FMCG Insights

AdvisorBase

June 2008

smarter decisions, better business

It was great to see everyone who was at the FGC half-yearly AGM. It was a wonderful opportunity to catch-up and listen to some interesting speakers.

The retailers continue to be busy…

Foodstuffs Auckland, Wellington and now South Island forge ahead with their plans to implement Primary Freight. Initially they have agreed to run a trial. Negotiating a primary freight arrangement can be costly if costs/benefits are not carefully analysed – so be prepared.

Progressive will be revisiting their warehouse allowance as part of a project to get almost everybody into their DCs. As part of this initiative they will also be reviewing their product offering. In addition to this, Progressive are making serious moves towards all promos being fully funded by suppliers.

This means that price points may now be higher even if suppliers spend the same. Also, the profitability parabola will move so suppliers will need to re-establish optimal pricing positions. These two initiatives are going to make knowing product performance, and how to best utilize trade spend, vital for suppliers.

Making the Most of Product Performance

Profit Squeeze

With reports that consumer confidence has fallen to the lowest point in a decade (Westpac Dermot Miller Consumer Confidence Index driven Q1 2008) driven by a deteriorating economic outlook and a decline in consumers perception about personal financial situations, Westpac predict that consumer spending will continue to moderate from current levels.

Consumer tightening of belts is already hitting the top line for many suppliers and the squeeze on margin continues with pressure on raw material costs such as wheat, sugar, dairy and petrol all experiencing dramatic increases in prices recently. Bottom line totals have never been under such sustained pressure from all sides as a result suppliers will be going through a somewhat challenging period. This is leading suppliers to ask how do we use our trade spend and product mix strategies to get the best outcome for the downturn.

Product Performance under the magnifying glass

Supplier spending on price support, co-op payments and promotional rebates is frequently the largest discretionary or controllable expense for suppliers (excluding cost of goods sold). This spend is critical for making or breaking the performance of a product and of a company – spend too little and product price is not competitive in the market and there is no volume lift; spend too much and volume will increases but margin is gifted away. This becomes even more critical in the face of Progressive's fully funded promo initiative.

Now more than ever suppliers should be evaluating the effectiveness of their trade spend, not only across products, but by products in particular accounts. Performance Based Pricing looks at the performance of brands within customers. It sets out to ensure that all customers perform, that all brands perform, and to optimise performance of brands by customer. *(E.g. see Fig. 1: this problem product traces its difficulties to one customer).*

Performance Based Pricing allows you to:

- Identify problematic customers or products
- Identify the leverage points and sub optimality

Profit & Loss		Products			
	TOTAL	Prod A	Prod B	Prod C	Prod D
Gross Sales	**298,150**	50,000	81,650	44,000	122,500
Trading Terms	**17,680**	2,500	6,390	2,420	6,370
Promo Spend	**48,808**	3,650	20,930	5,363	18,865
Net Sales Value	**231,663**	43,850	54,330	36,218	97,265
Cost of Goods	**171,650**	32,000	46,000	27,500	66,150
Gross Margin	**60,013**	11,850	8,330	8,718	31,115
All other product costs	**12,990**	6,000	5,780	4,400	9,800
Net Contribution	**47,023**	**5,850**	**2,550**	**4,318**	**21,315**
NC % of Gross Sales	***16%***	*12%*	*3%*	*10%*	*17%*

Fig 1.

Profit & Loss - Product B		Customers	
	Total	X	Y
Net Contribution	**2,550**	**3.850**	**- 1.300**
NC % of Gross Sales	***3%***	*11%*	*-3%*

- Size the opportunity and address
- Reflect product life cycle (including ranging/offering)
- Target customer – product mix
- Optimise contribution (not maximise sales?)

Performance Based Pricing identifies where promotional strategy has to change to realign product contribution.

What successful companies are doing?

Suppliers today have access to vast amounts of data but it is the ability to turn this data into knowledge and then be able to take action that is limiting many companies. Too much information is little better than no information if you don't have the time or skills to interrogate it. Successful suppliers are recognising the significance of product performance and are committing sufficiently experienced resource (both in-house and/or external) to the problem. Remember sometimes someone from outside can put things in perspective.

The old adage, *You can only manage what you can measure*, applies to product performance.

Specific advice or assistance with **Product Performance** or **Performance Based Pricing**:
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Lowest Cost to Shelf?

Progressive and Foodstuffs are each taking a different approach to lowest cost to shelf.

Foodstuffs have developed a Primary Freight strategy. They plan to take responsibility for in-bound distribution, including the coordination, collection and cost of goods movements from the supplier's consolidation point.

Progressive's goal, on the other hand, is to get all suppliers into their DCs. They are going to be revisiting their warehouse allowance as part of this, with the intention that all suppliers going through the DC pay a discount for the service provided.

No matter what approach is taken, or which retailer is being negotiated with, understanding the cost to serve involved is critical to making informed decisions. Cost to serve will expose what is practicable for your company, and what is not, when it comes to the level of discounting possible—and whether a retailer's strategy should even be taken up. As a bonus it also brings to light areas within your business that can be improved by changing internal practices without involving the retailer.

With the retailers' difference in focus there are opportunities for innovative suppliers to try and establish a lowest cost-to-shelf initiative with a retailer. This may mean thinking outside the current boxes, for instance looking at a cross-docking arrangement, or simply making sure that whatever is implemented with one retailer will not cause roll on problems with the other.

Lowest cost-to-shelf can only work if it is a joint scheme. However, remember the 4Cs when collaborating:

- Objectives of both organisations need to be **compatible,**
- Both organisations need to **committed** at a senior level,
- Organisations need to have the **capability** to collaborate, e.g. to generate, share and use specified data,
- Both organisations need to agree on mechanisms to **control** the inputs to, and outputs from, collaboration.

Lowest cost-to-shelf is a goal for everyone in the industry.

Collaborate to realise product movement opportunities and reduce total supply chain cost, enhance service and improve product presentation. *—ECR report "Efficient Product Movement".*

Related article:
Discounting retailer's DCs
by Jeremy Howcroft
http://www.advisorbase.co.nz/whitepages.htm

Supply Chain Related Cost Based Terms—The Risks

Primary Freight Arrangements and Warehouse Allowances are not so much supply chain issues as *cost based trade terms* and should be treated as such. Experience tells us that the impact of a Primary Freight Arrangement or a Warehouse Allowance on suppliers is variable but can readily cost 2% of Gross Sales.

The risks are immediate as well as having aspects that only emerge over time. The immediate and enduring risk is setting an inappropriate allowance by, for instance:

- Locking any inefficiencies, cross-subsidies or premiums associated with current distribution arrangements, into the allowance,
- Not including all the costs resulting from entering into the arrangement into the calculation,
- Including in the calculation potential savings/benefits which may not be able to be fully realised,
- Using an inappropriate methodology to calculate the discount/rebate,
- Selecting an inappropriate sample period for calculating the discount/rebate,
- Accepting an inappropriate basis for the arrangement as a percentage of gross sales, or $/carton or even as a single measure across all products.

Consumer goods leaders in adopting cost to serve based pricing, or "bracket" pricing, have logistics costs 10-20% below companies that don't practice this discipline. — *A recent study by McKinsey.*

AdvisorBase has the experience in determining cost based terms of trade to avoid these pitfalls and apply the appropriate methodology and criteria.

Future profitability is threatened by escalation of the allowance out of proportion to the value of the services provided by the retailer - undertaking a warehouse and/or secondary distribution function.

Our experience will be effective in protecting future profitability through:

- Identifying the many contractual criteria needed to trigger adjustments to the allowance,
- Developing an allowance structure that minimises exposure to changes in product mix, product characteristics and geographic market share,
- Establishing guidelines to monitor and manage the competitiveness of the warehouse allowance,
- Establishing appropriate KPIs and service level agreements to ensure the retailer is providing an effective service.

For more information regarding our services contact Charles Wilson on 021 899 161 Or Advisors@Advisorbase.com

AdvisorBase experience can help to protect your future profits as you enter into a very long term service contract with a key customer.

Knowing the "right" value for the allowance and recognising the contractual conditions to protect against the allowance blowing out is merely the first step in arriving at an acceptable outcome. Both retailers are tough negotiators and one should be prepared for forceful demands and an uncompromising stance. Not withstanding that, a well prepared supplier can seek meaningful concessions and understand the true impact of any negotiating compromises.

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