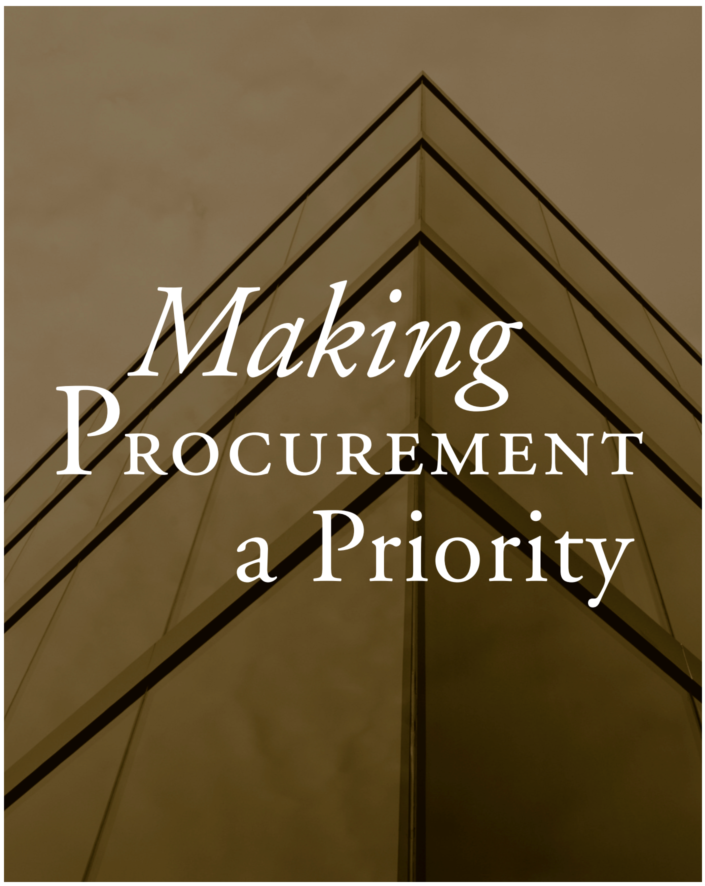
Insights from A.T. Kearney's Excellence in Procurement Study of the Retail Industry



Making Procurement a Priority

ATKEARNEY

Introduction

Every month, it seems, another retailer posts disappointing financial results. Top-line growth sags; bottom-line profitability erodes. Hypermarkets drive down prices, pharmacies cut into grocery sales, discounters invade malls. In today's hypercompetitive retail environment, no company is safe. All retailers need to find new ways to create value.

To drive the excitement and top-line growth that sustains the industry, CEOs must grow their businesses and, at the same time, deliver superior return on invested capital. How can CEOs deliver more profitable and customer-focused growth? A.T. Kearney believes CEOs should look more closely at their merchandising and procurement functions, with close regard to the following questions:

- How well integrated are merchandising and procurement?
- How successful has procurement been in reducing costs while simultaneously building collaborative relationships with strategic suppliers?
- How can employees, technology and other critical resources make merchandising and procurement high-value-added functions?

A.T. Kearney has found that excellence in procurement, both merchandise and non-merchandise, can be key to improving both top-line and bottom-line growth in the retail industry. We have spent more than a decade studying the trends, business developments and emerging issues surrounding procurement. Since our initial study in 1992, we have seen leading companies in every industry push their procurement function from a transaction-based business necessity into a strategic weapon capable of delivering significant competitive advantage.

So shouldn't following best practices in procurement lead to success for retailers as well? To test that theory, we engaged in our first-ever study of a single industry's purchasing practices.

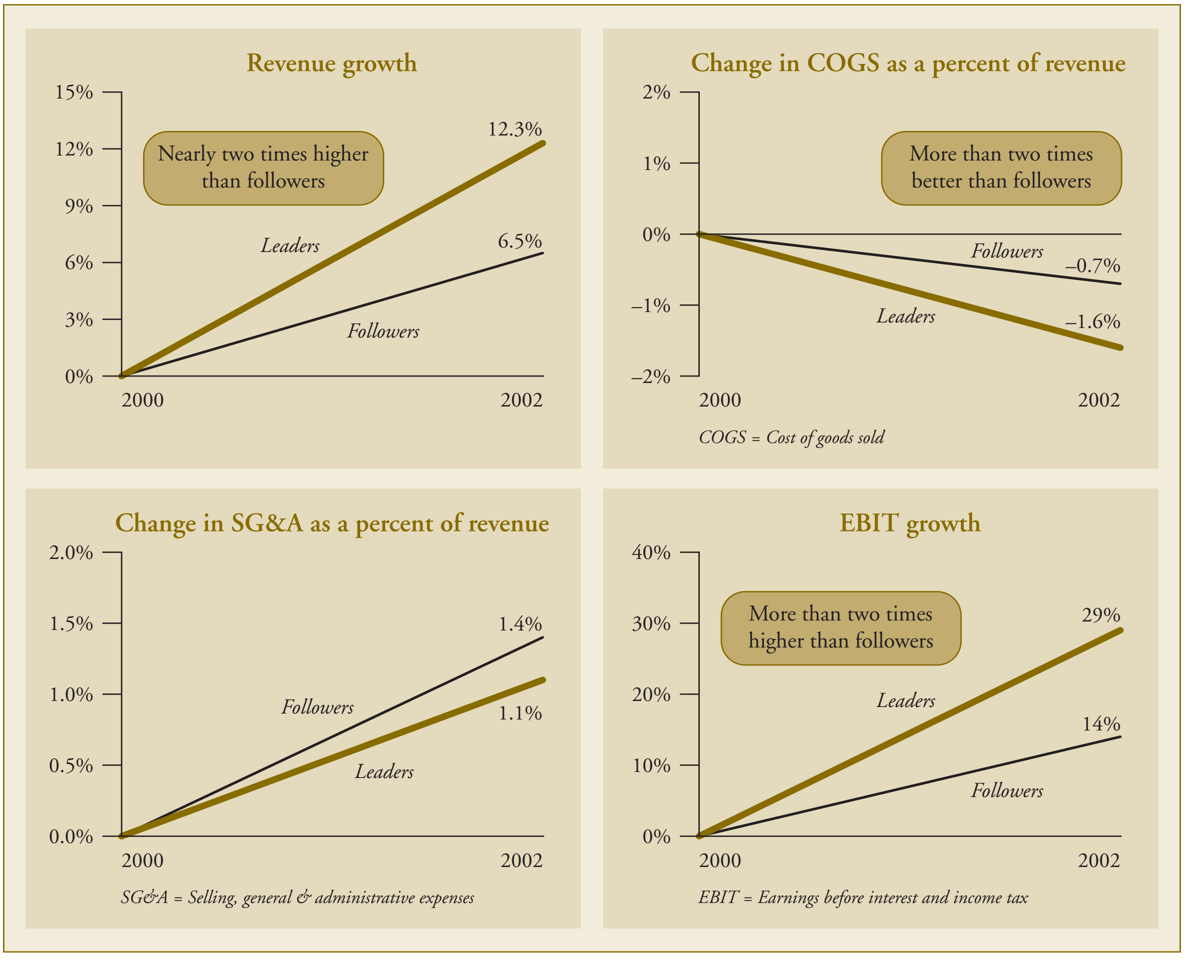
The results validated our hypothesis. There is a clear, distinct and measurable performance difference between leaders in retail procurement and merchandising and followers *(see figure 1 on page 2)*. When approached strategically, excellence in procurement is a key lever to create value and competitive advantage for retailers. Now the question is, how are these leaders doing it? How can they keep their advantage? What must other retailers do to match their impressive performance in a challenging industry? This paper discusses key insights developed from analyzing the survey results.

MANAGING PROCUREMENT: A BALANCED APPROACH

The Assessment of Excellence in Procurement (AEP) study of the retail industry builds on more than a decade of A.T. Kearney studies exploring trends, business developments and emerging issues surrounding procurement, with this study representing our first in-depth dive into a single industry's purchasing practices *(see sidebar: About the Study)*.

Our study concludes that while revenue growth understandably remains at the top of most retailers' agendas, industry leaders also consider cost management a high priority. They employ a balanced approach to procurement to ensure that margins remain high and operating costs low to shield against the very real possibility of suppressed top-line growth. In analyzing the study results further, two key areas dominated our findings: merchandise and indirect spending.

Figure 1: Leaders in procurement are also leaders in financial performance



Source: A.T. Kearney Retail AEP survey responses

MERCHANDISE SPENDING

As old retail formats have vanished, new retail approaches have emerged to fill the void. Gone are the days when shopping meant a day-long excursion starting with a bus trip "downtown" or waiting for the latest catalog to arrive in the mail. Now, retailers have to be category specialists—supplying a range of products through an array of channels to a mix of increasingly fickle customers.

Today's retail leaders not only keep up with these changes, they are well ahead of them. These companies have spent years preparing for the new retail environment—integrating merchandising processes with procurement practices and, in the process, improving supply chain and vendor efficiencies. The results have been impressive, both in top-line growth and improved margins.

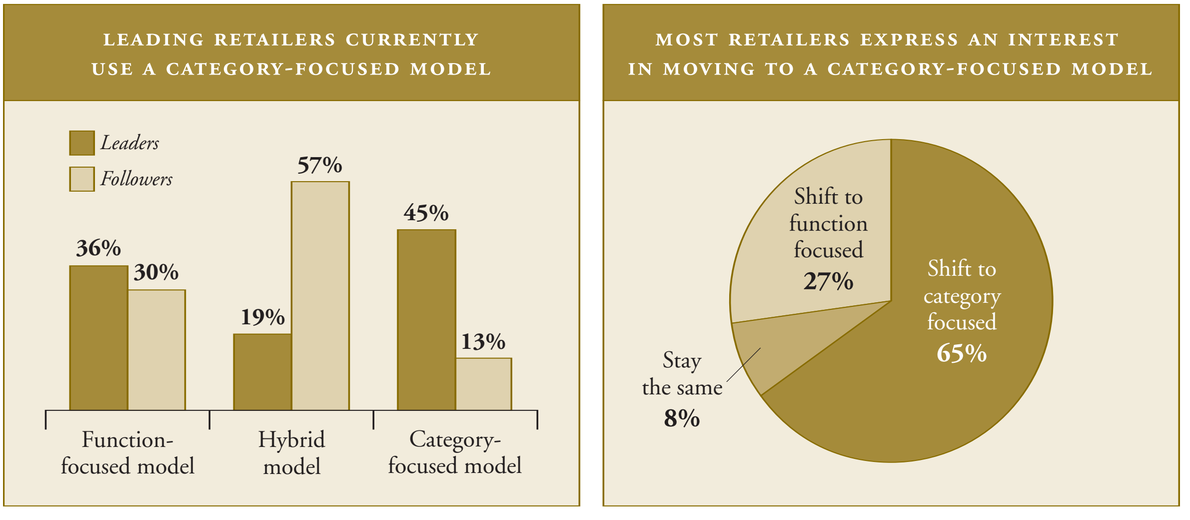
Our discussion begins with *merchandise* spending—goods purchased for resale to consumers. We isolate four areas that separate the leaders from the followers: establishment of a category-focused organizational model, understanding profit at the stock-keeping unit (SKU) level, using a supplier management strategy and employing technology to improve efficiencies.

What organizational model should you follow?

Deciding on an organizational model has generated lots of industry buzz in recent years as more retailers have begun adopting a category-focused merchandising organization as a point of competitive differentiation. The benefits are clear and companies are taking notice. One could conclude that everyone is looking to jump on the bandwagon and quickly transition to this organizational model. Our study does indeed reveal that two-thirds of respondents expressed a desire to move to an organizational model that focuses on categories *(see figure 2)*.

However, there is a wide gap between desire and reality. A category-focused organization

Figure 2: Choosing an organizational model



Source: A.T. Kearney Retail AEP survey responses

model is a clear point of separation between leaders and followers, but only 45 percent of leaders have adopted a category model. Furthermore, 27 percent of study participants are seriously considering reverting to a functional model. In our experience, companies reverting to a functional model do so because they have found the category-focused model too resource intensive and have difficulty justifying the investment in additional resources.

About the Study

A.T. Kearney regularly performs the Assessment of Excellence in Procurement study. This year, for the first time, the study focused on revealing the purchasing practices of a single industry: retail.

Our study involved obtaining answers to the following key questions: What characteristics do leading retailers have in common? How do they structure their organizations? How do they develop their merchandise strategies? What role does procurement play in sourcing decisions? How is technology helping, or hindering, their performance?

The study examined 45 major retailers in North America, Europe and South America in late 2003. These companies represent three distinct industry segments: food and drug, soft lines and hard lines. The food and drug segment includes grocery stores, drug stores and hypermarkets; soft lines refers to department and specialty-apparel stores; and hard lines includes specialty-appliance, electronics and furniture stores.

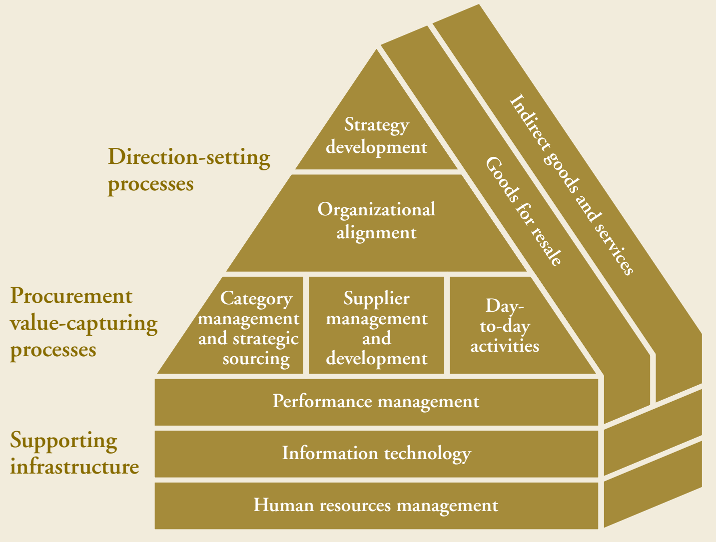
Survey responses collected from each participant were evaluated using a set of clearly defined scoring rules. A scoring mechanism that incorporated the use of leading procurement practices as a variable defined the "leaders" for the study group as the top quartile. We then validated the superior financial performance of the leaders against that of the followers.

The study examined companies' procurement practices for both goods for resale (merchandise) and indirect goods and services along six core dimensions:

1. *Strategy development*
2. *Organizational alignment*
3. *Category management and strategic sourcing*
4. *Supplier management and development*
5. *Day-to-day activities*
6. *Performance management*

We also explored the strategies and policies of IT and HR in terms of their effect on procurement. Combined, these eight dimensions collectively make up A.T. Kearney's House of Purchasing and Supply® (see figure).

A.T. KEARNEY'S HOUSE OF PURCHASING AND SUPPLY®



Source: A.T. Kearney

Still, the industry considers a category-focused organization model a best practice because it increases the transparency of all profitability levers across the organization. To better realize the benefits of a category model, we recommend the following steps:

• Define categories around a consumer perspective rather than a vendor or hierarchical perspective.

• Empower category managers with true profit-and-loss responsibility. Too often they are measured on vendor funds and other off-invoice cash flows, rather than true margin.

• Deploy adequate decision-support systems to measure meaningful category performance. Do your systems and processes allow you to measure profitability at the SKU level? Many systems only measure gross margins or performance only at the departmental level, which means category incentives and their impact are difficult to quantify.

• Reevaluate your hiring strategy. As category management moves from a functional role to a profit-and-loss responsibility, past experience remains important but should not be the sole factor in hiring new people. Category managers need merchandising and marketing skills as well as analytic and strategic skills *(see sidebar: The Human Element)*.

• Get "lean." Streamline execution activities; eliminate all types of waste and, if possible, transfer functional responsibilities to suppliers. A lean approach will offset the cost of any additional resource requirements to implement it and enable category teams to stay focused on developing growth strategies.

• Develop strategies at a corporate level; execute at a store level. A corporate-level plan should incorporate input from local area experts who understand local consumer needs, tastes and preferences.

Merchandising decisions can spell profits

Agreeing upon and calculating meaningful SKU-level profitability is a key driver for increasing profits. Our study indicates that 83 percent of leading retailers understand the importance of SKU profitability analysis and rank it as the most beneficial element in making merchandising decisions.

Determining profitability at the SKU level requires large amounts of data. Merchandising executives are often inundated with reams of information, from statistics on consumer loyalty, supplier costs and trade funds to internal figures on profitability. Sifting through this data can be challenging, if not overwhelming.

And technology is not a panacea, either. Our study reveals that retailers that invest large sums of money to deliver accurate product information directly to category managers think these capital investments have largely over-promised and under delivered. Only 60 percent of leaders, and 44 percent of followers, are satisfied that their capital investments—for the most part in IT—have improved their decision-making processes in merchandising.

Calculating SKU-level profitability requires the right mix of data, technology, and both process and organizational discipline. While not an easy task, the effort can be rewarding. A large U.S. retailer learned this lesson two years ago. Prior to investing in merchandising decision-support technologies, the retailer wanted to validate the financial impact that improved product information could deliver to its category managers. Using a team-based approach—with representatives from the different merchandising functions, procurement, finance and IT—the retailer put pen to paper and calculated SKU-level profitability. This manual analysis identified strategies to reduce COGS (cost of goods sold) for resale merchandise by 2 to 4 percent—results that persuaded the retailer to invest in decision-support technologies that could do the job faster and better.

What else can your suppliers offer you?

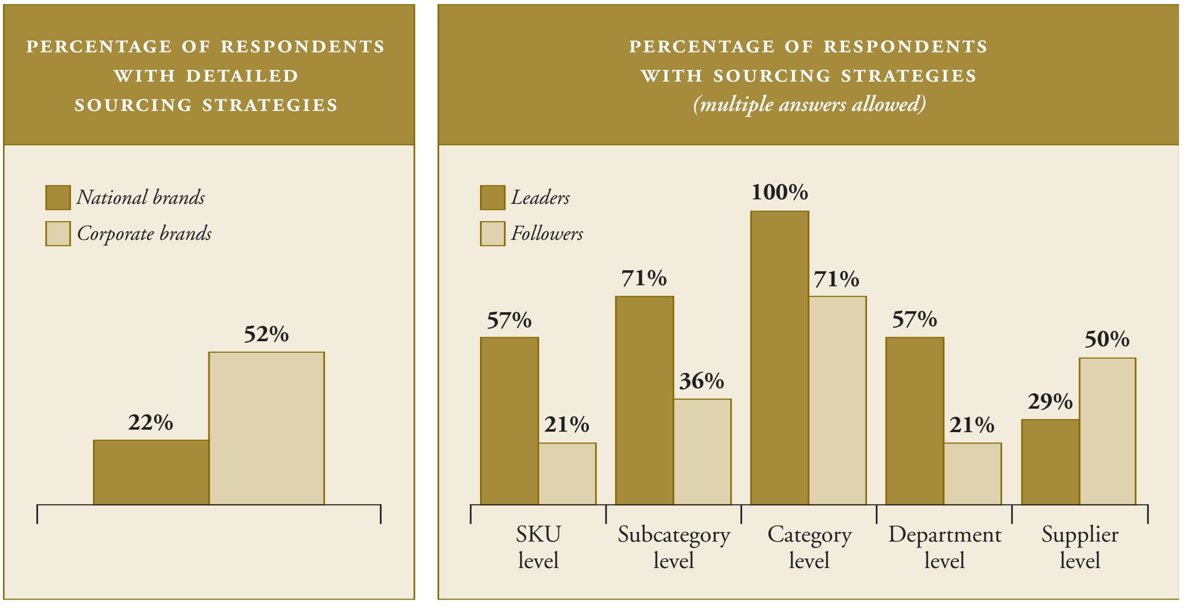
Determining SKU-level profitability is only the first step in a broader program to determine total category profitability. Digging deeper, A.T. Kearney uses a proprietary approach called category-profitability improvement (CPI) to help companies analyze the total profitability of a category. We look at all aspects of a category from supplier selection, volumes (aggregating purchases across divisions), supplier negotiations and management to assortment mix and operational costs.

In the AEP study, we evaluated retailers in two areas: category-profitability improvement (as it relates to sourcing strategies) and supplier collaboration.

Category-profitability improvement. In this area, we looked at merchandisers' effectiveness in translating category plans into formal sourcing strategies. The findings reveal that many retailers, particularly those with national-brand products, can improve margins through a disciplined sourcing process *(see figure 3)*. Fewer than one-half of both leaders and followers develop sourcing strategies for merchandising. When sourcing strategies are developed at the SKU level, however, there is a clear separation between the leaders and followers.

Supplier collaboration. As retail networks grow, it is important to build and maintain collaborative relationships with strategic suppliers. Our study evaluated the key tools and processes that retailers use to manage and leverage their

Figure 3: Sourcing strategies for merchandising



Source: A.T. Kearney Retail AEP survey responses

Retail leaders employ a balanced approach to procurement to ensure that margins remain high and operating costs stay low.

supply base. The purpose was to determine the following: the number of retailers with formal supplier-management programs, the extent to which formal supplier agreements are used to drive collaboration, the sophistication of metrics systems and areas where supplier collaboration does (and does not) occur.

According to the findings, leading retailers are more aggressive than followers at both segmenting their supply base to identify their top suppliers and developing formal supplier-management programs. Among leaders, 73 percent have formal supplier-management programs, compared to just 30 percent for followers. Similarly, 86 percent of leaders actively segment their merchandise suppliers, compared to just 55 percent for followers.

Leading retailers also employ more sophisticated performance-measurement programs. For example, both leaders and followers evaluate their suppliers using standard measurements of financial performance, service-level performance, product quality and whether or not annual improvement targets are met. Again, what separates the leaders from the followers is that the leaders go one step further—they also evaluate their suppliers' performance in areas that can drive revenue growth, such as product design and innovation, risk and reward opportunities, and brand recognition.

When our study turned to formal supplier agreements, we discovered that most agreements still tend to focus on performance control and penalty clauses rather than on joint-improvement initiatives. Among supplier agreements for national brands, for example, only 26 percent include a clause regarding year-on-year perfor-

The Human Element

In general, retailers need to upgrade the capabilities of their human resources within procurement. Getting talented people involved in procurement is important; after all, a buyer is typically negotiating with the supplier's highly trained sales representative. Sales departments generally attract people with multiple degrees who believe that their career success depends on making that important sale. With less stringent qualifications for the other side, how level is this playing field?

For retailers especially, the purchase of external goods and services represents a huge portion of total costs, and therefore large responsibilities. Procurement represents a cost that needs to be controlled just like the sales.

On the merchandising side, additional training and job rotation may provide the answer. Indeed, our survey found that leading retailers generally offer more training programs to their buying staff than followers. Despite training's critical role for merchandising buyers, however, only two-thirds of leaders offered category-management training. Retailers have been less active in offering internal programs (either rotational or trainee) to their strategic buyers. Programs such as these would create value by allowing retailers to train, develop and retain highly skilled individuals.

On the indirect side, however, it's often not just an issue of training, but of capabilities. Even at leading retailers, indirect buyers have years of hands-on experience but could use a general upgrade in capabilities. A good place for retailers to start would be to require higher degrees for entry-level buyers.

Excellence in procurement is not just about processes, organization and technology, but the human element. If you want to embed leading procurement practices in your organization, you need talented people to implement them.

mance improvement, 11 percent have an incentive clause encouraging suppliers to exceed their performance targets, and only 5 percent contain a clause regarding shared savings. Advances in data coding and supply chain technology provide an opportunity to reverse this trend, allowing retailers to create value by collaborating more closely with key suppliers.

And this is exactly what the leaders are doing *(see figure 4)*. Two-thirds of leaders (and fewer than one-third of followers) involve their strategic suppliers in their merchandising strategies, category management and supply chain and logistics processes. The leaders continually seek to strengthen these partnerships through information sharing, co-advertising and by collaborating on new product designs.

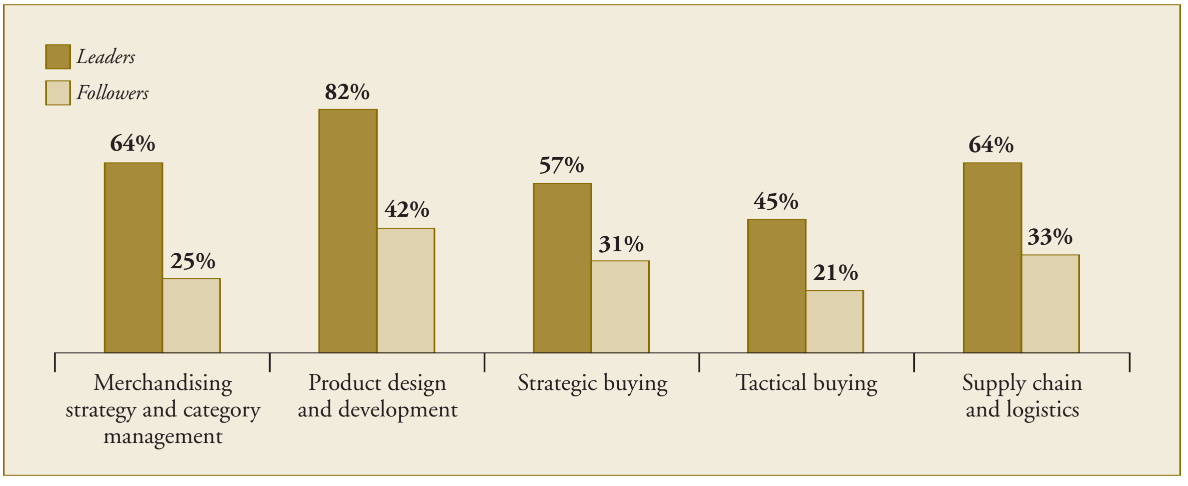
How can technology help you get lean?

The leanest retailers in our study have automated their supply chain management processes—using state-of-the-art technology to reduce costs, improve stock availability and increase financial growth.

Our study looked at both the transactional and strategic use of information technology in supporting procurement. On the transactional side, we asked retailers to rate the effectiveness of how their IT systems support day-to-day replenishment and supply chain activities. It's no surprise that leading retailers have an edge in automated supply chain processes. Roughly 60 percent of leaders have automated their entire procure-to-pay processes, compared to 20 percent of followers; 60 percent of leaders and 15 percent of followers say they have automated their entire inventory management processes.

In terms of strategic use of technology, we studied the application of data synchronization and radio frequency identification (RFID) technologies. In data synchronization, more than 75 percent of leaders have implemented or begun piloting product-data synchronization initiatives with their suppliers.

Figure 4: Leaders collaborate more with their key suppliers



Source: A.T. Kearney Retail AEP survey responses

When discussing RFID technology, most retailers are still evaluating their options. The leaders identify three general areas of application: stock-out reduction, shrink reduction and an improved customer shopping experience. By tagging pallets and cases, retailers will improve the tracking of goods, thus reducing situations when goods are in stock but unavailable to consumers. RFID can also ensure that replenishment orders are placed only when required. Also, goods with expiration dates can be moved more quickly when code dates are near, reducing the need for write-offs due to spoilage. Shrink reduction refers to reducing theft both in the supply chain and at the point of sale. And with RFID, customers will be able to access item-specific information about products on the shelf and speed the payment process by using a self-service checkout.

Today, RFID chips still cost about 50 cents each, making it prohibitively expensive to tag every product. In the next five to 10 years, however, the price is expected to drop to a penny or so per chip, allowing retailers to reap the true benefits.

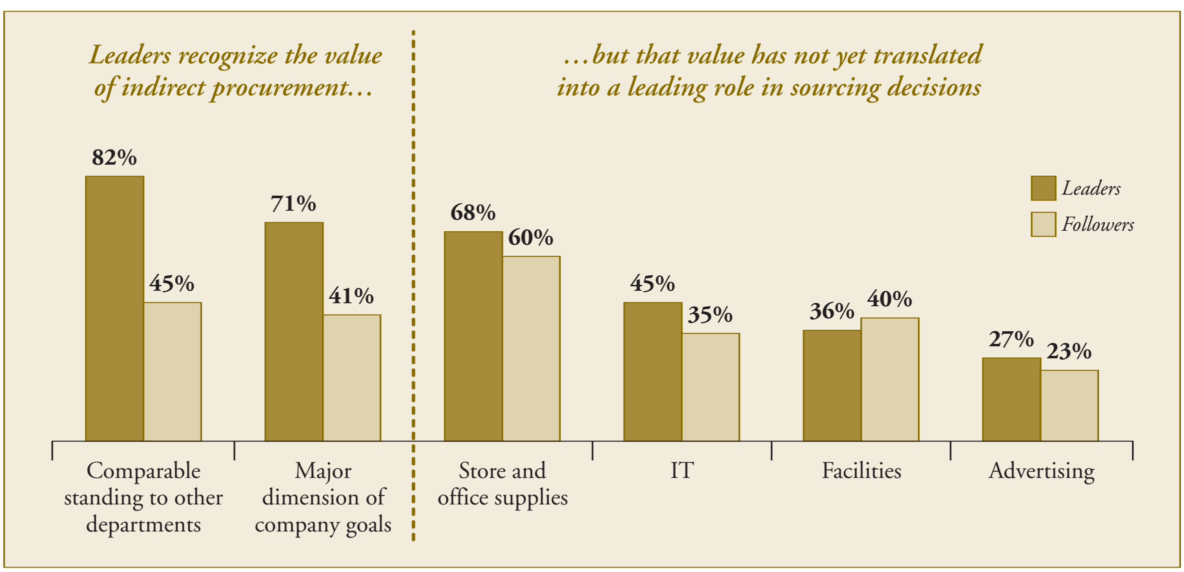
INDIRECT PURCHASING

Leading retailers organize and operate their indirect-procurement processes as they would any strategic function within the organization—with as much structure, control, ownership and visibility as they use in merchandising, marketing and store operations. Based on our findings, we discuss the importance of a center-led strategy, the value of strategic sourcing and the opportunities provided by demand management.

Who's who in decision-making

Where should your indirect-procurement decisions be made? For many retailers, the short answer to this question is that procurement

Figure 5: Indirect procurement not yet a major part of decision making



Source: A.T. Kearney Retail AEP survey responses

decisions are made daily in all parts of the company—and, regrettably, with little involvement from procurement. Historically, the indirect-procurement organization has had a nominal existence, treated as an administrative backwater with minimal influence in sourcing decisions, setting policy or coordinating procurement activities throughout the organization. To better understand why procurement is rarely involved in decision-making for indirect goods and services, we asked study participants two questions: What is the value retailers place on indirect procurement? What influence does your procurement organization have on sourcing decisions for major categories of indirect spend?

Their answers indicate that while leaders have begun to recognize the value of indirect procurement, that value has not yet translated into allowing procurement a leading role in sourcing decisions. This is particularly true for complex categories such as IT and advertising, where indirect procurement has not yet been given a seat at the table *(see figure 5)*.

How can retailers transform indirect procurement into a value-adding function that influences sourcing decisions? A good starting point is to implement a center-led organization model. While both center-led and distributed organization models have advantages, the center-led model provides the best balance—allowing firms to meet the specialized needs of end users, while centrally coordinating procurement activities. The center-led organization model harnesses the advantages of centralized coordination, while letting business units retain control over categories important to them *(see figure 6 on page 12)*.

The center-led model:

- Establishes clear accountability, control and transparency for all external purchases
- Maximizes leverage across business units and geographic boundaries
- Minimizes complexity within a business
- Maximizes material leverage capabilities

For example, a leading U.S.-based retailer reaped large dividends by making indirect procurement a strategic function. In a little more than 24 months, the retailer transformed its indirect-procurement group into a strategic boardroom weapon for cost leadership, process innovation and knowledge sharing. In fact, the company's success was so dramatic that indirect procurement is beginning to play a lead role in private-label sourcing.

Shouldn't sourcing be more strategic?

With changing market dynamics, increasingly global sources of supply and a cutthroat retail environment, retailers should be using the full arsenal of sourcing strategies to achieve cost leadership.

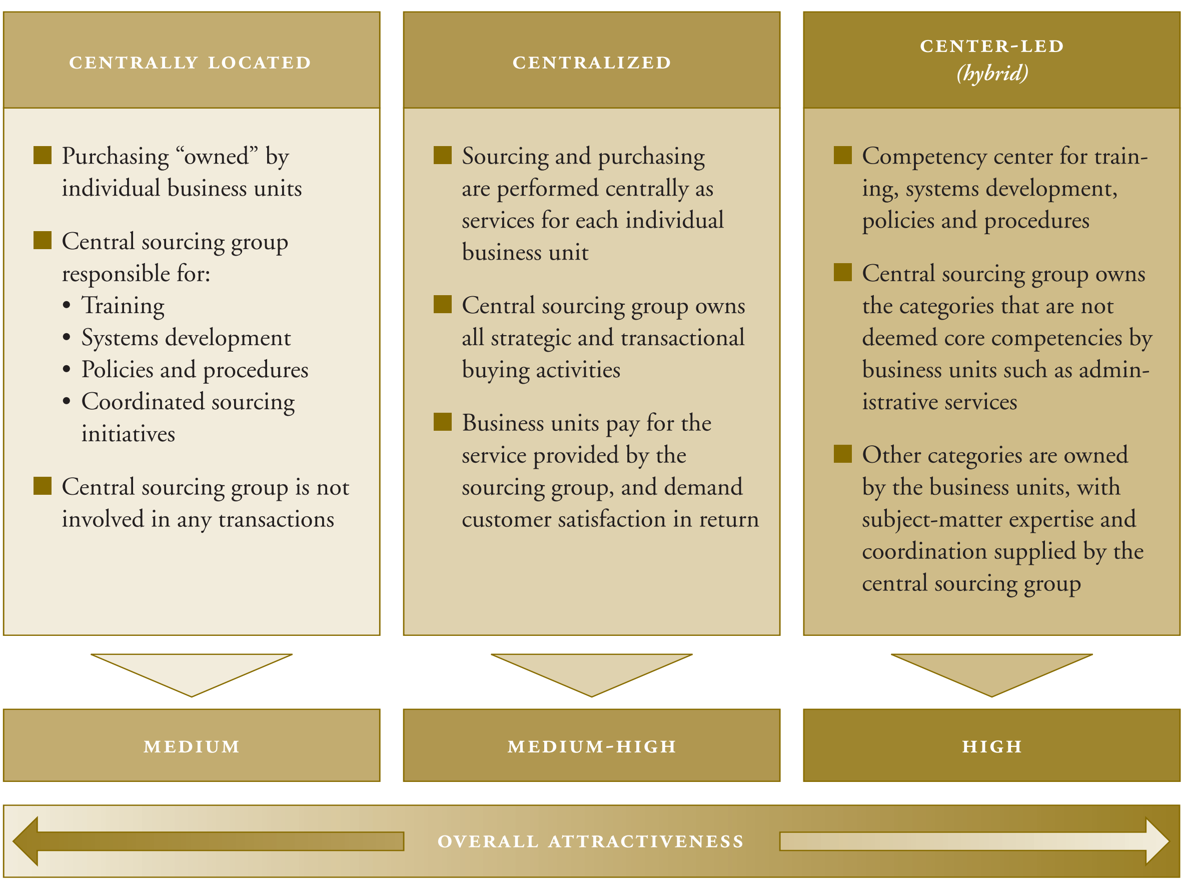
By now, almost everybody should be able to grasp the benefits of implementing a sourcing strategy to address back-office categories such as office supplies. The aggregate numbers reveal that 80 percent of leaders have developed formal strategies for procurement, compared to just 39 percent for followers. Indeed, most leading retailers have developed formal sourcing strategies for their back-office indirect categories. They outpace followers when it comes to sourcing policies for their more strategic and complex indirect categories, such as distribution, IT, travel and utilities. But they have merely picked the low-hanging fruit. When it comes to categories such as advertising and construction, they have a long way to go.

Part of the problem may be that such categories are not typically thought of as areas where procurement can provide value. Advertising? Construction? Yes. Even medical benefits should be considered part of the procurement function. At one retailer, based in the western United States, A.T. Kearney and the retailer's procurement organization worked with the executive in charge of benefits to evaluate the competitiveness of the firm's medical networks. "We were concerned because we had a national outlook," explained the benefits executive. "We wondered if a combination of several regional players might give better discounts."

A comprehensive comparison of discounts led to a successful solution. "Political issues sometimes don't allow you to move ahead with the best financial solutions," added the executive. "The procurement process ensured objectivity, taking subjectivity out of the decision-making. Procurement, working collaboratively with the benefits group, can provide independent analysis more valuable than that of a benefits consultant, who has a stake in the game."

How sophisticated are the sourcing strategies developed by leaders in our study and how

Figure 6: The attractiveness of organizational models



Source: A.T. Kearney

Retailers should use the full arsenal of sourcing strategies to achieve cost leadership.

advantageous are the savings? The short answer to both questions is, "not very." Leaders have generated cost savings but they need to apply more advanced strategic sourcing techniques across a broader spectrum of spend *(see figure 7)*.

Do you really need all that stuff?

Leading retailers not only establish strategic sourcing practices, they avoid costs entirely using demand management. Demand management involves all the activities associated with managing the volume of a company's external purchases. Through demand management, companies gain a better understanding of the rationale behind their purchases. Unlike traditional sourcing efforts, it targets the quantity and specifications of products purchased from suppliers—not just the price paid.

Strategic sourcing provides a well-defined method for supplier management, effectively controlling the price paid for goods and services. Demand management goes a step further, attacking the other element of the cost equation: consumption.

Some procurement organizations launch demand-management initiatives immediately following a strategic-sourcing initiative as a way to extract additional benefits and manage external spend. However, a more beneficial approach is to use the information acquired in a demand-management initiative to prepare for strategic-sourcing efforts.

The benefits achieved from demand management depend on how aggressively you apply the levers. Conservative approaches may include heightening cost awareness among employees and tightening policies to reduce rush and overtime charges; these approaches can generate up to 3 percent in cost savings. But as you move up the ladder and become more aggressive, such as encouraging substitution of less expensive products, reducing frequency of spend and simplifying specifications, you can generate 10 to 20 percent in cost savings *(see figure 8)*.

Figure 7: Indirect-procurement sourcing has not been very strategic

Leading retailers demonstrate procurement best practices…

- Leaders generate 25% additional cost savings
- Leaders develop sourcing strategies differentiated by expenditure category and market dynamics
- Leaders pursue collaborative sourcing with their suppliers

…yet there is still progress to be made.

- Leaders globally source less than 15% of spend, but intend to significantly increase this percentage over the next two years
- Leaders have not aggressively adopted e-sourcing tools beyond pilot categories such as general supplies and personal computers
- Leaders have not looked at demand management techniques as a source of value
- Leaders are not aggressively challenging specifications and usage patterns

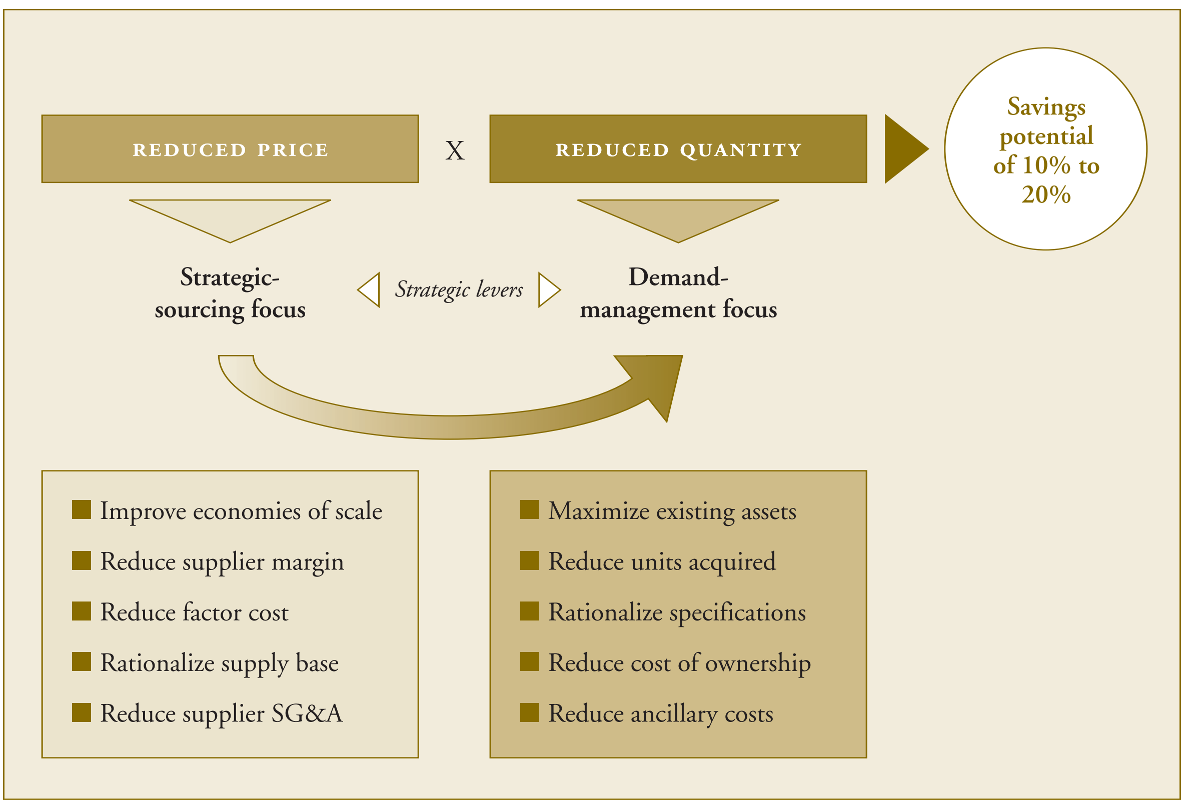
Source: A.T. Kearney Retail AEP survey responses

The most aggressive approaches involve reducing quantities, or at the limit actually eliminating demand completely. Though demand management is challenging to implement, it offers huge potential benefits. On the indirect side especially, demand management represents a significantly untapped opportunity.[1]

The path forward. The recommendation for retail procurement outlined in this paper is to chart a course that encompasses the following five steps:

- Go after the low-hanging fruit (indirect and private-label sourcing).
- Conduct true SKU-level profitability analysis for select, branded products.
- Upgrade resource skills and capabilities.
- Make targeted investments in decision-support technology.
- Evaluate your organizational model for category-driven benefits.

Figure 8: Leading retailers are moving beyond strategic sourcing



Source: A.T. Kearney

[1] *For more information, see also:* Demand Management: Changing the Way Organizations Acquire Goods and Services, *at www.atkearney.com.*

Conclusion

Our survey of excellence in retail procurement led us to several key insights:

- There is a clear, distinct and measurable difference in financial performance between leaders and followers in retail procurement and merchandising.
- Leaders use a category focus for their merchandising organization, strive to measure profitability per SKU, segment and leverage their supply base, and take advantage of new technologies.
- Leaders place more emphasis than followers on indirect purchasing, using a center-led organizational model and involving procurement in the decision-making.

What this means, especially in today's challenging environment, is that retailers that focus on excellence in procurement are not only improving profitability, they are setting the stage to provide long-term strategic differentiation.

A.T. Kearney is an innovative, corporate-focused management consulting firm known for high quality, tangible results and its working-partner style. The firm was established in 1926 to provide management advice concerning issues on the CEO's agenda. Today, we serve the largest global clients in all major industries. A.T. Kearney's offices are located in major business centers in 34 countries.

AMERICAS | Atlanta | Boston | Buenos Aires | Caracas | Chicago | Dallas | Detroit | Los Angeles | Mexico City | Miami | New York | San Francisco | Santiago | São Paulo | Silicon Valley | Stamford | Toronto | Washington, D.C.

EUROPE | Amsterdam | Athens | Berlin | Brussels | Copenhagen | Düsseldorf | Frankfurt | Geneva | Helsinki | Lisbon | London | Madrid | Milan | Moscow | Munich | Oslo | Paris | Prague | Rome | Stockholm | Stuttgart | Vienna | Warsaw | Zurich

ASIA PACIFIC | Bangkok | Beijing | Hong Kong | Jakarta | Kuala Lumpur | Melbourne | Mumbai | New Delhi | Seoul | Shanghai | Singapore | Sydney | Tokyo

AFRICA | Johannesburg

For information on obtaining additional copies, permission to reprint or translate this work, and all other correspondence, please contact:

A.T. Kearney, Inc.
Marketing & Communications
222 West Adams Street
Chicago, Illinois 60606 U.S.A.
1 312 648 0111
fax: 1 312 223 6759
email: insight@atkearney.com
www.atkearney.com

ATKEARNEY®