

Versare, Inc. - The Accidental Fax

David Deeds (University of St. Thomas)

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Abstract

Versare, which makes portable walls, fold-down beds, and similar products for businesses and institutions, is an entrepreneurial venture in crisis. They have received a fax from a distributor that generates 95% of their revenues. The fax, intended for a competitor but sent to Versare by mistake, offers the competitor a substantial contract for products they supply – after the distributor had promised Versare exclusivity a mere two days earlier. To add to the intrigue, Versare has developed a new[C1] product, but it has not been introduced yet and the distributor does not know about it. Versare has also been considering shifting their sales and distribution efforts to completely online.

This case shows how the relationship between Versare and the distributor evolved, allowing readers to examine the structure, nature and evolution of a critical external partnership and how that effects the development of a new venture. The case provides cost, pricing and sales numbers that allows readers to estimate contribution margins for the various options.

Introduction

On a cold winter morning in 2006, Jeff Ryan sat in his office steaming over the fax he had just received from his longtime distribution partner. This could easily be the last straw for him, but what choice did he have, since this partner was responsible for the sales and distribution of over 95% of their product? The fax had come on the heels of a highly charged discussion with this distributor just two days earlier, which had been tense but ended with the distributor assuring Jeff that they would continue their exclusive arrangement with Versare. At the meeting, Jeff aired his concerns forcefully about the distributor's lack of interest in the business; the cost increases being forced on Versare; and distributor's poor receiving and order-taking processes, which led to expensive and unnecessary extra work on wall bed installations. As Jeff walked out

of the meeting, though, he got an assurance from the distributor's president that they were maintaining the exclusive arrangement. "We give you our word. Everything goes through you," he assured Jeff.

So despite the tensions he felt good about the agreement that had been reached two days earlier. But this fax changed everything. Sent to Versare by mistake, the fax was intended for a competitor, and it included a large order for the same product that the distributor had promised would come only from Versare. Jeff quickly realized that the distributor's assurances of two days earlier had been a lie, and that he may have become the victim of a cold business calculation. In his head, he could already hear the president saying, "it's just business; you understand." He did understand, but he also knew that this relationship accounted for nearly all of his company's revenues. In hindsight, this may not have been smart, but in the early days it had been the only way to get their product to the customers. The alternative of direct sales, or a patchwork dealer network, was simply not a viable business model in 1998 when the company was founded. All of this begged the question of what to do next. Could they afford to continue the relationship with the distributor? Could they afford *not* to continue the relationship? What were their alternatives?

Versare's History

Robert Jantschek and Jeff Ryan founded Versare in 1998. The two had met while working at a manufacturer and distributor of mobile folding and rolling, space-efficient products. They left the company to start their own venture in 1998.

We had left on pretty good terms. You know, we look back at it and we kind of joked that wouldn't it have been smarter to sit there for a year and develop everything and get the thing going on somebody else's dime and still have it. But



Robert and I couldn't do that. We had to leave completely before we started something like that because we didn't think it was ethical.

Their first location was shared with a custom cabinetry company that did very high-end cabinetry work for upscale offices and homes. As Jeff explained it, "We bunked with them because I had had a relationship with the owner. He used to do work for me when I was at my previous life. The equipment he had we needed to build our stuff. So it was a good marriage."

The first product they developed was a portable room partition that they believed had significant competitive advantages over other product offerings in the market. While in the same general market as their previous employer, the product did not compete directly with any of their offerings. Versare manufactured the entire partition in-house. But distribution was a challenge.

We had a manufacturing arm, we had our marketing arm and we had our distribution arm. Unfortunately our distribution arm failed; we couldn't sign up any dealers. We had nothing. I'm not going to get in my car and go from church to church...well, you can't do it. And we can't build it. We don't have the infrastructure to buy a van and get a guy in a territory.

The company was saved in July 1998 when Jeff secured Hufcore as a distributor. Hufcore had a national dealer network that could sell their initial product. At approximately the same time Jeff began conversations with their previous employer.

The Product and the Market

Portable partitions are movable walls -- used mainly by institutions such as schools, churches, hotels and conference centers -- that divide large rooms into smaller, more intimate spaces. They are part of a larger category of portable products used by institutions to add flexibility to their larger rooms, such as portable dance floors, choral risers, portable stages, folding tables, etc. These products generally fall into NAICS 337215 -- Showcases, partitions, shelving and lockers. The 1,789 companies in this industry generated approximately \$9

billion in sales and employed 54,000 in the U.S. in 2005^[1]

These products are generally sold through a distribution network that includes local dealers and large distributors and catalog houses. Delivery times are generally 4 to 6 weeks to the end customer, with the products being shipped via local freight services to the loading docks of the institutional purchaser. Freight costs can run from \$300 to \$400 per partition. Dealers generally do not hold significant inventory, but place orders as needed with the distributors or manufacturers. Delivered price to the customer, including shipping, have averaged about \$850 for a basic partition.

The Distributor Relationship

The combination of Robert's design skills, the equipment they had purchased and cobbled together, and access to their office mate's millwork equipment provided them with a wide range of skills and potential work. The problems in attracting a dealer network had spurred them to begin looking for contract work and anything else they could do to generate revenues. This led to a conversation with the president of their former employer.

We had all these extra things that we could do, and I started a conversation with the president of our former employer about something else. During the meeting I said, 'Yeah, we've got all this millwork,' and he said, 'Well, we're really having trouble with the guys that do our case goods for our wall bed system. Would you guys be interested in it?' So I said, 'Sure,' and he handed me an order for \$162,000.

The distributor is a 50+ year old company located in Minnesota. It employs 350 people with sales of approximately \$25 million². The distributor manufactures and distributes a range of portable products for institutional users (hospitals, hotels, schools, churches, etc.) such as folding tables, choir risers, portable dance floors, luggage carts, etc. They are a leader in their industry and a private family-owned company. In both culture and operations they are a very traditional, conservative midsized Midwestern company. stable and prosperous while achieving modest annual growth. They had not yet embraced the Internet in the

late 1990s. They were still a brick and mortar, suitcase, car, van and printed literature company with no plans to change. They were positioned as the high-price provider of high-quality, fully featured, very reliable products in their market. According to Jeff Ryan, their philosophy was, "We're 30 percent higher and we better prove we're worth it."

By January 1999, Versare had become the primary supplier of the wood casing for the distributor's wall beds, and also assembled the beds the distributor was selling to the hospitality industry. Sales of wall beds quickly became a \$500,000 business for Versare. In November of 1999 The distributor approached them with an offer to OEM their portable wall partition under the distributor's name and branded as "The Insta-Wall." They priced the Insta-Wall at \$1,099 including shipping..

We had no sales force. We were struggling to get it sold. We had one OEM manufacturer out of Janesville that was selling it, but they were only doing \$400,000 a year. So you combo the two and we were under a million. We wanted to get bigger than that and we thought that that would be the way to do it.

In November 1999, Versare entered into an OEM contract with the distributor for their portable partition, a contract that in hindsight may not have been in Versare's best interests.

I look at the contract today and I kind of realize what they were doing. In fact, we knew it back then too. It basically says, 'We will sell this OEM, but, oh, by the way, you cannot manufacture any other products that are anywhere similar to any of our other products.'

The contract was for 18 months and automatically renewed unless one party informed the other that they were terminating the contract prior to the renewal. Once notified of the intent to terminate, the contract remained in force for 18 months. Once the contract was signed, sales increased substantially for the portable partition.

The distributor's dealer network began moving the product throughout the country. But in April of 2000, the distributor came to Jeff and demanded that they no longer sell directly to Hufcore.

They came to us and said, 'Oh, you can't sell to Hufcore anymore. You have to sell to us and we'll sell to Hufcore.' So now all of the sudden I'm manufacturing it and selling it to them, and they sell it to Hufcore; Hufcore sells it to the dealers and the dealers sell it to their end user. So you can imagine what happened to our sales through Hufcore. They went to zero.

Versare's revenues grew from \$250,000 in 1998 to over \$1 million in 2000 and their work force had expanded from the two partners to 13 employees by then. But after the September 11, 2001 terrorist attacks, the orders stopped. Within six months they were back down to themselves and a skeleton crew, and 100% dependent on the distributor for their revenues. The following year, 2002, was bleak.

The relationship with the distributor was supportive but also contentious. Jeff explained how the relationship worked in the wall beds segment:

We kind of filled in the gap. The customer would end up coming to us asking us for details that the distributor should have already done and they fell down on it. We'd fill in the gap and we'd step up for the customer and we'd make it happen.

The distributor supported Versare in many ways, including providing partial payment in advance for some big orders, paying promptly at 30 days and investing \$75,000 in Versare's inventory to allow Versare to maintain the inventory on hand to meet the two-week delivery time the distributor demanded.

On the other hand, the distributor made a lot of demands for features and product changes. As Robert explained:

Once they came in and they were OEM-ing the product they started to sell it, but then it was always something. No matter what we did there was always, 'Oh, we want you to change this,' and we started chasing our tail a lot. They never had anybody who had embraced our product. It was always, 'Oh, by the way,' or 'Oh, I guess we do have this.' So when you asked them, they'd make the sale. So you have all these different dealers and all these different reps out there getting that fall-off-the-truck sale, but every time they got that sale it was like, 'Oh, by the way, but if it did this...' We heard that a million times. So Jeff would say, 'Gosh, I'm seeing sales volume drop,' and they'd come back and say, 'Well, if it only did this, we could assure you this.' So by the end of our relationship we had probably the biggest Rube Goldberg devices you could ever imagine because we always gave them what they asked.

At one point the distributor demanded that a rubber gasket be developed for between the folding pieces of the partition to protect children's fingers. Versare had to spend \$10,000 on a special piece of equipment to create the gasket. While the additional features added to the cost, the distributor refused to raise the price to the customer, or the price they paid Versare. In fact, Versare was contractually forbidden from raising prices of the product to the distributor during the year; prices could only be adjusted at the start of the year, and, once set, remained in place for the entire year.

The distributor prohibited Versare from direct contact with customers, yet no one at the distributor had direct responsibility for the product. So no one took a minute to assess the market and what the market really wanted, and Versare couldn't because they never had the chance to talk to the customer....the distributor was their customer. As Robert noted, "So if Joe the sales guy out in the south territory says it needs to do this, it needed to do that. Nobody embraced the product at the company and said, 'No, no, no, no. Here are our features and benefits and here's what we need.'"

The relationship also included co-marketing between Versare and the distributor at trade shows. The distributor would purchase a large booth at the key

shows and place Versare's portable partition on the edge somewhere, while highlighting their own products in the central spaces. None of the distributor's sales staff would directly answer questions, show or sell the partition. This led to Jeff traveling to the shows at Versare's expense and representing the product at the booth, following up on leads and then handing them over to the distributor and their dealer network. It was like, "Jeff, you can stand here, and if somebody comes you can talk about that product as our product."

The School Specialty Catalog

In late 2002 the distributor approached Versare with an opportunity to get into the School Specialty Catalog, the leading provider of instructional solutions, basic school supplies and equipment to K-12 schools. As Jeff describes it, "They're out of Appleton, Wisconsin and they own the K-12 market. If you buy something in the K-12 you're buying it out of this catalog." However, in order to get into the catalog the distributor demanded that they reduce their price by 25% in order to meet the price of a competitive product already listed in the catalog. Versare agreed to lower their price to the distributor by 25% for catalog sales. The distributor then came back and said, "Oh, by the way, since you gave us 25% less for these guys, you have to now do it for every product you sell, otherwise we're out." In the end, Versare took a 25 percent price cut on all their partition products. The product was featured in the 2003 School Specialty Catalog. Sales rebounded and 2003 was record year for revenues, at \$1.3 million, but profits did not follow suit. Versare reduced their price by 25%; sales of partitions increased to about \$750,000 on double the number of units. To quote Robert, "We worked a lot harder and made slightly less." Versare had to nearly double infrastructure to support the unit growth, even though revenues grew substantially slower. Jeff noted that, "We never had a chance to grow equity. You know, we were always in survival mode because we got squeezed, squeezed, squeezed and we were growing, growing, growing, but our margins were shrinking, shrinking, shrinking. So we never could put nothing down." More than 95% of Versare's revenues still flowed directly through the distributor, with most of their volume for the partitions coming from the School Specialty Catalog.

The distributor didn't have any salesperson actually going into School Specialty managing the account. In January of 2004, Jeff had a school meeting with the Edina school board and was asked what he did. They

had a brand new School Specialty Catalog on the table – “I’m looking through it to show them what we do, and I see my competitor but we’re not even in the damn catalog. The catalog had just come out, and that’s how we found out. The next day I literally threw the catalog down on the president’s desk and said, ‘What the hell happened?’ Yeah, he wasn’t ready. He had no idea. He was so embarrassed. He had no clue that they got thrown out.”

In 2004, with their partition dropped from the catalog, sales stagnated, and margins continued to decline as the distributor demanded that additional features be added to the product. By 2005, Versare’s profitability had declined to the point that Robert had to take a full-time job at another company.

Robert in China

Robert’s new position had him manage several product lines for his new employer. The job required frequent travel to China for extended periods of time to oversee the design and manufacturing of these product lines by Chinese companies. It was grueling, but it was there that Robert had an epiphany.

During the first half of 2005, as Robert described it, “You know, I basically took over a few of their product lines. They basically just threw me to the wolves. I had no idea what I was doing. I figured it out. I learned how to do business in China.” Robert was over there for extended periods of time by himself, leaving him some free time to explore opportunities for Versare. Robert discovered that China presented Versare with “the opportunity to really make a first-class product with a limited budget. It’s going to do what it needs to do and how it needs to do it. Then I started to develop it and I started coming up with a bunch of designs and drawings.”

Robert focused on a simplified, streamlined design that removed much of the clutter that the distributor had demanded be added to their products over the years. Shipping had always been a significant challenge for partitions, which required the use of expensive, slow and unreliable local freight services. Partitions were shipped fully assembled because dealers did not want to mess with assembly, nor were the products designed to be easily assembled. This made the partitions heavy, awkward and challenging to ship, which also made them easily damaged during shipping. Robert noted that with the new design he believed they could “get

shipping costs down to \$40 and throw it in a box to ship to any address.” So the new design, the MP10, was designed to do 90% of what the existing portable partitions did but also be easily packaged, shipped and assembled. Robert also estimated that the new design would require less than half the labor at their plant to complete the assembly. Robert took the designs to one of his contacts in China, who offered to develop the mold in two weeks for \$1,500, a process that cost \$15,000 - \$20,000 at home and took well over a month. The new design was to be constructed in components that would be manufactured in China, shipped to Minneapolis and assembled into the finished product in Minneapolis. Jeff and Robert agreed to have the mold developed and prototypes created. It was a clean, spare, shippable design with minimal features – a product that they were pretty certain would not interest the distributor. Proud of their innovation, Versare was convinced it would be well received in the market - if they could get it to the market. They estimated that delivered price for the MP10 would be less than \$600.

Potential from Online Sales

New design in hand, Jeff attempted unsuccessfully to get back into the School Specialty Catalog. He attempted to reach an agreement with Staples to sell and distribute their product, again with no success. The distributor was still generating 95% of Versare’s revenues, split about evenly between partitions and wall beds.

Versare’s last option was to become a direct company, and their only path to that seemed to be via online sales. Versare had a simple informational website, Versare.com, since 2003, but no e-commerce or direct sales. The site attracted very little traffic and was rarely updated or changed. Neither Jeff nor Robert had any significant experience or knowledge of the Internet, or more specifically, e-commerce or Internet marketing. In fact Versare was not even set up to accept credit card orders.

In late 2005 they began researching the Internet and specifically looking at Google. Jeff began reading every article “about Google and how these guys were doing it. Key words, what do those mean? How does the whole process work? I typed in ‘portablepartitions.com’ and it came up as a website that linked to different partition companies, and the website was for sale. How much? \$1,400.”

The Opportunity

As Jeff sat in his car after that fateful fax in January of 2006, it was clear to him that they had an opportunity to go direct to the consumer via the Internet, but that it was highly risky and uncertain. No institutions were currently purchasing this type of product online, especially expensive products like theirs that cost \$1,500. The distribution and sales channels were well-established and institutionalized. Still, selling online offered them several advantages. One was eliminating the costs of the distribution margin, allowing them to capture retail pricing. Another advantage was that Versare's cash flow cycle would shift from a 6-8 week negative cash flow cycle to a pre-paid positive cash flow. Through their research, Jeff and Robert concluded that they would need to invest at least \$150,000 to develop their e-commerce capabilities and get two containers of the new MP10 manufactured and shipped to them -- which at that moment was \$150,000 more than Versare had in January of 2006. In order to get the necessary capital they would need to place second mortgages against their houses. Beyond the basic investment, Versare might also need as much as another \$150,000 to maintain liquidity during any transition, particularly if sales via the distributor declined in response to this move and they were sitting on the \$80,000 to \$90,000 in credit card debt that had supported company operations.

The move to direct sales of the MP10 places the relationship with the distributor at significant risk, jeopardizing nearly 100% of their revenues, of which only half are from partitions. How should they handle the distributor? Inform them directly of their new offerings? Given their contractual obligations, the distributor probably has the ability to block them from selling directly for the remaining 18 months of their contract. If the distributor exercised that option and shifted their orders to other companies, they would bankrupt Versare.

On this cold January day in Minneapolis, Jeff knew he and Robert had to decide whether to stay with the distributor, move to direct sales of their new product via the Internet, or wind Versare down and return to working for somebody else.

Questions for readers:

1. What should Jeff do about the fax?
2. Has the relationship with the distributor been

beneficial to Versare in the past? Was it still beneficial in 2006?

3. Did Jeff and Robert make a mistake in entering the relationship with the distributor?
4. In hindsight, what would you do differently in managing the relationship with the distributor?
5. Should Versare send a termination letter to end the contract?
6. What strategy and business model should Versare pursue moving forward?
7. What are the financial implications of the online sales model? Compare Versare's current business model to the Internet model.
8. Should Versare move to direct sales online?

References

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