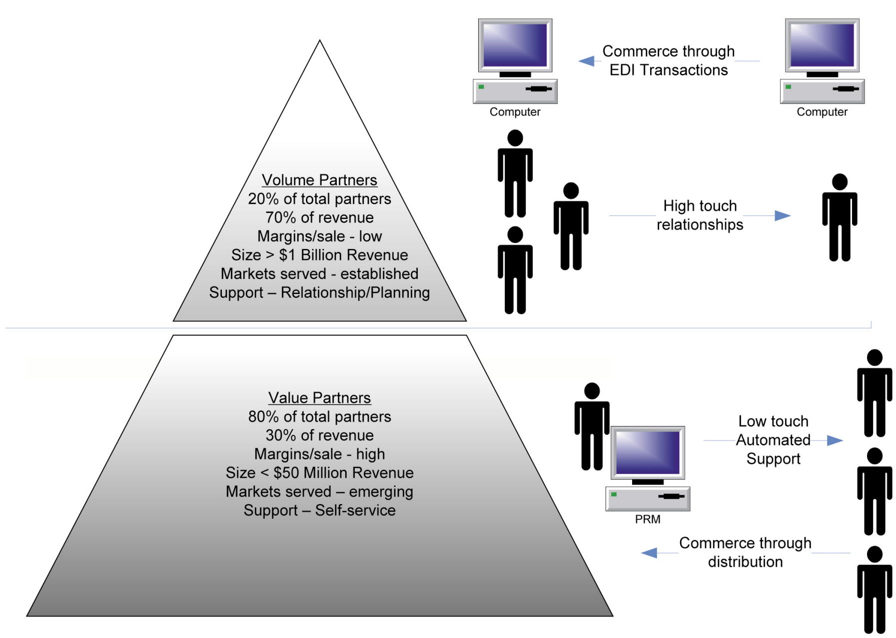
### Channel Challenges Across Industries

| Product Category | Tier 1 | Tier 2 |
|---|---|---|
| PC Components | OEM PC Manufacturers | White Box PC Manufacturers |
| Telecommunications | Master Agent/Wholesale | Independent Agent |
| Enterprise Software | Global SI | Influencer/Consultant |
| Mutual Funds | Financial Institutions | Independent Financial Advisors |
| Mortgage Banking | Financial Institutions | Mortgage Brokers, Independent Financial Advisors |
| Insurance | Master Agent | Independent Financial Advisors and Agents |
| Energy/Power Utilities | Master Agent | Independent Agents |

**The challenges of scaling profitable tier 2 channel relationships are common in many industries.**

All of these industries are converging on a common approach to partnering and how to use technology effectively to support partner relationships. Most companies find their partnerships fall into an 80/20 distribution in which 80 percent of revenue is derived from the top 20 percent of "volume" partners. This 80 percent of revenue often comes at the cost of razor thin margins and requires high-touch relationships and doing business direct through systems like EDI. The other 20 percent of revenue comes from a larger number of smaller partners, each providing a particular unique value that allows them to compete with volume providers. These "value" partnerships need to be managed with automated systems like PRM in order to reach more customers and capture higher net margins through this channel over time.

Figure: Although "volume" partners generate a high number of orders, they often produce lower gross margins. "Value" partnerships can generate higher gross margins but the cost of supporting these relationships with automation can reduce net margins. PRM tools increase net margins by providing scale to reduce the cost of managing each partner relationship and transitioning support activities to self-service systems, while maintaining transaction processing through distribution partners.




80/20 View of Partners

## How PRM solutions create profitable Tier 2 channel growth

Increasing sales through Tier 2 partners requires manufacturers to grow the membership and services available in their channel programs. This introduces new costs and difficulties that can increase the cost of doing business through these channels. Ramping up a channel program from a small number of partners to thousands requires tools that can personalize information and resources to enable a large number of individuals at hundreds, if not thousands, of partner sites to market, sell and service a manufacturer's products.

*Scaling revenue without increasing staff*

Providing precious staff resources to manage relationships with small-volume partners is not always efficient or cost-effective and creates an obstacle to success through these channels. Although a dedicated relationship manager is often necessary to maximize the profitability of a relationship with a Tier 1 partner, supporting smaller partners means that a channel manager may need to support 100 partners or more.

> *"I have three people on my operations staff. With ChannelWave, we went from supporting one reseller to 175 – without hiring more people."*
>
> Bob Thibeault, VP of Channel Operations and Strategy, PTC

PRM solutions provide the automation needed to effectively manage such a large number of business relationships by providing self-service tools for partners to standardize best practices in channel marketing and sales, with single sign-on access to all of the information and tools partners need to conduct business with manufacturers.

Channel program enrollment is established with automated workflows including reminders for prospective partners to complete key requirements to engage in programs. New partners can quickly ramp up their expertise by downloading personalized information for marketing, sales, technical and service professionals from online libraries. Broadcast email communications create scale by distributing targeted, relevant content to specific partners in newsletters and announcements. Using self-service order configuration and customer service, partners can place orders online and request order status automatically, without having to pick up the phone. By combining all of these tools, channel partners have a large set of resources at their fingertips without requiring expensive individual management and support for each partnership.

*Visibility into the black box of distribution and partners*

Visibility into channel marketing activities and sales performance can be limited to select target resellers within a community of smaller partners when strong distributor or master agent partnerships are in place. Information is not readily available from distributors regarding the identity of Tier 2 channel partners committed to specific products and solutions. Distributors or master agents solve a key problem for distributing products and credit through Tier 2 partners. However, because they maintain their own programs with channel partners, each partner is discouraged from making direct relationships with manufacturers.

Using PRM, to create 1-to-1 relationships with a large number of tier 2 partners, vendors can expand their reach with resellers and engage partners through channel marketing programs. The partners can then be recruited by establishing a vendor-owned and maintained partner profile database that consolidates partner information as a component of ongoing channel development efforts when partners respond to vendor-sponsored marketing programs. This data can also be augmented with licensed data from third party list providers like the Harte-Hanks channel database, or through POS data cleansing to create a dashboard report cards of each partner's performance.

The value of relationships with Tier 1 distributors can also be increased by using technology to syndicate content available through the partner portal to distribution partners so that the information is available both when partners visit distributor Web sites as well as on the vendor's site. Sales forecasting and deal registration tools provide visibility into the activities of partners when they need support to close key business opportunities and enable channel managers to focus their efforts on closing business, not partner administration

*Managing and rewarding performances*

Recruiting partners and providing them with tools to be successful at marketing, sales, and service is important, but it is not sufficient to drive increased sales through this channel. Additional rewards and investments need to be committed and distributed efficiently to increase market penetration and reward partners who are increasing sales. Because these market development funds are often distributed in small amounts, this process needs to be managed efficiently without distracting staff with too many administrative tasks.

Many partners expect lead referrals from vendors as a benefit of a partner program, but these also present challenges. Vendors must ensure that referrals go to partners who are actively selling their products. And they need more visibility around the results to understand the effectiveness of the marketing programs that generate demand and the partners who service it. With automation, manufacturers can more reliably track each opportunity, assign the right lead to the right partner and eliminate the complex static spreadsheets that many companies have tried to manage leads.

Market development funds (MDF), promotions, commissions and advertising kits provide ideal vehicles for small partners to leverage the strength of a manufacturer's brand in discrete markets. However, because programs are often not clearly communicated or too complex, many budgeted MDF and promotional funds go unspent – preventing Tier 2 partners from effectively reaching target markets. Automated channel marketing tools communicate available opportunities in a personalized fashion to each partner and simplify procedures to request funding, utilize marketing kits and get reimbursed for marketing expenditures. Managing these activities through self-service tools makes it possible to scale market development activities to a large volume of partners.

## Conclusion

As high volume Tier 1 channels become increasingly competitive, many manufacturers are faced with consistently decreasing margins. To grow profits in this environment, companies can engage lower volume, higher margin channels to reach new customers and markets more efficiently. By leveraging PRM strategies and tools to automate best practices with this large number of disparate Tier 2 partners, manufacturers can reduce the cost of managing each partner relationship, increase their margins and unlock the value of these untapped channels.