VECTOR Consulting Group | Leveraging the Potential

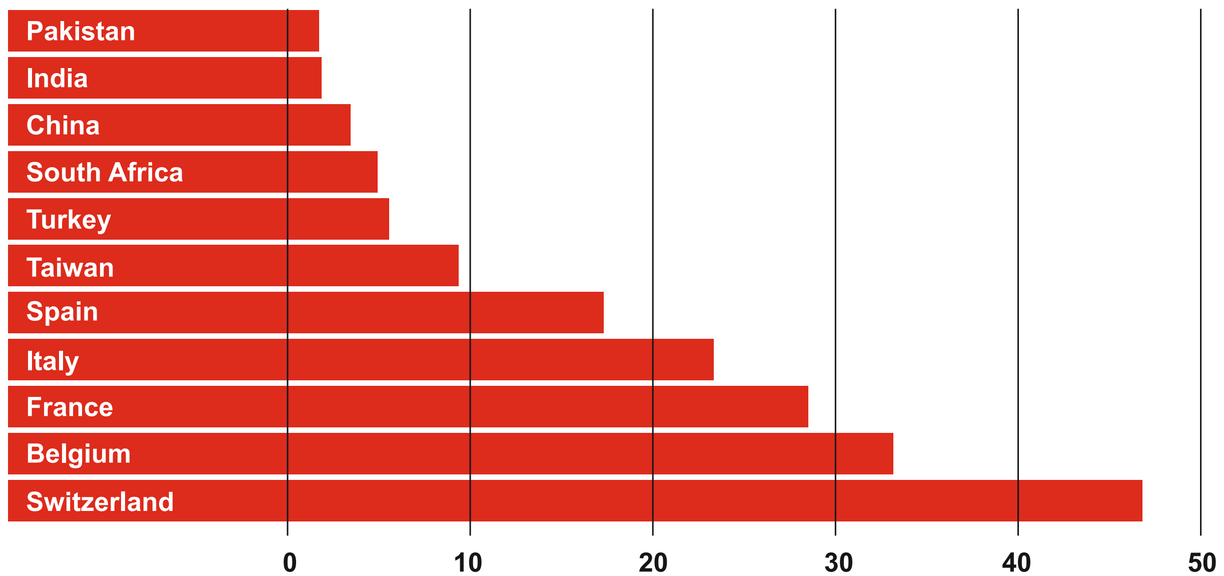
Think small, reap big

by **Satyashri Mohanty**

The textile industry has significant high entry barriers. Not only are most segments capital intensive, they are also labour intensive. India, however, has the advantages to meet these two challenges.

- Labour costs are low in the country as compared to those in developed countries like the US and newly-industrialized economies like Hong Kong, Taiwan, South Korea and China
- Capital subsidy support from the government of India is significantly high

The above factors have helped India become a favoured sourcing destination for fabrics, home textiles and garments for the western market. The opportunity has led to significant addition of textile mill capacities in the last five to six years. Most of the capacities have been added with the primary aim of exporting to large retailers in the US and Europe like Wal-Mart, JC Penny, Bed Bath & Beyond etc. For retailers, sourcing from India is cheap, while for manufacturers large retailers provide an assurance of capacity utilization.



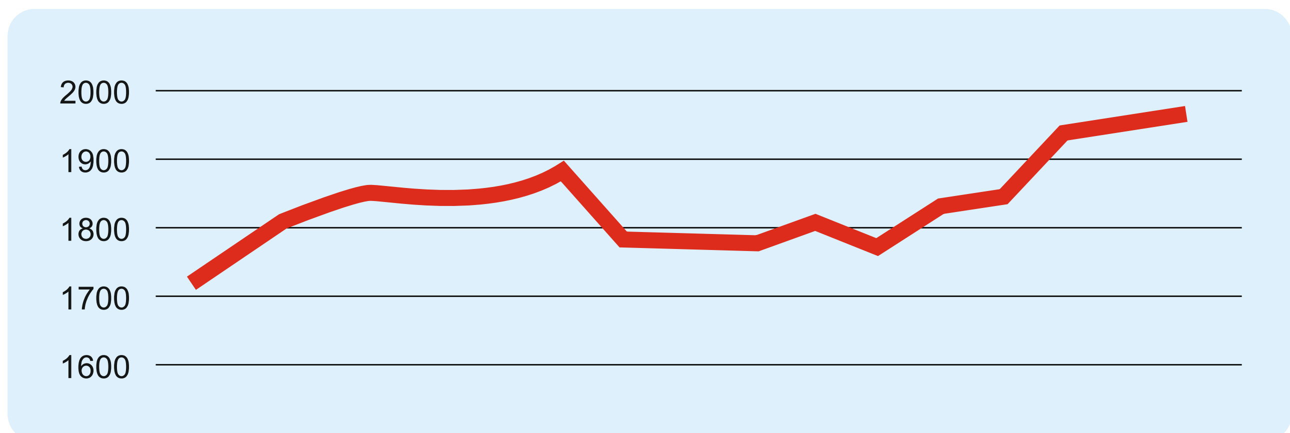
Growth of Textile Mills in India

Source: Werner International 2012

Labour cost (USD/hour)

On the face of it, it looks like a win-win arrangement. However, a study of financial performance of Indian companies reveals the kinks in the story. Less than 3% of the textile companies in India were able to maintain a consistent return of capital of only 8% or above in the period between FY-04 and FY-12. The financial performance, in terms of bottom line, has been inconsistent and widely varying.

Growth of Textile Mills in India



The reasons are as follows:

- The margins are extremely low. Therefore, the ability of the firms to absorb the shocks of currency fluctuations and raw material price variations is very limited.
- Whenever there is a downturn, large retailers drop volumes not just to compensate for reduced customer off-take but also to correct for excess inventory. With each downturn, there is significant drop in volumes. This dents the profitability of the supplying company.
- As price is the main basis for competition, time to time, either the volumes under annual contracts get diverted to others or there is a pressure to drop prices to retain volumes.

Most companies are aware of the risks, and as a way out, they try to improve product and market mix to get higher gross contribution from fixed assets.

Domestic Market – The Saviour?

A segment which has always looked attractive to textile players is retailing and distribution. Most textile mills know that large retail institutions sourcing fabric, garments or home textiles from them enjoy a mark-up ranging from 100% to even as high as 400% over their buying prices. Hence, a downstream integration always looks like an attractive proposition. Many assume that distribution and retailing one's own brand is a way to improve gross contribution and reduce overall risks. Since doing distribution and retailing in western countries is not a viable proposition, they prefer to operate in the Indian market.

With fast pace of development in the country, income levels will go up. It is but inevitable that India will lose out on the comparative advantage of being a low-cost sourcing destination, and instead, evolve into a large attractive customer segment. Looking at current risks and future opportunity, many Indian manufacturers are exploring reaching out directly to the Indian market.

A False Start?

In the last few years, many textile players have been trying their hand at distribution, brand building, and retailing in India. The bad news is that many have either burnt their fingers or their ventures have remained small and neglected. The inside story is that these ventures suffer from problems of huge inventory, write-offs and significant markdowns. The pot of gold of high gross contribution is not materializing for most of them.

The Problem

Dealing with exports is all about managing large confirmed volumes from few customers. Companies are tuned to this paradigm of "Bigger the Better".

One of the main mistakes that companies are making is managing the distribution and retail business with the same paradigm. While dealing with large retail chains, companies are used to having long-term commitment for capacity utilization. They want the same level of assurance while doing distribution business in India. They end up appointing few large distributors in the country who can book capacities with confirmed orders.

Since manufacturers require orders with adequate volumes, distributors are forced to book confirmed orders for longer horizons (three to six months depending on type of product). To improve the chances of booking the targeted volumes, companies try to excite distributors with new and a wide variety of products.

The "Designing for Traders" Trap

As the level of product knowledge of distributors is very high as compared to end customers, manufacturers end up creating many new designs with the informed trader in mind. Unfortunately, these products go unnoticed by the end customer.

(Most end customers go by price point, look and feel rather than nuances of construction of fabrics, type of yarn used or a special treatment of fabrics, aspects which are only understood and appreciated by traders.)

The forecast for longer horizon and practice of introducing many new designs in every booking season leads to huge forecasting errors as demand gets fragmented and becomes erratic across SKUs. The result is huge surplus of significant numbers of items and frequent/early stock outs of the "hits". Most distributors of shirting, suiting fabrics or home textiles in India have inventory turns ranging from two to four. Hence, despite having a good buying margin, most distributors have poor ROI. Manufacturers offer high margins (as compared to industries like FMCG) to compensate for the low inventory turns.

Low Inventory Turns – The Problem Amplifier
Ideally, a distributor should service retailers in his area with small but frequent lots so that the retailer can buy a wider range and pay on time. Distributors who have stocks of products lying for many months are under pressure to release capital for next buying season. Due to this pressure of locked capital, distributors tend to push out the stocks. They always look for opportunities to strike deals for large volumes. Hence, most focus on large retailers, ignoring small retailers. Consequently, this limits the reach of most brands.

(It is not strange that the distribution reach of large individual textile companies in India is much smaller than the distribution reach of large FMCG players. The primary reason is "pressure of inventory" of FMCG distributors is much lower than that of textile distributors.)

When reach is limited, the growth of sales tends to be restricted, too. When sale is not as per target, there is pressure to slash prices and increase spend on branding. Branding without reach does not help.

High receivables, demands for price reductions, huge investment in branding, lower than expected sales all together lead to companies concluding that domestic retail is not as attractive as it looks on paper. Many companies have backed out of the venture as if it was one bad dream!

How to exploit the promising domestic market
The potential of the domestic market is huge. This potential can be harnessed with the right approach which needs to address three critical aspects:

1. Customers willing to buy the brand
2. Retailers willing to sell the brand
3. Products being available at the point of sale

The industry has many categories like home textiles and fabrics, where the customer does not exhibit strong brand loyalty. His buying decisions are influenced by the recommendation of retailers, and his need to enhance his lifestyle. So the way to ensure the first factor (willingness of customer to buy) is to find a way to influence the retailer. One of the prime goals of any retailer is retaining customers. Every retailer has limited footfalls (people from his catchment area). In order to sustain or increase his sales he needs to increase footfalls. The only way a retailer can have repeat customers and new customers is by ensuring that his customers get the right product according to their expectations of quality and price. Hence, a retailer would never push a product, which does not match the price-quality expectation of his customer.

Every retailer makes an assessment of expectations and affordability of the customer and suggests the best product, as perceived by him, and available with him. This is not the approach of company sales people; they think that the retailer pushes only those products which give him higher margins.

Hence, the key to sales – for a product that is well accepted by customers, and which protects/enhances the reputation of the retailer – is ensuring high availability at the retail counter. When a retailer has high stocks of some SKUs or some slow moving SKUs, his ROI is low. Low ROI diminishes the interest of the retailer in

the brand. As stated, high stocks at the retailer are due to either:

- The retailer forecasting for a period longer than required because the distributor cannot be relied on for regular supply; that forecast goes wrong.
- The distributor pushing stocks using attractive schemes or discounts.

The way to have high availability and wide range at the retailer is to supply him with small quantities frequently. The distributor has to service the retailer with small quantities at a pre-determined high frequency (every week). Hence, the distributor has to:

- Hold back stocks rather than push it out
- Agree to implement a high frequency of collecting and fulfilling orders. This requires him to provide dedicated distributor sales representatives

A distributor will agree to implement these enablers only if he sees a huge benefit and no risks in the effort. He will move to a system of “holding back” and frequent replenishment, only when he is not faced with any stock pressure. This means that he, in turn, should also enjoy high availability at low inventory with high inventory turns. If the company can achieve this at low inventories – 1/3rd the current inventory – the ROI of the distributor increases more than three times presenting him with a financial motivation to put in the cost and effort.

An ordering system based on forecast cannot ensure high availability at low inventory due to forecast errors. To manage such high availability at low inventory at the distributors' requires the company to move to replenishment to actual secondary sales at high frequency. It has to move away from forecast-based ordering to consumption-based ordering. This requires textile plants to hold inventory, and supply to distributor as per his consumption. (Supply to consumption based system requires distributors to hold inventory only to protect against demand during the transportation time. Assuming that the maximum distance between any two points of India is 10 days, we can assess that a stock of one month will be more than enough for distributors to enjoy 12 turns.)

This way of working also requires that the manufacturer not have any stock pressure, else he will be forced to push the stock out and kill the inventory turns of the distributor. The only way this can happen is when the plant moves away from made-to-order to make-to-consumption. The consumption from central warehouse should trigger manufacturing orders in the plant. With lead times of production being long, the inventory required to be held at the central warehouse is huge. Hence, the lead times in the plant have to be reduced significantly. When the plant operates according to the **Theory of Constraints (TOC)** processes of production planning and execution, the production lead times reduce by about half and the reliability of delivery improves up to the high 90s.

Integrating with new product launches
A system of replenishment can lead to piling of non-moving inventory if product lifecycle is not long enough as compared to the production lead time. *(If product lifecycle is only two times that of production lead time, the ability of the system to prevent residuals is limited versus a product lifecycle which is about eight times that of production lead time.)*

The reduction in production lead time helps the cause of having production lead time as a small fraction of product lifecycle. However, it is also important to increase the product lifecycle. One of the main reasons for reduction in product lifecycle is the big-bang approach of new product introductions through two or three seasons. *(The pressure to design for trader, along with conditions of limited reach leads to premature end to many SKUs.)*

Since there is no system of booking by traders, there is no need to launch introductions to attract orders. One can then move to a system of introducing new products to replace only the slow moving products. This way of controlled introduction ensures the hits stay on for a longer period while the "duds" are taken out at the right time. When the supply chain is on a "pull" mode (producing and dispatching to consumption), the sale rate starts reflecting the demand rate of the retail point. The sale rate movement can be used to replace the products when the sale rate starts falling.

The introductions process moves away from a big-bang approach to frequent and small range introductions.

The paradigm shift

The way to approach the domestic market requires a paradigm of managing smalls – small customers, small orders, small dispatches, small collections, and small new product introductions. One can manage the smalls in an effective manner only when effort and resources required remains low. This can be achieved when the suggested paradigm shifts in sales, distribution, production, logistics, and new product launches are implemented in the right sequence.

Vector Consulting Group (www.vectorconsulting.in) is the leader of 'Theory of Constraints' consulting in India. Vector has been working closely with some of the well known FMCG, Engineering Goods, Custom Manufacturing and Auto Components companies to improve their overall profitability through supply chain effectiveness.