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Funding Investments For Growth

THE NEED FOR RADICAL COST REDUCTION

A new reality in food retail

Food retailers are caught in a perfect economic storm, as discounters, online and digital competition, and flat-lining customer demand simultaneously assail their industry. As food retailers confront these challenges, they must make new investments to stay competitive.

The experience of food retailers in the UK emphasizes the importance of responding adroitly to changes in the market. For several years, major UK food retailers had successfully kept discounters at bay, but two factors weakened their position. First, Tesco started raising prices, driving away some customers; second, when the financial crisis struck in the late 2000s, consumers' wallets were constrained and discounters' prices grew more appealing. Incumbents were slow to react to these changes, giving discounters five years to grow.

In the US, food retailers need to act as soon as the cost virus infects their market. Whether in the form of hard discounters or other sources of competition, it is critical to watch for early warning signs and take swift action.

A solution: radical cost reduction

Borrowing a tactic from other industries, food retailers can respond to present challenges by radically reducing costs.

The European telecom industry's example demonstrates the efficacy of this approach. The number of new subscribers per company was declining significantly in the last decade, forcing telecom providers to dramatically cut costs. Over eight years, providers decreased the operating expense per subscriber by 20 percent to 30 percent. They managed demand, reduced unnecessary activities, improved the efficiency of remaining activities, and reduced factor costs.

Likewise, after the financial crisis, wholesale banks were forced to cut costs, reducing overall front-, middle-, and back-office expenses by 10 percent from 2010 to 2015, with plans for further reductions of 10 percent to 15 percent by 2020.

Food retailers have always been focused on costs, so there's less fat to trim than in the case of telecom providers and banks.

On the one hand, this renders making initial plays more challenging and less obvious; but on the other, a historical focus on costs is an advantage. Food retailers will have to find new areas for reductions, leveraging their experience with cost management and achieving continued success in areas where they are already efficient.

To achieve "radical" cost reduction, food retailers must go above and beyond the everyday focus. Five major themes should be considered when building out the radical cost reduction playbook:

- **Radically simplifying the business**
- **Utilizing automation and AI**
- **Changing the nature of relationships with suppliers**
- **Managing the asset base more aggressively**
- **Building a cost-conscious culture**

The following sections describe each of these themes and examine success stories, primarily among European retailers.

1. RADICALLY SIMPLIFYING THE BUSINESS

There are three focus points for business simplification: the proposition, the operating model, and the head office.

Simplifying the proposition

One method is to carefully curate your proposition to a limited number of SKUs per store.

In Europe, the Spanish food retailer Mercadona delivers a full supermarket proposition with 9,000 carefully selected SKUs, roughly 25 percent to 50 percent the number of SKUs offered by a traditional supermarket.

The company is a market leader and has experienced remarkable success in the past 10 to 15 years. Not only does their simplified proposition reduce costs – it also contributes to a positive customer experience. Mercadona enjoys a reputation as a simple and fast shopping experience, with a high availability of products

Simplifying the operating model

Food retailers can make a number of changes to their operating model to increase the efficiency of their stores and drive costs downward.

The German hypermarket chain, Kaufland, has a streamlined operating model based on industrialization across all its store activities. (See Exhibit 1.) The chain has far fewer hand-stacked displays and far more pallets than traditional grocery stores.

Simplification of display type in this manner can cut labor costs by 1 percent to 1.5 percent.

Kaufland has also achieved efficiencies in checkout speeds. The checkout process at Kaufland is designed for maximal efficiency, with barcodes featured on both sides of an item. The result: While the average checkout at a traditional supermarket takes eight seconds per item, at Kaufland it takes only four seconds.

Kaufland has gained a massively optimal cost position, closer to that of discounters than that of a normal supermarket.

Simplifying the head office

Zero-based budgeting (ZBB) in the head office can serve as another tool for simplifying your business. (See Exhibit 2.)

ZBB starts with a few basic principles and steps. The first step is to determine a business's "survival minimum" costs, or the cost of base services required for proper functioning without any additional frills. The second step involves determining "strategic minimum" costs, taking into account short-, medium-, and long-term strategic goals. The last step is to set a realistic optimization target that lowers costs and the FTE base from its current state, while still leaving room for strategic development.

ZBB has enormous potential for cost reduction among food retailers. In an example from another industry, one UK insurance provider employed ZBB to reduce head office costs by 45 percent and achieved £100 million in savings over the course of 12 months.

Exhibit 1. Volume share by display type

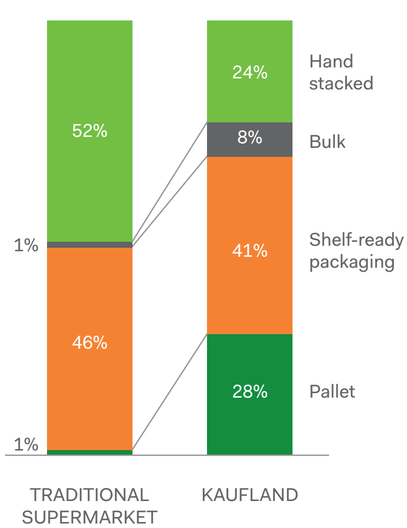


Exhibit 2. Three steps to a zero-based approach to cost

STEP 1: IDENTIFY SURVIVAL MINIMUM

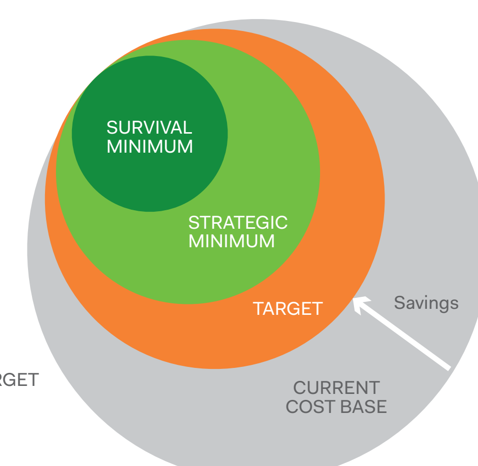
- Base services, such as regulatory reporting
- Justified internal demands, such as health and safety
- But no frills, no comfort, no breakouts

STEP 2: IDENTIFY STRATEGIC MINIMUM

- Short-, medium-, and long-term targets are all considered
- No frills, with only a few people creating impact, but targeted investments are delivered

STEP 3: AGREE REALISTIC OPTIMIZATION TARGET

- Limited amount of extra activities included
- No unnecessary internal demand
- Few activities that do not create extra value



2. UTILIZING AUTOMATION AND AI

Automation is another key tool for food retailers to unlock significant savings.

We are moving toward a world in which the proper "smart" tools serve as companies' primary decision makers on a range of business elements. As algorithms and data science improve, automation and AI can tackle such areas as pricing, assortment, and operations.

Making use of automation, food retailers can make business more cost efficient. For example, the British online supermarket Ocado relies on a lean digital head office, running a £1 billion per year business with fewer than 200 head-office FTEs.

Example: Amazon

Amazon has best-in-class automation capabilities and takes a fundamentally different approach to merchandising. Unlike traditional merchandisers, the company has highly centralized data stores and a largely automated decision-making process. Its small merchandising organization has a narrow focus, and overall the company retains a distinct culture and set of hiring practices.

Amazon merchants in the office supplies space are responsible for roughly 10 times as many SKUs as merchants at traditional retailers. (See Exhibit 3.) Because of greater automation, prices change 50 times as often for Amazon's office supplies than for traditional retailers.

Ultimately, Amazon's automated processes allow it to make better, more competitive decisions more quickly, and with fewer people.

3. CHANGING THE NATURE OF RELATIONSHIPS WITH SUPPLIERS

If retailers develop different types of relationships with suppliers, they can achieve better terms and reduce costs. (See our next report "More Trust Wins More Value".)

For the past five to 10 years, purchasing alliances have been a hot topic in Europe, as food retailers form buying groups to significantly increase their purchasing power and leverage to bargain. Through such alliances, retailers have achieved savings on the order of 200 to 300 basis points (bps) from suppliers.

Alternatively, retailers can form deep partnerships with the right suppliers and undertake joint value creation. By carefully selecting one or more suppliers, forming relationships built on trust, and innovating together, retailers and suppliers can secure mutual gains, improving processes and reducing costs. Oliver Wyman projects the potential savings in the US from supplier collaborations in fresh to be on the order of $7 billion to $10 billion.

Exhibit 3. Amazon: Fewer decision makers, responding more rapidly

1. Estimated using products listed on Office Deport and Amazon websites, excluding 3rd party resellers
2. Based on analysis from Profitero
Source: Amazon.com, Officedepot.com, ZDnet.com / Profitero, Oliver Wyman analysis

4. MANAGING THE ASSET BASE MORE AGGRESSIVELY

For incumbent retailers to maximize their fixed asset bases, they must be innovative about "sweating" their assets harder. Collaborations allow one partner to deliver low-cost points of presence while the other makes use of extra space.

EXAMPLE: PARTNERSHIPS IN THE UK

In the UK, Waitrose serves as a pickup point for John Lewis housewares, and several stores carry nonfood items. Likewise, Argos and Sainsbury host collection points, from which customers can pick up their eBay purchases. These arrangements allow retailers to find additional uses for their store locations.

In addition, Sainsbury's has opened up Argos outlets in its stores, allowing Argos to achieve lower cost points of presence.

EXAMPLE: AMAZON AND PROCTER & GAMBLE IN THE US

In the US, Procter & Gamble (P&G) has an arrangement with Amazon in which Amazon can set up fulfillment operations in P&G warehouses.

Through arrangements such as these, food retailers can maximize cash generation from their fixed assets.

5. BUILDING A COST-CONSCIOUS CULTURE

Ultimately, a successful program of radical cost reduction requires that food retailers create a cost-conscious culture. This requires looking at costs throughout the business, including the costs of goods not for resale (GNFR) and identifying the root causes of high costs.

Goods not for resale

Goods not for resale expenses fall into four major categories. (See Exhibit 4.) These categories are retail-specific purchasing, traditional indirect purchasing, supply chain costs, and construction and facility management.

A cost-conscious culture will look at GNFR spend holistically in order to identify areas with potential for cost savings. Success stories from GNFR cost-reduction programs include:

- A European retailer that achieved $200 million recurring savings on $2 billion scope
- A global B2B company that achieved $260 million recurring savings on $9 billion scope over three years
- A global service provider that achieved $500 million recurring savings on $12 billion scope over three years

Deeply examining their GNFR spend, food retailers can save on a recurring basis.

Exhibit 4. Four categories of goods not for resale (GNFR) spend

Retail-specific purchasing	Traditional indirect purchasing	Supply chain costs	Construction and facility mgmt.
Packaging	Marketing	Transportation of goods	New building construction and renovation
Sales shelves and furniture	Energy	Logistics services	Maintenance
Etc.	Waste treatment	Etc.	Cleaning
	IT and telecom		Security
	Temporary labor		Etc.
	Office supplies		
	Etc.		

Cost root causes

Ultimately, a truly cost-conscious culture seeks out the root causes of its highest costs and addresses them head-on.

Consider the challenge of high shrink in the fresh category. (See Exhibit 5.) This problem can be traced back to replenishment issues, cultural issues in stores, product handling, and a lack of range differentiation.

If food retailers look for root causes of costs throughout their stores, they will be able to tailor their solutions to be more effective.

Exhibit 5. Illustrative cost problem and root cause

CONCLUSION

As other industry sectors have made vast improvements in their cost position, retailers may take heart from their success – but they also need the vision to think big. Substantial increases in cost savings have not been achieved through small-scale incremental change to existing business models. Instead, retailers need to go back to the drawing board – leaving behind the "this is how we've always done it" mindset. To reduce costs anywhere from 20 percent to 40 percent, retailers need to find ways to simplify their business, increase automation, manage their asset base more aggressively, change the nature of their relationships with suppliers, and build a cost-conscious culture.

Once companies have scanned the horizon for increased cost pressures in their market and have precisely diagnosed their present cost position, they should develop a set of reduction plays to challenge their current models. Optimal plays will vary from business to business, and thus it is critical that each retailer understand their points of competitive advantage. By taking cost reduction to the next level, food retailers will be able to fund significant investments for important growth. This kind of change doesn't happen overnight, but we expect to see more retailers in more markets attempting similar programs over the next few years.