



**SINGLE COPY MAGAZINE DISTRIBUTION FOR THE
21ST CENTURY**

SUMMARY OF INITIAL FEASIBILITY STUDY

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Introduction

Six years ago, Safeway shocked the industry when it announced it would severely limit the number of magazine wholesalers with whom it did business. Soon after this announcement, other large retailers announced similar policies. In response, the single copy magazine distribution channel underwent rapid and significant change. Most notably, magazine wholesalers have consolidated dramatically: their number has declined from more than 180 to just four large wholesalers that handle 90% of the single copy business.

Despite the rapid change that has occurred, neither retailers who sell magazines to the public nor any of the other trading partners in the supply chain are content with how the channel currently operates. In particular, some retailers, dissatisfied both with the level of service that they receive and the efforts required of them to sell this product, have suggested that the amount of shelf space devoted to the sale of magazines should be reduced. The wholesalers are also facing severe economic pressures from loss of efficiency, lower margins, and other retailer demands, resulting in decreased liquidity and financial stability. They appear to be earning little or no profits and face substantial uncertainty with respect to their futures. As a result, these firms are unable to undertake further investments that would be likely to improve the retail distribution system.

Charles River Associates Incorporated (CRA) recently completed a feasibility study to identify potential solutions to the dissatisfaction, uncertainty, and unprofitability that currently dominate the channel. Because these issues affect firms at every stage of the production and distribution of magazines -- printers, publishers, national distributors and wholesalers -- MPA invited representatives of these supply chain members to sponsor and participate in the study. At the beginning of the study, CRA noted:

“Only through designing and implementing new, improved methods for getting magazines to the marketplace and defining the new roles of each channel participant will individual members of the industry be in a position both to earn profits and undertake successful launches of new products and/or services. And until this happens, neither retailers nor suppliers will be satisfied.”

This initial study was intended to examine the fundamental economics of the trading partners, to evaluate alternative roles and responsibilities, and to identify and highlight the kinds of structural change that might permit the channel, as a whole, to achieve long-term viability. In identifying the potential structural change, CRA was sensitive to any antitrust concerns that might arise from the collective participation of industry members in restructuring the distribution system.

Identification of Economic Issues

To gather information critical to development of possible reform initiatives, CRA interviewed more than 25 key members of the distribution channel, including executives from the publishers, national distributors, printers, wholesalers, and retailers. Several key economic issues that affect current operations were identified, including:

- Divergent incentives of publishers, national distributors, wholesalers, and retailers
- Economies of scale and wholesaler efficiency
- Customer relationships

Divergent Economic Incentives

For the vast majority of consumer products, the manufacturer, distributor, and retailer face similar, if not identical, interests regarding how much product to bring to the market and attempt to sell. Magazines, however, are an exception. Publishers don't directly bear the costs of returning unsold copies and want to maximize a magazine's rate base in order to maximize advertising revenues. The publisher is, therefore, much more concerned about out-of-stock risk than overstock risk. On the other hand, wholesalers, retailers, and to some extent, national distributors, bear the costs of handling returns but do not benefit directly from increased advertising revenues. As a result of these divergent incentives, there is dissatisfaction with the numbers of copies delivered to, but unsold, by retail establishments.

Wholesaler Efficiency

As the large wholesalers have competed nationwide for retail accounts in recent years, exclusive territories have been abandoned. This loss of exclusive territories has increased the average cost to service each outlet. Because transportation costs associated with a particular route are largely fixed, costs per stop (retail outlet) have increased. "Pre-weekend delivery" has further reduced wholesaler efficiency, as many retail outlets require multiple visits per week.

To some extent, the recent consolidation of retailers and technological advances have led to some countervailing efficiencies. However, the increased wholesaler competition for retail chain accounts and shelf space has further reduced margins to unprofitable levels. Retailers are increasingly demanding that wholesalers provide a single upfront payment that includes discounts such as the Retail Display Allowance (RDA) which were promised to the retailer by the publisher. This adds to the economic pressure on the wholesalers as they subsequently have to recoup the monies from the publisher. This pattern is unlikely to change: retailer demands will likely continue to limit potential changes that the channel might attempt in order to restore profitability, unless the retailers assess any potential change to the distribution system as enhancing their sell-through rates and profits.

Customer Relationships

Following the upheaval in 1995, the existing management structure of customer relationships broke down. Today, rates, quantity, and service negotiations remain uncoordinated, as there are no direct negotiations between the beginning and end of the channel -- the publisher and the retailer. As a result, the divergent incentives (see above) regarding the desired number of magazines to stock remain unsolved.

Despite the fact that the magazine industry sells approximately 5,000 products, no one claims “ownership” of category management. Traditionally, category management was the responsibility of the wholesaler. Recently, the publisher and the national distributor, as its agent, have begun competing for these functions. The ensuing lack of coordination has resulted in both redundancy and incompleteness in category management requirements. Moreover, while retail sales data provide a complete picture of sales by title, date, and retail outlet, this information is generally not shared with the publishers and national distributors in a timely fashion. As a result, it is impossible for them accurately to adjust the number of copies they distribute to wholesalers.

Finally, wholesalers and retailers perceive that an excessive number of “me too” titles exist, encouraged by the fact that publishers do not bear the full costs of handling poorly selling titles.

Features of a New System

In designing any new method for bringing magazines to the marketplace, the optimal role of each channel member must be determined. In interviews, many executives throughout the channel described how a distribution system might operate if initiated as a “clean sheet,” that is as the most efficient system going forward, without regard to the existing system or the necessary transition to the new, more efficient solution. While it is obviously difficult, if not impossible, to ignore the current structure entirely, it is still useful to consider an ideal new system.

CRA identified three critical questions that must be addressed in designing such a new system:

- Who negotiates with the retailer?
- For what activities should the wholesaler be paid?
- Who selects the wholesaler?

Each of these questions is discussed below.

Who negotiates with the retailer?

Currently, the wholesaler, as a reseller, negotiates terms with the retailer and arranges certain marketing programs. At the same time, the publisher also negotiates some marketing components with the retailer. In an alternative model, the publisher could sell directly to the retailer. (In a variant of this model, the national distributor might facilitate these negotiations by serving as a “messenger.”) This alternative system would require a new payment structure for

the wholesalers since they would no longer be serving as resellers or taking ownership of the magazines. While this system raises tax questions (which were not addressed in this phase of our study), most interviewed agreed that these issues could be resolved and would not prohibit this method from occurring.

There are several benefits of direct negotiations between publisher and retailer. In particular, direct communications between the publisher and the retailer should facilitate resolution of the current incentive-conflict issues. Moreover, negotiations over marketing and price issues that are currently separate could be combined. Finally, sales information could flow back to the publisher in a more timely fashion. Each of these benefits would reduce costs and enhance efficiency.

For what activities should the wholesaler be paid?

In the current system, where the wholesaler is paid as a reseller, the fee earned by the wholesaler is based on the cover prices of magazines and the number of copies sold. The wholesaler has a major marketing role, but both the publisher and the national distributor also market the product to the retailer.

Alternatively, the wholesaler might be paid as a logistics provider. A number of other industries such as drug and quick-serve restaurant wholesalers have already moved in this direction. The fee paid to the wholesaler would be based on a cost-to-serve model where publishers and retailers would select and pay for alternative bundles of services. These bundles would potentially include many or all of the services that the wholesaler currently provides. However, by selecting and paying for specific services, the economic incentives of publishers will be more fully aligned with those of other channel members. Publishers would bear the full cost of services selected, and wholesaler payments could be designed to provide them with incentives to increase retail sales. As a result, efficiency would be enhanced. For example, consider the important function of servicing the store. Currently, wholesalers service the racks of most retailers. Performance appears to be mixed, with service problems exacerbated by high wholesaler costs stemming from lack of route density and low sell-through rates. If wholesalers were paid specifically for servicing the racks and knew that satisfactory performance was required for them to maintain the business, they would be better incentivized to restock shelves and maintain the racks.

Moreover, in today's environment, wholesalers have little interest in supplying excess copies of magazines to the stores because this causes the wholesalers to incur the cost of bringing them back to the wholesalers' warehouses. At the same time, publishers have little incentive to minimize the number of unsold copies. With a cost-to-serve model, the publishers would pay for the costs of handling returns. This also provides more congruent incentives as it is the publishers who benefit from ensuring that no magazine is "out of stock" at the retailer. Similarly, during the interim period before the cost-to-serve model is implemented, the payment of wholesaler compensation for specified services might provide more congruent incentives and promote the provision of enhanced distributive services in a manner that benefits publishers, wholesalers, and the channel as a whole.

CRA noted that movement toward scan-based trading is likely to eliminate the need for counting unsold magazines. With the advent of this system, retailers would likely “pay on scan” for all copies that they sold. This would probably mean that those same retailers would become responsible for shredding all unsold copies. While everyone agrees that this is the model for the future, there seems to be mixed information regarding the proportion of retailers that would be able to scan magazines within the next two years. In any event, several key issues remain, including the need for collective action to facilitate standards and transition, further negotiation on how to handle “shrink” (copies unaccounted for) issues, and ensuring final disposition of unsold copies of magazines. It remains unclear what system will emerge to continue to service small retailers who will lack scanning capability.

Who selects the wholesaler?

Since Safeway first announced in 1995 that it would severely limit the number of magazine wholesalers with whom it did business nationwide, retailers have been selecting wholesalers. This system arose in part from the retailers’ interests in reducing the costs that they incurred from having to deal with so many different wholesalers. While retailers have succeeded in reducing their transactions costs, this shift has led to increased costs to wholesalers, as discussed above.

Some industry participants would like to see a return to some form of exclusive territories to enable wholesalers to achieve density and distribute the product more efficiently. It is their hope that the channel might be able to create such a solution. CRA concluded that this is unlikely to happen in the near future, as no publisher or national distributor is sufficiently large to drive this change unilaterally. CRA considered the merits of forming a consortium of publishers (and national distributors), perhaps with direct retailer participation, to designate an exclusive wholesaler for each territory. To determine which wholesaler would be designated the exclusive wholesaler in each particular territory and to ensure that prices remained competitive, the consortium might use a bidding process. The designated wholesaler would be paid as a logistics provider, not as a reseller. Throughout the term of the award, the consortium would be responsible for monitoring the performance of the winner to ensure that it complied with the consortium-established standards.

While the consortium would achieve the efficiencies associated with route density, it would also be costly to operate. These include the costs associated with identifying various tasks to be performed and establishing a relative cost for each in order to standardize bidding forms, the establishment of an auction in which firms would bid to become the exclusive wholesaler/logistical provider in an area, and the introduction of a board to monitor the behavior of the exclusive wholesalers. Furthermore, such a system likely would permit retailers to “opt out,” that is to arrange for their own delivery and service. All of these complications could well destroy even the best designed consortium.

Key Recommendations

The purpose of this study, an initial investigative evaluation, was to identify ways that the industry might distribute its products more efficiently and in a manner that helps to improve relations with its customers, the retailers. CRA set out to identify and highlight one or more specific initiatives that should be developed to restore financial stability to the channel.

CRA's key recommendations are to:

- Strongly consider, and further explore, adopting a model in which publishers negotiate price and marketing terms directly with retailers. In such a model, wholesalers would likely be transformed from resellers to logistics providers. National distributors, as agents for the publishers, might have a role in the negotiation process with retailers.
- Simultaneously, also strongly consider and explore paying wholesalers on a “cost-to-serve” basis that better aligns the incentives of all members of the distribution channel.
- Examine methods to facilitate the transition from the current system to such a more self-sustaining system. Consider and explore interim solutions whereby current roles of various members of the distribution channel are essentially maintained, but new financial incentives improve sell-through, marketing, and information sharing.

Coupling a cost-to-serve payment method with direct publisher/retailer negotiations shifts the economic incentives and the roles of participants. CRA recognized that changing roles is never easy, and that it is especially difficult during times of low profits. Despite this, CRA strongly urged that all current and future participants recognize the need for change and the potential benefits that will arise as a result. CRA will continue its involvement to help facilitate necessary changes.

Founded in 1965, Charles River Associates, an economics, finance, and business consulting firm, works with businesses, law firms, accounting firms, associations, and governments, in providing a wide range of services. CRA combines economic and financial analysis with expertise in litigation and regulatory support, business strategy and planning, market and demand forecasting, policy analysis, and engineering and technology management. In thousands of engagements, CRA has distinguished itself by its corporate philosophy of providing responsive, top-quality consulting; an interdisciplinary team approach; unsurpassed economic, financial, and other analytic skills; and pragmatic business insights.