

Specialty Teas

INTRODUCTION

Late one afternoon in March 2009, Tim Casey, owner of Specialty Teas (ST), purveyor of fine teas, sat down and composed a memo to his senior staff. ST had had superior growth over the last sixteen years; this growth had caused "growing pains" in the organization structure and operations of the firm. In the "early days" Tim made all the major decisions for the company; revenues in the very early years were shy of the \$1 million mark, and most of the decisions seemed quite straightforward.

Now that revenues were nearing the \$25 million mark, Tim was finding that decisions and operational procedures that worked well in the past were inadequate. ST's line of product offerings had risen sharply, the supply chain had become much more complicated and relationships with customers more difficult to manage. In addition, several high quality competitors had entered the market in recent years. Although profitability was still good, ST could no longer afford to operate inefficiently. The specialty tea market was now crowded with competitors, with all of them attempting to grab a portion of ST's hefty market share.

Tim had decided: the senior staff were going to meet in two weeks for a three day retreat to sort out some of the challenges facing ST. All aspects of the company were to be examined.

SPECIALTY TEAS

Specialty Teas (ST) is a privately held small tea company that imports tea (and some other tea-related food and beverage products) from several suppliers abroad and markets these products to both wholesale and retail customers, primarily in the USA. The company was founded in 1989 by Sam Westgood, Sheila Westgood, and Bob Jonas. The idea had been hatched some years earlier when they had met with some friends and discussed the lack of high quality tea in the United States. Sensing an unmet demand, they resolved to develop a tea to meet the needs of consumers desiring high quality tea. They managed to acquire some "angel" funding and soon developed a devoted following of their brand. They developed unique packaging, including a striking set of graphics and slogans, and they were off and running.

As marketers, the founders were extraordinarily successful. Unfortunately, they were less successful as business operators. They sold the business to Tim Casey in 1992. Under Tim's ownership, more effective business practices were put in place. More effort was spent attracting wholesale business instead of direct appeals to retail customers. The wholesale market constitutes about 85% of their business.

OPERATIONS

The Supply Chain

Our examination of the supply chain process for ST begins with the sourcing of raw materials (primarily tea) in several Asian countries - China, India, Taiwan, Japan, and Sri Lanka. A relatively small portion of the goods are imported directly from these countries by ST; the majority of the goods are imported from Twinhof (TH), located in a suburb of London. This company processes the teas according to proprietary specifications for ST. ST is a relatively small customer of TH; as such, ST only produces specialized blends in batches about twice a year. More frequent production runs are considered economically infeasible by ST, as each run requires TH to adjust the settings on the production equipment to the proper specifications. There is substantial time and cost associated with this set up process, effectively limiting the number of runs per year. At present, TH only ships to ST in container size lots; each container holds about 10,000 kilos of tea.

Purchase orders are generated from the production facilities just outside Indianapolis, Indiana. The chief of purchasing also functions as the controller of the company; although product purchases rarely vary in quality, there are times when a particular specialized ingredient for the tea blend is unavailable. In these cases, substitute ingredients need to be identified; this will occasionally result in production delays. Further, any changes in the production formula need to be cleared with the head of Sales & Marketing. This division is based in Los Angeles, however, since California accounts for the largest concentration of sales.

TH requires a three-month lead time from ST to deliver the orders. This lead time is established as: 1) two months to acquire/process the tea from the source, and 2) one month transit time to ST. In the current arrangement, some of the "favorites" (high volume tea) are produced and shipped on a regular schedule. Other products are ordered and shipped on an irregular basis. The shipments arrive in Indianapolis in large sealed bags. Upon arrival at the plant, the tea is packaged into retail-sized containers, which are then held until shipped to a retailer (and, in some cases, directly to the consumer). Typically, about two months worth of sales are held as inventory. However, this average inventory size masks several problems associated with inventory management. Order volume is not only seasonal, but also irregular. Although many of the retailers with which ST does business order tea on a relatively predictable basis, some of the large customers order infrequently, and these large orders (often in excess of \$200,000 per order) are not wholly predictable.

The processing plant is able to pack approximately \$100,000 worth of tea per day (about 20,000 lbs). Although ST usually has sufficient quantities of packaged product available for shipment, they

are sometimes caught "short" on large orders. In some cases, the delay caused by the limited processing capacity results in ST needing to air freight orders to these customers. Management of ST feels this to be necessary since the potential loss of business to these large customers would be disastrous.

Customer Orders

As noted above, large orders (from the biggest customers) are made directly to headquarters in Indianapolis. However, most of the orders are smaller, and are made by members of sales representative organizations hired by ST. ST is too small a company to have their own nationwide sales force. Regional sales organizations are hired to "service" the accounts; the size of the accounts varies widely. Some are as small as \$1,000/year (annual sales). The sales representatives ("reps") receive 10% of the amount sold; payment is made to the reps upon receipt of funds by ST. The volume of sales order may be described as moderately predictable. Like any consumer product, though, there is a substantial degree of uncertainty in the order patterns, particularly in the peak order months of July through October.

Orders are sent by fax, phone and via the firm's website. The firm would prefer to have all orders sent electronically but many of the sales reps continue to use the phone or fax. When ST's sales managers push the reps to use the website, some complain the process is "complicated". Many of these reps have been in the business for fifteen or more years and are reluctant to change their method of doing business. ST management suspects many find using the phone or fax simpler and are unwilling to make the investment in learning the web technology.

ST feels that some sales are "left on the table" since the sales representative organizations are of varying efficiency. Anecdotal evidence suggests that some retailers order product from competitors if the sales representatives do not make timely visits to the store. In effect, if shelf inventory disappears and no sales representative appears to take an order, the retailer will simply fill the shelf space with other items (usually from a competitor). In most cases, the retailer has limited loyalty to the ST brand. The extent of lost sales from lack of attention is unknown, but believed to be substantial.

A further complication to ST order flow and inventory management is the reluctance of most retailers to keep much inventory in house. This often results in calls from retailers, either directly or through the sales representatives, to send a shipment "yesterday". These orders are frequent, and tend to be small. They are also irregular in their timing.

Payments

Payment terms for ST's customers are net 30. In theory, the thirty-day time period starts at the time that an order is shipped from Indianapolis. Typically, the invoice is mailed or faxed to the customer; a copy of the invoice is also sent with the physical shipment. In practice, the average collection period averages 52 days.

Some smaller companies with weaker credit histories have different payment requirements. Some pay with credit cards; others must pay in cash prior to delivery. These accounts represent less than 5% of total revenues, however.

The Growth Strategy

The Marketing team, at the request of Casey, began a systematic study of the marketing practices of the firm. In the past year and a half, the number of tea varieties ("stock keeping units", or SKUs) sold to retailers has nearly doubled. The company has always introduced new blends on a periodic basis, especially in anticipation of the winter holiday season. Last year, a line of green teas that appealed to a more health conscious public was very successful.

However, other new product launches were less successful. A new line linked to a successful healthy snack proved to be a "bust". Wholesale customers were also concerned about the number of SKUs that the company requested them to carry. In many cases, some of the newer products were not selling well, and they were collecting dust on the shelves. This problem is especially acute in smaller retail outlets that are not well serviced by the sales rep groups. This situation is a "lose-lose" for all concerned; ST is foregoing sales that could be generated with a better selling product, and the retail outlet has idle shelf space. In the longer run, the retail outlet is likely to eliminate some shelf space allocated to ST.

A second issue involved the long-standing policy of selling only to "quality" commercial customers. The owner and VP of Sales periodically received requests from "mass" retailers such as Safeway, Target, Costco, and Walmart to carry their product. Acquiring these new customers would boost sales substantially but profit margins would erode as these large customers would require discount pricing. Further, ST is concerned that selling through these outlets would erode the brand image.

FINANCE ISSUES

In the early years of ST's operations, product pricing appeared to have little effect on demand. The typical customer was willing to pay a higher price for the perceived higher quality. In recent years a

number of competitors have entered the market and, though many current ST customers remain intensely loyal, this has caused more pricing pressure from retailers. With increases in materials costs, this has inevitably resulted in a reduction in profit margins. Although pricing decisions are generally associated with marketing, such decisions inevitably impact profitability. Both Tim Casey and the controller have a strong desire to maintain substantial gross profit margins.

Other potential financial decisions loom as well. There have been some proposals to perform more blending on site in the Indiana headquarters and reduce the dependence on their London supplier. Of course, this would require substantial capital expenditures as well as hiring capable staff. Further, some of the blending formulas, though developed jointly between TH and ST, were "owned" by TH. Formula recipes could be closely mimicked through a reverse engineering process, but this process would be costly and time consuming.

MEETING OF THE MANAGEMENT TEAM

The owner of the company met with the management team to discuss ways in which the company could operate more efficiently. The team was assigned the task of generating a list of problem areas; Tim Casey, the owner, directed his staff to "put all the issues on the table". At the end of the three day meeting the following were identified:

1. Lost sales due to poor customer servicing. Though there are a number of relevant factors, the motivation of external sales force members seems to be a prominent issue. They are not employees of the company, and it is likely that many of their small customers are simply not worth the effort. There is also a question as to whether the separation of production (Indianapolis) and sales and marketing (Los Angeles) is a problem.
2. Inventory inefficiencies; in particular, the large average levels as well as very high levels just prior to the peak sales months of July through October. Further, there are still occasional "stock outs" on some orders. This occurs primarily when one of the larger customers presents a large order for a particular tea flavor.
3. Collection time: although credit terms are a uniform "net 30" for all customers, actual receipt of payment varies widely. The current collections systems is primarily "paper based"; the Accounts Receivable personnel attach a paper copy of the invoice to the actual shipment, and send a duplicate copy to the customer via regular mail. The customer then sends the invoice to their Accounts Payable department, at which point the "30-day clock" starts, from the perspective of the customer.

4. The Sales/Marketing manager expressed her concern that the Purchaser/Controller would occasionally purchase cheaper ingredients than those listed on the labels. He maintained he did this only when the desired ingredients were unavailable or unusually highly priced due to temporary supply problems. She maintains that such substitutions may impair quality, and damage the company's reputation. As ST is perceived as a seller of a high quality product, she argues that the "reputational loss" in value of the brand would be substantial if competitors (or, worse, the press) were to discover the substitutions. Privately, she is concerned that the Controller/Purchaser has incentives to focus primarily on reducing Cost of Goods sold, and is not looking at the "bigger picture".

5. Heavy Reliance on TH: TH supplies about 80% of their finished tea. Several members of the management team expressed concern about this reliance. Prices were already rising due to exchange rate changes, and both the quality control manager and sales manager were quietly expressing concerns about the quality of shipped product.

6. Product Portfolio: How many products should ST sell? A relatively small number of blends accounted for a majority of sales (a version of the "80/20" rule). Yet the owner felt that growth required an expansion of the product line.

POSSIBLE RESPONSES/CONCERNS

The committee of senior staff for ST developed the following list of concerns and possible responses to them; they felt that the solution to many of the problems identified above requires the assistance of a consultant.

1. Distribution channels. Product distribution to date has either been "in house" or through the network of independent sales representatives. One possible change is hiring "distributors" to service customers. Distributors typically require a 20% discount on the wholesale price, and act as dealers (as opposed to the broker function provided by the independent sales representatives). The distributors visit stores more regularly, physically stock shelves themselves, and hold sufficient inventory to maintain the shelves. Further, several of the retail chains to whom ST sells regularly use distributors to stock their shelves, and prefer that form of service.

2. The owner is reluctant to hire distributors for two major reasons: first, and most importantly, is the 10% "lost" margin associated with the distributors. Second, once the distributors acquire the merchandise, ST has no real control over the distribution of it. He is concerned that it may appear in such "low-end" outlets as Walmart or Albertson's. Such placement may jeopardize ST's relationship

with their current premium customers. Another possibility is the hiring of additional in-house sales staff, though that is impractical for servicing many of their small customers.

3. A more integrated supply chain. Management agreed this was probably a good idea, but they lack the expertise to develop and manage such a system. The plant manager, Felicity Hammon, expressed her concern about the company's reliance of TH for most of the tea. She noted their costs have been rising substantially, mostly due to the appreciation of the British pound relative to the dollar.

4. Inventory control. In addition to the distribution problems noted above, the current system of infrequent "batch" shipments from England seems inefficient. Management would like to consider a way to solve this problem.

5. Financial payment system. Some members of the team feel that such a system could speed A/R collections from the current 52 days. Others question whether it would be "worth it".

6. Sales/Marketing. Was it time for a substantive review of the entire marketing plan?

CONCLUSION

Management would like some preliminary recommendations from your consulting group on some actions they might take to increase production and financial efficiency. Appendix 1 provides some basic financial data.

Questions

1. You need to perform a SWOT analysis on the company
2. What do you think of STs strategy of selling only to "high end" retail outlets?
3. ST still maintains a very loyal following for its product. How should the company ensure growth, or at least maintenance, of this customer base?
4. How would you characterize the internal communications of the company?

5. What communication habits and behaviors have been established by leadership within the company to date? Evaluate how this communication influences motivation, innovation, and productivity within the company.

6. ST has a relatively complex supply chain, starting with growers in tea producing countries. Discuss opportunities and challenges for the company in managing this chain.