

Name:
Enrolment No:



UNIVERSITY OF PETROLEUM AND ENERGY STUDIES
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Course: Sales & Distribution Management
Program: BBA (AM)
Course Code: MKTG1001

Semester: V
Time: 03 hrs.
Marks: 100

SECTION A
(30 marks)

- 1. There are SIX MCQs in this section. All are compulsory.**
2. Instruction: Choose the correct answer.

Q.No	Question	Marks	CO
1	Which of the following statements about sales force management is true? a. The sales force is the firm's most direct link to the customer b. As organizations implement the marketing concept, they soon realize how important it is to be sales-oriented c. Personal selling is usually less expensive than advertising d. Sales management is no different from any other kind of management	5	CO-1
2	Choose the correct statement. a. Marketing management is a broader concept and sales management is a part of marketing management. b. Sales management is a broader concept and marketing management is a part of marketing management. c. Marketing management and sales management are equivalent. d. There is no connection between sales management and marketing management.	5	CO-2
3	Arun and Paul are sales reps for a major pharmaceutical company in the same geographic area. Arun calls on private practice physicians, while Paul calls on hospital groups. Their sales manager would likely have an ethical dilemma in the area of: a. Determining compensation and incentives b. Equal treatment in hiring and promotion c. Respect for individuals in supervisory and training programs d. Fairness in the design of sales territories	5	CO-3
4	Kishor is studying the potential for selling her company's products in China. As part of her analysis, she is assessing the number, types and availability of wholesalers and retailers. Kishor is studying the country's	5	CO-3

	<ul style="list-style-type: none"> a. Natural conditions b. Technological feasibility c. Social and cultural norms d. Distribution structure 		
5	<p>What type of intermediary would purchase cricket bats from one producer, gloves & guards from another and balls from still another and then sell an assortment to sporting goods stores</p> <ul style="list-style-type: none"> a. Agent b. Producer c. Retailer d. Wholesaler 	5	CO-2
6	<p>A form of distribution in which manufacturer makes an agreement, with a middleman in each market area stipulating that the distribution of the product within that is to be confined solely to that middleman is known as-</p> <ul style="list-style-type: none"> a. Mass Distribution b. Exclusive distribution c. Selective distribution d. Price Distribution 	5	CO-1

SECTION B
(70 Marks)

In this section, there is ONE Case Study. It is compulsory.

Q.No	Discuss the given Case Study by giving the answers to all the questions (a-e)		CO
7.	(a) By giving a brief introduction of the case, describe the occurrences taking place in it. Also, recognize the key personnel who are facing the challenges in the operation of the organization.	10 marks	CO-3
	(b) Define the business problems being-faced by the key officials in the case. Also, discuss the short-term and long-term problems.	15 marks	CO-3
	(c) Illustrate the reasons of the problem. Also, explain, in detail, the identified problems as well as apply relevant theories and models, if applicable, from the text and/or readings.	15 marks	CO-4
	(d) Calculate the identified decision criteria against which you evaluate alternative solutions. In addition, compare the possible alternative solutions along with the appropriate pros and cons of each alternative.	15 marks	CO-4
	(e) Apply the solution and implementation for the problems and causes identified in the case. Also, discuss why this recommended plan of action is the best and why it would work. Remember the “who”, “what”, “when”, and “how” in your recommended plan of action.	15 marks	CO-4

CASE STUDY

Channel Alternative- Direct Channel vs Distribution Channel

Lotus Development Corporation's director of sales operations, John Shagoury, stood at his office window staring across the Charles River at a breathtaking view of downtown Boston. But on this January 1986 morning, the view was lost on Shagoury. He was preoccupied with a major decision facing his young company—whether Lotus should bypass its distributors and dealers and have its own, salesforce sell directly to its large corporate users. Currently, Lotus's 90-person salesforce called on several of these large accounts and took them through the complete selling cycle except for the final exchange of products for money. The company's local retail dealers drew up the final contract and effected delivery and after-sales service.

The evolving sophistication of these corporate buyers was starting to demand direct servicing, but this would mean the cannibalization of the dealers' highest-volume accounts. Indeed, dealer pressure had forced Lotus to discontinue direct selling when the company had tried it three years earlier. Lotus wanted to maintain its good relationship with dealers and distributors because under any scenario they would continue to be a primary sales channel. They would be particularly important for future products the company was planning to roll out.

Shagoury described the difficulty of making decisions in this new and rapidly changing industry.

One of the things companies have going for them in other industries is history—growth trends, buying trends, and so on. We do not have any of that. There is not enough reliable data on which to base any analysis or decisions. Then if you do get something figured out, it changes the next day. Three years ago, software was being distributed in zip-lock bags with mimeographed documentation. Now we spend hundreds of thousands of dollars on packaging and creating user-friendly tutorials. Five years from now, software may be burned into ROM chips¹ and the integrated packages distributed by the hardware manufacturers. Who knows?

¹ROM stands for read-only memory—the silicon chip inside a computer that contains the basic operating instructions for the computer. Technological advances in silicon chip design and manufacture were expected to increase the capacity of the ROM chip so that it could also hold large operating systems and applications programs.

Industry Background

During the 1970s, technical and manufacturing advances in the semiconductor and magnetic memory fields greatly increased microprocessor and memory capabilities and greatly reduced their costs. This precipitated the development of the microcomputer (otherwise known as the personal computer), which could store, access, and process significant amounts of data and solve problems at a low cost.

The microcomputer created a demand for software that would address the needs of a vast new group of users. Entrepreneurial software programmers recognized this opportunity, and many individuals (often working out of their homes) developed functional packages. Low entry barriers soon gave rise to a small, highly fragmented market. Then in 1982, a start-up company, Lotus Development

Corporation, changed the rules of the game. The company's founder obtained \$1 million in venture capital and used it to finance a blitz of advertising and marketing support programs to promote a new spreadsheet package for businesses—Lotus 1-2-3. This bold move expanded the market and greatly raised entry hurdles in the industry. A high-powered marketing program became the price that a software developer had to pay to be heard above the crowd of new product offerings. The “Lotus-style launch” was necessary to get distributors and dealers to carry a product, to get the computer magazines to review it, and to generate crucial word-of-mouth referrals.

By the end of 1983, the market stabilized somewhat as various one-product firms such as Lotus (with 1-2-3), Ashton-Tate (with dBase II), and Microsoft (with MS/DOS) established their products as industry standards in their respective market segments. By 1985 the micro software industry was estimated to be about \$5 billion (inclusive of an estimated 45% channel margin), with 14,000 companies and 27,000 different products.

Included in the \$5 billion figure was a \$2 billion to \$2.5 billion market for special-purpose software and services. These software programs were written for the unique requirements of an industry or a client, e.g., computer-aided instruction programs for educational institutions, order-entry systems for distribution warehouses, and medical-diagnosis bibliographies for physicians. The special-purpose segment of the industry was fragmented by many players and products.

The \$2.5 billion general-purpose software market was divided into two major segments: operating systems and application software. Operating systems organized and managed the activities of the computer hardware and peripheral equipment; they got the hardware into a ready-to-think mode and hence were integral to the use of every microcomputer, regardless of the ultimate application. In 1985, the operating systems market was estimated to be about \$250 million (in retail sales). Application software made up the rest of the general-purpose market. These were programs written to accomplish general problem-solving tasks, such as (1) mathematical computations (spreadsheet programs), (2) writing reports (word processing programs), and (3) organizing data files (database management programs). These three application segments were nearly equal in size, and together accounted for 75% of all general-application software sales. Several other application pieces, such as electronic mail programs, made up the other 25%.

About 50% of the general-purpose software market was shared by seven companies: Lotus was the clear leader with 1985 sales of \$225 million, followed by Ashton-Tate and Microsoft, each with sales of about \$100 million to \$125 million. IBM, the industry leader in microcomputer hardware (with sales of about \$6 billion to \$7 billion) was a minor but not unimportant player in the micro software industry. IBM's sales of micro software in 1985 were estimated to be about \$75 million.

Apple Computer, the number two company in microcomputer hardware, also marketed software but to a lesser extent than IBM. Finally, other important participants such as Software Publishing and MicroPro, with sales of about \$40 million each, were constantly challenging Lotus, Ashton-Tate, and Microsoft.

By early 1986, new challenges arose for all participants as the demand for microcomputers slowed significantly. The growth rate for microcomputer sales went from 101% in 1982 to 55% in 1984 and to 22% in 1985. This slowdown seemed to signal that the sales to the “early adopters” had approached saturation and that product modifications would be required to develop other potential markets. The

micro software industry, which had grown at a rate of 55% to 60% from 1982 to 1983, slumped to 20% in 1985. An article on the industry summed up the situation.

It was not long ago that computer software makers were the sexiest, craziest, glitziest members of corporate America. They possessed money, magic, and a seemingly limitless future. . . . However, almost overnight the industry changed. Slumping sales, a jaded public, and some spectacular failures forced the nation's computer software industry to grow up in a hurry. It skipped puberty, shed its flash and dazzle, and donned a business suit.

The article went on to discuss the basic dilemma facing micro software companies:

Some software executives continue to believe that improvements in technology will restore an edge of excitement to what has suddenly become a mundane business. Salvation for them lies in speedier microchips and bigger electronic brains.

Others, however, have started to de-emphasize the technical aspects of their business and have adopted more fundamental, long-term strategies for improving market share. These include establishing closer relationships with customers and better addressing their needs.

Company Background

In the 1960s, Mitch Kapor, eventual founder of Lotus Development Corporation, was a drifter. During the 1970s, he worked as a disk jockey, a stand-up comedian, and a teacher of transcendental meditation. In 1986, as founder and chairperson of the nation's leading micro software firm, Kapor was considered an industry visionary and an entrepreneurial legend.

It was on New Year's Day, 1979 that Kapor decided to get into the personal computer business. This decision first took him to Visicorp, producer of Visicalc, the first financial spreadsheet package in the market. He wrote a pair of program enhancements for Visicorp but quit after five months and teamed up with a former Data General programming wizard, Jonathan Sachs, to create an integrated business spreadsheet for the newly announced IBM PC.² Kapor devised a business plan with projected first-year revenues of \$3 million to \$4 million and approached Ben Rosen, a venture capitalist with a reputation for near-clairvoyance in high-technology areas. Rosen was skeptical but came up with \$1 million. Kapor used the money to finance an intensive marketing effort, and the company went on to earn \$53 million in revenues in its first year of operation (see Exhibit 1).

²The word *integrate* is used to describe software in which functions that were originally sold as separate applications programs (such as financial spreadsheets and word processing programs) have been combined onto one program. In the integrated 1-2-3, the financial spreadsheet was tied into graphics and database management capabilities.

One of the company's goals in 1986 was to become the first software house to grow into a major corporation. Thus far, with every new generation of microcomputer hardware, major software companies had failed and new ones had moved in to take their places. Lotus was attempting to stay on top and grow by (1) diversifying beyond business spreadsheets and (2) becoming the worldwide leader in a full range of high-productivity micro software and services for the business and professional market. Industry analysts felt that the company's superior sales organization, customer support programs, enormous installed base (estimated to be 1.7 million users worldwide), and

dominant advertising presence would enable it to continually roll out new products, companion products, and product enhancements.

To keep the pipeline full of new products, Lotus followed a strategy of spending heavily on R&D, acquiring promising but underfunded software firms, forming joint ventures with hardware and other software vendors, and using innovative arrangements to retain proven independent developers.

Lotus Products

1-2-3 This integrated spreadsheet program was the 1982 brainchild of Mitch Kapor and Jonathan Sachs that gave birth to the company called Lotus. The company's \$4 million product launch in 1983 has been identified by many industry experts as the starting point in the creation of an entire industry. Lotus backed 1-2-3 with an intense sales support and advertising program. Its marketing budget was split 70:30 between dealer support and print advertising. The company's very first product brochure summarized Lotus's marketing strategy as follows:

At the heart of our product philosophy is a recognition that it is not enough in today's marketplace to merely provide top quality productivity software. A software manufacturer in business for the long term must also fully document and support its products and consistently back its dealers with a full range of services— services that will make the products uniquely easy, painless, and profitable to sell.

In keeping with this philosophy, the company backed up its advertising campaigns (see Exhibit 2) with intensive dealer support such as:

- Training seminars to provide dealers and their staff with extensive hands-on experience using 1-2-3 in an office environment.
- Special telephone support to answer specific product-related questions and provide on-the-spot advice.
- Promotions called "Dealer Demo Days" in which a Lotus retail sales representative organized site demonstrations of the product to dealer-invited prospects.
- Assistance in designing and managing direct-mail campaigns.
- Cooperative advertising allowances of up to 3% on net purchases.
- Product brochures, banners, counter cards, and shelf hangers.

1-2-3's extraordinary success was unparalleled in the micro software industry. It had stayed on top of the Softsel Hot List since March 1983.³

Reluctant to rest on the success of the original program, Lotus was committed to maintaining 1-2-3 as a state-of-the art product. The two revised releases (2.0 in September 1985 and 2.01 scheduled for September 1986) and the 1-2-3 Report Writer companion product increased the package's size, speed, and functions. Enhancements were planned to further improve the program's efficiency, user friendliness, and compatibility with other programs and possibly to give it a more flexible data structure.

A variety of competitive threats was expected to challenge 1-2-3. Products known as "1-2-3 clones," with retail prices as low as \$99 (versus 1-2-3's price of \$495), were one such threat. Industry analysts believed that 1-2-3's continuing enhancements would make it difficult for other products to

completely duplicate its functions, and, unlike 1-2-3, documentation and customer support for the clones was expected to be sparse. It remained to be seen, however, whether the market would continue to pay \$495 for 1-2-3 if a functional spreadsheet could be purchased for \$99.

Javelin, a financial program (from a start-up company of the same name) released in late 1985, was another potential challenger. Javelin boasted a radically new data structure that greatly facilitated the handling of larger and highly interrelated spreadsheets, and several experts predicted considerable success for it.

A third challenge was expected from Microsoft: it had announced that Excel, an integrated spreadsheet developed for Apple hardware, would be adapted to IBM and IBM-compatible PCs by late 1986. The IBM version of Excel would feature a spreadsheet tied into a sophisticated, graphical user interface and a mouse-based entry system—features that both 1-2-3 and Symphony lacked.⁴

Symphony The success of 1-2-3 set off an industrywide race to produce integrated software. The market opportunities for such products seemed as broad as the microcomputer industry itself, since integrated software appeared likely to make single-purpose programs obsolete. Almost overnight, dozens of software companies fell under integration's spell; many made splashy announcements of products that did not even exist. The stronger the integration fever became, the more vulnerable Lotus looked. Industry experts believed that as soon as a five- or six-function program came along, 1-2-3 would be superseded. Kapor, who believed in integration as much as anyone was determined not to be leapfrogged? Lotus poured about \$14 million into Symphony (its own five-function successor to 1-2-3) and Jazz (a similar package for Apple's Macintosh computer).

Symphony debuted in the summer of 1984 with the biggest advertising fanfare in software history—an \$8 million campaign that included television spots during the Los Angeles Olympics (see Exhibit 3). In addition to the 1-2-3 functions, Symphony (priced at \$695) enabled users to do word processing and manage telephone communications with other computers. Symphony played to mixed reviews. Computer magazines hailed it as a technical achievement, but they complained that it was too complex and that its commands were different from 1-2-3's.

³*Softsel was the largest micro software distributor, carrying over 4,000 software programs from vendors. Softsel's "Hot List" was its weekly listing of best-selling programs.*

⁴*The graphical user interface employed pictorial symbols to represent certain function alternatives instead of the one-word menus that the Lotus products used. A "mouse" was a small, hand-held device that allowed entries to be made by moving the mouse across the computer screen instead of using the keyboard. Excel would allow users to select functions by pointing to the function symbols with a mouse. Lotus believed that the programming required running this system on current hardware used too much memory and made the computer too slow to be attractive to consumers.*

Yet instead of catastrophe, there was anticlimax. The integration craze evaporated, and 1-2-3 regained its position as the number one selling program in the market. The integrated software market turned out to be much like the stereo component market: although some users on the low end of the market preferred the multifunction packages, most preferred to own the more sophisticated, single-purpose programs.

Even though Symphony did not live up to the industry's expectations, it was nevertheless quite successful. Of the multifunctional packages, it was by far the dominant leader, generating an estimated \$30 million in revenues in its first year. Although Ashton-Tate's Framework, with its more

sophisticated database and word processing functions, won several “performance showdowns,” Symphony outsold Framework 5 to 1. Many industry observers felt that this demonstrated the benefits of being associated with Lotus 1-2-3 and the strength of the Lotus marketing organization. Symphony was evolving through an upgrade program similar to the one for 1-2-3, and Lotus had already introduced several companion products such as Symphony Spelling Checker and Text Outliner.

Jazz Jazz, programmed for the Apple Macintosh personal computer, was the equivalent of the Symphony program for IBM PCs. Apple was banking on Jazz to help it break not only IBM’s but also 1-2-3/Symphony’s domination of the corporate microcomputer market. It did not turn out that way: individual hobbyists, not corporations, bought Macintoshes; unlike corporations, they did not need high-powered financial spreadsheets. Jazz apparently did not meet a need for many users, and its sales were disappointing.

Future product offerings In addition to its three leading products (1-2-3, Symphony, and Jazz), Lotus worked toward broadening its product line outside the spreadsheet segment with additions such as Spotlight (for desktop organizing) and Signal (for stock market prices). Despite the company’s attempts at diversification, 1-2-3 was projected to continue to provide more than half of the company’s revenues in 1986 (see Exhibit 4).

Lotus hoped to create another sales boom by exploiting the neglected market for engineers and scientists. The company estimated that a half million people were using 1-2-3 for technical purposes and believed the right product offerings could provide access to this huge market. In 1985, Lotus established an Engineering and Scientific Products Division in order to explore this market.

Lotus’s strategy centered on two approaches: (1) to enhance 1-2-3 through expanded statistical functions enhanced logic capabilities, improved graphics, and the development of direct data acquisition capabilities, so that it was much more useful as a technical calculation aid; and (2) to develop a technical word processor that could handle the complex character demands of mathematical and scientific equations. Lotus committed significant programming talent to this challenge in hopes of creating another hot-selling package within one to three years.

Main Competitors

Ashton-Tate In 1985 Ashton-Tate was the second-largest microcomputer software company in terms of applications programs revenues, and the third largest in terms of total revenues. With the introduction of dBase II in 1981, Ashton-Tate emerged as the leader in microcomputer database management technology. In June 1984, that company came out with a successful upgrade, dBase III, which was easier to use and had greater storage capacity, speed, and power. For the fiscal year ended January 31, 1985, dBase II provided 30% and dBase III provided 46% of the company’s revenues.

Ashton-Tate’s strategy for the future was to become a one-stop shopping center for corporate applications software. Like Lotus, it had started to explore the market for information services—including possible arrangements with such information suppliers as Dun & Bradstreet, Dow Jones, and McGraw-Hill. The company’s overriding goal was to become the leading software company for corporatewide systems that linked microcomputers into mini and mainframe computer systems. Ashton-Tate’s 45-person salesforce sold through dealers and distributors; unlike Lotus, Ashton-Tate did not call on corporate accounts.

Microsoft **Microsoft**, like Lotus, got its start from a single hit product. By the middle of 1983, the company had earned \$50 million in royalties from its MS/DOS operating system (“the software that tells the IBM PC how to think”). By 1986, this operating system had become standard on nearly every IBM PC or compatible computer used in business. Microsoft was also making a push to become the “total micro software company” by expanding into the rapidly growing applications market, and by 1986, it offered a very large range of programs (19) and ranked third in micro software applications revenues, behind Lotus and Ashton-Tate.

Microsoft had a smaller salesforce (45 people) than Lotus, and its efforts were spread over three times as many products—directed primarily at retail accounts instead of corporate users. Because of this and other marketing disadvantages, Microsoft had traditionally been weaker than Lotus in serving the large corporate accounts. On the other hand, the company had channeled all of its applications sales through distributors and dealers; its exclusive use of distributors and dealers (who were annoyed by Lotus’s attempts to sell directly to large corporate accounts) endeared it to the trade.

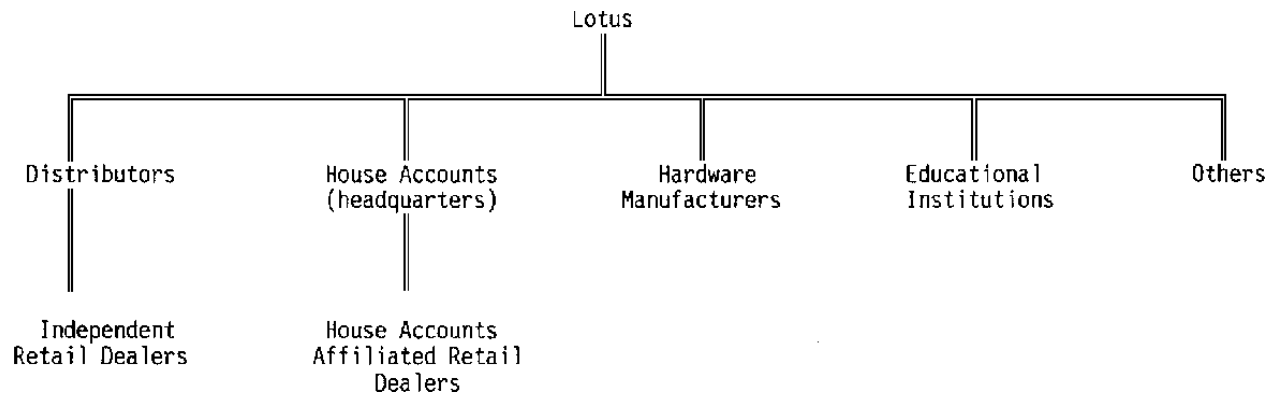
IBM For some time IBM had limited its participation in the micro software business to selling “vendor logo” software (products developed to IBM specifications by third parties). However, in September 1984, IBM struck out on its own with a splashy announcement of 31 programs that either had been developed internally or had been obtained through purchase of marketing rights. For the business market, it offered the Personal Decision Series: five programs centered on a data management system that was positioned to compete with Lotus products and Ashton-Tate’s dBase II. The prices of these five modules ran from \$150 to \$250 per module.

In May 1985, IBM caused a stir in the micro software industry by running a temporary promotion that included free software with the purchase of a PC XT (a special version of the IBM PC). If IBM were to permanently pursue this hardware/software bundling strategy for its entire PC product line, it would radically change the character of the micro software business. IBM’s micro software, however, did not make inroads into many market segments; its products were not technically outstanding, and many industry experts claimed that IBM’s large organization prevented it from effectively transferring its technological and marketing skills to small-ticket items like micro software and from bringing these products to market on a timely basis. All the same, and probably because of similar products in wide use on dedicated IBM office equipment, IBM emerged as a major player in the word processing market segment, with a share of about 20%.

Distribution Channels

Table A presents an outline of the Lotus distribution system. As of 1985, 47% of the company’s sales were made to distributors who then sold to retail dealers authorized by Lotus. Approximately 30 “house accounts” (very large retail dealers) bought directly from Lotus and accounted for an additional 19% of the company’s sales. A large portion (about 70%) of house account sales were too large and medium businesses as opposed to individual customers. The remaining sales were made through hardware manufacturers (15%), educational institutions (11%), and others (8%).

Table A: Lotus Distribution System



Distributors Although the micro software distribution industry was less than seven years old, it had become the primary channel for all micro software products. Distributors received publishers' shrink-wrapped diskettes and documentation by the case, warehoused them, split them into smaller orders, and then delivered them to the retail dealers as needed.

Distributors provided dealers with many benefits. One advantage was price: they bought in such large lots that they could pass quantity discount savings on to dealers (see Exhibit 5 for the volume-purchasing discount structure). Distributors always had products in stock and could usually make shipments to local dealers much faster than could the average publisher, and their broad exposure to many products enabled them to serve as the dealers' objective, one-stop source of technical advice. Many distributors furnished retailers with catalogs and product guides that described various packages and the differences among them. Selling on credit, distributors were often a critical source of financing for thinly capitalized dealers; also, they allowed dealers to return slow-moving packages and exchange them for other products.

At one point, Lotus had five distributors: Softsel, Micro D, Softeam, First Software, and Software Distribution Services. Software distributors averaged a gross margin of about 10% on the sale of Lotus products and incurred total selling, handling, and transportation costs of about 5% on sales. The 1985 industry slowdown was interpreted by Lotus management to indicate that Lotus had too many competing distributors; price wars prevented any of them from achieving profitable margins. In April of that year, the company dropped Softeam and Software Distribution Services. These two distributors had sold the smallest volumes, and their weak financial positions had often made them a significant credit risk.

Microsoft used five distributors, and Ashton-Tate used six; both companies used the three distributors that Lotus used. IBM did not use distributors, but instead sold directly to retail dealers through its salesforce.

Dealers Unlike the distributors, who specialized in software, dealers typically carried both hardware and software products. Microsoft ware on the average made up only 7% of dealer revenues, but it was felt that software capabilities often drove the sale of a hardware configuration.

To avoid oversaturating the market, Lotus capped the number of its authorized dealers at 4,000 in 1984. IBM had approximately 3,500 authorized dealers, and Ashton-Tate had 2,000. Microsoft, on

the other hand, did not require dealers to be authorized; the number of Microsoft dealers was estimated to be more than 6,000.

Based on list prices, retail dealers could theoretically make a 35% gross margin on sales. Intense competition for the large accounts, however, had often lowered this to about 8% to 10%, leaving retailers with little or no margin on direct costs, and even losses on total costs, for such accounts (see Table B).

Table B Dealer Costs

Direct Costs:	
Customer service, installation, and training	3-5%
Order processing/invoicing	2-3
Inventory support	2-3
Credit	<u>1-2</u>
Subtotal	8-13%
Allocated Costs:	
Salesperson salary	3-5%
Sales promotion and advertising	3-5
Administrative expenditure	6-7
Subtotal	<u>12-17%</u>
TOTAL	<u>20-30%</u>

One industry analyst divided the dealers into three classes:

First, there are the traditional storefronts, dealing with walk-in business, largely the low-end, price-sensitive sort. These resemble stereo stores in a number of ways, and indeed sometimes were run by people with a stereo-selling background. Second, there are the high-end dealers, often with a number of outside salespeople who call on business accounts; these dealers usually emphasize support and systems integration. Finally, there are the pure discounters, largely mail order but also storefront operations such as the 47th Street Photo.

One Lotus manager estimated that of Lotus's 4,000 retail dealers, approximately 15% were storefronts, 70% were full-service retailers, and the balance (15%) were discounters. In terms of dollars, however, the discount stores accounted for 25% of sales, while the storefronts accounted for only 10% of the company's retail sales.

In August 1984 Lotus targeted 30 of its largest retail dealers (mostly large retail chains, such as Computerland and Sears) to participate in its House Account program. These retailers were offered the opportunity to bypass the distributors and purchase directly from Lotus. Most of these accounts did not actually come on board until five months later when Lotus reduced the distributors' margins by 5% across the board, thereby enabling the House Accounts to buy at a lower price than their distributors (see Exhibit 6 for the volume-purchase discount structure).

Computer manufacturers IBM, DEC, and Wang were authorized to sell Lotus products to their corporate accounts along with their hardware configurations. Lotus sold directly to these manufacturers at 40% off the suggested retail price.

Educational institutions Lotus also sold directly (and offered its greatest discounts—50% off the retail price) to colleges and universities. Its objective was to familiarize the student population with Lotus products in order to develop a loyalty that would endure when the students entered the work force.

Lotus's Salesforce

By January 1986, Lotus had a 90-person national sales organization that consisted of both account representatives (reps) and systems engineers. The 75 account reps handled the traditional sales responsibilities, whereas the 15 systems engineers served as technical consultants to end users and potential buyers. The account reps tended to specialize by channel, either selling to corporate accounts or working with national retailers to develop sales programs. About 50 to 60 account reps called directly on large corporate users. On an average, each direct rep had about 10 to 15 corporate accounts.

When Lotus first started shipping 1-2-3 in 1983, it made sales through both the distributor/dealer channel and directly through its own salesforce. However, as the industry evolved and 1-2-3 gained wider penetration, dealers often found themselves competing with Lotus's salesforce for the high-volume accounts. As a result, in May 1984 Lotus discontinued direct selling through its salesforce, under pressure from its dealers and distributors. Commenting on this decision, a company manager explained:

Clearly, sensitivity to our dealers' requests was a major factor. However, customer-buying behavior was an equally important factor. Corporate America did not purchase micro software centrally. Decisions to use and support personal computers were largely made by individual departments or managers. Order sizes were small and irregular. Frankly, I doubt if direct selling was a viable option at all under those circumstances.

After May 1984, the Lotus salesperson took a potential corporate buyer through the entire sales cycle until the buying decision was reached (at list price). At that point, the customer was given a list of authorized dealers in the area and encouraged to negotiate the best deal for price and support. The buyers, seeking a low price in return for a large purchase order, typically solicited bids from several dealers. This arrangement became an industry standard and was considered the best way to ensure maximum penetration of major corporate accounts without cannibalization of the dealers' highest-volume buyers. Because of competitive bidding, dealers did not make high margins on these large accounts, but they used this volume to achieve higher discount levels with Lotus.

Customer Buying Behavior

Financial spreadsheet packages were usually purchased for business use. The market was divided by type of business into two major segments: large corporate users and medium and small business users. The large corporations (loosely referred to as the Fortune 2000) accounted for approximately one-half of the Lotus spreadsheets in use. The buying process within this segment, however, varied significantly and continued to change. Financial spreadsheet packages were initially purchased by

individual employees or departments within a corporation and charged as expense items. Eventually, as the corporation became aware of its significant microcomputer needs and expenditures, someone (often a data processing manager) was given responsibility for consolidating microcomputer purchases in an attempt to ensure compatibility and to gain discounts from high-volume purchase arrangements. Consequently, the purchase of microcomputer capabilities was evolving from an individual expense item decision to a corporate capital budget proposal that had to be sold to various levels of decision makers. In other related industries such as personal computers, similar buying patterns were generally better served by a manufacturer's direct salesforce than by a distributor organization. In addition, since buyers received both purchase and usage guidance from their data processing departments, they were not completely dependent on the dealers' services. This reduced dependence usually meant that these customers aggressively shopped around for low prices, which often took them directly to manufacturers in search of a price deal for a committed large quantity.

A related buying trend was further increasing pressure on micro software companies to sell directly. While divisions or even departments of large corporations bought individually in the past, more recently there was an increased sensitivity toward standardization and aggregation of software purchases. This not only helped administrative uniformity, but also achieved purchasing efficiencies. Generally called National Accounts, these large corporations bought centrally but requested delivery and service at various locations. Lotus's managers were aware of the trend, but were helpless for the time being as the company's distribution logistics were not geared to shipping small lots of a large order efficiently to several locations. Lotus's warehouse staff preferred to dispatch in pallet loads of 500 units, whereas dealers could affect dispatches in case loads (20 units) or even less. As a result, Lotus's retail dealers were allowed to accept orders for multi-location dispatches regardless of where the deal was originally negotiated. The only requirement was that the sale be negotiated face-to-face and not by mail order. Thus the company's Boston dealer, for instance, could book orders at the Boston headquarters of a large corporation for delivery anywhere in the United States.

The medium/small business segment and individual users that accounted for the other half of Lotus spreadsheet sales were expected to be the source of most of the market's growth over the next five to ten years. One microcomputer hardware maker estimated that there were 5 million to 7 million medium and small businesses in the United States (and a similar number of individuals) that could use microcomputers to improve job productivity. Without the aid of in-house expertise, this segment was much more dependent on the dealer's guidance. Consequently, these customers were more dealer-loyal and less price-sensitive; their decreased sensitivity was further aided by the fact that the software cost was usually overshadowed by an accompanying \$2,000-\$12,000 hardware purchase.

The Decision

John Shagoury returned to his desk to grapple with the "direct versus distributor" decision. As he leaned back in his leather chair, his thoughts bounced back and forth over the pros and cons of the issue. There was absolutely no doubt in Shagoury's mind that customer buying behavior demanded a direct selling relationship between Lotus and the company's larger corporate accounts. Shagoury was aware of dealer limitations in servicing such accounts.

The problem with most of the dealers is that if they do call on a large corporate account, they typically only get to the purchasing manager, and their sales effort is diluted across several hardware and

software products.

Now that microcomputer purchase decisions are being put into the capital budgeting process, the sales effort has to go way beyond the purchasing manager. We also have to sell aggressively to the information managers and actual users within the company. If the company sold direct, in spite of 1-2-3 street prices, which were as low as \$360 in many cases, it would be able to capture an additional \$60 in margin, because its current average selling price to distributors and house accounts was only \$300. Shagoury estimated that the fully loaded cost (including expenses) of a salesperson currently averaged about \$150,000 per year. Lotus's sales managers had often told him that, as a rule of thumb, a salesperson had to invest an average of 20 hours on a corporate account for every 100 programs sold. In practice, however, it required double that time because a salesperson usually spent 50% of his/her time traveling. Shagoury wondered about the margin implications of the two approaches.

Regardless of the numbers, a direct selling approach could have significant potential side benefits for the company. The challenge of direct selling responsibility combined with an appropriate commission plan could possibly provide its salesforce the right motivation to consolidate the company's relationship aggressively with its large accounts.

On the downside, a return to direct selling would make Lotus the only major micro software publisher to compete with its dealers. The company did not want to upset its distributors and dealers and forfeit this primary channel to a competitor like Microsoft. The channel would be critical to Lotus's future; the company's planned engineering and scientific products would be sold to a fragmented and unknown market that could only be served effectively through a widespread network of local dealers. The medium and small business users who represented nearly half of Lotus's current revenues would also continue to be dependent on local service. Shagoury valued the dealer's marketing role:

The problem is not so much getting dealer shelf space; our market presence will get that. The problem is getting dealer "mind space." We want the dealers to invest the time in getting to know our products and us so they will sell them over products they do not feel so good about them.

He also felt that it would be impossible for Lotus's small salesforce to provide direct service to all of the large corporate accounts:

There is no way that our 90-person salesforce can serve all of the Fortune 2000. We can probably do 500 very well and maybe 1,000 adequately. But what can we do for a corporation like Gillette, which is too sophisticated to buy from a retail dealer, yet not big enough to be serviced by a Lotus salesperson? We run the risk of offending them and losing their business.

As John Shagoury sat tugging at his beard, one of Mitch Kapor's favorite Zen quotes was running through his mind: "When standing, stand. When sitting, sit. But above all, don't wobble."

In an industry that had often extracted a fatal price for strategic errors, Shagoury knew that Lotus had to announce its decision soon. Procrastination—just as much as a poor decision—could cost Lotus its market leadership.

Exhibit 1: Channel Choice: Direct versus Distribution, Consolidated Operations Statements, through December 31 (\$ in thousands, except per-share data)

	1983	1984	1985
Net sales	\$53,007	\$156,978	\$225,526
<i>Costs and Expenses:</i>			
Cost of sales	6,798	24,459	42,893
Research and development	2,201	14,752	21,192
Sales and marketing	12,086	43,139	73,046
General and administrative	<u>5,923</u>	<u>15,941</u>	<u>27,464</u>
Total operating expenses	\$27,008	\$98,291	\$164,595
Income from operations	25,999	58,687	60,931
Interest income	944	3,826	3,932
Other income	<u>489</u>	<u>3,025</u>	<u>2,540</u>
Total income	\$27,432	\$65,538	\$67,403
Tax provisions	13,715	29,492	29,253
Income before extraordinary item	13,717	36,046	38,150
Extraordinary item: utilization of net operating loss carryforward	<u>600</u>	—	—
Net income	\$14,317	\$36,046	\$38,150
<i>Net Income Per Share:</i>			
Income before extraordinary item	0.98	2.24	2.31
Extraordinary item	<u>0.04</u>	—	—
Net income per share	\$ 1.02	\$ 2.24	\$ 2.31

INTRODUCING 1-2-3.TM
IT HELPS TAKE
THE INSECURITY OUT
OF USING A
PERSONAL COMPUTER.



Exhibit 2 (continued)

It's a fact. Ninety percent of the business executives in this country suffer anxiety, insecurity and sweaty palms at the mere thought of using a personal computer.

Even though they know a personal computer can increase their productivity.

Enter a remarkable new software program that makes a personal computer so easy to run that we've named it 1-2-3. All those horror stories you've heard about how long it takes to learn to use a computer, how the commands are all in code, etc., you can now safely forget.

With 1-2-3, you can be using a personal computer in a surprisingly short time. Even if you've never been near one before. 1-2-3 instructs you right on the computer's screen in a friendly, helpful way, so you learn as you go along. Everything is in English, not code, so there's no new language to learn.

And there's a special HELP key you can press to put special instructions on the screen if you can't remember what to do next.

But for all its comforting ease of use, 1-2-3 is one of the most powerful programs available for the personal computer. It combines spreadsheet, information management and graphics all in one. It can look at more information in more different ways and do it faster than anything else you can buy. As a result, your productivity increases dramatically.

So there it is. Powerful. Easy to learn and use. Doesn't that sound like the perfect answer for you?

So put down your blankie and pick up the phone and call us at 1-800-343-5414. We'll give you the name of the dealer nearest you, who will give you a complete demonstration.

Once you see 1-2-3 in action you won't have a worry in the world. Except what to worry about next.

*1-2-3 currently operates on the IBM and COMPAQ personal computers.
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Source: Company material*



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Exhibit 3 Channel Choice: Direct versus Distribution, Symphony: TV Advertising

Lotus "Talk of the PC World" :30 sec.

Lotus' exciting new commercials will be seen on major television networks throughout the year.



Source: Company materials.

Exhibit 4: Channel Choice: Direct versus Distribution, Projected Sales by Product (\$ millions)

	1986	1987
1-2-3	\$160	\$188
Symphony	41	44
Upgrades and add-ins	33	43
Jazz	8	8
Word processing	-	14
Business products (new)	8	22
Engineering #1 (Extended 1-2-3)	8	10
Engineering #2 (Word Processor)	3	10
Signal receivers	2	2
Signal subscribers	6	14
Lotus magazine	8	9
Total revenue	\$277	364

Sources: *Software Access International* and Paine Webber estimates

Exhibit 5: Channel Choice: Direct versus Distribution, Distributors Volume-Purchasing Terms

Annual Units Purchased^a	Discount Off Retail List (%) Price^b
50,000 and below	36%
50,001 to 100,000	37
100,001 to 150,000	38
150,001 to 200,000	39
200,001 and over	40

^aA unit means one 1-2-3, Symphony, or Jazz program. Other Lotus programs, companion products, or upgrades did not count toward discount volumes, but were purchased at the same discount levels achieved through unit purchases.

^bThese discount levels became effective September 1985. Previously, they were each 5% higher.

Exhibit 6: Channel Choice: Direct versus Distribution, House Accounts Volume-Purchasing Terms

Annual Units Purchased	Discount off Retail List (%) Price
2,000 to 12,000 ^a	37%
12,001 to 20,000	38
20,001 to 30,000	39
30,001 to 40,000	40
40,001 and over	41

^aAll house accounts had to commit to a minimum of 2,000 units. Since a majority of such accounts was large retail chains, there never was a problem of getting this commitment.