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Retail Practice

Rethinking procurement in retail

For retailers, procurement is no longer solely a matter of negotiating "A" brands. Private labels and verticalization are trending. Advanced approaches and tools help get procurement in shape for the future.

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The days in which bricks-and-mortar retail monopolized touchpoints to customers are gone. Alongside pure internet retailers such as Amazon and Zalando, and start-ups like the beverage delivery service Flaschenpost, brand manufacturers are increasingly seeking to gain direct access to consumers—be it online or through ultramodern flagship stores in premium city-center locations. Aside from pioneers like Apple, many categories are encroaching on the final consumer business, from coffee brands (take Nespresso) through to cosmetic lines such as Kiehl's and Nyx by L'Oréal. As a result, traditional retailers not only face intensified pressure on margins but also unrelenting pressure to innovate.

And the retail sector is mounting a response. By increasing its share of private brands, it is endeavoring to win the loyalty of customers and set itself apart from the growing competition. Some retailers, among them the French sports equipment discounter Decathlon, are already aiming to increase their share of private labels to 100 percent. Those who can afford it pursue verticalization and set up in-house production facilities for their private labels. Leading grocery retailers such as Edeka, Migros Switzerland, Morrisons UK, and Kroger US have long produced much of their assortment themselves—from beverages to meat through to baked goods. Even coffee roasters, ice cream factories, or potting-soil producers have since been added to the vertically integrated portfolios of retail chains.

These trends do more than simply change the face of retail: they are also making a deep impact on procurement management. The procurement function is now not solely fixated on annual negotiations with manufacturers of "A" brands. Instead, the focus is increasingly turning to the procurement of private labels and purchasing of raw materials for in-house production. At the same time, this approach is changing the entire procurement organization. New team structures and skills are needed, as are new approaches and tools.

Priorities are shifting

For years, procurement officers in the retail sector had primarily focused on premium brands and their suppliers; little effort was dedicated to the procurement of private labels, which was sidelined as an activity of less importance. That is fundamentally changing with the emergence of new competitors and sales channels. Meanwhile, the share of private labels in the portfolio of many bricks-and-mortar retailers is very close to 50 percent. Private labels have long since outgrown their original function as entry-level products. Today, private labels assume quality leadership positions (take for instance REWE Feine Welt, Tesco Finest, or President's Choice at Loblaw), address popular niches such as organic food and vegan cosmetics, or serve special customer groups (consider children's brands at Tesco like Fred & Flo baby care and Tesco Goodness for Kids food, or at Asda like Little Kids food and Little Angels baby care). In the meantime, there is barely any market segment that the retail sector has not conquered with its in-house products—through to the branding of complete categories such as EDEKA zuhause, under which the retail chain sells its home products.

As they expand their portfolio of private labels, retailers are not merely focusing on securing their position in the face of often limited supply sources. Particularly in the premium segment, their aim is to systematically improve margins and strengthen their negotiating position against brand suppliers. At the same time, their high-quality in-house products set a counterpoint to the design-to-cost programs of many A brands that seek to improve their own margins with cheaper components and packaging. Against this backdrop, the private label is set to become an unprecedented strategic competitive advantage—vis-à-vis brand manufacturers, but also other retailers.

As verticalization increases, so too does the importance of the procurement of resources and raw materials. Retailers with in-house manufacturing capacity can no longer simply pass on prices to their customers. Instead, they have to ensure the supply and capacity utilization of their production facilities. Not only does that make the task of procurement more demanding, it also involves far more complex processes.

Agile work structures are needed

The new trends have a wide-ranging impact on the procurement function. Established power plays in negotiations with brand suppliers have become more difficult. Indeed, as retailers have lost their ability to monopolize touchpoints to customers, they have also lost their most powerful negotiation argument in some areas. Brand manufacturers have known how to take advantage of this opportunity: they have professionalized their customer management and today have access to data-based customer knowledge that had long been exclusively controlled by the retail sector. In contrast, many retailers have changed little in the way they manage their procurement activities and are seeing their past negotiation power dwindle. In order to restore the level playing field with manufacturers, they have to revolutionize their procurement functions at multiple levels simultaneously:

— **Organization.** Conventional procurement management dependent on a few core suppliers is no longer enough. Clever retailers set their procurement organizations on a far broader footing and, in particular, endow them with greater agility. Category specialists are replaced by agile, cross-functional teams that link procurement to other functions, like product development, category management, and supply-chain management, and that set the foundations for successful procurement based on sprints.

— **Capabilities.** Agile procurement teams need a broader range of competencies. Negotiation tactics are no longer such a decisive factor; more important are analytical skills, especially in the disciplines of advanced analytics and machine learning, coupled with an extensive understanding of products.

— **Tools.** Retailers have long operated with sell-off and margin analytics that ideally also factor in additional agreements such as advertising subsidies. However, that's not enough in the current environment: procurement officers need a detailed understanding of how much value can be created with each product and what prices are actually feasible in the market, and also for well-established products beyond their "brand bonus." Also needed are highly professional requests for quotations for product development, manufacturing, or collaboration agreements with suppliers. This is only possible with the assistance of digital processes and a toolbox that supports procurement in the retail sector with new procedures and technologies.

New tools for every purpose: From the parametric cleansheet to the negotiation cockpit

As they seek to optimize their procurement functions, today's retailers have at their disposal a large spectrum of methodological approaches and digital analytics tools—not just for the procurement of private labels but also for products produced in-house, for nonretail goods, and for the procurement of industrial brands. Some of these tools should be standard equipment in every retailer's toolbox, given that they provide the fact base needed for making the best possible procurement decisions. Such tools include analytics tools for determining spending and price variance, a supplier positioning matrix, and the cleansheet—an essential tool for shedding transparency on complex product categories. Beyond that, tried-and-true tools are also used as needed, such as guidelines for optimizing negotiation tactics or contractual terms and conditions, presentation playbooks, or aids for global procurement (Exhibit 1).

A closer look at a cleansheet analysis helps illustrate the benefits of using digital tools. It sheds light on the dense undergrowth of product components and specifications: it is not unusual for categories to comprise in excess of 1,000 stock-keeping units (SKUs) and a correspondingly large number of suppliers. That said, many articles within a category are often manufactured and assembled in similar ways—suggesting that considerable savings potential lurks below the surface that a parametric model could help uncover. Such a model would

Exhibit 1

For each step in the procurement process, there are approaches and tools for optimization—both digital and classic ones.

Overview of key tools along the purchasing value chain

Create a fact basis	Conduct request for quotation	Generate ideas and derive positioning	Prepare and conduct negotiations	Document and follow up on negotiation results	Monitor changes and measure impact
Spend analysis	Request for quotation	Defining specifications	Global sourcing	Negotiation notes	Performance tracking
Price variance analysis	E-auction	Linear performance pricing	Negotiating tactics		
Supplier profiles		Internal idea generation workshop	Contract terms and conditions		
Cleansheet		Global sourcing	Playbook for presentation		
Supplier positioning matrix		Supplier workshop			

Source: McKinsey analysis

help combine similarly manufactured products into clusters and transpose the cost information on individual parts to all others within the product cluster. In this way, the retailer can quickly calculate the costs for hundreds of products and thereby determine competitive pricing.

Another helpful approach in order to improve internally manufactured brands in particular is the design-to-value (DTV) method. Innovative tools such as ethnographic consumer research or industry-wide design trend analytics today provide even more detailed insights into what truly drives customers' purchase decisions and what designs are in demand in the market. Equipped with these and other DTV tools, retailers can boost sales, optimize prices, and simultaneously reduce costs—thus ratcheting up value creation for each and every product.

Generally speaking, no procurement officer looking for the best product at the best price can afford to bypass advanced analytics any more. Take for instance today's grocery sector, where algorithm-based machine learning is used to develop complex demand forecasts or agronomic predictive models, compile global cost curves, or analyze market conditions based on geodata. To this end, the tools combine an array of data on market trends or developments in the weather and commodities markets in order that procurement officers can predict the purchasing prices of wheat, for instance.

Many tools touched on here can be used both in contract manufacturing and in the in-house production of private-label goods. However, they differ in terms of their range of influence. They offer the greatest leverage effect for in-house production, as they can impact the selection of raw materials, the manufacturing process, and even the deployment of personnel. A number of levers are also available for the procurement of private labels. For instance, DTV can be used to manage a product's exact specifications, while procurement tools and e-auctions help find the best suppliers.

Why the effort pays: Big savings potential

A closer look at the levers in procurement clearly shows that private labels offer procurement officers substantially more opportunities for influencing the product than industrial brands. Accordingly, there are greater opportunities for reducing costs and widening margins. It is possible to capture quick savings through the procurement price alone. A cleansheet analysis again helps determine the extent of the potential: in the procurement of a mass article—in the illustrated example, a candle for home use—the difference between the determined target price and the supplier's offer was almost 30 percent (Exhibit 2).

Cost savings can be captured in the medium term by combining procurement sources, switching to other suppliers, or adjusting volumes. By contrast,

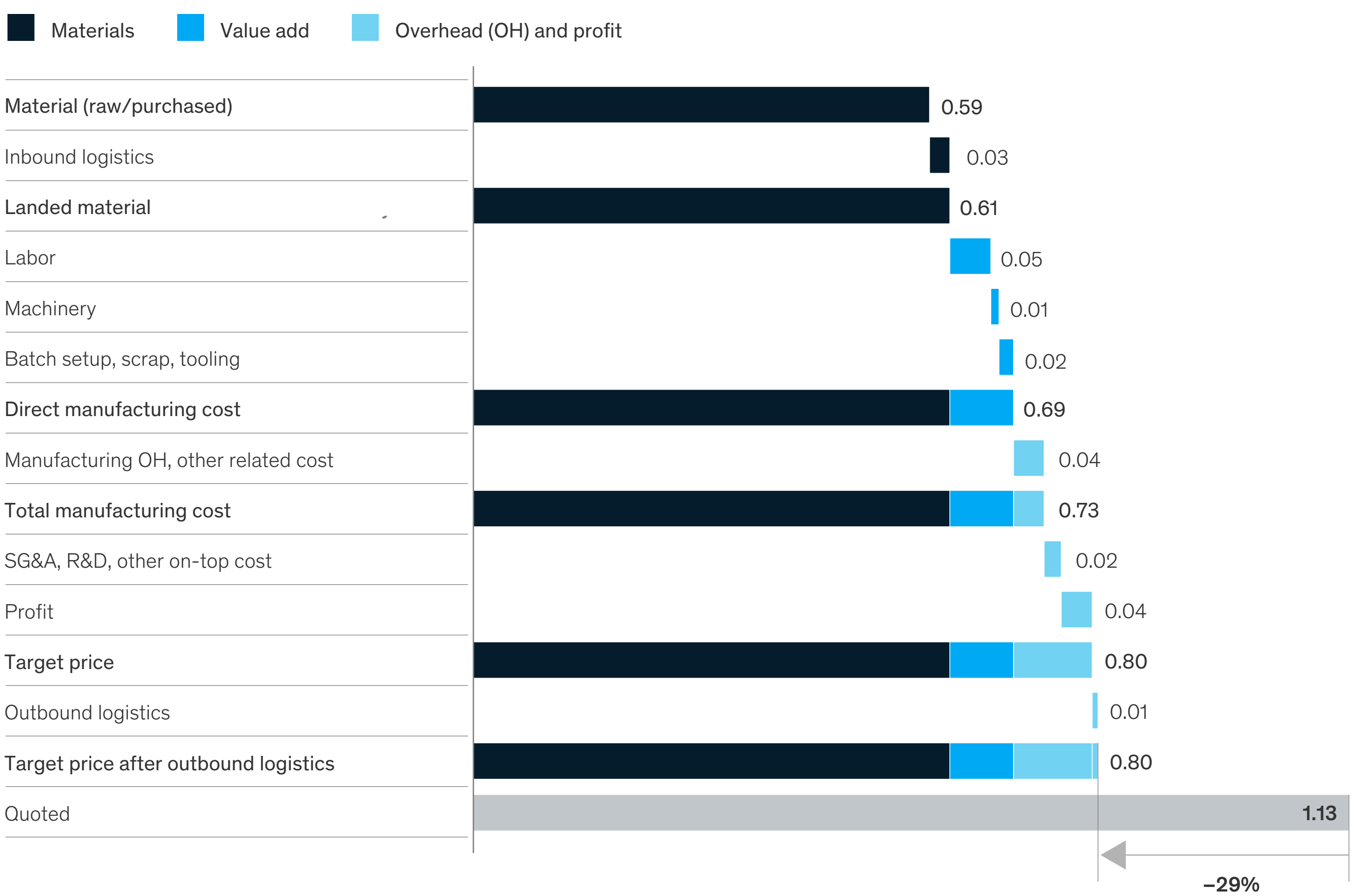
Exhibit 2

Cleansheet analysis reveals high cost-savings potential—especially in procurement of commodity products.

Cleansheet cost calculation for a high-volume candle (private label), € per piece

Basic assumptions

- Profit of 5% included in the price
- Batch size of 10,000 pieces
- Tender volume of ~15,000 pieces
- Manufacturing location: Germany
- Paraffin cost: €0.794/kg
- Interest rate: 2% assumed
- SG&A[1] costs: 3%; no R&D costs
- Labor rates: €23.6 to €27.03 depending on skill level



[1] Sales, general, and administrative expenses.

Source: McKinsey analysis

changing the content or packaging requires more time, although it can likewise prove an effective means of saving costs in the long run.

The effort is certainly worth it. After all, the costs of procurement or manufacture of articles make up as much as 75 percent of the retail price. Professional procurement management with advanced methodologies and smart tools can make a substantial contribution toward cutting these costs—by more than 10 percent in the case of private labels. Retailers should not miss this opportunity to stretch their margins and maneuver into a stronger market position—because the competition does not sleep.

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