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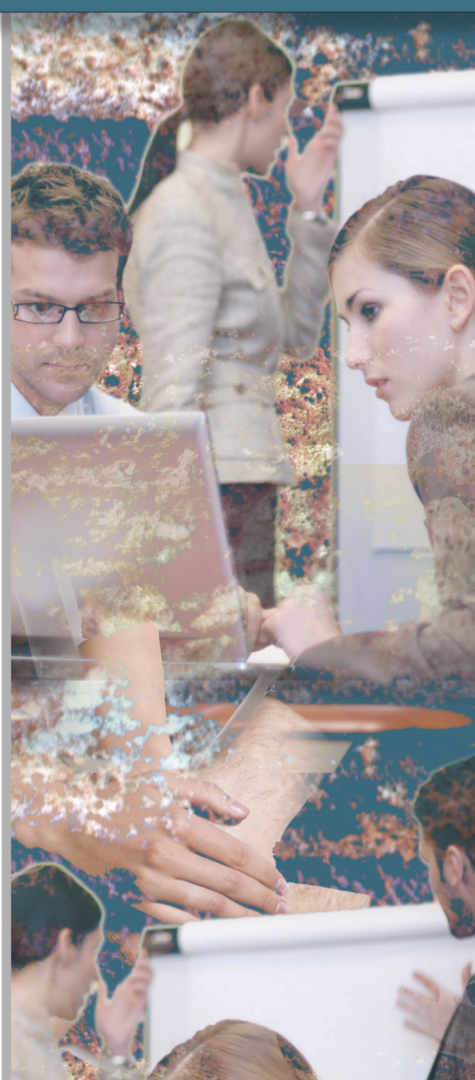
Collaboration— But Not as We've Known It

The changing relationship between retailers and suppliers



In today's fast moving consumer goods market, there seems to be more untapped value than ever. Retailers and suppliers believe collaboration is the key to capturing more customers—but how to go about it? An A.T. Kearney study reveals that traditional relationships are no longer working, and only a fundamental rethinking of value chains and business models will capture today's more diverse, demanding and well-heeled consumers.

A wealth of opportunities exists in fast moving consumer goods (FMCG) markets—especially in developed markets where fundamental demographic changes are taking place. Segments of the population that once were niches are becoming mainstream, and mainstream segments are becoming niches. A polarization of wealth is occurring; the middle-income brackets are slowly vanishing, replaced by more upper- and upper-middle-income consumers on one end and low-middle to low-income consumers on the other. And as the global population ages it is altering traditional consumer segments worldwide.

Consider this: In 40 years, 40 percent of the Japanese will be more than 60 years of age, compared with 25 percent today. In Western Europe, the 60-and-older age-group will increase from 20 percent to more than 30 percent, and in the United States from 15 to 25 percent. Multicultural societies in developed countries are on the rise and will further drive the diversity and complexity of consumer demand. In Canada, for example, the population as a whole rose roughly 5 percent between 2001 and 2006, while the minority population rose 27 percent during this same period. Similar trends can be found in other developed FMCG markets in Asia, Europe and the United States.

These demographic changes offer retailers and suppliers in the consumers goods industry the chance to target new consumer needs, develop specific products and services and deliver customized value.

As variety grows, consumers are becoming more demanding and discerning in their purchasing criteria. Today's consumers want more for their money, including a unique shopping experience. For example, the butchers at Whole Foods grocery stores sing while they work, like they might do in a "real" market. More consumers are also interested in sustainability (some retailers are printing carbon labels on their products), authenticity (consider Ralph Lauren's bleached jeans, sold at premium prices) and a feeling of health and well-being (Frito Lay is now selling fruit and vegetable chips).

"Good relations result when everybody understands the value chain of the other. If we understand the value chain of our supplier, and they understand ours, we can make something happen."

— Renaud Cogels
Executive Vice President, Delhaize

Consumers are Integrators

Consumers are not only demanding products that satisfy their increasingly diverse and complex needs, but also want those products to be available at different stores in multiple locations. Gone are the days when people made a weekly trip to the supermarket and purchased everything they needed at once. In the United States, for example, 73 percent of customers shop in five or more stores. While this presents a challenge (as people spend less money at any one store), it also presents an opportunity to create new formats.

The fastest-growing formats for the top 30 retailers worldwide (stores opened in 2006 compared with 2001) are discount, drug and convenience stores. In the same time period, fewer supermarkets and neighborhood shops opened in 2006 than in 2001. It is almost as if consumers are rebuffing two decades of what they perceive as retailer dominance and are no longer willing to let retailers dictate shopping formats. Some forward-thinking companies have picked up on this: Log on to Amazon.com and "subscribe" to receiving four boxes of Raisin Bran cereal per month and get them for a lower price than at most supermarkets.

Besides demographic changes and rising demand, there are still more opportunities as customers are no longer confined by their traditional segments. The same person who flies Virgin Atlantic first-class on business, flies EasyJet on vacation. It is not unusual to see Mercedes-Benz and BMW vehicles in the parking lots of discount stores. Consumers are becoming integrators: cross-shopping and scaling up and down among products, categories and formats.

The Traditional Approach Isn't Working

The buy-sell relationship of today's A-brand manufacturers and retailers has not been able to adapt to these consumer shifts or capitalize on the opportunities. The FMCG industry, in particular, has done little to attract new customers with discretionary income—and there are lots to attract *(see sidebar: Fighting for Wallet Share).*

To determine why retailers and suppliers are not reaching these new customers, we launched the A.T. Kearney Retailer and Supplier study and surveyed retail and supplier company executives in 40 firms in Asia, Europe and North America. We conducted one-on-one interviews with several industry leaders to gain a better understanding of how retailers and suppliers collaborate, how the relationship is changing, whether or not collaboration is creating value and what can be done to expand the profit pool.

The findings reveal that executives are often disappointed with the results of collaboration. On a scale of 1 to 5, retailers' satisfaction in achieving desired results is 2.9, while suppliers' satisfaction is even lower at 2.6. Although retailers and suppliers say they expect to collaborate more in the future, they do not seem to have a clear idea of how they will do so—or, at least, how they will create more value through these collaborations.

Renaud Cogels, executive vice president and head of global sourcing, Delhaize.

Impediments to Creating and Capturing Value

There are several obstacles that prevent retailers and suppliers from working together to create more customer value.

Traditional buy-sell relationship. The traditional buy-sell relationship between A-brand manufacturers and retailers makes collaboration counterintuitive, keeping them in the age old "buy low, sell high" negotiating mode. Anthony

Fighting for Wallet Share

In developed markets, consumer spending is increasing faster than inflation while the proportional share of money spent on food has been decreasing. In France, for example, the share of discretionary income spent on food was nearly 28 percent in 1994 and by 2007 had declined to 20 percent.

"When we look at the share of wallet that food spending represents, I think we all know that this has been shrinking for the past decade and that consumers are enticed to spend more on travel and leisure," explains Eugene Willemsen, PepsiCo's general manager for northern Europe.

Economic forecasters say this trend will continue. In Germany, for example, households will spend nearly 4 percent less on food in 2030 compared with 2003, while spending on travel will increase by 3 percent. (These are absolute, not proportional figures.) Many observers say the trend diverts the focus away from growth toward more intense competition among retailers and suppliers.

"The margin 'pie' is flat because of suppliers fighting against each other and against retailers, rather than working together against other competitors, such as car manufacturers and travel agencies," explains Ab Pasman, former chief executive officer and board chairman of Dutch beer-maker Grolsch. "The current way we fight for share of wallet is the wrong battle."

Tsai, chief executive officer of the Beijing Hualian National Retail Innovation Institute and executive vice president of the BJ Hualian Hypermarket Company says, "There is a plateau of performance because at the core of our business today, we have a negotiation strategy. I think this is limiting the growth in our industry."

The business focus has been the traditional one: horizontal competition, market share and each group's piece of the margin pie. Renaud Cogels, executive vice president and head of global sourcing of Belgian retailer Delhaize, adds, "In fact, we are not there to grow *the* pie; we are there to grow *our* piece of the pie."

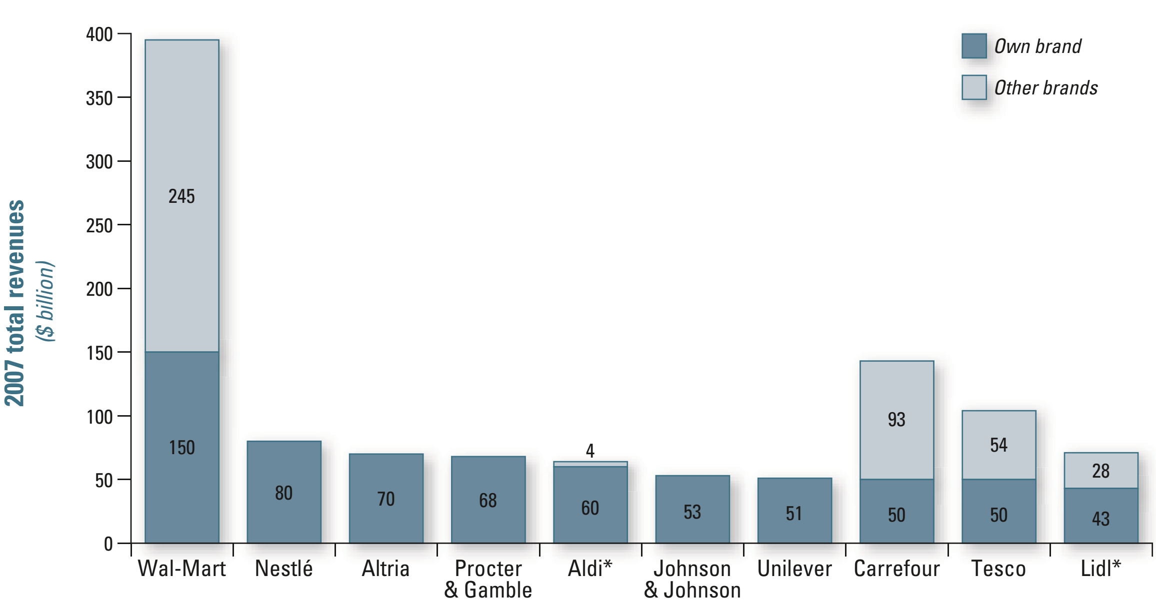
Anthony Tsai, chief executive officer, Beijing Hualian National Retail Innovation Institute and executive vice president, BJ Hualian Hypermarket Company.

Consolidation and concentrated markets. In recent years, this traditional model has been reinforced by major mergers and acquisitions, including Procter & Gamble and Gillette, Mars and Wrigley and Group Danone and Royal Numico N.V.

Concentrated retail markets are common in Western Europe, with the top five retailers having anywhere from 60 to 90 percent of market share. Such consolidation creates bigger, more powerful players and further embeds the traditional buy-sell relationships. It also creates an opportunity to leverage size and buying power, and divert the focus from the benefits of collaborating.

Figure 1

Half of the largest food manufacturers are also retailers



Note: Dollar figures are based on U.S. exchange rate during each company's fiscal year
**Aldi figure includes Aldi Sud; Lidl figure includes Schwarz Gruppe and Kaufland*
Sources: Planet Retail, 2007; Fortune Global 500, 2007; A.T. Kearney analysis

"Collaboration between suppliers and retailers in Western Europe showed improvements on the supply-chain side because it was a cost-reduction issue for retailers," says Philippe Guyard, vice president of group sales for Danone.

But combined with increasingly demanding consumers, collaborative results have too often been value eroding rather than the steady growth of revenues and margins.

Private-label strategies. Retailers are capitalizing on this consolidation by vertically integrating through private-label strategies, bypassing the traditional buy-sell supplier relationship and competing directly with suppliers. The increased scale retailers now enjoy allows them to implement these strategies more effectively. This is a major reason for the success of private-labels, which is expected to grow globally by 4 percent per year. "The supply chains' private-label suppliers offers are much more tailored to our supply chain . . . they are very much focused on our strategy and specific offerings," says Sander van der Laan, president and chief executive officer of Giant-Carlisle, a subsidiary of Ahold USA.

In private-label strategies, retailers compete directly with suppliers for product design and customization and, ultimately, shelf space. Consequently, retailers now rival traditional manufacturers in implied manufacturing volumes: Five of the top 10 consumer goods manufacturers are also retailers *(see figure 1)*. Conversely, suppliers are becoming retailers: Häagen-Dazs and illycaffè opened their own stores.

This raises a question: How do you collaborate with your direct competitors on anything other than efficiency? Renaud Cogels has an answer: "In my personal view, we cannot cooperate with the competition."

Collaboration: Lukewarm, At Best

It should come as no surprise then that the survey reveals that retailers describe their relationships with suppliers as halfway between transactional and collaborative, while suppliers view their relationships with retailers as *more* transactional than collaborative. Perhaps more startling, the results also indicate that only 10 percent view their collaborative results as exceeding expectations, less than 50 percent claim to have achieved expectations, and more than 40 percent say their collaborations have fallen short of expectations.

> Consumers are becoming integrators: **cross-shopping and scaling up and down** among products, categories and formats.

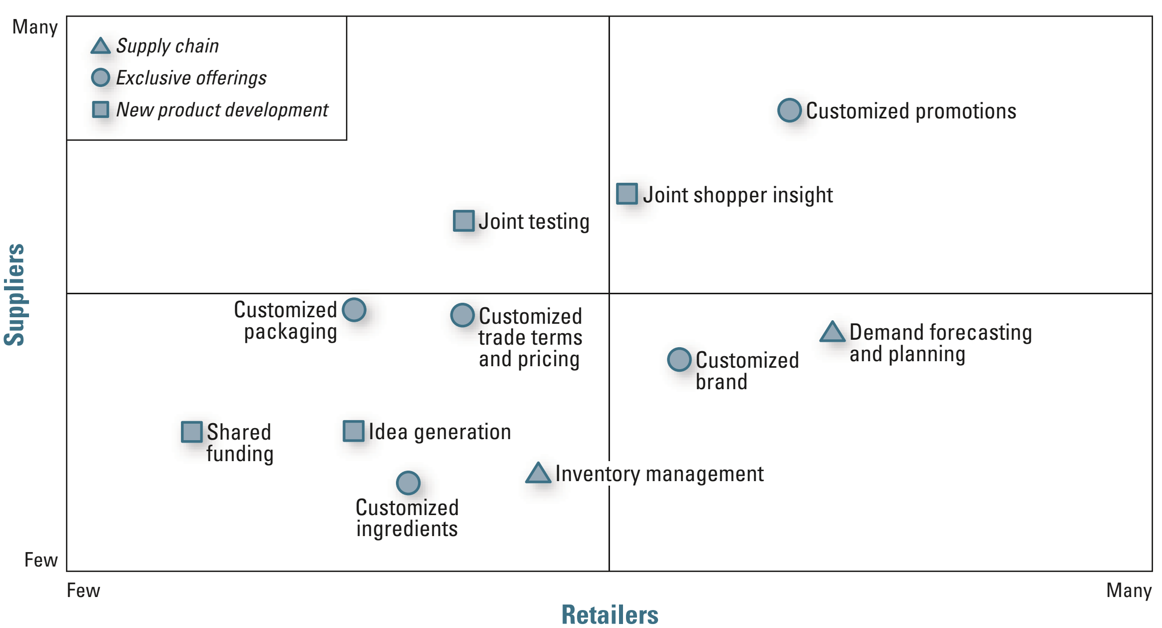
We presume, therefore, that these cooperative working relationships are primarily random and unfocused *(see figure 2 on page 6)*. Retailers and suppliers are substantially involved in only two of the 11 areas—customized promotions and joint shopper insight. Even the one traditional area of collaboration—supply chain—shows limited involvement. There is little teamwork in six of 11 areas in which both retailers and suppliers could be jointly involved. We were unable to determine what type of collaboration is most common.

Collaborating on more initiatives does not necessarily translate into better results *(see figure 3)*. Several retailers and suppliers have partnered in only a few areas, yet have achieved significant results. Conversely, several suppliers have collaborated in many areas and have *not* achieved desired results. The majority fall somewhere in the middle, working together in some areas but achieving mediocre results. Retailers seem to be getting more out of these initiatives than traditional suppliers, probably because retailers are used to working closely with private-label suppliers. This indicates that, for retailers at least, collaboration in the traditional sense is not naturally conducive to capturing real value.

However, in the future, both retailers and suppliers say they expect to work together more in all areas, including innovation, exclusive offerings and supply chain. For example, today less than 30 percent of retailers and suppliers say they partner on idea generation, while more than 70 percent say they expect to do so in the future. Food retailers and suppliers say they want to step up to a new level of value creation. As Renaud Cogels puts it, "Absolute growth is to give value to the consumer, which gives value to everybody."

There are some first examples of value-creation in the FMCG industry. "We ran a promotion where we put the consumer fully in charge to develop a new flavor and name for a new variety," says Eugene Willemsen, PepsiCo's

Figure 2
What are suppliers and retailers collaborating on?



Source: A.T. Kearney retailer and supplier survey, 2007 general manager for northern Europe. "This has been a phenomenal success."

But to capture real value, much remains to be done. Too many retailers and suppliers are not truly differentiated, since they do not assign strategic importance to partner selection and exclusivity. As Sander van der Laan says, "Our suppliers should think more in terms of differentiation, not a one-size-fits-all approach for every retailer."

Eugene Willemsen, general manger for northen Europe, PepsiCo.

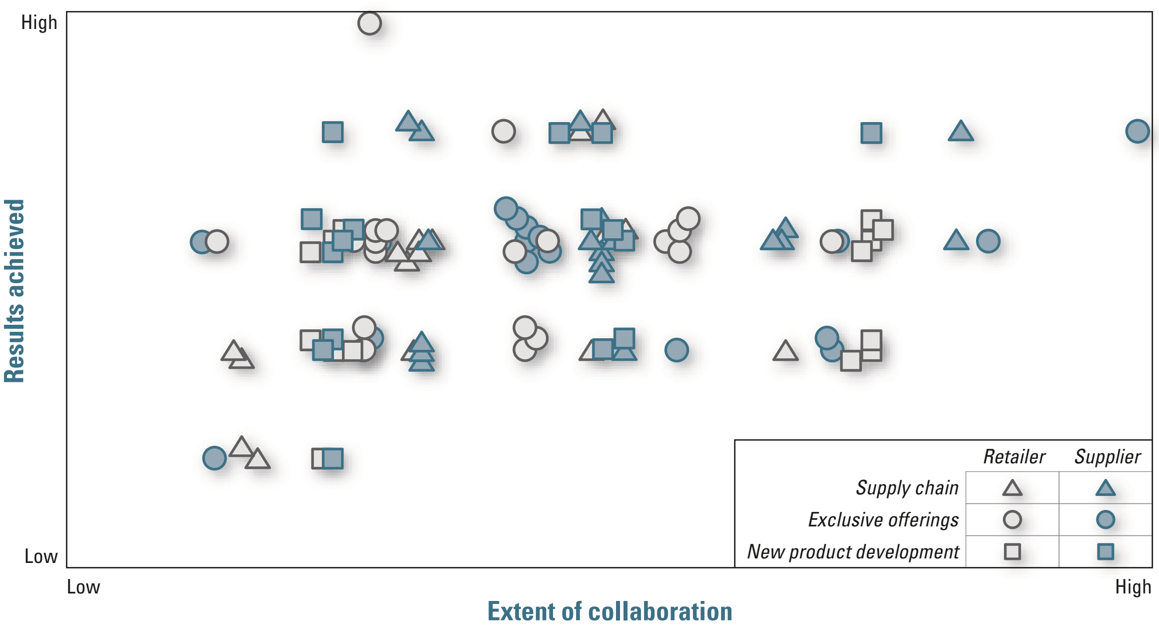
Exclusive offerings are achieved largely on the "soft" side of product offerings, such as promotions, trade terms, supply chain and pricing, and less on the "hard" side, such as ingredients and packaging, which have a bigger influence on consumer value. More than 70 percent of respondents say they have exclusive agreements on promotions, yet only 30 percent collaborate on exclusive packaging and ingredients. Suppliers seem to be walking a thin line between offering all retailers the same products and offering exclusivity through customization.

"A-brands are still not open to developing specific products for their clients," says Nathalie Pellen, chief procurement officer of France for the Casino Group.

This makes it difficult for retailers to differentiate from each other or to provide a format that offers customers a unique experience.

Figure 3

Collaborating more does not mean that desired results will be achieved



Source: A.T. Kearney retailer and supplier survey, 2007

"A lot of changes initiated by the A-brand suppliers are not real innovations," says Sander van der Laan. "We are not looking for the 25th variant of shampoo or the 27th variant of chocolate. We would very much prefer to talk about *real* innovation, creating a point of differentiation between us and discounters and also between us and other full-service supermarkets."

SANDER VAN DER LAAN, *president and chief executive officer of Giant-Carlisle.*

Because of suppliers' need for volume and the amount of risk involved in exclusivity, most refrain from offering truly differentiated products to different retailers. "Weak growth in the industry limits risk-taking," says Philippe Guyard. "We are therefore never in a position to test our strongest ideas."

Overall, our survey reveals a lukewarm attitude toward collaboration and its ability to deliver value. Despite high expectations, these collaborative relationships do not seem to be living up to their potential.

Overcoming the Buy-Sell Interface

If the traditional relationship between A-brand manufacturers and retailers is not conducive to capturing consumer value, what other approaches should be considered? Certainly approaches that align consumer value and create interest along the entire chain, within the manufacturer and retailer interface.

"[The shopper] is the common goal that we as retailers and suppliers share, so the more we bring the shopper into our decision-making, the more we can be partners, rather than negotiating over different aspects of our business," says Anthony Tsai. "When the shopper is in the middle of our thinking, we won't drift into margin expansion. We need to be focused on new experiences, new offerings and new business models."

Many of the acknowledged value-creators have overcome the strong buy-sell interface and a closer look reveals how: they bypassed the traditional interface by aligning objectives and integrating collaboration into their organizations.

Nike, for example, pioneered a unique strategy aimed at capturing consumers at both the high-end and low-end segments of the market. On the high-end, Nike plans to open up to 100 new concept stores to cater to particular consumer segments. Partnering with Foot Locker, Nike opened its first basketball-specific store. Dubbed House of Hoops, the store sells limited-edition items in a shopping environment that includes, among other things, large-screen displays and live appearances by professional basketball players. In this partnership, each company focuses on what it does best: Nike helps with the store design, layout and product choices, while Foot Locker runs logistics, operations and rings up retail sales. In a similar vein, Nike is planning to open a running-specific store in partnership with The Finish Line.

On the low-end, Nike formed a partnership with Payless ShoeSource to design and produce the Tailwind collection, a line of five shoe styles for which Payless serves as the exclusive retailer. Nike also acquired the Starter brand, which is sold exclusively at Wal-Mart. Nike executives understand that a single format, such as their traditional Niketown flagship stores, cannot accommodate the needs of all customers.

Creating Value through Collaboration

Collaboration combines the market knowledge of both retailers and suppliers, enabling the creation of new formats and experiences to tap more consumer value. Based on lessons learned from Nike and other value-creators, we developed the following four-step approach to creating value through collaboration:

Pursue the *real* value. Successful value-creators focus on and understand where the real and sufficient consumer value lies. As consumers become increasingly diverse and demanding, companies have to determine what product or service to deliver and if they have, or can acquire, the capabilities to deliver it. There are pockets of value along the continuum, from premium to discount. Is your brand a true innovator or merely mainstream? Are you really full-service or more "cheap and cheerful"? Whether the focus is on one end of the continuum or on a specific niche, the best companies target enough value to create a win-win situation along the entire chain.

Tailor operations to deliver value. All operations should be aligned to deliver on the value proposition. For example, EasyJet reduces costs by eliminating non-value-added features. To deliver "cheap, no-frills" travel, EasyJet eliminated travel agents, did away with seat reservations, made in-flight meals optional and scaled back its destinations.

Conversely, Starbucks offers the ultimate experience by featuring 25 to 30 drink varieties (including 20 types of coffee beans), introducing seasonal drinks four times a year, providing comfortable lounge chairs and free wireless Internet access, connecting with consumers through "My Starbucks Idea" and sourcing premium coffee beans rather than the lowest-cost beans.

While both EasyJet and Starbucks specialize in delivering a clearly defined value proposition to their customers, other retailers and suppliers are not tapping into this concept experience: "Our suppliers are focusing on the average rather than on specific propositions, stores or concepts," says Sander van der Laan.

Each company focuses on what it does best: Nike handles store design, layout and product choices, while Foot Locker runs logistics, operations and rings up retail sales.

Identify all necessary players. Successful firms not only match their value focus with every step of the supply chain, but also reconsider each link in the *total* value chain. "Good relations result when everybody understands the value chain of the other," explains Renaud Cogels. "If we understand the value chain of our supplier, and they understand our value chain, we can make something happen."

Reconfiguring the value chain will necessitate key decisions. Should we include consumers in the innovation and product-evaluation process? Should we collaborate with suppliers to generate new concepts? Should we outsource production to larger competitors that are specialists? The answers to these questions will depend on the type of value being pursued. IKEA, for example, outsources to its customers the tasks traditionally performed by the manufacturer—picking up orders, last-mile delivery and furniture assembly—compensating them for it through reduced prices. EasyJet eliminated travel agents and began booking flights via the Internet. By challenging industry assumptions both IKEA and EasyJet not only differentiated their businesses from competitors but also had a hand in transforming their industries.

Lock in value. Lock in value by creating business models that align interests with the overall objectives and focus everyone on growing the overall pie. For example, by forging sharing arrangements, Philips profits on coffee by Senseo; Starbucks and PepsiCo produce ready-to-drink chilled coffee; Nespresso has shop-in-shops dotting the retail landscape; and Amazon continues to share its marketplace with a host of suitors. Such collaborations neutralize the traditional interface between buyers and suppliers.

A company that has executed all four steps effectively is Zara, a Spain-based retail fashion leader. Zara has stores all over the world and attributes its success to delivering what consumers *would like* to have, at affordable prices, quickly. Zara does not have Asia-based operations, thus eliminating the typical three-month ordering time, and performs all retail, design and manufacturing in house; the company purchases fabric from external providers. Zara understands the importance of owning certain steps in the value chain and aligning its interests with others along the value chain.

The Future of the FMCG Industry

Retailers and suppliers will be collaborating in new and more significant ways in the future. There success will depend on it. “Building dedicated value chains will pay off in the long term,” adds Ab Pasman. ”And consumer-centric thinking and tailor-made products should be the focus to create more value.”

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