OLIVER WYMAN

CUTTING COGS

GOING BEYOND SUPPLIER NEGOTIATIONS

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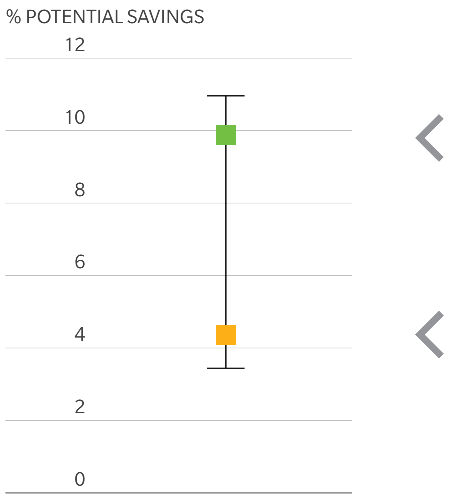
CUTTING COGS

In today's tough retail markets, reducing Cost of Goods Sold (COGS) is more important than ever. Buying cheaper means better financial performance even when sales growth is hard to come by, and while driving costs down requires little investment, the cash it frees up can allow the business to invest in other areas.

Of course, reducing COGS is easier said than done. Retailers have always tried hard to buy product as cheaply as possible, and most have redoubled their efforts in recent years. Although weak demand and increased competition have encouraged manufacturers to offer more attractive deals to maintain sales volumes, they can't escape rising costs forever: ultimately, they will need to pass them on to retailers. With many retailers experiencing weak sales, it's harder for them to promise suppliers volume growth tomorrow in exchange for lower costs today.

But there remains significant scope for retailers to reduce bought-in costs – in some cases by as much as 10% (see Exhibit 1). It takes a concerted effort over a 3–5 year period to reap the full rewards, but it can greatly improve earnings performance.

Exhibit 1: Range of opportunity



Higher Savings Potential (8%+) e.g. Hard Goods

- High proportion of complex, manufactured products
- Some spending with major brands, with limited previous negotiations based on robust data and analytics
- Strong buyer power, growth opportunities for suppliers
- Fragmented supplier base, with no partner structure
- Untapped opportunities for low cost country soucing

Lower Savings Potential (4%+) e.g. Grocery

- High proportion of commodity items, e.g. fresh produce
- Extensive previous use of supplier negotiations based on robust data and analytics
- Weak buyer power; limited supplier growth opportunities
- Consolidated supply base with clear supplier partnership structure
- Low cost country sourcing offices in place

The key to achieving these significant, sustained reductions in COGS is to recognise that achieving excellence in supplier negotiations is necessary, but not sufficient. Going beyond negotiations and getting into the detail of suppliers' underlying costs can yield multiple opportunities for further cost reductions. However, capturing these savings requires a transformation in the retailer's relationship with its suppliers. In this article, we will briefly discuss achieving excellence in supplier negotiations and then focus on going beyond this by taking cost out with partner suppliers.

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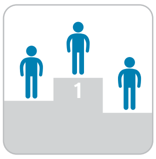
1. ACHIEVING EXCELLENCE IN SUPPLIER NEGOTIATIONS

Adopting sophisticated, systematised approaches to deliver the maximum results from each supplier negotiation



2. TAKING COST OUT WITH PARTNER SUPPLIERS

Building deeper relationships with a smaller group of suppliers and working with them to capture mutually beneficial savings

1. ACHIEVING EXCELLENCE IN SUPPLIER NEGOTIATIONS

Many retailers have made large improvements in their negotiating capabilities over recent years. It is no longer the case that suppliers are more likely to have the edge when it comes to negotiating with retailers. Sales teams at suppliers are able to focus on much smaller ranges of products compared to retail buyers who have to cope with hundreds of dissimilar ones. However, retailers have access to a lot more data, which, if they are able to analyse it and deploy it effectively, they can more than redress the balance in the negotiating process.

In many retailers, the information needed is scattered across unrelated, incompatible systems, making it extremely difficult for time-pressed buyers to get hold of what they need when preparing for negotiations with multiple suppliers. By working out how to provide buyers with the most relevant and useful information in an accessible, user-friendly form, retailers can ensure their buying teams make the strongest arguments possible and achieve the best results from the negotiation process.

The earlier Oliver Wyman articles "Five Questions For Effective Negotiations", "Negotiating with Suppliers from a Position of Strength", and "Smarter Arguments For Higher Profits" (available on request) provide more detail on how a retailer can build the most effective negotiating capability.

2. TAKING COST OUT WITH PARTNER SUPPLIERS

For those retailers seeking to move beyond supplier negotiations and reduce costs further, there are multiple large and untapped opportunities available. However, accessing them requires such a shift in approach and mindset that success has eluded most retailers. It is deeply ingrained in the psyche of retail buyers to use confrontational negotiation techniques with suppliers, focused on maximising leverage to get the best possible deals. And yet, getting at cost savings that are hidden deep in the end to end product supply chain necessitates extremely close co-operation between retailer and supplier. That means operating in a true partnership, openly sharing information and fairly dividing up the benefits.

This approach is standard practice in industries such as aerospace or automotive, where long-term supplier relationships are the norm and there is a strong sense of mutual dependency. In our experience, this approach makes most retailers feel extremely uncomfortable – they are reluctant to make long-term commitments with suppliers and often take the view that "it's none of their business" to understand how the products are made. As a result, to achieve further COGS reductions they have tended to revert to ever more aggressive negotiation approaches. In the long run though, these either fail to yield further savings or become counterproductive as stronger suppliers prefer to work with less aggressive competitors and weaker ones find they cannot cut margins further, ending up in financial difficulties or having to cut corners on product quality or safety to meet the retailers' demands.

SELECTING PARTNERS

It is neither practical nor sensible for a retailer to attempt to do this with its entire supply base. For a start, the work involved tends to be both time consuming and complex. Even the largest retailers will not have the bandwidth or capabilities to work in partnership with hundreds of different suppliers. More appropriate is to select a smaller group, typically up to 50 suppliers. These should be selected from the group of the largest suppliers, but not all of them will be appropriate. There are a number of important factors involved in selecting the partners to work with:

- Confidence that it is the right supplier for the longer term:
  - Those suppliers whose combination of product offering and commercial proposition will consistently drive both sales growth and superior margins
  - For some suppliers, their brands are so strong and consumer loyalty so high that it is inconceivable that they would not be a long term supplier. Their products are core to the range architecture and will continue to be for the foreseeable future
  - In other cases, the supplier is uniquely positioned, for example, with a structural advantage over its competitors in cost or freshness, or by providing unique products
- Relationship with the supplier:
  - A high degree of mutual trust and openness is critical. Success will be hard to achieve with suppliers that don't show a strong willingness to co-operate
  - The desire to work in partnership needs to be reciprocated. It may not make sense to partner with a supplier that has a much stronger relationship with a competitor retailer

Adopting the partnering approach doesn't mean an end to confrontational supplier negotiations. One of the challenges for retailers is to work out how to get both approaches working effectively together. In fact, the partner selection process itself can be used as a way to drive more from supplier negotiations. With the opportunity to become a partner at stake, suppliers will need to put forward their best possible proposals, on the basis that partners will grow share and non-partners will lose out.

This partner selection process presents a good opportunity to consider new suppliers, and indeed new types of supplier. For example:

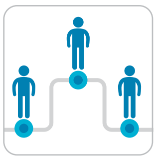
- Could a wholesaler be replaced with a manufacturer?
- Could a local supplier be replaced with a lower cost overseas source?
- Are there suppliers with fundamentally superior propositions, say in terms of quality, service level or speed to shelf?
- Are there suppliers with unique innovations or products that could be exclusive?

REDUCING COSTS TOGETHER

The process of selecting partners, agreeing 'more for more' deals with them and systematically shifting spend towards those partners will yield significant benefits. However, the more significant savings opportunities will come from getting into the detail of the cost out work with those partners. The biggest cost reduction opportunities are usually found in the following areas:

SUPPLY CHAIN

from raw materials to manufacturing and distribution

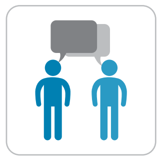


PRODUCT SPECIFICATIONS

including materials, design, accessories and packaging

INTERFACE BETWEEN RETAILER AND SUPPLIER

efficiency of processes, optimal order quantities



SUPPLY CHAIN

There are many ways that retailers can help their suppliers reduce costs in their supply chains. For example, retailers often have greater buying power than their suppliers in certain categories, such as specific raw materials or commodities such as fuel. A supplier which uses the increased buying power of one of its retail customers to reduce its costs can achieve benefits across all of its customers, and as a result the retailer involved should seek to capture a disproportionate share of the savings. Distribution costs can be another area for significant savings. For example, through optimising the use of backhaul whereby a supplier's delivery costs can be virtually eliminated by using the retailer's empty vehicles that pass the supplier's factory on the way back to their own distribution centre.

PRODUCT SPECIFICATIONS

As far as product specifications are concerned, large retailers often have little understanding of the cost implications of their demands. In fact, in many cases the supplier's own sales teams do not have a full understanding of the true costs associated with producing the products. Take, for example, the manufacturer of silicone sealants selling to a DIY retailer who, in order to hit a lower price point, made a small reduction in quantity of product in the tube believing this would reduce the cost, not understanding the knock-on cost increase from disrupting the manufacturing process. Or the retailer that produced a detailed packaging specification for one of its own brand products but didn't know that this would require the manufacturer to use a non-standard, and more expensive, printing process, but where a small change, unnoticeable to the end consumer, would mean a standard process could be used.

INTERFACE BETWEEN RETAILER AND SUPPLIER

Significant costs can arise from the way in which the retailer and supplier work together. There can be multiple opportunities for streamlining the way that key processes operate, including demand forecasting, order placement and replenishment, goods receipting and payment. Minor adjustments on either side, for example improving how data is shared, can lead to big improvements by reducing workloads and improving accuracy. Order quantities can have a significant impact on a supplier's production costs. In some cases the production costs per unit of a full batch can be significantly less those for a part batch due to the effects of set up costs and line downtime. Hitting the optimal order quantity, taking into account all of the costs including production and storage can pay big dividends for certain product categories – see Case Study 1.

All of these efforts by the retailer and supplier working together to reduce costs can deliver large benefits for both. However, there is one important caveat: while this close partnering with suppliers can yield big benefits, there is clearly a risk that suppliers will find opportunities to take advantage of the reduced competitive pressure associated with their partner status. As a result, retailers need to include mechanisms in their partner agreements to prevent this. For example, by including 'best price guarantees' that give the retailer the opportunity to find the best prices in the market and require the partner to match these in order to retain its status. This can be achieved by running a regular process of price benchmarking and competitive tendering or reverse auctions at the product level.

We have focused on the potential cost benefits of this approach, however there are a number of other important benefits from cultivating these close relationships with core suppliers. For example, in some categories which experience supply bottlenecks, building close relationships with certain suppliers can lead to a significant competitive advantage in terms of security of supply. In other cases there can be benefits from working together to achieve improvements in sustainability or drive improvements in service levels, product quality or developing unique products to give the retailer a competitive edge.

CASE STUDY 1

MULTINATIONAL DISTRIBUTOR

A multinational distributor was working closely with a key supplier to identify cost reduction opportunities. Together, they spotted the potential benefits from optimising order quantities. The products were made to order for the distributor in batches. Small orders meant the manufacturer needed to set up a production line then shut down and clean it just a few hours later. Unit manufacturing costs would reduce as the order size increased until a second production line was needed which would increase unit costs again (Exhibit 2). Analysis showed that orders were not being placed in a way that minimised production cost. Only 7% of orders were within the lowest cost zone (Exhibit 3). The companies also factored in storage and delivery costs to minimise total costs. Because of their partnership, the distributor could recognise which order quantities minimised total cost, with the subsequent savings shared between the two parties.

Exhibit 2: Cost of different order quantities

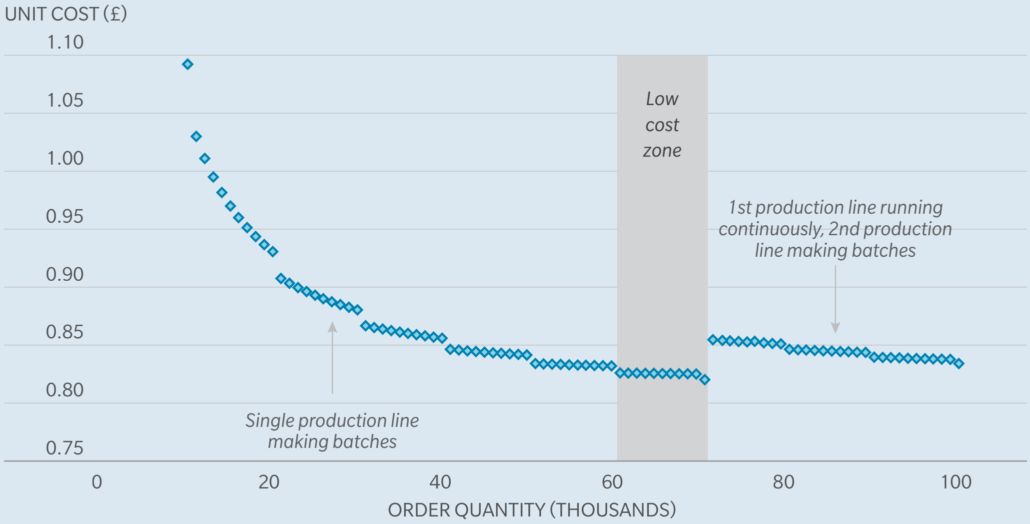


Exhibit 3: Order quantity distribution

PUTTING IT INTO PRACTICE

A systematic programme to reduce COGS can deliver significant gains, but it's important not to underestimate the amount of work required. It needs a significant effort over and above the existing work of the retailer's commercial teams, and these teams are often already stretched with a multitude of other requirements – managing the range, running promotions, managing prices, and so on.

When it comes to supplier negotiations, the challenge isn't usually a lack of awareness or understanding from buyers of what needs to be done, but a lack of time combined with a lack of access to the analysis and tools that would enable them to develop the best possible negotiating positions.

Successfully executing a 'partner cost out' programme is a much more significant challenge for most retailers. It is likely to require a considerable change management effort, not only with the retailer's commercial team but also with the suppliers. There needs to be clear and consistent communication of the programme, so that the suppliers understand what is happening, why it is important and what is expected of them – supplier conferences and direct communication from the retailer's CEO form an important part of this. Internally, everyone should be aligned on what needs to be done: how they should be working with partner suppliers and what the expectations are from both sides. In addition, there needs to be detailed tracking of activities to ensure the programme remains on course across all the partner suppliers, combined with robust measurement of the benefits being delivered.

For those retailers with a degree of vertical integration, or those with low cost country sourcing offices, they will have some in house experience further up the supply chain. However, in most cases the skills required differ so much from those traditionally associated with retail buying that it is necessary to bring in specialists with deep cost reduction experience (probably from other industries), as well as putting in place a thorough programme of training and development for the commercial team.

In summary, venturing beyond supplier negotiations into the world of 'partner cost out' isn't going to be a short, 'one off' project. It needs to be thought of as a multi-year programme, with a focus on building and embedding the capabilities the organisation needs to ensure the benefits are sustainable in the long term. Those retailers that are able to implement successfully will be able to access reductions in COGS that would be unobtainable through negotiations alone. The case study on the next page describes how one retailer approached the problem, and was ultimately able to reap significant rewards.

CASE STUDY 2

EUROPEAN DIY RETAILER

CONTEXT

A multi-country, multi-format DIY retailer with historically high margins was facing an increasingly difficult market, with new competitors entering. Its commercial teams had been working hard to negotiate deals with suppliers – although synergies across countries were very limited. A new management team came on board with a view that a reduction in COGS of 8–10% was possible and decided to embark on a three-year programme.

APPROACH

The management team created a strategy to deliver the reduction in COGS over three years – at the core of this was partnering with suppliers.

The initial focus was on the top 50 suppliers. This was kicked off with a supplier conference, and was followed by detailed analysis to create negotiation ‘asks’ tailored for each supplier and a structured process of negotiations with each supplier to obtain best offers for re-alignment and future growth. This re-alignment and re-negotiation approach was replicated across the wider supplier base, but with a lighter touch approach.

Regular meetings were held for the senior team to evaluate supplier offers and select partners. Then three year agreements were put in place with all partners to lock-in the benefits proposed by suppliers, and to facilitate the next stage.

Once partners were in place and spend had been largely consolidated to them, a cost down programme was initiated to identify and deliver the next wave of savings – getting suppliers to deliver on the commitments they made in their agreements.

In parallel, an intensive programme of tenders, e-auctions and product cost benchmarking was launched to deliver further savings from non-partner suppliers and ensure partners were providing the most competitive possible product pricing. In some categories, this included moving to direct sourcing from lower cost countries.

Throughout the three years, a comprehensive programme management approach has been in place to ensure activities remained on track and benefits were robustly measured and captured. Additionally, specialists with cost reduction expertise were brought in from outside the organisation to help drive the cost out work with partners and develop these skills across the commercial team and tools were built to enable the commercial teams to repeat the process and sustain the benefits over the long term.

THE RESULTS

The programme is on track to achieve its savings target of 8% in three years, despite extremely challenging trading conditions that impacted the ability to offer growth to suppliers. The COGS reduction programme has been a huge contributor to the company’s financial performance over this period.

ABOUT OLIVER WYMAN

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

In the Retail practice, we draw on unrivalled customer and strategic insight and state-of-the-art analytical techniques to deliver better results for our clients. We understand what it takes to win in retail: an obsession with serving the customer, constant dedication to better execution, and a relentless drive to improve capabilities. We believe our hands-on approach to making change happen is truly unique – and over the last 20 years, we've built our business by helping retailers build theirs.

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