A White Paper from the Americas Leaders in Supply Chain Management

# Consumer Goods Manufacturers Seek Greater Supply Chain Flexibility

## Uncovering Packaging and Distribution Efficiency Opportunities

## Introduction

Over the past few decades Fast Moving Consumer Goods (FMCG) companies have been forced to react to a multitude of changing market dynamics. The mergers and acquisitions era created strong competitors and rapid growth for many companies, but resulted in complex and costly logistics infrastructures. And, the growth in big box retailing and e-commerce placed increased attention on the consumer shopping experience, creating a shift in the balance of power from the manufacturer to the retailer.

At the same time, the technology and manufacturing boom was giving rise to developing economies in Asia and Latin America, creating new consumers and growth opportunities for FMCG manufacturers and retailers alike. While top-line growth was enticing in these emerging markets, lack of infrastructure, dispersed populations and cultural nuances created challenges for even the best manufacturing and logistics planners seeking to establish operations and capture market share quickly and profitably.

> "The shift to modern trade in emerging markets is a clear trend. We see different stages of retailer requirements during this evolution, creating more complexity in dealing with these differing models."
>
> *Source: FMCG Manufacturer, Asia*

While each of these dynamics influenced how FMCG manufacturers and retailers went to market, the economic fluctuations experienced around the world in recent years have most dramatically impacted growth and operating strategies.

### Responding to Shifting Demand in Developed Economies

In mature markets, the early 21st century saw unprecedented affluence among busy, technologically advanced consumers who were demanding higher levels of service, quality and shopping convenience. Savvy retailers anticipated and capitalized on these consumers' expectations, giving rise to big box and specialty retailers that offered unique shopping experiences and a nearly endless selection of products to meet diverse needs. Many major retailers and FMCG manufacturers benefited from this high consumption era – and supply chains were all about keeping up with demand.

Then, in 2006, consumer spending patterns in developed economies, such as North America, Western Europe and Japan, began shifting as volatile stock prices signaled an early warning to the severe and lingering economic crisis to come. The effects of the recession – falling home values, lack of credit, high unemployment and the dramatic erosion of personal savings – pushed consumers toward a more frugal lifestyle characterized by lower rates of spending, value purchasing and trading some convenience for better prices. They also shifted their spending to retail channels such as discount centers and convenience stores and made a variety of other shopping choices, including turning to store brands, to obtain the best possible price.

The demographics of developed countries are also evolving, forcing retailers and FMCG manufacturers alike to further segment their go-to-market strategies. For example, aging baby boomers who once loved the convenience of big box stores are now seeking more accessible neighborhood locations.

Recognition that local consumer preferences and needs vary by locale is also growing. Whether catering to the requirements of a rural community or offering products that fit the tastes of an ethnic neighborhood in an urban area, adapting to customer needs has never been more critical to maintaining market share.

The decreased consumption of consumer goods in North America, Western Europe and Japan, combined with shifting demographics and lower rates of spending, will continue to limit growth potential in these areas.

## Positioning for Sustained Growth in Emerging Markets

Even before the global recession started, FMCG companies were extending their reach into Asia, Eastern Europe and Latin America. While lack of infrastructure and diverse retail channels, including local markets and street vendors, made product distribution challenging, it was clear these countries could offer sustained growth for decades to come – an upside manufacturers needed as mature markets were reaching the saturation point.

Whereas consumers in mature economic markets are remaining frugal during the recovery, studies indicate that young, new middle classes in countries such as India, China, Mexico, Brazil and South Africa are steadily increasing their rate of spending on consumer goods. These countries are seeing increased output, employment growth and the emergence of increasingly affluent consumers ready to explore new products, brands and retail channels.

> "Even during the financial crisis, emerging market consumers kept buying, helping to buffer many emerging economies from the global recession. While sales of consumer goods in developed markets fell 14% between 2007 and 2009, demand in emerging markets kept growing, increasing 11%."
>
> *JPMorgan Market Commentary, September 2010*

However, the opportunity to capitalize on sales and market share growth will not last forever. The middle classes are quickly forming attachments to brands and products, particularly those that align with local tastes and cultures.

A major cultural shift is also underway as consumers who have traditionally purchased goods at markets or small local stores are beginning to shop at supermarkets, mass merchandisers and discount stores. But, competition and channel complexity remain, because both retail models are viable options in urban and rural areas.

Whether already established and looking to increase market share or just preparing to enter an emerging market, there is a greater sense of urgency for FMCG manufacturers and retail distributors to ensure their supply chains are positioned for growth and flexibility.

## Capitalizing on Converging Market Dynamics

While the market dynamics of developed and emerging economies remain distinct, supply chain strategies employed in both markets are converging in some areas. A recent Grocery Manufacturers Association (GMA) report noted that managing supply chains in silos on a regional basis and "reinventing the wheel" are lost opportunities to optimize best practices on a global scale. The phrase "think globally, act locally" has never been more appropriate.

This paper examines how retailers are reacting to these changing consumer dynamics and, in turn, how FMCG manufacturer strategies are being impacted. It then reviews several areas FMCG supply chain managers can optimize to help meet customers' needs, while achieving their own operational efficiency and sales support goals.

## Retailers' Strategies to Meet New Consumer and Economic Dynamics

In a benchmarking study by the Aberdeen Group, retailers identified the need to react to fluctuations in demand in a timely manner as their top supply chain execution pressure. This is a result of historical buying trends in mature markets no longer being a clear indicator of future consumer behavior in an uncertain economy. And, in emerging markets, demand is difficult to measure accurately due to the diverse retail distribution channels and still-developing consumer preferences.

In spite of demand measurement challenges, retailers must still act quickly to compete for share of the consumer wallet by looking for new ways to attract customers to existing stores in established geographies, and attempting to localize the product offering and increase market penetration in emerging markets.

Product selection, marketing and merchandising strategies, and new store formats are all being evaluated to secure the highest possible market share in target geographies.

At the same time, retailers are continually focusing on reducing overall levels of inventory and seeking to lower total landed costs to maximize profits. Whether succeeding in a mature market with value-conscious consumers or seeking to influence how increasingly affluent consumers in emerging markets shop, retailers are taking similar approaches to differentiate and achieve competitive advantage.

## Localized Retail Formats

Merchandising and other product-driven strategies are common areas of focus when adapting to changing consumer needs, but new views on optimal store formats are taking center stage in recent years. The first mass merchandisers to enter markets like Mexico and China quickly learned that large, inventory-packed stores did not always align with the shopping habits and preferences of local consumers. This has resulted in smaller stores that feel more like the casual markets locals prefer. Although the driver is different, a similar transformation of retail formats is occurring in mature markets. Retailers are catering to consumer target groups, such as aging baby boomers and ethnic populations, by building stores that offer shopping experiences uniquely aligned to their needs.

> "Lead times are going down. Smaller deliveries are increasing. These changes are the new reality and will stay in place even with an economic turnaround."
>
> *Source: Beverage Producer, Europe*

## Stock Keeping Unit (SKU) Rationalization

Retailers are continually evaluating their SKU assortment to improve the consumer shopping experience, reduce out-of-stocks and lower overall inventory and waste, thereby improving margins. SKU optimization strategies in mature markets were particularly important during the economic downturn when point-of-sale data was less reliable in anticipating future demand. And, emerging markets are unpredictable by nature due to visibility limitations and rapidly evolving customer needs. Determining the appropriate mix of SKUs to satisfy consumer shopping habits while avoiding under- or over-stocks that could negatively impact top-line sales and bottom-line profits, is now a more dynamic process requiring frequent adjustments.

## Smaller, More Frequent Orders

Traditional retailers are responding to demand dynamism by changing their replenishment strategies to smaller, more frequent orders. Changes in store size, format and location to accommodate local or demographic needs have also influenced inventory replenishment strategies. Smaller retail formats, dollar stores and convenience stores have limited shelf and inventory storage space. Maintaining less inventory at stores also avoids over-stocks and obsolescence when demand fluctuates.

## Store-Level Differentiation

Product customization through innovative packaging, specialty packs, promotional bundles and assortments continues to grow in popularity among retailers. The concept of secondary packaging (co-packing), first introduced in club stores as a way to entice customers to buy in bulk for more value, is now a sophisticated marketing strategy focused on drawing customers into the store and differentiating the product offering.

Retailers are also enjoying higher sales and profits from store brands, which can provide consumers more value for their money than brand-name products. Private labels today bear no resemblance to the unappealing black and white generic brands introduced in the 1970s, and they are gaining respect as good-quality alternatives to higher priced national brands. In the U.K., private labels make up more than half of its grocery market, according

to data from IBISWorld. Recent research by Information Resources, Inc. indicates that in the U.S., store brands have captured an estimated 23 percent of the market, with annual growth rates of 18 percent in the last two years.

These retail strategies, which are designed to address changes in economic conditions and consumer behavior, have upstream market share and profit implications for consumer goods manufacturers.

## FMCG Supply Chain Impacts of Evolving Consumer & Retailer Needs

While consumer goods fared better than most industries during the economic downturn, manufacturers are still faced with unpredictable consumer demand, strong competitors, increasing retailer requirements, rising commodity costs and pressures to reduce carbon emissions. In addition, unique infrastructure challenges create efficiency obstacles for operations in both mature and emerging markets.

In mature markets, consumer goods manufacturing and supply chain operations are well established, but that brings as many issues as benefits. Traditional manufacturing operations were designed to utilize standard high-volume, highly automated equipment to maximize productivity and capital investments, and reduce labor costs. Corresponding supply chain goals were to use standard package sizes shipped in truckload quantities to minimize transportation costs, support mechanized distribution centers and reduce labor costs. "Smaller," "customized" and "highly differentiated" do not work well with these legacy operations. Figure 1 illustrates a traditional distribution supply chain in a mature market.

The growth of modern retail channels in emerging markets will eventually be a benefit to FMCG companies operating in these regions, offering distribution synergies and sales channels more aligned to their production capabilities. Today, however, it adds complexity to an already tenuous situation. In addition to using local distributors to get product to markets and local retail outlets, FMCG manufacturers are now challenged to meet the needs of an even more diverse retail channel mix. And, of course, manufacturing quality and product safety remain a concern and challenge, particularly in remote or unstable regions.

Manufacturers in all parts of the world are looking for better ways to meet retailer and consumer needs, including:

– Cost-effectively adapting manufacturing and packaging processes for point-of-sale customization and differentiation;

– Optimizing the supply chain network and organizing deliveries to support smaller, more frequent orders; and

– Introducing flexibility into complex, high-cost supply chains.

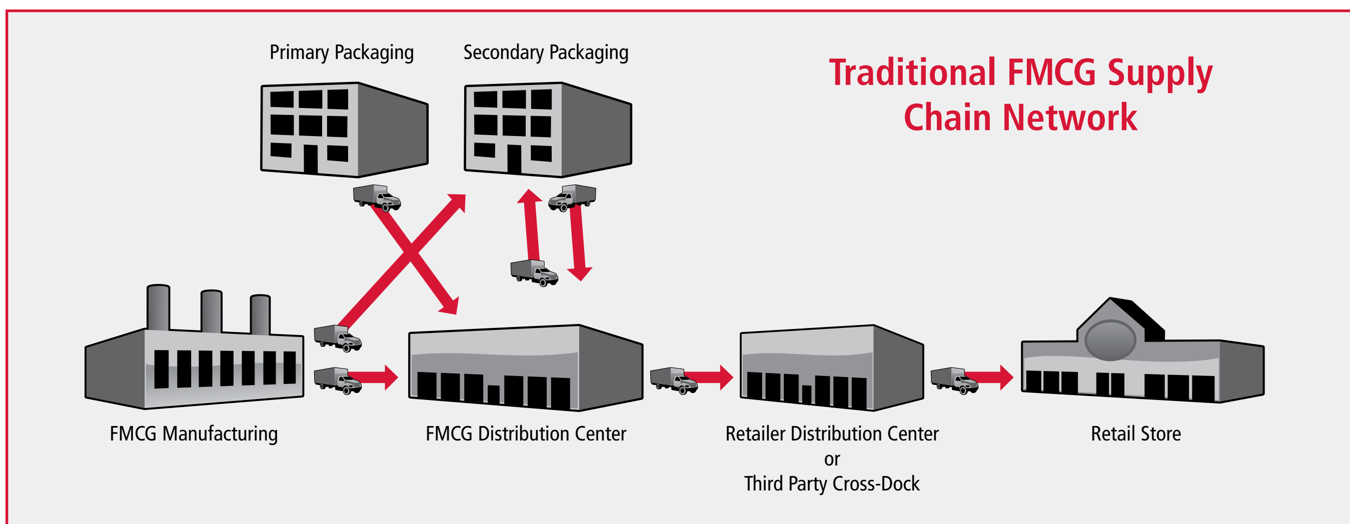


Figure 1

These objectives can be accomplished through improved manufacturing and distribution supply chain strategies. While FMCG supply chains have continued to evolve, opportunities remain to profitably meet new challenges. As retailers and consumers in emerging markets follow the lead of modern trade in mature markets, manufacturers can look to some of these same efficiency and productivity opportunities to capitalize on new sales growth.

## Strategies for Creating More Responsive, Efficient and Cost-Effective FMCG Supply Chains

This paper discusses four supply chain strategies that can help manufacturers meet new market demands, while also satisfying their own requirements to operate efficiently and support growth:

- Outsourcing Primary Packaging (Contract Manufacturing);
- Optimizing Secondary Packaging (Co-packing) Locations;
- Regionalization of Distribution Networks; and
- Horizontal Collaboration.

These strategies can be used alone or together as part of an integrated solution that simplifies and drives costs from FMCG supply chains. While these practices are not new, to benefit all parties in the FMCG supply chain, they need to be better integrated and streamlined from design through execution.

## Strategy 1: Outsourcing Primary Packaging

Although the outsourcing of primary packaging has been around for decades, it is experiencing renewed interest from companies entering emerging markets and those trying to streamline existing operations in mature markets. In many emerging markets, FMCG companies have already outsourced manufacturing as a means to enter the market since, initially, there is insufficient demand to require a dedicated manufacturing facility. In mature markets, the shift to smaller, more frequent, customized orders requires shorter production runs or specialty equipment that is not available on all manufacturing lines.

In either scenario, manufacturing and packaging processes for some consumer goods can be outsourced to an appropriately equipped and qualified distribution center to bring the product closer to the end customer. Outsourcing manufacturing can increase asset utilization, reduce new capital investments, help facilitate product packaging based on regionalized demand and provide greater flexibility in responding to the changing marketplace. With this strategy, bulk product or ingredients are shipped to the production facility or distribution center where it is mixed, if needed, and packaged into smaller containers. This is a very flexible strategy that provides retailers with the different package sizes they require, including the smaller packaging sizes for convenience and dollar stores.

> "Retailers will continue to look for ways to customize. For our supply chain, it is about speed to market in a cost-effective and sustainable way."
>
> *Source: FMCG Manufacturer, North America*

For the FMCG manufacturer, outsourcing saves costs and provides flexibility for both operations and marketing. Outsourcing reduces the time and complexity required to change manufacturing lines that support product launches or shorter promotional runs. And flexibility can increase by shifting primary packaging into the distribution center network, since final packaging decisions can be postponed. This allows marketers to delay decisions on product customization based on distinct demographic or cultural differences. In the end, product moves less frequently, transportation costs are reduced and the product is packaged closer to the local distribution points and the end consumer.

## Strategy 2: Optimizing Secondary Packaging Locations

Warehouse club stores have long used customized displays and promotional packaging as merchandising tactics to attract customers. However, this strategy has proliferated as major retailers are increasing their use of customized packaging, product sizes and promotional bundles to differentiate themselves in the marketplace.

With the rate of customization on the rise, secondary packaging has become an important competitive advantage in the FMCG supply chain, because it supports product promotions and provides the ability to vary pack sizes by repackaging finished goods into multipacks, assortments and bundles. Demographic-based customization also provides FMCG manufacturers an opportunity to compete against private labels by assembling like products in more appealing value or combination packs to create increased shelf differentiation.

The secondary packaging process can be inefficient and costly, since many manufacturers ship product out to co-packers for customization, which then ship it back to the plant or a distribution center. For these companies, consolidating secondary packaging operations into an existing facility allows them to postpone customization closer to consumption and avoid adding steps and time to the production process. This helps reduce order lead times, avoid carrying unnecessary inventory, enables just-in-time shipment of floor-ready displays and products for advertised promotions, and can result in less SKU and material obsolescence.

### Campus Operations

A typical campus site operated by a 3PL encompasses numerous facilities that offer dedicated and shared use space. Located near intermodal hubs and staffed with administrative as well as facility support personnel, these sites offer a full range of transportation, warehousing and packaging services to multiple customers.

*See Figure 2*

Co-locating secondary packaging in an existing distribution or manufacturing location also eliminates transportation to and from the co-packer, reducing carbon emissions, minimizing transportation costs and eliminating potential product damage. Additional overhead cost savings can be achieved through improved facility use and eliminating resource redundancy, particularly in campus operations where trained labor is readily available to support special projects. By using resources from within the campus, the manufacturer can avoid maintaining extra staff to support co-pack projects or hiring less productive temporary labor. In addition, product security and visibility can be better controlled when product moves less frequently, particularly in emerging markets where counterfeiting and theft are growing concerns.

## Strategy 3: Regionalization of Distribution Networks

In mature and emerging markets, many of the top FMCG manufacturers have moved away from a centralized distribution model in favor of a regional distribution center (RDC) network or cross-dock network that positions product closer to customers. This strategy enables shorter order lead times, which allows retail customers to respond quicker to fluctuating consumer demand. It also reduces retail store inventory, product obsolescence and security burdens that come with managing large volumes of product in some regions.

Manufacturers can reduce both inbound and outbound transportation costs by locating RDCs or cross-docks near the plant or in campus operations that provide access to intermodal facilities. Campus-based sites also offer additional

space, flexible labor availability and the opportunity for multi-manufacturer collaboration for shared warehousing and transportation, as shown in Figure 2.

While some FMCG companies already have RDC networks in place, the existing locations may be the result of acquisitions or facilities built for distinct product lines. These companies may consolidate into fewer, larger RDCs in more strategic locations for greater efficiency and savings.

## Strategy 4: Horizontal Collaboration

Horizontal supply chain collaboration among FMCG manufacturers involves sharing warehouse space and/or consolidating smaller shipments of multiple manufacturers into more economical truckload shipments going to the same retail customer. In many emerging markets, collaboration is a cost-efficient way to establish and serve remote areas that have low population density or infrastructure challenges. And in mature markets, it can help meet the demands of the retailer as order and shipment sizes shrink.

> "Collaboration is a challenge in most markets. Everyone seems positive about the idea, but bringing it to practice and gaining benefits are difficult. We need trust and efficient solutions to make it work."
>
> *Source: FMCG Manufacturer, Europe*

This type of strategic collaboration between FMCG manufacturers to reduce costs and improve efficiencies is an idea that has been around for some time. However, competitive concerns as well as cost- and savings-sharing complexities have stalled progress.

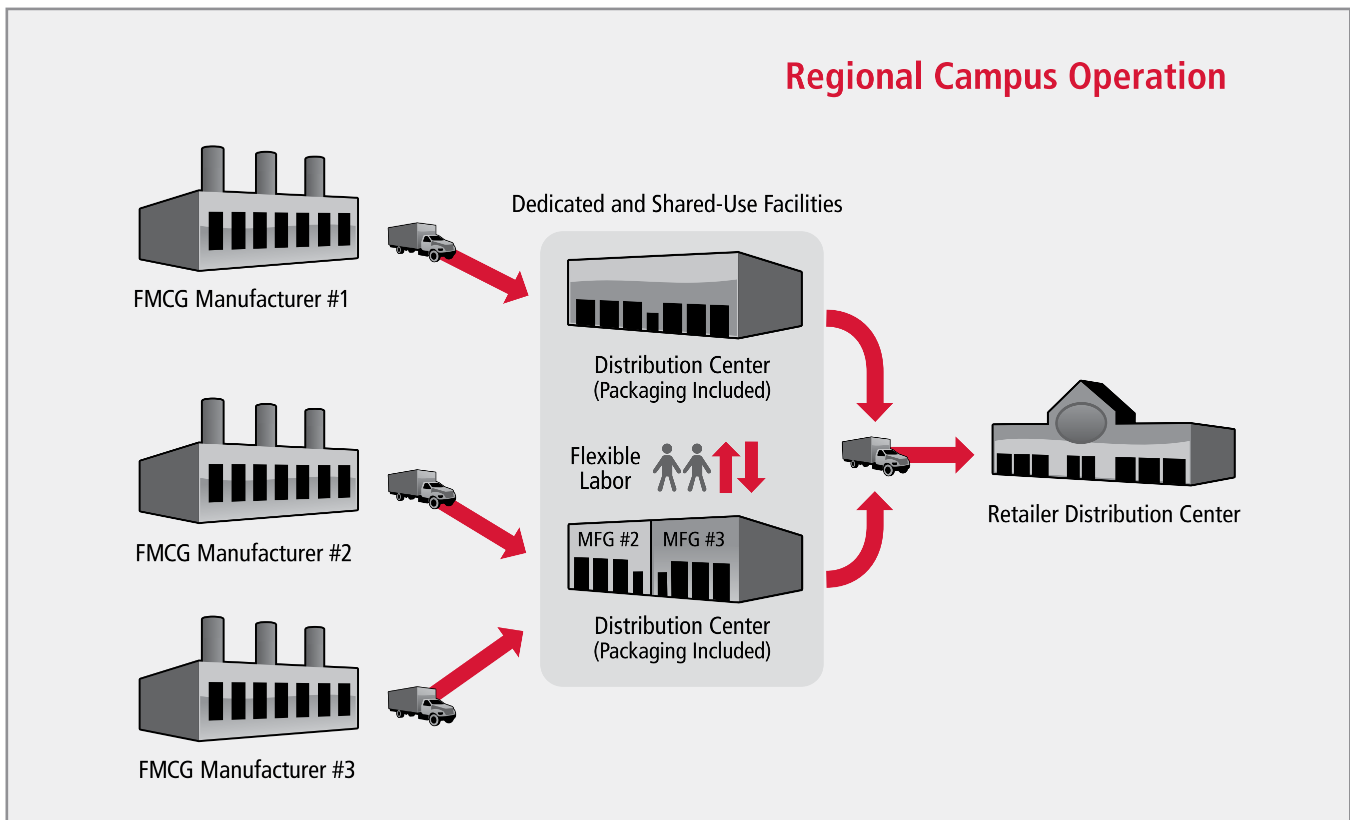


Figure 2

Manufacturers across the world are now looking seriously at collaboration as a way to drive supply chain efficiencies, share costs and reduce carbon emissions in support of sustainability strategies.

A first area of focus is typically collaborative freight consolidation. Manufacturers can save significant costs on the smaller, more frequent deliveries that retailers are increasingly demanding – or in emerging markets where stores have less shelf space and consumer demand is still building.

Shared warehousing provides each manufacturer flexibility, because space can be configured to meet fluctuations in demand, which results in greater optimization of assets.

Value-added services such as packaging, consolidation and merge-in-transit can also be provided. The cross-docking capability is particularly beneficial for manufacturers that fulfill retail orders from multiple plants in smaller quantities. By merging shipments at the cross-docks, manufacturers reduce transportation costs and decrease stock transfers while retailers achieve receiving synergies.

**Store-Ready Pallets**

Pallets created by product category (e.g. health and beauty) can be assembled at cross-dock locations prior to store delivery. These store-ready pallets contain products from multiple manufacturers for reduced freight costs and improved receiving synergies at the retail outlet.

With enough volume and coordination, "store-ready" pallets can be built. This decreases retail receiving costs by allowing shipments to bypass the retail DC and be delivered in truckload quantities directly to the store.

Collaboration can also be a particularly effective strategy for mid-sized manufacturers that struggle to meet retailer requirements without incurring additional costs. Collaboration offers the economies of scale needed to procure flexible storage, packaging and transportation solutions.

## Integrating Strategies for a More Streamlined Supply Chain

With the new reality of smaller, more frequent shipments, shorter lead times and fluctuating economic conditions, price-driven logistics decisions that do not anticipate and support quick response to consumer and retailer expectations can do more harm than good.

Traditional approaches of bidding out individual locations or services can take costs out of the business in the short term and offer immediate business impact. However, in the long term, managing multiple suppliers with limited integration and connectivity can result in additional administrative costs and inefficiencies.

A recent industry report calculated that logistics costs alone consume, on average, 6.8% of a FMCG manufacturer's annual sales.

*Source: The GMA logistics benchmark report, March 2010*

In emerging markets where securing accurate cost, service and product data is already challenging, buying transportation, warehousing, packaging and other services separately creates even greater inventory and visibility challenges. And with multiple suppliers, trying to apply standard operating procedures or trace product damages becomes increasingly difficult.

In the end, if products are moving more frequently or service levels cannot be met due to the longer lead time required to make extra moves between manufacturing, packaging and distribution partners, the impact may be higher total landed costs and lost sales for both FMCG manufacturers and retailers. Figure 3 illustrates a streamlined supply chain network.

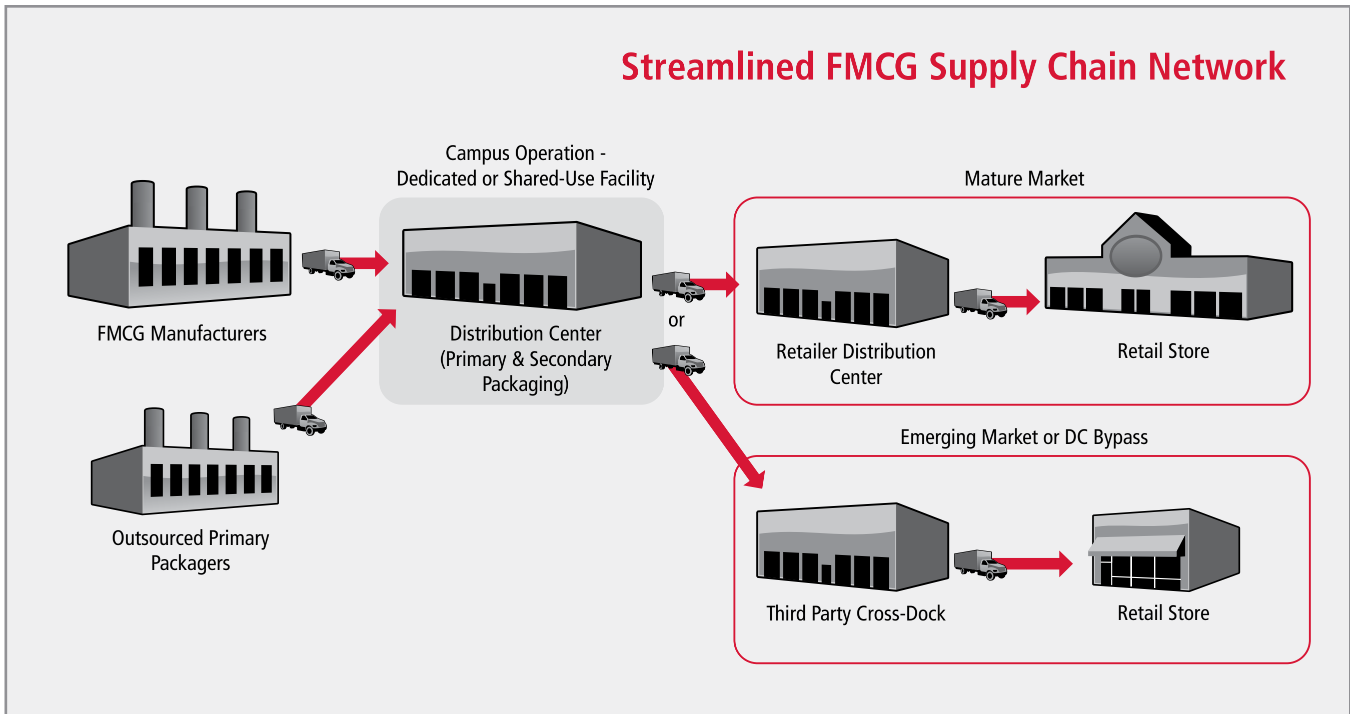


Figure 3

## Strategic Role of Third-Party Supply Chain Partners

Achieving optimal efficiency takes knowledge and control over all the moving parts of a supply chain. Having a partner with the knowledge and the resources available to support these challenges is critical to achieving sales and profit goals, particularly in emerging markets where experience with local customs and business practices can make a difference.

A third-party logistics provider that can offer network design and optimization, primary and secondary packaging support, campus-based warehouse and transportation solutions, labor management, real estate services, regional expertise, and collaboration opportunities will be equipped to deliver the service, flexibility and value needed to remain competitive in any market.

These providers can also offer the visibility and control needed to better understand and manage the increasing costs to serve both retailers and consumers, supporting long-term sales and profitability goals that reach far beyond the supply chain.

## Conclusion

The consumer dynamics created in both developed and emerging markets by the global economic crisis are likely here to stay. As retail channels proliferate and retailers mount new strategies to capture market share and extend geographic reach, FMCG manufacturers need more flexible supply chain solutions that better position them to capitalize on new revenue and market share growth opportunities.

The supply chain strategies outlined in this white paper not only deliver the flexibility and cost efficiency dynamic retail channels demand, but also create the foundation for improvements in quality and service that lead to a more sustainable competitive position.

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For more information about DHL Supply Chain's solutions for the consumer sector visit: www.dhl.com/consumersolutions.

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