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OLIVER WIGHTPAPER series

# Managing *the* Private Label *Supply Chain*

Inspiring Business Performance

**By Stuart Harman**
*Oliver Wight Partner*

# Managing the private label supply chain

According to leading industry researchers, IBISWorld, an expected $31.8 billion will be spent on private-label grocery products in Australia by 2017-18. This represents a massive growth of nearly 50% compared to just five years ago, as the phenomenon of private label continues to increase exponentially.

Thirty years ago the leading manufacturers were significantly larger than their retail customers. Today, as retailers have evolved into national and international corporations, the balance of power has shifted, and with it has come a greater focus on retailer's own brands, or 'private labels'.

Most manufacturers are now either engaged in supplying private label products, or wrestling with the decision as to whether they should introduce a private label strategy. For those considering private label, the cost and effect on the supply chain needs to be given serious consideration.

This white paper uncovers the secrets to understanding, embarking on and managing the private label supply chain.

## Why get into private label

The retail landscape has undergone rapid transformation over the past decade. In the UK, market share of private label products has grown to over 40% of the grocery market. In the US private labels continue to increase in popularity, with rapid growth in multi-tiered private label programs (good, better, best) and in Australia growth has been faster still.

Private labels now account for a quarter of supermarket sales, with major grocery retailers, Woolworths and Coles, who control 70 per cent of the nation's available shelf space, having significantly increased the proportion of their private label products as they battle for customer loyalty in an ongoing quest to deliver greater value to consumers. Whilst Aldi, a grocery retailer stocked almost exclusively with private label products, is significantly growing its share of the grocery market.

And it's not just grocery private labels and retailer brands that have grown. Private label has penetrated other categories, including clothing and apparel, electrical goods, wine and beer, even furniture. For the consumer, private label means the choice and opportunity to purchase products at lower costs compared to manufacturer brands, often at the same or better quality. For the retailer, private labels enhance profit margins, promote differentiation from the competition, and build customer loyalty. This, combined with lower cost competition from overseas, leaves less and less space for manufacturer brands.

For manufacturers, falling sales of branded products often results in underutilised manufacturing capacity, as well as lower revenues. The obvious solution is to switch idle machinery over to private label production. And with no country or market immune to the increasing competition of private labels, it seems there is no better time to enter the private label industry.

## The cost of the private label supply chain

Whilst the benefits of successfully entering the private label market appear clear, manufacturers must resist the temptation to leap in head first, reasoning the additional volume produced will absorb overhead, without first giving all costs involved proper consideration. Some companies cost the production of private label products on a variable costs basis alone. Their assumption is that much of the traditional sales and marketing overheads associated with branded products are now passed on to the private label retailer and the fixed costs of manufacturing are absorbed by the existing manufacturer branded products. So as long as the private label offering is priced on a variable cost-plus-margin basis margin will flow through as incremental profit. Unfortunately however, this thinking is often flawed due to a lack of understanding of the tangible and intangible costs associated with private label manufacture.

Manufacturers may be able to eliminate some of the costs associated with branded products, as retailers bear the brunt of the advertising, marketing and shelving costs, but the price to pay is loss of control.

Understanding the dynamics and specifics of the supply chain being operated in, and the retailers' ability to influence performance is vital if private label manufacturing is to be undertaken profitably.

## Plugging the leaks

The private label supply chain is just as, if not more complicated than the branded product supply chain. There are a number of tangible ways organisations can leak profit in their private label manufacturing operations. These are five of the most common:

1. Not accounting for raw material price fluctuation
2. Delays in the product management process resulting in unbudgeted costs to meet launch deadlines
3. Obsolete stock following product deletions
4. Confusing the value proposition and thus business priorities
5. Lack of visibility over demand variations

Each of these profit leaks - and how an organisation can avoid falling prey to them - are considered below.

## 1. Factor in ‘life of contract’ costs

When entering into an agreement to supply private label product to a retailer on a contractual basis it is vital the potential cost movements of product inputs and distribution, such as raw materials, energy and fuel, are factored in to the product pricing.

Unless ‘life of contract’ costs are included, price fluctuations, over which an organisation has no control, can have a detrimental effect. One major food manufacturer went from making a small profit on a private label contract to a major loss following a rapid, significant increase in wheat prices and a lack of forward cover for the life of the contract. Negotiations with the retailer to increase product price were time consuming, acrimonious and negatively impacted the company’s ability to pitch its new ranges of private label and manufacturer-branded products to the retailer.

Any fixed-terms contracts should include a mechanism to vary pricing to reflect changes in input costs, or need to fix or hedge input costs with the supplier for the life of the contract.

## 2. Integrate product management

In private label manufacture, delays or gaps in the product management process can lead to unbudgeted costs during launch. Collaboration with the retailer is vital if timelines are to be met.

Unfortunately it is all too common for communication between a supplier and retailer to break down, leading to a rush of activity to get a product launched and the use of overtime, airfreight and other unbudgeted spend to get the product to the retailer in time. Effective new product management processes and communications with retail partners are essential to prevent these types of cost overruns.

Many traditional business planning processes, used in both branded and private label environments, do not allow for the integration of product portfolio management, focusing instead on balancing demand with supply, and viewing product development as an altogether separate ‘creative’ activity. By integrating product management in to the business planning process, organisations can ensure they are able to move quickly to exploit opportunities, and close any gaps that emerge.

Leading organisations are using Integrated Business Planning (IBP) to ensure that their Product plans are aligned with their customers and the rest of the organisation. Integrated Business Planning, most simply described as advanced, or next-generation, sales and operations planning (S&OP) is a common sense process designed for effective decision-making. It allows senior management to plan and manage the entire organisation over a 24 month horizon or more, aligning strategic and tactical plans each month, and allocating critical resources – people, equipment, inventory, materials, time and money – to satisfy customers in the most profitable way. As depicted in Figure 1, Integrated Business Planning connects the core processes of Product, Demand and Supply into one seamless management process with integrated financials, and allows the executive team to

re-optimise the business on a monthly basis through the Integrated Reconciliation and Management Business Review processes.

With private label manufacture, there is a tendency to consider product development as a separate entity, in the hands of the retailer. But unless manufacturers and retailers work together on product management and it is integrated in to the business planning process, manufacturers will find themselves unable to monitor whether or not they are on track to deliver.

*Figure 1: Integrated Business Planning model*

## 3. Establish rules for deletion

Another area of private label product management, which can be very costly, is product deletions - where the retailer decides to no longer stock and sell the product. There is only one customer for the product, so the usual options of switching supply to another retailer or clearing stock via another outlet do not exist.

To prevent costly write-offs of obsolete stock, any supplier-retailer agreements need to establish clear rules for inventories of finished goods, packaging and raw materials unique to that private label product. Similarly, clear communication between the supplier sales team and supply/procurement team to signal any potential or actual product deletions will prevent the purchase of excess raw materials and packaging and the production of surplus finished goods.

Suppliers also need to be wary of stock clearance, as the most common tool used is price reduction. If this has to be funded by the supplier, profits are rapidly eroded.

## 4. Have a clear value proposition

The value proposition between private label products and branded products varies considerably. Brands seek to offer a customer intimate value proposition, segmenting or targeting markets and tailoring offerings to match the demands of specific niches. Or they have a product leadership value proposition, introducing category-leading products seen to offer greater value than their rivals by enhancing customer experience of the product. The value proposition of a private label, in contrast, is typically one of cost competitiveness. That means providing reliable products, delivered with minimal difficulty at competitive or lowest cost.

These varying value propositions demand different skill sets, and the uniformed, disciplined approach to controlling costs and eliminating waste required in a cost competitive organisation will not necessarily be at the forefront of a customer intimate or product leadership company. Those manufacturers which attempt to provide one value proposition with their branded product and another with their private label offering can end up ‘stuck in the middle’, and risk compromising both value propositions in addition to confusing employees about what is important.

Having a clear business value proposition is paramount. And this needs to be communicated throughout the organisation so that everyone has a thorough understanding of their individual role and responsibilities as well as the overarching business aims.

## 5. Increase visibility to manage demand variability

When the private label industry first emerged, private label grocery products were exclusively economy or value versions of branded products. Retailers rarely spent money promoting their own brand offerings and so customer demand remained steady with variability not a major concern.

Nowadays the range offering, often referred to as 'good, better, best' places focus on standard lines, with premium and economy ranges as supplements. And in recent years this offering, particularly in the grocery space, has further segmented with super premium and higher quality value ranges appearing on the shelves of many retailers (see Figure 2). Many of these ranges are the subject of regular promotional activity from the retailers, from print, radio, TV and social media advertising, to direct marketing, through to price discounting.

The desired impact of promotion is to increase demand, and the results can be spectacular. Ten-fold increases in sales volume are not uncommon in product categories where advertising and discounting is aggressive. The effect of this huge variability in demand on the supply chain can be problematic, especially for organisations that lack visibility.

It is commonplace for branded manufacturers to completely fund or at least part-fund promotional activities for products, including retailer discounts; whereas, many private label or contract manufacturers do not contribute to toward the cost of specific promotions. Whilst this has obvious financial benefits it does mean early warning signals for changes in demand are missed.

From re-planning the production schedule, to paying staff overtime, using premium freight for importing raw materials or delivering finished goods, and paying for 'loss of profit claims' when the retailer goes out of stock; the impact of 'surprise' promotional activity can be very costly. Plus, unlike with branded product, the option to redirect product from another supply chain segment to fill supply shortages does not exist, since the product is unique to the specific retailer.

Overly optimistic sales forecasts can also be very costly, resulting in excess inventory that needs to be borne either by the supplier or retailer.

It is important for organisations to work together and share insight and knowledge. As a minimum, the manufacturer needs visibility of planned retailer activities that will cause a demand variation. The closer retailers and suppliers work to the demand signal and the more accurately it is communicated, the less amplification there is further back in the supply chain. The process then becomes more efficient, producing less waste and fundamentally generating more profit for everyone.

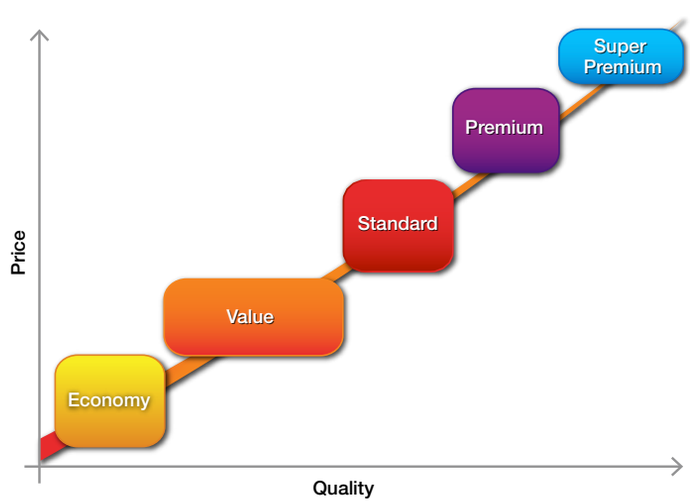



*Figure 2: Private label trends*

## Collaboration is key

The solution to plugging potential profit leaks and more effectively meeting demand ultimately lies in greater collaboration between suppliers and retailers. Ongoing communication, sharing of plans and integration inevitably has an enormous impact on the ability of both parties to service customers effectively and profitably. Real collaboration takes a long time to develop as it needs to be based on understanding and trust, both between the supplier and retailer but also in the data and information flowing between them and each party's ability to use it (see Figure 3).

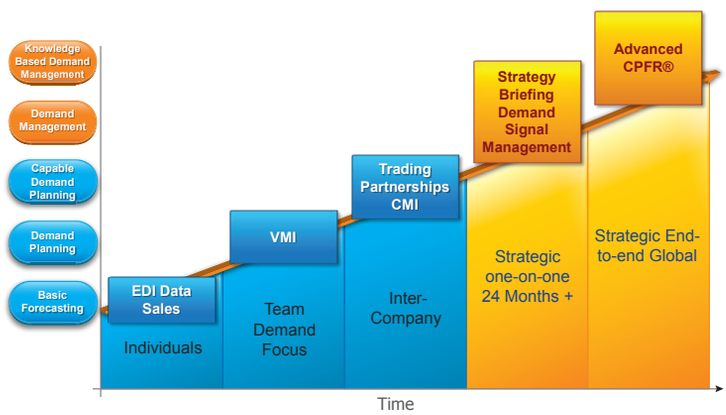



*Figure 3: The collaboration journey*

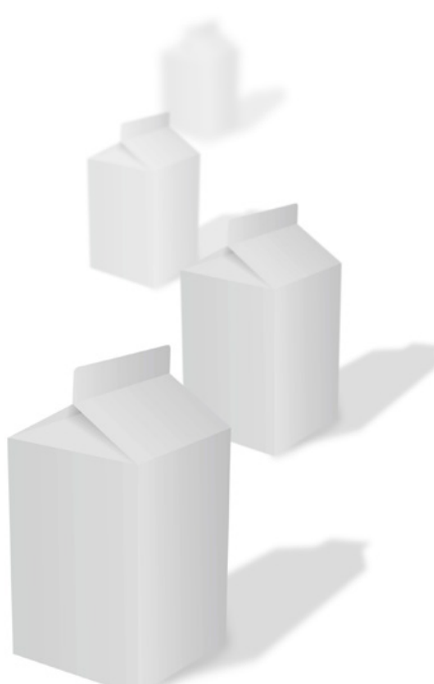
Whilst developing collaboration is a long journey that must be worked at by both parties, paradoxically it's at the outset of a relationship, when the supply contract is costed and negotiated, that the basis of understanding and trust, has its biggest impact. If the level of demand volatility and the notice period for significant planned changes to demand are understood at the time of negotiation, the supplier can design the supply chain to provide the required levels of service at optimum cost given the level and notice time of anticipated demand volatility. To enter into this type of dialogue with the retailer, private label manufacturers need to demonstrate how having this information will enable them to provide greater value. Similarly, the retailer needs to understand the benefits that designing a supply chain to match a planned demand profile can bring. That requires a completely different conversation than a buyer simply driving competing suppliers for the lowest purchase price.

## Conclusion

As private label witnesses an unprecedented growth, manufacturers are presented with an exciting opportunity to produce products for major retailers and take advantage of their promotional and marketing activities, global expansions and steady customer demand. Entering into the private label supply chain however, is no mean feat and with the risk of leaving profit, power, and supply chain control at the mercy of powerful retailers, there is a lot at stake.

By embarking on a private label strategy with a clear understanding of the supply chain - factoring in life of contract costs; introducing effective product management as part of an Integrated Business Planning process; establishing clear rules for deletion; understanding the value proposition; and managing variability of demand through shared visibility with the retailer, manufacturers can plug any potential leaks in profit.

With collaboration at its heart, private label manufacturing can become not just a reaction to falling sales of branded products, but a real opportunity for manufacturing excellence, growth and ultimately success.



## About Oliver Wight

Oliver Wight has a 40 year track record of delivering business improvement to some of the world's best-known organisations. We believe that sustainable improvement can only be made through your own people. So unlike other consultancy firms, we transfer our knowledge to you, which means you can achieve performance levels and financial results that last.

At the leading edge of management thinking and practice, our Integrated Business Planning (IBP) model lies at the heart of our clients' journey to outstanding business performance. Oliver Wight originated Sales and Operations Planning in the 1980s and IBP can most simply described as advanced S&OP; evolving from its production planning roots over 40 years into the fully integrated management and supply chain collaboration process it is today. IBP allows the senior executive to plan and manage the entire organisation over a 24 month horizon, aligning tactical and strategic plans each month and allocating critical resources to satisfy customers in the most profitable way.

OLIVER WIGHT

**Oliver Wight Asia/Pacific**
131 Martin Street, Brighton
Victoria 3186, Australia

T: +61 (0)3 9596-5830
F: +61 (0)3 9596-5840

information@oliverwight-ap.com

**www.oliverwight-ap.com**

**Oliver Wight Europe, Africa & Middle East**

The Willows, The Steadings Business Centre
Maisemore, Gloucester GL2 8EY, UK

**Oliver Wight Americas**

P.O. Box 368, 292 Main Street
New London, NH 03257, USA

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