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Articles

TOC Replenishment in a wholesale-dominated market, an oxymoron?

by **Vector Consulting Group**

A lot of my friends in the distribution industry (and I have lots of them!) are quite intrigued by the fact I make a living out of implementing things as simple as "The Goal[1]" and "Its Not Luck[2]".

Yes of course, they have read the books during the course of their MBAs, but that was the classroom, right? Reality is complicated. There is the unpredictable competition, the conflicting interests of trade channel partners, of course the pressure of internal (stretch) targets, the economic uncertainty and on top of all this the ever changing consumer mindset. How can something as simple as "supply according to consumption" ensure that they will be able to meet their sales targets in an environment of such changing complexities?

When presented with the complete logic and taken through the CRT[3] , some of them grudgingly agreed to the solution but were extremely skeptical of the results. At least they seemed so. One of them called me after some months and wanted an urgent meeting. He explained to me that he had tried implementing the replenishment solution but contrary to expectations, the results were quite discouraging.

The inventory kept in the regional warehouses was higher than normal yet the stockouts increased leading to considerable loss of sale and very quickly the system had to revert to the old forecast based placement of stocks.

A few questions later the mystery unraveled itself.

True to the book, they calculated the buffers based on the lead time, level of demand and variability of both. The trouble was that the company's monthly sales graph showed a remarkable skew towards the end of the month. As much as 50% of the sales happened in the last week of the month. Yes the familiar "hockey stick" is back again!

And now understand the conflict: If you sized the buffers to the average sales factored for variability, the buffers will not be large enough to protect the month end peak, and if you tried to keep the buffers to the maximum sale, the inventory levels would be so high that the bean counters would throw a fit (besides not having the space in warehouses!)

We could try tweaking the buffers and find a good enough level and put pressure on the logistics manager to ensure faster and more frequent supplies in the last week of the month, but it behooves us to understand why we get such a huge peak when the consumption of the products is more or less even throughout the month.

Well, most distribution led companies in India operate through distributors who supply to retailers in their catchment area. The number of retailers in the country is not small – it is estimated at about 6 million. Yes, you read it right the first time – the country has more retailers than the population of some nations! (Read Eli's articles – Comfort Zones in "The Choice" for his take on this topic) Now as you would well imagine it is not possible for distributors to reach all these retailers (companies do have about 7500 distributors) so the smaller retailers and those located in remotes reaches of the country are serviced by wholesalers.

Wholesalers are the link between organized distribution and fragmented retail. Due to the large and fragmented market they serve (one that buys in very small quantities), the wholesalers co exists along with Distributors to serve that segment of the retailers which is left unaddressed by

Distributors or The Company. They buy in bulk, deal in limited range of high runners, operate on wafer thin margins and focus on rotating their inventory as many times as possible. In fact the need to rotate money for wholesalers is quite severe considering the thin margins they operate on. Why do they buy in bulk? Now that is a good question! When the wholesaler supplies essentially to large number of retailers who buy in small quantities from him, what is his need to buy in bulk and hold large stocks?

Remember that the wholesaler is interested in very high Inventory turns (and ROI). One of the key variables to determine sales (at least in his mind) is the price. So when he buys in bulk, he gets a substantial discount. He can then pass out a significant portion of this discount to the market, lower the price and thus create higher velocity of sales. The wholesalers buy in bulk during the last week of the month, when they are likely to get maximum "freebies" (sales guys are desperate for their targets). Anyways, the bulk money outflow in the last week of the previous month leaves less cash available with the wholesaler to buy in first few weeks. The cash flow cycle of the wholesalers, coupled with the month end "freebies" makes the hockey stick a "fact of life" for the industry. Yes it is almost like "sun rises in the east" and nothing can be done about it!

Now imagine the plight of those companies whose sales are dominated by wholesalers. I know of one such FMCG company who sells only 20% directly into retail and 80% through wholesale. They do as much as 60% of the entire month's sales on the last day of the month! Chronic problems are the perfect excuse for inaction. For most people, the fact that a problem exists for long is enough of a reason to avoid solving it.

However, we have learnt from fundamental principles of TOC that each chronic problem, which is an inherent, lose-lose for parties involved, is also an opportunity for a path breaking solution (a real win-win) We have seen how this way of operations is not conducive for wholesalers. At the same time behavior of the wholesaler creates other significant ills for the company (in addition to the hockey stick effect) – infiltration into the area of the very distributor that he buys from (competing on price to supply to the same retailers that the distributor supplies to) and the bigger one – price undercutting leading to poor market hygiene and erosion of brand value.

So as long as this distortion in the buying behavior of the wholesaler exists (his own sales are much smoother compared to the "spikey" pattern of his purchases), there is very little chance that we can smoothly transit to a real Win Win solution of a consumption based replenishment.

How do we start to implement consumption based replenishment in such environments? Remember we do not want to start with a mess of very high initial inventory!

The solution is again very simple: we have to break the bulk buying habit (of at least the few giant wholesalers to start with). At the same time trim the negative of the potential loss of the wholesale channel – offer the same discounts that they get but not on one time purchase, instead on the cumulative SALES that they report on the secondary sales system. The more they sell, the more they gain, yet if their sales are not high, they still get the benefit of the discount. This should enable replenishment to actual sales and break the skew at the same time. We need not have to start with very high inventory to cater to the peak of the last week.

You have probably guessed by now that though this is the first and a crucial step, but it is not the complete solution. The long term direction of solution is to increase the direct retail coverage of the company at an aggressive pace. Most of Vector's clients are on this path and are enjoying much better control over the market and price stability too. And of course, while they have wholesalers in their system, they are operating on pull replenishment. Oxymoron, anyone?

[1] Goal is one of the most popular business novels, by Eli Goldratt, describing the Theory of Constraints production solution

[2] It's not luck is a business novel by Eli Goldratt, describing the distribution solution of TOC

[3] Current Reality Tree is a TOC thinking process tool used to analyze complex business environment to differentiate the symptoms from the real issues