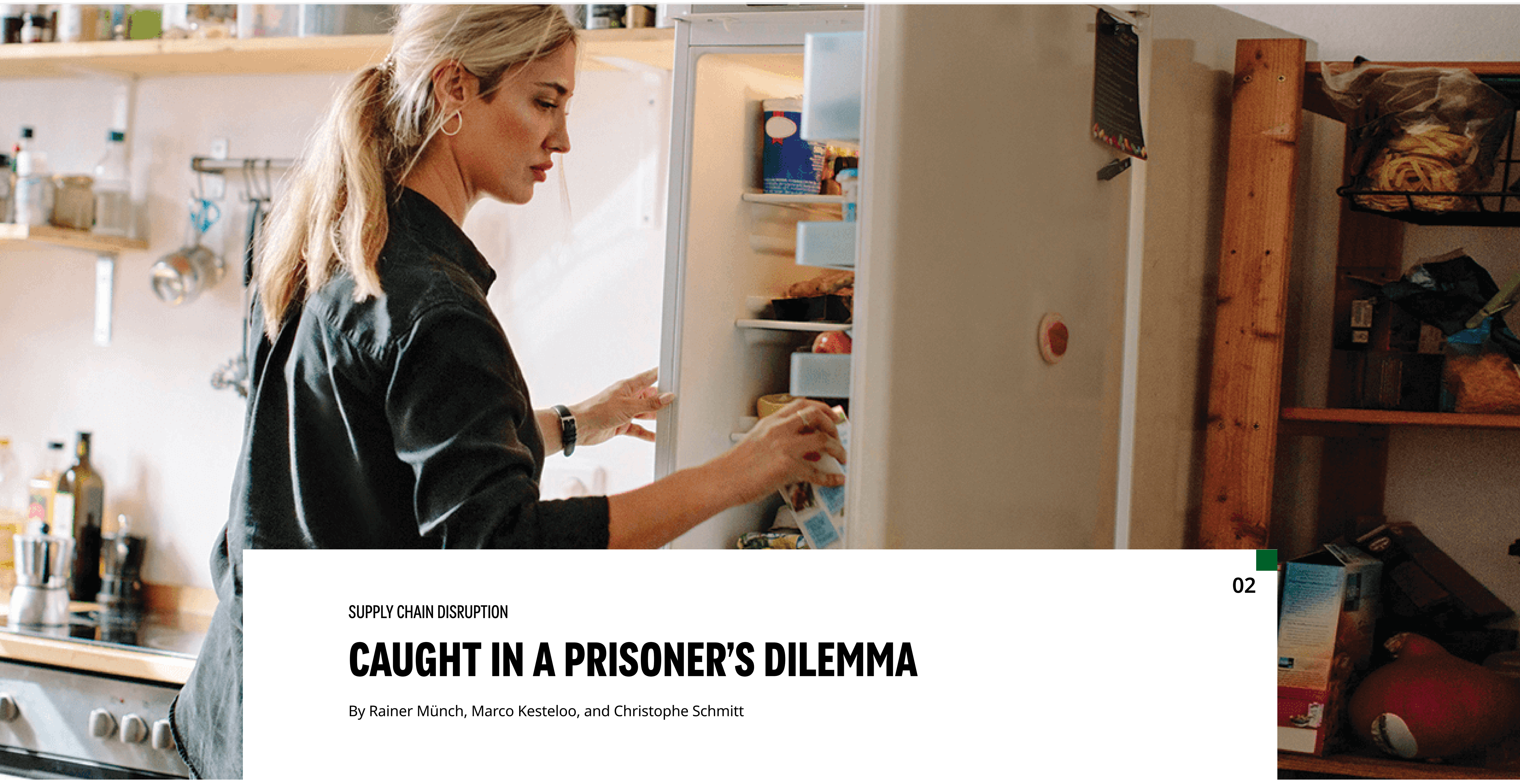


SUPPLY CHAIN DISRUPTION

CAUGHT IN A PRISONER'S DILEMMA

By Rainer Münch, Marco Kesteloo, and Christophe Schmitt

With elevated demand and supply-chain challenges, retailers and suppliers must choose whether to initiate a new type of collaboration or remain stalled in a standoff benefiting no one.

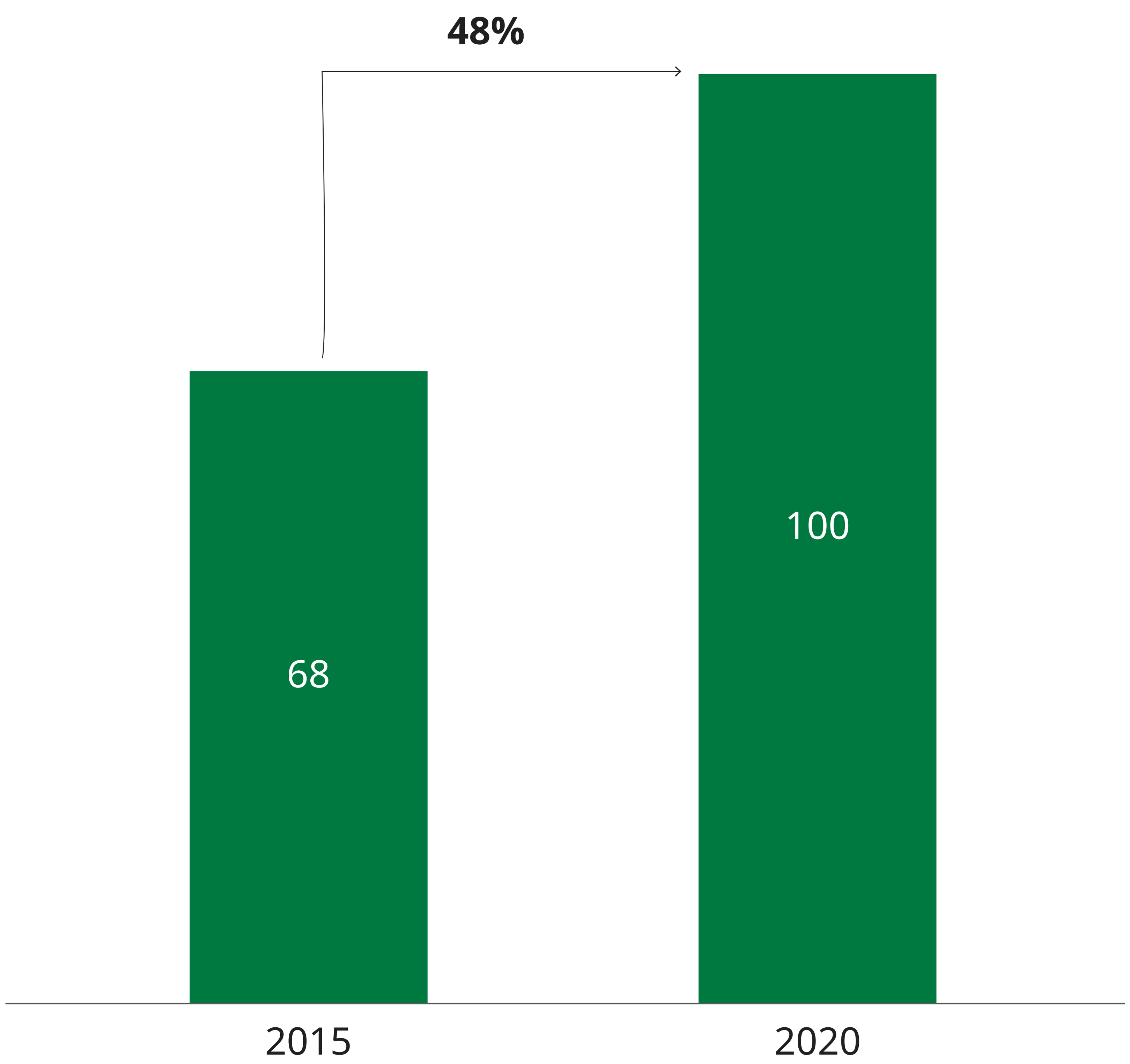
Both sides of the trading partner relationship are looking at negotiations differently. The starting point is challenging, with mutual term structures that could hardly be more complex, combining dozens of terms on the national, and (in Europe) international level linked to a broad set of counterparts ranging from in-store displays, to promotions, supply-chain conditions, or access to sales data. Many retailers report hundreds of individual term agreements across their supplier base, while suppliers oftentimes quarrel with retailers' operationalization and the effectiveness of the counterparts. In summary, it's a case of the prisoner's dilemma, a paradoxical situation in game theory in which two individuals acting in their own self-interests fail to produce the optimal outcome — and as a result, both participants find themselves in a worse state than if they had cooperated with each other in the decision-making process.

Both retailers and suppliers are confronted with a challenging market environment characterized by saturation and slow growth, rising cost to serve, and an increasingly active role of regulators. The time has come for the two sides to simplify their term agreements and devote more time, and energy to focusing on customers and joint value creation — or ultimately having government regulations imposed on them.

Observers have long wondered how long such a highly inefficient collaboration could prevail in an industry that often praises itself for its efficiency and speed. The system in Europe in particular is under tremendous pressure, paving the way for a fundamental reset of the retailer-supplier negotiations, which may have lessons and implications for the US as well:

Convergence and internationalization of competition. Hard discounters are becoming more like supermarkets, Amazon has become a serious fast-moving consumer goods (FMCG) player, and new multinational e-food players are entering the market. In response, traditional retailers increasingly are becoming part of international buying alliances — in Europe, for example, we have seen almost 50% more such participation in 2020 compared to 2015. (See Exhibit 1.)

Exhibit 1: Number of grocery retailer[1]/buying alliance[2] combinations in Europe



1. European grocery retailers with > 1bn € yearly sales (2020)
2. Alliances on both cross-European as well as national level, for private label and A-Brands
Source: Oliver Wyman analysis

Yet the incremental return of volume bundling alone is diminishing. All these elements are pushing toward a real redesign and simplification of (international) term structures and doing so from an increasingly powerful position in the market.

Tighter regulation. In Europe, French regulators — together with official watchdogs in several key markets in Eastern Europe — are limiting back margin elements while demanding more transparent counterpart measurement. Retailers are starting to use these dynamics to simplify their term structures not only from a domestic legal perspective, but also as a trigger for a more comprehensive redesign across markets.

Coming to senses. Despite all drawbacks, today's complexity of terms is often interpreted as a unilateral advantage by both sides, but in reality, it involves unnecessary use of resources and reduced net-net-margin transparency for everyone. If "omnichannel customer-centricity" is to become a real paradigm, then it can only be supported by simpler term and agreement structures.

In our view, now is the right time for retailers and suppliers to drive changes before losing the customer out of sight and the appearance of additional regulatory impediments. This will allow for a simplification of the collaboration and more time and energy for (jointly) focusing on customers. Some European retailers have already begun this transformation and are starting to reap the benefits. Others who have yet to begin the process should not lose time and consider the following recommendations:

Create net-net transparency on stock-keeping unit (SKU) level first. Knowledge is power, and leading the change is better than reacting to the proposals of others. Economic control over term simplification first requires deep transparency on the true net-net profitability on a product level. Retailers and suppliers should prepare now for the dynamics to come or risk losing control over the total P&L impact.

Dramatically simplify term and agreement structures. Reduce funding agreements with suppliers, trimming them to fewer than 20 from the hundreds that currently exist, and get as close as possible to net-net-margin basis on SKU level, so as to allow for a more effective steering of the business and a P&L forecast in real time.

Move from highly specific counterparts to strategic guardrails. Detailed definitions of counterparts may signal control for suppliers, but it often prevents a more holistic optimization of the value proposition to the end customers — let alone secondary effects like supply-chain efficiency or food waste further down the chain.

Start a new era of transparent, data-driven, customer-centric collaboration. Jointly focusing on the customers across channels should also mean working off the same data and KPIs. This will require more openness on both sides to share data, KPIs, and objectives.

Dramatic change will come to the industry within the next two to three years. It is up to retailers and suppliers if they want to get ahead of the curve and initiate a new type of collaboration now — or continue to devote their energy on complex negotiations until the sum of regulatory requirements demands action.

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