

Cracking the Cost To Serve Conundrum in Rural Markets

Rural India offers attractive growth opportunities across a number of consumer product categories. However, rural market distribution continues to be plagued by problems of limited reach and high cost to serve. Companies need to develop out-of-the box approaches to profitably serve rural markets if they wish to solve the cost to serve conundrum say Pankaj Gupta (Practice Head – Consumer & Retail) and Raghavendra Rao of Tata Strategic Management Group.

India's rural growth story

Rural India is home to around 790 million consumers. Total rural income at US\$220 billion constituted 43% of total national income in 2004-05. It is expected to increase to around US \$425 billion by 2010-11, a CAGR of 12% making it a compelling market for companies to be present in.

The rural growth story in India keeps getting bigger. Farm income in rural India has risen steadily on the back of robust agricultural growth and higher procurement prices. Government initiatives like the National Rural Employment Guarantee Scheme (NREGS) have reduced unemployment and increased wages for rural labor. All these factors put together have fuelled rapid income growth in rural India offering attractive opportunities for companies to augment growth across categories like automobiles, telecom, financial services, FMCG and consumer durables. The impact of the deficient monsoon in 2009 would have a marginal impact on rural income with output decline being substantially offset by a combination of further increase in minimum support prices and larger outlays under NREGS. With a normal monsoon expected next year, rural incomes will again move upwards.

Problems of rural reach

While rural potential seems to be well recognized, why is it that few companies have been able to tap rural opportunity in a significant manner? The

commonly quoted problems with regard to rural India revolve around cost of directly serving these markets and inadequate control in rural market operations.

High cost of reach is caused by lack of adequate throughput which pushes up per unit cost of distribution in traditional models. This is due to the nature of rural markets – widely dispersed and thinly populated, low per capita spends and high demand seasonality.

In-direct models usually throw up control issues for a company over the channel. In the wholesale distribution channel typically adopted by most companies, the company has little knowledge of the multiple intermediaries that buy from the wholesaler. Thus, it is very difficult for the company to influence the retail point-of-sale in terms of SKUs to carry or POS merchandising to be displayed.



Current FMCG rural distribution

Different FMCG companies are at various levels of direct rural market coverage. For example HUL which has the largest reach directly serves ~100,000 out of 600,000 villages in the

country. Godrej Consumer Products reaches 17-18,000 villages, while most other players have a far smaller reach.

The current rural distribution structure followed by most FMCG companies involves a super-stockist and multiple sub-stockists between the company's carrying & forwarding agent and the village retail

outlet. The super-stockist is generally based at a district HQ/ tehsil and services a number of sub-stockists. The sub-stockist is typically based out of a tehsil/ large village and services a cluster of villages.

The typical margin outgo in this structure, between a super-stockist and sub-stockist is ~7-9%, inclusive of transportation subsidies. This compares adversely with urban distribution margin of 4~5% and highlights why companies are hesitant to grow current models of rural distribution.

Innovations in Rural Distribution

A few leading FMCG companies have established new rural distribution models. HUL Project Shakti, Tata Tea Gaon Chalo and ITC e-choupal are some examples of new models being adopted in India. These models have a very different set of intermediaries between the company and the rural consumer as compared with traditional models. These intermediaries could be NGOs, self-help groups or rural entrepreneurs.

For a completely breakthrough performance, companies will need to think out-of-the-box for strengthening their rural distribution based on levers that fractionalize fixed costs or make them variable.

Approach 1 : Dedicated Rural Entrepreneur

A flexible and lean-structure linking a super-stockist to village retail outlets can be established in the form of a Rural Entrepreneur (RE). The RE is an individual who being a local is well versed with the geography of villages to be serviced. The RE should own a two-wheeler and have a minimum level of education (preferably graduation or, alternatively, higher secondary).

The RE would cover multiple village clusters located within a radius of ~30-40 km from the super-stockist using the two-wheeler. The company would have previously covered these villages through multiple sub-stockists. Sales calls and delivery would be made to all villages in the area thereby increasing reach to villages not currently covered. More importantly, as the RE does not incur administrative expenses – rent, salary, electricity etc. and earns a semi-variable income, he could lower the cost of reach.

The economics would depend on the nature of product being distributed and the brand pull. The product should not be bulky and should be compatible for two-wheeler transportation. Our analysis suggests that the economics of the arrangement can work well for products with a value-volume ratio of greater than Rs.75 per kg. With a monthly sales of Rs. 1 lakh per RE, the model can bring down the cost of rural distribution by 1-1.2% of sales.

	High	Moderate potential for usage of new approach (e.g. Branded staples, small durables)	High potential for usage of new approach (e.g Telecom, home/ personal care)
Rural Sales Potential	Low	Continuation of traditional approaches	Use of new approach in select geographies
		Low	High
		Value (Price)/Volume (Weight) Ratio	

Approach 2: Distributor consolidation for urban and rural markets

An alternate approach is to consolidate an urban distributor and super-stockist & sub-stockist into a single entity who services retail outlets. The markets covered by the entity include the local town and a set of villages around the town. This arrangement can offer advantages of savings in administrative costs and lower inventory requirements, resulting in a lower margin outgo of ~0.7% for the company for rural distribution.

Approach 3: Consolidated Distribution with tele-order booking

Rural tele-density in India currently at ~16% is expected to rise exponentially over the next few years driven by increased mobile penetration. This trend can be used to un-bundle the traditional order-booking role of the salesman. This idea entails collection of orders from rural retail outlets over a phone and subsequent servicing of the market through an order delivery system.

This arrangement can provide savings in transportation costs since there is better utilization of vehicle space as compared to a ready stock system. Another head of savings is in manpower costs – with orders being tele-booked, the salesman visit frequency can be sharply reduced. An existing staff can be utilized to make tele-calls at a much smaller addition to cost. This model can further reduce the margin outgo by ~1.3-1.5% for rural distribution.

The attractiveness of this approach will need to be evaluated against the limitations that may emerge. First of all, orders collected would be almost entirely off-take led limiting the element of push. Secondly, with a reduced visit frequency of the salesman, relationship-management with outlets may be compromised.

Approach 4: Distributor choice based on unutilized reverse logistics potential

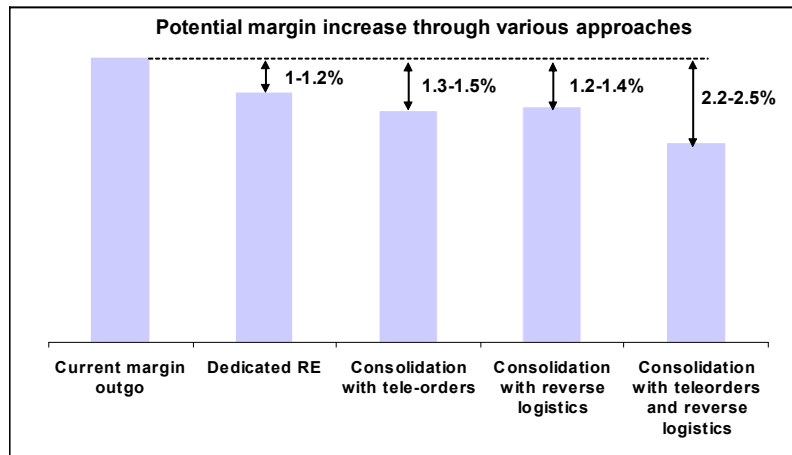
Another non-traditional form of cooperation for rural distribution could be to partner low-margin, high-reach players in rural markets. The dairy industry is one such option. Dairy vehicles go empty to rural locations and come back filled, exactly opposite to how rural FMCG distribution is run. There is potential for distribution synergy between FMCG and dairy players.

For this arrangement to work, the FMCG distributor can be based at locations where the dairy vehicles originate from (typically a district HQ/ tehsil). Retail outlets in collection centre locations can be serviced with dairy vehicles engaged in collection of milk. As the vehicle moves from the collection centre to the villages, it can offload FMCG stocks along its route, which have been pre-booked by the FMCG salesman. On its return journey the vehicle can pick up milk from the same villages. For the role played, the dairy transporter can be paid a small commission towards delivery charges at the outlets in addition to compensation towards transportation.

The advantages of the arrangement include a reduction in the logistics cost for the distributor

since there is no empty return of vehicles. Also, since milk collection is a daily run, a suitably higher frequency of servicing of retail outlets can be worked out. However, a number of potential issues need to be addressed to operationalize such an arrangement. These include suitable modifications to the vehicle to permit use of collapsible packaging

material for milk, management of transit time to avoid milk spoilage and aligning stock delivery timing with shop working hours. This model can lower delivery costs resulting in a lower margin outgo of ~1.2-1.4% for the company.



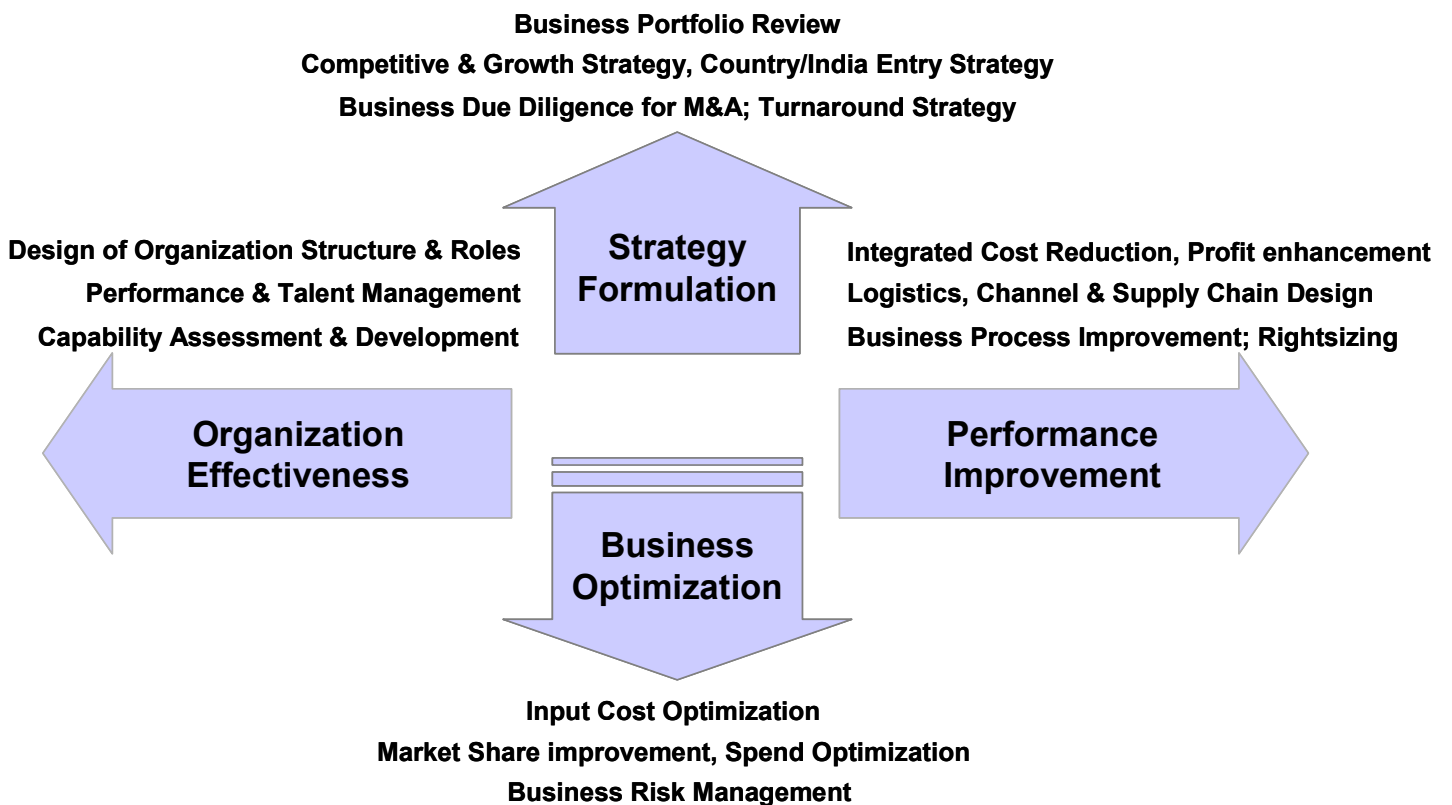
Choice of approach

Many approaches to serve rural markets can be evolved based on the principles of consolidation, de-layering and activity unbundling. The choice of approach will depend on the nature of product, its sales potential in rural markets and its value-volume ratio. Adoption of one or more of these approaches requires an innovation mind-set within the companies themselves as none of these approaches are taught as best practice case studies in B-schools or on-the-job training in the company.

Given the buoyant conditions, rural markets will continue to offer attractive opportunities for growth. Companies which do not initiate action on rural distribution are likely to miss out on the potential waiting to be tapped. However, only those who can create a profitable model through non-conventional and alternate approaches are likely to succeed.

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