Changing Trends in the Distribution System

By Honda Chieko

Japan's distribution system has reached a turning point. The traditional maker-led marketing system is giving way to policy shifts and corporate restructuring. These changes reflect increasing retailer buying power, diversified retail businesses represented by discounters, changing consumption patterns, increased use of information and systemization, U.S. demands to change traditional business practices and structures following the Japan-U.S. Structural Impediments Initiative (SII) talks in 1989-90, and the weak economy which has been in a slump since 1991.

The SII negotiations have had a particularly strong effect as they were followed by a quick two-pronged shift in distribution policy by the government: deregulation and increased competition. Accordingly, the Large-scale Retail Store Law was revised and the Fair Trade Committee (FTC) drew up new guidelines on distribution and trade practices. The question now is to what extent have these changes solved the structural problems in Japan's distribution system. To answer this, we will examine existing conditions in the distribution system as well as recent industry developments vis-a-vis the post-SII distribution structure and openness of Japan's markets.

Traditional practices

In the 1960s Japan entered an era of high economic growth with manufacturers seeking effective marketing for their mass-produced products. Thus their influence over wholesalers and retailers was strengthened through mixed strategies in pricing, sales channels, promotion and products which gradually evolved into a marketing system dominated by manufacturers' pricing power. This has crystallized into particular trading practices such as retail price, manufacturers' set retail prices and rebates, as well as the formation of integrated marketing networks (*keiretsu*). The strength of the system varies from company to industry, making it all the more elusive. Nevertheless the general pricing mechanism formula is based on a total marketing strategy, the maker sets retail prices (manufactures' suggested retail price) and wholesale prices at each stage are set by multiplying a certain percentage on the standard retail price.

In reality, however, decreases in the marketing margin are the results of retail/wholesale price cuts due to competition and higher labor/distribution costs. Such losses are compensated by the maker after a certain period through rebates.

By coordinating rebates and retail prices, makers guarantee their distributors a certain profit and thus the distributors maintain the manufactures' suggested retail prices. A kind of communal profit-sharing relation is established between them which stabilizes and perpetuates trade relations. Consumers also benefit from a stable commodity supply. This system, no doubt, has contributed to Japan's economic development.

However, the system recently has been questioned by Western countries as the rebate system is vague because such agreements cannot be included in the contract at the point of shipment. Furthermore, once the vertical integration is established, competition is discouraged, prices become rigid and new entrances barred. As a matter of course, these points were raised during the SII negotiations.

As time passed, domestic contradictions also become apparent; the production system is shifting toward more variety and less quantity in line with the diversification of consumer preference, and larger retailers are expanding their market share at the expense of smaller stores. Pricing power allows makers to use the rebate system to facilitate the retail price system. However, increasing retailer buying power has undermined the quotation system on which rebate calculations are based. Irregularity in the quotation system lets retailers regard rebates as a vested right.

In attempts to minimize the effects of the recession and endaka, Toyota and Nissan have opened a joint outlet.

To illustrate, we will closely look at cases in the consumer electronics, cosmetics and auto industries.

Shift from market share to profits

In consumer electronics, makers have restructured their marketing system to cut costs in the face of a depressed market due to its maturation. The maker-led pricing structure eroded as volume sellers and general merchandise stores (GMS) increased their buying power, and the sales proportion of integrated stores shrunk. Regarding volume sellers, makers, partly encouraged by the

Aoyama Shoji continues to experience brisk sales in the midst of the sluggish economy.

disputes in the SII, have simplified the rebate system and reduced stuff-loaning.

As for integrated stores, the traditional structure has been revised. For example, industry leader Matsushita Electronic Industries Co., Ltd. dissolved its existing structure in April 1992 and reorganized a new network based on stores that make certain monthly purchases above a specified level. Also, it abolished an internal saving system whereby Matsushita deposited 1% of each integrated store's sales and paid a 20% annual dividend. As a result, the number of integrated stores decreased more than 30% from 27,000 to 18,000.

Makers are cutting off dependent small stores with low morale under heavy rebate protection, trying to revitalize the network. In Matsushita's case, this has been met with some success—the sales share at the integrated stores has outpaced volume sellers. On the other hand, discounters, a new business, which eschews in-store service and concentrates exclusively on lower pricing, have been growing, and volume sellers are expanding their sales through franchising maker integrated stores displeased with ongoing restructuring. Thus this industrywide restructuring will likely continue.

In contrast, cosmetics makers have long enjoyed a resale price maintenance system, and a recent challenge to this by a discounter has drawn attention. In this industry, restructuring is retailer-led. Shiseido Co., Ltd., Japan's top cosmetic maker, announced in July that it would cancel all business and halt shipment to its Tokyo integrated retailer May-K after it started discount sales of Shiseido's products in June. Discount sales can be conducted either by outsiders who purchase goods from integrated stores with excess inventories through brokers, or by integrated stores with formal contracts. If the latter case prospers, it could cause a collapse of the maker's sales network and price control system which was costly and time consuming to develop. This particular case is now being examined by the FTC and we are waiting for the results.

In both consumer electronics and cosmetics, it seems makers mean to maintain their marketing network of integrated retailers to safeguard their existing market shares. But this has necessitated a policy shift from protecting all the integrated stores to selecting only those which are capable of competing. So far, consumer electronics makers are trying to differentiate their sales network through better customer service and home visit campaigns by the integrated stores. However, as more discounters enter the market, it will be difficult for integrated stores to survive without heavy rebate protection and price cuts. It seems makers must be more geared to profits than market share and to adopt a new pricing policy which allows a more varied response to retailers, depending on business conditions.

In the auto industry, on the other hand, a tight monopolistic marketing system has been established where sales outlets are divided according to the car models sold. The merits of the monopolistic dealer system is that it allows competition among a maker's sales channels. Recently, however, dealers started to open joint outlets with other dealers crossing channel and maker boundaries. For example, there is a shop jointly owned by Toyota Motor Corp. and Nissan Motor Co., Ltd. dealers, and some Nissan dealers of different channels have merged to form a new store handling most models. Behind this is the fact that makers are abolishing the back margin paid to dealers who achieve certain sales targets, and this has forced dealers to find an alternative method of securing profits.

As auto sales usually rise sharply after a model change, dealers who merge to handle more models are better positioned to benefit from these changes. At the same time, as more dealers offer the same model in the same area, buyers will start looking for a lower price and competition will take place. Japan's number two automaker Nissan, which once promoted mixing its sales channels, announced last July that it will maintain the existing monopolized dealer system and, as a supplement, expand showroom type dealers who handle all models (currently 17 in Japan).

Makers are now opening their domestic sales channels for foreign cars. For example, Toyota set up DUO stores at existing dealers in April 1992 to sell Volkswagons and Audis and exhibited General Motors cars for a while in its Tokyo general showroom. Although Toyota has yet to market foreign cars with its own in the same store, the cooperation of Japan's largest auto maker is setting the stage for foreign makers to enter the market.

Changing trends

It has always been said that the existence of a myriad of small retailers and a multi-layered wholesale system are features peculiar to the Japanese distribution system compared to the West.

Two factors help explain this: Major store openings have been strictly regulated to protect small local stores (the Large-scale Retail Store Law); and the weak enforcement of the Anti-Monopoly Act has allowed the aforementioned maker-led pricing system to exist and, along with resale price maintenance, prices have remained statistically high. But, commerce statistics indicate the number of smaller sized stores is in fact decreasing. The Large-scale Retail Store Law has protected existing large store profits by discouraging competition from new large stores, while maker pricing policies tend to favor larger stores as they can secure bigger margins even with retail prices below those of small stores.

Western countries have charged that Japan's import growth has been discouraged by the lack of large store expansion. The SII discussed the competition-killing Large-scale Retail Store Law and certain marketing practices stemming from the increased buying power of retailers. Below are the policy changes that followed SII and other recent developments.

The Large-scale Retail Law was revised in May 1990—the required preadjustment period with locals was cut to within one year and a half, and import sales floor expansion under 100 square meters was exempt from adjustment. In January 1992, the waiting period was shortened to only one year. The actual number of openings and applications, however, has been rather limited based on cautious estimations of long-term returns, largely due to the current recession and increased certainty over actual opening dates, which was not at all clear under the old law.

A careful examination of the content of the new openings suggests a shift in location strategy—urban department stores are opening outlying outlets while roadside men's suits speciality stores are opening urban outlets. Also, department stores and GMSs have opened more price-oriented stores including general discount, home centers, U.S.-originated member system wholesale clubs and factory outlet stores.

For wholesalers, the legal revisions have reduced the number of common retail stores wholesalers can effectively control. Among toy wholesalers, whose domain has been threatened by the entry of Toy's"R"Us which opened the way for direct trade between makers and retailers, some have quit while others have forged links with major companies. The need for such stores to develop new functions is greater than ever, otherwise they will be victimized by the trend towards a major realignment of the industry.

The July 1991 FTC's *Anti-Monoply Act Guidelines Concerning Distribution Systems and Business Practices* outlined undesirable trade practices with details of returned goods, seconded labor, supporting funds, excessive small deliveries and central fees. However, the response of large-scale retailers has been largely limited to improvements more oriented to their own benefit than to any social responsibility. Department stores suffering from weak business conditions are revising traditional costly business practices, such as loaning personnel and returning goods, and emphasizing the development of self-merchandising private brands. However, this has met with strong opposition from the wholesalers and makers, who are being forced to revise their customer informa-

Discounters such as STEP (right) and Yodobashi (below), which concentrate on low prices and fast moving merchandise, have ballooned as the bubble has burst.

International Comparison of Trade Practices

	Japan	U.S.	U.K.	France	Former West Germany
Returned goods	•Returning unsold goods is common	•Does not exist except for imperfect or damaged goods	•Doesn't exist except for imperfect or damaged goods	•Doesn't exist except for imperfect or damaged goods	•Doesn't exist except for imperfect or damaged goods
Rebate system	•Various and complicated structure (volume, fixed date, evaluation, promotion) •Long-term in pay unit (yearly, half-yearly, etc.) •Rebates are not necessarily open	•No rebates but discounts and allowances exist •Open rule •Pay unit depends	•Quantitative and date fixed rebates exist •Open rule •Pay unit depends	•Quantitative and date fixed rebates exist •Open rule •Pay unit depends	•Quantitative and date fixed rebates exist •Open rule •Pay unit depends
Quotations	•Manufacturers' suggested retail prices exist •Written materials and certain drugs and cosmetics are allowed to maintain resale prices	•Manufacturers' suggested price exists	•Does not exist in principle •Books and drugs are allowed to keep resale prices	•Doesn't exist in principle •Books and certain cosmetics, ski equipment and some consumer electronics are allowed to keep resale prices	•Doesn't exist in principle •Books, newspaper and magazines are allowed to keep resale prices
Marketing integration	•Exists (consumer electronics, auto, cosmetics)	•Uncommon	•Exists (auto)	•Exists (auto)	•Exists (auto)
Others	•Loaned sales stuff •Frequent and small amount delivery •Perpetuates business relations •Unclear contracts	•Uncommon	•Uncommon	•Uncommon	•Uncommon

Note: Distribution Economics Institute, *Survey on International Comparison on the Distribution Industry* (May 1990)

tion sources and price setting.

On the other hand, volume sellers are being attacked by wholesalers who, encouraged by the government's policy revisions, demand improvement in trade practices. However, these improvements are likely to be limited only to returned goods. Moreover, the likely reason for revising the returned goods practice is that profit increases with fewer returns through minimum marketing inventories made possible through a point of sales system. Both department stores and volume sellers, who do not spare money for the environment or other fields appealing to consumers, should become more assertive in improving their internationally criticized unclear trade practices.

The reason for a price gap in the same product between Japan and the West generally has been explained by the combined effects of the maker-led pricing system, high land prices, government regulations (such as food control and licensing), existence of sole import agents which monopolize certain products to protect the brand image with artificially high prices, and Japanese consumer preference for brand goods. If this is true, the gap should shrink due to lower land prices, a more frugal consumer consciousness which accompanies the recession, relaxed government regulations which encourages competition, a proliferation of discounters and the higher yen.

There has been a noticeable price gap reduction in the alcohol retail industry, where discounters are mushrooming due to FTC protection by strong surveillance over makers and sole import agents now engaging in parallel imports. Moreover, the relaxation in licensing allows for GMS alcohol sales to grow, adding more pressure on sole import agents' price control. The FTC has also intervened in a proposed joint-venture between Kirin Brewery Co., Ltd., which has a 50% domestic beer market share, and Anheiser-Busch, setting severe conditions on the percentage of ownership and number of executives sent from the parent companies to prevent a violation of the Anti-Monopoly Act. Goods that still have a high price gap, despite current sharp yen rises, are possibly the result of insufficient deregulation or some competition-limiting activities that may violate the act.

Three years after SII began, reforms in the domestic distribution industry are still at a stage where corporations' efforts are driven by their own needs rather than social needs. However, with the end of the Liberal Democratic Party's monopolistic rule in July, the system of industry protection and cartels centered by an iron triangle of politicians, bureaucracy and the business circle has started to erode. Not only the distribution system but Japan's economy as a whole is likely to go through changes from the traditional system which barred new entries at a high social cost to economic renewal and expansion based on the market principle. This requires the determining power to shift from makers to consumers.

The distribution industry should not be dependent upon protective regulations and the traditional system, which is likely in violation of the Anti-Monopoly Act, nor entirely surrender to the Western style, but seek a more consumer-oriented system. Distributors cannot survive without consumer support.

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