OLIVER WYMAN

PRESS RELEASE

MEDIA CONTACT:
John Campbell
1-617-424-3323
john.campbell@oliverwyman.com

Retail Squeeze: Commodity Costs Fall, but Grocery and Drug Store Chains Lag in Renegotiating with Suppliers

- Many packaged-good suppliers have kept wholesale costs high
- Smart retailers can use their private-label knowledge to renegotiate terms

New York, April 27, 2009 – The balance of pricing power between retailers and suppliers may be starting to shift.

With raw material prices falling and consumer demand weak in many markets, grocery and drug store chains are under tremendous pressure to lower their prices. Costs for commodities such as wheat, steel, and crude oil, which are widely used in food, grooming, and household products, have been falling since mid-2008. That's translated into lower prices for consumers: U.S. food prices fell on a month-to-month basis in February for the first time since April 2006.

Yet costs for retailers have not come down as quickly or as far – sometimes not at all. That's partly because many packaged-good suppliers have maintained high wholesale costs that are no longer justified by the underlying commodities. Take yogurt, where raw materials, packaging, and motor fuel costs to the manufacturers have declined in the range of 20% since their peak in mid-2008, whereas the wholesale cost to retailers has actually *risen* by a few percentage points.

Some suppliers have not been shy about advertising this trend to analysts and investors. For instance, Unilever said its recent jump in profits was driven partly by price increases. One supermarket chain in Belgium stopped carrying a selection of about 300 Unilever items after the two sides could not agree on pricing and promotional terms. The two companies resolved their dispute after a few weeks of negotiation.

In the U.S., Costco and Supervalu are among the retail chains that have publicly called for suppliers to lower their prices now that input commodity costs have fallen. At the Kroger supermarket chain, supplier pricing policies are partly responsible for the strong growth in Kroger's private-label sales.

"Smart suppliers pulled one over on retailers and increased their share of the market's value as a result," said Paul Beswick, a partner in the Retail practice of Oliver Wyman, an international management consulting firm.

How can retailers extricate themselves from this cost/price squeeze? Beswick says ramping up promotions of private-label lines is definitely one option, but takes time to yield results, requires

OLIVER WYMAN

expensive promotions, and may not succeed for products where brands have a lot of clout, such as soda.

Instead, says Matthew Isotta, another partner at Oliver Wyman, “Smart retailers are using data on their own private-label product lines to gain insight into their branded suppliers’ cost structure and negotiate new terms.” Grocery and drug store chains can reduce their spend through supplier renegotiations, but they need to gather data about the input costs of each supplier and the profitability of each product, determine which suppliers are acting as supportive partners and which are gouging, and tailor negotiations accordingly.

Differentiating the approach by supplier is central to negotiation success, Isotta says. “You don’t want to make blanket demands of all your suppliers, because their rational response will be to price up in advance so the givebacks are less painful,” he says. “Also, suppliers that are already passing through part of their efficiency gains deserve credit.”

About Oliver Wyman
With more than 2,900 professionals in over 40 cities around the globe, Oliver Wyman is an international management consulting firm that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, organizational transformation, and leadership development. The firm helps clients optimize their businesses, improve their operations and risk profile, and accelerate their organizational performance to seize the most attractive opportunities. Oliver Wyman is part of Marsh & McLennan Companies [NYSE: MMC]. For more information, visit www.oliverwyman.com.