Research Reports
Articles

Small is Big

by **Vector Consulting Group**

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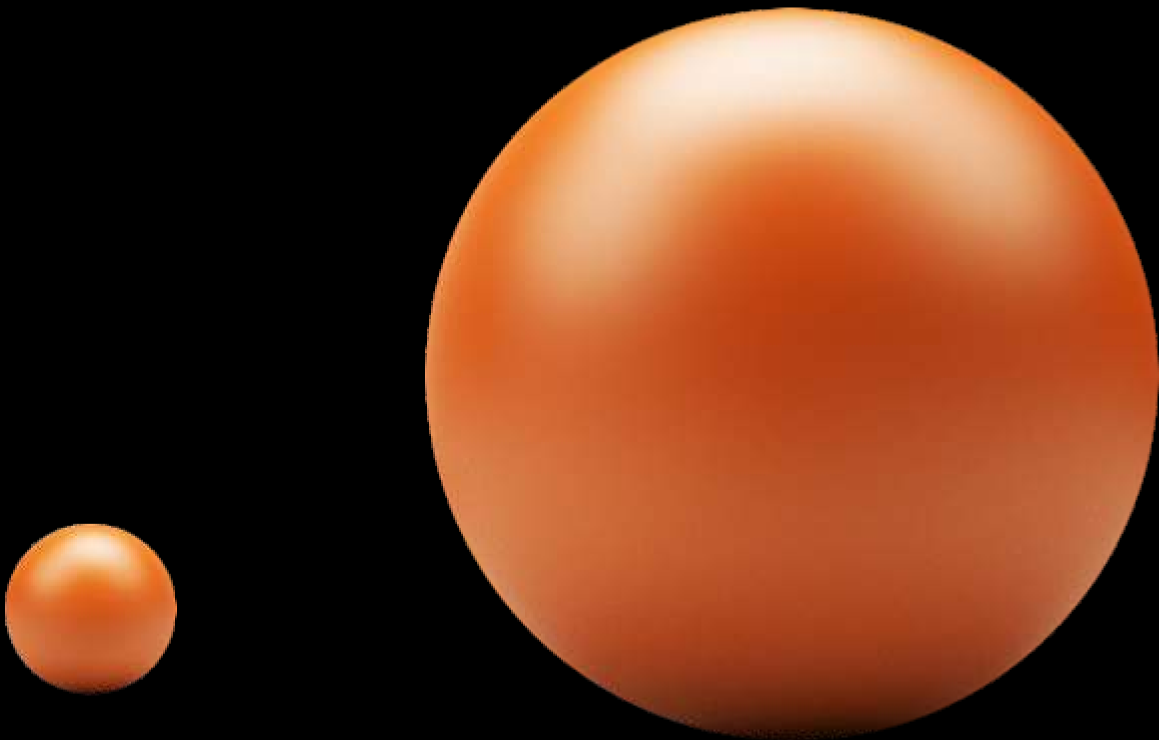
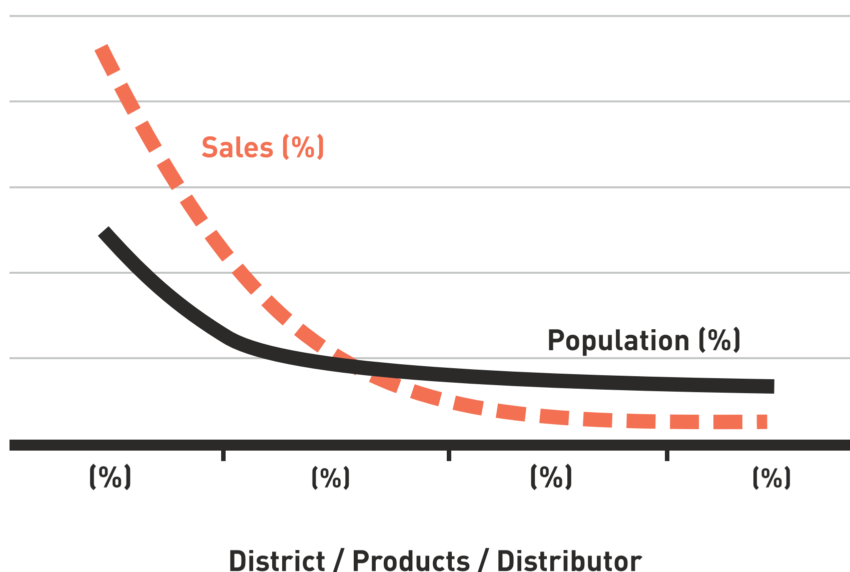


India's population follows a long tail distribution – 15% of the total districts (640) are occupied by 35% of the total population. The remaining 65% of the population is spread across the larger number of remaining districts. The size of the population in the "tail" is bigger than that under the "head". Assuming every district has a representation of various socioeconomic classes, the sales data of distributors of a consumer goods company with a pan India presence should ideally mirror the long tail population distribution curve. However if one looks at the sales data of a consumer goods company across distributors, most of them have a much bigger "head" – 70-80% of the sales will come from 20 to 25% of the distributors or in other words – a few distributors or wholesalers contribute to a lion's share of the total sales of the company.



Despite the contradicting demand and sales curve, these companies strongly believe that they do not have a reach problem due to the presence of a few large wholesalers who buy in bulk and are supposed to reach out to the vast population of small retailers.

Myth of reach through wholesaling

By design, wholesalers are meant to service the markets where a company's distributor is unable to reach. However most wholesalers do not service the tail because:

- Wholesalers operate with wafer thin margins and hence cannot invest in physical infrastructure to service small retailers there by resorting to passive selling- they do not go out to sell, instead, wait for retailers to buy.
- At the same time, the need for collections bandwidth and the risk of default also forces them to limit credit (to avoid hassles of follow up with many retailers).

The above factors limit the number of retailers buying from the wholesalers – only those who can buy on cash and are willing to invest time and effort to physically get the products from the

wholesalers. At the same time, to reduce risks, most wholesalers limit their portfolio to the few fast movers, resulting in limited penetration of the range of company's products, amongst wide population of small retailers.

Surprisingly, the phenomenon of wholesaling is not only seen in rural areas but also in urban areas for many companies. It is not uncommon to find wholesalers in many metros of the country across various consumer brands, when such areas have adequate distributors. The presence of wholesalers in prime metros is a phenomenon created by Brand Company.

The pressure of primary sales target forces sales team to nurture distributors who are willing to buy in huge lots, much more than their immediate requirement. When the distributors are saddled with large stocks, they use the bait of high volumes and deep discounts to liquidate – this limits the number of parties who buy from them. These parties turn out to be wholesalers. (Some companies even deal directly with wholesalers in their prime territories as a mechanism to get easy sales for their targets). Having liquidated most of his stock to the wholesaler and few large retailers, the distributor does not have material (or even motivation) to do the difficult job of actively servicing small retailers in his area. This leaves vacant a large market, where no-one is working proactively to secure shelf space – the large number of small retailers. The above phenomenon of "wholesale driven sales" strategy creates not only a large head of distribution sales amongst distributors but also for SKUs. 20%-30% of SKUs (or product categories) contribute to 70-80% of the sales. This forces companies to critically look at trimming their product range. Even though a dysfunctional distribution setup prevents an SKU from being present in all shops and expose itself to real demand.

Living with the penetration gap

Brand companies and distributors have learnt to live with this penetration gap justifying it as "cost inefficient" to try to plug the penetration gap directly using a distribution structure. They assume that the gains will not commensurate with the costs required to do the same and that the retailers and customers will find out a way to get to the brand. This logic holds good when the brand is near monopoly, and consumers will put up with the purchase inconvenience. Not many brands in the Indian market enjoy that iconic status. This means, one cannot assume that all potential customers will seek those limited retail points, serviced by the distributor based on his business considerations.

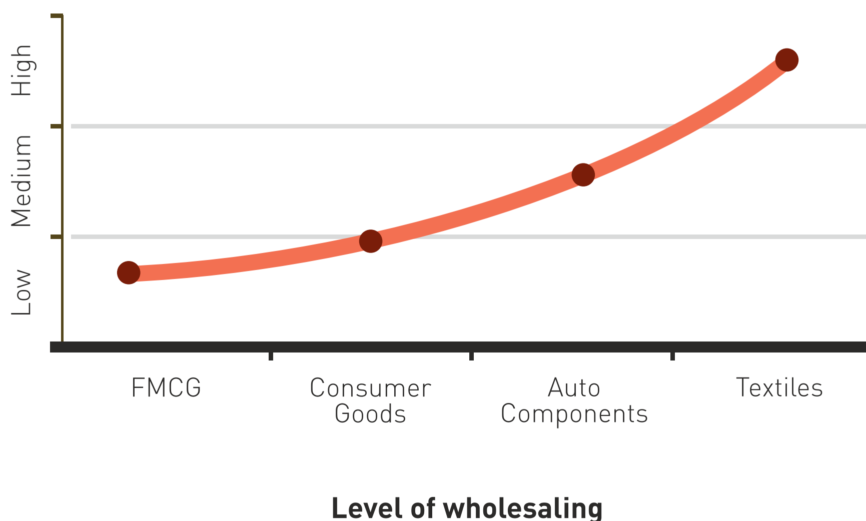
It is safer to assume that one does not know where one's potential customers will walk-in to buy the product. If we assume this, then it becomes imperative to be present (with adequate range) in all potential retail points where one's customer is likely to walk in. This means one needs to develop a distribution method, which is cost efficient to directly service frequently the long tail of smaller retailers. In order to develop such a distribution structure, one needs to understand why companies have not been able to do so.

Origin of the problem

From the supply side, it is the paradigm of "big" which dominates the management thinking – bigger batches for efficient production run, bigger case lots, large truckloads and few large distributors. However, the real requirement of tail is the paradigm of small – small and frequent

supplies, small investment and service to many small retail points. The model of wholesaling was supposed to act as a bridge between these two paradigms of management. However wholesalers stay on the side of the paradigm of "big" by controlling range and reach, thus creating the penetration gap in the market.

Interestingly, the manufacturing and buying practices in the industries and organizations drive the level of conflict between two paradigms. Industries with very large capital investment, like textiles or steel, or the ones dependent on buying from large vendor set-ups, have a dominant voice of big in their supply chain as compared to industry like fast moving consumer goods. Big (and fixed) batches for manufacturing and purchasing are assumed to be necessary to keep costs minimal. However the forecast errors associated with large batches, coupled with long and rigid lead-time of supply create a higher pressure of inventory in these environments. Due to this pressure of inventory, these environments typically depend more on wholesaling than pure distribution to reach out to customers. The dependence on wholesaling is very high for textile and steel companies while seemingly low for FMCG. Still most industries have significant wholesaling which is a sign of inadequate penetration of the company's range. The dependence on few and large traders also puts a never-ending pressure to perennially reduce product costs which in turn leads companies to keep looking for cheaper sources of manufacturing and constantly changing vendor bases, leading to stock outs and inventory problems due to unreliability in supplies.



Level of wholesaling

*Source: Vector Research Cell.

Resolving the conflict between big and small

Company can get advantage of adequate penetration only if it can reduce the costs of showcasing a wider range to a wider reach of population.

The costs associated with dealing with smalls are as follows:

- Cost (or associated investment) of distribution.

- Cost of manufacturing – large batches reduces manufacturing costs but puts a pressure of inventory on everyone in the chain.
- Cost of follow up for delivery of an order and follow up for collections – this forces sales team to deal with few large distributors or retailers.

Reducing cost of distribution

The challenge of servicing the Long tail is the sheer spread of smalls across a wide geography. This requires one to have distributors who are willing to service ALL retail outlets in a defined geography, at a defined frequency regardless of size of outlet. They have to stop "cherry picking" retailers in their territory. However if a distributor earns standard 25 to 30% on a smaller base (due to limited territory), then the absolute returns may not be attractive. The only way out is to improve ROI multifold – close to 80 to 90%, to make distribution an attractive proposition even with a smaller territory. This means the investment in stock and credit in the market has to be very significantly lower without creating a stock out. At the same time when a distributor services all the outlets in an area with a fixed frequency (weekly) visit, the consolidated orders form a good enough volume to justify a single delivery vehicle to service those orders.

To ease the pressure of inventory from the distributors, it is important the distributor buying is not constrained by manufacturing MOQ requirements. This can only happen when distributor is always serviced from a buffer stock rather than from scheduled production, in other words production should be decoupled from distribution.

Reducing cost of manufacturing

Producing to forecast was supposed to decouple production from distribution. However forecasting errors, lead to frequent situations where production ends up producing some items where stock is high while others are stocked out. This puts a continuous backpressure on production to keep changing schedules, and unplanned expediting which adds to costs. The attempt to manufacture as per fixed large batch sizes with a rigid schedule creates the biggest waste of manufacturing capacity. The only way out of this rigid system is to move to a system of producing to replenish buffers.

Replenishing to a common central buffer enables production to react to changing demand patterns, with a flexible batch size approach, at a frequency which is adequate to prevent any resource from turning into a bottleneck due to too many unplanned set ups.

Reducing costs of follow up and collections

Follow up and collections takes away sales bandwidth and hence sales teams always try to use the capacity to deal with few large customers. The only way one can deal with large number of customers regardless of size is when supply and collections is on autopilot. This means, in most cases, the payments come automatically when due, without extra-ordinary effort for every collection. At the same time, products reach the end customers without any need to expedite and follow up for them. This can happen only when:

- Supply to distributors and retailers is limited to frequent small quantities (more frequent supplies) per SKU so that capital is not stuck with unwanted inventory – the small lots are facilitated by the frequent visits and service which create a constant flow of orders and payments.
- At same time there is NEVER a stock out to prevent loss of sales, to avoid follow up efforts.

The above conditions require an ability of the entire supply chain to be very agile so that it can create and move inventory quickly to the latest demand. This means one has to move away from a rigid forecast based production and inventory management to agile pull based manufacturing and distribution, which reacts dynamically to consumption signals.

As opposed to monthly forecasting based push where a distributor ends up having inventory of about 30-45 days, a consumption based system with high availability at central warehouse ensures high availability with about 10-12 days of inventory (depending on distance from nearest warehouse), thus improving the ROI dramatically. The released capital of distributors can then be used to increase reach and range in a defined geographical market segment. This mandates that the DSO (Distributor Sales Officer) has to reach every potential counter in the assigned geography in a predefined beat plan regardless of the size of the retail shop. The distributor also has to ensure limited supply per SKU to the retailer. When both distributor and retailer use released capital to deploy a wider range, more SKUs start reaching out to the market, thus creating a Win-Win-Win for everyone in the chain.

The suggested model calls for dramatic changes in ageold beliefs, measures and practices like restricting primary sales to an agreed norm per SKU, ruthlessly stopping territory transgression by distributors. It also calls for enforcing price hygiene in the retail market, removal of trade schemes, ensuring daily availability to distributors etc.

The journey is arduous but has been fruitful for the companies who had the courage to embark on the change. Perhaps they are inspired by the famous quote from Apple "The people who are crazy enough to think they can change the world, are the ones who do."

Vector Consulting Group **(www.vectorconsulting.in)**, is the largest Theory of Constraints (TOC) consulting firm in Asia. The firm has been working closely with well-known companies across industries to help them build unique operations and supply chain capabilities that can be leveraged as a competitive edge in the market. Vector now has the highest number of success stories in Theory of Constraints Consulting and has also won several national and international awards for their work.