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The Unresolved Conflict: Modern Retail vs. Consumer Goods Companies

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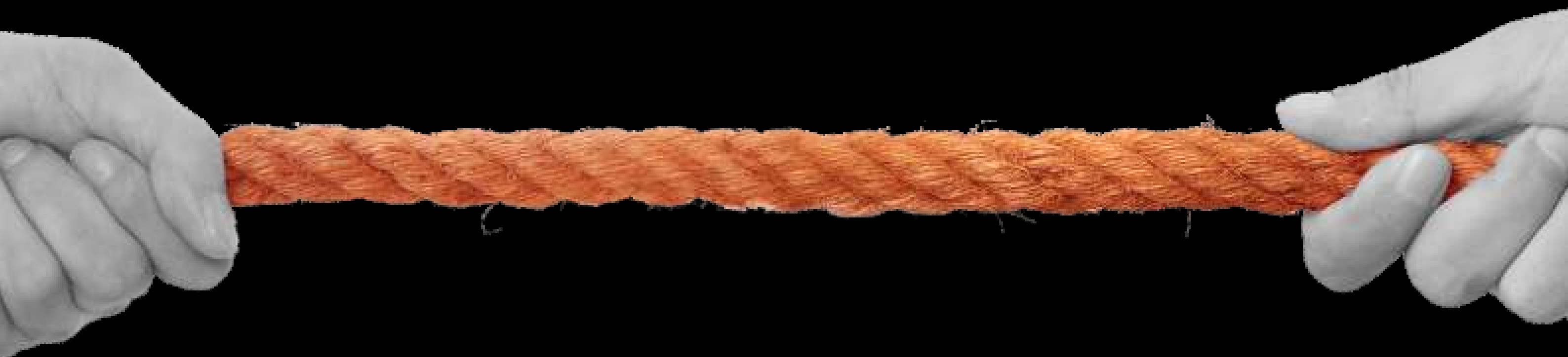

It's war! Multi-brand retailers and companies supplying their brands to the retailers are always in conflict.

This tug of war over 'margins' between consumer goods companies and the retailers is a ubiquitous phenomenon world over and has been experienced by generations of business people. In some markets, retailers have an upper hand and in others like India, consumer goods companies have the upper hand. But the battle lines always stay drawn!

In India, where the retail sector is largely unorganized and fragmented, retailers are mere Davids to the Goliaths that are the large consumer goods companies. Since these consumer goods companies sell to hundred odd distributers and they in turn cater to multitude of retailers, there is no single entity in this chain with the buying clout to negotiate for more favorable terms. Even the largest organized food and grocery retailers in the country typically have only a 14%[1] gross margin while internationally many retailers command a far higher figure. The friction between the duo over margins and shelf space hit the headlines when Future Group, the country's largest retailer pulled Kellogg's breakfast cereals off the shelves of around 150 Big Bazaar[2] outlets. But such instances are very rare and moreover with modern retailers contributing just 6-7% to the total sales, most consumer goods companies in the country aren't overly worried because their overall margins don't get impacted drastically.

But the terms of trade are slowly tilting in favor of modern retail. Steadily improving scale is enabling them to seek higher payouts from suppliers. While not all consumer product companies have increased margins, retailers say that margins from some FMCG companies have gone up to 17-19 per cent in some categories (breakfast cereals, shaving systems, etc.) where modern trade accounts for 30-40 per cent of sales for that brand[3]. Obviously with rise in volumes sold through the channel, modern retailers will increasingly exercise their influence. In time, India too is expected to move to a scenario similar to that experienced in more advanced nations. In these countries where organized retail is more mature and consolidated, it's the retailers that are the giants and have the upper hand in the relationship over their many suppliers.

For example, Walmart in the U.S. has almost 57,000 suppliers and it controls a large and rapidly increasing share of the business done by almost every major U.S. consumer-products company: 28% of Dial, 24% of Del Monte Foods, 23% of Clorox, 23% of Revlon, and so on[4]. Therefore, in spite of the company's everyday low prices strategy, the company has maintained 26-27%[5] gross margins using its strong negotiating power. Its supplier agreements are such that it never obligates the retailer to buy[6] anything but yet they do not ever let up on exerting downward pressure on supplier prices. Walmart also charges a fee to almost all vendors for stocking their items in new stores and for warehousing inventory. Since it commands 30% of the U.S. market with its 4,700 stores and 138 million shoppers who regularly visit them, the retailer is irresistible and unavoidable for suppliers. So, while not happy about it, most bend over backwards to accommodate this mega retailer.

Brands are created by consumer goods companies therefore they believe that the lion's share of the margins should be theirs. But retailers insist that the products reach the end consumers through them and they should be allowed the larger share of the pie. Therefore, whichever the market, retailers and suppliers have a complicated, time-consuming and often frustrating relationship. Occasionally, consumer goods companies make an attempt to reach a compromise by offering schemes to their channel. But instead of helping, this escalates the plight for both parties. Many retailers pick up stock under these schemes in bulk and since they cannot liquidate these, they end

up with a lot of slow-moving stocks that lock up their money. This hurts their ability to pick up more stock from the company in the future. Retailers have also tried to launch private labels to reduce their dependence on consumer goods companies but this strategy has its limitations. Their customers visit these multi-brand stores so that they can choose from a variety of brands; the unavailability of their favorite brands will negatively impact footfall. Further, creating and distributing their own private label brands bring with it the additional hassles of sourcing, manufacturing, packaging, marketing etc. which retailers prefer to avoid since that would mean becoming a consumer goods company themselves! Since all parties are attuned to staying in this frustrating skirmish of "win-lose" outcomes, the conflict persists unresolved.

Is it really not possible to bring "win-win" solution to this conflict? Who will cut this Gordian Knot?

The key to resolving this conflict lies in each understanding what the other is haranguing for when they demand more margins. "Margins" they make in each transaction is obviously, not the 'end' these companies are striving for; it is clearly ROI (Return on Investment) which each party feels will only improve if it could manage to wrangle for a better margin from its business partner.

Consumer goods companies know that they cannot do much to reduce the capital invested in factories and their marketing machinery. They need higher sales at full margins from the same investments in order to increase ROI. For that, they should be able to avoid stock outs, display a wider range and sell in full margins. At the same time, for a retailer, bulk of the capital is locked up in inventory so they need to generate higher sales from lower inventory to make a difference i.e. higher inventory turns. But since they are currently not able to fully protect sales even at high inventory levels, retailers are convinced that they cannot make this happen. Moreover, retailers have visual merchandising and MOQ (minimum order quantity) considerations that make it counterproductive for them to go below a certain level of inventory for certain products. So, because they see no hope to significantly influence inventory or operating expenses that could get them better ROI, "margins" become the inevitable battle ground!

A step forward by the supplier companies can actually transform this equation completely!

Even in markets where the power equation favors the large retailers, the consumer goods companies can work on reducing their inventory leading to huge gains for retailers and themselves. Suppliers who can make this possible i.e. those who can ensure availability at lower inventories will naturally be favored by retailers as is illustrated by the case of Indomaret and Godrej Indonesia.

Indomaret is a chain of retail convenience stores from Indonesia with over 11,000 stores across various towns in like Greater Jakarta, Sumatra, Java, Madura, Bali, Lombok, Kalimantan and Sulawesi. Indomaret is a minimarket network that provides daily needs; the stores are easily found in residential areas, office buildings and public facilities since the placement location of outlets is based on the motto 'simple and frugal'. Headquartered in Jakarta, it is the largest chain of its kind in Indonesia. Indomaret sells more than 5,000 types of food products and non-food to meet the needs of everyday consumers.

Godrej Indonesia, part of Godrej Consumer Products Limited, India, one of its major suppliers, embarked on a journey to transform its business of manufacturing and distribution of various household products like air fresheners, wet tissues, baby care products, etc. through the platform of 'Theory of Constraints'. They partnered with Vector Consulting Group for this.

Since Godrej Indonesia had stocking points close to Indomaret's DCs (distribution centers), it takes no more than four days (even in places where goods had to be delivered via sea) to transport goods from the former to the latter. And deliveries were being made thrice weekly based on forecasts made by the retailer for each location. With this lead time, Indomart should have been able to comfortably manage with 10-15 days' stock. In reality, however, they carried 20-30 days of stock! Indomaret and Godrej Indonesia were not undesirous of reducing inventory but what both believed was that, with fall in inventory, availability will also crash, hurting sales. The only way to protect sales was if Godrej Indonesia could ensure that all their SKUs are present at the retailers DCs on a daily basis while reducing inventory at the same time! Since availability was an issue at even the existing level of inventory, how could this be possible?

But this was achieved when Godrej Indonesia built a rapid response supply chain that operates on pull-based replenishment based on the Theory of Constraints philosophy. Once implemented, the items under replenishment at two Indomaret DCs were maintained with dynamic buffer norms (target inventory based on replenishment time to each stocking point). On depletion (actual consumption by the stores supplied to by the DCs) of the stocks from the buffer, the items were replenished in quantities equal to the depletion (consumption). The same was implemented at the regional warehouses and the factory warehouse (the stocking locations). Each SKU was assigned a color priority based on relative chance of stock-out. Red is top priority (as it has highest risk of stock out), followed by Yellow and Green. The color priority dictated expediting in manufacturing or urgency of supply of the SKU to the next node. All concerned at Indomaret and at Godrej Indonesia were trained to work on the new system of daily consumption data transfers to the previous node and also taught to react to color priorities. Required IT infrastructure and facilities were put up at each node to enable daily data transfers. Thus, now, availability continuously matched actual demand pattern even when demand was varying.

Further, Godrej Indonesia guaranteed that it would pull back any stock that was not moving with Indomaret. While the risk for the consumer good company in adopting this strategy was not much (after all it can redirect the stock elsewhere where it's selling better), this reduced Indomaret's risk in carrying a larger range of Godrej Indonesia's products allowing the company to place a much larger variety on the shelves of its large retail partner. This was especially useful when the company launched new and untried products in the market which Indomaret was earlier reluctant to host.

These steps resulted in a dramatic (41%) reduction in the retailers' inventory while improving availability to a consistent 98-100%. Indomaret responded by eliminating the hefty fee that it was charging Godrej Indonesia for hosting its products on their shelves leading to instant cash release. Additionally, this reduction of inventory levels (28%) in the entire channel (including to the regular distribution channel to smaller retailers) led to a substantial release of working capital for the company (cash in bank went up by 61%). Inventory turns for the company improved by 37% and the ROCE (operating) went up from 47% to 65%.

The case of Indomaret and Godrej Indonesia is not unique. Harnessing the TOC philosophy in distribution, an increasing number of consumer goods companies are developing harmonious win-win relationships with their channel partners.

[1]http://www.businesstoday.in/magazine/cover-story/organised-retail-india-problems/story/184980.html
[2]http://articles.economictimes.indiatimes.com/2010-10-15/news/27628854_1_private-labels-private-brandsmodern-retailers
[3]http://www.business-standard.com/article/companies/retailers-extract-higher-margins-from-fmcg-firms-109110600071_1.html
[4]http://www.bloomberg.com/bw/stories/2003-10-05/is-wal-mart-too-powerful
[5]http://www.forbes.com/sites/greatspeculations/2014/09/09/why-are-wal-marts-margins-gradually-declining/
[6]www.businessweek.com/smallbiz/

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.