INSIDE CHINA: The heavy consequences of indiscriminate distributor loading

Michael Alper of NeuvoMedica discusses the sales practice of distributor loading and explains why the short-term gain from this strategy does not pay off long term in China

In today's results-oriented marketplace, companies both public and private often make trade-offs between short-term results and longer-term healthy revenue streams and a healthy market overall. Often, the sale of products to distributors represent a convenient way for manufacturers to fill revenue gaps, as the latter can leverage these relationship via incentives or obligations to get distributors to increase their inventories to amounts significantly beyond the actual market demand.

This is a practice commonly referred to as loading, and is prevalent in China. Due to the nature of the Chinese market, most medical device manufacturers sell entirely or almost entirely through dealers. Also, since the Chinese medical device market continues to have double-digit growth, the idea of loading becomes easier since companies feel with some certainty they can make up the sales in the following year. Public companies are known to leverage dealers in China and other dealer-based markets due to their quarterly earnings pressures.

So long as the manufacturer has a very clear understanding of the market in terms of actual usage of the products, amount of loading (usually expressed in months of inventory), and market growth expectations, loading could be a very good tool to help manage risk. For instance, if a manufacturer forecast sales due to some product approval in 2015 but the approval was delayed to 2016, the manufacturer can make up the revenue gap by loading its dealers, knowing they will have strong sales in 2016. The manufacturer gets a more even revenue stream and meets the expectations of their shareholders, while the distributors get their products at a better discounted price.

Sometimes, however, manufacturers – or more precisely, sales people working for the manufacturers – use distributor loading as a way to pad sales, oftentimes at the market or distributors' expense. There are cases of sales managers giving incentives to significantly load their dealers in the short term to make their numbers look good. Some sales managers even use strategies to load up their dealers, then fire the dealers or shrink their territory in order to find more dealers to load. This leads to very good sales results for the sales manager in the short term, but for obvious reasons is not a good long-term strategy. Eventually dealers catch on and become unwilling to take on more of the product or become unwilling to partner with the manufacturer at all. However, by that time, the sales person has usually already leveraged their great results to move on and get a job at a new company. The remaining sales team is left unable to generate much sales after that for a significant amount of time while the market digests the dealers' inventories.

SMEs: don't be tempted

For small companies with new products to the market, distributors are sometimes willing to commit to very large numbers over several years (often at a significantly discounted price) in exchange for exclusive distribution rights. For small companies, such a commitment would be very tempting. The thought might be "to try it out," and even if the distributor can only make their commitments in the first year or two, the amount of cash generated would be significant enough to take the risk and in the worst case, the distributor can be changed.

The problem is that in such a situation, it can be very hard to switch distributors. If the distributor overcommitted in order to gain the business, their likely strategy would be to get a sufficiently low price that they can load sub-dealers and buy a significant amount of inventory themselves. Such a distributor would of course obfuscate this strategy and not share their sub-dealers. Thus the manufacturer would not know there is a problem until it's too late. Changing distributors at the time a problem is discovered would be very risky as there would be significant amount of inventory loaded with the distributor and sub-dealers and the communication to the sub-dealers would be controlled by the distributor. Thus the distributor could threaten to dump the inventory on the market, which would cause major pricing issues difficult to recover from. Other distributors knowing the market situation might not be willing to take on this business as well.

Thus, when dealing with distributors in China, it is very important to not just have numbers and commitments but also a clear understanding of the market – why and how you think distributors can make the numbers that they have committed to. Though China can sometimes be used as a good short-term revenue opportunity, it is important to clearly understand the market dynamics and evaluate the long-term risk to avoid long-term problems. China is not a place you want to be penny-wise and pound-foolish.

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