OLIVER WYMAN

Distribution & Wholesale

PURCHASING COST REDUCTION:

WHAT DISTRIBUTORS CAN LEARN FROM LEADING RETAILERS AND MANUFACTURERS

"Our GFR cost reduction program delivered a 23% increase in group profits in its first year by transforming the way we negotiate with our vendors. However, the really big savings have come since then by working with our largest vendors to take cost out."

– CPO, $BN FOODSERVICE BUSINESS

Distributors and wholesalers are in a brutal business. Many operate on thin net margins, typically between 3% and 5%, with revenues under constant pressure. But some companies have been figuring out how to thrive by driving down COGS while at the same time fostering critical vendor partnerships in such a demanding environment. What is their secret?

A large part of the answer comes from their ability to reduce costs by learning from two industries renowned for their skills in purchasing: Retail and Manufacturing. By adopting a pragmatic strategy that combines the best of both approaches, our experience is that distributors and wholesalers can reap substantial value. Generally speaking, Goods For Resale (GFR) can account for up to 80% or more of a distributor's cost base. By using a more sophisticated approach, our experience is that a typical distributor can achieve 7% to 10% savings from GFR cost-reduction programs, potentially doubling net profits. (For distributors who buy a significant proportion of commodity items typical savings percentages are of course lower, although the impact can still transform the bottom line.)

Top retailers have sophisticated negotiation approaches aimed at squeezing out the best possible deals from their vendors. In contrast, leading manufacturers work hand in hand with their vendors on the intricate task of finding new efficiency gains together. Distributors often find themselves sitting in the middle, without the depth of capability deployed by either retailers or manufacturers. They are often not organized for success, with a good deal of purchasing happening locally – making it difficult to bring effective scale to either pooling purchasing volumes, or to creating valuable insight. As a result they leave considerable money on the table. How, then, to combine the best of those two approaches in the unique sector that is wholesale distribution?

A TALE OF TWO APPROACHES

That these two approaches could hardly be more different from each other makes their linkage a challenge. Essentially, retail buying reflects a "trader" mentality, whereas manufacturer purchasing requires an "engineering" mind-set.

In retail buying, the primary focus is on maximizing the difference between what consumers will pay and what vendors will accept as payment for their products. Negotiations are thus typically characterized by deal making that frequently involves aggressive, confrontational tactics. Generally, retail buyers are reluctant to commit to multi-year deals with vendors, wanting the flexibility to switch between brands. Indeed, this threat of de-listing is often used as a powerful lever to increase bargaining power. While retailers often deploy sophisticated approaches, the basic goal is to maximize negotiation leverage, and most retail buyers have little interest in what goes on behind the scenes in the production facilities or supply chains of their vendors.

Manufacturer buying is completely different. When producing complex products, such as cars, planes or industrial equipment, it is essential to work closely with vendors, resulting in a mutual dependency that both parties understand well, and from which both parties benefit. Generally, the relationships are characterized by an extremely high level of trust and detailed information sharing. Both manufacturer and vendor constantly seek small, even tiny improvements (for example, shaving a millimeter off the thickness of a component) that will drive out cost and achieve performance benefits for the overall system. As such, vendor relationships are true partnerships, expected to last for many years and underpinned by multi-year contracts.

ACHIEVING THE BEST OF BOTH WORLDS

For distributors, achieving world-class purchasing on a par with leading retailers and manufacturers can be a long, difficult journey. One challenge is that there isn't a single unified solution; distributors need to pragmatically deploy multiple approaches depending on their product and vendor characteristics. Moreover, many distributors find that they need to re-think what they are purchasing where, and how, in order to extract the full benefits. That makes getting the money a substantial effort, unless you organize effectively.

Having observed various distributors attack the GFR challenge in recent years, we have captured those tools that have proven to be the most effective, and codified them into a "Purchasing Periodic Table" (see Exhibit 1).

Note that the elements of the table are grouped into two major clusters. The first is aligned to the retailer approach where the focus is, "taking margin out of vendors": picking the right vendors and maximizing your

EXHIBIT 1: Purchasing Periodic Table

Take margin out of vendors				Take cost out of the system			
Maximize negotiating effectiveness		Optimize supply base		Reduce total cost of ownership		Rationalize requirements & specifications	Redesign the system
Information superiority	Competitive tendering	Vendor consolidation	Middle-man removal / consolidation	Reverse cost engineering	Use vendor assets to reduce costs	Product design to cost	Changing the organization's boundaries
Vendor economic modelling	Auctioning	New vendor introduction and development	Global / low cost country sourcing	Complexity reduction	Vendor led TCO innovation 50:50	Product standardization	Vendor business design innovation
Bargaining power analysis	Target pricing	Strategic supply alliances, partnerships & JVs	Grey market sourcing	Commodity cost management	Vendor Managed Inventory	Product substitution	Next generation technology
Volume commitments / base loading	Dynamic/ automated negotiation	Vendor tiering and share management	Vendor disaggregation	Logistics optimization	Procurement outsourcing	Wastage reduction	End user demand engineering
Benchmarking		Vendor metrics and incentives	Backwards integration	Buying for vendors	Minimizing transaction costs	Packaging elimination / reuse	Network redesign
Research and market intelligence		Risk and profit sharing		Vendor consortia buying	SKU / catalog rationalization	Transport mileage reduction	Client TCO reduction
Competitor comparisons		Commodity price / FX management		Smart forecasting and planning			
		Contract compliance and auditing					

negotiating position to get the best possible deals. The second cluster is aligned to the manufacturer approach where the focus is "taking cost out of the system": attacking the larger part of the cost base that is the vendors' costs, rather than just their margins, by challenging and working on topics such as product specifications and manufacturing efficiency.

For the typical distributor, the most effective approaches we have seen start on the left and move to the right. In other words, first mastering the best of the negotiation techniques used by top retailers. Then introducing the "cost out" approaches used by leading manufacturers: working with the selected partners to achieve cost savings beyond those achievable just through a negotiation approach. Achieving the full potential of 7% to 10% cost savings may take two to three years, but much can be achieved in as little as five to six months.

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A TWO-STAGE METHODOLOGY

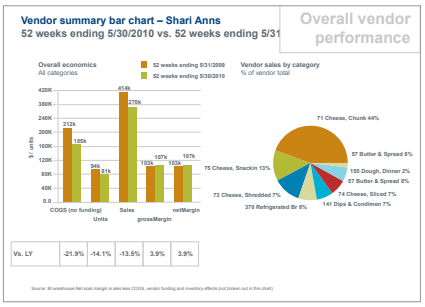
1. RE-ALIGN AND RESHAPE THE VENDOR BASE

You must bring your vendors with you along this journey. The first step is to explain your growth strategy and describe how your company will be re-shaping its vendor base to focus on fewer partners. Tell vendors that the transition will result in "big winners" and "big losers". But before vendors can even be considered as partners, you will be thoroughly reviewing the potential candidates.

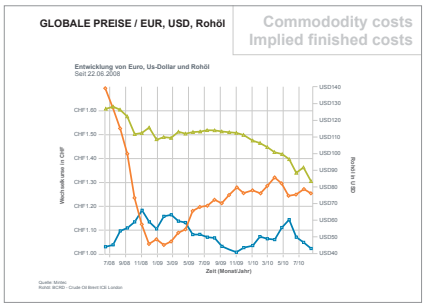
To prepare for your negotiations with vendors you will need to do some real analysis to identify the opportunities for savings. You should look in detail at how vendors have been performing and examine the competitiveness of their offerings. Consider, for example, the evolution of their prices compared to changes in their input costs, their delivery performance, their margins versus the competition, and so on.

You will need to describe to each vendor how it needs to re-align its proposition to your expectations. A vendor might, for instance, have to atone for over-charging and under-performance in the past. You can emphasize that complying is necessary for moving to the next stage. Of course, such discussions are difficult, but you can minimize any pushback by anchoring your arguments on robust, fact-based analyses that vendors cannot dispute. This analysis package is the critical foundation of a successful program (see Exhibit 2 and 3).

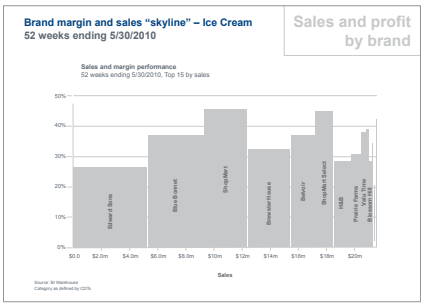
EXHIBIT 2: ANALYTICAL INSIGHTS – Category and product managers already have lots of data – what they need is the right insightful analysis, delivered in a way that is easy for them to use. For example:



Overall summary of vendor's sales and margin by category



Comparison of vendor's cost evolution vs. their known input cost changes



Comparison of vendor's sales and margin performance by brand vs. competitor brands

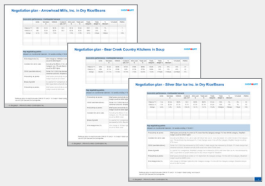
EXHIBIT 3: NEGOTIATION PLANNING & SUPPORT – Example of Oliver Wyman tool that: i) Enables and underpins a highly structured negotiation process, ii) Auto-generates a wide range of compelling analyses to provide negotiating leverage 'at the touch of a button'

1. Develop Category Strategies based on Category and Brand performance

Category performance
Materials used for the Category Strategy Workshop; detailed performance by category

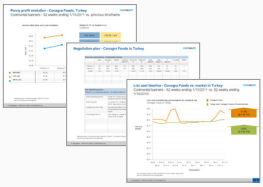
Brand performance
Brand-level data of vendor-category performance for developing negotiation plans

2. Develop negotiation plans based on a summary of vendor performance



Negotiation Plans
A one-page summary of vendor-category performance with key negotiating points highlighted

3. Build negotiation arguments based on detailed analysis of vendor performance



Vendor performance within category
Full vendor-category performance detail for developing negotiation plans

Vendor performance across categories
Brief overview of vendor performance across categories and across desks

4. Produce disguised reports to use in the room with vendors

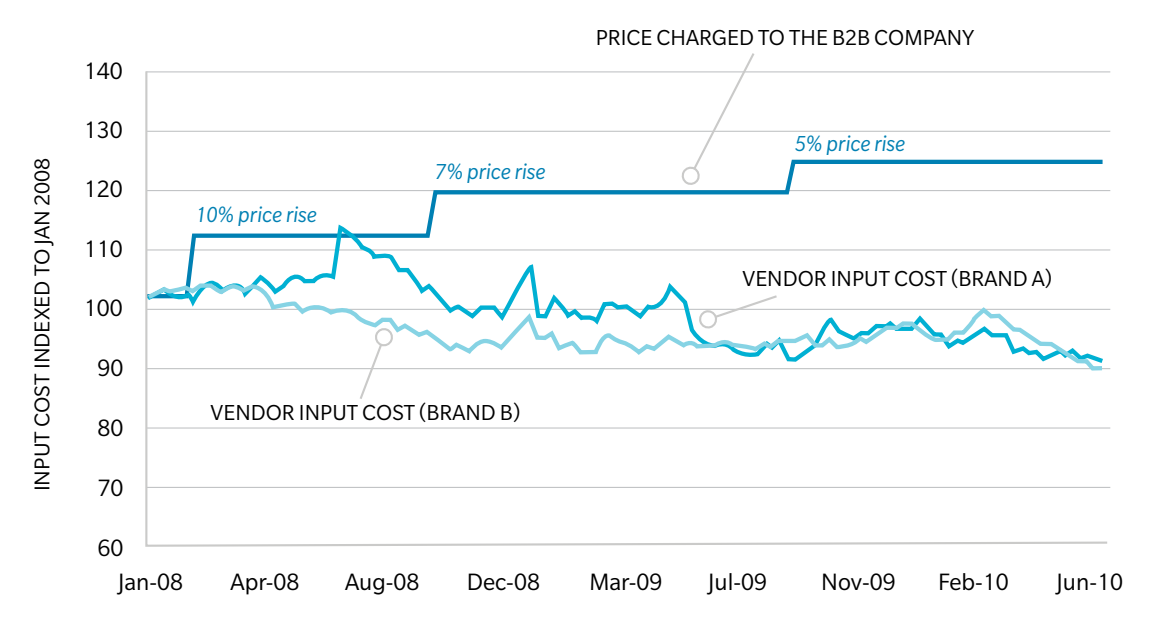
Disguised charts and reports to share with vendors
Potentially sharable charts with labels removed

CASE STUDY 1

A large food services business adopted a rigorous, analytical approach to negotiations. Its largest vendor had put through a series of price rises and was pushing for more. The vendor argued that it was merely passing along some of its costs from a rise in commodity prices (see Exhibit 4). However, a detailed analysis – taking into account the actual cost changes for the ingredients in the correct proportions in the ordered items – showed that the vendor's costs had fallen by more than 10%, driven by a 19% fall in the cost of raw materials, offset by higher fuel prices and wages.

If the vendor's prices had tracked input costs, the company's costs would have been lower by some $4m. The negotiation outcome was a substantial and immediate price reduction plus an upfront compensatory payment equivalent to 20% of the annual spend with the vendor. This negotiation was a major contributor to the overall program which delivered more than $15m in savings.

EXHIBIT 4:



"We successfully persuaded our branded footwear vendor to cut prices on key styles by over 10% based on our detailed analysis of costs and margins."

– CEO, $BN CLOTHING AND FOOTWEAR BUSINESS

Vendors that you believe have the potential to be future partners will need to submit their best possible proposals to be considered for a multi-year contract or "memorandum of understanding" (MOU). You should focus the process by providing clear guidance on what each vendor needs to do to protect its existing business. For example, if your margins with a particular vendor are below the category average, the vendor must rectify that to remain in consideration.

You should suggest what each vendor might propose in exchange for growing its business with your company. You might, for instance, agree to share the additional profits that a vendor attains from the future higher volume based on an analysis of that firm's variable margins. (Note the right answer is rarely a simple 50/50 split when you consider the leverage that increased volume typically has on a manufacturer's gross margin given their larger fixed cost base.) This process of reshaping the vendor base also presents the opportunity to consider new vendors, including those from new, and potentially lower cost, countries.

The outcome should be a significant consolidation in your vendor base, allowing some vendors to achieve significant growth and your business to benefit from multiple "more for more" agreements. Those benefits will often take time to fully accrue as you clear stock, evaluate new SKUs from partner vendors, establish new supply chains, and so on.

Success depends on vendors truly believing that their business is at significant risk if they don't comply – that is, they will automatically become "big losers". Many distributors that have distribution agreements with powerful brands mistakenly think they have little clout to negotiate. In contrast, we have seen that the approaches described here can be deployed with equal effectiveness when applied with the right analysis, process, and tools.

The scale of benefits you can achieve from this stage will depend on the characteristics of your sector and the sophistication of your starting point. In some cases, 6% to 8% GFR savings are achievable just from improved vendor negotiations; in other cases 3% or 4% may be the limit.

2. WRING OUT COSTS

Distributors then face a substantial opportunity to reduce costs further, with the benefits being shared between them and the vendor. Typical areas where waste and inefficiencies can be eliminated are: the supply chain, from raw materials to manufacturing and logistics; product specifications, including materials, design, accessories and packaging; and the interface between distributor and manufacturer, particularly with regards to order quantities and the efficiency of processes such as forecasting, ordering, and payment.

Most responsibilities for achieving the savings will sit with the vendor, although some will reside with the distributor or will require joint work between the two parties. The opportunities will be very different depending on the characteristics of the vendor. For small vendors selling high value-add products (and for which the distributor accounts for a large percentage of the turnover), the opportunity for cost reductions will likely be large. For major global brands and true commodity items (fuel, basic chemicals, commodity food etc.), the opportunities will typically be much more limited in percentage terms, although the potential dollar savings may still be very large.

CASE STUDY 2

A multi-national home improvement distributor was working closely with a key vendor to identify cost reduction opportunities. Together, they spotted the potential benefits from optimizing order quantities. The products were made to order for the distributor in batches. Small orders meant the manufacturer needed to set up a production line then shut down and clean it just a few hours later. Unit manufacturing costs would reduce as the order size increased until a second production line was needed which would increase unit costs again (see Exhibit 5A).

Analysis showed that orders were not being placed in a way that minimized production cost: Only 8% of orders were within 10% of the most efficient level, 22% were above and 70% below (see Exhibit 5B). The companies also factored in storage and delivery costs to minimize total costs. Because of their partnership, the distributor could recognize which order quantities minimized total cost, with the subsequent savings shared between the two parties. This was a key component of an overall program that delivered a total cost reduction of over 7% across all products.

EXHIBIT 5A

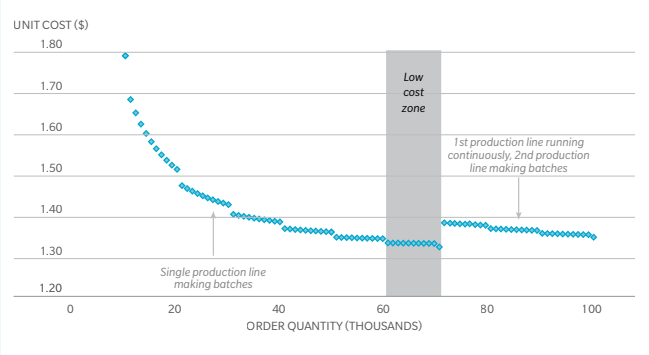


EXHIBIT 5B

THE DELIVERY CHALLENGE

Sizeable "quick wins" can almost always be achieved with the right approach.

The task of working with partners to wring out costs can be challenging and time consuming. We have seen several distributors achieve limited success and end up reverting to ever more aggressive, non-fact-based negotiations. In the long run that tactic becomes counterproductive, particularly with partner vendors who have earned the right to be "big winners". Vendors that are continually forced to slash margins will inevitably either start cutting corners on product quality, or service; or they will start investing in your competitors instead. Successful programs therefore take time and discipline to achieve their full potential, although sizeable "quick wins" can almost always be achieved with the right approach.

In our experience, we have found that success depends on four critical factors:

1. COMMUNICATION

Effective vendor co-operation is based on great communication, real understanding, and enlightened self-interest. Vendors need to understand that cost cutting is absolutely necessary and that non-compliance will inevitably lead to loss of their partner status. To emphasize that point, you should embed annual targets for minimum cost reductions in multi-year agreements.

2. TIGHTLY STRUCTURED NEGOTIATION AND PLANNING PROCESSES

An efficient and structured approach is necessary so that vendors can fully understand what is required from them, and by when – whether as part of the initial structured negotiation round, or as part of an annual joint business plan. You should monitor their progress (as well as your own), and track results versus the plan at each stage.

3. ROBUST DATA AND EFFECTIVE ANALYSIS TOOLS

Getting all the necessary information and talking points for negotiation into the hands of the buyer or product manager quickly and efficiently is essential. The most effective programs use analytical tools that can generate all relevant vendor facts and prioritized insights "at the touch of a button" (see Exhibit 3).

4. ADDRESSING ORGANIZATION AND CAPABILITY GAPS

The product and purchasing organization will typically need to evolve and embrace new approaches. Yet great progress can be made initially without large scale restructuring or hiring. Creating a small expert set of buyer "champions" to manage the overall process and support other product managers in negotiations can go a long way.

But the ball isn't only in the vendor's court. Distributors can often play a large role in wringing out costs, particularly when a vendor is comparatively small. You might, for example, be a much larger buyer of raw materials, energy, or other items needed by the vendor. In such cases, by enabling that vendor to share your purchasing power, you can help it reduce its costs. The vendor would then improve its margins with all of its customers, and you should argue for a share of those savings too.

Although the work to wring out costs can yield big savings, there is a danger that vendors seek to take advantage of their partner status, especially if the competitive tension they experienced during the first stage has faded. You will need to put in place mechanisms to avoid this, such as "best price guarantees" in your partner agreements so that you have the opportunity to find the best prices for products (through benchmarking, competitive tendering or reverse auctions) and your partner will need to match those prices in order to retain its status.

CONCLUSION

Driving down GFR costs while at the same time maintaining or improving critical vendor relationships is a tough challenge for any business. In the complex and often 'local' world of wholesale distribution it is tougher still. Yet a small number of distributors have looked beyond traditional industry approaches to learn from the purchasing methods used by leading retailers and manufacturers. These distributors have typically achieved a 7% to 10% reduction in non-commodity GFR costs and unlocked a new wave of productive partnership and collaboration with their vendors.

The key is to first select the right purchasing tools for the distributor's unique circumstances (from a 'periodic table' or similar), and then apply them in a thoughtful sequence – starting by reshaping the vendor base to take margin out of vendors, and then progressively engineering cost out of the system with the vendor base that remains. Core to achieving enduring savings are effective communication, a tightly structured negotiation process, robust data and analysis tools, and a sequential upgrade of organization and capability.

For many distributors, these types of benefits are not only compelling, they can also serve to step change growth by enabling the business to be more competitive on those products that matter most to customers.

ABOUT OLIVER WYMAN

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

In the Distribution and Wholesale practice, we draw on unrivalled customer and strategic insight and state-of-the-art analytical techniques to deliver better results for our clients. We understand what it takes to win in distribution and wholesale: an obsession with attracting, serving and growing customers, constant dedication to operational excellence, and a relentless drive to improve capabilities. We have a track record of helping clients win in this environment, creating real competitive advantage and driving significant growth. We believe our hands-on approach to making change happen is truly unique – and over the last 25 years, we've built our business by helping distributors and wholesalers build theirs.

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