OLIVER WYMAN

THE ART OF NOT-FOR-RESALE PROCUREMENT

UNLEASHING THE NEXT COMPETITIVE EDGE

A **NEW WAY** OF THINKING ABOUT NOT-FOR-RESALE CATEGORIES

Retailers have long been working to cut the cost of not-for-resale goods and services (NFR). Here, they have focused on reducing unit costs, as well as finding less-expensive solutions. For the most part, these efforts have yielded good results, but the long-hanging fruit is now largely gone. Companies must now think beyond cost reduction in isolation – the challenge now is to reduce expenditures and, at the same time, create better stores and a better customer experience. NFR are thus becoming strategic, and a strong potential driver of top-line growth, as well as brand equity.

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NOT-FOR-RESALE PURCHASING: THE OLD PARADIGM – AND THE NEW

NFR represent between seven and 10 percent of retailers' costs, depending on the type of product and the channel – online or through traditional stores. For an industry facing ever-increasing margin pressure, reducing these expenditures is an evergreen priority.

Retailers have been trying to cut their NFR costs over the past five or 10 years, and best-in-class players have managed reductions of up to 15 percent compared to initial baselines. These results have largely come from driving down unit prices through volume pooling, supplier challenge, and specification optimization.

Most retailers have now moved a step further, and are implementing more-advanced levers to reduce costs and improve cash flow. These measures include:

Buying cheaper – pushing unit-cost optimization levers to the limit

Forming alliances with competitors: Companies are joining forces to increase the scale with which they approach the supplier market. This approach is especially effective in cost areas where bargaining power is skewed in favor of suppliers, such as Energy, IT and Telecom, as well as car fleets. Buying alliances are already common in goods for re-sale, and are now spreading to NFR buying.

Increasing competitive pressure, especially by introducing new, alternative vendors to areas where value chains are evolving and new players emerging, such as IT and Marketing. This implies clearly identifying suppliers and markets in which competition provides leverage.

Managing demand – engaging proactively in the specification processes

In customer-facing categories, do more with less: Retailers are cutting specifications and supplier cost structures to the bone through systematic cost reviews. This approach is relevant for any design-sensitive category such as Interior Design, Furniture, Marketing, IT (for example customer interface software, apps), and Facility Management (for example store cleaning). Some leading retailers have developed costing teams with the expertise to optimize design by distinguishing between things that are visible to customers and those that are not.

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For purely internal categories, develop frugal spending approaches: Control NFR consumption through a combination of zero-based budgeting, the adoption and enforcement of consumption policies (for example making different choices and spending less), and ad-hoc procurement systems and technologies. These controls work best in consumption-sensitive categories such as Energy, Professional Services, and Travel.

NEW THINKING FOR RETAIL'S NEW ERA

However, an approach based purely on cost savings is no longer effective in a context where retailers are transforming their business models. The consumer trends and habits that are driving these transformations should be reflected throughout the entire retail value chain, including NFR expenditure. The implications here are profound.

Customers want a compelling in-store experience. The look and feel of a store and the end-to-end shopping experience are now critical differentiators, and they present new NFR challenges: how to optimize store design for cost, so as to "do better with less"; the development of modular layouts to adapt to the growing variety of store formats; and finding new suppliers to fulfill new technology needs.

Customer engagement needs to be personal and continuous. Marketing has undergone a massive change in recent years towards digital, social, and mobile practices. A shift is still underway as legacy offline channels are moved online as retailers' omni-channel strategies mature. While this shift brings opportunities, it also demands new investment in technology and advertising, both of which are becoming increasingly expensive. NFR activities will play an important role in enabling the development of new marketing tools such as instant messaging, social networks, and behavioral re-targeting. Creating such tools will require that retailers build a new landscape of IT suppliers and form partnerships with innovative market leaders.

A leading grocery retailer in China

This retailer has launched its first fully-automated, employee-free urban store in the center of Shanghai. NFR teams were strongly involved throughout the development process. They used a design-to-cost approach to develop the new model, and they also identified the most appropriate suppliers to fulfill the store's digital and technology needs.

Time-to-market was crucial to the success of this project. Thanks to a strong supplier relationship management program and a simplified purchasing process, the retailer's NFR teams were able to meet an ambitious timeline.

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Customer experience goes beyond store walls. The rollout of home delivery and other value-added services requires greater flexibility. These services will impact NFR spending, as retailers develop partnerships with leading-edge logistics and service providers to manage a new range of services and costs, in particular related to delivery.

Data science is not just the latest fashion. Data has become the essence of competitiveness for retailers, whether they operate online or offline. Those that do not master this new reality will face difficult challenges ahead. The expanding requirements of data applications will have an impact on spending, as IT infrastructure and solutions need to handle large datasets, enable machine learning, and produce actionable business insights that boost competitiveness. Ensuring optimal returns on data will be a critical priority for those managing NFR costs.

THREE LEVERS TO BOOST PERFORMANCE

NFR activities can help to reinvigorate the retail industry and put some of the magic back into physical stores. They can help to identify new opportunities that will boost top-line growth and brand equity. Our experience has identified three key areas for focus.

1. **Maximize supplier innovation.** The combined innovative power of a retailer and its suppliers is far greater than that of the retailer alone. Suppliers have unique views on competitors' practices and can sometimes provide unexpected or unconventional ways to reduce costs. They can also often anticipate consumer trends. The key here, and the challenge, is to identify those suppliers who are truly innovative, and engage effectively with them in a collaborative and mutually-beneficial way.
2. **Invest in technology.** New technologies offer unprecedented ways to reduce costs. These include automated handling of materials, security services, in-store client interfaces, and autonomous trucking. But these opportunities will require complex investment decisions based on limited historical data. They also imply large-scale change management: Substituting workers for robots, for example, understandably meets resistance.

Electronic labels

A retailer has globally aligned the specifications for its electronic labels and partnered with a single supplier to serve all countries. The labels will be highly sophisticated – displaying much more product information than just the unit price and price per kilo – and will also work out cheaper overall than regular labels.

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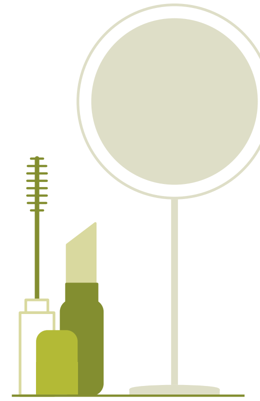
3. **360-degree ecosystem spend optimization.** Value-creation opportunities should be identified and realized through a holistic approach – take Energy as an example, a cost item which represents a sizeable portion of retailers' NFR costs: Beyond optimizing the unit cost of energy on their own, retailers can also create partnerships with energy management leaders. Such collaborations not only can enable continuously optimized energy consumption, but also open new revenue streams – for example through the installation of solar panels on supermarket roofs, and the sale of excess energy generation to other businesses.

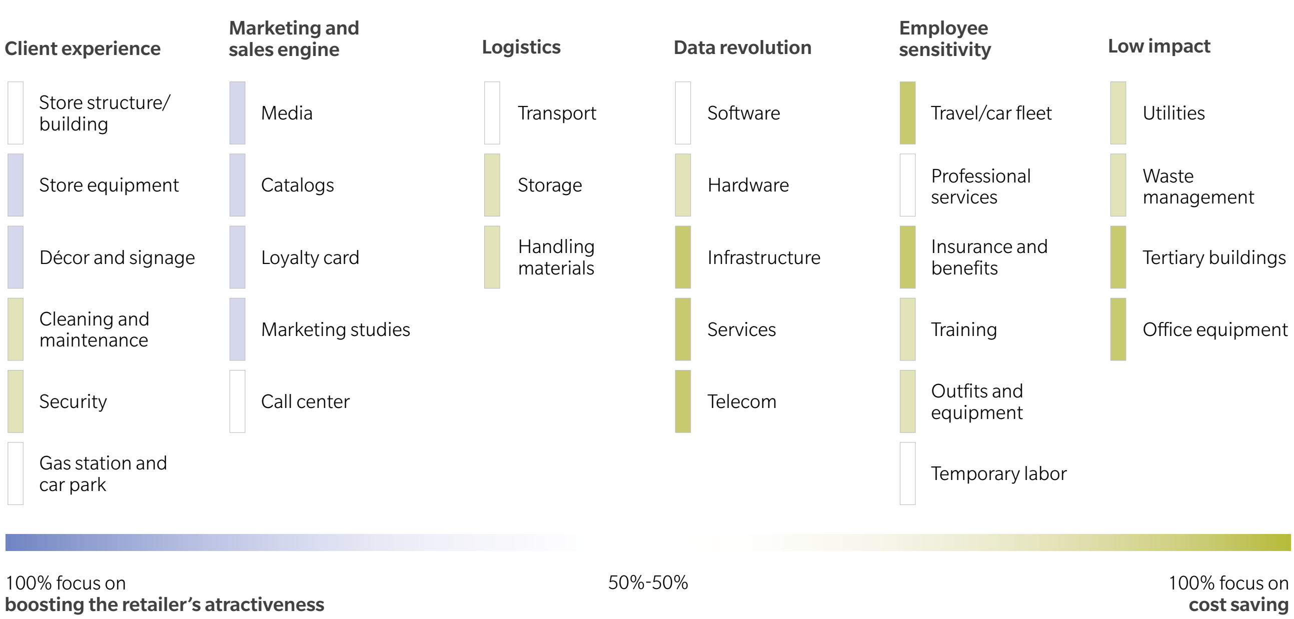
The new NFR paradigm thus has two sides, and their relative importance will depend on the categories of spending. When the spend supports customer-facing activities, the main challenge will be to help make the retailer more attractive and identify new opportunities to meet customer demand and boost top-line growth, as well as brand equity. In other cases, the priority will continue to be more on "pure" cost reduction – albeit through more-advanced levers.

A cosmetics retailer's beauty advisors



A cosmetics retailer has transformed the management of its beauty advisors. It used to focus on the cost per hour of the advisors. Now it aims to optimize return on investment, by using indicators of sales contribution to assess the beauty advisors' performance. The retailer has changed its work schedules to make the advisors more efficient, by making better use of "downtime" – when there are few customers in a store. It has also developed tools and guidelines so that the beauty advisors can feed social networks with ideas, pictures, and stories.

Exhibit 1: Value patterns by NFR category



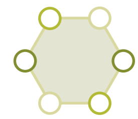
Source: Oliver Wyman analysis

HOW TO MASTER NFR SPENDING

Going forward, companies will need to adapt the organizational construct to address more effectively the new double paradigm. To go beyond conventional cost savings, it will be critical to adopt new and perhaps unconventional ways of working, engage differently (less confrontation, more collaboration) with suppliers, and better manage innovation and data. Most NFR organizations today are ill-suited to these challenges. However, we see best-practice emerging.

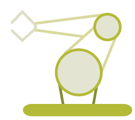
Cross-functional collaboration: Defining a joint technical and procurement strategy requires a cross functional collaboration supervised by a category management board comprising key decision makers per category. This approach needs to be collaborative, so all the relevant stakeholders should be embedded. It will require the soft skills necessary to influence business stakeholders and encourage suppliers to innovate.

Investment in talent: Traditional negotiation skills are necessary, but now insufficient. A critical success factor going forward will be upgrading category manager and buyer skillsets. Going forward, they will need new and broader skills in order to exercise more influence on stakeholders internally, attract innovation from their most dynamic suppliers (intellectual property, M&A deals, partnership), and bring a stronger business sense to customer-facing categories.



Frictionless relationships: Create a compelling relationship in NFR activities between internal customers and suppliers, by doing away with paper-based transactions and communications to reduce friction for example. This will foster internal compliance and attract high-performing suppliers.

A nimble, efficient organization: The NFR function will need to move away from traditional staffing models based on spend ratios, in which each buyer is allocated a budget. Instead, buyers must take a nimbler, more dynamic approach, in which the NFR function focuses on strategic spending based on the benefits and cost-saving potential in each category. For non-strategic spending, activities can be optimized with RFP processes (Request for proposal) for medium-size spend categories. Non-strategic or small spend can be optimized via automation or outsourcing.



Smart use of technology: All procurement professionals will need to prioritize technology, the main source of new savings. This can mean robotics in facility management services, sensors, big data for energy consumption, bigdata applications in IT, "Uberization", as well as autonomous trucks for logistics, and radio-frequency identification (RFID) for check-out. Personnel must be able to carry out smart analyses of the company's spending, challenge demands for outlays by calculating cost driver ratios, and forecast demand using new analytics solutions.

CONCLUSION

Changes to NFR spending present opportunities to cut costs while also getting ahead of consumer trends – and can thus boost competitiveness in a highly challenging environment. In our experience such measures are essential, given the turbulence in the sector and the ever-evolving threats from new players. Any retailer that fails to do everything possible to boost competitiveness will soon find itself under pressure, as its rivals push ahead with ambitious programs. Innovation in NFR, and the move from a tactical to a truly strategic perspective, will be key elements in sorting out the winners (and losers) in the increasingly brutal world of online and offline retailing.

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ABOUT

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 Retail & Consumer Goods 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 retail: an obsession with serving the customer, constant dedication to better execution, and a relentless drive to improve capabilities. We believe our hands-on approach to making change happen is truly unique – and over the last 20 years, we've built our business by helping retailers build theirs.

For more information please visit www.oliverwyman.com

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