Vending Times

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DIRECT OR NOT DIRECT? THAT IS THE QUESTION!

CRANKIN' WITH FRANK - Frank Seninsky

Shakespeare asked the immortal question, “To be or not to be?” -- and today a lot of manufacturers in the amusement industry are asking, “Shall we go direct or not?” -- which many factory executives believe amounts to the same question. They think their survival may hinge on their decisions.

In recent years we have been hearing more and more allegations about jukebox or pool table manufacturers that, it’s said, are quietly selling direct to locations. In some cases, we hear about videogame or redemption game manufacturers that are selling directly to operators, as well as to locations.

The industry is abuzz with talk about Benchmark’s announcement that it is selling direct to operators in its home state of Florida. That makes now a good time to examine the past, present and future of distribution and direct sales or leasing terms of manufacturers.

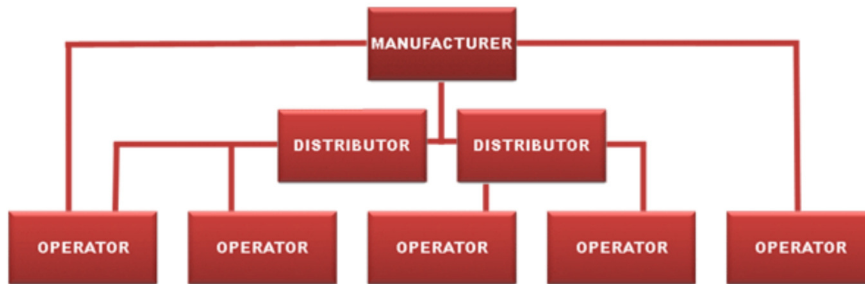
One important caveat: I have no inside knowledge about the strategic plans of any companies in this industry apart from my own. What I write here is either common knowledge or simply my own speculation with logical outcomes.

No matter how you slice it, it seems direct sales are increasing and likely to continue to do so for the near term. We’re in a time of confusion and controversy. Even the term “going direct” is controversial and unpopular, which is why euphemisms abound such as “national accounts” and “revenue-sharing programs.” Of course, these alternative phrases tend to make the picture even more confusing.

The sector of the industry that is most directly pressured by going direct is the distributor. This should not be surprising, if you understand the history of the industry. It’s kind of a “last hired, first fired” effect. After all, operators and manufacturers got started in the 1890s so they had already strongly established their roles for 30 years or more by the time the distribution tier was added and became the third layer of a three-tiered amusement vending industry.

The distributor network as we know it today came about in the 1930s when Wurlitzer established dealerships for local sales, service and financing. Back then local dealers could even recruit a new operator, and often did, by “carrying” that operator on the distributor’s books for a while, allowing him to pay for brand-new jukeboxes or pinball machines out of cashbox earnings.

Thus, the famous three-tiered chain structure was born: manufacturer, distributor, and operator. For the next 50 years, this three-tiered structure worked beautifully. The beginning of the squeeze on distributors may have come in the 1990s when new entrants to the FEC segment placed big orders at discounted prices and became national accounts.



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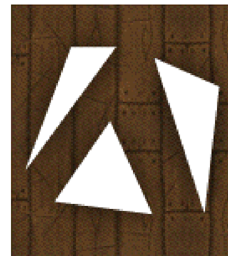
Meanwhile, 800 numbers began to erode territories as distributors began selling nationwide -- first a handful, then everybody. Finally, the Internet took all the mystery out of prices and commissions, sparking fierce price wars for the operator's and FEC's business.

By the late 1990s some manufacturers (Sega was a prominent example) officially reduced the number of dealers representing them to just a handful, establishing national accounts so they could sell directly to theme parks, operators serving movie theater accounts and FEC chains, among large buyers.

Perhaps the most publicized instance of a manufacturer going direct to operators occurred in the mid-2000s after Incredible Technologies had a falling-out with Betson Enterprises for 18 months. (They eventually reconciled, which -- as we'll see -- may prove a hopeful sign of the future for today's distributors.)

In the 1990s, distributors' exclusive value as Johnny-on-the-spot local parts suppliers began eroding quickly thanks to UPS, Federal Express and computerization of machines. Suddenly it seemed all that operators needed to fix a broken machine or upgrade an old unit were PCBs, chips, CD-ROMs or DVDs.

In the past decade, some distributors began losing the ability to offer financing to operators, as all business credit tightened up as the world entered the latest recession. Today, obtaining financing for startups remains difficult.



DISTRIBUTOR PROFITABILITY

A decade ago it was reported that a typical distributor needed a profit margin of 15% to 16% of gross sales in order to break even. With today's inflation, it may be slightly higher. Yet all of the above-described factors created severe "margin compression" and became a serious threat to a dealer's viability. From 2000 to 2011, about a dozen distributors shut their doors. The rest cut back sharply on staff -- at least 40%, in most cases, and quite often more than 50%.

Now we come to Benchmark's decision to go direct in Florida. Again, while I have no inside knowledge of what any manufacturer or distributor is thinking, I do hear the industry scuttlebutt like everyone else. So here is the logical story behind the Benchmark policy as I understand it in my own mind.

For many years, a leading distributor in the Florida and southeastern U.S. market decided not to sell Benchmark product unless a customer specifically requested it. I do not know what started this situation (and it is not important for the sake of this article).

This meant many FECs in the Sunshine State were poorly served because at least 25% of the top

earners (on my recommended “workhorse” list of top-earning games for the past several years) were and are Benchmark titles. Operators, of course, know what games to install and if one distributor won’t sell the top equipment, they’ll find a way to get these games somewhere else.

But Florida is a special case. This vibrant tourist economy supports the opening of many new FECs and other attractions each year. Many of them don’t work with operators; they buy from distributors. In such cases, these Florida venues did not get Benchmark games when, in my opinion, they should have.

As I understand it, Benchmark’s decision to go direct was simply a logical response to this situation. Consequently, Benchmark is now selling a great deal more equipment in Florida than it used to. What’s more, FECs in the state (and Florida operators who now have full access to Benchmark games) are likely to see increases in their revenues.

Benchmark’s success going direct in Florida seems almost certain to accelerate the trend toward direct sales by more of the larger and most successful manufacturers. Of course, if a manufacturer is going to sell direct, it must provide service, after-sales support and some financing (let’s call it “deferred terms”) -- all the things that a traditional distributor used to provide.

What does the future hold in this ongoing restructuring of the industry? To me it seems logical and almost inevitable that we are about to go through a new round of a familiar cycle where operators, distributors and manufacturers struggle and compete to defend and redefine their roles -- but may very well end up, a couple of years from now, in the same place where they started.

Here’s how it may happen. First, manufacturers are frustrated that so many operators are not buying new equipment. They don’t feel they can count on distribution to make sales happen. They are faced with the choice: to go direct or not?

I would not be surprised if some frustrated manufacturers decide to go to the biggest cities and identify the top locations that don’t have the latest and greatest games (either because operators refuse to buy them or for any other reason). These manufacturers could go to the location owner, offer a revenue-sharing deal (or a lease deal), install equipment and demonstrate a significant boost to the total location cashbox.

To start, manufacturers would probably offer locations the usual 50-50 split, but negotiations would be free to go in either direction in a capitalistic market. This strategy could only work with the top-earning equipment.

We all can predict what happens next. Other locations in that same city see the results, turn to their operators and demand the same games. If the operator refuses to buy, the location calls the manufacturer and asks for the same revenue-sharing deal that their competitor across town received.

The manufacturer logically replies: “We only have a limited budget to invest in revenue-sharing deals, especially at 50-50.” The location counters: “I simply must have those games. What if we split 60-40 in your favor? Or 70-30?” Eventually, the location gets the deal.

Now the pressure is really on the local operators. They may continue to boycott at first. Operators will complain, “You are competing with your old customers.” There could be a couple of years of bad feelings between operators and manufacturers as a result. If so, it would not be the first time -- nor the last.

But money talks and operators can only hold out so long. Eventually the operator is forced to start buying again -- grudgingly. He approaches a manufacturer and says, “If I buy 20 games for my route, will you lay off my locations?”

The manufacturer happily agrees. The operator then approaches his locations and says, “I can’t afford to buy these games outright; I need minimums and a more favorable split.” Yes, it’s capitalism at work again.

If operators start buying enough equipment, there is no need for the manufacturer to go into further debt with extensive revenue sharing. This selective targeting would be enough to jump start the industry for the near future. And all would be well once again in operator-manufacturer land.

The irony is that, in many cases, manufacturers might actually be doing operators a favor by pushing them to buy new equipment and convincing locations to accept splits that are better for the equipment provider.

This pattern occurred at least once, in my memory, in the 1980s, and perhaps again in a later cycle, with a certain brand of countertop videogames. But today the likeliest sector for this selective

revenue-sharing policy is redemption and prize-vending games, which generally drive higher ROI than the more expensive videogames.

An obvious candidate for this approach is Bay-Tek's Big Bass Wheel. Last time I looked, only a few thousand units had been sold worldwide. But since this game frequently accounts for 15% of revenues for a total gameroom, thousands of underserved locations could use one or two units. (Especially since it can be resold three years later for just a few thousand dollars less than what it cost new.)

In the long run, it's also possible this scenario might even be good for distributors. Once manufacturers "seed" the top locations with great new equipment, location demand will exceed supply. The B and C locations will also want in on the action. Distributors could help get that equipment to the operators, who in turn could supply these locations.

SURVIVAL STRATEGY

If distributors as a class are going to return to strong financial health, they know they must be more than order takers. What role can distributors play in the 21st century amusement industry?

Some distributors still provide financing or help operators qualify for loans at the local bank. Some provide excellent monthly leasing terms to operators. Others continue to scout the market and provide terrific leads to their operator customers; and these distributors don't compete with their operator customers by running a route in the same selling territory. A few still offer outstanding regional service centers, too.

For equipment distributors, who perform these and other added-value functions, there will always be a viable place in the industry structure. But as the amusement services industry continues to evolve, and its competition grows, a viable distribution business will always require hard work and innovation. For those few distributors there will be a happy "distributor land" that can coexist and play a major role working as the middle ground between operators and manufacturers.

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