Deloitte.

The Future of Consumer Product Companies:

Customers

Focusing on Better Relations

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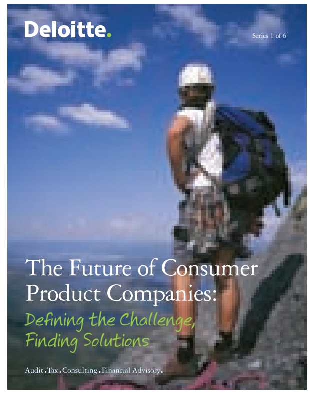
A Series on The Future of Consumer Product Companies

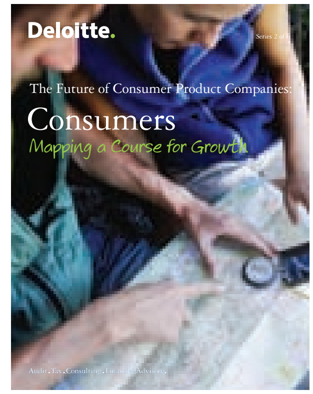
The Consumer Products Industry practice of Deloitte & Touche USA LLP is proud to produce a revealing six-part series about key issues that consumer product manufacturers should be thinking about now to achieve sustained, profitable growth in the years ahead. The challenges that consumer product manufacturers currently face are daunting, and the traditional growth models of yesterday are no longer providing the return on investment they once did. Intense competition, fickle consumers, a stronger set of retailers, and a shrinking talent pool, are some of the causes for increased volatility in this sector. The result has been intense pressure on margins, commoditization and shareholder frustration. For these reasons and more, consumer product manufacturers must now change their competitive strategies to stay relevant as a company, and a brand, in the future.

In order to help consumer product manufacturers adapt their competitive strategies and put a new transformative growth model to work, Deloitte introduces a series of forward-thinking articles aimed at providing possible solutions to the challenges vexing the industry. Since these problems are not going away anytime soon, and will only continue to intensify, new ideas are needed to deal with these industry dilemmas. The articles in our series will focus on five areas critical to the success of the enterprise, including consumers, customers, products, people and technology. The company's relationship to its customers, the process of developing and selling products, the search for the best talent, and the implementation of technology to guide all these areas are the keys to building long-term success.

Together, these reports will span all levels of management activity—strategic, administrative, and operational—to ensure that the right resources, organization, processes, and culture are in place to embrace new growth initiatives and meet existing growth objectives. In this, our fourth article, Book Series 4 of 6, entitled *Customers: Focusing on Better Relations*, we examine the state of retailer-supplier relations and discuss opportunities for retailers and suppliers to better collaborate resulting in long-term, profitable growth for years to come.



The Future of Consumer Product Companies



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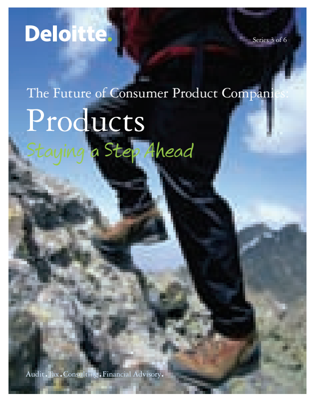

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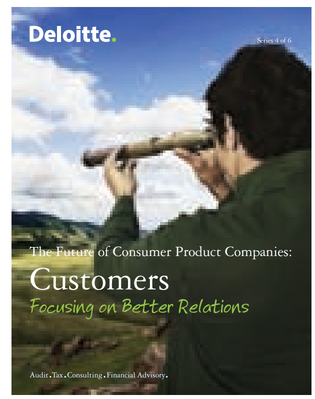

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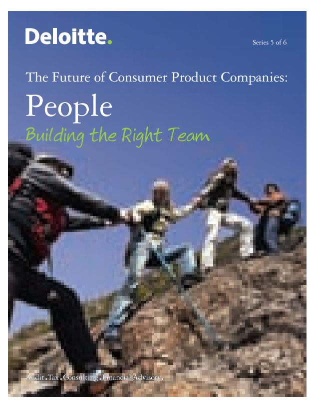

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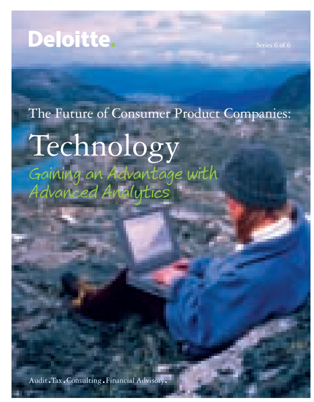

Technology

The state of retailer-supplier relations

Retailers and suppliers are locked in a struggle. The retailing industry is consolidating, with the result that a handful of mass market, price-oriented behemoths are gaining market share globally and placing enormous pressure on branded suppliers. This is taking place, in part, as a response to consumers who are increasingly focused on price and who view many products as mere commodities. For the competitors of these behemoths, commoditization is driving down margins and creating a battle for survival. At the same time suppliers are struggling to differentiate and manage brand identity. Facing competition from retailers' private-label brands (some of which are now managed by former consumer goods marketing executives), suppliers need a new approach not only to prosper, but in some cases just to survive.

Interestingly, the solution for both retailers and suppliers may involve working more closely with one another. After all, avoiding commoditization requires innovation, differentiation, branding, and better customer experiences - all of which can be enhanced through better cooperation and collaboration between retailers and their suppliers.

Can suppliers improve the balance of power with retailers?

In the first half of this decade, sales of packaged goods at U.S. supermarkets failed to grow at all. Yet supermarket sales overall did grow. Sales of prepared meals grew 10.4 percent per year. Sales at supermarket pharmacies grew 8.6 percent per year. Moreover, sales of branded packaged goods suffered at the hands of private labels[1]. In addition, the stagnation of packaged goods sales at supermarkets was due, in part, to a shift in market share toward mass merchants, principally Wal-Mart Stores, Inc. The result was that suppliers of branded packaged goods became increasingly dependent on one big retailer for growth. And that retailer was focused more on price than anything else.

None of this is good news for consumer packaged goods (CPG) suppliers. Yet what can they do? The retail world is changing in ways in which they have no control. Is it possible for them to improve the situation? Can a single company change the relationship with retailers in such a way as to propel significant growth?

Deloitte & Touche USA LLP believes the answer is yes. There are several elements of a potential solution. These include:

- **Innovation.** Innovative products that are clearly differentiated from others, and that offer unique benefits to consumers, will be in strong demand by retailers. Innovative processes that enable retailers to generate incremental sales, smooth inventory, or better serve fickle consumers will be in strong demand as well. Enabling retailers to participate in the process of innovation could benefit both players. Why? Cooperation will increase the likelihood that suppliers will have access to favorable shelf space. For retailers, such cooperation will increase the likelihood of having a product mix that is differentiated from competitors.

[1] Retail Forward

- **True partnership**. Whole forests have been destroyed printing treatises on the importance of retailer-supplier partnerships. Yet that does not negate their importance. The problem is that partnerships must entail more than paying for shelf space. Instead, partnerships will benefit retailers if they allow suppliers to obtain a positive return on trade dollars, obtain consumer information from retailer systems, and enable suppliers to truly share marketing responsibilities. Retailers need to be educated on the benefits of such partnerships. As for suppliers, they must recognize that, with consumers increasingly choosing stores rather than brands, investment in channel management is more important than ever – and could be more important than traditional brand marketing.

- **Trust.** Is it possible for competitors to cooperate? The answer is yes, but the reality is that it hasn't happened nearly enough. Suppliers and retailers will have to take the same leap of faith that entertainment companies have done and learn to be partners with competitors. They must understand that failure to do so will consign them to failure with consumers.

- **Investment in new channels.** Suppliers are likely to see a disproportionate share of their future growth come from innovative products targeted at niche consumer cohorts. These products will often be sold through newer, innovative, niche channels. The rise of health-oriented food retailers, for example, creates both an opportunity and a challenge for suppliers. That means that suppliers must invest in understanding these channels, create products and packaging that are useful to these channels, and create partnerships with the players in these channels.

- **Size.** At the end of the day, few suppliers will have much leverage with giant retailers unless they are giants as well. Size may not be a sufficient condition for success, but it is probably a necessary one. Consequently, we can probably expect further consolidation in the industry through merger, acquisition and divestiture activity. The resulting powerhouses will be well served if they can exploit their size in managing customer relations.

- **Closeness to consumer.** Serving retailers well will require a better understanding of the needs of consumers who are attracted to those retailers. Access to retailer information gleaned from frequent shopper programs or point of sale data will better enable suppliers to be close to consumers. Two-way sharing of consumer information between retailers and suppliers could enable each to gain knowledge that they currently lack. In doing so, we believe retailers and suppliers will be better positioned to address consumer needs and wants.

- **Brands that matter.** Retailers will be willing to play ball with those suppliers who own the brands that matter. Consequently, suppliers must rationalize their brand portfolios to focus on a core set of profitable brands. They must focus on first-tier brands, profitable niche brands, and innovative brands, while either shedding second tier brands or shifting the channel strategy for such brands. Having the right mix will gain the respect of retailers and lead them toward partnership and sharing of information.

Trends driving retail change

The retail world is polarizing. On the one hand, there are massive, global retailers such as Wal-Mart, Tesco, Carrefour, Metro and others that are moving in the direction of global relationships with suppliers with harmonized prices and trade promotions. On the other hand, there are smaller regional players some of which continue to perform well. Large mainstream food retailers are losing share to both. They cannot match the prices of the leaders, yet are not sufficiently differentiated to compete on the basis of anything beyond price. The blurring of lines between premium and regular brands is working against them.

Among the more successful players are upscale retailers that are not necessarily price focused. These niche players are growing in importance. Servicing these players is challenging as they require a portfolio of products and brands that clearly differentiate them from the mainstream players. Many mainstream suppliers are under-developed when it comes to serving these retailers.

To develop the newer channels, suppliers will need to either develop or acquire new products and brands, or extend existing brands and create new sub-brands. Doing this successfully will require a good understanding of the consumers who patronize these channels. Cooperation with the retailers can facilitate this acquisition of knowledge. Moreover, working with these new channels will require that CPG companies adjust to new circumstances. There will be new requirements in terms of packaging, labeling, information about ingredients, and information about commodity suppliers.

At the same time, CPG companies must continue to serve the demanding needs of traditional channels. This will involve differentiating through better service to retailers and better service to consumers. In addition, suppliers will be wise to invest in relationships with those merchants best suited to promoting their brands.

What is causing the retail industry to change? There are several factors at work.

First, the rise in income disparity in the U.S. is creating a more bifurcated consumer market. Retailers are responding with a more bifurcated selection of formats causing mass market retailers aimed at the middle class to struggle for survival. At the polar ends, on the other hand, discount stores and upscale specialty chains are performing well.

Second, consumer lifestyle changes are affecting retailers. Americans are eating more meals away from home or purchasing prepared meals for consumption at home. This long-term trend continues to create competition for food retailers. In addition, it is necessitating that food retailers offer a more compelling selection of prepared foods.

Third, consumers are less loyal to retailers than in the past, especially young consumers. Hence, consumers seek the best value proposition and often shop at multiple retail formats depending on where the best deals can be found. As a result, the lines that separate different retail formats are becoming increasingly blurred. Various retail formats often sell many of the same products, brands, and even SKUs in order to attract and retain a fickle consumer. For consumers, this creates an impression that stores across different retailers are interchangeable commodity sellers. Consequently, shopping choices are often made on the basis of price or convenience rather than merchandise selection or store experience. Of course there are exceptions to this, but they are indeed exceptions.

Finally, the retailing industry has become far more consolidated as the leading players grow rapidly, smaller players disappear or become absorbed into larger players, and medium sized players merge in order to create economies of scale.

Changing consumer expectations

Supermarket sales in the U.S. rose at an annual rate of 3.0 percent during the period 2000 to 2005. Yet consumer spending on food at home rose at a rate of 5.5 percent. The difference is accounted by the rise of Wal-Mart and the rise of alternative formats such as dollar stores and specialty food stores[2]. The latter include stores specializing in healthy, organic, ethnic, or upscale prepared foods.

In recent years, the average physical size of a new supermarket has been in decline as retailers focus less on the mass market and more on niche opportunities. Moreover, many retailers are doing this in order to accommodate the needs of more restrictive zoning regulations. According to the Food Marketing Institute, the median size of a new supermarket declined from 54,000 square feet in 1995 to 43,500 square feet in 2004.

According to a survey conducted for Progressive Grocer, the top future priorities for grocery retailers are ready to eat meals, natural and organic foods, in-store demonstrations and sampling, and private label. Let us consider some of these:

- *Ready to eat:* This is an area where suppliers must innovate lest they lose out to the food retailers themselves. Retailers will likely invest heavily in improving their offerings. Those branded suppliers that can offer innovative solutions will provide retailers with a way to compete with out-of-home eating opportunities.

The retailing industry has become far more consolidated as the leading players grow rapidly, smaller players disappear or become absorbed into larger players, and medium sized players merge in order to create economies of scale.

[2]Retail Forward

- *Natural and organics:* This represents an opportunity for suppliers to latch onto a market that is likely to far outgrow the general food market. The challenge will be for mainstream suppliers to develop brands or sub-brands that resonate with consumers and are attractive to specialty retailers. It may entail acquiring smaller entrepreneurial brands in addition to developing new products in-house. In addition, success could also entail assisting mainstream retailers in improving their offering of natural and organic products. After all, such retailers are threatened by newer niche players. They are eager to serve the needs of the relatively less price sensitive consumers who shop for these products. Partnering with suppliers will help them to meet this challenge.

- *In-store demonstrations.* Clearly, retailers want to improve their in-store marketing, especially at a time when mass marketing is becoming less effective and more challenging. Suppliers will be critical to retailer success, and retailers will be critical to supplier success.

- *Private label:* Most major food and mass retailers intend to increase private label as a share of total sales. For branded suppliers, this means added competition. Moreover, this competition cannot be won on the basis of price. It can only be won on the basis of innovation. That is, branded suppliers must offer superior products that retailers and consumers must have.

Getting the message across

Given the trends in retailing, suppliers face a more challenging environment for getting their message across and truly differentiating their products. Brand development through mass marketing continues to make an impact. Yet data from a recent Deloitte Consulting LLP survey indicates that consumers looking for a particular product rely on the retailer as opposed to the supplier to make their choice. As the retail brand becomes more important, the supplier brand becomes less important in the minds of the consumer. Their mass marketing is less productive. In earlier reports we discussed how suppliers need to get closer to consumers. They also need to be closer to the retailer in order to get the consumer's attention. If consumers choose the retailer first, then the channel strategy of a supplier becomes even more critical to their success.

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Retailers get better at marketing

While suppliers are good at understanding consumers in terms of their emotional connections with products, retailers are often better at understanding their shopping behavior. This includes purchasing decisions, store traffic patterns, impulse versus destination shopping, and how decisions are made at the point of sale. While many retailers are not yet skilled in this area of market research, they are getting better. Many are hiring high profile marketing executives from the consumer products industry itself in order to improve such understanding. Moreover, some retailers are attempting to use loyalty scheme data to improve their understanding. With such knowledge, retailers will be well positioned to improve store formats, assortments, merchandise positioning, and in-store marketing.

From the perspective of the supplier, access to this information could be critical. On the other hand, this information, in the hands of retailers, could improve the performance of private labels. So the basis now exists for both competition and partnership between retailers and suppliers. And, indeed, both take place today. Moreover, we can almost be certain that competition between retailers and suppliers will intensify in the future. An important question is whether cooperation will improve.

Supplier marketing imperatives

In the future, suppliers will require greater sophistication in marketing at the store level. Marketing organizations will require a portfolio of skills beyond market research and marketing campaigns. In addition, they will need to improve expertise in logistics, shopping patterns, in-store merchandising and marketing, and key account relationships.

While traditional mass means of marketing will remain important for maintaining consumer brand awareness, in-store marketing will grow in importance – both due to fragmentation of mass media and concentration of retailing. Brand equity must be built at the point where consumers meet the product assortment. This means more engagement marketing versus interruption marketing. It means partnering with retailers to engage consumers with information that matters to their daily lives.

Paying for nothing?

What about trade promotion? Can this critical component of supplier-retailer relations become a more productive endeavor for all involved?

On average, about half of CPG marketing expenditures are devoted to trade promotion. Yet the return on this spending is usually pretty poor. As measured by several studies, the return is often negative. Why is this?

The answer is that some of the money is not really used for marketing. It is simply a subsidy to retailers. The largest retailers, legally restricted from negotiating the prices of products, seek trade money as part of their negotiating strategy. And given the increasing consolidation of retailers, many have substantial negotiating power with their suppliers. Some experts suggest that as much as 30 percent of trade promotion money is not actually spent on marketing. For suppliers, this is simply a cost of doing business, a cost of obtaining access to shelf space.

The problem with this economic model is that it involves negotiating with retailers to push products to the store rather than marketing to get consumers to pull products from suppliers. The challenge for suppliers is to try to change the dynamics of this game. Each supplier needs to ask whether the money spent is truly generating additional revenue from consumers.

Tools for success

What can suppliers do to change their relationship with retailers? Here are several ideas:

- First, consolidate. Bigger suppliers clearly have more leverage with retailers. Indeed much of the consolidation that has already taken place was, in part, motivated by a desire to increase negotiating power with retailers.
- Second, suppliers that own "favored brands" have more leverage with retailers than those with second tier brands. Thus, the route to better retailer relations obviously lies with better consumer relations. Focusing on what consumers want from brands will enhance brand equity.
- Third, innovative brands and products that are on the leading edge often attract the most consumer attention. Owning a "must have" brand also provides suppliers with leverage.

The most powerful brands that belong to large CPG companies have considerable leverage. They can insist that retailers prove the performance of their marketing dollars before committing to further such expenditures. In addition, large CPG companies that manage multiple successful brands can leverage their negotiating power across categories.

Data mining

Beyond size and best brands, there are other things suppliers can do to improve retailer performance. For example, access to better data and analysis can enhance performance. If suppliers can better understand consumer preferences with respect to shopping patterns, product packaging and sizing, and product attributes for specific occasions, they can be better positioned to drive brand equity. Suppliers often obtain such information from national polling or survey firms. Yet some useful data can be obtained from retailers' frequent shopping programs. This, of course, will require greater cooperation between retailers and suppliers.

What about trust?

Greater retailer-supplier cooperation is all well and good, and indeed it has been promoted for years, but not much has happened. Why? In a recent study conducted by Deloitte & Touche LLP, United Kingdom, retailers and suppliers were asked to name the biggest barrier to enhanced cooperation. The most mentioned explanation, at 59 percent of respondents, was a lack of trust. The problem is that, although cooperation is critical, it is hard to get around the fact that retailers are increasingly competitors to suppliers. Thus, they eye one another with apprehension. The challenge will be to break that barrier by simply accepting the reality of competition and getting on with business.

Consider the entertainment industry in the US. There, it is not unusual for a studio to produce a television program that is sold to a competing television network for broadcast. Although the two companies are intense competitors when it comes to the television networks they own, they nonetheless cooperate by producing programming for one another. In the end, everyone wins. The reason is that each party recognizes that failure to cooperate means failure to exploit a real opportunity. Why can't the retailer-supplier relationship be thus? One problem is concern over competition regulations. Yet that is not the main obstacle. The main obstacle is a lack of trust, a belief that the other party will take unfair advantage of a partnership. Successful exploitation of partnership will simply require a change in thinking.

What does the future hold?

Unfortunately for suppliers, much of what happens in the retailer-supplier relationship will be driven by retailer behavior. Retailers are becoming more concentrated, more powerful, are more focused on private label while managing and marketing their own brands. Moreover, retailers are now hiring marketing executives away from consumer product companies in order to improve their own private labels. If retailers become better at managing private labels, they will be more serious competitors to consumer product companies.

Portfolio management

Yet that is not to say that consumer product companies have no choices. Purveyors of the leading brands, especially those with a strong consumer following, will be well positioned to negotiate with retailers from strength. At the same time, the development of niche brands that focus on small, focused consumer cohorts, will take expanded market share. That will leave second tier national brands, however, to struggle to survive. Many, in fact, will not. They will be stuck in the middle between leading brands, private brands, and niche brands. It could very well be that the optimal strategy for consumer product companies will be to rationalize their brand portfolios by shedding second tier brands. Instead, they will do best to focus on leading brands and newer niche and innovative brands. Thus, an important part of managing retail relationships will be successfully managing brand portfolios.

Another important part of managing retail relationships will be managing new kinds of retailers. As mentioned, a disproportionate share of the growth of consumer spending on packaged goods will probably be driven through new channels such as organic and health related food retailers, upscale and specialty grocers, downscale retailers (one price stores), and some big foreign retailers bold enough to try and tackle the U.S. market. Managing these will require some new approaches – especially the organic and health related retailers.

In the case of the latter, we feel success will require development of new brands and sub-brands, a focus on smaller packaging, and a focus on environmentally friendly products and packaging. For large packaged goods companies accustomed to massive relationships with massive retailers, this will represent a challenge.

Product cycle time

In the future, more retailers will attempt to move toward an EDLP (everyday low price) strategy. The critical word here is "move." They will not completely abandon hi-lo pricing. That is nearly impossible. Instead, they will try to be more precise in pricing products in order to move inventory optimally. They will require more real-time information about consumer shopping behavior in order to minimize inventory and avoid volatile pricing. To do this, they will need the help of suppliers. Those suppliers that can improve product cycle time will be favored by retailers.

For example, a detergent manufacturer can produce plenty of detergent in bulk at minimal cost. Timing is not an issue. The challenge, however, will be to package the detergent appropriately close to the time of store delivery. With appropriate information from retail customers, a supplier can choose the optimal package size and get detergent to the store just in time to be purchased. The retailer can price appropriately and move the inventory in a timely manner. This kind of collaboration could be beneficial to both retailer and supplier – reducing costs, driving sales, and smoothing inventory. Yet it requires many things: good information, sharing of information, and ability to respond to information – on the part of both retailer and supplier.

Brand management

CPG companies will need to re-think the value proposition of their leading brands. To get the retailer's attention, they will have to offer the brands that retailers must have. Price and quality will be important, but not sufficient. They will have to offer solutions to consumer problems.

Achieving this goal may require a different organization. Today in many consumer product companies, branding and sales are distinct functions that operate independently. This must change. Brand marketers need to understand shopper marketing and need to better integrate with the sales function to execute the marketing plan.

What are the atttributes for success?

In the future, we feel successful CPG companies will have the following attributes:

- **Lots of experimentation in marketing and selling.** The most profitable CPG companies will be those that have the most innovative, differentiated brands. This requires constant experimentation, both at the product development level and in terms of in-store marketing.
- **Further consolidation with better exploitation of scale.** With few exceptions, only very large CPG companies will have the resources and clout to shift the relationship with retailers for the better.
- **A culture that accepts failure, promotes innovation.** Successful innovation requires a willingness to take risks. This extends to retailer relationships. Innovative failures should not be punished lest future innovation is stymied.
- **Focus on top-tier or niche brands while shedding second-tier brands.** Brand portfolio rationalization will be critical. Moreover, managing a portfolio of channels to promote the right brands will be critical as well. Yet the underlying portfolio will be one of consumer cohorts. Each targeted consumer must be provided with an appropriate brand at an appropriate retail channel. Understanding that consumer will require information shared by retailers. It will also require reinvestment by suppliers in the marketing and sales functions.

In the future, we feel successful CPG relations with retailers will be characterized by:

- **Joint investment in innovation, both of products and processes.** The most successful innovation will involve the retailer. After all, the retailer understands consumer motivation and has direct access to the consumer. Having buy-in from the retailer on product characteristics, packaging, pricing, and in-store marketing increases the likelihood of success.
- **Intensive, real-time sharing of information.** This can be used to drive innovation, improve supply chain efficiency, and improve overall performance.
- **Focus on Corporate Social Responsibility (CSR).** Retailers and suppliers will be judged by consumers and financial markets, in part, by how they manage the issue of CSR. The ability to cooperate in this arena will enable retailers and suppliers to have a competitive edge. This will involve product innovation, product marketing, product packaging, manufacturing processes, labor relations, and consumer experience in the shopping process. All of these areas can be enhanced by cooperation between retailers and suppliers.
- **Assist retailers in developing new markets.** In the future a disproportionate share of growth will come from emerging markets. As the traditional trade is replaced by modern retailing, suppliers will be challenged to secure favorable positions in new outlets. Many of the key modern trade players in emerging markets will be global companies. Consequently, helping retailers to develop these markets could enable suppliers to improve their position with emerging market consumers. In addition, helping retailers in these markets could also improve their relationships with retailers in mature markets. Therefore, suppliers will need to develop global trade strategies that are just as comprehensive as their consumer strategies.

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