



Making the right connections

Building profitable retail relationships through Cost to Serve

Issue

Consumer products companies are being squeezed between the increasingly onerous commercial demands of retailers and the challenges of the broader economic environment. A combination of record high commodity prices, zero or negative growth in developed markets, tough economic conditions, changing consumer behavior and declining retailer margins means consumer products companies have to deliver better service for less cost in order to remain competitive.

Why is this relevant now?

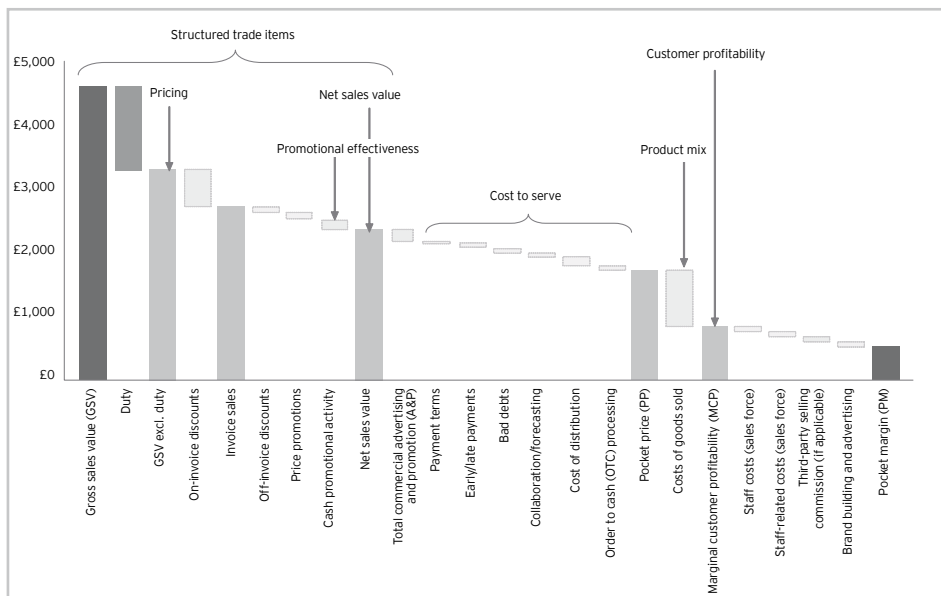
Supply chain makes up a significant proportion of consumer products companies' cost base. Up to 60% of COGS (cost of goods sold) can be affected by the impact of customer behaviour on distribution, warehousing and forecasting. Many manufacturers have inadvertently rewarded inefficient behavior through unconditional efficiency discounts and are now seeing potential cost increases as retailers become more demanding. In our experience, the difference in Cost to Serve between the most efficient and inefficient

customers can vary by a factor of 10. This is not tenable in today's tough economic environment in developed markets.

Implications

Consumer products companies need to be able to reconfigure their service offerings for top customers in order to differentiate themselves from the competition and liberate value for manufacturer and retailer – without driving up costs. To do this, companies need to understand both cost structures and drivers, how those drivers interact, and how retail customers' behavior influences these costs.

Deaggregating cost to serve highlights opportunities to reduce value leakage



What are the components of cost to serve?

Cost to serve is often averaged across customers and products in a profitability review. The results can be misleading because of the high variability between customers. Cost to serve is not just a function of customer scale but also behavior and organization. Deaggregating these averages highlights opportunities for businesses to reduce value leakage.



How does cost to serve vary by customer and promotion?

Customer behavior is a primary cost driver. Specific replenishment requirements, for example frequency and lead time, pallet requirements or network changes, all impact warehousing and distribution costs. In addition, ordering behavior can drive cost; for example, the frequency of ordering, the size of the order and the level of case pick will all drive different costs.

Customer type is also a factor. National retailers, wholesalers and more specialist retailers may have different ordering patterns that will lead to a particular cost profile. It is important for consumer products companies to identify the outliers – companies that do not fit the type (e.g., buying groups that don't break down orders themselves but require multiple drop-offs) and tailor service levels and price offerings accordingly. Small customers, or large customers that behave more like small customers, need to be recognized and managed.

Promotional activity is also an important component of cost to serve. Well-planned and integrated promotions generating full trucks of standard pallets will improve efficiency and create scope for additional value sharing with customers.

Response

What are good companies doing to make retail relationships pay?

Understanding the true cost to serve should be the basis for commercial negotiations with retailers. In our experience, there are three key areas on which teams should focus in order to build more productive relationships with retailers.

1. Identify and address the activities that drive cost

Up to 60% of COGS, including ordering, planning, logistics, warehousing and transportation can be directly impacted by retailer behavior. Yet consumer products companies often accede to customer's demands without truly understanding the impact on cost to serve. As illustrated in the chart on page 3, variation in customer ordering can have a significant impact on cost to serve.

A large UK retailer, for example, required a global manufacturer to deliver pallets without the top layer of cases in order to fit the height requirements within its distribution center. This created the need for expensive manual intervention in the warehouse and resulted in trucks running without a full load. The financial implication of this requirement, an additional annual supply chain cost, was not identified. Companies only need to concede to two or three apparently straightforward customer demands such as this before significant cost is added to the supply chain.

Manufacturers that can continually identify quick wins internally to drive cost out of the supply chain are at a clear competitive advantage. Key areas to focus on are: case pick, pallet pick and distribution.

2. Align cost to serve with efficiency trade terms to reward efficient behavior and defend against changes that drive cost

As pressure on consumer products companies increases, there has been more creativity around innovation, trade terms and individual product promotions. Consumer products manufacturers frequently reward inefficiency by returning up to 1.5%-2.0% of list price as part of standard trade terms, without enforcing the requirement that customers order efficiently.

If efficiency discounts on cost to serve are to be effective, they have to be embedded across the organization so they can form the basis of commercial negotiations with retailers. For example, assumptions on a level of case pick and truck fill should inform the level of discount offered and create the incentive to order more efficiently. If greater flexibility is required, creating supply chain inefficiency, this will be reflected in the level of discount available. Armed with this information, retailers can decide, for example, whether to replenish product in fast- or slow-moving warehouses.

"Because the cost structure is vast and complex, it is critical that supply chain and operational leaders understand it and work together to drive efficient behavior and avoid inadvertently rewarding value-destructive retailer behavior."

Fabian Wehren, Director, Supply Chains & Operations Advisory, Ernst & Young



Once cost to serve understanding is embedded in the trade terms agreement, it provides consumer products companies with a framework to defend against the sudden changes that drive increased cost. It also lays the groundwork for building differentiated service agreements tailored to each customer's requirements.

Successful consumer products companies define an efficiency discount matrix based on the true cost to serve and integrate this into the overall trade terms framework with their retail customers, enabling fact-based conversations with customers on joint value creation.

3. Model the impact of retailer demands to enable discussions that create joint value

As retailers demand increasing levels of service in terms of frequency, flexibility or responsiveness, it is key that manufacturers can model the impact of these changes on the supply chain, so they can have proactive, balanced, fact-based discussions with customers.

Modeling paves the way for a two-way dialogue for joint value creation in which the manufacturer is not only responding to the retailer, but proposing changes that will jointly create value, based on a much better understanding of current order flows. Such a capability will foster better working relationships with retailers even as they become more challenging.

Consumer products companies need to maximize the use of modeling to provide forward-looking perspectives as an aid in negotiation on new and varied service offerings being proposed by retailers.

By establishing a cost to serve modeling capability, companies can drive significant improvements to the bottom line through cost reduction and joint value creation initiatives, as shown in the table below.

Walmart, Carrefour, Tesco and Metro Group share similar supply chain priorities, according to recent research by the IGD (*Is your supply chain more strategic now? IGD Supply Chain Analysis*, June 2011.)

Walmart wants to consolidate global sourcing as a "major source of leverage for the company in years to come" with a clear focus on EDLP (everyday low pricing), broader assortments and greater promotional intensity. Carrefour is looking to optimize and integrate processes to reduce operating cost by €700m and inventory by seven days. Tesco wants stock on the shop floor, not in the warehouse, and Metro is focusing on reducing handling costs and improving shelf replenishment efficiencies.

The impact of these requirements on consumer products manufacturers will continue to be significant. Companies will be expected to deliver to retailers more frequently, often in smaller quantities and offering greater variety through a higher level of case pick. The challenge will be to deliver against these service expectations without allowing costs to rise.



Assess areas	Identify potential changes	Target benefits
Order assembly	<ul style="list-style-type: none"> ▶ Incentivize customers to order full pallets to reduce case picking ratio through structured pricing/trade terms ▶ Identify inefficient order demands and associated costs to drive fact-based discussions 	10%-20% of budget
Transport	<ul style="list-style-type: none"> ▶ Increase transport efficiency ratios via customer price negotiations/ introduction of logistics terms ▶ Support transport contract renegotiation 	6%-12% of budget
Distribution center utilization	<ul style="list-style-type: none"> ▶ Utilize spare capacity in distribution centers ▶ Manage warehouse labor pool across distribution centers and reduce headcount 	7.5%-15% of budget
OTC processing costs	<ul style="list-style-type: none"> ▶ Increase average order sizes via structured trade terms that reduce processing volumes 	15%-30% of budget

What should consumer products companies be asking themselves?

- ▶ Do I understand the true implications of increased service demands from retailers?
- ▶ How do I engage in fact-based conversations with retailers?
- ▶ How do I build collaborative relationships with retailers?

“Currently there is something of a dysfunctional triangle whereby retailers attempt to push costs down and increase demands on consumer products businesses. At the same time, the commercial departments within consumer products businesses become more creative around deals and promotions to satisfy increasing retailer demand. Supply chain is squeezed by both the external and the internal client, where decisions are being made, which ultimately drive up costs for both manufacturer and retailer. Effective and successful relationships exist where all three parties are working to more closely aligned objectives.”

Fabian Wehren, Director, Supply Chains & Operations Advisory, Ernst & Young

How Ernst & Young can help

Our work with the commercial and supply chain functions within consumer products companies enables our clients to have fact-based negotiations with customers as they evolve their requirements and service offerings. In our experience, better preparation for, and management of, these conversations can result in better value for you and your customers.

Specifically, we can work with you to:

- ▶ Develop scalable and sustainable capabilities to model and manage cost to serve
- ▶ Generate clarity on the return expected from investing in supply chain responsiveness - specifically responding to customer demands on deliveries and lead times
- ▶ Unlock cost savings by optimizing the overall supply chain in terms of customer ship points, inventory, direct shipments and increased truck fill
- ▶ Enhance the capability to defend against future customer demands by improving understanding of the likely impact of requests such as stockless supply chains, rebates based on reshaped delivery networks and changes to customer ordering profiles
- ▶ Cement your position as a leading manufacturer by proactively taking opportunities to retailers and engaging in joint value creation discussions

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How Ernst & Young's Global Consumer Products Center can help your business

The global recession has reset the consumer products landscape. Value-seeking consumers, intensified competition, increased commodity costs, and growth opportunities in emerging markets are driving change. Consumer products companies now need to be leaner and more agile, with a relentless focus on execution. If you lead a consumer products business, you need to anticipate trends, identify implications and make informed decisions that support your business goals. Our Global Consumer Products Center enables our worldwide network of over 13,000 industry-focused assurance, tax, transaction and advisory professionals to share powerful insights and deep sector knowledge with businesses like yours. This intelligence, combined with our technical experience, can help you accelerate and improve your execution. We can help you to realize the full value of your transactions, improve customer and brand profitability, drive down costs and build an agile and resilient supply chain. If you want to compete powerfully in your market, we'll help you achieve your potential today and tomorrow.

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