Specialty Food And Beverage: A Case Study Of Small Business Management

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ABSTRACT

Specialty Food and Beverage is facing growing pains from its rapid expansion over the last decade and more. The case provides a summary of the challenges faced by the company in the areas of supply chain management, marketing plans, the creation of economic value, and the development of a long term strategy for profitable growth.

Keywords: small business, supply chain, marketing

INTRODUCTION

Late one afternoon in March 2009, Tim Casey, owner of Specialty Foods and Beverage (SF), purveyor of fine teas, sat down and composed a memo to his senior staff. SF 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. SF'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, SF 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 SFs 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 SF. All aspects of the company were to be examined.

SPECIALTY FOOD AND BEVERAGE

Specialty Foods and Beverage (SF) 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 SF 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 SF; 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 SF. SF is a relatively small customer of TH; as such, SF only produces specialized blends in batches about twice a year. More frequent production runs are considered economically infeasible by SF, 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 SF 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 SF 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 SF. 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 SF 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 SF 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 SF needing to air freight orders to these customers. Management of SF 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 SF. SF 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 SF. 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 SF'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. SF management suspects many find using the phone or fax simpler and are unwilling to make the investment in learning the web technology.

SF 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 SF brand. The extent of lost sales from lack of attention is unknown, but believed to be substantial.

A further complication to SF 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 SF'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; SF 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 SF.

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, SF is concerned that selling through these outlets would erode the brand image.

FINANCE ISSUES

In the early years of SFs 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 SF 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 SF, 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 SF 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 SF 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 SF 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 SF 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, SF 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 SFs 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.

AUTHOR INFORMATION

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APPENDIX 1

Summary Financial Statements
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	2006	2007	2008
Revenues	18,065	20,210	22,500
CGS	9,600	10,850	12,000
SG&A	4,560	5,300	6,100
Deprec	1,050	1,050	1,050
EBIT	2,955	3,010	3,350
Interest	75	75	75
Tax	1,152	1,294	1,310
Net Income	1,728	1,941	1,965
Cash	100	100	100
A/R	3,100	3,650	4,200
Inventory	1,850	2,050	2,400
Current Assets	5,050	5,800	6,700
Net Fixed Assets	2,500	2,550	2,600
Total Assets	7,550	8,350	9,300
Acc't Payable	1,200	1,320	1,490
Accruals	200	230	250
Notes Payable	900	900	900
Total Liabilities	2,300	2,450	2,640
Owners Equity	5,250	5,900	6,660
Total	7,550	8,350	9,300

Selected Industry Ratios*

Gross Profit Margin	30%
Net Profit Margin	4%
Avg Coll Period	35 days
Inventory T/O (CGS/Inv)	8.2X

- These ratios are approximate; data from most comparable firms is difficult to obtain with any reliability.

CASE NOTES

Background and Objectives

In this case the student is cast as an outside consultant brought in to advise Specialty Food and Beverage on how to proceed with their strategy. A wide array of issues are presented, and the student must identify problem areas facing the company and make recommendations on how to address these problem areas.

Uses

1. As an introductory case for upper level undergraduate or new MBA students. The case authors have used this case to introduce entering MBA students to a variety of issues that may face a small business. We provide students with some guidelines and direct them to study some specific problems faced by Specialty Food and Beverage management.
2. This case may also be used by more advanced students. We would expect such students to require less direction and to be able to develop more specific, sophisticated recommendations to the problems facing Specialty Food and Beverage than would be typical for introductory students.

Suggested Questions for Students

For introductory students, we suggest students begin by approaching the relevant areas of interest by topical area as follows:

1. Marketing

    - What do you think of SFs strategy of selling only to "high end" retail outlets?
    - SF still maintains a very loyal following for its product. How should the company ensure growth, or at least maintenance, of this customer base?

2. Finance

    - How would you characterize SF's current financial health?
    - Looking forward, do you see any causes for concern?
    - What does the information in Exhibit I tell you about the company's present and future financial condition?

3. Operations

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

4. Organizational issues; internal communications

    - How would you characterize the internal communications of the company?
    - 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.
    - If you were to redesign the communication "architecture" of this company, what changes would you make in how people communicate, to whom they communicate, and the ease by which such communication takes place?

More advanced students should not require this "prodding" to examine specific areas of concern for the company. Instructors may wish to modify, or even eliminate, questions for these students.

Case Analysis and Teaching Plan

Marketing Issues

Specialty Food and Beverage is primarily a marketing driven firm, so this topic is an appropriate starting point. Most students will understand that the primary value of this firm comes from its **brand value**. Introductory students may not grasp this key point at the outset. Speciality Food and Beverage is facing increasing competition in the specialty tea market, and protecting the brand value is critical. Some students will likely suggest development of a lower end product that may be placed in "mass market" outlets strategy (the instructor may wish to raise this possibility if students do not). This strategy has initial appeal, but the instructor should question students carefully about the potential pitfalls. First, there is the possibility that the mass brand may "infect" the current premium brand. Much of what makes the brand attractive to mass marketers is exactly what Specialty Food and Beverage doesn't wish to erode—the value of its brand. Additionally, SF does not operate in the mass market, and it is unclear whether they have the expertise to compete successfully in this crowded sector.

Another area of concern is current expansion strategy. This strategy might be characterized as "spray and pray". The owner doesn't seem to realize that simply expanding the number of product offerings may not result in additional sales. Rather, the opposite may well be true. Although some of the recent additions to the product line have been quite successful, others have not. The less successful offerings crowd out the better sellers; as noted in the case, retailers do not have an infinite amount of shelf space available to carry SFs product lines. This observation should lead students to a better strategy—some form of test marketing for new product offerings. In addition to poor products replacing good ones, the development of the new lines is also costly.

Finally, there is the question of the quality, real and perceived, of the product. This may well be the most important factor in the future success of the firm. The operations and quality control personnel do not seem to understand clearly the danger of diluting the product quality to achieve a higher short term profitability. If students do not raise the point, the instructor should emphasize the potential disaster of the media discovering product content problems. This discussion may provide a good lead into a shared analysis of risks to the company associated with investigatory media attention focused on its labor policies in tea-growing regions; its success or failure in "blind taste test" comparisons with cheaper brands; or the possible shortcomings of company leadership.

Operations Issues

This area presents a host of challenges for SF. Managing an international supply chain is far from easy. A major risk factor in the supply chain is SF's dependence on a single supplier for the majority of its inventory. As a relatively small account, SF has limited control over the price and, to some extent, the quality of the tea supplied. Volatility in the dollar/pound exchange rate exacerbates the risk. At some point, class discussion should explore the feasibility of reducing the dependence of SF on their primary supplier. This should be emphasized. Suggestions may range from finding other suppliers to moving much of the processing in house; depending upon the imagination of the students, this discussion could be quite lengthy. It is a difficult problem for SF.

Another difficult problem is the relationship between SF and its retailers. Many similar companies use a distributor network: they simply sell the product to the distributors, who in turn market to the retailers, keep the shelves stocked, etc. As noted in the case, there are two major downsides to using a distributor network: 1) profit margins will be less; distributors charge 20% for their services, and 2) SF may lose effective control over the distribution network (this point may be tied back to the value of brand, discussed in the marketing area). Although distributors may agree to service only certain retail outlets, once they own the product it is difficult to prevent them from offloading excess inventory to a convenient (ie-mass) outlet.

Finally, the inventory and payment procedures are poorly designed. It is apparent that this area has not been a priority for the company. Quite simply, they need to overhaul the inventory and receivables process.

Finance Issues

At some point in the discussion, the instructor should direct the students' attention to the financial statements in the exhibit and ask "what do the financial statements tell you?". If students do not see the link between the competitive environment and the financial statements, the instructor should "nudge" the students in that direction. Although sales are still rising, the profit margin is shrinking. This is, of course, consistent with the increased competition that SF is facing. It is also a result of the reliance on TH as the primary supplier and, more generally, an inefficient supply chain. The instructor should also poll students as to the likely financial impact of a marketing strategy that includes creating a "lower end brand" (discussed in the Marketing Issues section); students should quickly realize that, even if successful, this strategy would further depress profit margin (though sales would increase). This will provide an opportunity to open discussion of "sales growth vs profit growth"; many introductory students will not have considered the distinction before.

Organizational Issues

It would be difficult indeed to find any individual in this organization who is happy with his or her job. At every level, company employees and those to whom work is outsourced (such as sales to retail outlets) can come up with a "laundry list" of factors that make their work less profitable and more difficult or time-consuming than they would wish.

Students need to discuss how this organization deals with discontent, including the kinds of complaints that often have good solutions attached. What structural barriers in the company prevent the discussion and resolution of problems? What non-structural, interpersonal issues are at play in letting problems fester and shutting down creative, constructive solution-seeking?

Concluding Remarks

This case provides an opportunity for students to explore a variety of issues that are relevant to small firms. This is a particularly rich example with its far-ranging global supply chain, unusual distribution network, changing competitive environment, and organizational problems. It is likely that the case discussion may flow back and forth between the "areas". As all of the areas are related, this synergistic mode of analysis should be encouraged to some extent, but some focus needs to be maintained. Instructors will be challenged to keep "big picture thinking" in the forefront of discussion.

NOTES