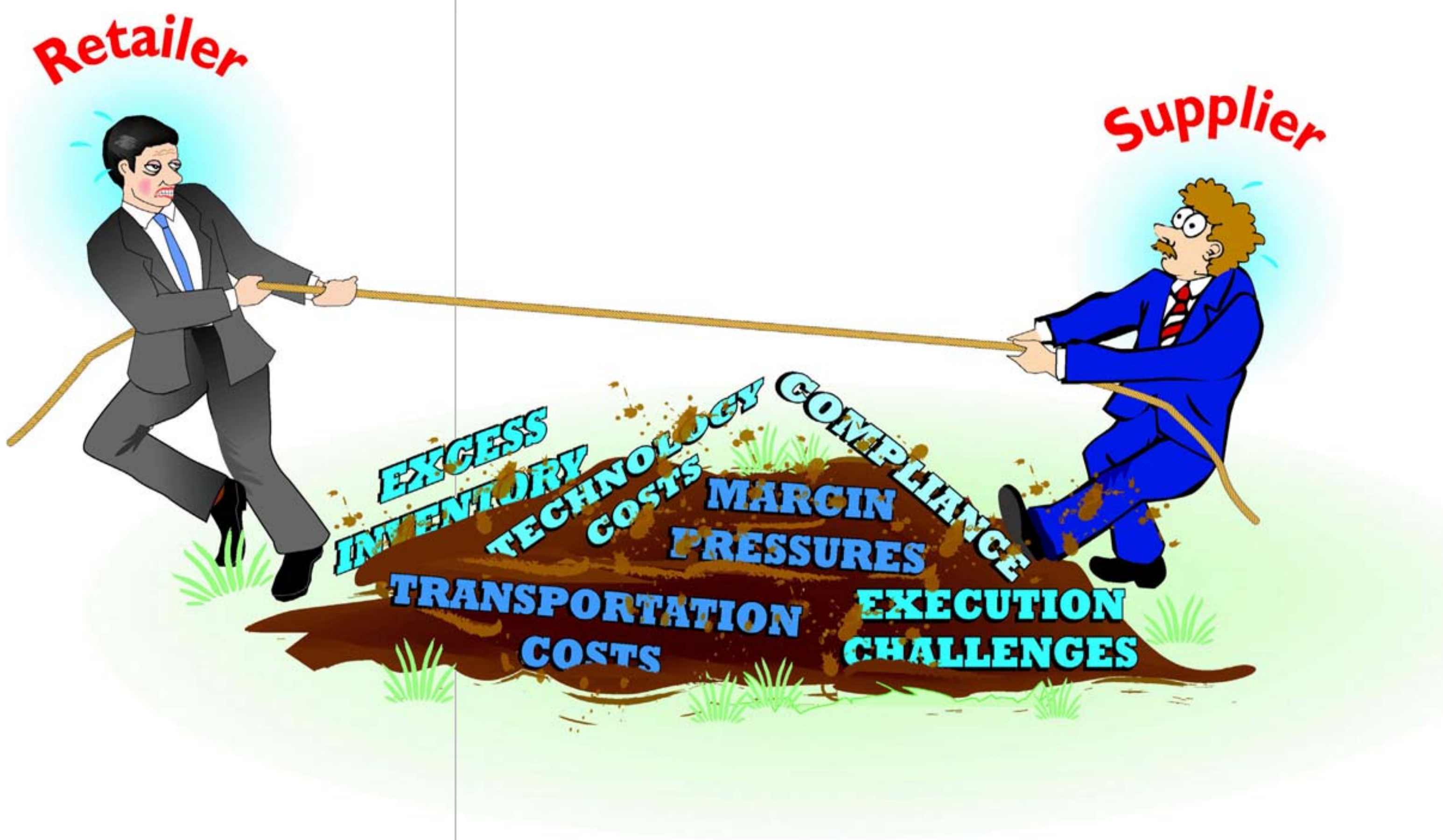

Dynamics of the Retailer-Supplier Relationship

ChainLink Research 2003 Retail Survey

By Bill McBeath

May 2003

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 for the 21st century.

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Introduction

In both retail and consumer-product-goods sectors, the gap between winners and losers widens every day. What is it about the winners that makes them more and more successful, extending their lead every quarter? What are the dynamics driving this “battlefront” between retailers and their suppliers in the struggle for projects, profits, customers and market share? What can trading partners do to win a stronger power position in the supply chain? To answer these questions, ChainLink Research surveyed more than 130 leading retailers and manufacturers[1]. Our unique approach explores the perspective from both sides of the trading-partner link to uncover differences in perception and reveal the myths and the realities.

The research found that the processes, policies, performance and enablers used by retailers widen the gap between winners and losers. Top-performing suppliers with high volumes and strong brands are rewarded with more shelf space and increased visibility, which further strengthens their brand and volumes. Marginal performers are “starved” out of the system. Winning retailers use logistics technologies (e.g. Track and Trace, ITL, RFID) and inbound compliance requirements such as labeling, packaging, documentation, loading sequences, delivery windows, and floor ready merchandise to streamline their inbound operations. Suppliers that fail to comply with these requirements are levied fines, while compliant suppliers’ products flow swiftly through the system onto shelves.

This study confirms one of ChainLink Research’s key tenets: Winners and losers are determined by how well each player manages the links with trading partners (see Figure 1). Disconnects in processes, perceptions and dialogues between trading partners are a major cause of problems and competitive disadvantages. For example, promotions are an important but contentious part of the retailer-supplier relationship. Properly done promotions can generate excitement and drive traffic, but poorly executed promotions are expensive, ineffective and result in excesses or shortages and unhappy customers.

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[1] See *Appendix A.—Research Background* for survey methodology.

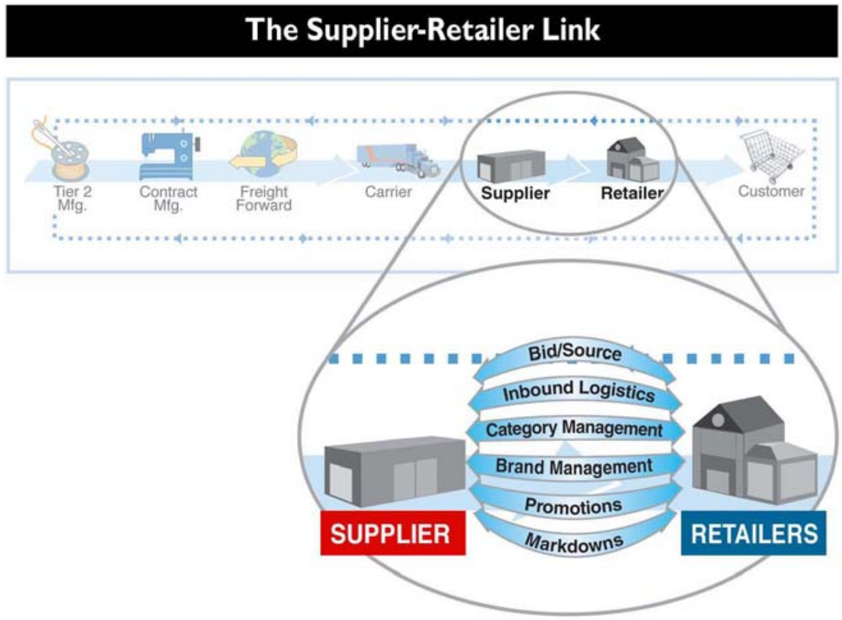

Figure 1

The survey showed that suppliers often underestimate the importance of yield to retailers, while overestimating their own performance. Suppliers that understand and support retailers' goals and differentiation have a much higher likelihood of success.

There will always be tension in the retailer-supplier trading partner relationship, because of the tug-of-war over margins and competing goals. Both parties want to maximize their own profits and shareholder value. Powerful brands demand more shelf space. Powerful retailers demand ever-lower prices and strict compliance with an increasingly elaborate and strict set of packaging, delivery and labeling requirements. These pressures make trading-partner collaboration elusive. The winners are smart about exploiting mutual self-interest, such as the use of industry standards for compliance, better communications on promotions, leveraging IT systems, and using bi-directional metrics to expose true supply chain costs and impacts to drive improvements.

Survey Results

ChainLink Research's unique approach to conducting surveys reveals the dynamics of the link relationship. We ask the same questions from the perspective of each trading partner to understand the perceptions of each side of the relationship. Each chart of results in this report compares the responses of supplier vs. retailers to each specific survey question.

Performance Management

Key Performance Indicators

A key part of understanding the retailer-supplier relationship is knowing how retailers measure the performance of their suppliers and which metrics are most important (see Figure 2).

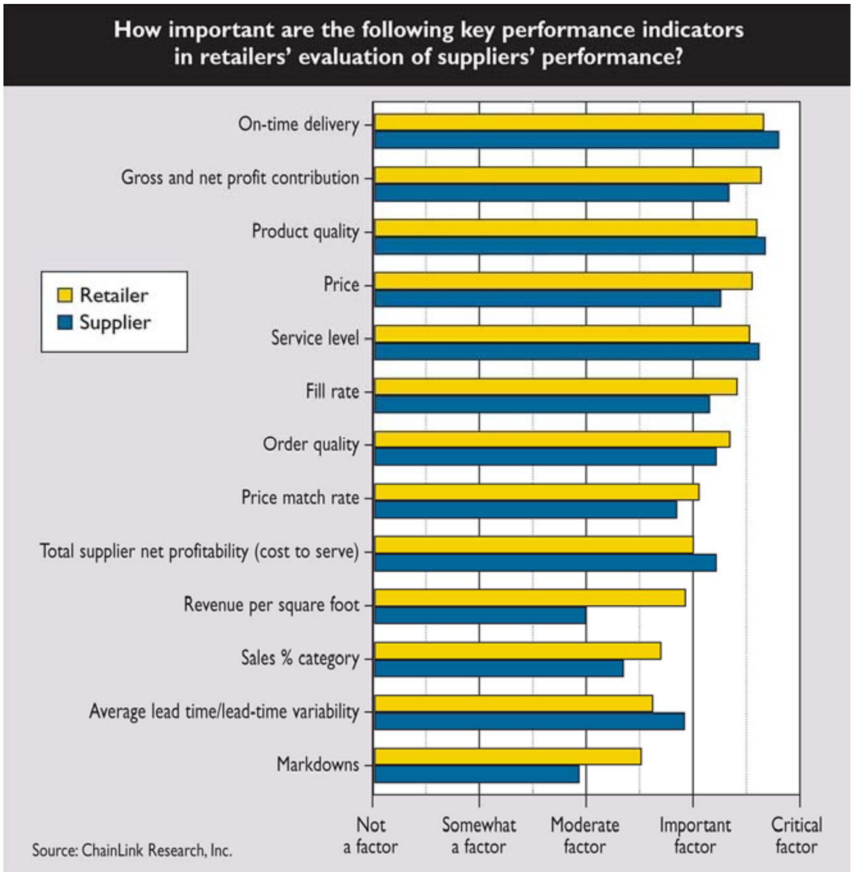

Figure 2

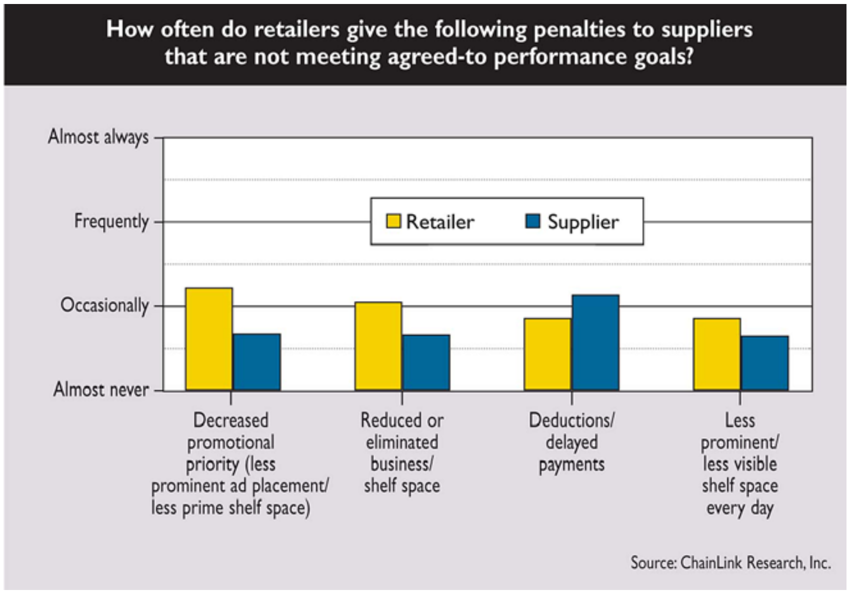

Figure 4

Suppliers are not aware of how often decreased promotional priority and reduced shelf space are being used as penalties for underperformance. In the battle for prime shelf space, suppliers have more control than they realize, by improving their performance in the areas considered key by retailers: profit contribution, brand and supply chain performance. Penalties are usually being assessed on the underperformers that are laggards in adopting process efficiencies and integration with retailers.

Suppliers said that delayed payments and deductions are the main penalty for underperformance. However, retailers said these are not used often as a penalty for underperformance. Delays in payment are, in reality, a significant pain point for suppliers but are not always directly tied to performance. The retailer simply may be extending float by whatever it can reasonably get away with. Good contract management and cash management—e.g., use of EFT (electronic-funds transfer)—help in managing payment issues.

Many retailers also have elaborate penalties and chargebacks for non-compliance with their standards such as barcodes and labeling, pallet, bin and packaging specifications, rainbow pallets, shelf-ready merchandise, documentation formats and accuracy, delivery to precise dock reservation windows, bin/pallet/truck loading sequence … the list goes on and on. Here, variations in supplier performance can make a tremendous difference. One-third of suppliers said that deductions and important factor. This is surprising, given that suppliers must understand as well as anyone the impact of seasonality on the demand for their products. They may view it as just a given—products are either in the assortment or out in a given season.

Interestingly, slotting fees, which have been the subject of much heated debate, were rated as the least important factor in shelf-space decisions, by a large margin.

Category Management

The research also asked how far the industry has gone in the trend toward suppliers having more responsibility for restocking and replenishment decisions for the shelf space. (Note: chart for this question is not included.) Retailers said they are still responsible for about 85% of replenishment decisions and suppliers are responsible for only about 5% of those decisions, although suppliers estimated slightly higher numbers for their share of the task. Retailers said 6% of replenishment decisions were made collaboratively and 4% by third parties. The survey also asked the same question about responsibility for category management. (See Figure 7.)

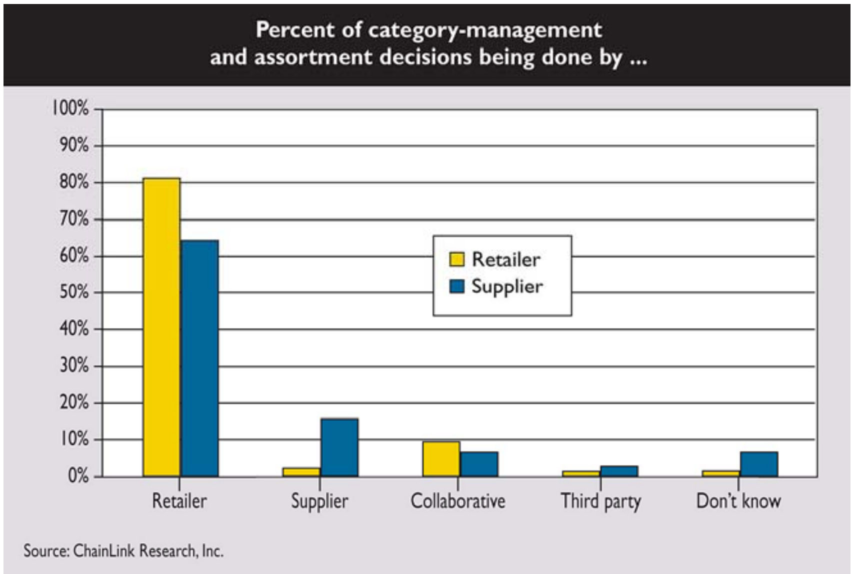

Figure 7

The responses reinforced how infrequently suppliers are selected to manage categories. It also uncovers a large difference in perception. Suppliers claim to make about 17% of category management decisions, whereas retailers say the figure is about 3%. This may be due to a difference of interpretation of what is meant by "managing" the category. Retailers, even if they rely heavily on manufacturers for insight and analytics, will still claim they make the final decision.

The responses in Figure 7 mask the degree to which retailers rely on suppliers' knowledge and input in making category decisions. As shown in Figure 8, supplier knowledge is almost as important as POS information in managing categories and shelf space. Retailers frequently are not willing to hand over the final category management decisions to the supplier, but they do leverage the information and experience of the supplier.

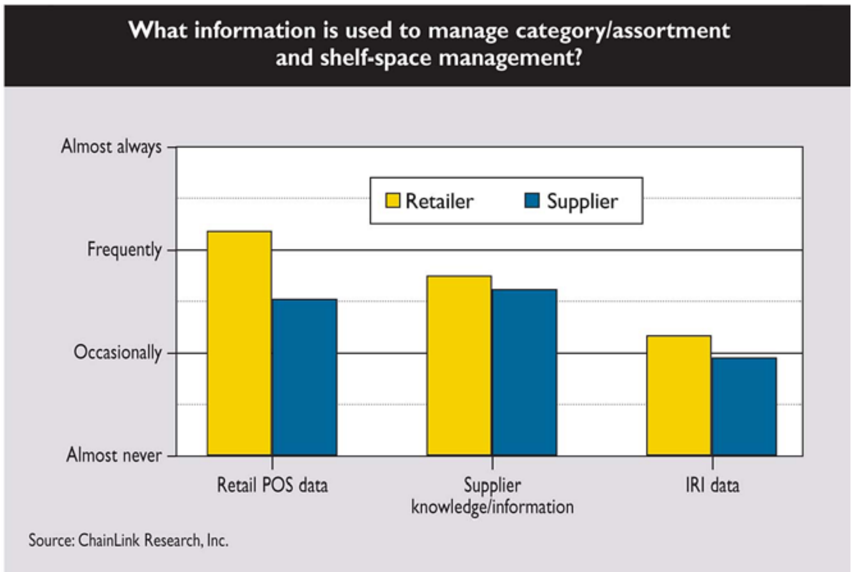

Figure 8

Many suppliers would like to manage categories. A case can be made for it based on the supplier's depth of knowledge, expertise and brand strength in its category. Figure 9 below illustrates that the No. 1 criterion used by retailers to select a supplier to be category manager is trust. Retailers need to have confidence that the supplier will maximize overall category performance for the retailer and not misuse the position of trust. This trust is gained through a solid trading-partner relationship when the supplier combines:

- Consistent execution excellence (always coming through, keeping promises, rock-solid reliability)
- Integrity (always doing what is in the best interest of the customer)

average about 25% of all promotions fail to achieve targeted lifts. For poorer-performing retailers, more than 75% of promotions under-achieve the targeted lift. Of course, many companies are only guessing at the performance of their promotions because they lack the systems and processes necessary to accurately track and measure the actual lift achieved. Given that there is still significant room for improvement in promotion performance, ChainLink Research wanted to zero in on the specific causes (see Figure 10).

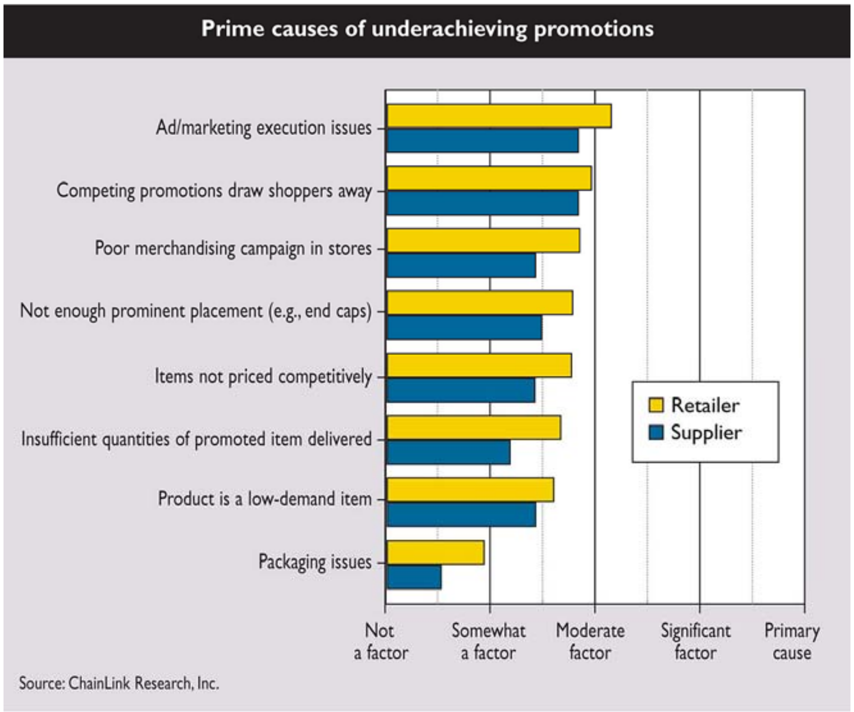

Figure 10

Many of the issues with promotions can be traced back to disconnects between the various players and processes. Poor advertising and marketing execution was cited as the biggest cause of failed promotions. Advertising planners may make decisions that are different than what was agreed between the manufacturer and retailer (e.g., an item that was supposed to be on the front page ends up on the second page). The buyer's decisions may not be in sync with the category manager's strategy. Agreements made at headquarters may be modified or re-negotiated at the regional or store level. Complete information doesn't flow down to associates on the floor. All of these disconnects lead to execution problems.

Supplier-to-Retailer Logistics

Winning retailers' philosophy of business is that every product not sitting in front of a customer is a bad use of capital. They are increasing the velocity between factory and shelf and improving in-store service levels using mechanisms such as cross-docks, continuous replenishment, and VMI. Because the retail supply chain is so distribution and logistics-intensive, it is not an exaggeration to say the effectiveness of logistics between the supplier and retailer can make the difference between growing market share vs. declining literally into bankruptcy—for both the retailer and supplier. If products aren't on the shelf, both retailer and supplier lose customers. If it costs too much to get them on the shelf, you can't compete. A number of growing forces are driving the adoption of leaner distribution models and the requisite enabling logistics technologies:

- *Ever-increasing service expectations*—Customers expect that what they want will always be on the shelf, or if being delivered direct will arrive quickly, reliably, without any errors. Retailers must meet those expectations without resorting to big piles of stagnant inventory in back-stores and warehouses.

- *Faster, smaller, more diverse units of delivery*—The shift from infrequent deliveries of large lots to more frequent deliveries of smaller lots, or even individual items. Manufacturers are moving to ever shorter product life cycles, increased # of SKU's, and mass customization. Retailers are moving to higher velocity inbound distribution systems, continuous replenishment, and increased direct-to-store or direct-to-consumer deliveries.

- *The margin squeeze*—Pressure to extract cost out of the supply chain by reducing transportation costs, handling and carrying costs, data-entry and error-resolution costs. This pressure flows from the consumer back through the chain. The retailer is squeezed by competition for the consumer's dollar and the consumer's relentless search for the best value. Consequently the supplier is squeezed by the retailer's relentless cost-reduction demands.

- *Rising retailer compliance requirements*—Increasingly detailed and strict compliance requirements in areas such as appointment scheduling, precise delivery timeslots, data standards, documentation, shelf-ready merchandise, and

The Market Drives Logistics

The requirements of the product and the marketplace being served drive the requirements of supplier-to-retailer logistics, for example:

- Transportation requirements (e.g. air freight for low-weight/high-value, refrigeration for perishables, etc.)
- Packing approach (unitized vs. loose, pallet configuration, etc.)
- Delivery approach (cross-dock for high volume fast movers, direct-to-store for merchandizing-intensive items, direct-to-consumer for high value items and multi-channel selling, etc.)

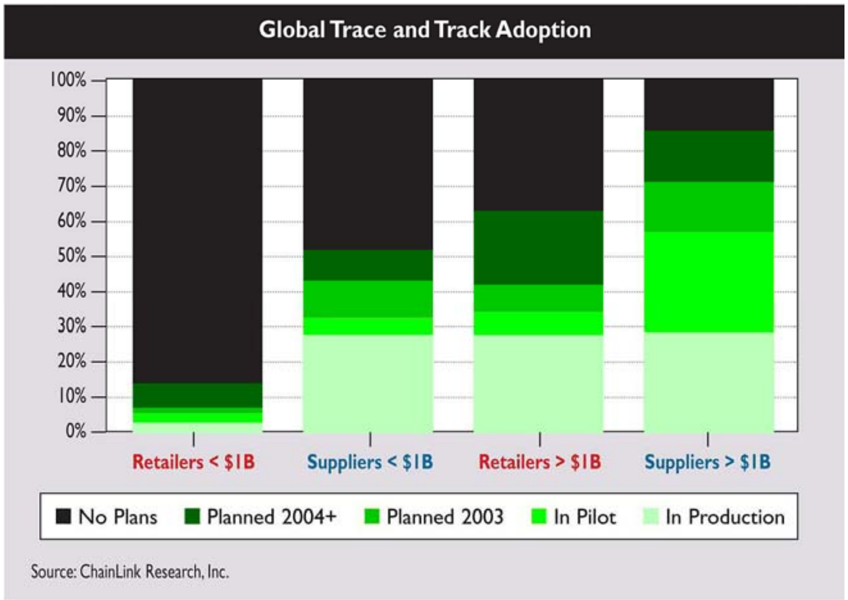

Figure 15 – Global Track and Trace Adoption Rates

Global Track and Trace has lower current adoption than ASNs, about 30% for large suppliers and retailers (see Figure 15), but it will go through rapid growth in the next 2-3 years to reach nearly the same levels as ASN usage over the next couple of years—about 85% of large suppliers and 65% of large retailers (55% of small suppliers and 15% of small retailers). This reflects the trend towards globalization and international supply—virtualization of companies and supply chains and other factors have created complex global supply chains, with many players and links in the chain.

Consequently, track and trace becomes much more critical in international shipments than domestic, since domestic shipments have shorter and more predictable total transit times. The complexity of a global supply chain makes tracking and tracing vital (see sidebar "Global Shipment Track Points"). Global finished goods shipments can have 25-30 hand-off points. The resulting global logistics is much more complex than domestic logistics (see Figure 16). In this setting, even something as basic as getting timely information on when goods actually leave the factory can be challenging. In addition, global shipments require extensive carrier information: serial number, seal, bill of lading numbers, as well as Item details per shipment (quantity, measures, pricing), documentation accuracy, and documentation receipts and filings.

Global Shipment Track Points

Critical track points for a simple global shipment:

- Exit Factory (estimate)
- Exit Factory (actual)
- Receipt at Consolidator (actual)
- Exit Consolidator (estimate)
- Exit Consolidator (actual)
- Arrival at Port (estimate)
- Arrival of Port (actual)
- Entry into Customs (actual)
- Entry released from Customs (actual)
- Shipment Release (actual)
- Inland Carrier shipment booking schedule (estimate)
- Inland Carrier pickup (actual)
- Receipt at DC

is large, process changes daunting, technology immature, and infrastructure investments substantial. Those who don't start tackling these issues now will be left in the dust, as those who learn and implement over the next few years will begin reaping massive competitive advantages.

Prepaid vs. Collect Shipments

Many retailers have looked at the transportation charges from their suppliers and thought "I can save money if I manage this myself". The reality is not always so simple, as there are many hidden costs in taking on this responsibility—the time, expertise, relationships, and systems required (i.e. TMS, ITL). The decision of who should own responsibility for transportation is partly a question of critical mass. Large retailers like Wal-Mart and manufacturer's like P&G have the volume necessary to manage carriers, get preferential rates, and mandate the information and performance requirements from their carriers.

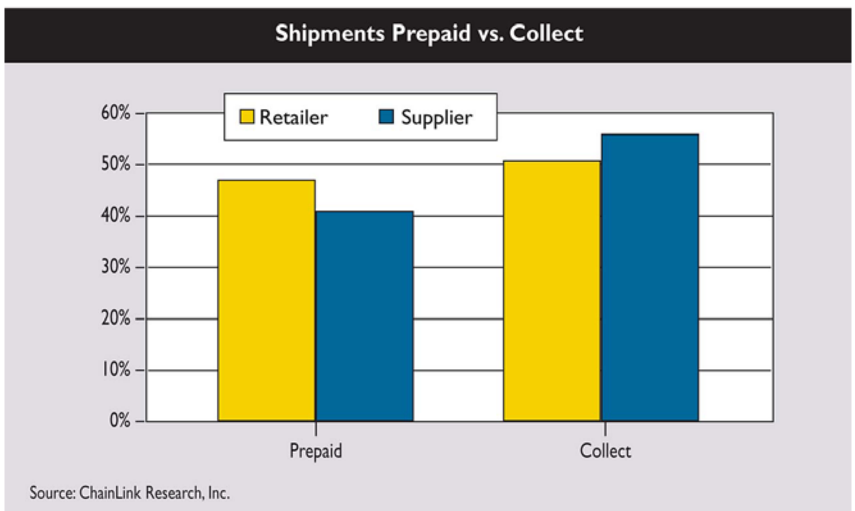

Figure 19 - Prepaid vs. Collect

However, here again the massive data requirements and number of transactions and manual activities involved represent expenses and learning curves that even a Wal-Mart may not want to take on. Retailers said responsibility for their inbound shipments is almost equally divided between retailers and suppliers (see Figure 19), whereas suppliers estimated slightly more collect shipments to retailers. Prepaid vs. collect is not an all or none proposition. Retailers may chose to take on domestic transportation responsibilities, but not international. Global environments present a whole other level of complexity, requiring a much

3. ***Measure and manage channel profitability***: Manufacturers should re-examine their channels and how they sell, based on the profitability of each retailer. Manufacturers should use new approaches and metrics, such as ChainLink's Holding-the-Bag quotient[5], to measure the burdens placed on the manufacturer by each channel vs. the revenue, profit, and market share derived from each channel. Highly profitable links can be nurtured and grown. Money-losing links should have problems identified and fixed, or if problems are truly intractable, those links may even have to be severed[6].

4. ***Drive compliance standardization***: Suppliers should unite behind organizations, like VICS and the Vendor Compliance Federation, to promote rationality and standardization in meeting the compliance demands of retailers. Wider adoption of compliance standards will lower the cost of complying and enable more automated compliance execution and exception tracking for both the supplier and retailer.

5. ***Use supply chain capabilities to build brand***: Retailers and suppliers can strengthen their brand image with consumers by leveraging innovative supply chain capabilities (see sidebar).

There will always be a tug-of-war between retailers and suppliers in their power struggle for margins, the customer's loyalty, and market share. To stay on the winning side of the winner-loser divide, companies must take charge of their own destiny by building the strength of their brand and constantly improving their processes, policies and performance. Suppliers need to understand end-consumer identity, behavior, and requirements, rather than relying on channels alone. Understanding the end customer over a lifetime will give suppliers knowledge and power to decisively design, develop, and deliver the right products and services into real, rewarding markets. At the end of the day, suppliers and retailers gain and maintain their power position in the chain by deeply understanding, focusing on, and connecting with the ultimate end-customer.

Using Supply Chain Capabilities to Build a Brand

Take the lead from success stories:

- Hot Topic (high velocity replenishment=latest fashion on the shelf)
- Wal-Mart (super-efficient inbound logistics=Always Low Prices)
- Mercedes-Benz (World-class, world-wide service network=elite, "pamper-you" services)
- Tesco (Cost-effective home delivery capabilities= easy, quick shopping)
- Nike (Personalized design-your-own shoes=Just do it!)

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[5] Holding-the-Bag Quotient (HBQ™) is ChainLink's approach to measuring burdens and rewards across a supply chain. An excellent article on HBQ titled "*New Models Require New Metrics*" can be found in the ASCET Volume 5 (2003)—on the web at http://www.ascet.com/documents.asp?grID=147&d_ID=2002.

[6] Sharing the data, pinpointing the issues, and working directly with your retail channels to resolve issues can avoid the drastic measure of "firing your customer".

Appendix A.—Research Background

We surveyed supply chain practitioners from 137 different business units of Drug, Grocery, and General Merchandise retailers and Food, Pharmaceutical, HBC, Electronics, and Apparel suppliers (see Figure 21).

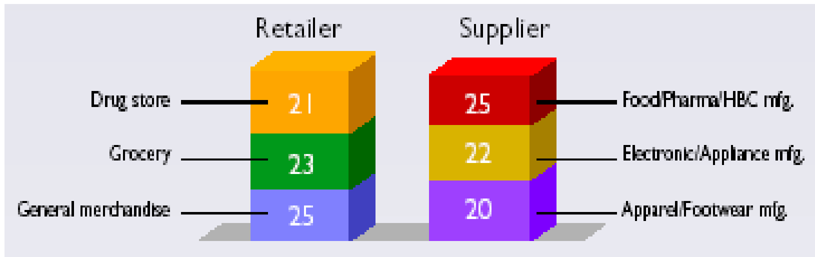

Figure 21 - Respondents by Type of Company

56% of the suppliers and 55% of the retailers were from business units with less than $75 million in revenue. 10% of suppliers and 25% of retailers were from business units with greater than $1 billion in revenue (see Figure 22).

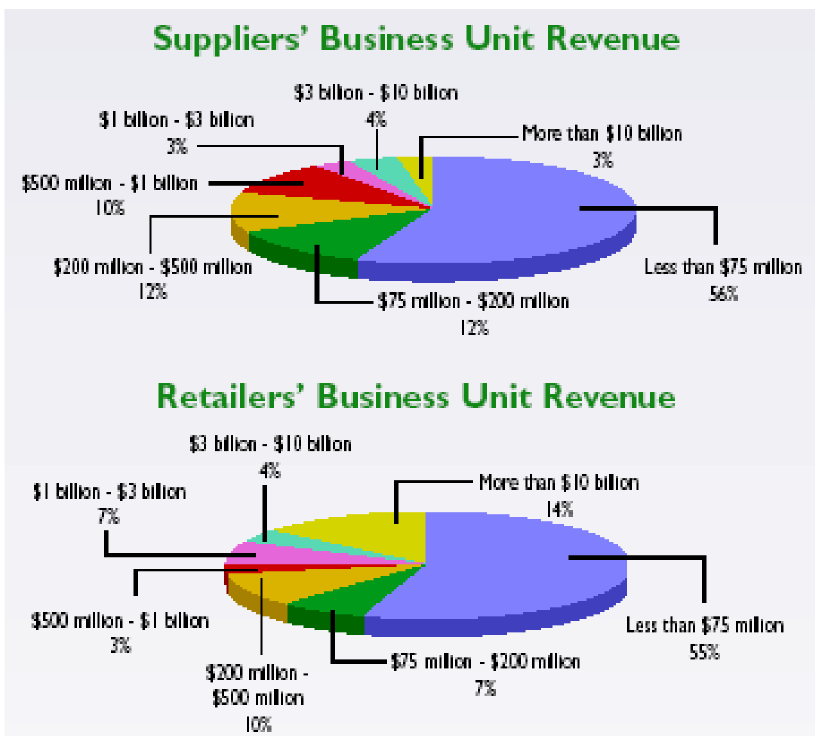

Figure 22 - Respondents by Size of Business Unit

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