

October 8, 2006

Cisco Systems, Inc.: Channel Strategies for New Growth Opportunities

Kirthi Kalyanam*

Background

Cisco is a networking company with \$24.8B in annual revenue, \$16B in cash and investments, and 38,413 employees around the world.

Cisco focuses on four market segments: service provider, enterprise, commercial (small and medium business) and consumer (with its Linksys product line). Cisco also focuses on a number of vertical markets: government, retail, financial services, healthcare, manufacturing and telecommunications.

The company's core technologies include routing, switching, software and services. Its advanced technologies include wireless, storage networking, IP telephony, security, the networked home and optical. Cisco offers the industry's broadest product line and holds a market leadership position in virtually every product category.

Keith Goodwin, Senior Vice President, Worldwide Channels

Keith Goodwin is senior vice president of Worldwide Channels for Cisco Systems. More than 90% of all Cisco business is sold through its Channel partners, of which there are 25,000, representing over 200,000 individual people, in approximately 150 countries.

* Kirthi Kalyanam is the J.C. Penney Research Professor, Director of Internet Retailing, and Director of E-Business at the Leavey School of Business, Santa Clara University. This case was prepared for the purposes of classroom discussion only. I am grateful to Paul Mounford and Keith Goodwin for their contributions to the case. It is not meant to imply effective or ineffective handling of a business situation or serve as an endorsement. This case should

Keith is responsible for the development and implementation of one of the most progressive and respected global channel strategies in the IT industry. In this role, he has a significant impact on how the company brings its technology solutions to market.

Channel partners are defined as any company that resells Cisco products and/or services. Examples include VARs (Value-Added Resellers) such as DiData, Distributors such as TechData, DMRs (Direct Marketing Resellers) such as CDW, and Service Providers such as SBC.

Cisco's Channel partners are categorized by their ability to provide expertise, support and value to customers. A series of requirements are set for partners, such as technology specializations, customer satisfaction, etc. By achieving these requirements, Cisco partners earn a "certification." The three primary levels of Cisco certification are Gold, Silver and Premier. The Cisco partner certification is considered one of the most important in the IT industry.

As part of the certification process, Cisco partners must achieve technology specializations, such as IPT Specialized, Wireless Specialized, etc. Cisco was the first company to specialize its partners, a practice that has been adopted by many of the leading IT companies in the industry.

The point of the certifications and specializations is to ensure that customers are receiving the same quality of knowledge, service and support regardless of whether they buy Cisco solutions direct or through partners.

Mr. Goodwin reports to Rick Justice, senior vice president, worldwide field operations. Other senior leaders in Cisco's field organization are:

Carlos Dominguez, SVP, WW Service Provider

Rob Lloyd, SVP, US/Canada

Owen Chan, SVP, Asia-Pacific

Chris Deddicoat, SVP, European Markets

Paul Mountford, SVP, Emerging Markets (Latin America, Middle East and Africa, Russia and Eastern Europe)

Yasuki Kurosawa, VP, Japan

The Case Study:

How Did Cisco Restore Partner Profitability and Confidence in the Midst of the IT Bust?

There have been three key cycles in the Networking segment, the Boom, a period of rapid growth; the Bust, a period of declining growth; and the Build Out, a period of steady, sustained growth. By 2001, the IT "Boom" was over and the "Bust" was in full swing. Cisco's Channel was affected very negatively by the Bust.

Partners' growth was flat and their Cisco margins were in the low single digits. In addition to low margins, pricing was being pre-set by the Cisco sales force. Partners were used to simply fulfill orders and were not enabled to offer strategic value to customers. Cisco had no margin left to offer enterprise-focused partners, no products for SMB partners and no money for service provider partners. Partners quickly became disenchanted with Cisco's Channel program because it was impossible for them to make any money.

Partners were adamant that Cisco either take immediate corrective action, or they would begin to sell Cisco's competitors' products. With so much of Cisco's business dependant on the Channel, losing the partner community to the competition would be detrimental to the company.

Around this same time period, Cisco was realizing 70% gross margin, \$1B in free cash flow per quarter, and 20 percent net income. However, top line growth was flat to declining.

By 2004, the IT "Build Out" period had begun and Cisco had managed to reinvent its Channel program. Cisco is now respected throughout the world as having the number one Channels program in all of IT. Its partners can now realize margins in the high teens and twenties and its direct sales team leverages partners as a strategic asset for growth.

So what happened? What did Cisco do during the bust and pre-build out to turn its partner program around 180 degrees?

The Four Possible Market Reactions to Low Partner Margins and Weakening Success...

There are at least four possible reactions to low partner margins and increasing partner dissatisfaction. Cisco implemented one of the following four. Review each and decided which one you would implement, which one you think Cisco implemented and why.

Market-based Reaction:

- **Summary:** The market-based reaction looks at the influence of sweeping market changes on partner profitability and satisfaction. It is assumed in this scenario that the primary factor in partners' inability to turn profits is the downturn of the market. As the market transitions from the Bust to Build Out stage, companies once again expand their IT budget, albeit not as extensively as in the boom. The market-based reaction thus calls for a shift in Channel strategy that complements the shift in the market and successfully accomplishes the goals of the corporation.
- **Cisco Steps:** In this model, Cisco was well aware of the three stages of the market, and thus evolved its partner program and strategy to diminish the impact of the Bust while preparing for the Build Out. To get in front of the market and leverage the eventual expansion of corporate IT budgets and growth in the industry, Cisco can take four primary steps with its partners.
 1. *Terminate Partners to Reduce Oversupply* – During the boom, customers were furiously buying technology. Consequently, Cisco's partner base grew exponentially. Without this feverish growth in the market, Cisco needed to reduce its partner base immediately to decrease its own costs and help improve the margins of the remaining partners. Because Cisco's direct sales force had the most contact with the partner community, it was their decision as to which partners to keep and which to terminate.
 2. *Decrease Channel Sales Team* – With the reduction of the partner base, there was no need to keep such a large Channels sales team. Thus, Cisco was able to reduce overhead costs by decreasing the size of its Channels sales force to complement the current partner base.
 3. *Increase Marketing Efforts* – To capitalize on the eventual build out, Cisco reinvested some of its OPEX savings in marketing demand programs in order to create pull-through for its newly reduced partner base.
 4. *Provide Immediate Margin Break to Partners* – To help partners realize immediate margin relief, Cisco increased the discount on its core, high-volume router and switch business, providing partners with a direct boost to their bottom line and doubling their current margins.

Marketing Model Reaction

- **Summary:** The marketing model reaction takes into consideration the strength of a company's brand, market position, influence and cost structure. A very strong brand dissolves the necessity for a focused Channel model because of the end user pull that brand creates. It is thus ultimately determined that the market should be covered by two distinct methods, neither of which focus on

partners. The direct sales force will cover larger, strategic customers, thereby eliminating the cost of a Channel while preserving high margins for the manufacturer. A direct marketing campaign is then utilized to reach the very large small and medium customer base. In this way, the company is able to meet its corporate growth and profitability goals in both segments of the market.

- **Cisco Steps:** The Cisco brand is one of the most highly valued in the world. It represents best-of-breed technology and has even generated the standard industry saying, “Nobody ever got fired for buying Cisco.” Because of the strength of its brand and its inflexible pricing model, Cisco would follow the Marketing-model reaction by implementing the following:
 1. *Move Enterprise Business to Direct* – By eliminating the partners, who were acting more as fulfillment houses than value-add partners, Cisco can retain its strong margin and improve customer satisfaction. Customers can be pleased with this shift in strategy as they are more inclined to want to work directly with Cisco than to go to a middle man. The business impact on Cisco’s bottom line can be significant due to the drastic decrease in expenses.
 2. *Move Small and Medium Business to an E-tail/Telesales Model* – Due to the strength of its brand, Cisco can create SMB demand through a fully funded advertising campaign. It can replace most of its Channels team over a 12 month period with a less expensive telesales team and use the remaining funds to support IT systems for CRM and sales order processing. Up until this point, Cisco had been unsuccessful reaching small and medium businesses because its partner base was heavily focused on the larger, enterprise customers. By shifting to telesales, the company can easily and cost effectively touch the thousands of small companies in this segment.
 3. *Leverage Outsourcing for Telesales Expertise* – Cisco is not a telesales company so to properly implement a telesales/e-tail model, the company should outsource its telesales operations, improving its efficiency, reducing its time to market, and reducing its cost. This is the only viable option. Had Cisco tried to handle the telesales process in-house, it would have had to increase head count by a large factor, thus negating the cost savings it was seeing by decreasing its Channel sales team.
 4. *Focus on Key Global Partners* – Even with a massive reduction in the use of partners, Cisco realizes that it needed to grow, develop and maintain a pool of key global partners to deliver comprehensive solutions to large enterprise customers and service providers. These key global partners are crucial to delivering consistent customer satisfaction for multinational companies.

Financial Analysis and Business Planning Reaction

- **Summary:** The financial analysis and business planning reaction is based on the assumption that deliberate steps around market analysis, partner profiling and financial analysis will create the most effective results. This reaction is very scientific in nature, takes 12-24 months to implement and often does not provide short-term edification for the industry. However, by understanding the profile of each partner, the company is better able to leverage the Channel to meet its long-term corporate goals.
- **Cisco Steps:** Cisco has to re-evaluate the way it pays its partner community as well as the behaviors of its partners. Instead of immediately cutting internal costs and boosting partner margins, the company should focus on the analytics of how a partner makes money. To do this, Cisco should take the following steps:
 1. *Implemented Regional Planning* – Cisco requires the direct sales force to evaluate its current partner set and identify its strongest, most valued partners. It then set up a stringent series of requirements that partners had to meet in order to remain part of Cisco’s channel. Partners

- not meeting said requirements were no longer certified by Cisco. By doing this, Cisco reduced its partner base significantly.
2. *Standardized a Financial Analysis Process* – Cisco also requires its direct sales force to understand its partners’ business models through a standard financial calculation called ROIC (Return on Invested Capital). The financial analysis is completed over a 12 month cycle and assesses a partner’s ability to make money selling Cisco technology and services. It is then used to profile a partner’s true role in the selling cycle.
 3. *Refocused Partner Role as Extended Sales Force* – Instead of viewing partners as simply a vehicle to get products to an end customer, Cisco begins to view partners as an extended sales force. As payment plans are crucial to the success of any sales team, Cisco should develop an incentive model for its Channel partners. While leaving the margins of the core technology alone, Cisco should focus on its lower volume, higher growth advanced technologies. Cisco creates programs that provide cyclical, 6-month based rebates or discounts to partners who sell advanced technologies and garner new business.
 4. *Refocus Role of Channel Sales Team* – Cisco develops a methodology for and expectation of Channel Account Managers as sales leaders, responsible for the development and success of their overall region or area. This creates in the CAM a feeling of responsibility towards the success of the partner, which in turn drives them to help develop the right set of partners.

Equity-based Reaction

- Summary – This model is based on the principal that for every inch Cisco gives, the partner should give an inch and the two will eventually meet in the middle. This model is very direct and simple in its implementation. It requires a very close working relationship between Cisco and its partner community, but in turn, develops a stronger, more loyal partnership. The Equity-based approach accomplishes the goals of both the vendor and the partner without either making radical concessions.
- Cisco Steps – By taking the equity approach, Cisco can improve partner margins immediately through a series of restructuring and refunding. It can then work with its most valued partners to help them develop a customized strategy for decreasing the costs associated with their own Cisco business. The steps to be taken by Cisco are:
 1. *Immediate Partner Rebates* – Cisco immediately provided partners with a 1% rebate on fast-moving, high-growth technology to help boost partners over the end of the down turn. Partners should be extremely pleased because it shows a good will gesture on the part of Cisco to share some of its own financial strength with its Channel. The move helped to restore the partner loyalty that had waned dramatically during the Bust.
 2. *10:10:10* – Cisco can reduce its number of partners by 10% to decrease partner competition, terminating the bottom producers. Cisco can reduce its Channel sales team by 10% to be inline with the decrease in partners, eliminating the Channel Account Managers who are responsible for the weakest producing partners. Based on its brand strength, Cisco can then increase its marketing spend by 10% to generate market demand.
 3. *Create New Branding Structure for Partner Program* – Cisco can revise its partner program naming conventions to better represent their partners’ behavior patterns and to correlate with the change in market cycle from boom to bust to build out. The current branding structure had been built during a high growth market. It no longer resonated with the partners and was, in fact, confusing to the customers. By creating a new branding structure, the value of the program can be better communicated to the partners and the value of the partner was better communicated to the customer.



4. *Outsource telesales* – Cisco can outsource all of its small business telesales to cut costs, which could then be reinvested in marketing. Cisco then created a series of advertising campaigns to drive small and medium business through its telesales group, driving partner demand and increasing top line revenue growth.
5. *Work Closely with Partner on Concessions* – Cisco can work directly with partners to identify how they could make the biggest impact with the smallest concessions. Together the two companies can identify, through a formal review process, how partners could cut costs and improve margins. By working together, Cisco shows a strong commitment to the success of the partner community.

Do Not Copy