CHAINLINK RESEARCH

Cooperation and Competition in Retailer-Supplier Relationships

2004 Retailer-Supplier Survey Results

By: Bill McBeath, August 2004

About ChainLink Research

ChainLink Research is a bold new supply chain research organization dedicated to helping executives improve business performance and competitiveness. ChainLink was founded on the premise that supply chains are market driven and that the management of the links between the companies has become the key determinant of the winners and losers. ChainLink's fresh approach to supply chain research, actionable analysis and high-impact decision-making workshops helps manufacturers, retailers and technology firms enter new markets, expand, share and achieve peak performance in their markets.

ChainLink focuses solely on supply chain. Our 3PE methodology encompasses the Policies, Processes, Performance and Enablers for realizing supply chain excellence. Our world-class team has created a rich knowledge base of timely, next-generation business innovations, practices and technologies such as supply chain networks and small/smart/fast technologies. ChainLink's customers have achieved dramatic business transformation and results they could not get from other firms. We customize our research and findings to meet your specific objectives.

ChainLink Research bridges the gulf between supply chain managers and the CEO's team. Emerging and leading supply chain executives have recognized ChainLink as the foremost supply chain thought leader and action catalyst of the 21st century.

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How much cost compliance requirements add to suppliers operations is a matter of debate. Most suppliers estimate these costs significantly higher than retailers estimate them (see Figure 4).

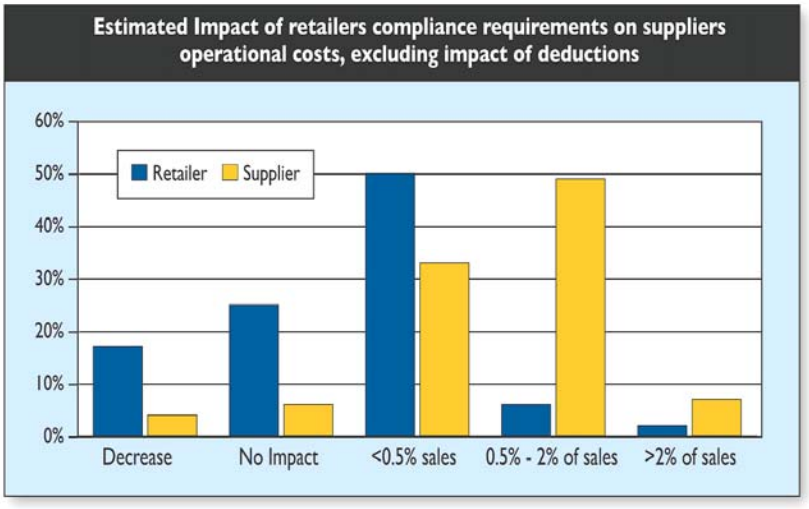

Figure 4 –Impact of Compliance on Supplier Operational Costs

This shows that many retailers do not fully appreciate the impact of their compliance requirements on suppliers operational costs. Retailers who dictate compliance without understanding the effect on suppliers' operations will increase their total cost in the long run[2]. Those who focus on making things more efficient across the whole chain, rather than simply shifting costs to the vendor will have an advantage.

Dialog with suppliers can create better end-to-end performance (see sidebar "The Fruits of Collaboration"). Retailers cannot afford to be lax in defining and enforcing compliance, but compliance requirements should be defined intelligently, with input from and in collaboration with key suppliers.

The Suppliers Responsibility

Highly compliant suppliers gain a significant advantage, both by relief of the huge burden of deductions (which can exceed 5% of suppliers revenue), and the acceleration of their products to the shelf, while non-compliant products are set aside, to be manually processed later. This has knock on benefits of improved demand management due to shortening the time from shipment to consumption, making the whole chain

The Fruits of Collaboration

In the mid-90's, one grocery retailer noticed that unpacking and putting tomatoes on display was labor intensive and caused a lot of shrinkage from all that handling of the delicate fruit. They worked closely over a period of months with their primary supplier to design new packaging—a single layer, store-ready box that reduced labor and shrink. During that process, the supplier came up with several ideas that reduced the cost of the packaging and reduced shrinkage in transit because the tomatoes were better protected and better ventilated. By involving the supplier rather than simply dictating, the retailer created a win-win situation.

[2] As one supplier put it, "Nobody works for free – the retailer may get away with it a couple times, but eventually they will see the cost coming back to them or else their best suppliers will leave them."

Not everything can be standardized. Successful retailers serve different customers segments and global regions very differently, with distinct compliance requirements for each unique environment.

Where and When Do Standards Make Sense

Not everything can be standardized. By their very nature, successful retailers serve different customers segments very differently using vastly different displays, store formats, and supply chain techniques—e.g. warehouse store vs. department store vs. specialty boutique. Globalization additionally creates unique demands for different regions. As a result, compliance requirements, such as packaging, labeling, store-ready formats, load packing, and delivery requirements, often differ by necessity from channel to channel and region to region.

However, there are still plenty of areas where standardization could be applied, but *unnecessary* differences in various retailers' compliance requirements add substantial, preventable complexity and effort for suppliers. In our survey there was consensus on what are the top two areas requiring more standardization: 1) Electronic Formats for Compliance Documentation and 2) Notification of Changes to Compliance Manuals (See Figure 6). These will allow suppliers to automatically load compliance requirements into their own systems and automatically adjust their operational systems' instructions and parameters when compliance requirements change (for everything from carrier selection to label placement). With this type of "auto-update" functionality, suppliers can adjust their operations much more quickly and accurately, reducing the errors and delays inherent in manual monitoring and deployment of the retailers' changing compliance requirements. As these standards mature, expect to see increasing support from software vendors for auto-update functions.

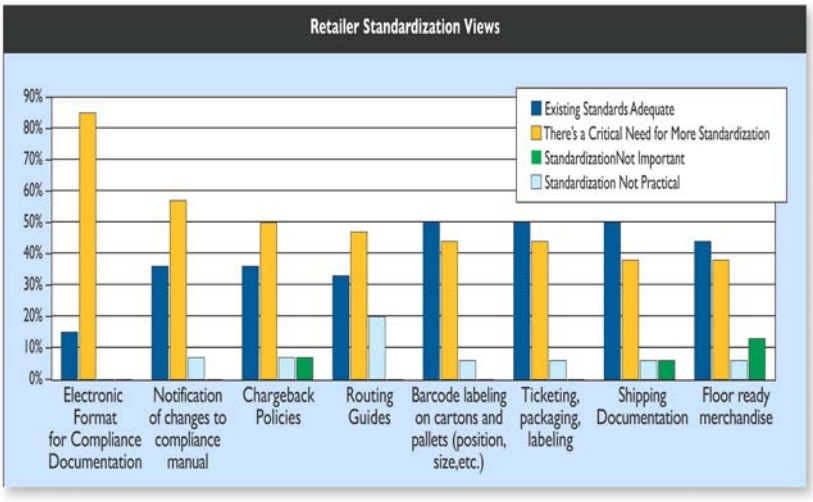

Figure 6 – Retailers' Views on Areas in Most Need of Standardization

Sample Page

Driver	Company/Product Characteristics	Examples
Shrinkage	Small, high value products (prevent theft) Perishables (enforce FIFO)	CDs, cell phones Produce, some pharmaceutical
IP protection / anti-counterfeiting	Easily imitated, high brand value and/or high IP value	Running shoes, software, DVDs
Merchandising Effectiveness	High ticket, assortment and merchandising driven categories	Electronics
Security / Customs	Internationally sourced, high cost for customs delays	Apparel, Personal Computers
Traceability / Recall	Products with regulatory requirements for recall	Pharmaceuticals, Food, Aerospace, Automotive
Service	Complex, High Service Costs	Computers, Telecommunications Equipment, Weapons Systems
DoD Compliance	Consumable products sold to DoD	Clothing, Food, Ammunition

Table 1 - RFID Adoption Drivers for Various Types of Products

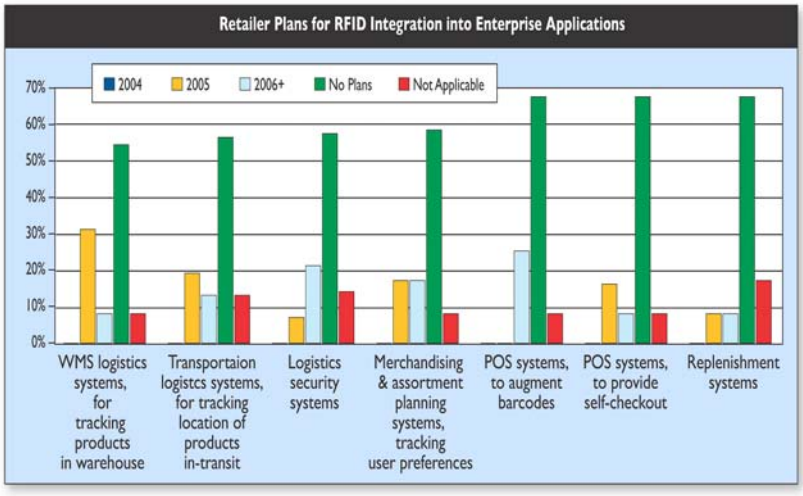

Figure 13 - Retailers Plans for Integrating RFID into Enterprise Application

Total Cost Requirements

Total cost calculation requires a sophisticated data model and capabilities for accumulating the elements of landed cost, such as:

- Ability to efficiently obtain quotes on raw material—i.e. cotton or wool—from multiple vendors around the world (New Zealand, Australia, United States, China, etc.) through a timely RFQ process.
- Ability to track and accumulate various logistics, customs, and additional processing costs as the materials flow from the source factory through each processing facility to the next until they arrive in their final packaged state at the retailer.
- Tracking additional costs to the retailer throughout their inbound logistics process all the way to checkout, including things like return or disposal of shipping/packaging materials, and carrying costs of the inventory between receipt and sale.
- Provide sourcing personnel with a comparative total estimated landed cost for the "final state" product from the various vendors so that an "optimal" buy can be identified.
- Comparison of actual vs. predicted costs for these elements to validate the total cost model
- Provide a complete, accurate view of the item, from the "final state" back to the raw material state showing the original vendor and country of origin, processing steps, etc.

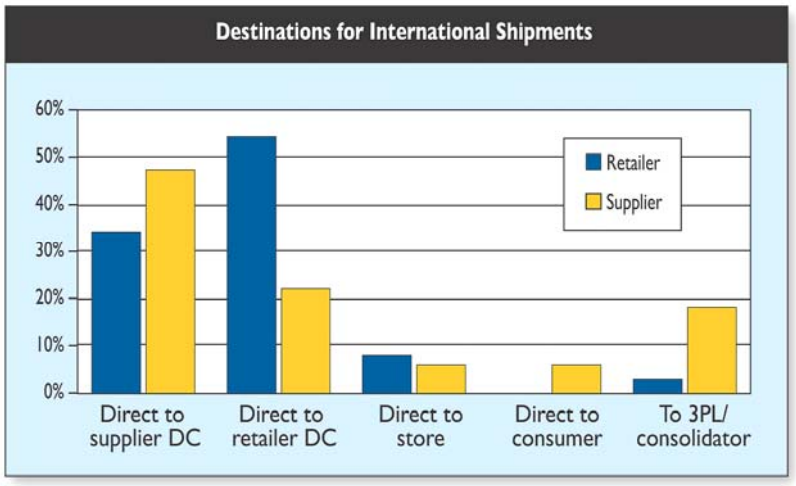

Figure 18 - First Domestic Destination of International Shipments

Destination of International Shipments

Our US-based sample of suppliers said the majority of goods come into their DC first (Figure 18). The retailers, who source not just from US based suppliers, but also from foreign suppliers, and directly from contract manufacturers receive the majority of shipments in their DC. Direct-to-store, or direct-to-consumer, is reserved for a select set of items such as high value, short life products.

Shipping full container loads of product directly to the retailers' DCs has some advantages including:

- Reduction in warehouse infrastructure required
- Reduction in labor and handling costs
- Reduction in pilferage/increased security

In addition to these operational benefits, in many cases manufacturers provide incentives in the form of discounts for 'drop shipments'.

Some suppliers want to ship to their own DC for quality control or compliance purposes. This is critical for example in the Produce industry where a certain portion of the product spoils in transit. The produce supplier sorts and removes the bad product before sending it on to their retail customers. In some cases a distributor or 3PL may provide this type of quality assurance function.

Some companies are trying to solve compliance for goods shipped from a contract manufacturer by shipping them into their own DC and handling the labeling and packaging there. However, this is an expensive approach. In the long run, suppliers will do better by building compliance consistency into their source plants. Overcoming challenges, such as language barriers and training issues, requires active

Sample Page

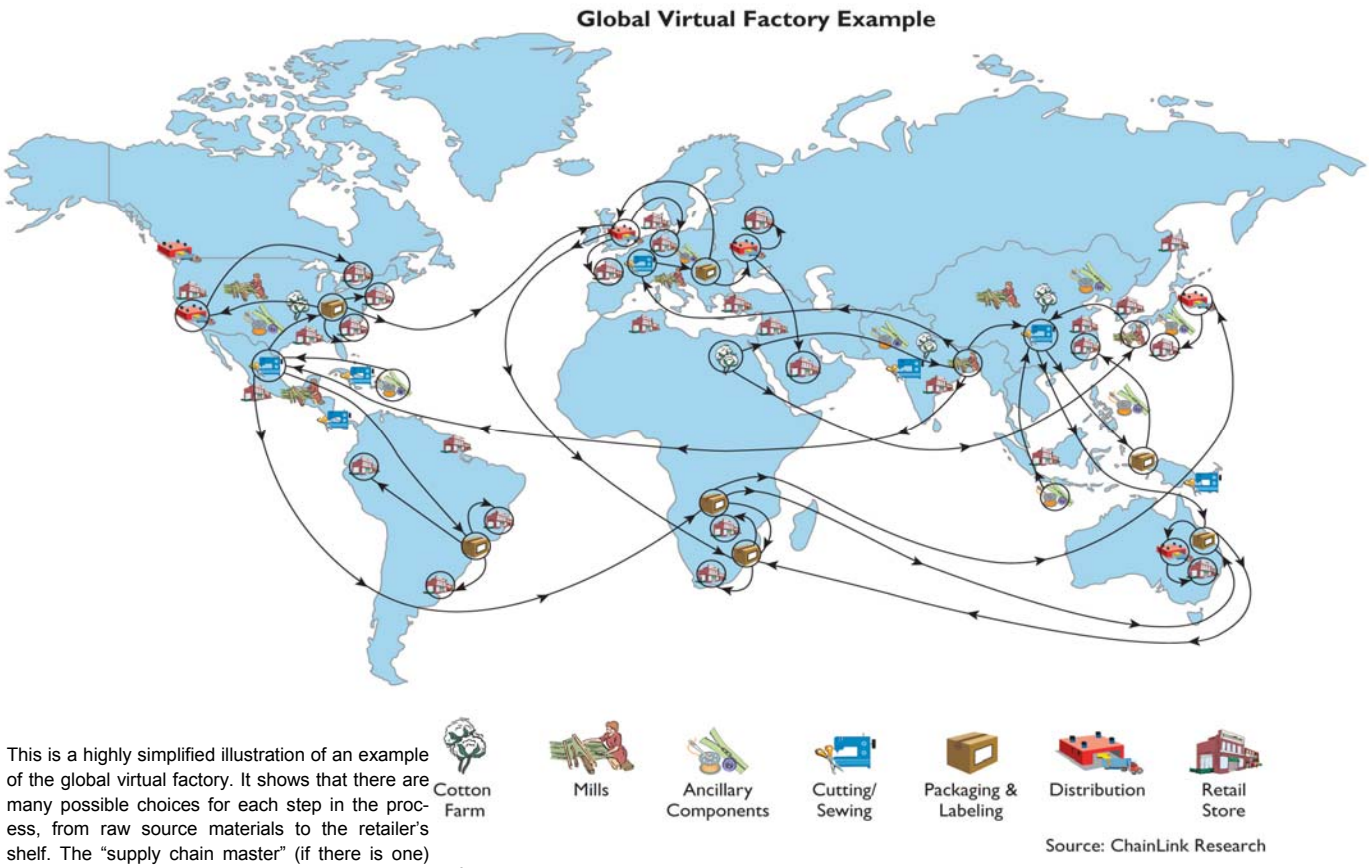

Figure 22 - Global Virtual Factory Example

This is a highly simplified illustration of an example of the global virtual factory. It shows that there are many possible choices for each step in the process, from raw source materials to the retailer's shelf. The "supply chain master" (if there is one) designs the virtual factory, making choices on where, when and how each of the steps takes place. More and more there is flexibility in how and where things are done. An example would be postponing the dying of cloth or the packaging and labeling to much later in the chain, to better match supply with demand.

The supply chain master configures the global virtual factory to meet their specific goals, such as minimizing total cost or maximizing flexibility and agility. Many factors go into these decisions such as the location and requirements of the end market(s) being served, location of raw materials, duties, tariffs, quotas, regulations, political stability of regions, labor costs and skills, infrastructure maturity, transportation times/ costs, perishability and/or price-erosion of the product, buying power of various players, etc.

Real supply chains are much more complex than what is shown here. They will have many more steps in the process (for example, from cotton to cloth can involve dozens of steps, instead of the single step illustrated here). Furthermore, they will have many more nodes to choose from than what is illustrated—tens of thousands of mills, factories, packaging operations and distribution facilities to choose from, as well as hundreds of thousands of potential retail outlets to ship to.

Once this global factory is instrumented (i.e. visibility and measurements at every step), it can be optimized, for instance by moving assembly or packaging downstream to postpone differentiation, or by moving compliance applications upstream to reduce cost. The dream of a global virtual factory is not so far-fetched; a select few global trading companies like Li & Fung have put into practice components of this vision for years. Making it a reality requires a deep understanding of the supply chain and connections in the various regions. It also demand the discipline of performance guarantees baked into the relationships between the parties in the form of SLAs (Service Level Agreements), metrics, and monitoring systems at every step. The desire to move closer to the ideal of a global virtual factory is highlighted in suppliers and retailers choices of the ITL functions that provide the most value to them (Figure 23).

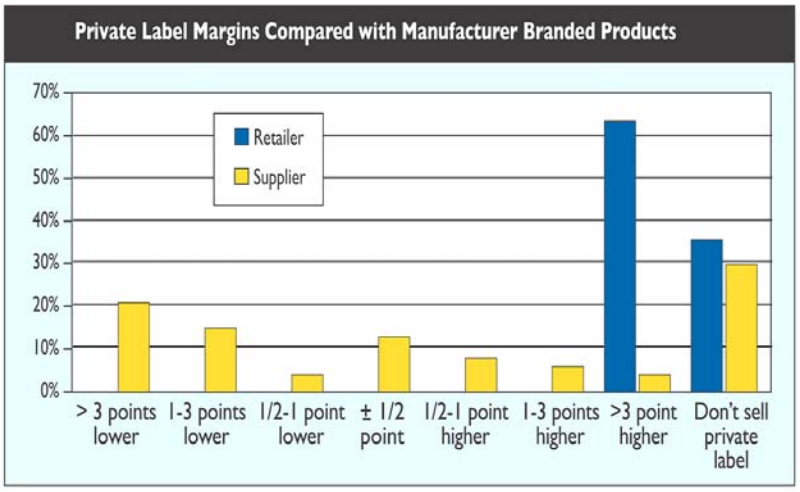

Figure 25 – Margin Difference Store vs. Manufacturer Brands

Figure 25 shows suppliers' and retailers' estimates of how much higher or lower their margins are for private label products vs. their margins for branded products. It turns out the question of margins on private label vs. national brands is not so simple:

- True profit measures need to take into account trade funds and handling cost. Handling costs can be considerably different between private label and national brands, even for the same product[8].
- Price elasticity varies widely between categories and determines the optimal price gap between manufacturer and private label brands, thereby impacting also on the margin differential as well.
- Because the price differential between private and national brands varies so much by category, and each supplier reported the margin differential for their own categories, their responses were all over the map (Figure 25).
- In contrast, retailers (with a much broader base of categories than individual suppliers) had a much more consistent reporting of the margin differential.

On average, suppliers reported lower margins for private label products. Retailers reported significantly higher average margins for private label. This implies that the shift from manufacturers brands to private label also results in a transfer of profit from suppliers to retailers.

National Brand Equivalents vs. Distinct Private Brands

For the branded manufacturer, private label is essentially a low-price competitor who has lower product development and marketing costs.

[8] Without activity-based costing, these handling costs cannot be accurately factored into margin calculations.

Glossary and Acronyms

- 3PL – Third Party Logistics
- COGS – Cost of Goods Sold
- COO – Country Of Origin
- COOL – Country Of Origin Labeling
- DC – Distribution Center
- DoD – Department of Defense
- FDA – Food & Drug Administration
- FIFO – First In, First Out
- IP- Intellectual Property
- IT – Information Technology
- ITL – International Trade Logistics
- ODM – Original Design Manufacturer
- OEM – Original Equipment Manufacturer
- OTC – Over the Counter
- PDQ packaging – “Pretty Darn Quick”, a form of packaging that has bottom and top pieces that are disconnected for fast setup and display purposes.
- RFID – Radio Frequency Identification
- RFQ – Request for Quote
- SLA – Service Level Agreement
- TMS – Transportation Management System
- VICS – Voluntary Interindustry Commerce Standards
- WIP – Work in Progress
- WMS – Warehouse Management System

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