Negotiating Distribution Agreements

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by Matt Miller

Putting together an international distribution agreement can be a confounding experience. You find yourself dealing with a language and/or culture you might not understand, people who live many time zones away (who are sleeping when you are working), and who view the world on a different scale. But when it comes down to principle, I've found that creating a successful international agreement isn't much different from constructing any other good business arrangement; the degree of success depends heavily on understanding what you want to get from the agreement before you negotiate it.

KNOW THYSELF

Your Number 1 priority when entering a negotiation should be knowing exactly what you want. You can be sure your distributors—your partners—will definitely know what they want. Even though this may be one of your first experiences in the international market, it is likely to be your partners' 20th. If your goals are ill-defined or in any way vague, you will probably end up with a lopsided agreement that puts you at a disadvantage. So you should determine exactly what you want before negotiating the agreement.

It takes extensive homework and forethought, planning and preparation. To help you think through the many questions you must answer, here are several key things to consider when doing your homework: On what terms will you do business with your partners? What stipulations are needed to take best advantage of your market? What defines territory and ownership? How will you handle the potential dissolution of the arrangement?
What are your marketing and sales goals?

STRUCTURING THE BUSINESS RELATIONSHIP

One of the most important parts of the contract is the framework of the business relationship with your partners, the nitty-gritty of how you will do business together:

payment terms, minimum order quantities, shipping and receiving, stock rotation, pricing, contract term, termination causes, how to handle defective products and warranties, and so forth.

A major consideration is how your partners will pay you. For example, will you use a standby letter of credit for the first year (in which the distributor secures a line of credit from a bank and the bank, in essence, guarantees it), or will your terms be net 30 days? When starting business with a new, untried partner, it's a good idea to protect yourself with the most specific and appropriate payment terms. Then, as the relationship develops—and as the market grows and your partners prove they are in the game for the long haul—you can expand the bounds of the agreement. At that point, you can be more flexible with such things as better terms, more credit, and the like.

In my book, death and taxes aren't the only unavoidables in life. So are freight- and postal-rate increases. Depending on the location of your manufacturing and warehouse facilities, shipping your product will most likely become more expensive. So one important initial consideration is making sure that both you and your partners have the same realistic understanding of how much it will cost to ship your product to its destination; you should agree on a basic minimum order quantity that meets both your needs.

And when you're doing business with partners who are many, many miles away, having a sound policy for handling defective products is critical. At Caere we have established a parts list for our hardware products and require that the distributor stock the components that have the highest probability of failure. If a customer has a problem, the distributor can replace the component and return the defective one to Caere. Then we rebate the partners by deducting the value of the returned part from what they owe us, since they have already paid for it. (This applies only to products that are under warranty.)

You must also clearly understand how you will ship and receive, whether you need an authorization for returned products, how you will rotate stock and protect prices, how long the agreement will last, and the 2 circumstances under which it can be dissolved.

Although it's always best to enter agreements with an optimistic attitude, we all recognize that even the best-laid plans can go awry. To prepare for that, you must have a clear vision of who owns the stock, the brand franchise, the reputation in that market, and

so forth. Being clear from the start will make a potentially unfortunate and disagreeable situation easier to manage.

TAKING BEST ADVANTAGE OF THE MARKET

Knowing what you want up front is also particularly important in making the many marketing decisions that will be governed by the agreement. For starters, it is crucial that you clarify whether you want an exclusive or a nonexclusive agreement. Both types of arrangements have their advantages and disadvantages; what you choose depends on your marketing objectives, your available resources, and your partner(s).

Exclusive agreements can lead your distributor to better focus on and give more attention to your product. This is especially important for developers who have limited resources and/or are entering a market with little or no presence. In such a case, you must depend on your distributor for extensive marketing and sales support, and you should structure your agreement accordingly. Granted, you may not get the same breadth of sales coverage that you would by having several partners sell your products, but instead you get a much more focused, concentrated sales effort.

In areas where you have little presence, nonexclusive agreements may also put you in a situation where you're expected to supply marketing clout and resources. If you have multiple sellers competing for the same customer, your partners will want you to invest a lot of money and time in that market—something you may be ill-prepared to do. No matter what the nature of the relationship, you should be crystal clear about the bounds of the territory you're giving your partner(s).

Another consideration: In exclusive agreements, your partner will probably ask for a bigger profit margin, but considering that the distributor will be doing a lot of the marketing and will incur high front-end costs to develop the market, agreeing to a higher margin may make sense. In the long run, both companies will benefit from it, if the agreement is carefully planned and executed.

STAYING OUT OF THE GRAY

No matter what kind of agreement you choose, you should carefully contemplate selling products to your partners at a better discount than you do to a U.S. company that may also end up selling your product in your partners' country. Defining an appropriate discount structure is one way to help protect yourself from "gray" marketing (unauthorized reselling) and also provides your partners with a good sales incentive (after all, if another retailer is marketing your product heavily in that same territory at a competitive price, there's less incentive for your partners). So, giving your international resellers a better pricing structure via the contract will not only help protect your partners' market but will also encourage them to more effectively and fully develop that channel. That way, your partners will be less likely to do all the up-front work with a customer and then lose that sale to another company that may do no post-sale support.

WHO OWNS WHAT?

When you localize a product, who owns what? The answer to this complex question has some long-term implications if you're trying to establish a brand franchise in a market—that is, a business that will "belong to you." When it comes to republishing, you must decide who does the translation; if your partners do the translation, who owns it? Who will print (and own) the manuals and duplicate the software? If your republisher has done most of the work in the market, it's going to be very difficult to establish your own franchise if you later decide to do that.

At Caere, our partners did the translating at first; we did the manufacturing, maintained an inventory, and kept ownership of the product and its intellectual property. But now we do a lot of the translation ourselves; when we allowed the distributors to do it, they did so on their own timetables, which often were inconsistent with our plans to release all localized versions of a product at the same time. Whichever route you choose, the best thing is to spell it out from the start.

SETTING MARKETING EXPECTATIONS

Sometimes my company has different marketing and sales goals than some partners do. In such cases, they think they're doing a fantastic job and are pleased and proud of their accomplishment, while I have the opposite reaction: "This isn't so good. I want a lot more." Being very clear about your marketing expectations puts you and your partners in a better position to succeed. I firmly believe that you must develop a comprehensive marketing plan before you make your partners buy a lot of your product. Make sure that they're committed to marketing the product, and attach the marketing plan to your contract as an exhibit. You'll all be measuring success with the same yardstick; together, you'll spot and solve potential problems, and you'll all be pleased with the results.

Set realistic goals. If you don't, you probably won't reach them and everyone will be dissatisfied. And if you do, I suggest putting a plan in place to increase satisfaction by rewarding exceptional performance. At Caere we're developing an incentive plan for our distributors. We're offering an extra discount when a distributor achieves a designated sales rate, or we put money into a market development fund. For example, if a sales goal in a market is $2 million in a certain year, we set a goal for each quarter based on that amount (taking unavoidable seasonality into account). If our partners reach the goal during a given quarter, we put a designated percentage of the sales into a market development fund that helps subsidize their marketing efforts. With this kind of incentive, we feel we'll get a lot more effort from our partners.

WHO PAYS?

Another question: Will you or your partners pay for the marketing, or will you all put money into the kitty? Keep in mind that when you co-fund activities (such as advertising, data sheet production, and so forth), you lose a degree of creative control. If your partners pay for and make some of the decisions about advertising, data sheets, and so on, they may have to increase the price of your product in that market to offset their marketing costs. As a result, your product may be overpriced in that market. However, once a market has been established and you've achieved your sales-rate goals, the price will probably decrease and everyone will win.

I've found that it's helpful to specify in the contract that you will have a dedicated product manager at the distributor site who will look after your product as you would. That person will be your advocate in that country and will give all the presentations to

corporate accounts and dealers. Even if your partners own the rights to your product, having an advocate on-site will probably increase your mindshare, because your partners have to put someone on their payroll whose presence is justified by the sale of your goods.

KEEPING IT ALIVE

Many people seem to view a contract as something you sign, throw into a drawer, and never look at again. This can be a dangerous perspective in a business environment where flux is the norm. Viewing your contract as a staid piece of paper can be counterproductive and can lull you into a similar frame of mind about your business arrangement with your partners. A good contract is best viewed as a living, breathing guideline to your relationship with another company. If you pull it out and examine it from time to time, it can help pinpoint whether you're still steering in the right direction. If necessary, you and your partners can make course corrections as often as needed (rather than just once a year) to keep you more firmly on track. Don't wait a whole year to find that you're off track; if you wait too long, it'll be harder (or impossible) to correct problems.

A few final words about keeping your agreement alive, well, and working in your best interest: Don't ever stop doing your homework. Review the contract regularly (say, quarterly), make trips to your partners' countries as often as possible, and sit down together to determine if all the proper marketing is being done and that the sales levels are as expected. You and your partners will be happier in the long run, and the process of doing international business will be more manageable and satisfying.

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