OLIVER WYMAN

Retail

With Commodity Costs Falling, Retailers Can Get Their Costs to Follow

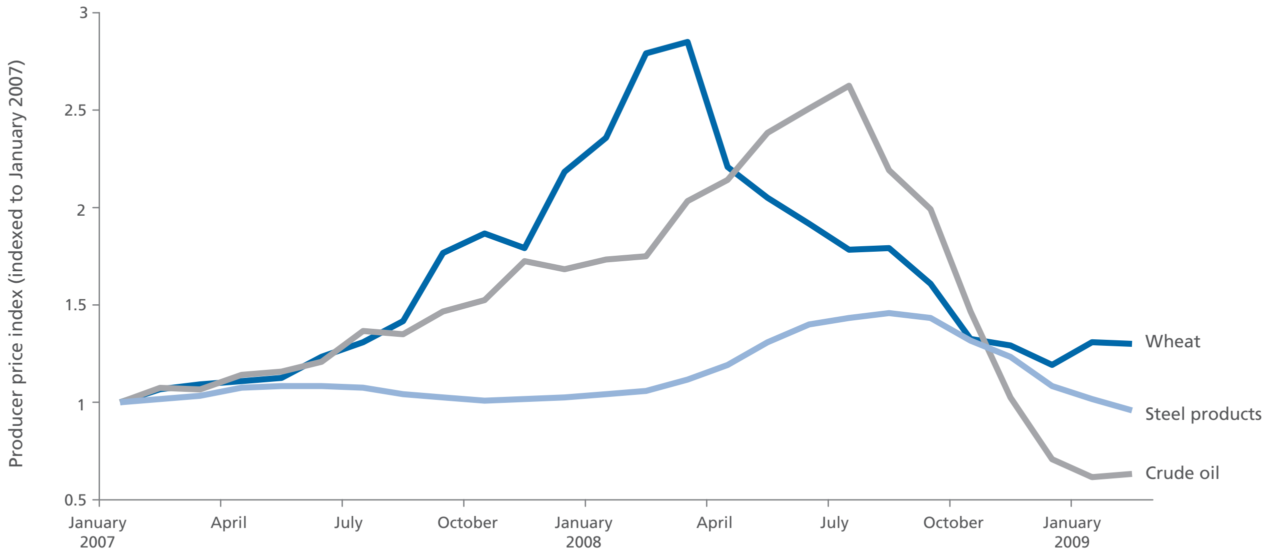
Commodity cost inflation in 2007 and much of 2008 drove up costs for many retailers. Even in categories where the main input costs remained stable, retailers experienced higher distribution costs. The recession then made consumers more price-sensitive, so that retailers needed to show strong value on the shelf and in promotions, in order to avoid losing share. That has forced retailers to hold or cut prices despite higher cost-of-goods, putting further pressure on margins already hurt by falling basket sizes and trading down.

In the first quarter of 2009, commodity prices have fallen—yet costs for retailers have not come down as quickly. To their credit, many branded manufacturers held the line on case cost increases for months through production efficiencies or product reformulations. Even today, some suppliers are working with retailers to hold down costs and ensure that their retail partners earn an acceptable margin. But other suppliers are maintaining high costs that are no longer justified by the underlying commodities. Others continue to pass through case price increases in excess of commodity costs—and they are not shy about advertising this fact to analysts and investors.

The timing is propitious for retailers to reduce their cost of goods, yet recent history shows that this exercise is fraught with peril. Retailers that take too hard a stance have had their reputations damaged by unflattering press coverage, depicting them as making unrealistic take-it-or-leave-it demands. Retailers that have been unable to reach an agreement with branded suppliers have taken popular products off the shelf, damaging both companies.

The commodities spike and decline

Costs for selected commodities



Source: BLS Producer Price Index, series WPU0212 (wheat), WPU056 (crude oil), WPU1017 (steel mill products)

A Choice

Retailers have a choice to make. They may conclude that this is a unique opportunity to increase share in private-label goods. The gap in costs between branded and private-label goods will allow retailers to improve the price discount of private-label at the shelf, while maintaining its cash profit advantage. They can increase promotions of private-label to drive trial, chip away at branded share-of-shelf by delisting weak variants, and shout about price comparisons at shelf edge and in weekly circulars. This strategy makes sense in categories where branded goods have weak equity and substitutability is high. But consumer behavior changes slowly, and this approach will take time to deliver results. In categories where brands have strong equity, it may never succeed.

On the other hand, one reason retailers have their own brands is to gain insight into their branded suppliers' cost structure. To identify and respond to unjustifiable costs of branded goods, they should make the most of that data. By understanding product formulations and commodity costs, retailers can assemble the fact base that will let them move beyond generalized demands. Instead the data can support more structured and effective negotiations with suppliers to drive costs down.

How to Engage with Suppliers

For retailers who choose the second path, here are the steps to make it work:

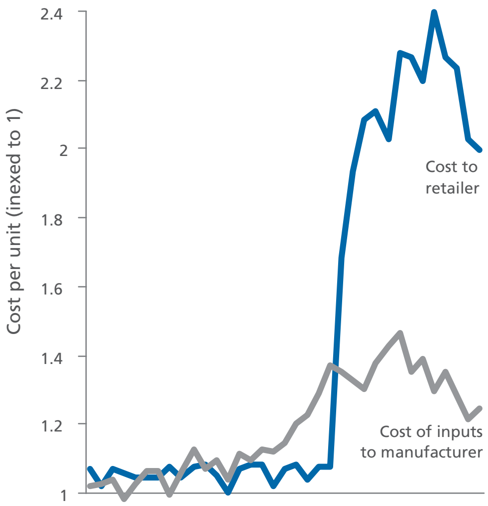
- **Forget about generalized complaints** such as "We know your costs have come down; you should lower your prices to us." Branded suppliers have long enjoyed data superiority over most of their retail partners, so they will easily stall and obfuscate when demands are not backed up with facts.

- **Assemble a robust fact base** to cut through the emotions that can color negotiations with branded suppliers. A solid foundation of data will help retailers understand what is happening, set priorities, and back up demands. Well-equipped retailers will know what has happened to the input costs of each supplier, which suppliers are delivering the best margins and space productivity, and where brands and SKUs are adding incremental choice for customers and where they are simply duplicates.

Heroes and villains

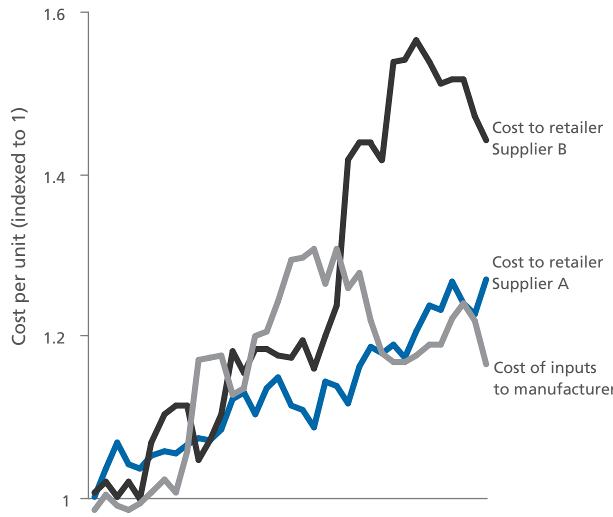
Dry grocery category

Top 5 supplier



Dairy category

Two top 5 suppliers



In the first example, from a dry grocery category, the supplier held off on case cost increases for months before making a massive case cost increase. Their case costs have come down from the peak, but are still well above their input costs. In the second example, from a dairy category, Supplier A's case cost has generally moved with input costs; it is acting as a good partner to the retailer. Supplier B's case costs initially tracked rising commodity costs. But as increases in commodity costs leveled off, and eventually started coming down, Supplier B continued to push through large increases to the retailer. Once the facts are known, each of these situations requires a different response from the retailer.

Note: Based on constant mix of products. Input costs includes raw materials, packaging and distribution.

Source: Oliver Wyman analysis.

- **Differentiate your expectations.** Determine which suppliers are supporting you and which are not, and tailor your negotiations accordingly. It is counterproductive and dangerous 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. Blanket demands also raise the risk of negative publicity. By contrast, suppliers that are helping by holding off on cost increases and passing through part of their efficiency gains deserve credit. If they are swept up in the net of blanket demands, they have little incentive to continue being good partners.

- **Get your corporate story straight.** Facts alone will not convince suppliers to move on costs; you must be able to articulate what you offer them as a value chain partner. Growth? Expansion into new geographies? Access to unique customer segments or trip types? Lower cost to serve? Think about your cost expectations from the other side's perspective, and paint a picture that will make them want to invest in your business.

- **Mobilize the organization.** Don't expect individual buyers and category managers to make massive progress on their own. Make clear to suppliers that getting cost-of-goods back in line with underlying commodities is a corporate initiative. Mobilize the entire merchandising organization with a clear and consistent message, and a tight process for engaging with suppliers.

For retailers that take up the challenge, bringing cost-of-goods back in line with commodity pricing represents one of the best opportunities to protect margin in a year of price cuts and increased markdowns.

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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].

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