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It's no secret that big box retailers have been driving the growth of the aftermarket in recent years, and that companies selling into this channel have experienced rapid growth in terms of both volume and revenue. Yet, behind the scenes this channel strategy has inherent risks that can irreparably damage an aftermarket manufacturer's bottom line. What are the pros and cons of doing business with the big box retailers?

by Joy James • The Joy James Group

At nearly $5 billion in North American retail sales and $13 billion worldwide, the printer cartridge aftermarket is often characterized as a large and growing industry that has been enjoying double-digit growth rates for the past 10 years. Yet a deeper look at the industry's trends shows that the aftermarket's growth is concentrated within certain segments and channels, and those companies that serve as vendors to the big box retail channel have been growing at a much faster rate compared to the industry as a whole.

Over the past five years big box retailers and, more specifically, office superstores such as Staples, Office Depot and OfficeMax have been driving the growth of the aftermarket by aggressively promoting their store-branded products. Through a combination of improved quality, consistent availability, and branding efforts, office retailers have created a value proposition that resonates with end users and has fueled aftermarket toner and ink sales.

Clearly, aftermarket vendors to large retailers have benefited greatly in terms of unit volume and revenue growth. However, being a vendor to the big box retail channel has its own set of unique challenges that includes navigating complex relationships with multibillion-dollar channel partners who are reliant on their OEM partners to survive.

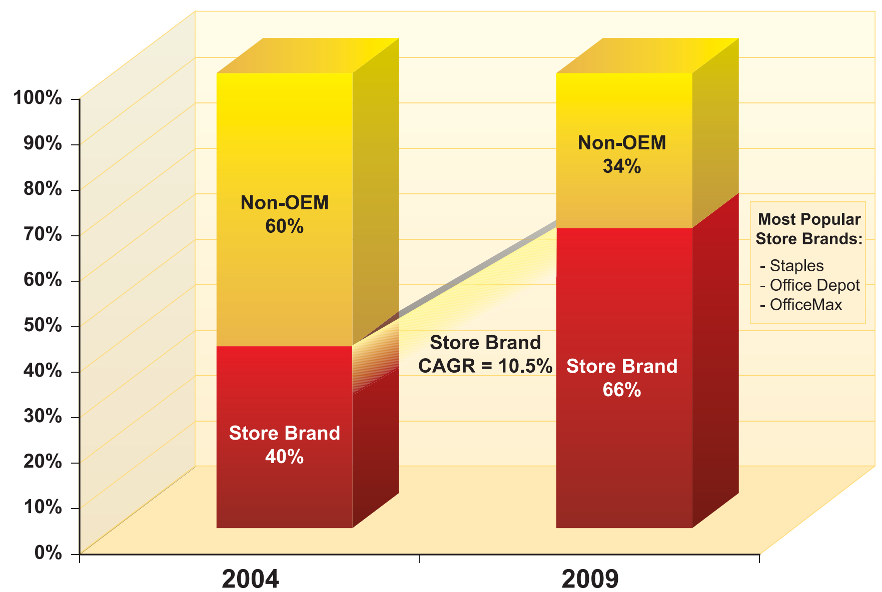
This article explores the topsy-turvy world of being a vendor to the big box retailer, and includes excerpts from recent interviews with current and past aftermarket vendors to "The Big Three" (Office Depot, Staples and OfficeMax), as well as comments from industry analysts, an OEM, and a major office superstore. It will explore both the pros and cons associated with serving this channel, and highlight the three most significant risks to consider when pursuing a big box retail channel strategy.

Big box drives the aftermarket

Although office superstores have been distributing aftermarket products since the early 1990s, it wasn't until 2002 when large office retailers identified remanufactured print cartridges as a key product category and took a heightened focus on building sales. Large profit margins estimated to be 20 points higher than OEM margins encouraged superstores to drive the aftermarket category growth, and the products were given premium shelf space and Web site placement.

As Figure 1 illustrates, end users have switched toward purchasing a store-branded product; store brands create a known entity that overcomes the trust and quality concerns in the consumer's mind.

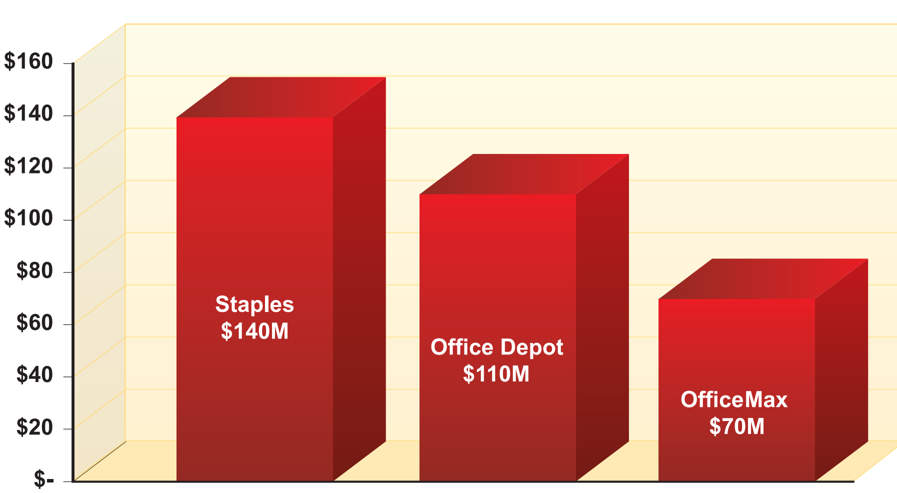
Figure 1: Non-OEM Inkjet Cartridge Purchases 2004-2009



Source: InfoTrends Store Brand Imaging Supplies Study, 2006

The most popular store brands are currently Staples, Office Depot and OfficeMax, and as Figure 2 shows, it seems that Staples has done the best job in terms of building its retail store sales at $140 million in revenue and $77 million in profits during 2006 (numbers do not include Staples contract and commercial divisions).

Figure 2: 2006 Office Superstore Retail Revenues Private-Label Toner and Ink North America



Source: Joy James Group Estimates, 2007

Earlier this year Staples announced the decision to discontinue selling its private label HP compatible cartridges in its retail stores and on its Web site. It has been widely rumored that HP is behind that decision, and there have been unsubstantiated rumors that HP has approached other channel partners with a similar proposition that was turned down.

Linda Boykin, divisional merchandising manager for Office Depot, confirmed that, "Office Depot's position has not changed. The customer must always come first." Boykin added that as long as the customer is demanding choice then Office Depot must offer options.

Staples' decision to exit opens an opportunity for other competitors to promote their house brands and win some of the $80 million in profits that Staples is effectively walking away from.

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Want to sell into big box retail?

Selling into big box retail channels has been a very successful strategy for several aftermarket companies including Nukote and Clover Technologies Group, both believed to hold the top two positions in terms of aftermarket printer cartridge revenues in North America.

Clover Technologies President Jim Cerkleski was interviewed back in 2005 (Recharger Magazine, Finding Black Gold Part 2, February 2005) prior to Clover's acquisition of Dataproducts, Throughbred and GRC, and at that time they reported impressive organic growth equal to 114 percent compounded annual growth rate (CAGR) between 1999 and 2004. It is very likely that much of Clover's revenue growth during that time was as a result of big box retail channel partnerships, and that they have since diversified into other channels through their acquisition efforts.

"Big box retailers have absolutely been responsible for much of the aftermarket's growth. They are highly sophisticated, volume-driven customers that have a lot of insight into the marketplace," explains Cerkleski, who added that the greatest payoff for Clover has been the growth rates that have allowed Clover to reinvest in the research and development necessary to remain competitive.

All of this growth does have drawbacks, however, including the fact that big box retailers are multibillion-dollar powerhouses. One industry observer notes that "aftermarket vendors have little to no leverage or negotiating power with the big boxes. They are completely at their mercy, which can become a significant challenge."

Figure 3: Pros and Cons of Selling to Big Box Retailers

Pros
- Volume and scale
- Financial strength
- Forces operational innovation
- Smart, strategic thinkers
- Good access to empty inkjets

Cons
- Unstable profitability, hidden costs, margin squeeze
- High IP exposure
- Easy to develop customer concentration
- Capital intensive
- Demanding customers
- "One-way" contracts, vendors have little leverage

Cerkleski views the pros and cons that are associated with serving big boxes as essentially equal, and made it clear that Clover will continue to do significant business with large retailers in the future.

Figure 3 overviews the main pros and cons that are discussed in this article.

The definitive benefit of doing business with large retailers is the unit volume and scale. For example, it is not unusual for an aftermarket vendor to receive orders for more than 300,000 units at a time and total monthly volume can exceed 1 million units.

Brad Roderick, executive vice president of InkCycle, explains, "(Serving the big box channel) has been a good strategy for InkCycle because the volumes have allowed us to effectively automate and mechanize processes, as well as give us the funding necessary to develop high-volume production machinery." Roderick added that it's a Catch-22 from an operational perspective because most aftermarket companies cannot afford to institute automation without high volumes.

In fact, most large-scale remanufacturers reinvest a majority of their profits back into the company's growth to effectively meet the demands of their big box channel customers. These investments typically enhance operational efficiencies as well as provide the intellectual capital required to sustain the business.

Another benefit is the strong financial condition of most big box retailers, which means that vendor invoices are always paid, and are typically paid in a timely manner. Although there have been some reports that retailers can string out receivables for as long as 110 days, most companies that we spoke with said they are paid within 45 to 60 days. Cash flow is obviously king for any company, but for a vendor to the big box retail channel, cash flow can make or break a company's ability to execute.

Finally, and perhaps most importantly, large retailers have access to large volumes of quality empty cartridges. In late 2005 certain office superstores began offering consumers a $3 coupon for the return of an empty printer cartridge and promoted the program heavily with a national television campaign. The results have paid off, and suppliers to the big box retail channels typically receive back more empty cartridges than required to fulfill production needs.

Proceed with caution: Three main risks

Any company seeking to become a vendor to the big box retail channel must consider the downside of serving this channel, including the three main risks identified below:

▶ **Unstable Profitability.** Although the office superstores make extraordinary margins in the 55-plus percent range, what is a sustainable profit margin for the aftermarket vendor is far less certain and predictable.

▶ **Heightened Legal Exposure.** Large companies that share shelf space with the OEMs in a retail environment are at a heightened legal risk.

▶ **Customer Concentration Risk.** Extraordinary volumes required by some big box retail chains can easily occupy a significant majority of a company's capacity, making them vulnerable should they lose the account for any reason.

Risk No. 1: Unstable profitability

"Everyone wants to get into big box retailers but they don't realize the small margins that you really make," explains Michael Andreottola, president of American Ink Jet, a main supplier to Staples in the 1990s.

Cerkleski of Clover agrees, saying that "You have to be really careful if these can be profitable accounts for you."

▶▶ Words of Wisdom

We asked aftermarket companies experienced in the big box for their advice to anyone considering pursuing a growth strategy via big box retail channels:

"I think it would be very difficult for a sub-$100 million company to handle the investment required for big box retailers. I honestly can't imagine smaller companies trying to enter the space and whether they realize the capital investment required. You need to have strong financial backing to execute."

— Jim Cerkleski, Clover Technologies

"Although it's definitely challenging to diversify when you are getting 200,000 to 500,000 unit orders, you can diversify in product line, customers, or in channels of distribution."

— Brad Roderick, InkCycle

"My advice to anyone considering a big box retail strategy is to consider how the dynamics of the business change with the introduction of one very large client (that could account for anywhere from maybe a quarter to half your volume produced). I'd never say that being a player in the big box arena isn't a good thing and my advice is mainly to do it but know how to play the game with a longer-term view."

— Pat Stead, Environmental Business Products Ltd.

"Be prepared. Like an iceberg, what you see on the surface is only a fraction of what it will ultimately require to effectively manage the business in this channel."

— Jim Daggs, GRC

Although at first blush the gross margins attached to this business appear quite healthy — in the 30-plus percent range — a closer investigation using an activity-based costing method tells a different story. For example, large retailers typically require so-called "off-invoice" or "soft money" programs that can require vendors to pay for a wide variety of activities including annual fees, promotional fees, and volume commitments. Although each retailer approaches these programs differently they can easily represent 20 to 30 points of the invoiced amount.

"Margins can be a bit of a moving target when you dial in the off-invoice programs and the countless requests for 'one-off' contributions throughout the year that may or may not benefit the vendor," explains Pat Stead, owner and managing director of U.K.-based Environmental Business Products and a vendor to the big box channel for more than 14 years. "This is where the danger lurks for the unsuspecting, naive, or inexperienced vendor."

In addition, vendors are subjected to a constant margin squeeze to remain competitive. Roderick of InkCycle explains, "Any company that doesn't continually review their costs and proactively offer cost reductions to their vendor runs a serious risk to their ongoing business."

Cerkleski says that although Clover prefers not to deal with too many back-end programs, there are certainly a ton of costs associated with being a major supplier to the big boxes. "One of the real big hidden costs is the staff that is required internally to manage the programs … it requires a full-time dedicated staff in both our building and in the retailer's corporate office to handle the business," he says. Additional staff in the

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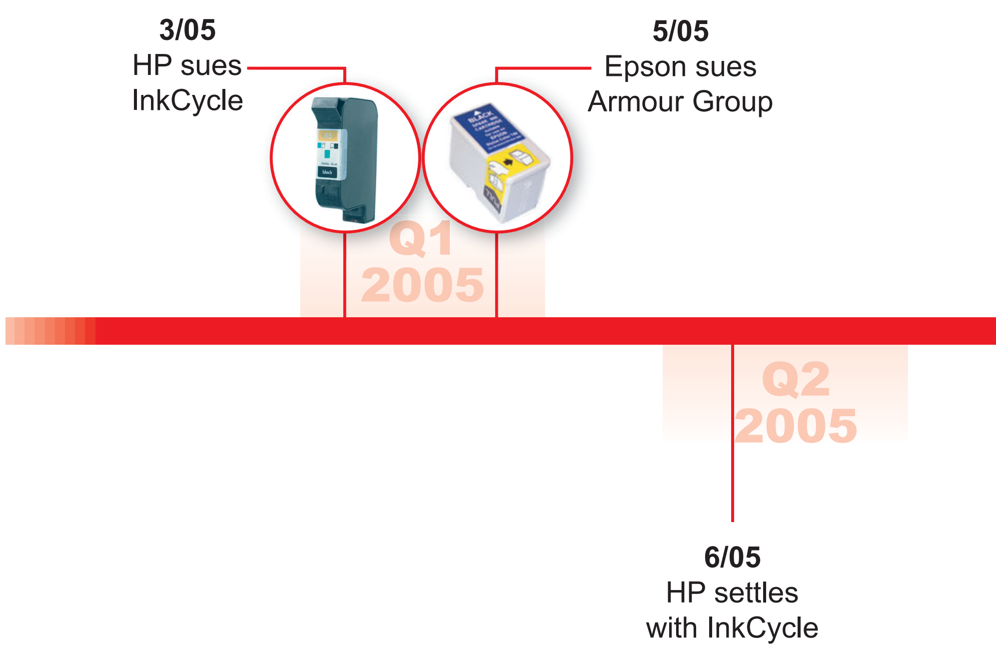
areas of customer care, technical support, sales and marketing is normally required to handle the retailer's extensive demands. "For example," he adds, "if a new (big box) director of marketing is hired and they don't prefer the look of the packaging it suddenly becomes your problem … we've been through thousands of packaging changes."

Other hidden costs can include required third-party audit fees, fines (for a multitude of reasonable and unreasonable violations), and very large legal fees that could exceed seven figures.

Figure 4: Staples IP-Related Timeline



Risk No. 2: Heightened legal exposure

The vast majority of aftermarket vendors to the "Big Three" office superstores have been sued or slapped on the wrist by an OEM over an intellectual property matter at some point.

As Figure 4 shows, within the last two years and within a 14-month period, four North American aftermarket companies that are believed to be vendors to Staples were sued by either HP, Canon, or Epson.

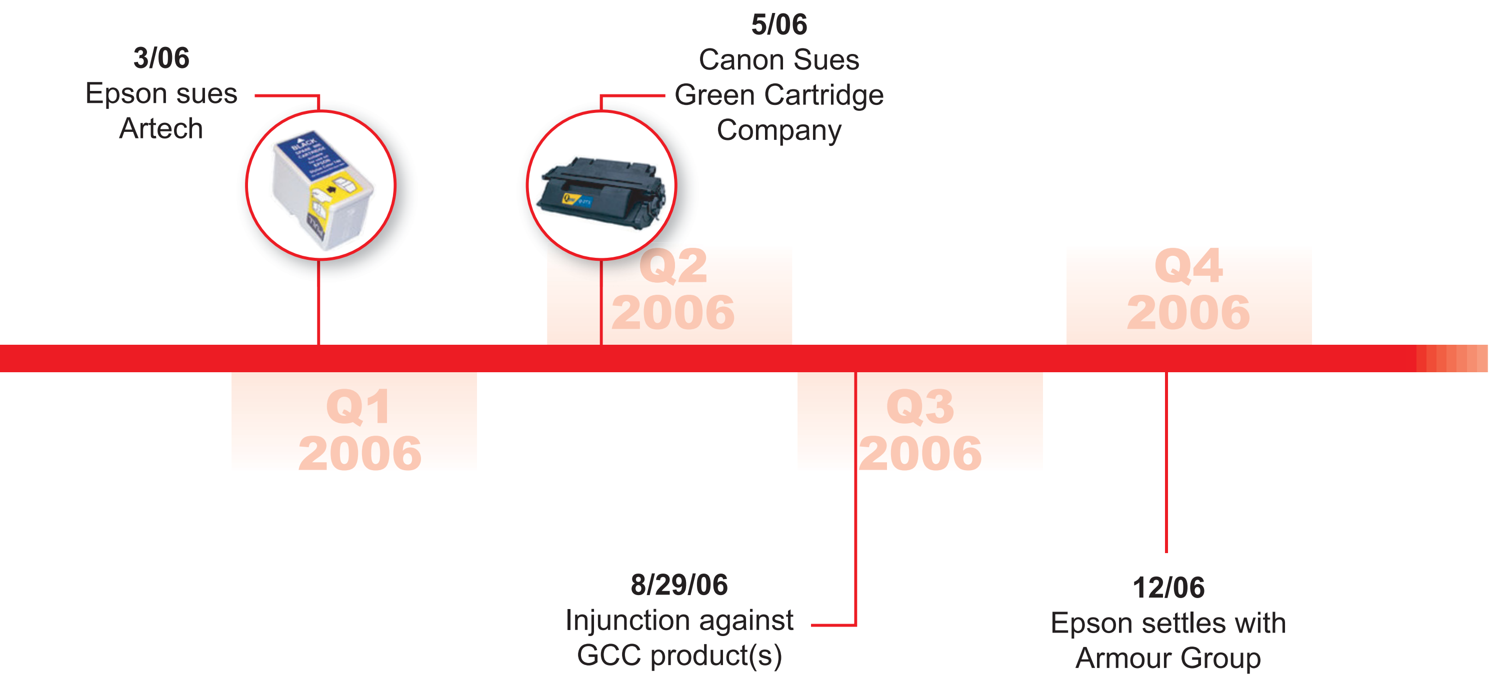
In its March 2005 complaint, HP named InkCycle as Staples' vendor for remanufactured inkjets and sued them for several patent violations related to ink formulations (a settlement was reached within three months). In May 2005 Epson sued Armor Group and later Artech (Armor's German manufacturing subsidiary) and both companies settled, agreeing to cease distributing Epson compatibles in North America. Finally in May 2006, Canon sued Green Cartridge Company (GCC), widely believed to be Staples' supplier for Canon and HP compatible laser products. In this case Canon won a preliminary injunction against GCC on its 100 percent new-build compatible cartridges (not remanufactured). If Staples was indeed put in the precarious position of having sold infringing products, it could have played into its decision to stop selling aftermarket SKUs.

The current industry climate requires remanufacturers to heavily invest in legal due diligence in order to make the retailer comfortable. Retailers typically require freedom-to-operate letters on every product sold as well as a full legal indemnification.

Clover's Cerkleski explains that his company employs a team of individuals who study patents on a full-time basis. "We take IP extremely seriously and we spend millions of dollars a year on it. If you don't spend your time (and money) reviewing it the OEMs will have a field day on the big guys."

In fact, every company we spoke with said that they indemnify their big box customers, which effectively puts their entire company on the line. Perhaps the silver lining for the aftermarket during this litigious period is the shakeout of those companies that are not legitimate and credible in their actions.

Stead of Environmental Business Products makes the point, "I believe the OEMs are fueling a response from our industry that will be positive and comprehensive, and those companies that are willing to play a longer and more strategic game will be the winners … those companies who do not wish to raise their game, their professionalism, their ability to execute and fulfill with products that are IP complaint will ultimately become the casualties." Stead adds that his company has employed considerable



resources to IP-related matters after a reasonably high-profile situation with Epson in 2005.

Risk No. 3: Customer concentration

Perhaps the most overlooked risk in doing business with the big box retailer is the potential for a company to develop a customer concentration issue. Even the largest remanufacturer is considered small to a $10-billion-plus big box retailer. One industry observer noted that the aftermarket industry is "littered with the corpses of some good remanufacturers who have suffered from concentration issues that were not properly managed."

Diversifying a customer base requires hard work, focus and tremendous discipline. During the 1990s Bill Patterson's former company, Golden Imaging (later sold to Turbon Group), provided aftermarket laser cartridges to Office Depot and was acutely aware of the threat to his business. "We knew early on that there was a risk of customer concentration, and we always had a philosophy to maintain a diversified customer base," Patterson said. "At one point we were pretty concentrated with that one account and we worked hard on growing the other segments of our business to minimize the impact of that account if we were to ever lose them." Patterson added that it was easy to get complacent because things were going so well but that they worked diligently and did successfully diversify the business over an 18-month period.

Roderick from InkCycle makes the point that approximately 60 to 80 percent of aftermarket inkjet cartridges are distributed through only five or six retail outlets, which effectively limits a company's ability to be diversified. "If ink is your total offering and you are seeking mass volume, you simply cannot be fully diversified. While our company has a long history of serving and supporting independent dealers in both toner and ink, a big part of our strategy is to more fully exploit our reputation for both ink and toner in the marketplace and attract more independents."

One company's story: American Ink Jet Corp.

"We had a lot of shelf space in there at one time. The Staples account was probably about 30 percent of our business at that time," explains Andreottola of American Ink Jet, a main inkjet and paper vendor to Staples between 1992 and 1997.

Times were mostly good — albeit demanding — during the five-year relationship between American Ink Jet and Staples. The parties would sign an annual agreement each November. Looking back, Andreottola recalls that his attorneys were never entirely comfortable with the contract language but that he signed because "they basically said that I could take it or leave it, and that there were five other companies that wanted the shelf space behind me."

After signing each contract, American purchased roughly $1 million of inventory and custom packaging that was specifically designed for the superstore. "The relatively low margins forced us to buy in bulk to get the price points we needed to remain profitable," Andreottola explains.

The relationship between American Ink Jet and Staples worked well up until 1997 when things unexpectedly changed. "We were basically displaced by Dataproducts/Hitachi who had put up $2 million in cash to acquire our shelf space," Andreottola says. "Four months after signing our fifth annual agreement Staples informed us that we were no longer a vendor and wanted us to take back all our products, which we did. We had to eat more than a half million dollars of inventory, including custom packaging that we could not reuse."

Although Andreottola's attorneys felt there was a chance to sue for breech of contract and possibly receive some compensation for the inventory, he decided against pursuing it and moved on with the business of business.

American Ink Jet has rebuilt and today remains one of the highest-quality ink vendors in the world. However, the experience has had a lasting impact on Andreottola to this day. "It hurt to lose that business and we've never fully recovered. But we survived it."

In terms of the greatest risk in his mind, Andreottola said it was having a one-way contract. He adds, "If you're willing to take a gamble on (doing business with a big box retailer) then go for it but recognize they have no loyalties to anyone other than their shareholders … if there is a better opportunity out there or someone offers them more money for shelf space, they will take it."

Multibillion-dollar balancing act

Rumors that HP paid Staples an eight-figure monetary incentive for exclusive shelf space have added a new risk for aftermarket big box vendors.

Charlie Brewer, managing editor of Hard Copy Supplies Journal, comments, "I think it must be tough supplying a big box retailer — margins are slim, lots of QA, the ability to deliver a lot of product, and a reliance on a partner that may not feel all that beholden given the fierce competition. But there's a lot of upside to such a huge channel partner."

Boykin from Office Depot acknowledged the challenges associated with balancing their vendor partnerships, saying, "The position remains that consumers are asking for options. The balance is continuing to be respectful of the vendor while staying true to what the market is demanding."

Matthew Hahn Jr., director of marketing for supplies at Brother International, weighs in from an OEM perspective. "As much as I would love to have less competition on the shelf, I believe it is the retailer's prerogative to do what's right for the customer," he said. Hahn did clarify that he believes that new products are the best alternative for the consumer but that "remanufactured products that go to market honestly based on differentiated value proposition fit a legitimate market need."

Risk versus reward

In conclusion, big box retailers will continue to fuel the growth of the aftermarket due to a strong consumer demand for a trusted alternative product. The mass exposure that remanufactured products have experienced over the past five years has, to a large extent, legitimized the industry and its products. Consumers have embraced the value proposition associated with a quality, lower-priced printer cartridge and the demand for remanufactured products should continue to grow.

Although at least one big box retailer has scaled back its remanufactured offerings, this can be seen as an opportunity for other large retailers to take market share and profits. For those who can execute there is a tremendous opportunity at hand.

Aftermarket vendors to big box retailers must carefully weigh the risks and rewards associated with serving this channel to determine the best strategy for their company. As the aftermarket continues to grow, change and consolidate we will likely see more turbulent times ahead. Although it may be a bumpy ride, those companies that can successfully execute stand to win big. R

Joy James is the managing principal of Joy James Group, a management consulting firm that specializes in the printer cartridge aftermarket. She has founded, built, and/or grown several category-leading aftermarket companies over the past 12 years, including InkCycle, Environmental Reclamation Services and Dataproducts. James has written nearly 100 articles on the aftermarket, won several industry awards, and is a professional speaker recently appearing on CNBC. James earned a master's degree in business from California State University, suma cum laude, and currently serves as a board member for the Wells Fargo Center for Small Business and Entrepreneurship at California State University Northridge. She can be reached at joy@joyjamesgroup.com.