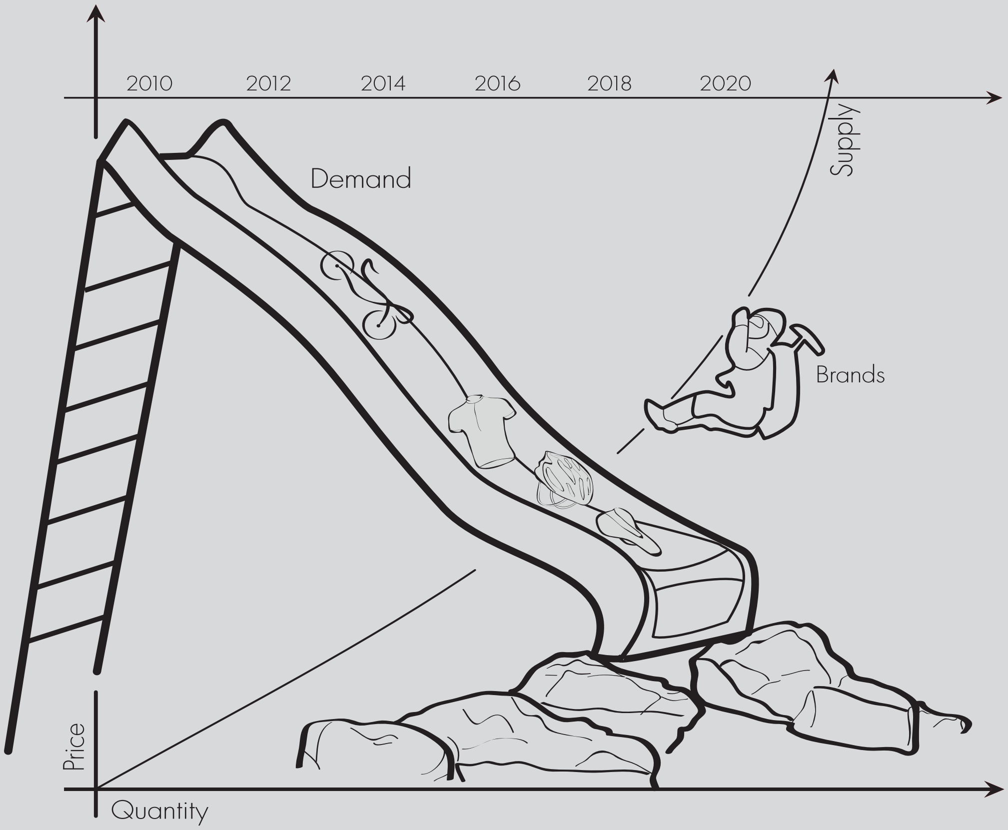
Commoditization & eCommerce



How Specialty Cycling Can Beat this Techno-Economic Cycle

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National Bicycle Dealers Association

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EXECUTIVE SUMMARY

The National Bicycle Dealers Association has represented specialty bicycle dealers in the United States since 1946. With over 1000 members currently, the non-profit association offers numerous programs for dealers, with an emphasis on education, research, communication and advocacy. The NBDA has prepared this White Paper to discuss the onset of commoditization of specialty bicycle retail products, the harm that this is causing to consumers and traditional brick-and-mortar retailers, and to raise up potential approaches to address the problem.

The specialty bicycle industry is at a cross road. Since the early 1970s there has been a significant loss of brick-and-mortar retail shops in parallel with a decline in consumer participation in cycling, and the losses continue annually. From the NBDA's perspective, there has been an unhealthy shift of focus away from high quality/service retailers to low service/price ones. Because of this shift, full-service, specialty retailers are disappearing at an alarming rate. The NBDA and other sources of research estimate that this industry has lost almost 3,000 local bike shops. In their place are mass market retailers, particularly the new wave of discount online retailers, who do little more than collect orders and deliver products at razor-thin margins. They are mere sales conduits who offer nothing else. They limit their relationship with brand owners and customers and disconnect these two from each other. They provide a disservice to the local economies and drive customer support away from communities where traditional bike retailers once existed. The following scenario is a frequent occurrence throughout the U.S. today:

> A customer visits a specialty local bicycle shop which has existed for over 20 years. The shop employs a dozen full-time and part-time staff. The customer is interested in a bicycle and accessories, but needs assistance with education and product selection on a range of products. After employees spend an hour or more educating the customer, fitting the customer who takes test rides, and helping the customer select several needed accessories, the customer takes this knowledge home. Then, while proceeding to shop online, the customer finds a bicycle claiming to offer the same experience as the ones offered in-store while finding the identical accessories to purchase with free delivery to the home. The customer attempts self-assembly with difficulty and later takes the bicycle back to the same shop for "quick adjustments" that the customer expects to be cheap or free. As this activity increases around this shop, it will soon lose viability and close its doors, laying off its employees and removing local support from the community which halts attracting existing and new riders to enjoyment of the sport.

The loss of one more shop may not seem significant to the whole industry, but it is certainly significant to the next community in which it occurs. Many smaller towns and cities could only previously support one or two shops such that, once gone, there are left behind broadening gaps in availability of local support of cycling. When consumers must leave their own community and drive significant distances to find experiential product education & mechanical support, and when they no longer have local organizers for cycling events, they will usually abandon the sport before long and new entrants will not be attracted to replace them. Novice and casual cyclists, which are the majority of them, require convenient access to a merchant who can afford to risk a commitment to location costs, maintain a broad range of choices in costly inventory, hire and train knowledgeable sales & service staff, and support community advocacy for cycling. Dollars spent in these stores support the local economic, tax and job base. Customers develop relationships with these stores and their staffs and become dependent on their support throughout the lifecycle of the products they have purchased. Thus, the loss of one shop is far more damaging to the consumer than often considered. This damage is not limited to the local level, but affects distributors, brand owners, and manufacturers.

The damage done may be masked by the short-term sales volume being delivered through mass-market and/or online channels, but this unit volume replacement will have its days numbered. Although existing consumers who were educated in local shops may temporarily have enough knowledge to help themselves with ongoing online product selection and limited self-support, this knowledge is not easily or widely passed on and new entrants to the sport will not be attracted to replace this singular generation of online shoppers. As they retire from the activity, mass market sales of the industry's products will have no place left to shift; they will simply plummet. Once a distributed network of local shops is effectively gone and without a critical mass of shops that covers most geographical areas of the population, there will be no opportunity to rebuild that network as the population will have stopped looking for the product – they will already have moved on to something else.

This industry lifecycle of innovation to specialization to commoditization to obsolescence is not fated to occur in its own random timing. Smart brand management is essential to maintaining a mature specialty industry, and it can be maintained indefinitely if care is taken. The customer is best advantaged by this smart management when a healthy network of specialty shops is rewarded with sufficient retail margins to support showrooms, staff training, stocking of multiple brands, and high quality repair and warranty service. Specialty brand competition drives innovation forward to continuously improve the product and the consumer experience. Excellent experiences draw new participants to the sport and increase the opportunity for more brands to enter, compete & grow which furthers offer the consumer additional, wider ranges of products to enjoy with healthy price competition.

Mass-market and online discount retailers take unfair advantage of specialty brick-and-mortar retailers by "free riding." Specialty retailers must invest heavily up-front, the costs of which must be made up in their retail margins. Online retailers can exist, in sharp contrast, with a tiny fraction of up-front costs which allows them to profit on the backs of specialty retailers who first educated the converted online customers and who grew the online-purchased brands' awareness and value in these customers' minds. This industry must once again recognize that without specialty local retailers, there will be no industry, and without sustainable retail margins that support specialty local retailers, specialty retailers cannot exist.

There is no short-term, stand alone or easy solution. However, the NBDA proposes a number of different approaches that may be employed together to address the problem. It is important to bear in mind that the NBDA recognizes that in order to provide the greatest benefit to the consumer, the industry must maintain and support healthy inter-brand competition. Each business, at each level of the chain of distribution, must make its own independent business decisions to address these problems and examine these approaches for appropriateness for its own business continuance. The NBDA also hopes that it is not too late for consumers to recognize the important role that they play in having ongoing access to quality cycling experiences by supporting their local independent bicycle retailers.

The NBDA urges the bicycle industry to consider the following approaches to maintain and grow anew a healthy bicycle industry which has not significantly grown for many years:

Approach #1 Retire the Use of MSRP For Non-Commodity Products.

Approach #2 Emphasize Product Quality and Service, Not Price.

Approach #3 Support Healthy Retail Margins.

Approach #4 Employ Effective Minimum Advertised Price Policies.

Approach #5 Limit Sales to Authorized Specialty Dealers.

Approach #6 Limit Internet Sales Only to Authorized Specialty Dealers.

Approach #7 Employ Effective Minimum Advertised Price Policies Outside of the U.S.

Approach #8 Limit Closeouts to Authorized Specialty Dealers.

Approach #9 Grow Brand Sales Through Product Diversification.

Approach #10 Consider Allowing Individual Models to Run in Longer Independent, Overlapping Sales Cycles.

Approach #11 Limit Warranty Service to Original Purchasers from Authorized Specialty Dealers.

Approach #12 Offer an Easy-to-Find Authorized Dealer Locator on Website.

Approach #13 Encourage Product Education Through Authorized Specialty Dealers Rather Than Consumer Self-Education Via Website.

Approach #14 Increase Authorized Specialty Dealers' Education through Software Solutions.

Approach #15 Take a Long-Term Approach to Growing Product Sales.

Approach #16 Avoid Direct Selling to End-User Customers.

Those who manage their way into a crisis are not necessarily the right people to manage their way out of a crisis

– Albert Einstein

But they may manage their way out of the crisis if they only understand what went wrong

– This Author

Introduction:
The Bicycle Industry – Stable & Mature or In Decline?

The bicycle industry has a long and storied history as the bicycle itself has now seen active use in three different centuries. According to The Gluskin Townley Group, the bicycle business today is a six billion dollar marketplace in the U.S. There are ~4000 IBDs currently operating in the U.S. While many big box and online non-IBD sources of new bicycles and accessories have flooded into the market, there is nothing to worry about… right?

Consider the market for home organs (brand example: Wurlitzer). This is another complex, durable product which was quite popular in the US a generation ago. Like quality bicycles, organs are relatively expensive, long lasting, difficult to ship and require a knowledgeable sales force and skilled installation and service. So they were sold quite successfully by expert local dealers across the US, peaking at a quarter of a million units in 1976. But by 2008, the market had fallen over 97% to 7,100 units and 2009 was even worse. Why? Changing technology? Diluted distribution? Greedy retailers? There's been plenty of finger-pointing – but with that kind of market collapse, it seems impossible to spin a positive story. Yet a few brand owners left in the organ industry continue, even today, to opine how profitable and misjudged their market is. At least one writer in that tiny space says the collapse has little to do with changing public tastes and technology, and names retailers who "don't believe in the product" as the entire cause of this decline.

To many, the home organ market may seem difficult to relate to, but the end of an industry life cycle that it represents is in various stages (and often late stages) of happening to bookstores, toys, snowboarding, cameras, and most other specialty durable consumer goods.

Misunderstanding the causes of decline is unfortunately commonplace in every business, including within our industry. Even as the numbers, properly understood, show that there is trouble ahead for cycling and little time left to change (which this paper will illuminate), there are still thousands of workers in the cycling industry, including those paid to write about it, who tell each other that the only possible future is bright.

Most cycling brand owners are well aware of the challenges they face. Whether they give credence to BRAIN, Leisure Trends, Gluskin Townley Group, studies commissioned by the NBDA or other sources of research, most have understood the following:

1. The average age of the specialty-enthusiast cyclist is climbing,
2. Unit sales volume has been largely flat over the last ten years, and
3. Average wholesale unit costs are rising due to higher production & import costs, not due to consumers buying higher-end models.

In the 2012 Outdoor Recreation Participation Topline Report from the Outdoor Foundation, outdoor sports participation between 2006 and 2011 has been flat – meaning that we are not growing the population or the incidence of sporting activity. Similarly, cycling has also been averaging out flat, even with the cycle-friendly influence of higher gas prices and increased urbanization.

When sales volume is flat in a society that is otherwise growing the number of consumers, that industry is, in fact, in decline per capita. This means that it is not attracting new customers to the activity at the same rate as the population growth. A telltale sign is increasing average age of participation, as we now see in bicycling.

Naturally, the high-volume sales of basic accessories follows BSOs into the mass market.

As consumers resort to cheaper substitutes over specialty products, there is no wonder at their decreased satisfaction with the activity. Before long, a generation grows up that is unaware of any difference between the quality bicycle vs. the cheaper toy-industry substitute. For the few who are aware of the better-but-costlier counterpart to the BSO, the prevailing wisdom of the consumer becomes "trying" a cheap bicycle to see if they enjoy cycling before buying a better-made model. But consumer logic breaks down when it is the cheap equipment itself that fails their satisfaction test, not the activity of cycling that the consumer might otherwise have been captivated by on a quality product. Not many consumers upgrade to specialty equipment if they don't understand that their lack of satisfaction was not the fault of cycling itself.

> These apologists are right, in a sense, that **this industry is not going anywhere** – it is rather stuck in its own blind faith.

But a deeper point must be carefully noted: even when production and operational costs are stable, a flat market creates upward unit pricing pressures. Without significant growth, specialty brands and retailers, who struggle to maintain their existing scales of operations, must incrementally raise prices to afford the increasing costs of doing business. Employees want raises, and the brand which can't afford them will lose scarce and valuable talent. Raw materials and shipping fuel costs rise. Regulatory compliance, marketing, real estate and other rising expenses bleed-off profit if there is not unit sales growth.

When unit prices are all that is increasing in otherwise flat markets, it further limits attracting new entrants to the sport. Those consumers who do enter the market opt for cheaper alternatives when they are offered. In cycling, these cheaper alternatives have come via a massive shift over the last few decades from quality manufactured products purchased in IBDs to cheaply manufactured imitations (affectionately called BSOs or Bicycle Shaped Objects) purchased through mass market channels. Seven out of eight bicycles (for our definition, having two wheels and a crank regardless of quality) are now purchased outside of IBDs.

But always ready to spin a positive story, the cycling industry has told itself that cheap product offerings "increase access" to the sport and introduce new entrants. As the example above reveals, the cheap substitute is actually a barrier to specialty equipment entry because it psychologically sets the price expectations too low for what cycling equipment should cost.

The process described above has compounding characteristics. That is, dwindling new customers create additional upward pricing pressures on specialty equipment which continues to reduce the number of new customers. Unchecked, it deflates the industry. Most makers and purveyors of home organs never saw it coming. Neither are many in the cycling industry willing to acknowledge what may be right around the corner.

Still, some industry apologists remain unconvinced of a problem. They will state that interest in cycling has never dwindled and use anecdotal references to prove that cycling "isn't going anywhere". These apologists are right, in a sense, that this industry is not going anywhere – it is rather stuck in its own blind faith. For them, the only challenge they acknowledge is that of attracting mass market customers back to the local store (if the apologist is an IBD owner) or capitalizing on the new internet retail ("eCommerce") channel without unwittingly hurting IBDs (if the apologist is a supplier).

What those rose-colored glasses are filtering out is that most online sales are merely a final step on the way to product commoditization. Today's purchases made online are largely to:

1. existing cycling enthusiasts who have graduated away from IBDs and who know (or think they understand well-enough) what it is that they are buying, and

2. new cyclists who don't get the benefit of introduction to the complexity and range of products via a knowledgeable IBD, who are first-time buyers of cycling equipment, and who often end up with the same experience as those who "try" a cheaper bicycle – disappointed in the experience and not likely to be repeat customers.

What follows is a deeper economic discussion of 1) the causes of industry decline for a durable good – applied to the specialty bicycle equipment industry, 2) the state of the various players in the bicycle industry, and 3) solutions which may usher in new growth. It should be thoughtfully and carefully considered by any brand owner or manager who is concerned that all may <u>not</u> be well with the future of cycling without significant course correction.

It is predicated on the assertion that there are two different camps: one which acknowledges the problem *is* real, and one which will acknowledge the problem *was* real after it is too late. If enough of the industry belongs to the former camp and acts decisively, those in the latter camp can pretend that they were right all along and take credit. But if too many are in the latter camp and remain content, few in the industry, like in home organs and other durable specialty goods industries, will be left to argue about it.

Having an in-house economist became for many business people something like having a resident astrologer for the royal court: I don't quite understand what this fellow is saying, but there must be something to it.

– Linden. (01/11/1993). Dreary Days in the Dismal Science. Forbes. p. 68-70.

Part One: Cycling Retail Economics

Any industry projections upon which people are going to make decisions must find solid footing in an understanding of the economics of that industry. And to understand the economics of an industry, one must understand the fundamentals of free-market economics in general. Ironically for cycling, in the same way that bicycle store owners did not open shops because they were retail economists, most brand owners did not start producing products with a deep understanding of economics either. This is to say nothing of the fact that most consumers are barely conscious of the economic forces acting upon them which influence how they make buying decisions.

Unfortunately, applied economics is not a subject that most Americans pursue, let alone relish. But for those who make decisions for our companies about things like production volume and price, their decision-making capacity may unknowingly harm their business if they are not well-acquainted with economic theory.

What follows is too densely summarized to bring up-to-speed someone who is unfamiliar with the concepts, but hopefully this will be a useful review upon which this industry can build a sustainable framework for renewed growth.

The Durable Goods Product/Industry Life Cycle

A simple and accepted understanding of the economic life cycle of durable goods is described by four phases: Introduction, Growth, Maturity and Decline. Interestingly parallel to this is the natural

Phase/Cycle	Human	Specialty Product	Specialty Industry
Birth	Very vulnerable - completely dependent on constant attention and provision of needs	Very costly - requiring great investment to develop and marketing investment to create demand for	Very speculative - requiring great investment and risk to create manufacturing efficiencies and spur initial demand; premium priced
Growth	Impressionable - continuous training and investment of time and expense to keep healthy	Unstable - continued investment with care to keep from undersupplying (stifling growth) or overproducing (choking-off profit)	Collaborative - many partners needed to build a distribution and retail network and gain market acceptance; highly priced
Maturity	Less dependent - able to be self-sustainable and reproduce; the longest of the four phases	Stable - requiring minimal costs to maintain current customers while investing in turning new customers to generate unit growth	Entrenchment - price equilibrium of supply and demand; moderately priced
Decline	Naturally via age –or– prematurely due to accident or disease caused by environment, abuse or neglect	Failing – b/c of technological obsolescence –or– prematurely due to artificially human-caused pressures on supply or demand	Contraction - replacement by new technology –or– prematurely due to misunderstanding or mismanagement of brand distribution; commoditized, cheap

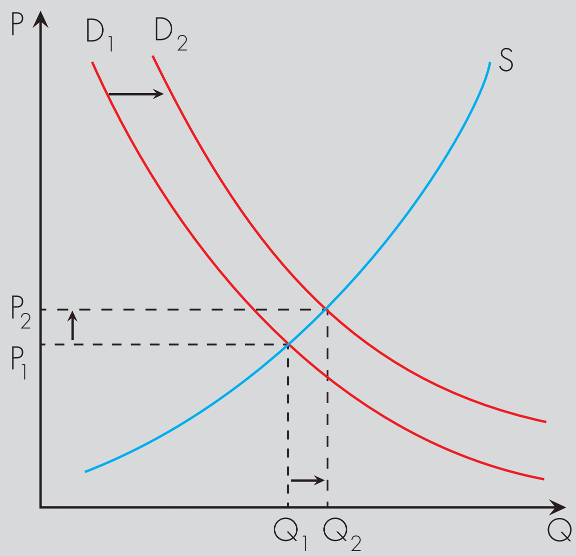
human life cycle. A comparison of human, product and industry life cycles is offered above:

In general, products and industries each take great investment and effort to build. Then they require smart management to maximize their longevity and profitability. In the same way that a human lifespan can be maximized through smart choices in nutrition, exercise & lifestyle or cut short by abuse & neglect, product and industry life spans can be maximized by smart management or prematurely ended by mismanagement.

In the case of products, there is usually one or sometimes a small group of decision-makers that manage a given brand and family of products. Accountability is clear and the results of either good or poor management will eventually be directly experienced by sellers and buyers. Even the decline of one industry and loss of its business activity impacts an entire national economy.

What's In a Price? Supply & Demand

The following chart illustrates one of the foundational concepts of a free-market (capitalist) economy:



P=Price, Q=Quantity, D=Demand, and S=Supply.

Supply increases or demand decreases generally drive down price, while supply decreases or demand increases push price up. The untenable goal of any business owner is to have perfect *price stability*, when 1) the price that the consumer is willing to pay for an item is high enough to fairly compensate manufacturer, distributor and retailer for their relative labor, and 2) consumers are willing to continue to steadily and predictably buy the same item for the price indefinitely. Production supply can be planned perfectly to match demand without any shortages or overstock. This would be a perfectly *efficient* system.

Of course, in a complex economy of millions of human beings, a perfectly efficient system is quite impossible. There are myriad unexpected variables always acting upon the actual demand and supply. Regardless, price can achieve a *relative stability* by avoiding wild fluctuations caused by strategic miscalculation and mismanagement.

Thus, the practical goal of any brand or business owner should be to see steady, *sustainable* growth in demand, to be able to support that demand growth with efficient, sustainable manufacturing capacity, and to maintain profitable wholesale and retail margins. Further, the desire is that pricing is able to:

1. withstand minor increases to accommodate inflation or increased costs without significantly reducing demand, while also able to

2. withstand minor decreases to accommodate new competitors without significantly impacting profitability; and

3. to encourage product innovation and reinvestment.

Is It Gold Or Just A Pretty Rock? Scarcity and Speculation

A non-commoditized durable good possesses uniqueness, or distinctive *value propositions* that others are willing to pay for. This value of what is being offered in limited supply is described in the economic concept of *scarcity*.

Scarcity is paramount. A rock of no particular composition has no value. Anyone can go outside and find one for free. However, what about a particular quality of beautiful granite that isn't just lying around? What if a mining operator discovered sources for this granite and invested in research to determine how much there was and how much it would cost to mine? What if that company performed experiments and discovered that certain methods of extracting and cutting this granite destroyed its structure or beauty, so it learned a way to do these things that preserve its desirability? Would it grant other companies access to its mines or give them copies of their proven methods?

Utilizing the skills and know-how of highly trained specialists to find, harvest, cut, polish, transport, and sell such a product demands value because of its natural scarcity vs. the average rock, and because of the artificial (or strategically planned) scarcity of proprietary know-how. Scarcity is a fundamental operator on the marketplace negotiation of *price*. The less of something desirable there is, the more that certain customers will be willing to pay for it in order to gain access ahead of someone else, like tickets to the Super Bowl.

Speculation describes the activity of people guessing what the future supply and/or demand of something, or its relative scarcity, is likely to be. When something is expected to be plentiful, then price may fall in advance of the increase in supply because of the expectation that the price is about to fall anyway. Or, when demand is expected to increase, then price may rise in advance of the actual increase in demand because of a similar change in expectations. Thus, where scarcity has a direct and natural influence on price, the *perception of scarcity* also has a direct influence on price.

It must also be noted that artificially created scarcity of know-how works on price in a similar fashion, but with a fundamental twist: when proprietary know-how becomes common knowledge, it becomes commoditized and loses its value. Therefore, specialty know-how must be protected in order to support the price that is charged for benefiting from it.

Loaves and Fishes: Elasticity

Markets are *elastic*, and not *static*, meaning that they can expand and contract dynamically. When a marketplace expands, there is more opportunity for gain to be shared by all. But when it contracts, waning business activity creates unmet wants and needs. This can seem difficult to reconcile. If physical resources are limited, with growing populations on the planet demanding to use those resources, how can total wealth increase? This is answered in part as a function of the rate of *economic activity*.

A simplistic illustration: imagine a classroom of 30 kids and 60 differently colored balls. The balls are scattered randomly around the room and the children are told to find them, and then trade with them according to their perceptions of desirability of different colors. During the activity, no additional balls are added. If the rate of exchanging the balls is slow (say, traded an average of five times per hour), then the average child will have earned and spent a quantity of five. Some ambitious children may have earned & spent six or more, and others less than five, creating a sense of greater or lesser wealth in comparison to each other.

Now increase the rate of trading to ten per hour. A few kids will have refused to trade any faster and still only *turned* 2 or 3 balls or even preferred to rest and stopped trading, but other kids will have increased their effort and perhaps turned 15 or 20 balls, while average activity still increased and most kids earned and sold more than before.

In this simplistic example, no resources were added, and yet perceptions of wealth and gaps between who has most and least changed based on the rate of activity, both for individuals and for the whole group. Although more complex and with many more factors, business economic activity is a core concept in the understanding of market elasticity. Wealth is created, seemingly out of thin air, when there is more buying and selling going on. Even when raw materials from digging in the ground and technological advancement temporarily slows, markets can still expand. And even when additional resources are obtained from resource extraction or from technology-driven efficiencies, markets can still contract, all based on the rate of activity.

Concepts of satisfaction lie at the heart of the interaction between economics and human decisions.

The Turtle and the Hare: Sustainability, Inflation, & Human Ambition

Growing too quickly usually ends in failure when unsustainable demand snaps, and an unplanned *correction* (drop) in demand leaves a supplier over-extended to creditors, sitting on too much inventory, and saddled with too many expenses incurred to keep up with the previously hot growth rate. But growing too slowly is equally problematic as workers and companies must be able to keep up with *inflation*.

Inflation is a good and naturally occurring limited rise in the cost of goods and labor. Like growth, inflation that is too fast is destructive. When costs grow too fast, the buying power of currency cannot keep pace. And *deflation*, falling prices, is equally destructive as it reduces asset values, profit and incomes. While both conditions are relative opposites of each other, both reduce wealth and contract market activity.

Sustainable growth is even and steady. It does not outpace natural growth in demand and other economic factors, while it seeks not to under-pace these factors either. But buyers and sellers, who are acted upon by the scientific forces of economics, themselves also act upon those forces according to much less scientific *human values*.

Concepts of satisfaction lie at the heart of the interaction between economics and human decisions. Some people are inclined to be easily satisfied and don't wish to work harder just to gain more for themselves. People like this may understand the *law of diminishing returns* (discussed below). But many others are not so easily satisfied and look for any opportunity for the even smallest additional gain. This desire puts them into greater competition with others. The *competitive spirit* is a label for the satisfaction that some derive from winning and the dissatisfaction they experience from losing.

Businesses themselves are merely inanimate containers that define a collection of people and resources. It is the people within them that drive the business forward with different concepts of personal satisfaction. One business owner may be happy with a level of profitability that allows for some luxuries and is only measured against itself. But another business owner may not be satisfied enough with mere profitability and seeks additional glory by being the biggest or the best-recognized. One may seek to gain by maintaining the same share of and growing the pie, while another seeks to gain by increasing the share of the pie regardless of whether the whole pie is itself growing or shrinking.

In a discussion of economic theory, this human factor cannot be ignored because it is the single greatest source of unpredictability in an economy. Even nature's impact (like business interruption caused by a hurricane) is more predictable than the impacts of human decisions on the economy (or any subset industry like the bicycle business).

The novice armchair economist, like the average 401k account owner, understands that a national economy goes through cycles of expansion and recession (or increased and reduced economic activity). National policies attempt to regulate this to keep expansions going as long as possible while limiting recessions to short periods. So why can't we produce unending, slow, steady expansions? Why do recessions still occur at all?

It is the human element: no matter how many intentional controls, regulations, and policy decisions we apply, humans are still making countless decisions every day. Many of these decisions are aimed at reaching beyond a reasonable or sustainable gain in order to achieve maximum short-term personal benefit. There are many scientific factors that economists discuss as the cause of recession, but most of them result from an umbrella of human decision-making; and, it is decisions from short-term thinking which create economic recessionary pressures. After all, a recession is merely a correction for an overheated economy that expanded too quickly.

Carpe Diem! (Adepto Occupatis Locis Per Crastinum)

"Seize the day" is a famous call to action. The unknown phrase in parenthesis above means "get seized by tomorrow". Here is an illustration of how the two are related: cast off all inhibitions and party tonight, but you may not like where you wake up or how you feel the next morning.

The desire to maximize short-term performance is an understood and ongoing struggle that is endlessly debated throughout all levels of business decision-making. A very great deal of failure and loss has been caused by decisions made for short-term gain without sufficient understanding of (or concern for) future consequences.

In economic terms, this can be partially understood by studying the *law of diminishing returns*. According to this concept, just like the optimum price in the supply/demand curve, there is an optimum cost of producing something which is often charted in a *short-run marginal cost curve*, depicted below.

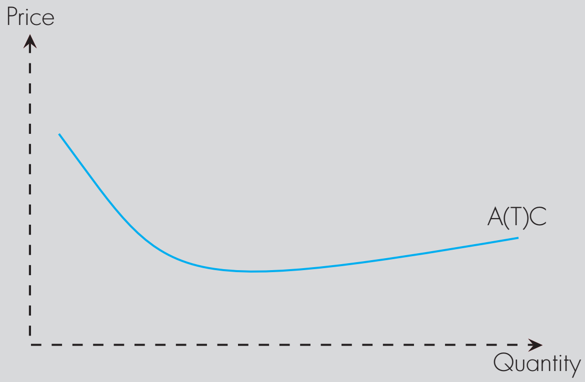
This simple illustration reveals that when only a few units are produced, the cost of production per unit is high. As more units are made, efficiencies are gained which drive down the cost of production per unit and increase profit (provided the market price does not change). However, there is always some point at which production efficiency is maximized, and pressing past this point begins to introduce inefficiencies which then begins raising the cost per unit produced (thus eating into marginal profitability of the next unit sold.)

In the real world, examples of efficiencies include factory automation, larger shipping quantities, and spreading fixed overhead costs across more units sold. Examples of inefficiencies include building new factories, adding layers of management, and the increased costs of government regulation and

Specialty dealers who cannot sell at the unsustainably low *street price* close-out that brand and stop ordering it, and new users are no longer introduced to the brand by those specialty retailers who have the ability to describe the product's complexities and **value**.

its scrutiny of larger companies.

The bicycle business, like all other complex, durable goods industries, is far from immune to the effects of short-term thinking. The human factor that drives decision-makers to conquer ground in the marketplace and make one more dollar today has a remarkable and powerful ability to overcome better judgment. For example, what does a company which compensates sales staff



based purely on commission communicate to that staff? The message is that there is no such thing as too much volume. If the market demand for a product is theoretically X units per year, and an order for $0.5X$ units for delivery this month alone can be generated from non-specialty retailers, then the supplier may accept that order and celebrate. But at that point, the real impact has not yet begun.

Meanwhile, inadvertent misunderstandings may incorrectly convey that the market has expanded and demand has increased (whether or not it is actually sustainable), so additional manufacturing resources, warehousing, and staffing resources are pursued. Once those commitments are made, there is now a drive to maintain that higher volume of orders.

This describes a classic type of bubble. Volume and sales go up in the short-term, retail price comes under downward pressure, and the cost per unit produced has gone up with the added resources that have been committed (as if the higher level of demand should continue indefinitely).

Meanwhile the brand gets commoditized by having a glut of units dumped on the market. Specialty dealers who cannot sell at the unsustainably low *street price* close-out that brand and stop ordering it, and new users are no longer introduced to the brand by those specialty retailers who have the ability to describe the product's complexities, innovation, and value.

Finally, when consumers of the product have purchased all they can utilize for now, demand proceeds to fall off – and it isn't being replaced by specialty retailers with new customers. Yet the brand has become dependent upon a greater overhead and higher volume of manufacturing, sales reps are accustomed to higher compensation, are losing volume. Oversupply naturally drives even deeper discounting. In the end, no one is profitable and the brand comes under extreme duress and faces bankruptcy.

This Is Not a Vacuum: The Added Pressures of a Changing Global Economy

External economic factors outside of one's own industry cannot be ignored by a brand manager, either. Following what some believe was a near financial market collapse in 2008, monetary policy and interest rates have had a profound effect by propping up wholesale and retail businesses on the brink of failure. Never before has the U.S. market been this artificially stimulated by creating massive amounts of virtual currency to maintain national debt obligations. This is diluting the "real" value of the dollar and making borrowing unsustainably and unreasonably cheap via rock bottom interest rates. If U.S. government policy makers are capable of making unsustainable, short-term-motivated decisions that sacrifice future performance, why would it be hard to believe that individual cycling brand managers and store owners can not?

Had fiscal policy since 2008 resulted in a sustainable money-supply and interest-rate environment, many businesses would already have been culled, but gradually so. In the event of a sudden market correction of interest rates and underlying currency values now, which some believe is already inevitable, businesses of any scale that are heavily debt leveraged with marginal positive cash flow and reserves will implode. Thereafter, spikes in unemployment and losses in debt and equity markets may reignite recession and suppress business activity and consumer spending.

These rumblings of trouble are not unique to the bicycle business. The same stories are unfolding in many consumer specialty durable goods industries that are on the brink of collapse.

According to Retail 2020: Reinventing Retailing—Once Again, a joint project between IBM and New York University Stern School of Business published last year, there is an impending, rapid shift in the next seven years in the attitudes of consumers. Today, our economy is still being driven by generation X, which can be defined as a blend of both pre-internet and post-internet shopping habits. By 2020, the U.S. economy will have transformed to a generation Y driven economy, who know no marketplace without the internet and instantly available electronic information.

Ready, Fire, Aim!

French writer Antoine de Saint-Exupery said that "*A goal without a plan is just a wish*". And action without a plan amounts to wild speculation and makes failure more likely. Yet much is spoken, in our fast-paced society, of setting goals and taking action. Goals and action get all the glory, while deliberative planning is the middle step that no one enjoys. The reason is usually that they don't know how to construct a mathematical model out of uncertain information. Thus, in short, decision-makers often *guess*.

Case in point: How many IBDs opened their doors without realistic and research-guided sales projections? Most business starts are just one big package of barely informed guesses with a wild hope that it all works out.

A mathematical approach to planning sales volume includes the following factors:

1. Market size: realistically, how many customers are willing to buy the product or service type being offered during the projected period?

2. Market reach: how many of those customers are already aware of the value proposition being offered by a given brand's solution?

3. Marketing expense: What is the marginal cost of reaching one more potential customer?

4. Marginal unit cost: at what unit volume of production is the cost per unit (including fixed costs) the lowest?

5. Market share: Considering all competitors' offerings, what is the unit volume of sales expected at various potential price points?

Equilibrium: balancing the factors above, what is the optimal sales & production volume that maximizes *profit per unit*?

Also known as the *sweet spot*, the volume at which profit per unit is maximized (before the law of diminishing returns takes over) should be the reasonable goal of any brand manager.

The benefits of planning are significant. Maximizing unit profit limits downside risk. If the market for that product or solution drops unexpectedly, a brand operating at or near its maximum unit profit has the most financial flexibility to weather the storm, whereas a competitor which has been pushing for maximum volume with minimum marginal add-on profit quickly starts losing money with the next unit sold at the depressed market price.

A Bird in the Hand or Two in the Bush?

Consider a widget market with two competitors, and a market size of 100 units annually. Brand A's strategy is to go after maximum volume and short-term profit. The going wholesale rate for a widget is $10, and Brand A is most efficient at 40 units, which it can produce at a cost of $6/widget. However, in order to accommodate more volume, Brand A must spend an average of $7/widget in order to produce 60 units. Meanwhile, Brand B is also most efficient at 40 units ($6 cost/unit), but rather than push beyond this, it holds production at that level and allows its competition the greater market share. Which brand is smarter?

Brand A sells 60 widgets at an average of $3 profit each for a total profit of $180. Brand B sells 40 widgets at an average of $4 profit each for a total profit of $160. However, while Brand A was working at expanding operations to sell 20 more widgets, Brand B worked instead at expanding into a new product and entered the "whatzits" market, which was being dominated by Brand C.

Brand C is like Brand A and was feverishly satisfying the annual demand for 100 whatzits retailing at $14 and was profitable doing so as the only provider. But when Brand B entered to compete, it introduced its whatzits for a lower price of $10. As the market settled, Brand B took 40 units of that market, too, where it was most efficient at a cost of $6. Brand C took a hit since it could previously afford to produce inefficiently at $8/unit and is stuck with too much overhead for only 60 units annually.

In the end, Brand A reaches for 60 widgets and makes $180. Brand C shrunk to 60 whatzits and, heavy with overhead expense at $2 profit/unit is only making $120. And the winner is Brand B who, making two products and limiting each to maximum per-unit profit, sells 40 widgets and 40 whatzits at $4 profit each for a total profit of $320.

This is how a smart business owner grows sustainably – through diversification, innovation, planning, and not reaching beyond its optimum efficiency. As quality brand recognition (market penetration) grows, and as each new product the brand introduces is itself volume-limited to its own maximum profit-per-unit, profits compound.

The business owner which understands that planning for marginal profit is advantageous vs. planning for maximum volume is much better positioned to maintain a solid balance sheet and operate from a position of strength in the marketplace over the long term. Other brands may burn hot and then burn out, while the strong brand produces steady, consistent and rewarding results.

The E-Myth

In closing this section about retail economics, a highly recommended, easy read for further study is The E-Myth Revisited: Why Most Small Businesses Don't Work and What To Do About It by Michael E. Gerber.

Mr. Gerber does an excellent job, in terms any layperson can understand, of explaining how most business owners succeed at making their product but fail at profiting from their business. One issue at heart is the fact that so many small businesses, which include most bicycling brands, are started, owned and/or run by product enthusiasts and engineers – not MBAs. They love the product, have great ideas and work hard with sincere enthusiasm. The necessary financial and economics concepts are considered later, with significant struggle.

A guy named Charlie Beacham was my first mentor at Ford. He taught me the importance of the dealers, and he rubbed my nose in the retail business.

– Lee Iacocca (Revived Chrysler in the 1980s)

Part Two:
The Pieces on the Cycling Industry Chess Board

The Independent Bicycle Dealer: "Don't Tread On Me"

IBD owners have been known to rib each other over the 'I' in the acronym. The independence of the IBD is a source of great variety and creativity for consumers, but is also often their Achilles heel.

Perhaps the most costly form of independence shared by bicycle shop owners is the inconsistency with which they understand the scientific principles of retailing. IBD owners must admit that most of them did not open a bicycle shop because they love the study of retail economics. With little-to-no formal training in business and a natural desire to play more with the machine than the bookkeeping file, they have frankly made a lot of bad business decisions.

Bicycle shops are not unique in this. The majority of locally owned & operated small businesses have lacked this know-how and expertise. American public policy has been to support and encourage new small business creation with as few requirements as possible, while little has been done by policy-makers to ensure that prospective owners are sufficiently educated and prepared before they make the leap. Of course, the private market provides many educational opportunities, but as the saying goes, "we don't know what we don't know". Therefore, how do aspiring business owners know what questions to even ask and where to find the answers?

The common story of the average American IBD has been to start under-capitalized, stretch financially into a lease, barely get along for a decade (with plentiful credit lines extended by suppliers) before some start to learn the relevant principles to get ahead, and others quietly disappear. Before perhaps 1980 ("the good old days"), a shop could make a fair number of survivable mistakes. Since then, the number of mistakes that an IBD owner can recover from has evaporated.

Most IBDs by now understand that it is a lot harder to succeed today than ever before. Yet, it hasn't changed *who* they are. They are often tech geeks, snobbish, fiercely territorial, untrained and ungraceful at handling opinionated people, thickheaded, remarkably creative but narrow-minded in their creativity, reticent to accept change, short-term oriented, and in short, *human*.

In their humanity and lack of business savvy, they have sometimes mistreated suppliers. They have been quick to complain and slow to praise. They whine. They will parsimoniously sacrifice the hard-earned value of a relationship for perceived "principles". They have been known to be late paying bills. They will accept being wined & dined, then turn cold when invited to place an order. They can be reticent to try new ideas, receive training or take risks suggested by a supplier. And suppliers have had difficulty getting IBDs to respond to inquiries from local customers interested in the brand!

IBDs have too often mishandled the consumers that have or might have purchased a brand's products. They have spent years on cruise-control rather than remain relevant to the current demands of their local marketplaces. They have lost business because they did not offer enough value in other ways to justify their prices. They have been forced to change their business models only after enough dissatisfied customers went around them to find access to favored brands.

Business viability is threatened enough when IBDs don't understand financial statements, inventory management, leveraging the power of advertising, and/or how to hire and train the right employees. But the highest of the skills of a successful businessperson is that of relating to customers and suppliers. IBD owners and their sales staff need to be masters of relationship. The most successful of them build consistently excellent relationships with suppliers and customers. They can do this not only with those who make it easy, but also with ones who are not so easy to get along with.

The State of the IBD: Tipping Over the Edge

A primary reason there are 3000 fewer bicycle shops in the U.S. over the last 40 years is that many IBDs did not skillfully nurture the relationship with the consumer. Bad customer experiences in bike shops continue to be told, to friends of those they happen to, on a daily basis. For many consumers, both snobbery and lack of caring help are synonymous with *bike shop.* Riders who naturally leave the sport are not replaced with new riders because badly run local bike shops don't warmly welcome the uninitiated.

So, over the years, IBDs left themselves open to competition. If IBDs are not going to provide excellent customer service, why should the consumer pay for it? The 1980s and early 1990s saw the proliferation and growth of big box chains which co-opted bicycles and accessories, offering little service for a lower price. Since the second half of the 1990s, big box chains having already driven down quality expectations, and now eCommerce continues to further commoditize cycling products, the consumer relationship and the entire cycling experience.

Quality durable goods are expensive to design, test & build. To sustain that expense, enough customers must continuously be available who are willing to pay for quality. The massive capital expense of building an airplane would be too high if only a few people were ever willing to buy plane tickets. But in order to attract enough sales of plane tickets, there must be enough planes flying and airport locations to support a transportation network. In this chicken vs. egg equation, the answer is that both supply and demand grow together and support each other. Investments must sometimes be made well ahead of realizing returns that pay the investments back.

Supply and demand also decline together. When a specialty industry declines to the point that large numbers of people become unaware of the specialty offerings, it can be said to have lost its *critical mass* – it is no longer self-sustainable. (Note: the importance of critical mass will be revealed in the discussion of the consumer below.)

To be sure, there are many excellent IBDs, owners, and employees who are bright stars operating today -- but are there enough of them to sustain the sport and the quality cycling industry for another generation?

The data screams at the industry to change, and fast. Participation in the sport has been in steady decline per capita. (Per capita is the only way that sales data should be measured because then it cannot be spun.) According to Gluskin-Townley Group, over 70 persons per 1000 population regularly rode a quality bicycle in the early 1970s. Today, the number has dropped to around 40. Over the same period of time, IBDs have dropped from 7000 to 4000. The correlation is direct: as goes supply coming through IBDs, so goes the population interested in riding quality equipment.

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Incremental growth in unit volume sales, average selling price, and the number of riders, as is happening now, can lull the bike industry into a sense of well-being. Yet these numbers have been largely flat per capita over the last decade such that there is no cause for celebration. Just look at the numbers of quality bicycles purchased and dollars spent on accessories in inflation-adjusted dollars *per capita* over time: these prove that this industry is in decline. Gains in market share by some quality brands come only at the expense of other brands, all of whom keep fighting for the same stale pie.

Thus, the critical mass of IBDs is at a tipping point. As previously mentioned, there may be a short-term spike in IBD closings ahead vs. the recent average 100 shops per year (net after accounting for new starts). A lot of debt-leveraged shops are becoming unaffordable for suppliers to keep carrying. As suppliers cut off the ability of underwater shops to place new orders, it will push up the IBD closure rate at an accelerated pace.

As shops close in local markets that are large enough to have more than one, the short-term increase in business for the remaining shops again lulls them into complacency, and the cycle of shrinkage restarts with the next most vulnerable store on the chopping block. But in those local markets that could never support more than one shop, or that have shrunk to the final one, once their only shop closes it is rarely replaced. Like black holes, these growing gaps in population coverage with specialty shops unravels the critical mass necessary to maintain nationwide participation in a specialty, equipment-intensive sport -- let alone grow it. An example of this process at work has already been witnessed in the specialty golf and skiing equipment industries.

But in the IBD's defense, it is also the "rope" in a cultural tug-of-war. What IBD owners wanted when they started was to make a living out of their hobby and invite others to enjoy the sport with them, and they assumed that customers would happily pay them for the privilege. But consumers have changed.

The Consumer: I Want What I Want When I Want It

The investment we're all looking for is actually saving [(not paying for)] labor . . . look at what the internet is doing to retail.

– James Chanos (President, Kynikos Associates; hedge fund manager)

The American cultural landscape today is losing sight of the value of a fair trade. How many of us understand the economic principle of *comparative advantage*? Comparative advantage exists where two parties each make something of value that the other would like to have. Each party is uniquely efficient at what it makes, such that when the two wares are traded, both parties are satisfied and consider themselves to have gotten the better value in the transaction.

Americans are susceptible to forgetting about creating comparative advantage and are becoming a people who contend for *absolute advantage* over each other. Absolute advantage employs any means necessary to get the best output of someone else for oneself regardless of paying fair value in-kind. Why is this happening? It may have to do with social isolation.

A couple of decades ago, *road rage* was coined in Los Angeles to describe aggressive and/or violently retaliatory behavior by motorists. If someone walking down a sidewalk is bumped into by another pedestrian coming out of a storefront, polite apologies are usually followed by forgiving the offense. But isolated in the perceived safety of a fast, sound-insulated, anonymous metal box, more people seemed willing to mistreat others.

This condition of being both anonymous and out-of-reach relaxes inhibitions and increases the likelihood of bad behavior. In no theory of psychology is general isolation considered good for people. Being in the presence of one another, as long as resource needs are being met, keeps us civil and concerned – it underpins the moral concept of "doing unto others as you would have them do unto you." But the more an isolated person repeats a bad behavior, the easier the inhibition is to overcome – even when in live company. On the internet, everyone is an expert, everyone is famous, everyone has a noteworthy opinion, everyone has followers which hang on their every word, and anyone who is critical of them deserves to be viciously slandered.

How do these societal changes affect the retail marketplace and the cycling industry?

Commerce is ultimately a form of community behavior in which people relate to each other and depend on one another to meet needs. Consider that we now have nearly 20 years of experiencing an internet-connected society and eCommerce – a complete human generation. Over the last two decades, studies in sociology analyzing the effects of electronic communication have revealed the dramatic increase in narcissism and social isolation, and with it, the decreasing value that people place on the labor and worth of others. The more isolated that people have become, the more distrusting, self-centered and ruthless they have behaved in their approach to transactions.

With electronic communication, people say things they might not dare say face-to-face, and especially when their identity is anonymous. Facebook bullying, slanderous "yelps", email phishing & spoofing scams, and online identity theft are all examples of threats that are new to this generation. These are common, but sad examples of the ways people are willing to damage each other when no one can identify them.

Beyond the obvious negative effects of life on the internet, some of the perceived positive effects also have their downsides. Instant access to information and ability to make purchases has brought increased demands for instant gratification. The ability to compare the price of a thing in two very different markets with different expense structures has devalued and created unrealistically low expectations for what those things should cost where the user actually resides. And having the inventory of anything, anywhere available for viewing online has dramatically impacted a critical component of economics: the *perception of scarcity*. (See SUPPLEMENTAL ARTICLE: "The Value of Information and the Scarcity of Supply," p.26.)

These changes in the consumer's information environment have had a dramatic impact on brick-and-mortar retail like the local bicycle shop (LBS, or IBD). Socially isolated consumers who are more willing to mistrust and mistreat merchants while expecting unsustainably low prices & boundless selection, are reducing the small merchant to a free public service.

LBSs are expected to offer free expertise, consulting and advice. They should be willing to do small jobs as customer favors (because they will be given a negative review on the web if they don't). They should handle warranty claims without charge (because they represent the brand that the customer purchased online). They should exchange products or even accept returns long after the items were purchased from that retailer and used (because a retailer like REI might, with no questions asked). And the LBS should never, under any circumstances, expect to charge more than the item can be found for online without inviting an accusation of price-gouging.

The term *showrooming* has exploded into the everyday vocabulary. Showrooming describes the consumer practice of going to a local store and examining, probing and trying on a product available for purchase at the store (and receiving all needed help to choose the correct SKU and answer compatibility questions) – then purchasing the selected product online for a lower price (sometimes on a smartphone right in front of the salesperson). "Showrooming" is far too gentle a word for this: it's better described as *theft of service*.

But calling it showrooming makes so much easier the task of writing about it as a wondrous new phenomenon that retailers like the LBS should accept as if it does not threaten their survival. Too many articles being written on the topic in the 'blogosphere' take a consumer-centric point of view that dismiss the damage to small business activity and jobs. These commentaries fail to disabuse readers of the notion that there is anything wrong with the behavior. Remember, bad behavior repeated often enough (like stealing someone's labor) doesn't seem so heinous anymore.

What happens when an employer presses employees for more productivity without a commensurate raise in wages? What would happen indeed, in the same circumstances, if the employer then demands a pay cut across the board of 10%, 15%, 20% or more – and when employees revolt, retorts that employees need to be competitive in an increasingly globalized marketplace? It is a stark comparison and yet a perfect parallel to what the consumer, as the employer, is demanding of the local retailers that work for them. Keep this in mind as the full impact on consumers is explored next.

The State of the Consumer: Losing Local Access to Quality

Ask any consumer for a general opinion on retail prices and the answer is obvious: most consumers will always demand a lower price in their own best interest. But ask a consumer what will happen if prices are too low, and expect an answer in the form of a blank look of incredulity: “that’s not possible!” It is not usually the interest of the consumer, who is focused on the short term (the *next* purchase), to be wary about getting deals that are too good over time. Still, consumers very much want products that interest them to continue to be available to them when they are ready for the next purchase.

In communities where there weren’t many choices to begin with, the loss of what little they had is felt with **dramatic** effect.

Will they consider their interests best served when local access to those products disappear or when their quality choices are reduced?

This question is not one that all consumers fully appreciate. But for many consumers in small towns across America, they have already lost their only LBS, and moderate-sized communities have seen their choices reduced to fewer shops. In the past 40 years, as mass market sales channels have attracted consumers away from the “Mom & Pop” shops, some 3000 LBS storefronts have been lost (net, not replaced by new stores).

Did those mass market channels keep the customers they gained? Recall above the statistic that correlates perfectly the number of IBDs with the participation rate (7000 shops & 70/1000 riding 40 years ago vs. 4000 shops and 40/1000 riding today.)

In communities where there weren’t many choices to begin with, the loss of what little they had is felt with dramatic effect. Those who still want local access to specialty products must now drive a distance to a neighboring community to find what they need. At some point, the effort to find what is desired will overcome the alternatives. The two primary alternatives that consumers turn to are 1) more cheaply made substitutes in other retail channels, or 2) finding something else to spend money on (abandoning the product).

For the vast majority of LBS customers, the bicycle is a luxury and not a need. It is quite capable of being abandoned, no matter how difficult to imagine for the country as a whole. In truth, there are those who will continue to be committed to enjoying the sport, and they will turn to alternative channels. But they will not often pass that desire on to others of their own or the next generation without the local access to a specialty dealer that can support them in attracting and educating new enthusiasts.

So, as local choice and access to specialty cycling products disappear in the outer, rural markets first, new entrants get captured by low-service/quality/price providers out of ignorance of the quality differences otherwise available to them. At the opposite end of the food chain, experienced consumers move their purchases to eCommerce where they can find some quality brands being sold which they first learned about in an LBS.

Both types of converted customer represent marketplace infertility – they don’t tend to reproduce themselves with new customers for specialty brands. In fact, consumers of quality products cannibalize the existing LBS customer base by spreading news about where to find their products for a low price online.

When one store closes without a replacement, no matter how insignificant that one store is, it affects the whole industry. One closure represents a portion of customers who will leave the sport rather than drive further away to shop, or otherwise resort to lower quality, non-specialty options. Another portion that once turned to catalog mail order will now turn to eCommerce and become accustomed to paying less, but only for themselves; the business activity that they represented does not get replaced when they retire from the activity.

In market economics, declining industries (lack of new customers resulting in falling participation per capita) need an ever-larger population to generate enough customers to support each local storefront. Therefore, it should come as no surprise that even while some loss of shops has also occurred in the largest cities, those populations (and some shop owners & product reps) don't necessarily perceive that the industry is in decline.

As this economic oxygen deprivation sets in, the average age of participant increases. This is precisely what sales data in
cycling has been showing, and yet far too few decision-makers in cycling seem to recognize the problem. After a while, like a victim of oxygen deprivation, an entire industry falls asleep to the realities of its situation!

The Distributor: Just a "Middleman"?

"Now along comes the potential creative destruction brought by a different distribution methodology, the Internet."

– Barry Diller (Chairman, IAC; responsible for creating Fox and USA networks)

Distributors are (or should be) masters of efficiency. They are like the chromosomes of a durable product industry, collecting products from factories that make up the building blocks of a retailer's inventory and sending them out to various locations just in time to meet every consumer need. But when a DNA strand mutates, and it begins to perform functions that are not what it was designed for or most efficient at, it can cause cancer throughout the system.

In a nutshell, distributors warehouse products for a brand and reduce the number of sales accounts that a brand owner needs to manage so that the brand can concentrate on what it is most efficient at: designing & manufacturing products. Distributors also aggregate small orders from retailers across many brands to satisfy their just-in-time inventory needs and limit the retailer's carrying costs and number of supplier accounts that they need to manage.

By serving both manufacturing brands and retailers and connecting them efficiently to each other, distributors create a profit margin for themselves derived out of the cost savings that they produced for each of these two ends of the chain of distribution.

It seems like a perfect arrangement. What can go wrong?

Because distributors open accounts with hundreds or even thousands of retailers, they are the gatekeepers of access to wholesale pricing. What keeps an enterprising consumer from calling up, pretending to be a retailer, and placing an order? What keeps the operator of an eBay Store, a garage-based Amazon reseller, a club of enthusiasts, a not-for-profit, or even a retailer in a non-related industry from calling up to step around the retailer for themselves, for their friends, or became illegitimate retailers (undercutting that retail industry and destroying brands)?

The answer <u>should be</u>: the vetting process of the distributor. But the next question is: What motivates the distributor to work that hard at gatekeeping? Once again, human short-term thinking raises its hand. Why not sell to whomever, however one can, and turn as many units as one can today without worrying about tomorrow?

Prior to the electronic information age, keeping distribution "clean" was relatively easy, because getting a wholesale account was hard. Transactions were completed face-to-face, far more often. In most states, getting retailers' and sales tax licenses was significantly more difficult than today. The barrier to entry was simply higher, and far fewer individuals had the potential to defraud the system.

In the 21st century, with so much information and so many transactions happening without a face, a handshake or, frankly, even an individual's real name, digital information exchange has blurred the lines. Write a book or a piece of music, and one can simultaneously be manufacturer (author), publisher (distributor), and retailer. Build a gadget, put up a website in minutes, and sell to consumers and a few retailers and similarly be all three. Or sit in a house-robe behind a $600 computer and be a "retailer," with nothing invested.

Where is the bar – and how high should it be? Every buyer has a theory for why he should be preferred or qualify for a wholesale rate. States hand out sales tax licenses online without vetting. Businesses can be created for a paltry financial fee in most jurisdictions, instantly, online. The IRS will issue a free Employee Identification Number to anyone who has no employees in five minutes, online. With it, an individual can open a "business" checking account, sometimes also online.

The term "business owner", which once implied a significant level of effort, achievement, risk, and commitment to upholding the images of brands being sold, has been cheapened to include virtually anyone who can sign up for an eBay account without a care for what happens to a brand tomorrow. A similar dilution has happened to "retailer", "distributor", "wholesaler" and "brand manager".

Distributors are not alone in "letting the cat out of the bag." Major brand owners in cycling have, like distributors, sold to "accounts" they already regret opening, or will. And some IBDs and their managers and owners, who opened legitimate accounts with distributors, have sold their industry

Supplemental Article:

The Value of Information and the Scarcity of Supply

Count not him among your friends who will retail your privacies to the world.

–Publilius Syrus

Most of us have heard the phrase "knowledge is power". Not many know how old the phrase is – coined by Sir Frances Bacon, an English philosopher in 1597. Information is power because the more we know about the resources of an adversary or a competitor, the more power we have to manipulate that party to our own desired ends. The more we know about the plans of rivals, the easier it is to outwit and outmaneuver them.

Information Is *Not* Free (Even If You Won't Charge For It)

Prior to the electronic age, exchanging information was much more costly. An early pioneer in the self-improvement movement prior to the advent of the Internet, Charlie "Tremendous" Jones, said: "*You are the same today you'll be in five years except for two things: the people you meet and the books you read.*" Mr. Jones understood that learning and gaining knowledge depended on relationships with people and reading what people have taken pains to write.

The bookstore industry was alive and well then. Remember locally owned bookstores (now facing extinction)? Even with modern copying technologies, printed words required an investment – writing, printing, selling and buying information had a price that could not be circumvented. Then, one had to invest time in reading. As a culture, we out by covertly selling through grey market channels outside their shops while trying to keep their identities from being discovered.

Facing these challenges, distributors today are trying to insulate themselves by going outside traditional boundaries.

One way has been developing in-house brands that make distributors into brand owners, offering substitute products which compete with the brands that they also warehouse and sell to retailers. Not unlike the dichotomy of Amazon resellers using Amazon to sell while also competing with it on the same items, when a distributor offers anything from its own bicycle to its own tube, it creates a conflict of interest with the brands it distributes. As distributors do this, they make the same mistakes that other brand owners do with seeing product get into the wrong hands of, and deeply discounted by, gray market sellers. Ironically, this makes it very difficult for the distributor to take a stand with a brand they warehouse while they struggle to control their own brand.

But some "forward-thinking" distributors and distributing brand owners have also been creating web portals to try to recapture online shoppers under the popular brick-and-mortar vs. internet notion "if you can't beat them, join them". These portals and experiments being offered in various flavors by several third-party software providers have all been resounding financial duds so far. In fact, they never had a chance of success because the traditional high-service model of retail distribution cannot compete with the internet on its own turf. There is no way to discount the value of local service while still paying the employees, and there is no way to compete with deeply discounted online prices and get the customer back without the discount, despite the charming sales pitches of many third-party software providers.

were accustomed to reading in chapters and spending hours doing it.

Contrast this with today: we increasingly demand to read in summary and reduce as many conclusions as we can to three-second "sound bites" – without investing much time in understanding the foundation for those conclusions. (Congratulations if you are still reading this paper!) In the span of one generation, we have transformed into a population of short attention spans, who read highly condensed *webpages* with little time invested per page.

Also in the past, we made great investments in each other in order to learn. We developed a system of education culminating in universities that cost each student years of future wages, to gain the knowledge to practice a professional specialty (and that investment still pays well: graduates of American universities are among the best, brightest and highest-paid doctors, engineers, academics and leaders in every nation, while the average college graduate gets a better job and earns far more than in a lifetime). Learning was always done experientially and interpersonally. But increasingly, class sizes have ballooned into the hundreds, and hundreds of colleges are offering online degrees with little interaction while students learn in increasing isolation (just as in retail products, these courses make money for universities in the short term by lowering overhead – but will lead to declines in the quality of education and, in the future, the number of physical universities).

In the larger world beyond education, information always had a price. Sharing information was dependent upon trust, and trust took time and a long investment in relationship to build. When information is too freely given or is too easily discovered by an untrusted party, it is disastrous. In World War II, "*loose lips sink ships*" was a warning against unguarded talk that could help an enemy bent on our demise. Cold war spy agencies invested monstrous sums to gain the slightest advantage from secret information. And corporate espionage can rob the revenue potential of a company's intellectual property.

– *Continued* –

The State of the Distributor: Damned If They Do and Damned If They Don't

In the same way that eCommerce continues to commoditize quality products, eCommerce is increasingly commoditizing distribution services.

Prior to the second half of the 1990s, process automation and logistical efficiency was a narrow field for experienced and trained professionals. The education and the tools of the trade required significant investment. Distributors open warehouses, employ hundreds, purchase complex machinery, spend heavily on communication with brands and retailers, negotiate for and reduce the sum total shipping expenditures of the industry, and are lynchpins of efficiency in product handling. Central to distribution operations is forecasting and planning because of the inherent risk in holding inventory.

But the traditional distributor is getting out-competed by eCommerce retailers who do not need to hold inventory. Many online, and increasingly international retailers have geographical distribution that is often greater than a regional or national distributor, but without the *inventory risk*. By being only a transaction broker, internet sellers need only find someone who is holding inventory that is eager to unload and drop-ship small orders.

If a distributor refuses to be that online discounter's supplier, the discounter is not thwarted. Brick & mortar retailers, other distributors, and brand owners themselves are all potential suppliers to online retailers, and these are all potential low-priced discounters themselves. It takes just one to undermine the distribution network.

Distributors are finding this conundrum more challenging than anything else they have ever faced. If they refuse to play ball with eCommerce retailers, volume shifts away from them. If they cooperate with eCommerce retailers, they lose orders from

The value of information is something that business people have always understood. The legal industry calls this *work product* which, as its name implies, encompasses a body of knowledge representing the discovery, collection and concentration of information, expertise, efficiencies and solutions. Work product must be guarded, or else competitors will too easily be able to outflank one another in the marketplace and no one will retain sufficient profit to create new work product!

When a business offers a product or service for sale and guards its work product, it creates uniqueness that has value which is wrapped up in the relative *scarcity* of what is being offered.

The Internet Marketplace – A Pinball Game On Full Tilt

The pinball machine was a game of mechanical skills for a disappearing generation. With great economy of motion, a skillful player used a series of paddles to keep a small steel ball in play, racking up points. Once in a while, the ball just wasn't going to be reachable by a paddle and was therefore on trajectory to be lost. In this game of otherwise quick, limited finger movements, the whole body was suddenly put in motion to knock the machine in order to alter the trajectory of the ball. But if a player used this "tilt" technique too much, the machine shut itself down and forced the loss of a turn.

With regard to the perception of scarcity, eCommerce has amounted to putting the market in "full tilt" -- and there is no safeguard programmed in to shut it down.

ECommerce has fundamentally and permanently tilted the marketplace by changing the *perception of scarcity*.

legitimate brick & mortar retailers. If they use their leverage with the brand, the brand may mutiny and begin selling directly to retailers. If they keep courting the brand, they find that other brands are dumping their own product through back channels. If they tightly police their legitimate dealer accounts and watch for signs of back-door product dumping, they are in an adversarial relationship with, and "firing" some of their own customers while losing market share to distributors who <u>will</u> sell the industry out.

Distributors have decreasing value to an industry where many brands are willing to offer direct accounts to retailers (doing the distributors' job), and when "retailers" don't need to place their hands on physical inventory in order to sell it.

While the brick & mortar specialty retailer appears to take the brunt of the impact from deeply discounted online selling, sufficient product complexity maintains at least some opportunity for a main-street presence when there are enough new customers interested in the product. But where a specialty retailer has no real opportunity to thrive online due to the higher costs of operating a main street business, a warehousing distributor can rather easily become an online retailer overnight as a last resort for survival.

The specialty retailer, distributor and brand owner are coming quickly to that point in game theory known as the *Prisoner's Dilemma* (http://en.wikipedia.org/wiki/Prisoner's_dilemma). While it may be in all parties' best interests keep to their traditional roles, if faced with the risk of trusting the other parties and losing everything if betrayed, or betraying the other parties first in a winner-takes-all gambit, what will happen?

However, retail and economic science is not a game. If the parties in traditional distribution do not respect each other, the specialty equipment industry will fail. If one party jumps first to leave the others

Consider the notion that the stock market is reputed to buy on the rumor and sell on the news. This concept means that the perception becomes the reality (with serious financial ramifications for those who trade on it). Similarly, in the retail sales of goods, <u>the internet depresses marketplace prices by causing a good in relative scarcity to appear to be in plentiful supply</u>.

An online retailer is not responsive to scarcity the way that other retailers traditionally have been. In the past, when supply could not meet demand, price went up to decrease the demand to a sustainable level. This also compensated specialty retailers for not being able to turn as many units. But an internet retailer's model does not change when items are in low supply. The internet retailer can shift from one product and industry to the next, looking to sell anything for the same narrow markup to make up for the lost margin dollars of an item in short supply. If two online retailers each get their next shipment of units and it will be a while before they can get any more, those two retailers will still tend to engage in a price war with one another for the opportunity to be the one to grab the next customer, instead of letting the other guy run out so that the next seller can enjoy a higher price. What causes this phenomenon and how does it affect consumers?

Something can be out of stock everywhere, and yet hundreds of websites can still all be advertising the product. While no one has it to sell, these internet retailers are still competing for the perception of being the lowest cost provider, and still setting the consumer's perception of what the price should be <u>from any retailer</u>. Under these conditions, a local dealer might be the only one in the country who has the item. But because of a *prevailing price* being advertised for the out-of-stock item online, what should be that local retailer's opportunity to sell the item to a motivated consumer for a sustainable price becomes that local retailer's bane as the internet-savvy consumer refuses to pay more than the prevailing internet advertised price. If the consumer is motivated enough, she may indeed be willing to pay more but it will probably come with a damaged relationship from the consumer's impression that she was forced to

– Continued –

behind, it will not take all, it will simply lead to all eventually finding jobs in other occupations.

Don't Forget The Reps: Bouncing Between The Roxbury Guys

Hey, you wanna dance, huh? Me? Him? Me? Him? Him? Me? Me? Me? Him? Him? Me? Him? Him!

– All Three Roxbury Guys (Saturday Night Live, Season 21 Episode 20)

Product reps have historically been a durable goods industry's built-in consultants. They are supposed to have the high-altitude view. What products are trending? What are suppliers saying? What are dealers saying? What new products are coming down the line? Which shops are growing, steady, or declining? Which shops are adhering to supplier policies? Which distributors and brands are supporting or eroding the specialty marketplace? How should the new products be used, merchandised, or supported? What is the right call on a debatable warranty claim? And much more.

Product reps sell brand stories downstream and give upstream suppliers access to dealers as they manage their territories, all while constantly taking the industry's pulse at a larger-than-local geographical level.

Like the three Roxbury Guys all competing for their next dancing partner, there can be said to be three types of product reps:

1. Captive agents: These are outside reps employed directly by a single, typically large, multi-national brand.

2. Non-captive agents: These are independent reps employed by a rep agency to represent an amalgamation of brands.

pay too much.

This recent phenomenon in retail economics has yet to be studied and understood in academia, which is just beginning to look at the effects of the electronic age on the human experience. But is the perception of scarcity really affecting the bicycle business?

What They Don't Know Won't Kill Us: eCommerce and "Laundry of Front Street"

'They' are consumers, and the merchants are 'Us'.

Like a country that loses control of its state secrets, an industry which loses control of its work product is in dire jeopardy of being marginalized at best and disappearing at worst.

The bicycle business has traditionally been a wonderfully complex and well-balanced industry. The 'most efficient vehicle ever invented', the bicycle has been worshipped by some and thoroughly enjoyed by millions. Like the example of prized granite vs. common rock, the cycling industry has been built around offering customers unique experiences of relative scarcity that were worth paying for. If the granite was suddenly lying around everywhere, as common as rocks, its value would plummet. Because anyone could easily and cheaply obtain it at any time, the consumer demand derived from its uniqueness would no longer exist.

This principle is an undeniable characteristic of the marketability of any durable product. To get the best cycling experience offered today requires many thousands of workers working millions of hours researching, designing,

3. Distributor reps: These represent multiple brands similar to independent agency reps, but are employed by a distributor who warehouses those brands.

Reps are the human focal points of love-hate relationships that retailers have with supplying brands. Reps should be essential resources to retailers and yet have been shrugged off by many retailers, not often undeservedly. Reps should be essential resources to suppliers and yet have been squeezed by declining profit margins. Being "on the road" has also been described as a young person's game: it's tough on the family lives and multi-dimensional health of reps. The increasing trend has been to move up or out, and not many possess the wisdom of many years, the experience of ownership, or the perspective of the future beyond the next month, quarter or year at most.

So as reps move about between products, agencies, and/or other job roles, the predominant measuring stick used to evaluate them is how much they sold today. Without the expectation or desire to be a rep for many years for the same products, there is little incentive to be concerned with an employing brand's future success. In fact, if moving up depends largely on putting up big numbers, a rep may make some decisions that are significantly damaging to long-term brand health (especially if they don't expect to be in the same position long enough to suffer the consequences).

There was a day prior to online retail, when specialty product industries were healthier, that afforded reps a lot more "slush" in their budgets. Wining & dining dealers, sending them on trips, to brand HQ offices handing out co-op marketing dollars and throwing them deals for local teams and clubs was easy. Perhaps too easy. Leftover from those days are aging relationships and memories which quickly became incompatible with an online retail world where unit volume is king.

fabricating, distributing and selling products in limited supply. The "better" (more reliable, comfortable, fast, etc) the experience, the more naturally limited the supply and the greater the cost should be of obtaining it.

As this paper gets written, \$300-\$600 carbon fiber and full-suspension frames are being sold to U.S. consumers directly from Asian factories. One dealer tells of a [former] customer who purchased one and has managed a good experience so far, with a carbon frame that looks suspiciously identical to a major brand & model.

So what happens if new design enhancements get quickly copied, if new manufacturing or distributing efficiencies over-expand supply, or if the private work product of parties in the chain of distribution get revealed (like inventory holdings, price lists, etc.) to competitors or customers? What happens if products are commoditized by cut-rate knock-offs or even if quality products are mass-produced for sale to every buyer for any price? What does all of this do to consumer perceptions of value?

These are not philosophical questions although some have tried to treat them as if they are. They are mathematical questions and the answers are as predictable as the time of the sunset. With the uncontrolled proliferation of information and supply comes a series of events that end in the loss of a specialty marketplace and the death of quality products and future innovation.

Few if any reps before the year 2000 could see what today's retail landscape would look like. And more and more young, new reps today are online consumers themselves. These are having difficulty telling tales of brand support to their specialty dealers, when they are often not loyal to local shopping themselves.

Whose new invention with no previous market is going to sell online at any price, without demand having **first** been created in local marketplaces?

Working for commission and needing to generate volume in a declining market segment, reps are being placed in direct competition with online discounters. Some reps, especially non-captive ones, are finding it difficult to resist looking the other way when one of their dealers dirties a brands' distribution by selling online themselves. And unfortunately, there are plenty of reps selling samples, demos and "pro deals" to their friends in the enthusiast, club, and racing scenes. They like to be everyone's favorite hook-up, directly undercutting the very dealer-customers they so often pressure to buy more.

Reps should see the writing on the wall: if their brands don't stem the tide of discounted product and find themselves increasingly catering to online and other alternative channels, then as specialty shops decline, brands won't be able to afford reps! While it would be a strategic error on the part of a brand manager who wants to maintain a specialty image, the rep force will be an increasingly tempting place to begin budget-cutting (dwindling reps in the industry will further decrease the exchange of information between the street and brand executive offices and make responsiveness to the marketplace and planning for production volume that much more challenging).

Ironically, just as it has been told that dealers and brand owners are not often accomplished retail economists, reps are likewise confused. They hear a lot of opinions about the future and struggle to chart their own courses. If they understood the science better, they would find themselves in lock-step with dealers who are protesting decreased margins, increased corner-cutting on quality, and lack of marketplace support from supplying brands. Yet, beholden to (paid by) those suppliers, it is very difficult for the reps to not, as they say, "drink the Kool-Aid" offered by their employers.

The Discount Internet Retailer: "Free-Riders" in the Industry

"The Internet is all about the free exchange and sale of other people's ideas."

– Eric Kaplan (writer for Fox TV's Futurama, spoken by fictional Napster executive, May 13, 2001 episode)

"Every industry that becomes digital will eventually become free."

– Chris Anderson (editor-in-chief of Wired)

"It's amazing how easy the Internet makes it to destroy a business without creating another one in its place."

– Robert Levine (journalist, author)

The term "free-riding" is an important concept as it relates to the rise of low-priced online discounters in our industry. IBDs play a significant role in the consumer buying experience by investing (and reinvesting) in brick-and-mortar retail stores, product displays and showrooms, employment and training of knowledgeable staff, product demonstrations, inventory and service, Consumers trust a brand in part because of the physical presence of retail establishments who have built a solid reputation for selling high-quality merchandise. All of those services that directly benefit the consumer (and thereby the entire industry) require capital investment and reinvestment. Online retailers, by contrast, provide none of those services but rather seek to take advantage of those services offered by the IBDs. If a consumer can be educated at an IBD but then shift its buying to an online discounter, the impact on the IBDs and thus the industry is dramatic. The IBDs will be forced to cut back on the very services that the consumer valued so highly in the buying experience. Online discounters, in this sense, "freeride" on IBDs capital investment. The cycle continues until the IBDs no longer can afford reinvestment and go out of business – in the end all to the detriment of the consumer.

Today's prototypical eCommerce retailer, a drop-shipping order taker, closeout dumper, or gray market warehouse is a cheap imitation of both distributor and retailer made possible by the world wide web. It seeks the smallest possible physical footprint, hires fewer and lower-wage laborers, limits communication with customers and suppliers as much (and as anonymously) as possible, cares only for getting the next sale (certainly not for customer success with or the future presence of a brand in the marketplace), and has little need to plan or forecast anything.

If that sounds harsh, it is no more so than a favorite jab that eCommerce marketers throw at traditional distribution that the distributor and main street retailer are unnecessary, greedy parties that take unconscionable markups for themselves. These marketers opine that traditional distributors and retailers are in the way of brands getting their products to consumers, and that eCommerce discounters are the saviors to consumers, delivering products more "efficiently".

The glaring hypocrisy, that even big box retailers aren't as guilty of, is that the eCommerce discounter is a leech on an otherwise healthy marketplace. Without a specialty dealer network building awareness and demand for products with years of investment and personal local service, the online discounter could not exist. Whose new invention with no previous market is going to sell online at any price, without widespread demand having first been created in local marketplaces? Further, the eCommerce discounter creates its "efficiency" not by providing value-added services, but by taking them away.

What is taken away? *Concern*. Without concern for the customer experience, the internet seller resists listening for wants, needs, and post-sale experiences from the customer. It is not paid enough to and either cannot or will not help with physical service, installation, warranty support, and education about proper use. Without concern for brand health, the internet seller has no commitment to pass service experience and customer feedback along and interface with the brand on the customer's behalf. Too quickly do internet sellers dismiss the vitality of this concern for customers, despite marketing claims to the contrary.

And too quickly do customers sacrifice current and future product support for the sake of a lower price. If the effects of their online purchasing decisions were experienced as "efficiently" as eCommerce discounters will sell them a product, it might make a difference… as one bicycle dealer likes to ask his customers, "if Huffy or Motobecane made airplanes, would you fly in one?"

Or imagine if Fandango (which sells movie tickets online) offered half-price movie tickets for the same current-release movies being shown in the full-service theater. The tickets would grant access to the theater but directs those ticket-holders to the self-service set of movie screens. In the self-service version, in exchange for the discount, the chairs are old, hard and torn. The theater is only cleaned once per week, by the ticket holders, and it smells. The sound system is several generations old and too low to hear all of the effects. The movie is film, not digital. And the climax of the movie (the final ten minutes) is cut out. If there is any dissatisfaction with the experience, Fandango has a customer service number but there is no access to local personnel to complain to.

Would this experience be worth the tremendous savings that a family of four who goes to the movies twice a month would enjoy by using the discount ticket seller? True, Fandango could market their more "efficient" ticket sales that cuts out the theater's employees who once provided clean, modern, late-technology theaters and local service. But do consumers want a discount experience to go along with the discount price?

Yet, when brand owners <u>unwittingly permit</u> this consumer experience with their products, they invite dissatisfied consumers to find another form of entertainment!

In addition, consumers will not generally embrace a new type of specialty product (whether new to the world or new to themselves) with only self-education online. Complex durable goods require physical learning experiences with the product, greatly helped by a knowledgeable and personal human interaction taking place simultaneously. Trust must be built in both the product and the advisor/salesperson in order for the consumer to bet their hard-earned money on a hoped-for, future experience with the new product.

Later in their education, after consumers have significant experience with the range of products available and learning about new technology has become an "update" to their personal knowledge, many consumers are prepared to discard their personal relationship with an LBS and substitute impersonal ones online, to save money. In this respect, online discounters of specialty durable goods can arise only where there is (or very recently was) a healthy, profitable marketplace for those goods established and maintained by brick-and-mortar stores with knowledgeable staff.

And, online discounters can only sell those products for as long as a healthy local marketplace exists. If online purchases starve the brick-and-mortar network out of business and the industry drops below a critical mass of stores to sustain new customer interest, consumers will find something else to be interested in, leading to falling online sales in the end.

While it may seem that the discount eSeller is efficient and nimble, it is an illusion as it is unconcerned with the future of an industry. In fact, the online discounter is completely disconnected from both the industry and the consumer. Its only real goal is to obtain short-term profit, not a healthy industry or consumer satisfaction. Here today, gone tomorrow, these outfits will quickly find other products to sell and
industries to undermine.

So, eCommerce is not advantaging a brand, the consumer, "growing the pie" or growing anything – it's more like a parasitical fungus which, without its own roots, steals resources from the plant until the host dies. When the host is dead, the parasite moves on to the next fertile crop. The lie that eCommerce tells to consumers (who would rather believe it in their own short-term interests vs. taking a longer view) is that the parasite won't kill the plant. Is that what history really shows?

Ask yesterday's Zenith television salesperson or repairman. Today, the television is a commodity that requires little up-front experience and knowledge to buy and use. It lasts for just a few years before becoming broken or obsolete. It fills up landfills at a far higher rate than before. TV brands make marketing claims that the consumer is hard-pressed to verify. Now "big box" electronics retailers are threatened with closing stores themselves, in the face of online competition.

So, too, the bicycle industry: If the cheap frame substitutes and limited quality of experience offered by 'mart' bicycle brands are satisfactory as our predominant future for cycling, then what this white paper advocates is wasted effort. Let the future come (and it rapidly is).

The State of the Online Internet Retailer: A Cake Baked Too Fast

http://digitalpublishingaustralia.org.au/2012/05/04/is-amazon-com-a-not-for-profit-company/

Amazon is touted as the world's most successful and innovative online sales company. It boasts massive annual increases in revenues. It aggregates thousands of individual sellers into its "Marketplace" platform (and has now written software to undercut these 'partners' of theirs). Jeff Bezos is hailed as an online marketing genius and commercial leader.

But the link above summarizes readily available information about Amazon, which is "barely profitable". In fact, this high-flying equity stock which trades in insane multiples of actual earnings has been in total a profitless failure, when offset against its startup years of losses. Will the hype last?

Ironically, Amazon now faces competition from out-of-country internet sellers who are selling direct to U.S. consumers, undercutting even U.S. wholesale distributors. Brand-direct to consumer (whether offered by the brand or via the brand being co-opted by a online discounter) is about to become factory-direct to consumer as the next link to be axed from the chain of distribution will be domestic brand managers.

Also ironic is the damage to the national economy as consumer dollars begin to leave the country, not merely leave the community and state of the buyer. Before eCommerce and its full impact on cycling has been understood, and proactively responded to here in the U.S., the next great wave of eCommerce across oceans is hitting the shore.

Brand Owners: Trying To Beat Each Other To The Electr(on)ic Chair

Your premium brand had better be delivering something special, or it's not going to get the business.

– Warren Buffet (Business magnate, investor & philanthropist)

Some brand owners appear to not understand the math, and thus do not accept it. They do not believe that fewer specialty shops will result in lower participation and market decline. They see internet retailing as the inevitably dominant future sales channel. Here is the lie that eCommerce has told and too many have believed: the LBS can successfully sell online, retain customers, and present the opportunity to grow anew the customer base for specialty durable goods. It is a faith-based belief. It is evangelized by software suppliers, as brands see consumers shifting their spending online and craft their own internet strategies to reclaim consumers. The falsehood of specialty industries sustaining demand online can only be maintained by utterly ignoring this singularly important factor: *product complexity*.

The local book store cannot be saved and will not be returned to former days because technology has converted it into a *simple* durable good. As a book is a collection of images and words, and the internet medium is also a collection of images and words, there is too little of unique value offered by local booksellers to keep them in business. The internet truly replaces information about books, sampling of books and often even the books themselves.

But someone cannot duplicate the satisfaction of riding a bicycle within a website. As a complex machine, the bicycle and its accessories need to be interacted with. Most people, in order to learn about the high-performance, high-quality version of products, need to interact with other human beings in-person. Aspects of setup, repair, fitting, demonstration of features, experience-testing, and more cannot be downloaded. The internet, until transporter technology as featured in *Star Trek* is invented, cannot duplicate what happens in the LBS. And that is the only reason why there are still any left today.

Branding consultant Simon Mainwaring has said that *"The keys to brand success are self-definition, transparency, authenticity and accountability. … the first principles of marketing involve brand definition and consistent storytelling."* And, *"It is a truly powerful phenomenon when a brand makes a stand for what it believes in."*

For durable, complex goods, these fundamental concepts of brand marketing happen with a network of specialty retailers and cannot exist otherwise. Online discounters will <u>never</u> care about helping to communicate a brand's story and definition of itself. They will <u>never</u> be a transparent conduit of information between brand owner and consumer. They will <u>never</u> be accountable for the product and the consumer's ultimate experience. This is mathematical and not philosophical: internet sellers are not <u>paid</u> to be any of those things, and they aren't asking to be.

Therefore, any specialty brand planning to build its future value with eCommerce, is expecting to become not just brand owner, but also local advertiser, pre-sale customer advisor, shipper of singular orders, customer feedback collector, warranty service provider, and more – and after all of that, still have little or no control over the average customer's experience with its products. Brand owners can hire a lot of people and spend a lot of dollars pursuing all these roles, and still fail to satisfy or even connect with the end users of their products. Plus, brands which intend to leverage the internet sales channel (or allow others to leverage their brands this way for them) will need to increase their wholesale prices to pay themselves for the personal services the specialty retailer once got paid to do well.

Follow the logic to its natural conclusion: what will be gained if wholesale price goes up to compensate brand owners for the work that their specialty retailers once did, while shifting end-sales to internet sellers at narrow margins? After the dust settles, the consumer will not be paying much less at all for the product, but will now be without the local showroom, expertise & service. Are cyclists going to keep buying those complex products? And can the brand afford to do the brand-awareness marketing in every locality that was once free to them by virtue of the marketing efforts of specialty dealers?

<u>The State of Brand Ownership: Racing To A Bottom That Will Fall Out First</u>

Specialty cycling brands whose products are being sold online today (now the vast majority) only get those sales because a critical mass of specialty retailers has worked to build these brands. The discounts that are received by consumers who buy online <u>represent the unpaid work</u> of those specialty retailers. Let this be clearly understood: An online discount for a complex, durable, specialty good is like enjoying an excellent Ruth's Chris Steakhouse meal and then going online to get a discount off of the menu price while not tipping the staff for their service. The lower amount collected is sufficient to pay the food suppliers while the website owner takes a cut and the physical restaurant, its employees, its landlord, and its local community (via tax revenues) are cut out.

This analogy cannot be debunked by theorizing that products can be ordered online without demanding local services and support. The consumer would have no idea what a Ruth's Chris meal was without having first experienced it and learned how desirable it was at a local level. Even vicariously (driven to demand by referral from a friend), the discounted online product parasitically depends upon the local availability of the product. That local availability itself depends on consistent repeat business. Local transaction processors cannot survive by giving people a taste and then sacrificing them to online providers. Once local exposure is gone, new demand will be stifled, the internet sales channel will commoditize the product, and there will be no more specialty marketplace.

A brand which allows low-priced online retailers to control its market image unwittingly allows any anonymous party to sell products with that brand's name on them, whether they are authentic or not.

What is the alternative to this dismal scenario?

Subsidiarity, as applied to retail economics, is the concept that a product ought to be handled by the smallest, lowest, or least centralized authority capable of assisting the consumer of that product effectively. The more centrally a product is sold, and the more distant the seller is from the consumer, the less benefit there is to the consumer. While the principle of product subsidiarity would seem to be demanded by consumers, the increasing sentiment of the consumer today is to sacrifice those benefits for the lowest price. Indeed, consumers are so inundated with messages about low price that they are not aware of what they are giving up to get it, up to and including their future inability to get quality choices following industry decline.

Brand owners are similarly unfamiliar with product subsidiarity, even though it should be among the first things they understand about successful brand management. Themselves inundated with messages about leveraging the internet to win out over their competitors, brand owners have been sucked into the vortex of being compared online primarily via price. They feel helpless to resist the urge to be exposed to consumers through as many sales channels as possible, while self-styled consultants to this industry urge them on to be first to the plate or miss their turn at bat.

But as has been learned, price-only competition leads to commoditization, which is directly opposed to product specialization (offering distinctive qualities), and which ultimately offers consumers an experience that is no longer uniquely special or highly valued. Racing to win online is a mad acceleration toward a market state where consumers with disposable income to spend on specialty products will abandon products that no longer deliver a special experience.

Thus, like a mirage in a desert, the paradise to which brand managers are racing to arrive first will be ever distant; they will exhaust their resources running towards it and find themselves arriving at a void of revenues from a market that has shrunk and been abandoned by consumers for something else.

Product subsidiarity demands that specialty brand owners use planned scarcity and brand messaging about everything other than price to offer a special experience to consumers. Those consumers must be able to count on consistent repeats of that experience in order to advocate it to their friends. Delivering a consistently high-quality experience cannot be done via online and even big-box chain retailers, but has always relied upon a quality network of local dealers who can adequately introduce and support the experience. And subsidiarity does not work unless the experience is brand- limited to those retailers who can truly provide it for them.

In the past, brand reps and owners have, for decades, understood well that opening too many dealers in too close a proximity to one another leads to over-saturation and does not provide enough opportunity for dealers to profit. Without opportunity in a brand, dealers will look for another brand that they can be profitable with. Thus the brand that reached for too much will have made a strategic error and ended up losing the most. If brands have understood this, then what has bewitched them to believe that online sellers competing with their local dealers would not represent this over-saturated condition to a much greater degree? The internet represents a direct competitor in every building with a web-enabled computer.

Losing local dealers who can no longer be financially healthy selling a specialty brand is eventually fatal to that brand, unless the brand chooses to become commoditized (no longer a specialty brand) -- certainly an available choice. The brand that chooses a future which depends on online retailers is choosing to give up its specialty image and positioning in the marketplace. Again, this is mathematical, a function of natural marketplace economics, and not philosophical. Philosophy only enters when a brand owner chooses to ignore the math and believe something untrue on faith or hype derived from the faith of others (misguided consultants, internet software sellers, etc.).

The latest developments unfolding for brand owners in 2013 include the additional challenges of product sold online into the U.S. from other countries, and counterfeiting. In the same way that faceless internet communication has made it much easier for individuals with little invested to be "in business", the internet is exposing U.S. consumers to international sources of both authentic and counterfeit product from countries that don't play by the same regulatory rules.

One specialty dealer tells the story of tearing up a top brand's letters every time this brand invites him to buy more or participate in the brand's programs while he has customers coming in with product purchased from overseas online at a price lower than the brands' U.S. wholesale cost. And BRAIN and other news sources have reported the skyrocketing incidence of counterfeit product coming into the U.S.

Like other forms of online fraud, there are insufficient law enforcement resources available to stop this activity. Further, it is as easy to restart a counterfeit operation that has been busted as it is to apply online for a new EIN number. For those who like to say "the internet isn't going away", which is certainly true, what is their defense for how easy the internet makes counterfeit distribution? Will they accept this "new reality", call it a fact of life, and aim to compete with it on price? That would lead only to near-instant brand destruction.

There must be a smarter way to adapt to technology. There is a model for protecting the consumer from counterfeit product, and it is offering authentic product only through brand-recommended authorized specialty dealers. A brand which allows low-priced online retailers to control its market image unwittingly allows any anonymous party to sell products with that brand's name on them, whether they are authentic or not.

The Economic Conclusion For Specialty Brands

Brands self-limiting distribution to retailers who support the brand's messaging and desired customer experience is not damaging to the consumer. On the contrary, it ensures the ongoing availability of a repeat, high-quality experience for the consumer. A lie too-often told in business is that a lower price is always better for customers and should not be inhibited. In reality, a price that is either too high or too low is damaging to consumers. But the price cannot be singularly determined. The free marketplace must be permitted to determine it.

This seems like a conundrum. If a free marketplace has brought us the world of online retail and lw online prices, then has it failed to do its natural work of finding price equilibrium? Not at all. A free market depends on all parties to do what is in their own total best interests. What we are experiencing is that product suppliers and consumers alike are failing to act in their own long-term best interests. Shortsighted human decisions (even if made in the parties' fleeting best interest) skew marketplace mechanics.

Low-price online discounts will never save this industry, rather they will slowly erode it to nothing. The only parties within a specialty industry able to ensure that industry's future existence are brand owners, because they have the unique ability to ensure their own products' positioning in the market.

A brand owner who chooses to remain in a specialty position will choose sales channels and dealer policies which keep it there. A brand owner who does not make those choices will not keep its specialty positioning. Brand owners and their wholesale distributors can work singularly and alone, operate independently and competitively, and still keep a specialty marketplace alive and thriving. And according to the number of brands who make this choice, the size of the market and the opportunity for industry growth will be determined. This white paper contends that should only a few brands choose a long-term to support the specialty marketplace, their success will be so attractive that other brands (whether new or previously commoditized) will quickly (re-)enter the specialty marketplace and work to avoid having their futures controlled by low-service, low-priced online retail channels.

The number one problem area, according to two-thirds of specialty bicycle retailers, is suppliers understanding the needs of retailers.

– NBDA Specialty Retailer Survey, 2012

Part Three:
Approaches for the Specialty Bicycle Industry

Having laid a basic foundation, this section offers specific approaches for each business within our industry to consider singularly and independently. The NBDA fully recognizes and supports the notion that each company within our industry must make its own independent decisions pertaining to the operation of its business, including but not limited to decisions related to: prices, profits, supplies, parts, inventories, capacities, deliveries, product offerings, discounts, geographic locations, advertising, and terms and conditions of sale. All companies must abide by and comply with all applicable state and federal antitrust and consumer protection laws. Nothing in this section should be construed any differently.

MSRP: Obsolete

Utilization of MSRP by brand owners grew out of a 1911 Supreme Court decision interpreting the Sherman Antitrust Act, which outlawed any agreement between manufacturers and resellers to maintain a price floor. As a result, *Suggested* Retail Price was permitted by law to be used by manufacturers to unilaterally set retail pricing for their products in the marketplace. As long as there was no negotiation between brand owner and retailer as to what MSRP would be, and as long as the MSRP was uniform throughout the marketplace, brand owners had the right to require retailers to maintain MSRP as the minimum selling price. Brand owners also had the right to enforce this by closing accounts with retailers that did not maintain MSRP.

Unfortunately, many brands did not maintain focus on managing MSRP the way it was intended. Thus, over the years, MSRP became misunderstood and not utilized effectively. Rather, the MSRP became that standard by which the consumer measured the *most* that should be paid for the item, while retailers saw this as the most that they could charge without inviting the ire of consumers. In effect, MSRP had become a *price ceiling*. Yet as misunderstood as it was, MSRP had some residual usefulness in providing guidance to retailers.. With most brands it provided margins that were *sustainable*. A retailer could be limited to selling at no higher than MSRP in any community and survive.

What the Sherman Act and the 1911 Supreme Court decision could never have anticipated was the future state of information technology. In a world of globally and instantly available information, the <u>perception</u> of scarcity has been fundamentally shifted with regard to how it influences price. So, MSRP has further retreated from being merely a perceived ceiling. Today, it is the standard against which the value of an <u>expected</u> discount is measured. Prior to eCommerce, absent a promotional sale, paying MSRP may have been satisfactory to the consumer. Now, paying MSRP (or close to it) at <u>any time</u> is widely considered by consumers to be overpaying for the item. Further, various online sellers will confuse consumers about MSRP by determining a “list” or “regular” price of their own creation in order to manipulate the perception of how great a discount they are offering.

For the modern IBD, brand-determined MSRP is not always helpful, and is increasingly viewed as retail interference because publishing MSRP only "poisons the well" unnecessarily and prematurely in two ways. 1) If the margin between dealer cost and MSRP has been reduced to a level that is too narrow to sustainably compensate specialty retailers, it discourages them from stocking the product. 2) MSRP artificially suppresses, without allowing the free market to determine, what would otherwise be reasonable pricing in a given local market relative to the consumer demand and costs of doing business <u>there</u>.

Supplier reps casually comment that there are still dealers who purportedly can and do price goods above MSRP. What they gloss over, though, is what such practices do to the image and reputation of an IBD, as consumers are able to easily check pricing online after their purchase. How would anyone feel when discovering they paid more than what even the manufacturer "suggested"? A product manager or rep who counsels specialty retailers to ignore its own published MSRP (if it makes this information available to consumers) and set a higher price is ignoring consumer psychology and setting those dealers up for tarnished local reputations and loss of repeat sales.

A consumer who seeks a product out because of an expected experience is much less price sensitive

Ultimately, both conditions listed above work to the detriment of the brand, which may be leaving *unit volume* on the table because these conditions act to decrease preference for the brand with specialty dealers. Indeed, not publishing MSRP today <u>might drive higher market share via increased reseller demand for a more profitable brand</u>. If a retailer has two comparable brands available but can profit more with one of them, which one is that retailer likely to put in front of customers first?

APPROACH #1:

> Retire the use of MSRP pricing for non-commodity products (those having distinct quality).

BENEFIT TO CONSUMERS:

> Wider access to brands which have enthusiastic dealer support; greater satisfaction in purchases without losing confidence that products were worth the price paid.

IBD owners have watched the margin between wholesale cost and published MSRP shrink, while brand owners assume more and more of the relationship directly with the customer. (For a discussion of this topic, see the SIDEBAR on p44-45: guest editorial by Jeff Koenig from the March 15, 2013 publication of BRAIN, p.38.) MSRP, for the IBD, amounts to supplier interference with their ability to charge what they need to in order to stay in business.

<u>Total Value for the Consumer Includes Much More Than Price</u>

So why do brand owners still publish MSRPs -- is there a reason beyond mere historical habit? The answer is that most brand owners use MSRP as a primary advertising tool in their own consumer marketing to create a price comparison with similar offerings by competitive brands. The danger in using MSRP this way is that the pressure will always be toward the brand decreasing MSRP (or limiting

MSRP growth) in order to appear competitive, while needing to raise prices at wholesale to pay for its own increased costs or grow its own bottom line. This puts the specialty retailer in a vise and removes the ability of the retailer to set prices that keep it in business..

And this point cannot be emphasized enough: in our culture, consumers are giving more and more weight to price, allowing it to overwhelm other important factors in making their purchasing decisions. Consumers are passing up their best total value in those decisions. This condition was <u>not</u> a natural, grassroots development. Consumers are suffering from commoditization of quality brands that occurs when brands and retailers compete only on price (while losing focus on other aspects of value that benefit consumers, like quality of experience, durability, service, warranty support, and other value-adds.).

But if a savvy brand eliminates MSRP, it will enjoy renewed and increased interest from dealers. If it produces products of unique quality, eliminating MSRP also removes a hazard that detracts from the quality image it wants to project. By not focusing consumers' attention only on price, it releases brand messaging to focus more on other unique value propositions. <u>This creates a demand by consumers for the product based on what it is, what it does, and the experience they will enjoy by owning it</u>. Specialty brands in particular (as opposed to commodity brands) should focus all marketing messaging -- from their public-facing websites to media buys -- on distinct and unique traits that set it apart from competitors, like quality of experience, engineering or technology, product durability, company location or history, country of manufacture, quality of warranty & support, excellence of their dealers, and any other measure of distinct value..

<u>A consumer who seeks a product out because of an expected experience is much less price sensitive, and more loyal to a brand over time (when the promised experience is delivered) than a consumer who was initially attracted to that brand merely because of price</u>. However, if consumers are attracted to a brand based on a promised experience and then later find out that the brand can be found heavily discounted via certain retail channels, their decision-making will be <u>converted</u> to a price-based one -- which will open them up to re-examining competitors based only on price.

APPROACH #2:

> Emphasize distinct product and service offerings instead of price.

BENEFIT TO CONSUMERS:

> Enhanced pre-sale understanding of the product by consumers; increased liklihood of a positive and long-term experience with the brand.

Emphasizing the distinct features and benefits of the product as well as the value-added services offered by authorized dealers refocuses the consumer's attention to what most benefits them. Product experience is not confined to the moment of purchase when money is exchanged. Proper pre-sale advice and post-sale support make the difference in a positive customer-brand experience. Lack of service never equates to a positive buying experience, no matter what the price. Each consumer is unique. Different consumers require different solutions. The point is to turn the consumer's attention away from the price as the primary consideration so that knowledgeable experts have an opportunity to treat each customer individually and not as just another number. By de-emphasizing price, the impact of low-priced, no-service online retailers will be marginalized.

This approach is not for every brand. Brands who are not trying to produce anything distinct or unique, who cannot or are not willing to stand behind quality claims, and who are positioned only to compete on price by chasing high turns at low

Margins Squeezed as Suppliers Become Retailers

By Jeff Koenig

Reduced gross margins are nothing new to the IBD and it is easy to blame it on the discounting that happens in the big-box and online channels. But there is another often overlooked and poorly understood reason for squeezed margins.

Suppliers have worked to hold down raising MSRPs while raising the cost to the IBD, effectively squeezing the IBD's profit margin. Most quality bicycle brands now offer margins that are break-even (40 points) at best and usually worse, forcing IBDs to sell bikes at a net loss after expenses. And many parts and accessories have now also lost significant margin ground.

While suppliers are maintaining their margins, they're sacrificing those of the IBD. Why? Because they have increasingly moved into the retail role. I am not talking about suppliers who abandon the dealer channel to sell directly to the consumer online. I am talking about brands that still claim adherence to the traditional distribution model. They have, in concert with retailers over time, taken over the most valuable part of the retailer's role—the customer relationship.

Customers always need product information before the sale and support after the sale. Before ecommerce, it resulted in phone calls to the supplier, which grew the need for customer service staff. During that generation, technical support became a household term. As consumers began to shift to purchasing online, even more information was lost in the transaction. Customers still need information and support, so brands have invested in content-rich websites and had to maintain and increase their access to the customer via web chat, email, social networking and telephone.

Most IBDs have failed to make it a point with suppliers that they do not want them to offer feature-rich public websites about their products or take customer support calls. After all, in prior retail eras, all such product information was provided to dealers—the sole source of this valuable information for consumers. Now, retailers are no longer sought as the primary provider of brand marketing content. They've been replaced by an online, consumer-direct presentation.

Could it have been any other way? Yes, if brands had supplied copyrighted, electronic content to authorized dealers' for exclusive use on their websites while maintaining their own customer-facing web presence limited to non-technical information. A brand's website can tell the company's value story, discuss general technology offerings, showcase staff, etc., but for detailed product offerings, technical questions and pricing, a brand's website should be a portal to a dealer in the customer's area.

In the end, he who has the information gets paid and this has always been the case. Today IBDs are finding themselves to be less and less the go-to source for customers

margins, will find this approach ineffective. These are *commoditized brands*. For them, the most profitable move is to exit specialty distribution and focus on direct-to-consumer or mass market channels. This move will be welcomed by specialty dealers, because it clears up the landscape of brands who are qualified to be called *specialty brands*. Does Wal-Mart air commercials primarily about its product quality -- or its prices? Does Armani market a retail price point – or a unique quality of experience with its clothing? Wal-Mart cannot sell Armani, and Armani could not be sold at Wal-Mart and remain "Armani". Yes, it's that simple.

APPROACH #3:

> Price products with sufficient margin to support the brand and its authorized specialty retailers.

BENEFIT TO CONSUMERS:

> Stimulates competition, maintains high manufacturing quality, and supports high retail service levels for customers.

Obtaining a sufficient margin at both the brand owner and retail level has many pro-competitive effects: (1) it stimulates inter-brand competition; (2) it encourages reinvestment in the brand by both the brand owner and retailers; (3) it attracts new ideas and innovations into the specialty industry; and (4) it supports great retailer product knowledge by fostering investment in (a) showrooms, (b) product displays, (c) product demonstrations, and (d) expert training for employees. Selling specialty cycling with sufficient wholesale and retail margins spurs long-term consumer satisfaction & demand and industry growth. This is only the tip of the iceberg, and these benefits will next be explored in greater detail.

A Well-Compensated Specialty Retailer is Good for Consumers

A price that is *too* low cannot pay for a good consumer experience. When forced to work for too little, sellers will inevitably remove all kinds of added value that is desired, and even necessary for consumer satisfaction from the experience. Lower price means slower pre-sales assistance, fewer service & support workers, less employee training, reduced product testing & quality assurance efforts (and cutting safety corners), shrinking research & development budgets, thinner in-store inventory & selection, and slower adoption by retailers of newer models. As consumer dissatisfaction with a brand and/or product increases, sales decrease and consumers look elsewhere for a substitute in hopes of finding a better experience. Sometimes that substitute is another brand, but many times the substitute is another activity; for example, abandoning outdoor cycling for indoor spinning or migrating to a different activity altogether -- which leads to industry stagnation and decline.

A Well-Compensated Specialty Retailer is Good for Employment

A price that is *too* low cannot support Americans' own jobs. Before consumers can spend, they must have opportunities to earn more than they need to live. Growing, profitable industries provide more quality jobs and more consumer disposable income to spend on favored interests. Any industry feeds itself to some extent. More jobs in the *specialty equipment* cycling industry mean more cyclists able to work at what they enjoy; these also form a critical mass of influencers (of relatives and friends) toward the sport. In contrast, industries that shift from a network of specialty dealers to being serviced primarily by big-box and online retailers do not correlate with employing enthusiasts for their products. Such jobs are lower-paying and ironically, what one earns working in a given sales channel tends only to be able to afford what that channel sells. 'Mart' workers can't afford to shop anywhere else!

to have their information needs met. With suppliers willing to give it to them directly and discounters able to pass pre-sale information on as quickly as you can say "screen scrape," consumers are not starting their research with the IBD. When consumers don't start with us, our likelihood of getting the sale decreases.

So, if the effort of supporting customers has somewhat shifted from the IBD to suppliers, are suppliers not working harder just to maintain their same margin and paying for this with decreased margins for the dealer? In fact, brands are looking at increased in-house costs from providing these new services and are just as displeased with the lack of growth of profits relative to their growth in unit sales.

Our margins are being squeezed because we are forced to pay suppliers to do some of what was once solely our job as retailers—introducing the product, explaining its features and benefits, demonstrating its use (in person, not via a streaming video), helping the customer choose the make and model, and ultimately getting paid for our work at the register.

We need to take the customer information conduit back and be thankful and eager for any inexperienced customer that can take up our time in our stores.

It would help to have suppliers aid that process by coming back to a traditional distribution model that builds an authorized network of retailers, sells only to them, provides technical information only through them to the consumer and advertises with messages that drive consumers to their nearest dealer to find out more.

I applaud those few brands that have limited their scale from its mass-market potential. Becoming a dealer for them is arduous, but worth knowing you won't easily be clobbered on price or regularly caught knowing less than your customer. Isn't it interesting that among the quality bike brands, the three with the greatest market share are still the ones that are the most exclusive?

We cannot be ignorant of retail economics and sit around waiting for the industry to right itself. If we think happy retailing is a customer coming in already knowing what they want and willing to pay full fare for it, then our happiness will be fleetingly elusive.

Jeff Koenig co-owns and operates Big Poppi Bicycle Co in Manhattan, Kansas, and he serves on the board of the National Bicycle Dealers Association.

A Well-Compensated Specialty Retailer is Good for Economic Activity

A price that is *too* low destroys economic activity. As an industry is strangled and commoditized, lower wages are not the only economic factor. Industries support each other. As an industry grows, there is greater demand for more legal & accounting services, more industry-related fields of study for educators, more need for engineers, researchers, industry journalists, business associations, advertising providers, consultants, advocates, real estate & new construction, and other service providers. The wonder of economic scale is that the pie is not a finite size. The economic pie can expand in all directions as industries that profit make more industries more profitable, <u>while industries that contract cause other industries to contract -- that is, "shrinking the pie"</u>. Sustainable pricing is pivotal: where buyers and sellers are each benefitted without the economic destruction caused by value-lopsided transactions.

A Well-Compensated Specialty Retailer is Good for Consumer Choice

A price that is *too* low results in severe reduction of high-quality, specialty choices. <u>Commoditization not only reduces jobs & consumer income, but also limits the entry of new participants and new competitors -- stifling both future supply and demand</u>. We've all seen this: complex goods like bicycles require in-store introduction for uninitiated consumers to enter the sport successfully. Specialty bicycle stores are centers of learning. Without them, far fewer young people will become interested in and adopt the sport. While specialty stores always need new customers, they must also retain existing customers. When initiated customers find cheap outlets for the same-brand products and abandon specialty stores, those stores become unviable. Without the LBS, bicycling will be reduced from a sport which continually creates new enthusiasts, to a commodity mode of transportation for those who cannot afford motor vehicles and must seek a cheaper alternative. Neither new nor past customers alone sustain specialty retailers; <u>they must have both</u>.

A Well-Compensated Specialty Retailer is Good for Advocacy

A price that is *too* low results in reduced budgets for governmental and public advocacy. What too many legislators have historically failed to recognize is that laws and regulations which are unbalanced in the favor of consumers and which pit consumers against merchants backfire in reduced economic activity and tax revenues. A shrinking government cannot spend on economy-stimulating projects, like cycling and walking infrastructure. Building upon all of the principles above, a profitably growing industry that gains users will fund advocacy which results in public projects -- these, in turn, support additional growth in the activity and increasing tax revenues from corporate and personal incomes in that industry.

A Well-Compensated Specialty Retailer is Good for Brand Owners

Finally, a price that is *too* low, by resulting in all of the other impacts above, results either in the *loss of the quality brand* <u>or</u> *the dilution of the brand's quality*. It will always be one or the other. Every specialty brand owner wants to protect the quality image of his or her brand in the marketplace. <u>Allowing low-service discounters to set the price is a recipe for brand image destruction</u>. Brand owners or managers must be careful that their sales managers and reps do not sacrifice the brand's future by fulfilling orders to resellers that don't have an interest in maintaining the brand's quality positioning in the marketplace – all for a short-term bump in unit volume or commissions. As "slow and steady wins the race", solid sustainable growth depends on a stable price range. Fluctuating peaks in unit volume shipped that cause oversupply always drive down price and sacrifice long-term profitability for short-term gain.

It is scientifically and mathematically unquestionable: low-service discounting kills brands *and* starves them and their industry of profitability and growth.

MAP: Long-Term Sustainability For Specialty Brands

Minimum Advertised Price ("MAP") policies are an effective tool used by brand owners to control mass market retail pricing. Brand owners may unilaterally create and administer online advertising policies and require retailer compliance with such policies.

How do they work? As the name suggests, it is an "advertising" policy. It is not a means to control the actual retail selling prices. It relates only to the advertised prices used in retailer advertising. Brand owners contribute dollars toward the costs associated with such advertising and give the retailer permission to use product images and descriptions (which are owned by the brand owner) in such advertising. As part of the policy, brand owners set minimum advertised prices used for their products.

If a retailer advertises prices lower than the prices set by the brand owner, the brand owner terminates the advertising program and the retailer for noncompliance. There is no bargaining between the brand owner and the retailer as to any term (period); it is a take-it-or-leave it retail advertising policy.

Many brands are beginning to commoditize in the eyes of consumers due to online, low-service discounting. Yet, brand owners have hesitated to set and manage IBD-sustainable, minimum consumer price expectations.

In reality, most quality brands in most durable goods industries, whether by accident or by choice, have already allowed their products to slip into mass market sales channels, competing with their specialty dealer networks. In that condition, a brand owner's great fears are that "feathering the levers" will amount to putting the brakes on unit volume -- and that they cannot survive this.

In truth, like curing cancer, correcting course and taking back control of one's brand requires some short-term discipline. But in the few last couple of years, some well-known brands have undertaken just that -- and these courageous first to act are beginning to see light at the end of the tunnel. The most successful among them are already following this approach:

APPROACH #4:

> Employ unilateral, effective MAP policies for all products that create enough margin to support specialty dealers; rigidly enforce this policy across all sales channels with no tolerance for violations.

BENEFIT TO CONSUMERS:

> The opportunity for Generation Y (Millenials) and their children to have access to quality products and services beyond 2020, when Generation Y has assumed dominance of the economy.

Open-ended Discounting Periods Defeat MAP Effectiveness

If a brand owner utilizes a MAP policy, to what extent should the brand owner permit short-term promotional or late season closeout discounting below the set MAP? There are natural discount cycles in every industry, and the specialty bicycle industry is no exception. A MAP policy can still be effective even if it includes advertised discount periods. The point is to limit those periods and avoid inadvertently hurting program and stocking dealers who supported the brand by investing early in inventory.

A MAP that allows open-ended discounting and sets the discount amount is otherwise the classic "tail-wagging-the-dog." The discounted advertised price becomes the rule rather than the exception. Consider: a MAP policy which allows some number of sale periods per year to all retailers of (*x*) length for (*y*) percent off, at a random time of the retailer's choosing is exactly the same as MAP pricing equal to the (*y*) discount year-round. That is not an effective MAP policy. There are so many internet retailers and brick-and-mortar stores trying to sell online that someone will always be offering it for the (*y*) discounted price. In essence, the (*y*) price <u>is the only price that will matter</u>. If the (*y*) price does not offer a sustainable margin to specialty dealers, then it is a toothless and failed MAP implementation. A scheme like this is also much more difficult to monitor and enforce, and honest retailers who want to follow the policy will be unhappy being constantly undercut by those who always run the sale.

The criticism some brand owners have feared by not allowing sale periods selected by the retailer is that from specialty retailers who don't utilize just-in-time inventory management. These retailers want to be able to blow-out overstocked product to make room for newer offerings, and they consider it an infringement on their business practices to be told that they cannot advertise product discounts when they want to. The answer to this is multi-part. First, specialty retailers who haven't figured out that both overbuying and over-discounting cost them needed profitability can't hold the rest of the industry hostage waiting for them to learn. Second, if a brand offers great products with rigidly enforced MAP pricing, there will be no loss of sales to low-service online discounters, meaning that those units should turn consistently without a retailer needing to fear that it will be unable to sell units through. Third, should a brand owner determine that it would like to run a nationwide sale to grab some extra market share from another brand, or move through some units that weren't selling well, it can set a period and a price for all its dealers to advertise the units on sale simultaneously (discussed below.) Finally, by law there is nothing that will prevent a retailer from marking down anything it wants at any time <u>in-store</u>, as long as it does not <u>advertise</u> the brand's make/model and sale price.

At the other end of the spectrum are low-price discounters whose entire business model is focused on competing with other similar discounters on price and moving volume. To them, little else matters and they resist being limited in advertising their discounts. However, a brand owner should thoughtfully exercise great caution in catering to these retailers as they do not help consumers succeed with the brand, they are only interested in getting the sale. These sales channels commoditize brands, which this paper highlights, and this will not be in the best interests of most brands or, ultimately, their customers who want a high quality experience with them. The best way for brand owners to keep their brands and products from being commoditized by low-service discounters is to partner with specialty retailers that adhere to brand advertising (MAP) policies.

APPROACH #5:

Limit retail distribution and sales to authorized, brick-and-moartar specialty dealers.

BENEFIT TO CONSUMERS:

Prevent brand commoditization that erodes customer quality of experience with a brand; prevent industry commoditization that shrinks quality choices for consumers.

As the supplemental article points out, information technology has acted upon scarcity in a way that cannot be undone. Internet retailers do not act "normally" along the supply-demand curve. If they can only get ten units of something in high demand shipped to them once per month due to short supply, they will still be willing to steeply discount those ten units (to get the next sale before the next-lowest-price seller who just received their allotment of ten units). The online discounting model is so micro-oriented that it literally operates minute-to-minute.

Therefore, while a brand certainly could choose to limit distribution solely to an authorized brick-and-mortar network of specialty dealers, and benefit from doing so, that is not advocated in this paper as the *only* possible solution to halt brand destruction. Specialty brick-and-mortar retailers who don't understand retail economics have been caught up in the belief that the only way for quality brands to succeed with them is with *them alone*. This uninformed sentiment has confused the conversation between suppliers and retailers.

Multi-Channel Distribution Is Possible, But Not Viable For Every Brand

A brand may have good reason for wishing to be available for purchase in big-box stores and online. For instance, it may produce a product of limited complexity for which there are many substitute brands and choices. For this brand, maximum exposure is highly sought after; it does not want to be "missing" anywhere.

But the danger is this: if mass market and internet retailers are free to advertise at any price, an unstoppable race to the bottom will commence almost immediately. This will force specialty brick-and-mortar retailers to seek other brands to replace commoditized ones. No longer welcome in specialty retailers' stores, these brands will eventually produce only cheapened commodity products for the mass market channel. This is fine as long as the brand does not mind becoming a so-called 'mart' brand like Schwinn, Motobecane and Diamondback (or Sony, Kenwood and JVC in another industry). But that co-opted brand will not be able to compete with other 'mart' brands unless it is also willing to cheapen production in order to achieve a lower price and get the sale. Otherwise, the brand will also lose sales volume in the mass market (to even cheaper brands) and find itself sidelined at both ends of the marketplace.

Yet, should the brand wish to retain high-quality manufacturing, R&D, and an exclusive image, it must retain prominence in a specialty brick-and-mortar network. In order to do that, it must protect those dealers from being undercut by the mass market. Hence, MAP policies which have *365 day-per-year consistent boundaries that are strictly enforced* are needed. If not strictly enforced and if not consistent, MAP policies are meaningless symbols at best, and without effect on the marketplace at all.

So there is a price to pay for a brand which wishes to be found in every channel. MAP enforcement adds a level of complexity and cost to brand management. A brand owner must weigh the benefit of mass market and online distribution against the cost of protecting a quality brand identity in the marketplace. Universal distribution will not make sense or be achievable for many brands. Those few who can do this well will tend to be larger brands with the human resources available to protect brand identity. For all but the biggest brands, limited (or no) distribution to mass market and online sales channels will be more efficient and sustainable.

APPROACH #6:

> Consider limiting internet sales only to authorized specialty dealers (but only with one year-round, IBD-sustainable MAP price).

BENEFIT TO CONSUMERS:

> Keeps the customers of a brand dependent on a network of specialty dealers that offer much better service and who are much more concerned about the customer's success.

RISK TO CONSUMERS:

> Makes it easier for consumers to make purchasing decisions without in-store

expertise and advice, preventing local dealers the opportunity to correct brand/product misperceptions; increases risk of a bad brand experience due to lack of education.

Global Economy + Global Retailing = Global Brand Destruction?

There is an obvious correlation between the size of a retailer and how much of that retailer's value proposition to the consumer is oriented around price, particularly in mass market channels. With increased size comes an increased dependence on sales volume, and with dependence on volume comes the increased incidence of discounting to maintain that volume.

And in just a few years, the threat from foreign retailers crossing international borders to compete with domestic ones has progressed from "beneath notice" to "quickly growing".

The ultimate scale, indeed the final frontier of retailing is the global marketplace. The internet has bridged that final barrier of distance and speed of information exchange and enabled companies on separate continents to compete for the same customer located anywhere with an internet connection.

Regulators, brands and domestic retailers were not ready for this.

Governments regulate international trade based on large scale operations. Wholesalers have historically imported and exported massive volumes of product for end-country distribution -- and had great incentive to comply with national laws because violations threatened the disruption of their large operations.

But the singular consumer that can buy from anywhere is too small to receive consistent government scrutiny, and both the buyer and seller are willing to take more risk because the stakes are small. Most consumers are ignorant (or will claim ignorance) of violating any import rule, duty or tariff. Sellers who ship one product at a time are very difficult targets for enforcement by any country other than the one in which they are located.

It is likely to be years before countries can adequately regulate their own in-country internet commerce, let alone agree between nations on cross-border policies. Yet, such laws seem necessary to protect consumers and each country's own domestic marketplace from what can happen when opportunistic sellers in one country, having no fear of law, undercut industries in other countries. Without regulation, the practice of selling counterfeit, defective, or illegitimately obtained products online with quality name brands on them at discounted prices that no legitimate domestic retailer can compete with, will be altogether too common.

Once again, it is up to brand owners to control their own futures. Working within the existing laws of various jurisdictions, <u>a premium supplier must limit the behaviors of dealers of its products in every country, or risk the health of its retail presence in all countries</u>.

APPROACH #7:

Employ effective MAP policies outside of the U.S..

BENEFIT TO CONSUMERS:

Protect brand from being commoditized which erodes consumer quality & choice; prevents consumer fraud and abuse originating in other countries for which consumers may have no recourse.

To the extent that MAP policies are permitted in countries outside of the United States, they should be implemented in those countries. Retailers located in other countries who do not abide by brand owner MAP policies should be terminated for noncompliance. If a brand is prevented from doing this, then it should cease selling into that country in order to retain its global image as a specialty brand. A brand must not allow itself to be hijacked by unscrupulous sellers in one country to the detriment of all other country markets.

This cross-border challenge must not be dismissed or underestimated. In the same way that commoditization by low-service discounting within a country can destroy a brand's specialty positioning and, ultimately, the demand for a brand in that country, commoditization caused by such discounters selling into a country from abroad will have the same effect.

...too much of a drug abused as a coping mechanism can create unhealthy dependency... Product discounting works in much the same way.

The summary approach so far to maintain specialty brand image and resist commoditization:

> Implement MAP in the United States and in those countries where such policies are permitted. Make it sustainable for brick & mortar specialty dealers. Require all retailers within or into the U.S. to follow it or lose access to the brand with zero tolerance and no exceptions. De-emphasize pricing information for the public so that dealers are free to advertise their own price as long as it is at or above MAP.

‘Discount’ Is Not a Dirty Word (But Beware of Addiction)

It is certainly true that not every item of inventory is going to sell through at retail within the intended season, which creates *excess supply*. Inventory dollars must be recaptured -- no one in this business can afford to make a habit of throwing away unsold merchandise. The goal is *efficient inventory management*; when inventory sits anywhere in the supply chain and is not being moved efficiently to consumers, *carrying costs* sap profitability.

But perfect inventory planning is a mathematical impossibility. There will always be some products introduced which are not accepted by consumers as quickly as the maker hoped. The fickle and changing preferences of consumers are an endless challenge for every product designer, brand manager, distributor & retailer. Too much of a given SKU at any level of distribution represents tied-up capital that is needed to produce or buy better-selling inventory. Such overstocks are unhealthy for the balance sheet, and a way must be found to shed the excess weight. This is traditionally done through *discounting*.

Most people appreciate the power of pharmaceutical medicine. A painkiller used at the right time in limited amounts, for a limited period, can have dramatically positive effects on a sick patient by assisting with rest. The faster the recuperation, the sooner the patient can resume normal family and work life for the sake of those who depend on that person. However, too much of a drug abused as a coping mechanism can create unhealthy dependency and cause dysfunction. Product discounting works in much the same way.

Appropriate discounting is used at the end of a product or seasonal cycle to prepare for model replacement. Most major LBS bike brands generally follow a disciplined approach to discounting. For annual and seasonal products, advertised pricing will remain unchanged until near the end of the selling cycle, while non-seasonal SKUs that remain unchanged for several years will have consistent pricing or even see wholesale price increases as manufacturing costs rise. Only when a product is being discontinued, or on occasion when it is severely overstocked, will suppliers discount product to retailers. Generally, the supplier does not intend to reorder such a product, so these discounts are for limited time periods while supply lasts.

Retailers, on the other hand, are mixed. Some retailers (and these far more likely to be specialty LBSs) maintain consistent pricing as long as the product remains in season and in production from the supplier. If these retailers discount products, they do so for the same reasons as their favorite suppliers and at similar times. But others – in a practice prevalent across mass market channels -- use discounting as their primary promotional tool and not for the limited purpose of cyclical obsolete inventory reduction. Their advertised "sale" price on some items can remain unchanged year-round and they continue to reorder these items just to keep selling them at a discount. Many direct-to-consumer brands behave in the same way.

Such practices shift the marketplace and establish a product's *street value*. While not improper per se, this retailer behavior reduces a brand's perception of value with consumers and threatens its premium positioning in the marketplace. Remember: retailers who do not use discounting as their primary business model and promotional tool tend to be far more focused on selecting products which offer their customers a uniquely valuable experience. Retailers who use discounting as their primary attractor of customers tend to be more focused on turning unit volume to compensate for poor planning and/or lower margins, and are not as concerned about their customers' experience.

Those buyers and sellers who are focused more on the discounts than on the product, like a patient on painkillers for too long, can be described as discount-addicted. Used as a coping mechanism to reduce the perceived difficulty of better *planning* or of focusing on other value propositions, discount addiction drives some consumers into debt, buying things they can't afford. It creates a mentality among discount retailers that is not unlike an illicit drug dealer, attempting to find profit at the expense of the discount-addicted consumer.

A brand owner's careful observation of a retailer's behavior can reveal a lot about the way this retailer approaches both suppliers and consumers. Retailers, who do business like the brand does business, are usually going to be better partners than retailers who have a very different business model and approach to the consumer's experience.

Unauthorized retailers of a brand who use deceptive means to get access to quality products from premium brands for the purpose of discounting them (and often make themselves hard to identify and hold accountable) have an economic morality akin to the social morality of a drug seller. But equally unscrupulous are brand suppliers and distributors who aid these retailers, or who themselves dump product quietly through discount channels in order to ease their own pain while hiding the activity from the authorized retailers who trust them.

In a practical business sense, a brand which is over-discounted is a disappointment to specialty retailers (who will then avoid that brand) and creates an unsustainable consumer pricing expectation which cheapens the brand and disappoints the consumer.

APPROACH #8:

> If and when inventory closeouts are needed, limit closeout access to stocking, authorized retailers and participate *with* retailers in promotional sales.

BENEFIT TO CONSUMERS:

> Avoid cheapening brand image with consumers and preserves consumer

relationship with local specialty dealers who provide better service.

For the bicycle industry, brands who understand the wisdom of utilizing MAP policies must first recognize what profitable margin is for the average IBD --, and it isn't 33, 35, or even 40 margin points. Brands competing with each other to attract specialty retailers need to make the best offer to retailers that they can.

Within this, it is important to understand that MAP policies which, in the pursuit of retail market share, are only barely profitable or sustainable, limit the ability of the brand owner to discount excess inventory through specialty retailers. This is because any discounting of a brand that is already barely-to-unprofitable for a specialty retailer puts a specialty retailer 'in the red' and causes forced subsidization of that retailer's store by other brands. A specialty retailer will soon switch to a brand which does not require subsidization.

In order for IBDs to provide brick-and-mortar retail stores, product displays, showrooms, inventory, train knowledgeable staff, inventory parts, and provide service and warranty capabilities, there must be sufficient margins. All of those costs borne by the IBD must be passed on to the consumer, they cannot be absorbed. This fact is evidenced by the loss of 3000 IBDs over the past 40 years. They could not absorb those costs and neither can the remaining 4000 IBDs.

Consider the apparel and furniture durable goods markets. Both of these products have much, much higher initial gross margins at retail. While the consumer sees very large percentage discounts when these categories are placed on sale, these industries have already factored in the need to move excess or slow-moving inventory with attractive discounting, and they have already built-in the margin room with their retailers to do so without making the sale price unprofitable to the retailer.

But the bicycle industry has been suffering from a steady, progressive gross margin squeeze at retail, starting with margins that were never nearly as healthy as those of furniture or apparel and trending downward. Even apparel and shoe brands within cycling have rarely offered the margins that general apparel and shoe sellers start from with their in-season offerings. Many cycling soft goods sales reps have been taught to encourage IBDs to utilize the same clearance strategies that department and shoe stores use, without ever having offered the department store margins that make those strategies possible. But because many bicycle shop owners do not themselves understand the pricing structures of other retail segments, they do indeed use department store discounting strategies (to their own great harm).

When a coordinated promotional sale takes place that includes all retailers, it is vital for the brand to participate with the retailers in the sale by also discounting it at wholesale (including, when possible, a rebate for units already held in stock by the retailer). This has been a long-needed reform in the bicycle industry, where once-premium brand managers have too often cut the legs out from under their once-loyal retailers by blowing excess inventory "out the back doors" through clearance websites.

The defense put up by these brand managers is that it costs them less to find one outlet to send all the excess inventory to vs. working through their existing dealer network with a coordinated sale. Could not specialty dealers make the same claim to justify an eBay store? Yet, the dealer agreements that many of these same brands hold over their dealers' heads is that dealers cannot do the same (though some do anyway, further weakening the brand). This is ironic at best, considering that dumping by a brand owner causes the very damage to the brand that it wishes to prevent (by stopping dealers from dumping its products). Why should specialty dealers accept this double standard from a "partner" brand?

Finally, in order to protect brand image, it is important to clearly label discounted, closeout inventory as "closeout" in order to protect specialty brand image and positioning. Customers who find in-season product discounted and readily available in all size & color options, or who perceive that the items are still in-season because they are mixed in with other in-season merchandise and not labeled "closeout", begin to discount the true value of the brand at all times in their own beliefs. Limiting closeouts through high-service authorized retailers makes it much more likely that the closeout merchandise will be separated and labeled as "closeout". Low-service online retailers do not have the incentive that specialty retailers do to represent closeout merchandise appropriately, since their entire model is based on discounting.

Planned Scarcity & Short-run Marginal Cost Curve: In Short, Production Planning

Brand owners in complex goods who do not own domestic factories (which are most of them in bicycling) are encumbered by a great deal of risk in factory lead times and the importing of goods. Fluctuating currencies, volatile shipping costs, import regulations and beliefs about consumer expectations make the job of having just the right amount of inventory at the right time exceedingly difficult.

Retail buyers also face the daily challenge of having the right inventory at the right time. They face the bi-directional risk of misjudging customer wants & needs *and* the risk of having inventory instantly devalued by supplier or mass market discounting. A comparative advantage that distributors and self-distributing brands have is that they can balance low demand in one geographical region against high demand in another. In contrast, local shop buyers who have bet on too much of something don't have these outlets available to them.

> Brand managers, just like store owners, tend to over expand and over reach because they want to "beat" the competition...

Planning is the lynchpin of sustainable, profitable sales.

Consider the analogy of a live concert of a favored artist. When the artist performs an hour of his greatest hits, the audience gets an unabated musical high. When it ends, the audience is left wanting more. But sometimes the artist mixes in a few 'B tracks' and unknown material in order to push some of the slower moving stuff. During these numbers, the audience mood drops a little while they wait for another well-loved favorite. And sometimes, the concert goes on so long that it wears the audience out, such that even a better known song loses some satisfaction.

Part of the art of durable goods sales is finding the optimum short-term marginal cost, and using planned scarcity to maintain a consistent demand and/or sustainable growth curve. Planned scarcity is the intention of running out of supply --, but not too soon. Optimum marginal cost is finding the number of units to make that has the lowest average cost (and thus highest unit profit), which is virtually never equal to the maximum production number possible.

What a brand that understands this does is their own version of deciding how many and which songs they should put in their "concert". There may be a hundred SKUs they could make, but limiting themselves to a subset of their best opportunities is a rare and valuable skill. There may be 10,000 customers who *might* buy an item, but a smaller number (even only slightly smaller) would be much less of a risk to sell in a reasonable time frame. Balanced against this is production analysis that determines how many units have the lowest average cost per unit. (Refer to discussion of this topic in Section 1.)

A smart brand doesn't make all of a SKU that it can. It considers the market size, its market share, the historical bell-curve for range of variation (like gender, sizes, etc.), and calculates the quantity it thinks it can sell in a production cycle. But the job is not done, there. The smart brand's managers then look at the cost of production, and determine if the lowest average cost per unit is achieved by making fewer than the target number, about the same, or more.

If the optimal cost is at a higher unit volume than the unit target sales, then the brand needs to perform a cost-benefit analysis of buying additional marketing to increase the market size and/or its market share. If this pencils out, it can offer better terms to dealers in order to increase unit sales. This shows why high-growth industries are so great when booming – they make this look easy! -- sadly, cycling is not currently one of these. But if the optimal cost comes in at a lower number than unit target sales, a brand could certainly look into how to change the production factors to bring the optimal production unit number up -- and if it cannot, then it *should* make less and reduce its unit sales target. Why?

The reason is that when a brand produces more than the optimum lowest average cost dictates, it (a) pushes wholesale price up, making the product less competitive, (b) robs itself of capital that could be used to diversify its product mix and make something else more efficiently, and (c) raises the marketplace risk that if its projections are wrong and sales activity falls short, the dangerous conditions of oversupply and product dumping that threaten an entire industry are created. That this battle is raging is evidence that many product brand managers do <u>not</u> sufficiently utilize this understanding of planned scarcity and marginal cost curves. Why not?

Brand managers, just like store owners, tend to over expand and over reach because they want to "beat" the competition, be the biggest, get the glory, make the extra million dollars and feed their egos. This is the unpredictable human element of an otherwise predictable science.

But routinely dumping product and looking the other way is a Band-Aid on a severed limb. The root of the problem is poor production planning, and that is where the solution to specialty brand profitability needs to start.

APPROACH #9:

> Consider targeting production to the lowest average unit cost, and grow through product diversification instead of placing artificial pressure on maximizing unit sales at any cost.

BENEFIT TO CONSUMERS:

> Increased consumer choice and variety; greater diversification and stability for the brand increases longevity and consumer confidence that the brand will be there for them in the future.

Specialty retailers are unprofitable with a brand when oversupply and product dumping leaves them underwater with that brand. But they are also unprofitable with a brand when they have customers willing to buy and no inventory available to sell. The answer to undersupply is product diversification.

Model variations give consumers choices. And they provide alternatives when one SKU is temporarily out of stock. Most specialty retailers understand that they don't want to have an account open with just one brand in any important product segment. If that brand is out of stock, lost sales can eat up any profits already made. Having a diversity of available brands keeps the retailer supplied. In the same way, a brand itself can keep its retailers' shelves stocked' (and keep on shipping and invoicing) when it offers variations that can cross-substitute for temporary SKU under-runs.

This discussion is not complete without pointing out that the shorter the production cycle, the more difficult inventory is to manage.

Imagine if specialty bicycle production cycles were shortened from the current 12-month to a 3-6 month basis. For the sake of argument, add to this the possibility of having two seasons each year for each category of cycling competition, from MTB to cyclocross to road/triathlon. But keep annual volume the same. This thought would cause most any bicycle brand manager to instantly go gray-haired. Shortening the cycle and planning inventory volumes accordingly is nothing less than frightening. (In fact, this is exactly what happened early-on to the computer and computer parts retail industry, which is today commoditized and in which few specialty shops that stock any selection of parts are left.)

If shortening product cycles is maddening, would it not be an attractive proposition to consider lengthening product cycles?

In the case of bicycles, many specialty retailers have long believed that models change too often, particularly higher-volume models at lower and middle price points where the consumer is not very sensitive to (or even aware of) the latest technology. Add to this the ever-shortening production cycles for core components, often released at the opposite end of the calendar from new bicycle models. New releases instantly devalue existing models. The shorter those product life cycles get, the more devalued inventory there is in the system. The cycling industry often jokes to itself about its cannibalistic nature, eating its own opportunities up in the haphazard and uncoordinated way in which it releases new products.

APPROACH #10:

> Consider allowing individual models to run in independent, overlapping sales cycles and to run longer.

BENEFIT TO CONSUMERS:

> More consistent availability for when the consumer is ready for their purchase instead of needing to time their purchases according to entrenched industry behavior.

How often do bicycle models under $800, give or take, really need to change? And how much sense does it make to being out-of-stock in early Summer at the height of the U.S. cycling season? What about core colors of helmets, shorts & shoes? How likely is it that specialty retailers could have sold just as many of these models across a multi-year production cycle, with a few extra color variations to choose from, without brands and retailers needing to discount them because of the artificial perception of being "old" caused by a designated model year? And when was it decided that all of a brand's models need to change at the same time? It would certainly seem easier to manage warehouse space and product launches if model changes were staggered and models run according to their own consumer demand life cycles.

But brand owners and their retailers have both been motivated by inertia and fear: this is how things have "always been done", and unknown losses may result from attempting a new way.

Suppliers and retailers together need to become better economists and planners. Frankly, they don't need better projections as much as they just need good historical data (which Leisure Trends and others can readily supply), that they can use appropriately. Suppliers can also help their profitability and that of specialty retailers by being willing to run core models longer so that they can produce in higher quantities, if this lowers average unit cost, and avoid running out during times of

Getting customers in front of a brand's product is becoming an increasingly flat, one-dimensional proposition due to internet retailing.

peak demand.

And if their planning is occasionally wrong, suppliers and retailers both need to leverage logistics instead of reverting to panic mode.

A few soft goods brands have come to understand using planned scarcity and still keep dealers supplied with product. Individual stores are far less able to plot their future sales of individual SKUs than national brand offices. Where one store orders too many, another store has ordered too few of that same SKU. By allowing stores to return a limited amount of product, these smart brands help those stores (taking the fear out of placing a large preseason order for the next year) and also help the stores who have run out and are looking for more of that SKU. Closeouts are reduced, retailers are delighted with the brand and everyone wins. The automobile industry long ago figured out a way to move product sitting on the lot to another dealer who wants it, through a system of regional auctions. Why can't specialty cycling brands be clever about redistributing product while maintaining the product's value in the marketplace?

Even when the whole country has too much of something, another country whose market trends differ might love to get that product for the following season.

Authorized Specialty Dealers Reduce Brand Warranty Service Costs

It's long been apparent that customers are not likely to repurchase a product or brand with which they have experienced premature product failure that went uncompensated -- and often even when it is compensated.

Warranties are not trivial value add-ons to durable goods. Even when a motivated consumer seems willing to make a purchase without first examining the specific warranty offered, there is still an expectation of reasonable performance and life rooted in general knowledge and experience with quality brands. When a product fails prematurely, whether or not the customer was aware of a warranty at purchase, a strong warranty response is expected —and the customer will look to be made whole.

Warranties represent a statement of intent by manufacturer, brand, wholesaler & retailer together to sell and support a product able to meet consumers' reasonable expectations. No brand owner sells new durable products "As Is" with a stated waiver of all warranties or dismissal of promises to perform.

Yet, this concept cuts both ways. When a brand is willing to provide warranty support to anyone for any product that bears its name without performing a reasonable review, then that brand is the one being taken advantage of.

APPROACH #11:

> Manufacture to a high quality standard, provide a solid warranty, and <u>limit warranty service to original purchasers who purchased from and are being serviced through a brand-authorized dealer</u>.

BENEFIT TO CONSUMER:

> Dramatically increase customer success and satisfaction with products; reduce costs of

> illegitimate warranty servicing & claims, which savings can be passed on to bonafide customers.

Reasonable review must include ensuring that the product was legitimately produced for or by that brand owner. Warranty replacement for counterfeit and factory-rejected product rewards and encourages fraudulent products and back-door sellers. The more counterfeit and defective products that enter the marketplace in the name of a brand, the more that this brand sees its premium image and positioning suffer with consumers; it is brand suicide to be unconcerned with such activity.

Warrantable review must also include ensuring that the product was originally purchased from an authorized dealer (approved by the brand as committed to and capable of adequately educating and supporting the customer in the proper choice and operation of the product). Customers who make uninformed assumptions about product operation and suitability and who did not buy from a retailer concerned with their success, will blame the brand if their product choice disappoints them. Again, to be unconcerned with consumer dissatisfaction which could have been prevented is highly damaging to brand equity.

Warrantable review must include verification by an authorized dealer that a warranty claim is for a genuine manufacturing defect. The case for a limited number of "authorized" dealers is, in large part, that the dealer of a brand should be intimately familiar with that company, its products and their reasonable expectation for performance. An authorized dealer must be trusted party to credibly advise the brand owner of the nature of a defect that has been brought to its attention. Time is saved, illegitimate claims filtered out, and the brand's reputation preserved when authorized dealers, who can get the customer back to health with the product immediately, are the voice and face of the brand.

Warrantable review must include verification by an authorized dealer that a warranty claim is for the original purchaser of the product. There is a common consumer notion that the reason some warranties don't pass through to subsequent owners is so that the brand can be "let out" of supporting its own products on a technicality. However, for the same reason that a brand should greatly desire its products to be sold by authorized dealers, the brand should also greatly desire that its new product sales not be suppressed by an overactive used marketplace. Authorized dealers' success is tied to the brand's success: dealers want to see their customers satisfied with the brand's products, not getting rid of them second-hand. But when a unit is sold as "used" by the original purchaser, there is no vested interest on the part of the seller in the success of the next owner. Subsequent owners introduced to a brand or product this way may form a faulty image of that brand if the experience is unsuccessful. If second-hand owners of a product are permitted to enjoy warranty support in the attempt to preserve the brand's image, this will encourage shoppers to seek out used products and increases the incidence of unsuccessful product experiences, even if the brand and its dealers fix the immediate problem. Providing warranty support for second-hand goods also raises the per-unit cost of supporting the product after the sale which works to raise the retail price and make that product line less competitive in the marketplace.

The best-case scenario is for customers to not need warranty assistance, as any claim for warranty is, at the least, an inconvenience to the consumer: in the consumer's mind this "should not have happened". Limiting claims, both in financial and reputational cost to the brand, is best accomplished by using warranty policies that encourage customers to 1) buy new from authorized dealers who can help them with product selection and success of experience, and then 2) use the product themselves to the end of its life cycle. This also makes a case against the value of internet retailers to a brand; online-only sellers are not overly motivated to concern themselves with individual customers' successful brand experiences (due to the remote, self-service nature of internet shopping and the rapidity with which such sellers change brands).

Finally, in order for a brand to prevent cross-border commoditization, it must implement warranty support policies that refuse to support products not purchased through authorized dealers abroad. An authorized dealer is specifically supported and empowered by a brand in a country in which it grants authorized dealerships.

Brand Websites Should Leverage Specialty Retailers, Not Go Around Them

Effectively Used Dealer Locators

Any company's internet website should be its visually interactive calling card. Great websites create and enhance consumers' desire for what the brand offers. A specialty brand's website should also inspire the customer to want to be around others who are using the brand's products, and to consult an enthusiastic expert (their nearby authorized dealer) to discuss their needs and to find *all* the right products to fulfill their desired experience.

APPROACH #12:

> Offer an easy-to-find authorized dealer locator on the brand's website and diligently keep it current.

BENEFIT TO CONSUMER:

> Ensures customers that are seeking the brand will quickly find the desired experience with the brand, and have an opportunity to purchase locally and preserve convenient support.

Getting customers in front of a brand's product is becoming an increasingly flat, one-dimensional proposition due to internet retailing. On the internet, one dealer is hardly perceived differently from another with respect to quality of service. For those brands that still enjoy or wish to re-establish a closer relationship between specialty retailers and consumers, it will be important for a dealer locator to not be so one-dimensional; the experience with all potential sellers is *not*, and must not artificially made to appear to be, equal. Some sellers do a much better job of caring about the customer's needs, and of aligning with a brand's values, than others.

Who should be on a dealer locator? Should it be limited only to direct accounts as opposed to other dealers that stock and support the brand strongly but choose to buy it through a P&A distributor? Should it be limited only to a stocking dealer even if a non-stocking dealer can still source the brand for an interested customer? Should a large chain like an REI or Performance store be included as a peer with a locally owned & operated dealer?

These questions don't have obvious or easy conclusions and the answers will vary greatly between brands, product categories, and sales channels. However, merely presenting a consumer with a one-dimensional, geographically pinned list of potential sellers, while it may be the easiest solution, is certainly not the best one.

A dealer locator that rewards excellence in retailing, will reward the brand in loyalty from the consumer. The more often that consumers who rely on a dealer locator (and many do; statistics are readily available) have a successful experience with the first dealer they try, the more willing consumers will be to trust the brand's other messages and products.

Therefore, in whatever way that a dealer can be recognized, elevated or promoted within a dealer locator according to the likelihood that a potential customer is going to succeed with the brand through that dealer, this should be done. This will tend to suppress, or move to the bottom of the list, internet retailers, big box chains, and non-stocking IBDs, and raise to the top long-time, stocking IBD partners who are most often creating the greatest local following for a brand.

Keep in mind that a brand's "best" dealers are not always the ones holding the most inventory from that brand. This is because a dealer that overstocks may be a dealer that later over-discounts which, in turn, destroys brand image. It also often over-leverages that dealer's credit line with the brand, risking that dealer's ability to pay its bill. Brand owners:: beware the short-term increase in accounts receivable that later becomes a mountain of dumped product or bad debt. The best brand managers don't let dealers load up on models that their local markets can't absorb.

Consumer Education That Actually Works

In any mechanical product industry, tinkerers will be attracted to it who loves to be their own technical support. DIY-ers can be supported, and need not be discouraged from learning how to support themselves. But there are two kinds of DIY customers.

First are the DIY-ers primarily motivated by a love and respect of the product, who are often friends of the specialty retailer. They spend time in the store learning, and they have historically supported specialty retailers with their parts and tools purchases. The best place for them to learn is in the store, where the education is hands-on and there is an expert interacting with them to make sure that they are getting it right.

But a second strain is increasingly plentiful: DIY-ers primarily motivated by purchasing cheaply, who are often adversarial to the specialty retailer. The internet has facilitated the rapid growth of this consumer class. They don't wish to pay for the effort of others and (ironically) also want to limit their own effort expended. But when something goes wrong, who do they hold accountable? Putting just enough information in their hands to "make them dangerous" turns them into costly headaches for brands and specialty retailers alike.

As presented in the Supplemental Article on p.26, information has value -- and a company that protects its know-how and limits its delivery through authorized distributors and retailers, protects future opportunities in the marketplace. Yet, some brands have forgotten that guarding the exclusivity of product know-how is every bit as important as guarding patent rights or trade secrets. Too often, the number one informational resource for the second class of DIY consumer is a brand's own website.

APPROACH #13:

> Consider re-focusing brand websites to communicating the value of the brand and its authorized retailers. Don't devalue both by teaching consumers to be their own product experts.

BENEFIT TO CONSUMERS:

> Increase customers' success with the brand by putting them in front of live, expert retail salespeople who can best assist and support them.

Consider online shopping guides, for example. There are brands with broad product choices who have devalued their networks of specialty retailers by "stepping in front" to instruct consumers in how to choose and use their products. Misguided consumer education includes providing over-detailed technical specs, complex compatibility information, and/or in-depth installation/repair manuals & videos direct to consumers via brand-owned websites. When brands go around specialty retailers to convey this information to consumers, they significantly increase the likelihood that consumers will make self-help mistakes.

Consumers are hesitant to blame themselves when they don't have the desired experience with a product, even when it was self-selected and self-supported. Every specialty retailer has had difficult interactions with customers under these circumstances. Brand and retailer reputations are both damaged when consumers get frustrated, caught between their own interpretation of impersonally conveyed information from the brand and a service provider's attempts to correct those misperceptions later.

Specialty retailers, properly trained, can and should be the experts who drive consumers into their stores with questions. Those questions become sales opportunities and support the existence of a network of specialty retailers that a brand needs. Authorized dealers are supposed to be a brand manager's "boots on the ground," armed with years of focused experience and training. Local specialty retailers are able to anticipate problems that no customer-website interaction can. These retail partners of a brand are able to make sure that consumers are going down the right path, and to correct their course before they have suffered bad outcomes (which sour consumers on the brand, even when the consumer's own lack of understanding was at the root of the problem).

The online information that a brand chooses to supply to consumers signals what it believes. If a brand does not believe that it needs the specialty retail channel to maintain its premium positioning, then it will assume more and more of the role of educating consumers directly while using mass market retailers to be product pick-up depots. Yet, the market mechanisms explained within this paper will eventually deny brand owners of this outcome. Instead, the brand will face commoditization and will not maintain its premium positioning.

What brand owners fear about not "putting it all out there" on their websites is the notion that consumers who aren't given every possible detail about a product will pass it up and choose one about which nothing has been held back. Ironically, this notion backfires as often as it succeeds. What if, after having provided every imaginable detail, one of those details is something that causes the customer concern or something that customer wanted to avoid? What if one of those details took the perception of the product down a notch with the customer because a competitive brand had it beat on that singular point alone?

It's a mad struggle to try to out-spec and out-present every competitor on every possible technical detail. And for reasons described above, allowing the consumer to shop without the brand's dealers keeps the brand's most ardent supporters from being able to accentuate the unique features a brand may be offering or overcome objections coming from misperception or inexperience. Cannot a quality, well-trained and motivated dealer do a better job of pitching a product than any website can?

Beware Third-Party Software Providers Promising Streets of Gold

A small but growing number of software solution providers are seeing a profit opportunity in providing customer-facing tools to the bicycle retail industry. These range from cookie-cutter eCommerce solutions (ushering the LBS into global competition for online purchases) to widgets that attempt to intercept online shoppers and point them back to their LBS. Brand owners, distributors and retailers alike, looking for some way to recapture online customers, have been attracted to these new offerings, with very mixed results. These solutions can be costly, complex to implement, and extremely time-consuming for the LBS to manage.

And as is only reasonable, these software providers are focused on creating profit opportunity for themselves -- with only a secondary concern for whether their solutions are truly the best long-term approach for the industry. Much of the ROI that software companies pitch in their solutions is unmeasurable. Like an awareness marketing ad buy, there is no way to directly attribute absolute bottom-line increase in dollars. So, a significant investment is being made on faith.

One increasingly popular solution being pitched to specialty LBS retailers is search engine functionality that depends upon real-time lookup of LBSs' current inventory databases. These tell an online customer where they can find an item they may be interested in, in-stock, near to them – sometimes including the price. A newer version of this functionality is also being offered higher up the supply chain to brand owners in order to connect a consumer from the brand's website to a local authorized retailer. This brand-provided functionality goes beyond the traditional store locator and actually lets the customer know which among their authorized retailers have the item in open stock, often quoting their respective prices.

The sales pitch for these solutions are not unlike that of yellow page advertising, some variant of, "If you don't do this, you'll miss (or lose) customers who are looking for you". Wrapped within the presentation are messages about embracing the inevitable dominance of internet shopping and fearing that those who do not employ these solutions are being left behind.

The problem with these solutions is *not* that these software tools don't work as designed. Information will be conveyed to the consumer accurately enough. Rather, the problem is that these solutions themselves represent a model of doing business that is incompatible with the LBS. They are like trying to fit cyclocross tires on a triathlon bike.

Internet shoppers who research products online are influenced by industry, brand, retailer & user claims, filtered through their widely varying levels of amateur expertise. But there is a distinction among them: those shoppers who are committed to helping themselves with product selection (and buying at the lowest possible price) vs. those who are still willing to depend on their local specialty dealer for advice and reward that dealer with the purchase.

For those shoppers who are committed to excluding all but the lowest priced seller, there is no software solution possible that will help the LBS recapture them. The brick & mortar store's expense structure is so dissimilar to the low-rent warehouse, minimum wage internet retailer that the LBS has no chance at those sales. If the LBS were to advertise the lowest price to get those sales, it will either be forced to match its online advertised prices in its store, which it cannot survive, or it will be punishing in-store shoppers with higher prices so that it can keep the doors open and quickly alienate them.

This still leaves those shoppers who are open to buying from their LBS and paying more for local service. Do online software solutions help with these customers?

While it is true that some customers may wish to start their product search by looking online and then finish the process in the store, these are fledgling self-help shoppers. They are in a transitory state: once dependent on the LBS but already starting to migrate away from being educated chiefly in-store. During this transition, the online-enabling LBS is hoping that the consumer decides to buy what brands and models it happens to have in stock rather than what someone else nearby may have. As customers' knowledge and level of comfort with self-education increases, their need for the LBS decreases until they have graduated away from LBS-dependency.

This is precisely the customer-bleeding that the LBS cannot continue to survive. And the irony of the software solutions being offered to retailers, often in co-operation with their own specialty brand suppliers, is that they <u>assist and accelerate this transition by facilitating customer self-help</u>.

The previously described economic principle of perceived *scarcity of supply* (including the supply of information) is at work. An LBS which must be visited in order to have its knowledge and services enjoyed is able to be a trusted advisor who listens to the need and provides the solution. Its best customers are those who do not know what make and model they will buy, only that they want a solution for a need or desire that they are bringing to their trusted provider. When an LBS encourages

A brand owner who *is* concerned about the next generation (or longer) needs to be able to rely on sales staff who are thoroughly committed to long-term brand success…

its local customers to shop by online without the trusted advisor's live input, it is essentially putting all of its products for sale in a giant vending machine, placing the machine in a mall next to other vending machines that sell the same products (and substitutes), and leaving the scene while hoping for good results. A fly on the wall would likely observe customers choosing the machine they use at *random*. Some of the purchases made will not satisfy customers, who had to make their own inexpert judgments about which products best suited their needs.

Even worse, putting all the vending machines next to each other allows one vendor to come around and quickly collect data about what all its competitors are stocking in their machines, what their prices are, and then to make changes to its own offerings accordingly. Broadcasting store-specific inventory places downward pressure on price while adding upward pressure on inventory levels to match or exceed competitors' breadth of product offerings. This psychology can financially cripple an LBS. When customers shop in-person, live interactions provide the LBS with valuable feedback about what customers are and are not asking for. This allows the LBS to streamline its inventory and adjust to the unique desires of its own customer base. But when customers start the shopping process online, this natural feedback to the LBS is severed.

Thus, when multiple shops in a competitive market list their inventory offerings online, one shop's stocking miscalculation becomes another shop's perceived [but non-existent] opportunity, tying up inventory dollars and sapping profitability. For example, a shop that never did well with carbon clincher wheelsets may notice these being offered on a local competitor's site. Not knowing whether this competitor has actually sold any, and fearful that it may be missing out, the first shop decides to stock carbon clinchers -- and adds more model choices to outdo the second store. Similar to price wars, wars of perception also occur as competitors scramble to outdo each other's offerings without enough customers willing to buy it all – a balance sheet disaster in the making.

APPROACH #14:

> Help dealers with software solutions that make them more efficient working with the brand and telling it's value story versus software solutions that pressure dealers into overstocking unneeded inventory.

BENEFIT TO CONSUMERS:

> Maintain focus on educating dealers to win customer sales by being better educated and prepared to introduce and sell the brand in the store.

As with anything, talented software developers are in limited supply, and particularly ones who come from or who understand the cycling business in particular. While these limited resources focus most of their attention on trying to leverage the IBD in the discounted online landscape, far better opportunities are being missed. These developers could be making and selling tools to the industry to help dealers place and suppliers fulfill orders more efficiently, know which of many suppliers has an item in stock and compare supplier prices, crawl the web to let retailers and suppliers know where their specialty products are bleeding into the market at over-discounted prices (that is, help brand owners enforce MAP), etc. Software developers to this industry need to be allies that work in directions which truly help the industry long-term, as opposed to assisting it in destructive, short-term thinking.

Brand Culture and Brand Longevity Are Conjoined Twins

In September of 2012, an Economic News Release from the Bureau of Labor Statistics reported that the median number of years that wage and salary workers had been with their current employer is just 4.6. For workers age 25-34 the average tenure is even shorter: 3.2 years -- while for older adults it is 10.3 years. Even in managerial and professional roles, the *highest* median tenure for younger professionals stands at just 5.5 years. Recent research shows that job-hopping results in higher salaries for those who engage in this behavior.

We are not aware of any study measuring how often a specialty bike shop changes its primary bicycle brand, but imagine the brand damage if the average brand turnover in the LBS looked like these figures. Yet brand owners are seeing their corporate staff follow the prevailing culture of short tenures, which must make applying consistent sales strategies and policies very difficult. The temptation for the ambitious sales rep who wishes to move up is to put up big numbers over the short-term and then leverage that "success" to garner promotions and pay increases -- whether from the current employer or the next one.

As this type of sales professional moves up into sales management, there is naturally great resistance to change what appears to be working for their own career. How can sales managers be concerned about brand health in ten, twenty or thirty years when they don't expect to be working for that brand beyond the next five? But the question sales managers should be asking themselves is how they expect to find future employment in this industry at all if their short-term goals are helping it to its demise!

APPROACH #15:

> Hire sales staff and choose retailers who take the long view.

BENEFIT TO CONSUMERS:

> Longer-term, stronger relationships brands have with happy retailers build the same longer-term, strong relationships with their customers to both customers' and brands' benefits.

A brand owner who *is* concerned about the next generation (or longer) needs to be able to rely on sales staff who are thoroughly committed to long-term brand success, not just results for the next quarter. Otherwise, that brand owner may become intoxicated with rosy sales numbers (which the staff claim are sustainable) while the brand is being undersold in the marketplace.

It must be noted that the high quality image of a currently "premium" brand makes that brand a very attractive target to a low-service discounter seeking the next opportunity to profit from a short run of high turns. Like a sleazy bar-hopper looking for his next "one night stand", that discount seller doesn't care what happens after this brief opportunity is exhausted. The hard work over time required to build a quality company, product and image, which created that demand, can be wasted in a matter of months if its product is permitted to flood the market at unsustainable prices.

Many brands are, right now, shooting themselves in the foot and their specialty retailers in the gut by dumping product through outlets like The Clymb. When they do this, they devalue their brand and train consumers that their brand is now an online "discount" brand for which a 'smart' consumer should never pay full price. It may make sense in the short term to sales managers eager to unload inventory, but it also angers specialty dealers (who will then flee that brand and look for a replacement who won't punish them for having built the brand's equity with years of hard work, only to have it sold out from under them).

In the same way that a brand's sales staff and management are woven into its long-term success, a brand's retail partners greatly influence consumer confidence in the brand's longevity. Retailers who have no vested interest in the customer beyond today's sale have no vested interest in the brands they sell. Will those retailers recognize the customer by name and face and ask how that last purchase worked out? Will they listen to customer wants and needs and pass them along to brand management for future product ideas? Do brand managers really consider mass-market retailers "partners" in their business and future success?

IBDs are yearning for brands they can build long-term relationships with. They don't want to constantly phase-out and change up their brand mix whenever a brand becomes unprofitable for quality dealers. But IBDs are not all the same. Some have sold *themselves* out to discounting and competing online, often covertly. For reasons already described in this paper, they will eventually fail, just like the brands who let them do this. It doesn't take much observation to get the measure of a retailer's quality, and well-chosen and trained outside reps can quickly provide this guidance.

Brand Owners: Please Stop Stealing Retail Customers

If dealers seem increasingly a bit touchy and elusive when it comes to supporting the advocacy wing of cycling, sponsoring teams & clubs, and donating their time and products, they have good reason to be. A lot of recognizable brands are stepping on dealer toes to win customers.

It has become too easy for people who have no ownership in the bicycle industry, just ownership of their own gear and cycling-related projects, to contact brands with their hands out. Some brand managers have not learned how to say 'no'. In truth, they do not need to say 'no', they need to say, "Which local bicycle shop is your primary sponsor? My brand is happy to help but we want to work through the local bike shop."

Every IBD has experienced the sour taste of giving countless hours of their time, talent and treasure to help a local community group who is doing something cycling-related, only to be bitterly disappointed when members of that group do not reward the shop with their cycling purchases. Instead, these club members, ride organizers, local teams and advocacy group members get memberships to gear-discounting website when registering through sites like active.com, get team and group apparel direct from the brand, and discounts on everything under the sun.

The strategy is understood. Brand managers see these folks as key influencers in the cycling community and want to buy that influence directly with feel-good overtures, schwag and wholesale deals from the brand. Years of this bleeding of product around the retailers (who are responsible for most of the cycling culture that exists in their communities) have created entitled cycling participants who, instead of being the best customers of the local shop, have become its most damaging detractors.

APPROACH #16:

> Avoid inadvertantly devaluing the IBD, which happens when brands sell directly to end-users.

BENEFIT TO CONSUMERS:

> Reconnect consumers to the LBS where they can find far more support than just a discount;

and because it is simply doing right by supporting dealers that have supported the brand.

Specialty bicycle brand owners who bypass retailers and sell products direct to consumers undermine their authorized retailers. Authorized retailers are well-trained professionals who are in a better position in the local community to match the product to the consumer. The focus should always be on the consumer, not just a sale. Detached, direct consumer selling by brand owners sends the wrong message to the consumer: that the retailer's investment in the brand is irrelevant. Eliminating the retailer from the buying process leads to product commoditization. Authorized retailers have every incentive – because of their place in the local community - to ensure that the consumer is properly fitted to the right specialty product.

Examples (a few of many) of IBD-destructive side-dealing:

A trainer brand selling trainers at wholesale to a gym or army fitness program who has a stocking IBD nearby.

A coaching organization signing on bike and gear brands to sell to their clients at wholesale.

An event registration site that connects registrants to low-service online discounting retailers.

A cycling advocacy group using its email distribution list to promote low-service online retailing sites. (The brand's error? Allowing its products to be sold this way.)

A race team or riding club permitted to buy custom-branded apparel, bottles, etc. direct.

Explanation really should not be required: is a brand in the business of wholesaling or retailing? Are the customers and key-influencers that it should take care of first its authorized retailers or end-using consumers? Little generates a more emotional reaction from an IBD that has spent years of risk and dollars developing a local marketplace for a brand than to find that brand getting into local customer hands without the dealer receiving fair compensation for its investment in the brand and those customers.

The side-dealing is an impediment to a brand being specialty-positioned and deserving to enjoy a network of community advocates for the brand in its authorized network of dealers.

Summary

There is no short-term, stand alone or easy solution the problems facing our industry. The approaches offered above are not meant to be exclusive or exhaustive; there may be many more approaches to consider. Each company in our industry has had a role to play in the problems we currently face and each company will need to play a role in the solution. Our industry is here for one purpose: To serve the needs of the consumer. Without them, we would not exist.

Conclusion: 20% or 2020, Whichever Comes First

The IBD is at a tipping point, and twenty seems to be the number to bet on.

20% of the remaining IBD sit on the edge of insolvency, are already slow-paying with their suppliers, and cannot afford a bad season or an upward correction of interest rates.

Another net loss of 20% of the remaining IBDs, and the specialty industry probably loses critical mass leading to a rapid reduction in the rate of new participants looking for specialty cycling equipment.

20% of P&A revenue alone shifting to low-service online discounters could easily be enough to ensure a net loss of 20% of IBDs, and probably more.

2020: the projected year that generation Y assumes control of the economic rudder. That is not long to change their expectations and attitudes about whether specialty equipment is worth owning and where it is best purchased and supported.

20% may not be far from the number of brands left, compared with today, if the cycling equipment industry commoditizes and consolidates. That means 20% of the industry jobs left over, 20% of the work for supporting industries, 20% of the revenue for advocacy organizations and associations, 20% of the participants, 20% of the communities that have some kind of bike shop, and 20% of the rides and events compared with today. Is this the future that brand owners hope for? Will they gamble on being among the 20% left and be proud of the result?

It is time to choose.

JCPenney:

A New Transformation Story Still Being Written

Of late, there are more than a few cycling brands that have, like JCPenney in early 2012, arrived at the right idea but so badly botched the implementation that they have dug themselves a deeper hole.

About a year ago, having picked up a new executive from Apple Inc. (a master at controlling its market positioning), JCPenney launched a national ad campaign announcing the end of promotional sales. Their pitch: rather than play ping-pong games with price, why not offer the consumer a consistently great value with a minimum of neon “Clearance!!!” tags and sale advertising? For the department store industry, struggling with the same issues of commoditization facing the bicycle industry, this was an insightful and bold move. Give customers an expectation of always getting a fair price without the need for customers to time their store visits. Outflank the other chains with a whole new approach, rather than chasing the herd over the cliff.

But announcing this to customers via a TV advertising campaign, though a hilariously comedic one, was a huge mistake. Consumer advocates and mass media commentators nationwide ridiculed the idea. Consumers scoffed. Sales dropped. JCPenney failed to recognize one important thing: consumers are addicted to getting “the deal”. They can live without getting “the deal” and will still buy a brand’s products even if no one is discounting them, but it is “poking the bear” to shout at the customer, “We are NOT giving you a discount!”.

JCPenney assumed incorrectly that consumers actually understand economic price theory and its impact on their own behavior. Most consumers do not and never will. Customers decide that they want something, and then they decide where to buy it -- with price most often being given more weight in the decision than is best for them. Not enough consumers recognize that it is advantageous to their wallets in the long run, to buy fewer (but very well-chosen) products and pay enough to sustain a durable goods industry. There is far better consumer value in a product that costs 50% more but outperforms cheaper options and lasts twice as long. But advertising gimmicks and pricing games are so heavily utilized in mass market channels because, sadly, they appear in the short term to be working. These gimmicks drive sales even when consumers are being duped into spending more, over and over again, on cheaply made products that under perform and don’t last.

To JCPenney’s credit, it has stayed the course on the new pricing strategy, but stopped spending millions of dollars running a national TV campaign to tell customers they won’t get a discount. They have learned a painful lesson. In the end, their gambit will prove successful if they also keep working toward offering consistently above-average quality, private label, exclusive products found nowhere else for consistently reasonable prices that are also sustainably profitable. Meanwhile their big box competitors who don’t want to admit that they have been outflanked, keep bleeding customers to internet retailers while running expensive sales promotions and engaging in heavy overstock rotation.

Levi's Jeans:

A Brand About What It Is, Not What It Costs

Unpersuaded brand owners may believe that the market is too dynamic, the internet too untamed, and the road traveled too far for the strategies in this paper to work for them. Is this you? Then consider a well-known brand: Levi's Jeans.

Levi's Jeans are sold everywhere – literally. They are all over the internet, big box chains, and are yet still sold in smaller brick & mortar stores. They are even sold in overstock stores like Kohl's and on sites like Overstock.com.

Anyone can choose a current-production style and color and go price it. Everywhere you look, the price will be the same. If it is "on sale", then everywhere you look, the sale price will be the same. How?

Like many cycling brands, Levi's has been around for a very long time. It's a durable good with a complexity of types, styles, sizes and SKUs. It is considered a quality name brand. Levi's was around long before Jordache and Z.Cavaricci when those brands commanded $100+ price tags in the 1980s, and it is still around, still very profitably selling at the same $30-$60 price points long after those other brands allowed low-service online discounting (in the 1990s) to destroy them and take them out of the consumer consciousness.

The secret is no secret at all. Levi's has a simple business model, and a requirement of all its retailers everywhere: "you will advertise it for at least the MAP we set, in or into this country, or you will not be permitted to buy it." The worst offending retailers in the online world won't violate that policy for long, because any clothing seller doesn't want to be caught dead without getting their share of the Levi's market. It is a consistent turner and profit-maker.

Can any of the quality brands in the cycling industry, who want to, achieve the same thing? Absolutely. If a brand offers a product of distinct quality and consistent reputation, advertises to its target market, and keeps a level playing field among retailers, it can produce consistently strong, year-after-year, repeatable results. In the same way that a brand would not fail to get its unique inventions patented [and thus protect itself from losing its market], why on earth should it not want to protect its dealers from losing their markets -- the outlet for that brand's products?

A top cycling soft goods brand offers a line of the essential accessories that cover many of the basic needs of a cyclist. The brand has a distinct and well-known logo. It has a consistent color scheme. It is completely independent of any bike brand and enhances the offerings of any bike shop. It has designed and produced products of significantly unique and high-quality engineering and manufacturing and backed them up with lifetime warranties. This well-known brand should have "everything going for it".

Yet, this brand has been very slow to respond to the network of independent dealers who gave it prominence. It has been slow to manage inventory (planned scarcity); slow to maintain specialty dealer profitability (MAP); and slow to consider the long view. Its product image is eroding because it has been found deeply discounted on several prominent discount websites.

Case Study #2

Several bike shop owners who have independently approached this brand have, meeting with resistance, brought the decision makers around to recognizing the need for a MAP policy. When a proposed MAP schedule was floated to a few dealers, the reaction was one of dismay. The brand was proposing margins that are worse than the lowest margins offered by small, niche, high-end bicycle brands. When challenged, the reaction of the brand manager was shocked confusion.

After many years of careful building, this brand could become a future Harvard Business textbook case study in the commoditization of durable goods retail. Not understanding the forces at work, all of the things going for this brand are being wasted by the concern of its owners for competing on price. By focusing retailers and consumers at the competitiveness of their pricing, they are leaving money on the table. Without knowing today how they will continue to behave, this author is hearing of a mass exodus of dealers around the country from this long-cherished brand.

Automobile Rental:

Commoditized And Without Quality Choices

When it comes to price competition, no industry is more price-conscious and price-competitive than the auto rental industry. An early adopter of the internet, car rental reservations are today made chiefly on travel websites, directly on auto rental brand websites, or over the telephone. Via these media, there are two things every consumer wants to know: availability and price.

The product is commoditized. Every consumer expects a comparable quality of experience regardless of the rental brand -- price has become the only differentiator.

From the early 20th century through the 1970s, the auto rental industry was made up of a network of independent franchise owners, like the bicycle industry is still made up of a network of independent dealers. Over those years, franchise owners associated together into brands that grew into nationwide chains like Dollar, National, Budget, Hertz, etc. When small in-town lots could no longer compete on price with larger airport operations owned by the national brands, those brands began to buy-out the remaining small operations. Why not just let the small, uncompetitive locations fail? Those large auto rental brands recognized that they needed the in-town locations. They did not want to lose flexibility offered by in-town lots; a large demand would always exist for rental cars by those whose primary vehicle was being repaired and for whom the airport was too inconvenient. They calculated that the risk and expense of those smaller lots could be profitably spread around a larger corporate network that could efficiently consolidate inventory.

As small owners disappeared, so did local uniqueness. Rental policies became “boilerplate” and anyone under the age of 21 [and most under 25] were excluded from renting (choice was reduced). By the 2000s, there were very few franchisees left, and those few were mostly multi-lot owners who operated like the corporate entity that managed their brands.

Parallel to this process of driving away uniqueness was the process of driving prices down so low that they have been unsustainable and destroyed product quality. Auto rental brand stocks have seen decades of poor performance. The cost of new vehicles skyrocketed while Enterprise led the way into impossibly low, cut-throat pricing. Many IBDs rent bicycles out at a daily rate that is higher than cars (worth 30 times more!) are rented for.

So as the last of the original franchise owners disappear, nationwide brands have also been consolidating – combining and merging brands into larger corporate entities to pool even more of the costs in order to eke out a profit. Auto rental companies are relegated to scratching for pennies per day on hundreds of thousands of units of owned inventory, while maintaining multiple brand names for the sake of aggregate market share and leased airport desk presence (Avis-Budget, Hertz-Dollar-Thrifty, Enterprise-National-Alamo).

What has been the experience of renting a car for the consumer? It is a commodity. Not much is expected in the way of friendly service (as a famous episode of Seinfeld parodied) or low mileage (it was once rare for a rental car to show 15,000 miles; now 50,000+ is common). Cars with mechanical issues, or that smell bad, are dirty, or that seem to get smaller and smaller for a given class are common experiences for a recurring renter. While consumers may complain, they have accepted that a rental car is all about the price, and they don’t want to pay a dollar more than anyone else is offering. Or do they?

Case Study #3

Having once purchased an old franchise (a small, in-town Budget location), this author went against the prevailing wisdom of the auto rental industry -- the corporate network's rules were thrown out. National discount programs were opted out-of. Reservations without a monetary deposit to guarantee them were refused. Pricing was set at rates higher than all local competitors. A custom contract was written that increased the rules for renters, forcing greater personal responsibility while also relaxing the age and credit requirements. In essence, everything that the rental industry thought worked well was reversed, to the chagrin of the "corporate office".

In 16 months, a sparsely rented 11-car fleet grew to 40 vehicles, moved to an upgraded location, and became busy at 90% inventory utilization. More employees were hired on staff per unit of inventory than any other rental location. Cars were thoroughly cleaned and rigidly inspected after each rental. The owner worked in the business and shook his customer's hands. And the business was so profitable that it was sold for double its purchase price in just sixteen months. Apparently, customers were willing to come back to quality – and pay for it!

What should not have succeeded (according to a $35 BIllion industry's "wisdom") did, in fact, succeed because one independent owner recognized the value of relationship with customers and offering them a product and service that uniquely set his business apart from its competition. The $6 Billion bicycle business is not too big for similar "course correction" – in fact, it's the only thing that can save our industry as we know it. We who enjoy our work here, and know its value to the health of our nation, owe it to ourselves and our communities to make the changes we now understand are possible and necessary for a sustainable future.