Vertical Players – Manufacturers and Verticals 6

Abstract

This chapter will describe the role of controlled and secured distribution systems in manufacturers' channel strategies and explore the business model of a vertically integrated manufacturer/retailer. Traditional retailers are increasingly adopting vertical integration to innovate, conduct quality management and even produce products. The impact on retail competition will also be discussed.

6.1 Channel Innovations and New Business Models as Driving Forces of Competition in Retailing

Some of the most important changes in the retailing industry involve new vertical marketing systems or new distribution arrangements for many manufacturers and verticals (**vertical retailers**).

Manufacturers operating in **secured distribution systems** (fully integrated systems) or **controlled distribution systems** (contractually-based systems) are increasingly common retail players. In both types of vertical marketing systems, the manufacturer can exercise power over the distribution channel (Zentes et al. 2006). Fig. 6.1 illustrates the motives or goals for manufacturers implementing vertical marketing systems.

In addition to this **downstream verticalisation** tendency from manufacturers who have traditionally operated with wholesalers and/or retailers in **independent systems**, other approaches can be identified. **Born verticals** perform all production and distribution functions from the moment they are founded. **Vertical retailers** are traditional retailers who modify their **value chain architecture** via upstream verticalisation to exploit the competitive advantages of verticals.

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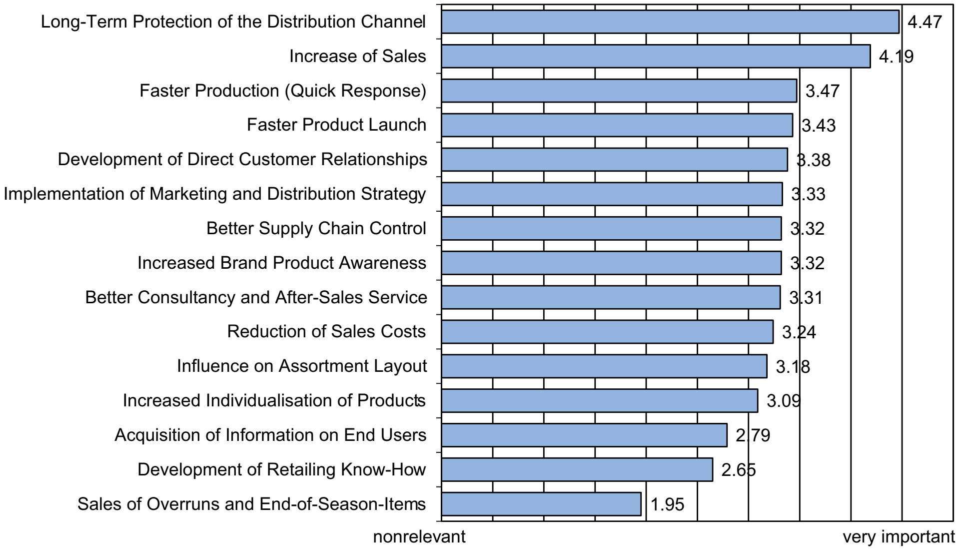

Fig. 6.1 Reasons for verticalisation. (Zentes et al. 2006, p. 12)

6.2 Downstream Verticalisation

6.2.1 Secured Distribution Systems

Overview

In secured distribution systems (fully integrated systems), the manufacturer performs every distribution function. In addition to traditional direct selling, new kinds of secured distribution systems are emerging, including electronic selling (online retailing) and equity stores.

Direct Selling

Direct selling is a traditional vertical marketing system where salespeople interact with customers face-to-face either at the customer's home or work. They demonstrate the merchandise and/or explain a service, take orders and sometimes deliver the merchandise (Levy et al. 2014, pp. 70–71). This kind of fully integrated system "emphasizes convenient shopping and a personal touch, and detailed demonstrations can be made" (Berman and Evans 2013, p. 175). Because no stores are needed, direct selling has lower overhead costs. Direct selling is employed by manufacturers such as *Avon*, *Tupperware* and *Amway*.

Fig. 6.2 illustrates the development of the economic importance of direct selling in terms of turnover and sales force. Overall, the worldwide total turnover generated by direct selling has grown by more than 40 % in recent years (1998–2009; the database from 2010 onwards is not comparable with previous years). Table 6.1 shows the importance of the sales force in the direct selling systems of leading manufacturers in this field.

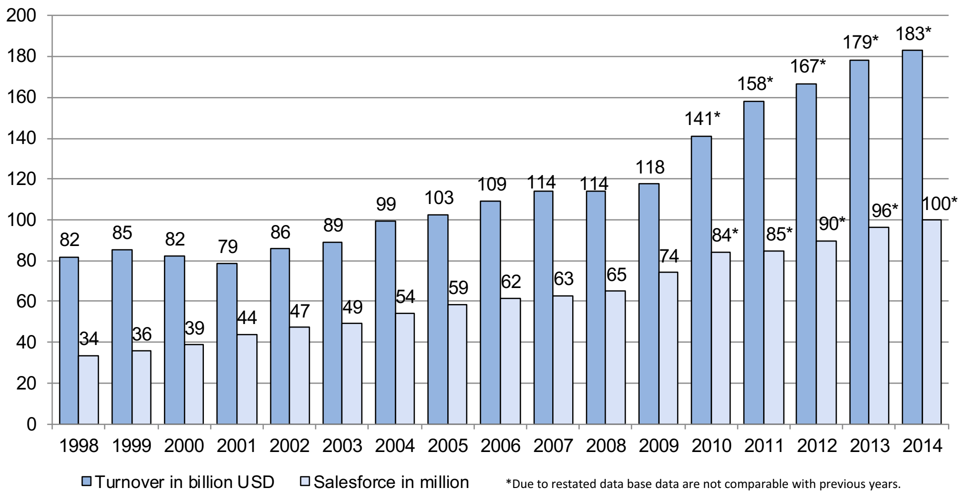

Fig. 6.2 Development of direct selling (worldwide). (World Federation of Direct Selling Associations 2015)

Table 6.1 Sales force size of leading direct selling firms in 2013. (Direct Selling News 2014)

Company	Country (HQ)	Salespeople/Partners
Amway	USA	3.0 million
Avon Products	USA	6.0 million
Herbalife	USA	3.0 million
Vorwerk	GER	0.6 million
Mary Kay	USA	3.0 million

Electronic Selling

Electronic selling (via Internet, e-commerce, m-commerce or television) is a technological variant of direct selling. Manufacturers communicate with customers and offer products and services for sale via digital channels such as the Internet or television (see Chap. 4). Some manufacturers, such as *Apple*, have also begun using this distribution channel within the framework of a **multi-channel** or **cross-channel approach** (see Fig. 6.3).

Manufacturers from all industries are increasingly "discovering" this form of secured distribution via online selling. A recent example is *Procter & Gamble*, which has begun selling its cosmetics, hair care, shaving and home care products via its Internet store.

Equity Stores

Equity stores are a brick-and-mortar approach to secured distribution. The manufacturers operate store retail formats. The major types are concept stores, flagship stores and factory outlets.

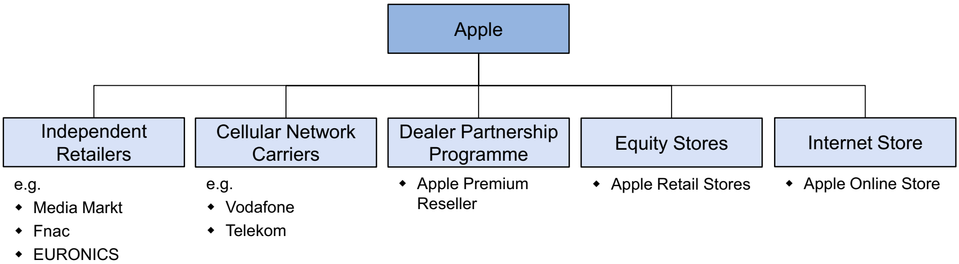

Fig. 6.3 Multi-channel/cross-channel distribution example – *Apple*

Manufacturers, especially in the apparel, footwear, jewellery, sports equipment and homeware industries, often operate **monobrand concept stores**. These stores, usually located in traditional shopping streets, shopping centres or malls, can be classified as **monobrand specialty stores** (see Chap. 3), offering a manufacturer's complete assortment via in-store marketing which communicates the "fascination" of the brand. Under the ownership of the manufacturer, multiple store units are managed as a **retail chain**. The manufacturers exert strong control and decision-making, including **price fixing**, is centralised.

Manufacturers from all industries use equity stores. For example, the Swiss company *Nestlé* runs around 320 *Nespresso* shops in key cities around the world. These combined retail outlets and coffee shops are exclusively managed as equity stores.

In **flagship stores**, top manufacturers (e. g., *Gucci*, *Nike*, *Apple*) offer their entire assortment via high quality presentation (lifestyle presentation) in premium locations in large metropolitan markets. Kozinets et al. (2002, p. 17) identified three characteristics of flagship stores:

- They carry only a single brand of product.
- They are company-owned.
- They aim to build brand image rather than simply generate profit.

Factory outlets, operated as isolated stores (freestanding retail outlets) or integrated in factory outlet centres (FOCs), are viewed by manufacturers "as an opportunity to improve their revenues from irregulars, production overruns, and merchandise returned by retailers" (Levy et al. 2014, p. 56).

In an example of a comprehensive multi-channel distribution system, *Nike* sells its products through different types of channels: independent retailers or retail chains such as *SportScheck* in Germany, *Foot Locker* in the United States, Canada and the United Kingdom or *Finish Line* in the United States; flagship stores, as in New York, Miami, San Francisco, London and Berlin; factory outlets, for example in factory outlet centres in Zweibrücken, Herzogenaurach and Metzingen (Germany), New Orleans (USA), Brisbane (Australia) and Alicante (Spain); and an online shop.

6.2.2 Controlled Distribution Systems

Overview
Controlled distribution systems have extremely diverse structures which vary from industry to industry. In general, these so-called **contractual concepts** can be broken down into contractual dealer systems, franchise systems and commercial agent or commission agent systems.

Contractual Dealer Systems
Contractual dealer systems or **dealer partnership programmes** are (long-term) partnership contracts in which the manufacturer offers a limited support package to participating dealers. This support package could include marketing, advertising, training or IT support, among others. In most programmes the dealer also benefits from a shared corporate or retail branding. As a reward, the dealer focuses on marketing the manufacturer's brands. "The concepts are often viewed as customer loyalty programmes for independent dealers through which the company can rapidly increase its retail presence" (Uellendahl 2002, p. 208).

There are also dealer partnership programmes, for example in the apparel industry as **shop-in-shop concepts** and **corner concepts** (Zentes et al. 2006), or in the tyre business (replacement business) as dealer partner concepts. For example, the *Goodyear Dunlop Company* runs contractual outlets in Germany through the retail concepts *HMI* and *HMI plus*, in the United Kingdom as *HiQ* and in France as *Vulco*. Contractual dealer systems in the fashion or apparel industry include support for in-store marketing, assortment or merchandising management and supply chain management, as discussed in Chap. 12, 15 and 19.

Franchising
Franchising (see also Chap. 7) involves a contractual arrangement between a franchisor (e. g., a manufacturer) and a (retail) franchisee, "which allows the franchisee to conduct business under an established name and according to a given pattern of business" (Berman and Evans 2013, p. 128). Linked by a shared business interest, each partner contributes to the cooperation. Thus, the franchisor and franchisee benefit from each other's strengths. Uellendahl (2002, p. 208) describes the structure of franchise systems, using the example of *Goodyear Dunlop's Premio* and *Quick* franchises, which operate in the German tyre replacement market:

- The franchisor contributes their extensive business expertise and organisation (e. g., a full support package including marketing, sales promotion, training, IT, auto service, CRM, national advertising, business counselling, business planning, common branding, financial support, etc.).
- The franchisee contributes their individual effort as an independent businessman in the local market.

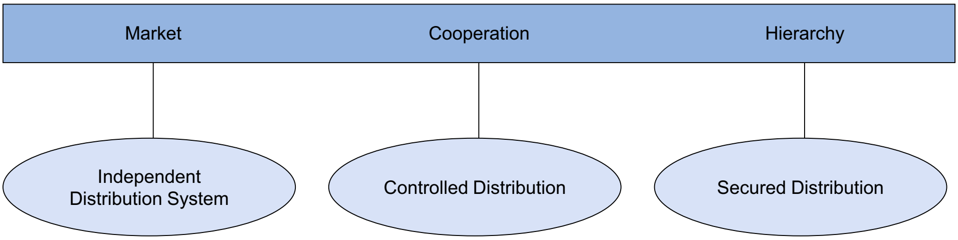

Fig. 6.4 Vertical marketing systems and transaction cost economics

As controlled distribution systems, franchise systems are operated in many industries, for example by car manufacturers (auto/truck dealers), auto accessory manufacturers (auto accessories stores), consumer electronics manufacturers (consumer electronic stores), hardware manufacturers (hardware stores) and apparel manufacturers (specialty stores). Examples in the apparel industry include *Palmers*, *Rodier*, *Benetton*, *Boss*, *Marc O'Polo*.

Commercial Agent/Commission Agent Systems

A third category of contractual arrangements is commercial agent systems and commission agent systems. A retailer operating as a **commercial agent** or **commercial representative** "is constantly entrusted with the task of arranging transactions on behalf of another business person (i. e. the manufacturer) or concluding such transactions in their name. The arrangement of transactions in the name of a third party distinguishes the commercial representatives from a **merchant** who concludes transactions in his own name for his own account" (Committee for Definition of Terms in Trade and Distribution 2009, p. 23).

Commercial agent systems let manufacturers control the retail prices of their goods and services. In other forms of controlled distribution, e. g., contractual dealer systems or franchise systems, **vertical price fixing** is not allowed (in the European Union). Besides equity stores, an agent system is the best way to fix consumer prices. Another possibility is **consignment selling**, whereby the manufacturer owns items until they are sold by the retailer. This contractual arrangement can be combined with controlled distribution systems. However, this combination is rare in practice because of legal restrictions (in the EU).

A **commission agent** is a commercial operator who undertakes the sale of goods in his own name for the account of his principal. The commission agent bears the risks resulting from the commission contract towards the customer (Committee for Definitions of Terms in Trade and Distribution 2009, p. 23).

Commercial agent and commission agent systems are common in the oil distribution business, but also in food and non-food retailing. Oil companies like *BP*, *Esso* or *Shell* run worldwide networks of equity stations and petrol stations operated by self-employed commercial agents. Another example is the German company *Tchibo*, which runs equity stores and cooperates with retailers and bakeries by using commercial agent contracts.

Table 6.2 Advantages and disadvantages of secured and controlled distribution concepts

	Strengths	Weaknesses
Equity stores	High degree of control organisational control brand/promotional control guaranteed distribution	High capital costs huge operational costs
Franchising	Limited/no capital costs less ownership risk guaranteed distribution low fluctuation	Limited control
Commercial/Commission agent systems	High degree of control organisational control Brand/promotional control guaranteed distribution	Capital costs (of goods)
Contractual dealer systems	Relatively low-cost solution rapid expansion	Little control high risk of losing partners less stability

Concession Shops

Concession shops are positioned between secured and controlled distribution systems. "A concession shop refers to a cooperative space concept in the trade in which a concessionaire rents a selling area from a trading company and manages it. As in the case of shop-in-shop concepts, the concession area is separate from the rest of the shop by its own design and corresponding shopfitting elements. The concessionaire sells its goods for its own account, i. e., bears the merchandise risk. A concessionaire normally operates the shops with its own personnel. Marketing activities and merchandise-management processes like shop design, assortment planning, price policy or merchandise procurement and control are normally within the area of responsibility of the concessionaire" (Committee for Definition of Terms in Trade and Distribution 2009, pp. 60–61). The retail company acts as a **lessor**, receiving both a flat rate for its services and remuneration based on turnover (**concession fee**). In this way, the retailer bears part of the sales risk, rather than solely letting space.

6.2.3 Advantages and Disadvantages of Secured and Controlled Distribution

Secured, controlled and independent distribution systems are presented in Fig. 6.4, which characterises these systems in the context of the market-hierarchy paradigm of **transaction cost economics**.

Table 6.2 provides an overview of the main advantages and disadvantages of the different concepts of controlled and secured distribution. The "high degree of control" in secured distribution systems (equity stores) and commercial agent systems includes retail pricing.

Table 6.3 H&M's global outlet network. (H&M 2015)

Country	Number of Outlets	Country	Number of Outlets
Australia	3	Lithuania	7
Austria	73	Luxemburg	10
Belgium	77	Malaysia	19
Bulgaria	16	Mexico	9
Canada	73	Netherlands	136
Chile	1	Norway	118
Croatia	14	Philippines	5
China	278	Poland	140
Czech Republic	43	Portugal	30
Denmark	98	Romania	38
Estonia	6	Russia	75
Finland	59	Serbia	5
France	205	Singapore	10
Germany	439	Slovakia	16
Great Britain	253	Slovenia	12
Greece	31	South Korea	22
Hungary	35	Spain	163
Ireland	21	Sweden	177
Italy	133	Switzerland	94
Japan	53	Turkey	30
Latvia	6	USA	364

6.3 Verticals

6.3.1 Value Chain Architecture of Verticals

Born verticals perform or at least coordinate all production and distribution functions themselves from the time of their founding. Examples are often found in e-business, but also in store formats. *Chocri* (www.chocri.de), for example, sells customised chocolate bars exclusively over the Internet. *Hennes & Mauritz* (*H&M*), *Mango* and *Zara* are all successful examples from the apparel industry, where verticals are gaining market share, and *IKEA* is a well-known example from the furniture industry. Table 6.3 provides an overview of the global outlet network of *H&M*.

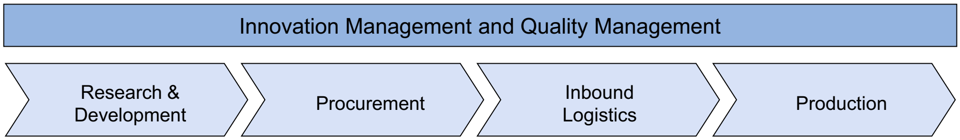

Fig. 6.5 A producer's (supply-side) value chain architecture. (Hertel et al. 2011, p. 94)

The value chain architecture of a vertically integrated manufacturer or retailer corresponds to the model of a **producer** or a **coordinator** on the supply side. Verticals usually produce a significant share of their products, and sometimes produce all of their products themselves, in which case they act as producer (see Fig. 6.5). *Zara,* for example, a company from the Spanish *Inditex* group, produces around 50 % of its merchandise in its own manufacturing facilities.

As a coordinator, verticals control or coordinate upstream value chain activities like procurement, production and logistics for their contract manufacturers through their own internal innovation and quality management. They concentrate on *intellectual value creation* (see Fig. 6.6).

Looking downstream (i. e., at the demand side of the value chain architecture), verticals sell their merchandise according to a **secured distribution** model, meaning through equity stores and other channels such as online shops (see Fig. 6.7). But they also use controlled distribution, e. g. franchising.

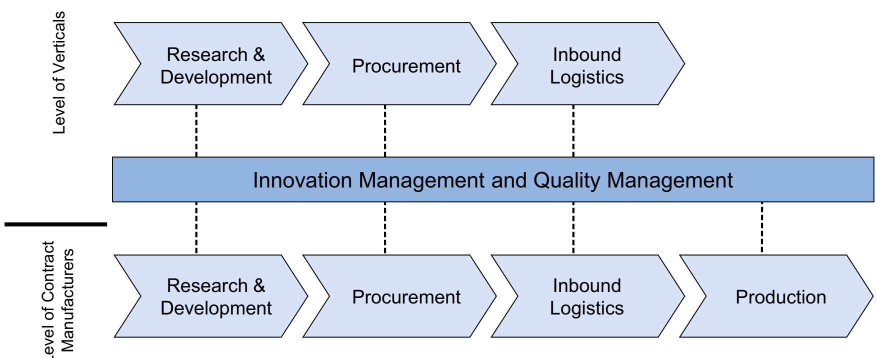

Fig. 6.6 A coordinator's (supply-side) value chain architecture. (Hertel et al. 2011, p. 94)

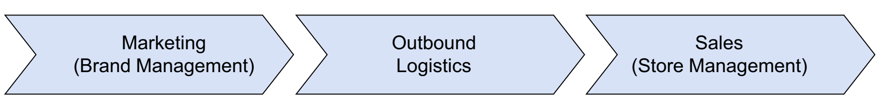

Fig. 6.7 Secured distribution (demand-side) value chain architecture. (Hertel et al. 2011, p. 98)

6.3.2 Competitive Advantages of Verticals

Verticals create essential competitive advantages through their uniform market image. They have direct market access, meaning direct access to the consumer, and thus can fully implement their **branding strategy** (see Chap. 9). They control assortment, store layout, merchandise presentation, market communication, customer relationship management and retail pricing (in the case of secured distribution). This uniform market image guarantees them control over conveying the "fascination" of the brand.

Therefore, they can create a **unique selling proposition** (USP) in the form of exclusivity. Products marked by official, unique designs and/or specific qualities that are different from competitors' products are only available in their outlets, where they are offered in a brand-compliant manner.

Vertical integration via in-house sourcing or procurement through contract manufacturers not only leads to cost advantages compared with outside suppliers (see Jennings 2001), for example in production and inbound logistics, but also leads to other market-based competitive advantages. Verticals can create an innovative competitive advantage through a highly efficient supply chain. In this context, **speed** is a key factor in the competitive strategies of so-called **fast-fashion retailers**. *Zara,* for example, has significantly influenced this strategic group by optimising its supply chain. As a result of this optimisation, *Zara* can produce and sell a piece of clothing – from design to production to delivery and availability in its stores worldwide stores – in under 15 days (Ferdows et al. 2005, p. 84).

6.4 Verticalisation of Traditional Retailers

Today's retailers and most sectors' most important **buying groups** have an increasing number of store brands in their assortments (see Chap. 12). "This development will continue, whereby a clearly modified working method in the conception, management and character of these brands will be added. It will further enhance the triumphal procession of exclusive store brand concepts and it will further increase the importance of these concepts on a retailer's profitability" (Janz and Swoboda 2007, p. 301).

These brand concepts have led to increasingly independent store brands and have blurred the distinction between store and manufacturer brands. These brand concepts have also led to increasing vertical integration. Thus, traditional retailers are not only trying to catch up with verticals' competitive advantages in **product differentiation**, but also in areas such as **supply chain management**.

Outside supply for these companies means control over the upstream value chain of their contract manufacturers via their own innovation and quality management (coordinator's value chain architecture). In addition to this form of **controlled production, secured production** (in-house sourcing) sources products through company-owned production facilities.

In food retailing, many companies have been verticalised upstream for a long time. The American company *Kroger* is one example. Approximately 40 % of *Kroger's* store brand units are produced in *Kroger's* 37 manufacturing plants. The remainder are produced by outside manufacturers according to *Kroger's* strict specifications.

With the exception of verticals, external production dominates the fashion industry. However, the influence of retailers on the supply chain is increasing, for example via store brands (see Merkel et al. 2008, p. 32). Retailers are creating assortments and procuring products directly. Although manufacture of the finished product remains with suppliers, retailers are verticalising the process by taking over the procurement and logistics of fabrics and ancillary items (yarn, labels, accessories, and packaging) which are then delivered to production plants (Merkel et al. 2008, p. 41). This kind of external production is called **cut-make-trim (CMT)**.

KATAG is a European buying group that directly influences its independent retail partners' marketing through an innovative **floor management model** and also influences its contract manufacturers' production (controlled production) in the Far East, by

- designing products internally,
- setting ecological, social and ethical standards, and
- procuring accessories.

6.5 Effects on Retail Competition

6.5.1 Channel Conflicts

The development of controlled and secured distribution channels as possible sales channels is a core element in many manufacturers' marketing strategies (**downstream verticalisation**). While secured distribution used to involve the development of equity chains (owned by the manufacturer), the situation has changed significantly. Thanks to the Internet, manufacturers can sell directly to consumers without brick-and-mortar stores, and dealer partnership programmes and franchising let manufacturers engage in contractual distribution systems (cooperation with independent dealers). Technological developments and contractual arrangements have increased the potential for controlling distribution channels.

The main challenge for manufacturers is to manage the conflict in multi-channel and cross-channel distribution systems between independent retailers selling products from a particular manufacturer, retailers cooperating in a contractual system with this manufacturer and competition from the manufacturer's equity stores or other direct distribution channels.

Conflicts in distribution channels or **channel conflicts** are not a new phenomenon. They are well known in the consumer goods industry. **Conflict theories** in retailing explain retail change in terms of rivalry between new and established retail institutions (see Chap. 1). This approach refers primarily to **horizontal conflicts** (i. e., conflicts between different retail formats), but can be transferred to "vertical retail institutions" as new players (see, e. g., McGoldrick 2002, pp. 24–25).

Vertical channel conflicts are the result of **shifts in power**. Traditionally, consumer goods distribution was characterised by a manufacturer-centric view of channels. Retailing was a relatively passive link in the distribution channel from manufacturers to consumers. However, the abolition of **resale price maintenance** (e. g., in 1964 in the UK and 1974 in Germany), the concentration of retail trade, the development of store brands and retail branding have shifted power from manufacturers to retailers. This development of **retailer power** can be seen in the relative weakness of manufacturers in customer negotiations. The dependence of suppliers on major retailers has spurred the development of new vertical systems to control or even secure the distribution, including the intention of building brand image. Through verticalisation, manufacturers are **re-balancing** the power within the distribution channel. This re-balancing has led to a new type of channel conflict, where manufacturers are suppliers to both retailers and their competitors.

6.5.2 Corporate Social Responsibility and Supply Security

Another competitive advantage of an integrated value chain and shift in the competitive arena is how consistent control of all processes affects compliance with ecological and social standards. **Corporate social responsibility** (CSR) and **sustainability** are increasingly important in public debates, and are also necessary elements of future-oriented corporate strategies (see Chap. 10). At the same time, social and ecological positioning offers the potential for corporate profiling. This in turn requires holistic **compliance management**.

Hennes & Mauritz (*H&M*) provides a good example of **managing sustainability**. "Our Head of Sustainability reports directly to our CEO and the responsibility for the implementation of our sustainability strategy is held by our executive management team. We have a total of around 170 colleagues who work with sustainability as a core task. At our head office, our sustainability team consists of more than 20 people responsible for developing global targets, reviewing progress, and encouraging and advising all relevant departments on the development and implementation of prioritised Conscious Actions. With this support, in turn each department is responsible for developing and carrying out their Conscious Actions to fulfil our seven commitments. […] Major sustainability issues influencing more than one department and conflicting interests are discussed in a decision-making form called the Green Room with the involvement of our CEO" (H&M 2013, p. 10).

Sustainability, in the sense of a company's social, ecological and economic responsibility ("**people**, **planet**, **profit**") is increasingly paired with **supply security**. Besides the responsible handling of natural resources (e. g., agricultural and metal resources), the question of access to these resources is increasingly found on strategic corporate agendas. The growing global population and changing consumption patterns in developing and emerging countries has led to shortages due to limited expandability of supply, for example of agricultural cultivation areas (see PwC/H.I.MA. 2010). Thus, **backward vertical integration** includes not only production but also preliminary stages, all the way down to agricultural production (e. g., cultivation of bio-cotton). Verticals have a competitive advantage over traditional retailers here, and (downstream) verticalised manufacturers will exercise this competitive advantage in the same way.

For example, the Dutch fashion company *C&A* emphasises long-term business relationships with suppliers to secure **win-win situations**: "At *C&A* we recognise that the best way to achieve sustainable success is to act in the long-term interests of our internal and external stakeholders, the wider society – and our planet" (C&A 2014, p. 6). These long-term partnerships also include cooperation with **non-profit organisations** (NGOs): "It was through dialogue with non-profit organisations on organic cotton that we initiated a partnership to develop new methods and innovations in the supply chain and to launch our Bio Cotton initiative" (C&A 2014, p. 10).

6.6 Conclusion and Outlook

Manufacturers' main demand-side challenges involve managing multi-channel or cross-channel distribution systems and conflicts between distribution channels. They are also restructuring their value chains upstream, for example by outsourcing production activities and concentrating on "intellectual" activities such as innovation and quality management. In addition, the challenges of sustainability and supply security require new approaches to backward vertical integration. Ultimately, this leads to new **value chain architectures.**

New value-creation systems, such as verticals, compete not only in downstream markets but along the entire supply chain. In this context, the **agile fashion industry** provides a clear example of the competitive advantages that strong performing supply chain management can create via a **quick response** (QR) approach. While QR originated in the fashion industry, this approach can be adapted for other sectors, e. g., the grocery sector.

In response, traditional retailers are increasingly integrating upstream activities into their value chains: developing store brands produced by contract manufacturers ("controlled production") or at their own production sites ("secured production"). This strategy leads to a higher degree of **upstream verticalisation** ("vertical retailers") and ultimately means a convergence of manufacturers and retailers' value chain architectures (see also Chap. 1).

Further Reading

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6.7 Case Study: HUGO BOSS

6.7.1 Profile, History and Status Quo

HUGO BOSS[1] is a globally active fashion and lifestyle group and one of the global leaders in the premium and luxury segment of the apparel market. Today, the company focuses on developing and marketing men's and women's premium fashion and accessories. The company's early success is based on a long history of practical experience in exclusive fashion industries and producing and distributing clothes.

The German group dates back to 1924, when Hugo Ferdinand Boss opened his clothing factory with financial support from two other manufacturers in Metzingen, Germany. Until the end of the 1960s, production and manufacturing steadily expanded under the control of Boss' son-in-law, Eugen Holy. After receiving its first orders for men's suits during the 1950s, the company started its first series production. This was the start of a new era and laid the foundation for the company's future success. Nine years later, Jochen and Uwe Holy, Eugen Holy's sons, absorbed the fashion group and transformed it into the international company it is today. In 1985, *HUGO BOSS* changed its company structure into a public holding company and was listed on the German Stock Exchange in Frankfurt. In 2007, *HUGO BOSS* presented its collection for the first time in New York. Today, the company is a regular part of the New York Fashion Week (*The New York Times* 2014).

Nowadays, the former manufacturing plant in Germany has developed into a global player in the premium and luxury segment in classic and elegant clothing, along with accessories that appeal to modern, successful and self-confident customers. Fig. 6.8 shows

[1] In addition to the explicitly cited sources, the sources for this case study include the website http://group.hugoboss.com and various annual and company reports.

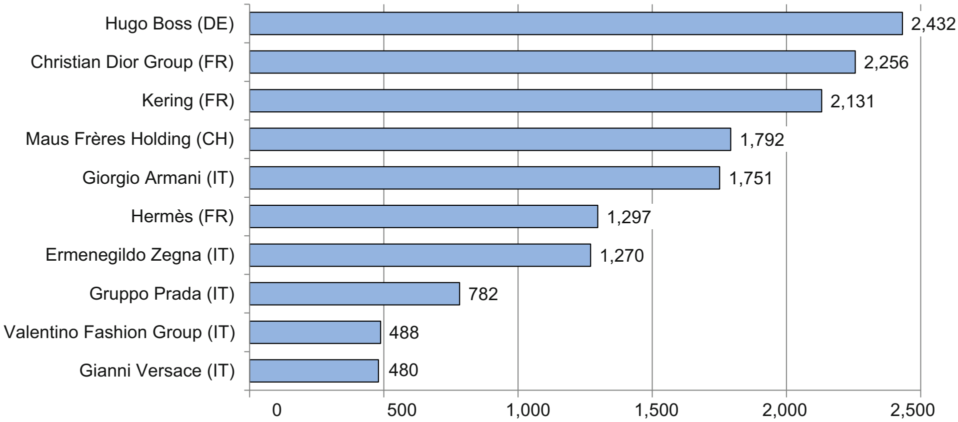

Fig. 6.8 Leading European clothing manufacturers in the luxury segment as of 2013 (sales in million EUR). (Adapted from TextilWirtschaft 2013)

HUGO BOSS' turnover compared to other European clothing manufacturers in the luxury segment.

In recent years, *HUGO BOSS* has been pursuing a multi-branding strategy that seems to be successful. This includes the *BOSS* core brand for authentic and understated luxury with business, evening and casual attire for men and women. The *BOSS* core brand is complemented by *BOSS Orange* and *BOSS Green*. *BOSS Orange* offers urban casualwear outfits with an uncomplicated and modern look, while *BOSS Green*, the group's premium sportswear line, contains functional golf apparel and modern leisure collections in impressive colours. In addition, the *HUGO* brand provides progressive looks in both business and leisurewear. The brand portfolio comprises a huge product assortment from classic to modern collections, shoes, leather accessories, licensed watches, eyewear, children's fashion, home textiles, mobile accessories and fragrances. With its wide selection, the company addresses clearly differentiated target groups and simultaneously satisfies their needs.

For years, *HUGO BOSS* has been one of the most profitable listed clothing manufacturers worldwide. In the 2014 fiscal year, *HUGO BOSS* generated annual sales of 2.57 billion EUR, a 6 % increase compared to 2013. *HUGO BOSS'* annual turnover is based on four operating segments: sales in Europe, Americas, Asia/Pacific and licenses, which include business with external companies. As Table 6.4 shows, Europe (including Middle East and Africa) experienced the highest sales at 1.5 billion EUR, a 7 % increase over 2013. America also played an important role with sales of 586.6 million EUR, followed by Asia/Pacific with annual sales of 360.8 million EUR. Licenses provide the smallest turnover at 57.7 million EUR. In 2014, the company's EBIT was 448.7 million EUR.

HUGO BOSS is also a new entrant in *Interbrand's* (2014)'s "Best Global Brand" ranking. *HUGO BOSS'* brand value is 4.1 billion USD, making it the world's 97th most valuable brand (Interbrand 2014).

Table 6.4 Sales by region (in million EUR). (Adapted from HUGO BOSS 2015, p. 80)

Region	2014		2013	
	Sales	Share of Sales [%]	Sales	Share of Sales [%]
Europe	1566.5	61	1457.3	60
Americas	586.6	23	570.1	24
Asia/Pacific	360.8	14	346.8	14
Licenses	57.7	2	57.9	2
TOTAL	2571.6	100	2432.1	100

Today, *HUGO BOSS* operates in 130 countries and runs about 7600 points of sale worldwide. In addition, the company owns 1041 retail stores and runs 19 showrooms, where the collection is demonstrated and sold to the wholesale customers. The company also owns five production facilities in Germany, Turkey, Poland, Italy and the USA, which allows the company to protect crucial expertise and provide consistent development for subsequent industrial manufacturing. The company currently has around 13,000 employees who form the basis of the company's success by adhering to the group's mission statement "*HUGO BOSS* inspires people towards success" (HUGO BOSS 2015, p. 51).

6.7.2 HUGO BOSS' Verticalisation Approach

With its diverse retail activities, *HUGO BOSS* employs a verticalisation strategy, distributing its products to globally selected partners among upmarket retailers and through *BOSS* stores, which are run as franchise systems or through the group's directly operated stores (DOSs). The company benefits from both secured and controlled distribution as it conducts a range of sales activities from *BOSS* flagship stores to freestanding stores, factory outlets, shop-in-shops, multi-brand points of sale, franchising and license agreements and Internet sales.

Secured distribution is the most significant part of *HUGO BOSS'* distribution system, with a sales share of 57 % of the company's total revenue. This includes a huge range of totally integrated secured distribution channels from the group's DOSs to outlets and online sales. Table 6.5 shows the retail stores' total sales structured by distribution channel for the past five years.

The group combines its extensive expertise as a long-established manufacturer with various distribution activities to provide its customers a first-class retail experience. This has led to strong control over the vertically integrated channels and allows for flexible decisions about store designs and concepts, such as the product range and in- and out-of-store marketing.

Table 6.5 Sales by distribution channel (in million EUR). (Adapted from HUGO BOSS 2015, p. 80)

Distribution Channel	2010	2011	2012	2013	2014	Share of Sales 2014 [%]
Directly Operated Stores	447.7	617.7	757.6	874.0	976.4	38
Factory Outlets	223.7	273.6	343.2	378.6	427.1	17
Online	19.7	32.9	48.9	61.5	67.8	2
Group-run Retail Business	691.1	924.2	1149.7	1314.1	1471.3	57
Wholesale	993.2	1085.3	1139.7	1060.1	1042.6	41
Licenses	45.1	49.3	56.5	57.9	57.7	2
TOTAL	1729.4	2058.8	2345.9	2432.1	2571.6	100

In the 2014 fiscal year, sales at *HUGO BOSS'* DOSs increased by 12 % to 976.4 million EUR and contributed 38 % to the group's positive sales development. This includes revenue from the company's own freestanding stores and sales generated by *HUGO BOSS* shop-in-shops in retail partners' sales areas.

During the past five years, the number of *HUGO BOSS'* retail businesses has almost doubled, from 537 in 2010 to 1041 in 2014. The group has focused on establishing retail businesses in growth markets, where the company's presence is still relatively low.

Flagship stores are a special type of DOS which boost *HUGO BOSS's* brand impact and customer retention due to their size and exclusivity. Flagship stores also play a major role in *HUGO BOSS's* global image, so the group continues to open and renovate flagship stores in major cities all around the world, including Rome, Shanghai, Hong Kong, Zurich, Amsterdam, Vienna, Stuttgart, Moscow, Tokyo and New York.

HUGO BOSS factory outlets are specialist stores that sell preseason products in highly frequented outer city locations. The outlet stores offer casual and business apparel along with accessories such as eyewear, ties and wallets at discounted prices (Metzingen-Best 2014). In 2014, *HUGO BOSS* owned 122 outlet stores worldwide, most of them in Europe (49 stores), immediately followed by the Americas (46 stores). The outlet business contributed 427.1 million EUR to the group's retail business revenue.

HUGO BOSS stores are operated as mono-brand concept stores. In the future, the core brand *BOSS* will cover an even greater area of the group's retail stores to provide a globally persistent brand image and an exclusive setting with a wide variety of goods. By using standardised store designs and well-trained personnel, the company can create an extensive brand perception and reinforce its brand equity. This strategy is applied to wholesale partners as well, who can only sell the *BOSS* brand in a mono-brand context, such as shop-in-shops, to further boost brand image. Nowadays, *HUGO BOSS* runs more than

2000 *BOSS* stores, 531 of them in shop-in-shop systems and 388 part of the group's own freestanding stores.

Like the *HUGO BOSS* flagship stores, regular *HUGO BOSS* stores also concentrate on top locations in metropolitan regions. In 2014, a new store portfolio was opened across Washington, D.C., Canada and Mexico. In addition, *HUGO BOSS* expanded its European and Asia/Pacific network in 2014 by adding 56 new stores and taking over 15 stores and five shop-in-shops previously managed by wholesale partners.

Women's fashion is also increasingly important for the group's retail business. Standout presentation and the use of large areas in new stores ensures a coherent worldwide approach and provides an opportunity to attract new female customers. The group also aims to produce unique products via its "Made to Measure" approach, offering customised and tailored apparel.

The group also runs *HUGO BOSS* online stores. In 2008, the company started selling products over the Internet in the UK. Today, the group owns eleven online shops in Austria, Belgium, China, France, Germany, the UK, Italy, Spain, Switzerland, the Netherlands and the USA. In addition, *HUGO BOSS* distributes online with the aid of specialist online retailers within its controlled distribution strategy, with special emphasis placed on a high-class brand presentation to attract new customer groups.

In recent years, *HUGO BOSS* has increased its sales significantly in both stationary retail and online business. In the 2014 fiscal year, sales from the group's own online stores rose by 10 % to 67.8 million EUR. In 2015, *HUGO BOSS* plans to improve its online experience and user-friendliness by adding new features. Soon they hope to offer customers a digital flagship store.

In addition to the group's own retail business, *HUGO BOSS* also operates with wholesale partners. These include department stores, specialist retailers, franchise partners and a few specialist online retailers. While the first two offer *HUGO BOSS* products either in shop-in-shops or multi-brand points of sale, franchise partners run freestanding *HUGO BOSS* stores according to the group's guidelines. In total, wholesale partners manage 6550 points of sale worldwide. In the 2014 fiscal year, the wholesale business contributed 1.6 billion EUR (41 %) to *HUGO BOSS'* sales.

As well as the group's own retail business, which is predominantly located in superior areas, the franchise partners run stores mainly in smaller foreign markets which have not been entered by *HUGO BOSS'* own retail industry. *HUGO BOSS* grants franchisees rights to the *HUGO BOSS* brand name, which helps the company generate global awareness, humanise the brand and increase its brand perception. In total, the company operates more than 1200 franchise stores.

Nevertheless, the wholesale business declined in recent years thanks to the group's takeover activities. In March 2015, *HUGO BOSS* took over all 17 existing franchise stores from its partner *TDCo Limited* in Korea. The company will also operate seven duty-free shops in collaboration with its partners in the future. These activities demonstrate the growing significance of the Korean market as a tourist destination and fashion trend-setter. The takeover opens up new opportunities for *HUGO BOSS* to attract the Korean female market and simultaneously strengthen its market position in men's apparel. In June 2014, its brand presence was also strengthened by the complete takeover of joint venture activities with the *Rainbow Group*, a former franchise partner.

HUGO BOSS also pursued its strategy of expanding its own retail business and acquired ten stores from former franchise partners in Australia, the US and Singapore in 2013. Additionally, the group took over shares of a shop in France and absorbed mono-brand shops in Great Britain from their long-standing franchise partner *MOSS Bros* in 2011.

In 1984, additional revenue opportunities were opened up by a license business for fragrances, which includes some of today's leading products in high-class perfume market. In addition, *HUGO BOSS* offers licenses for eyewear, watches, mobile accessories, children's fashion and home textiles. License partners include *Procter & Gamble* and *Safilo*, who both hold license agreements until 2020 (Safilo 2012). *HUGO BOSS* also collaborates with *Children Worldwide Fashion SAS* and *MGI Luxury Group S.A.*, a Swiss subsidiary of *Movado Group* (Textilwirtschaft 2009, Movado Group 2012). Thus, *HUGO BOSS* profits from its licensees' expertise and distribution system.

By integrating previously licensed clothes, socks and knitwear into the group's own retail business as well as the takeover of *MH shoes & accessories*, a former licensee of *HUGO BOSS'* shoes and leather goods, the group continues to expand and gain control over its vertically integrated distribution activities.

In the 2014 fiscal year, licensing showed stable development by contributing 2 % to the group's total sales. The license income from fragrances fell only marginally in comparison to 2013, with women's fragrances compensating for declining sales of men's fragrances. License income for watches rose by over 10 %.

6.7.3 HUGO BOSS' Group Strategy and Future Activities

Over the past few decades, *HUGO BOSS* has established a strong economic performance that underlines the power of the group's business model. Based on this, the company aims at sales growth and profitability in the high single digits by 2020. By characterising new core themes, the proven strategy has been enhanced in 2014 and now focuses on five pillars:

- The elevation of the *BOSS* core brand supports the increasing verticalisation of the brand portfolio and is expected to be used in markets where the brand has been perceived principally in a multi-brand context or among entry-price products. By 2020, *BOSS* brand sales are predicted to double to around 20 % market share in the luxury segment.
- The group also plans to expand its market position in womenswear with the help of a new artistic director, Jason Wu, and to increase its share of sales to 15 % by 2020 (2014: 11 %).
- *HUGO BOSS* will also bolster its own retail operations, both online and offline, to present and sell its collections in the best possible way and provide its customers

with a seamless experience. In addition, the group will acquire components of the e-commerce value chain to provide several digital services, such as "Click & Collect" in 2016. Although the group's wholesale business will shrink, it will still remain an important channel and provide an opportunity to gain new market shares. Thanks to new openings, increased productivity and takeovers, the company expects the sales share of its retail businesses to increase to at least 75 % by 2020 (2014: 57 %).

- *HUGO BOSS's* global growth strategy also includes opening new stores or shop-in-shops, predominantly in cosmopolitan areas, as well as renovating or taking over existing stores. The group sees strong opportunities in the Asian market, so *HUGO BOSS* is working on its retail network and brand perception in the region. Thus, the group will now run partner-operated stores in Korea and the Middle East under its own initiative. The group will also absorb the last franchise stores in China. Their agreement from January 26, 2015 with the franchise partner *Wenzhou Noble* gives the group control over all 21 BOSS stores, which are currently run as franchises, from April 1, 2015. After completing this transferral, the company will run around 130 stores on the Chinese mainland. Additionally, the group plans to establish its own distribution company in the United Arab Emirates in 2015. The company will be headquartered in Dubai and will take over distribution activities in the region from January 2016. As a result, *HUGO BOSS's* collaboration with the commercial agent *Fashion Trading Company SARL* from Lebanon has been cancelled effective December 31, 2015. Despite these developments, Europe will continue to be the group's largest sales market.
- The *HUGO BOSS* group's strategy aims to maximise operational strengths to retain control of all business-critical proceedings and ensure high-performance processes to deliver excellent quality products.

6.7.4 Summary and Outlook

In recent years, the *HUGO BOSS* group has become one of the global leaders in manufacturing luxury and premium goods within the apparel industry. By operating different distribution strategies, the company is internationally active in the world's largest markets. In particular, the group's own retail business, such as directly operated stores, will become increasingly important as part of the group's verticalisation approach for penetrating new markets. *HUGO BOSS's* global growth strategy allows for extensive brand control and autonomous increase of retail operations. By assuming full control over its brand impact in the Asian market, *HUGO BOSS* reinforces its presence in the region, particularly in essential growth markets.

Finally, *HUGO BOSS'* distribution strategy lets the group attract customers in a targeted and individual manner and react to market trends. In addition, the integration of regional companies fosters speedy knowledge exchange and puts the company in the optimal position to secure further international growth.

Questions

1. List possible reasons to implement secured distribution activities from a manufacturer's perspective and apply these insights to *HUGO BOSS'* situation in detail.
2. Describe potential channel conflicts for a manufacturer adding a new company-owned retail channel and use *HUGO BOSS* to illustrate some examples. Focus on methods that are suited to managing channel conflicts.
3. Assess the contribution of *HUGO BOSS'* company-owned retail activities to the long-term success of the company.

- For a general overview of motivations for secured distribution from a manufacturer's perspective, see Tsay and Agrawal (2004).
- Consider channel conflicts between a manufacturer and independent retailer's channels and between manufacturers' channels. See the discussion in Bucklin et al. (1997) for potential channel conflicts and a framework for managing them.
- Transfer Hauptkorn et al. (2005) on success factors for verticalisation strategies to *HUGO BOSS'* current situation.

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