

Retail and Consumer Worlds

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On the economic front, I'm sure most of us were not sorry to say good-bye to 2008. But will 2009 prove to be any better? The economic forecast is "mostly cloudy", but there will certainly be rays of sunshine here and there. Two rays of sunshine may turn out to be China and India, where forecasters predict 5-7% GDP growth this year.

Our focus in this issue is on the economy, its impacts on the retail and consumer goods sector, and ideas for coping with the crisis. Inside you'll find a kick-off interview with the Economist Intelligence Unit on the outlook for 2009 in global markets and in the retail and consumer goods sector.

On the emerging markets front, you'll also learn why Brazil is weathering the financial storms in reasonably good shape – with several major retail chains going forward with pre-existing expansion plans.

Keeping a watchful eye on the key elements of your business is critical at any time – and even more so in today's turbulent times. You'll find suggestions inside for improving operational efficiencies and reducing costs. In times of uncertainty managing suppliers becomes ever more critical – and this issue offers a number of suggestions for reducing supply chain risk, as well.

Interested in the European retail and consumer goods sector? You'll find an article discussing why investors look favourably on the European markets – and one focusing on HR trends in the sector.

We have indeed entered into difficult times. During these times it makes sense to revisit fundamentals and reaffirm core values. We'll all need to think smarter, work harder and be courageous in order to make a step change. Tough times often bring out the best in us, so that we are more equipped to build sustainable businesses. To this end, I am pleased to note that 2009 marked the 18th anniversary of this publication.

Regards,



Carrie Yu
Global Retail & Consumer Leader



A global economic outlook: The Economist Intelligence Unit on 2009, world markets and the picture for retail and consumer goods companies

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The Economist Intelligence Unit is a leading research and advisory firm with more than 40 offices worldwide. Founded in 1946, the organisation provides country, industry and management analysis to decision-makers around the world.

With the global economy in free fall and business confidence taking a beating, we talked with the Economist Intelligence Unit (EIU) about what to expect in the coming year. The upshot? Don't expect any quick fixes.

PwC: Now that it is official that the US is in recession, what are you expecting on the economic horizon for the US in the next 12 to 24 months?

EIU: The US economy is in something close to free-fall. Every major element of the domestic economy—consumer spending, car sales, factory orders, industrial production, business investment and, most importantly, jobs—is spiraling downward. The crash of equity prices has seriously eroded the savings and retirement funds of American households, and nearly one in ten homeowners is facing serious financial stress. Bank lending remains largely frozen and is likely to remain so well into 2010. The government has already signaled that it will support the financial system, but its stimulus packages will not do much to boost the real economy. Even a major further stimulus package, already factored into our forecast, cannot prevent a substantial economic contraction in 2009—we are forecasting a contraction of 2%.

President Barack Obama is introducing a massive stimulus package and a plan of the size now under discussion – US\$500-700bn – could cushion the economy. But much will depend on how and when the money is spent. Even if hundreds of thousands of jobs can be created, the income earned may not be quickly or readily spent because of the huge losses most Americans have had to absorb from the falling prices of equities and homes.

PwC: What are the likely policy priorities the new US President will have to revive the US economy?

EIU: The stimulus plan being talked about by Mr. Obama would mimic the programmes engineered by Franklin Roosevelt in the 1930s, focusing on public works and other infrastructure projects. Mr. Obama is looking not only to jumpstart economic growth but also to “put a down payment on” the longer-term goals that were the basis of his campaign. As well as infrastructure, he will focus on job creation (to the tune of 2.5m jobs over the two years), and also on tax relief for lower- and middle-income earners, and the promotion of use of energy alternatives and environmentally-friendly technologies. The biggest difference from past programmes is that this one will concentrate more on environmentally-sensitive initiatives—for example, equipping schools, public buildings and other facilities with energy-saving technologies and helping industry, including car companies, to build more fuel-efficient products.

PwC: The G20 includes most of the world's largest national economies and the EU. In your view, can the G20 reshape global finance and the economy?

EIU: Probably not. There are too many cooks, too many differences of opinion and too big a divergence in terms of long-term strategic goals for there to be any meaningful agreement on a global financial roadmap. Nonetheless, the summit held in November in Washington does point towards more inclusive global policy formulation, and there is perhaps scope for a G8 +5 forum, comprising the G8 countries plus China, India, Brazil, Mexico and South Africa, which could make a more credible decision-making body than the unwieldy G20.

PwC: What's your prediction for the emerging markets economies? The Asia economies seem to be in better shape than they were a decade ago. What do you foresee in terms of a slowdown? Which countries or areas of the world do you think are most vulnerable?

EIU: Emerging markets have not yet felt the full impact of the global crisis, but they are beginning to suffer. Some, notably in Eastern Europe, rely on external financing that has now dried up. Others will be hit by falling demand for their exports (we forecast that global trade will contract by 1.5%), which are an important driver of investment and employment, and by falling commodity prices. Of the 30 largest emerging markets, we think there is an 80% chance of at least five experiencing an economic contraction in 2009. We also think there is a 50% probability of at least ten countries suffering the same fate, while the chance of 15 countries suffering declines in GDP is 30%. Likely candidates for economic contraction include South Korea, Ukraine and the United Arab Emirates. The risk of foreign payments crises has also increased sharply. Many emerging markets countries—including India and China—have huge war chests of foreign reserves and are much better prepared for the current crisis than the last one. However, reserves can be depleted surprisingly quickly with an external shock as massive as the current one.

Emerging Asia will remain the world's fastest-growing region over the next two years, but its trade dependence will put it most at risk from recession in the developed world, notably the US. The central and eastern Europe region will be hit hard by the weakening of demand in the euro area, to which it is exposed in terms of export and investment inflows. There could be further economic crises in the region, in addition to those already seen in Hungary and Ukraine—the Baltics and the Balkans both look vulnerable. Major oil-exporting countries of the Commonwealth of Independent States (CIS) and Middle

East and North Africa (MENA), will see domestic demand growth stagnate in the face of collapsing oil prices. Sub-Saharan Africa is less vulnerable because it is less integrated in the global financial and commercial systems, but growth in South Africa, which has been driven largely by high commodity prices, will slow abruptly. Latin America is not as vulnerable to financial turmoil as it once was because of structural adjustments made in Brazil, its largest economy, but it will be adversely affected by the downturn in the US and the euro zone.

PwC: How concerned are you about short-term deflation? Are we on the verge of a major deflationary cycle?

EIU: It is almost certain that the recent fall in commodity prices will lead to one or several months of negative inflation in the US and euro area during 2009. In fact, this will be good for GDP growth in the main advanced economies as it will raise consumer purchasing power. We estimate that the chance of a more damaging episode of "proper" deflation—that is, with depressed demand leading to continuously falling consumer prices in year-on-year terms for more than 12 months—is 40%. This would reduce business revenues and salaries in nominal terms and would render outstanding debts even less affordable. Particularly if the trend towards declining prices became entrenched, this could seriously undermine growth prospects further ahead and lead to a performance similar to that of Japan during its infamous "lost decade". Policymakers are so anxious to head off the risk of deflation that they are injecting huge amounts of liquidity into the global financial system. This creates a separate risk that inflation will take off once economic growth recovers. We believe that policymakers will be able to mop up most of the excess liquidity relatively quickly, although the timing and scale of liquidity adjustment will be very difficult. Consequently, we still see a 20% chance of a surge in inflation to more than 4% in the US or Europe in 2011-13.

PwC: Retail and consumer goods companies are affected head on by the much-reduced consumption power. How are you seeing this sector reacting (i.e., reduced headcounts, cutbacks in ad expenditures, scalebacks in capital expenditure or acquisition plans)?

EIU: The most obvious sign of reduced consumption power has been the failure of several retail and consumer goods companies. US retailers such as Circuit City, Steve & Barry's, Linens N Things, Shoe Pavilion, KB Toys and Mervyns have already filed for bankruptcy protection, while Sears is under threat. In the UK, furniture and high-street retailers MFI and Woolworths have gone into administration while sports retailer JJB, among others, is struggling.

The pressures are also apparent in the restaurant and hotel business, where hundreds of businesses are closing, among them the parent company of Bennigan's Grill & Tavern and Steak and Ale. Even those businesses that are not shutting down are trimming their operations, with Office Depot (US) among those closing dozens of stores.

Partly as a result of this, job losses are increasing throughout the sector. US employment figures for November showed that the retail sector had lost 91,300 jobs, the biggest monthly loss since 1956. As well as redundancies, companies are reducing headcount in other ways, with widespread hiring freezes or a reliance on natural attrition.

The picture when it comes to mergers and acquisitions is more mixed, with some companies taking advantage of distress sales and reduced asset values to build up their own market presence. PepsiCo is typical – it has ruled out plans to buy US beverage businesses in favour of developing its own products, but is still eyeing opportunities in the snacks business. Indeed, the shifting strategies of many investment funds suggests 2009 will be a bumper year for M&A in the retail sector in terms of the number, if not the value, of sales.

PwC: What are the first signs of recovery you would expect to see, and when do you expect to start seeing them? What types of signs should businesses watch for?

EIU: Recovery from this crisis will be slower than that seen in either the 1991 or 2001 global recessions. We forecast global GDP to grow by just 1.5% in 2010. As this suggests, the first signs of recovery will be tentative, with a high chance of a relapse. Given the crisis started in the financial sector, all eyes will be watching there for signs of a return to normality. Any recovery will rely on the resumption of interbank lending, which will in turn allow retail banks to start increasing lending to consumers and businesses. This may lead to an increase in business activity, including mergers and acquisitions, in anticipation of a revival in retail markets. A sustained recovery in equity markets will also indicate a revival in business confidence, and will contribute to a rise in bank lending.

For a recovery in consumer confidence, the first indicator is likely to be the savings rate. We expect this to rise sharply in 2009, particularly in countries with a high debt/income ratio such as the UK and Australia. Once the rate stabilises, this will suggest that consumers are once again prepared to spend out of income, though they are likely to remain cautious about taking on new debt. A revival of housing markets is unlikely to take hold for years, but confidence will start to return once the nominal value of

houses stabilises. A recovery of world trade will be another important indicator, suggesting that demand is recovering in some markets, with spillover effects for others.

Nevertheless, many of the most serious problems in the real economy – including job losses and wage stagnation – will continue for up to two years after the financial sector starts to recover. This, along with the lessons learned from the crisis, will dampen consumer confidence well into the next decade.

PwC: While executives around the world expect 2009 to open with a global recession and continuing volatility in equity markets, some are finding opportunities amid the broad pessimistic economic trends. In your view, how can retail and consumer goods companies turn the crisis to their advantage?

EIU: The accepted wisdom is that during recessions consumers cut back spending on non-essential items, while continuing to spend on essentials such as food. So far, the experience of food producers is bearing this out. Revenues at Switzerland's Nestle, for example, are still outstripping forecasts, while France's Danone is faring even better. These companies are also benefiting from a fall in commodity prices. More surprisingly, alcohol and tobacco remain on the list of consumer priorities, with good results from producers such as SAB Miller and Imperial Tobacco (UK) suggesting that consumers are prepared to continue spending on small sins, particularly those that can replace a night out.

Even for some non-essentials, consumer spending is proving more resilient and less predictable than expected. For example, small, long-lasting items like books had been seen as vulnerable to a spending downturn, but Amazon (US) is one of many companies reporting surprisingly buoyant sales. CD and DVD sales are down, but largely thanks to internet piracy rather than lack of demand. Genuine innovations will push sales of higher-priced goods, too, though at a slower pace than before.

Despite this, pricing pressures are increasing as consumers seek to pay down debt and increase savings. In the supermarket sector, this is playing into the hands of discounters such as Germany's Aldi and Lidl or Costco of the US. Mainstream supermarkets with the clout to negotiate good supply deals and cut prices, including Wal-Mart (US) and Tesco (UK), are also seeing a rise in sales.

As a result of all these factors, the global retail and consumer goods sectors will see consolidation – to the benefit of those players with strong cash flow or those that managed to secure relatively cheap financing deals before credit started to dry up in mid-2007. Those with strong finances and good bargaining clout can use this to renegotiate supply deals, hold down prices, and secure customer loyalty. Strong players will also be able to use the collapse in advertising markets to push their own message through, while investment in technology and logistics will give a good basis for organic growth, particularly in the crucial first months of the recovery.

In the realm of mergers and acquisitions, meanwhile, private equity funds and other investors are already finding it hard to secure financing for deals, and this will continue for the next two years at least. Stock market prices have also fallen. Those players with cash to spare – including global retailers such as Tesco and Wal-Mart – will therefore find potential acquisition targets cheaper in both developed and developing markets, allowing them to secure market positions in time for a recovery.

Another set of beneficiaries could come from emerging markets. Some ambitious companies, such as India's Tata Motors, are suffering with the downturn and difficulty in securing financing. But others are poised to benefit from an increased focus on price in both developed and emerging markets, with low wage costs allowing them to undercut more established rivals.



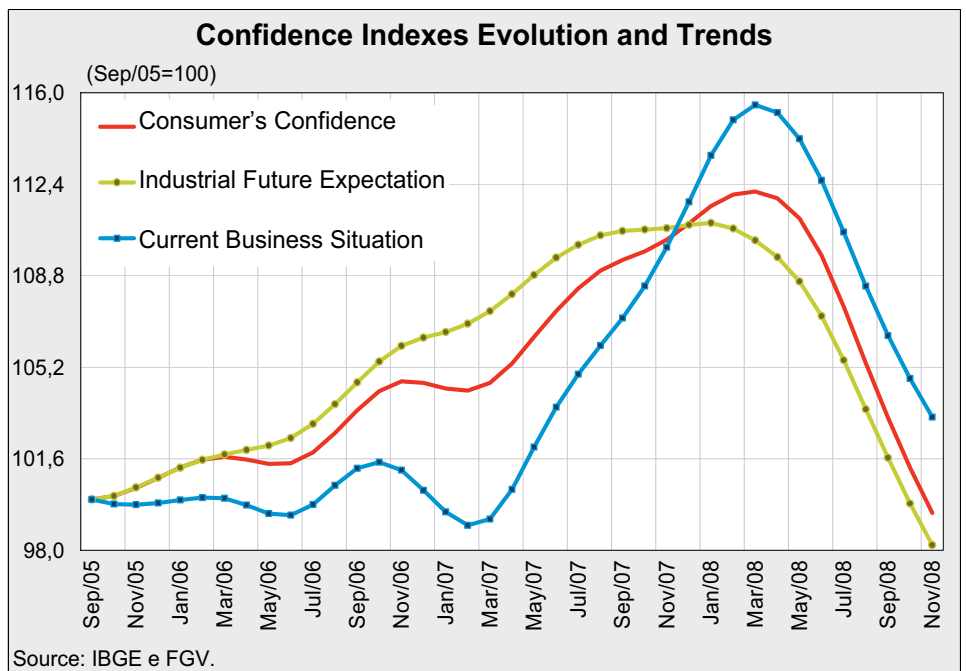
Brazil's retail and consumer sector well set to ride out the economic crisis



With a strong track record of growth so far this year, good exchange reserve levels and confirmed expansion investment plans by players in the retail and consumer goods sector, Brazil looks to be in comparatively good shape to weather the current economic storms.

Within the context of the world's financial and credit crisis, what impacts will be felt by Brazil – an emerging economy that has recorded solid growth rates in recent years? What will be the effects on the financial markets – stock markets, interest rates and currency exchange rates? Beyond that, what about the more tangible consequences on people's lives? How will prices, consumption, production and jobs be affected?

Some of the indexes published in the last half of 2008 have already hinted at part of this impact, as shown in the associated graph. At first there was a substantial reduction in consumer confidence, which slipped 5% in November, in comparison with October, after declining 12.7% the previous month. This was the lowest rate since the FGV-devised Consumer Confidence Index first came out in September 2005. On the other hand, pessimistic expectations about industrial activity in the next few months were most widely felt in November, when the Industrial Confidence Index, also measured by the FGV, dropped 19.4% between October and November, reaching its lowest level since July 2003, considering seasonally adjusted data. Another index that retreated substantially was purchase intent for deseasonalised durable goods, which fell 9.6% in November, dropping to its lowest level since December 2005.



This erosion of consumer confidence partially reflects the concerns about the future expressed recently by business news and financial market analysts and is primarily a consequence of the effects of the crisis on credit markets. Credit conditions have deteriorated noticeably in Brazil in seasonally adjusted and deflated (discounting inflation) terms. The granting of credit to private individuals and companies in October, compared to September, fell back 3.6% and 4.2%, respectively. Conversely, in deseasonalised and deflated terms, the granting of credit to private individuals hit the same level recorded in December 2006. That is to say, credit became more scarce and therefore more costly – a trend which is expected to continue in the next few months.

As a result, the effects of the international financial crisis have already started to ricochet through Brazil's real economy. Credit has been an important engine of the economy until now, driving the purchase of durable goods (cars and consumer electronics) and real-estate, which in turn drove production, investment, hiring, payroll increases, and came around again to drive consumption. Now that the dynamic core source of the economy has practically dried up, we can expect exactly the same movements, but in reverse. That is to say, a reduction in demand due to more restricted and expensive credit will lead to a reduction in production, which in turn will lead to reduced hiring (or dismissals) and smaller investments. At first, the dollar appreciation relative to all other world currencies (including the Brazilian

Real) will cause an upward impact on prices, compensated partially in the short term by the reduction in international commodity prices. In the mid term, the pace of depressed economic activity will greatly repress the drive to hike prices, thus bringing prices under control.

So what effects will this have on the retail and consumer sector? Initially, durable consumer goods will be the hardest hit; nevertheless, as the real economy starts to slow down and this reflects on jobs and income, the consumption of semi- and non-durable goods will start to be affected. Supermarkets are expected to outperform other commercial establishments on average in 2009, but we will be far from matching the good performance levels achieved in 2008. Sinking confidence makes consumers seek to save more than consume, leading not just to purchasing less, but also to reducing the average amounts spent. That lack of confidence will also lead to a continuous accommodation of stock volume and an ongoing renegotiation of prices and terms with suppliers, so that lower inventory costs can be passed on as quickly as possible.

Offsetting this process are factors such as Brazil's good economic growth level in 2008 – nearly 6% GDP growth in the third quarter; the country's good exchange reserve level, totaling roughly US\$ 200 billion; and a financial system with relatively low leverage and default rates with solid, large public and private banks. These factors place Brazil in a better position to face the crisis, in relation to other emerging world economies. Some of the measures recently adopted by the Brazilian government to incentivise credit and reduce both the tax burden on durable goods (especially cars) and personal income tax are expected to buffer the drop in sales volume in the economy and its respective slowdown.

Some retail and consumer companies have confirmed their intention to maintain already-announced expansion investments in 2009, believing this is their opportunity to gain market share against weaker competitors – or be better positioned when exiting the downward cycle. Major Brazilian national retail chains such as Casas Bahia, Magazine Luiza and Grupo Pão de Açúcar have publicly confirmed expansion

investments which had already been announced before the crisis. Global retail and consumer goods multinationals present in Brazil have been quieter than their national counterparts. Some of the strategic initiatives being contemplated by the most dynamic companies include acquiring weaker players, switching to a cheaper product mix to offer consumers lower ticket options, and improving performance through cost reduction initiatives such as renegotiating contracts and optimising supply chains.

The Brazilian economy, particularly the retail and consumer sector, will not pass the crisis unscathed. Nevertheless, in comparison with other emerging world economies, Brazil finds itself in one of the best situations not just to face the crisis, but also to promptly exit the cycle of the coming recession.



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Improve your business focus to survive a downturn



In a market downturn, keeping your eye on the key elements of your business is more important than ever. Companies that are prepared and can act quickly and decisively will be the post-recession winners.

The management challenge

Fears of a recession have now become harsh reality, with many retail and consumer goods companies already experiencing declining sales and profits. A recession isn't necessarily all doom and gloom, however: there will be winners as well as losers.

Experience from previous recessions indicates that many companies that were bottom quartile performers going into the recession will emerge as top quartile performers coming out.

How to ensure your business survives and prospers? Plan early and keep a steady focus on your business's critical success factors.

Retail CEOs are increasingly asking the following questions:

Is our market position clearly differentiated? Is our position being eroded by competitors and new market entrants? What actions can we take to ensure market differentiation?

Is our price range architecture competitive in attracting new customers and retaining existing ones?

Are we optimising our space range allocation? Are we allocating too much space to low-importance, low-profit products at the expense of key brands? Can we reallocate space to improve profitability?

Are we successfully executing key customer service, promotional and availability initiatives in store?

A leading UK grocer found that it was identifying hundreds of store improvement initiatives annually, but central store support lacked the process to prioritise, and stores were overburdened with too many poorly-planned initiatives. By developing more robust screening mechanisms and a business case for initiatives, the company was able to focus on those that would best drive customer satisfaction and product sales. They also implemented a new process to trail and refine initiatives prior to national rollout. The impact was a more motivated shop floor staff and better-executed initiatives. The company significantly increased market share, and shopper research indicated that a key reason was the improved service and environment.

Are our store locations and formats competitive?

Do we operate in overcompeted market areas? Are we underrepresented in key formats? Should we divest underperforming/over competed stores?

Are our staffing levels productive? Are they aligned to meet peaks and troughs of customer demand and footfall? Can we rebalance back of store to store floor?

Are we getting trade terms from our suppliers that are as good as our competitors get?

In the UK grocery sector, for example, there is a wide disparity in discounts and payments offered by suppliers to key accounts. Although 30 days is perceived as standard payment terms many grocers are demanding and receiving up to 60 days. Payment days and rebates have a very significant impact on working capital and cash flow.

Consumer goods CEOs are increasingly asking the following questions:

Are we overly dependent on too few large customers?

What is the potential impact on our business of losing some of these customers? What actions can we take to mitigate this risk?

Are we overly dependent on own label? Do we have strategies and plans in place to move to more value-added and brand products?

Are our customer trade terms becoming more onerous? Are we actively seeking to manage and renegotiate terms?

Can we better manage our product range to improve profitability? Do we understand which of our products are most profitable? Do we have a long tail of unprofitable stock keeping units (SKUs)? Can we reprice or eliminate poor performing SKUs to improve profitability?

Consumer goods companies have significantly increased the number of products and SKUs they take to market. We find that when allocating all relevant costs (i.e., manufacturing, packaging, logistics, order processing) at SKU level, up to 30% are loss-making. Eliminating loss-making SKUs can deliver many benefits.

A foodservice company embarked on a significant SKU rationalisation programme with the goal of increasing margins by 1%. Improvements included reducing procurement and warehousing costs, wastage, packaging materials and working capital via inventory reduction. The decrease in sales was more than offset by increased production capacity for more profitable new products and selected brand extensions.



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Are trade promotions effectively targeted and managed? Consumer products companies' trade promotion expenditures have significantly increased over the past decade and now typically account for about 25% of revenue. Our experience indicates that up to 75% of promotions lose money and fail to grow long-term sales.

Promotions also complicate and reduce forecasting accuracy and add significant complexity and costs, particularly in terms of production (special packs) and sales time and effort. Consumer goods companies need to reevaluate how trade funds are allocated and managed by category, promotional mechanism and trade account.

A snack food manufacturer carried out a major review of its trade promotions programme with its partners. They jointly assessed the ROI of promotions such as buy one get one free, extra fill, and banded packs as well as the impact of in-store positioning. A collaborative effort to better target funds on the best-performing promotions increased ROI by 30%.

Can we better manage our customer portfolio to improve profitability? Do we understand who our most profitable customers are? Do we have a large number of unprofitable customers? Can we renegotiate prices and service levels to improve profitability? Factors that impact customer profitability include sales time and effort, trade terms, order frequency, special/bespoke products, production runs and special logistic and packaging arrangements. We typically find that when costs are fully allocated, up to 25% of customers are loss-making. Understanding customer profitability lets you develop alternate models – possibly new pricing, logistics or service levels – to reduce the “cost to serve” for unprofitable customers.

Summary

The downturn in the economy will result in increased competition for key customers. Companies will need to focus on improving operational efficiencies and reducing costs. Just as important is the need to have a clear and single-minded focus on key business drivers. CEOs need to pursue with a renewed emphasis initiatives that eliminate waste, duplication, non value-added activities and poor-performing assets. Increasing focus on initiatives that differentiate you in the market and having a clearer customer value proposition will make it easier for your customers to buy!



Managing supplier risks in an economic downturn



Do you know how your suppliers are doing? The answer to this question is critical to the integrity of any supply chain. Yet many companies don't know how suppliers run their businesses or whether they are in trouble. This is especially true in China and other emerging markets, but it is true in mature markets, as well. Given the recent economic downturn and resulting turmoil, every supply chain is at risk. These are dangerous times for supply chain managers.

Managing supply chain risk is a critical dimension of any supply chain manager's job. While price was the initial focus of most sourcing initiatives, recent attention has been on quality and supply chain integrity. The recent quality problems with milk products, toys and pet food were simply the most high-profile examples. But these problems were symptoms of much greater problems earlier in the supply chain – ones that originated with financial stress.

In fact, financial stress is one of the most common causes of supply chain quality disruption. Yet most supply chain managers have limited, if any, training in assessing the financial viability of suppliers, and data about financial performance can be relatively opaque and difficult to track. But now more than ever, understanding the full set of risks that impact the supply chain is critical – and that means procurement groups need to raise their game.

Supply chain managers can substantially reduce the risk in their supply chains if they adopt a more balanced and proactive view of what drives risk. Here are some suggestions:

- Understand which suppliers are most critical to maintaining ongoing operations. Often supplier development programmes focus too much on suppliers that have high spending volume and not enough on suppliers that may not be able to deliver on time.
- Know your suppliers. In China, many suppliers own disparate businesses – for instance, an auto parts supplier may have a legacy steel foundry and also real estate assets like hotels – which could increase their risk exposure.
- Focus on process and not an event. Risk mitigation should be incorporated in the sourcing strategy and qualification along with the traditional selection criteria: price, quality, delivery and design. Regular monitoring and a second source strategy are also necessary.

- Understand the manufacturing techniques and controls – don't just look at quality of delivered products. While quality checks are important, they are not a means to manage risk. By the time the checks are complete most of the costs are already embedded. Companies must reach further down into their supply chains with process-based quality programmes that ensure that risks and costs are eliminated before they occur.
- Make it your business to know your trading partners' supply chains and how they manage them. Too often, second and third tier suppliers are unknown and their activities even less transparent. How your suppliers manage their suppliers – how quickly they pay, how they are related, how they enforce quality and specifications – has a major impact on the extended supply chain and its risk.
- Structure all agreements in a way that reinforces the importance of transparency and measurement. Incorporate early warning systems. Just because it is harder in emerging markets does not mean it should be less important – just the opposite is true.
- Enhance the mandate and skill set of supply chain managers and organisations to focus on the full set of measurements that drive quality and integrity across the supply chain.

Although supply chain managers have been working on many of these pillars for decades, as supply chains become more global these become more complex and logistically difficult. Compounding this is the fact that sourcing offices in emerging markets rarely have capabilities as robust as necessary for their markets. The result is frequent surprises, reduced savings and high-profile failures.

Case Study:

Company A is a western multi-national with operations in China. They were surprised when Supplier X, a supplier of a key raw material, suddenly began to exhibit erratic delivery behaviours. After several efforts to get them to improve, Company A found that they had taken on excessive amounts of debt as a result of trying to acquire other companies.

Company A sent in a multi-disciplined team to see if they could stabilise their supply and found that debt was just one problem. The acquisitions had stretched the management team to its limits. They had also been diverting supplies of the raw material to another, larger company that was threatening to stop payment unless they improved their delivery performance. Company A bore the brunt of this diversion.

Company A's team began to work with their supplier's team and even had a discussion with the other customer. They helped put together a plan to speed up payments to Supplier X. They also moved from a purely order-based relationship to a planned volume and order basis to help Supplier X plan their resource needs better. In return for this Supplier X agreed to provide more regular financial updates and cooperate with reviews.

As companies and their supply chains become more global, more effort must be put to transforming supply chain organisations, their tools and their mandates. Here are some steps that global companies can take today to improve supply chain risk management:

Select the right suppliers

- Perform adequate levels of financial and operational due diligence based on the potential risk of the supplier and the commodity of product being sourced
- Do not rely on third party data sources for critical suppliers – obtain and validate all the relevant financial and other data
- Investigate their portfolio of customers and understand where you rank
- Investigate their suppliers and supplier management process and ensure that they reinforce your own principles of management and supply integrity

Improve supplier measurement and monitoring

- Develop a robust and risk-based supplier monitoring framework that leverages self-reporting, financial and operational data collection, industry information and on-site supplier reviews
- Analyse risk data against established limits and other industry warning signs
- Identify suppliers that are outside risk limits and enhance the monitoring process

Develop supplier development and contingency plans

- Based on the outcomes of the monitoring process, determine which suppliers need development and support programmes
- Perform targeted onsite financial reviews
- Advise suppliers on performance improvement initiatives
- Selectively provide financial support or modified terms of business
- Identify alternative supply sources if necessary

Develop a supplier workout approach

- Form a cross-functional workout team
- Perform on-site assessment
- Analyse strategic and financial alternatives
- Determine appropriate course of action (exit, workout, sale)
- Execute preferred course

The ever-increasing shift to global sourcing offers unique opportunities but also creates risks. Emerging market risks require careful management. Global transactions and product flows require constant tuning. Hence this new world order requires companies to review their dealings with global trading partners. Managed effectively, the rewards are great. Leaving the process unmanaged – or assuming that traditional techniques are sufficient – may well result in a very high-profile failure.



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European retail: A silver lining to the storm clouds?



M&A activity in the European¹ retail sector has been intense in recent years. Private equity investors have shown a strong interest in the sector and have been involved in 40% of deals. While investors' enthusiasm for retail is completely at a standstill due to the looming recession, we believe that compelling investment opportunities will emerge as the economic picture gets clearer. As this happens however, it will be more critical than ever that investors root investment decisions in a deep understanding of long-term market trends, locally and on a European scale. This will determine their ability to unlock value in the business and to have a well-thought-out exit strategy to realise the full potential of their investments.

Many factors suggest that European retail will remain attractive to investors once the recession bottoms out:

- Investors will be able to draw on a large pool of potential targets: 350 retailers with revenues over €200m in Europe, the great majority of whom are still under private or family ownership
- Some regions within Europe are still growing fast, albeit from a lower point, particularly Eastern Europe, Russia and Turkey
- Even during a consumer downturn, market discontinuities and the nature of retail businesses mean there will be winners and losers

A large pool of potential targets

Fragmentation

Retail is still fragmented, with the top 350 companies representing 50% of sales in Europe. There are some variations across sub-segments though, and grocery, home shopping and electricals are more consolidated than clothing, health and beauty or furniture. Compare this with automotive, where the top ten manufacturers hold a 78% market share on a global basis.

Local activity

Retail also remains a very “local” activity: 60% of the top European retailers operate solely in their home country. However, the largest players and particularly some sectors such as clothing have pursued rollouts on a cross-country basis over the last decade, and in due course this activity will resume.

More than 50% of the largest European retailers² are in private hands, often family owned. There is scope to improve operations, to focus more on profit and cash and to dare what previous owners may have never dared before: rationalise the store portfolio where it is not profitable and expand internationally. The approach has been developed and implemented in the past; there is a strong track record of retail businesses creating value under new ownership.

Private ownership

Some regions offer further growth prospects: While Western Europe may well be facing a recession, trends vary across the “greater European region”. It is highly diverse and must be seen as a set of local markets of various sizes, growth prospects and characteristics.

Within Western Europe alone, consumer habits and retail growth prospects differ widely. The largest Western economies are expected to experience a low growth, but should still drive 40% of total European retail absolute growth over the next five years due to their size, while Scandinavian countries and Greece show better growth prospects but are smaller markets. Significant structural or cultural differences exist, even between markets of similar size or growth: for example, the Greek retail market is highly fragmented while the Finnish one is the most concentrated Western retail market; online spending per capita is about twice as high in the UK as it is in Germany and France.

¹ defined as the European Union as well as Norway, Switzerland, Croatia, Russia and Turkey

² based on a sample of 190 large European retailers

Central and Eastern Europe too is far from being uniform. On a high level, a first distinction can be made between “first wave” Central Eastern European countries, i.e., countries that joined the EU in 2004 (Slovenia, Poland, Hungary, Slovakia, Czech Republic, Baltic countries) and “emerging countries” such as Russia, Turkey, and Bulgaria.

In the first wave countries, foreign players have already established a strong presence and consolidation is ongoing. Mid to high growth is expected, but the growth potential remains limited in absolute terms. Added together, the retail markets of these “first wave” Eastern Europe countries are still smaller than the Spanish retail market.

By contrast, emerging countries are in transition towards modern retailing and have a high growth potential that has so far been relatively untapped by foreign players. Russia and Turkey are both large retail markets with potential for fast growth, and hence attractive to potential investors. The transition towards modern retail opens opportunities for a buy and build strategy, store roll-out and operational improvements, while the limited presence but strong interest from foreign retailers should provide exit opportunities. However, investments in these geographies are not exempt of risks: political uncertainties remain, inflation is less controlled, currency exchange rates are unstable and, for example, tax risk is a real issue in Russia.

Market discontinuities, winning players and formats

The various retail sub-segments (i.e., grocery, clothing) are expected to grow at broadly similar rates, ranging from 1% to 4% at a European level. This suggests that no sub-segment should be ‘a priori’ excluded from a first investment screening, but also that there is no obvious faster-growing sector to focus on. Opportunities will arise driven by underlying trends that may apply in any sub-segment. The key to success will be to anticipate trends and to take advantage of them.

Online and multi-channel

Technological changes made the development of the online channel possible. The development of online and multi-channel strategies has a long way to go in many countries, and we will see waves of growth driven, inter alia, by broadband penetration, consumer experience and retailer investment.

Sustainability

Changes in consumer lifestyle led to increased demand for convenience or healthy and sustainable products. While some believe this will remain a niche development for affluent, sustainability-conscious consumers, we believe this trend will be one to count with over the next decades, and that we are just seeing the tip of the iceberg.

Discounting in food and non-food

The rise of the discount format offers another example of a nascent trend to capitalise on. First introduced by food retailers in Germany, discounting is rapidly spreading throughout Europe. Retailers understanding this format’s development pattern and potential by country are well positioned to outperform. Even bigger rewards may await players that expand and refine the format: discounting has been used mainly by food retailers so far but can be successfully rolled out to other segments, as illustrated by the strong growth of For You, the first discount chain of personal care products to be introduced in Turkey. Enhancing store environment and quality of offering could also contribute to widening this format’s appeal.

Deregulation

While retail overall is not highly regulated, we anticipate substantial regulatory changes driven by the EU’s push for greater harmonisation in the pharmacy and health and beauty segment. While the timelines may be long, the expected changes are likely to be significant and will create challenges for the sector, as well as opportunities.

All retailers will need to adapt to changes to survive, but the real winners will be those able to identify nascent trends early on, to shape them and to expand them either geographically or in terms of format/products. This requires a good understanding of development cycles and where various countries and formats are within this development cycle. Discontinuities can yield significant returns for investors who have anticipated them.

Finally, as in any investment, company-specific criteria come into play. Investors will look for retailers where they can unlock value through improving operations, refining propositions or rolling out stores. These potential deal rationales will have to be considered in relation to the wider external environment, which determines exit opportunities: for example, large retailers looking to expand internationally may be natural trade buyers.

The worldwide slowdown, credit crunch and recession in the most developed markets all mean that things are slow on the high street currently. However, this will mean opportunity to the most savvy corporate and financial acquirers and, in due course, we will see significant new activity in this sector – all across Europe.



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European survey highlights HR function



The European retail sector human resource function is most often focused on satisfying business needs, rather than the needs of the employee, according to a recent PwC survey entitled *Living a Brand Experience through Employees: Benchmarking Human Resource Practices and Policies in the Retail Sector within Europe*. Is it time for a change?

To adapt to the changes taking place in the market and to satisfy the needs and desires of customers, retailers and distributors alike have had to change. That change has impacted retail employees, who are not only expected to perform standard sales functions but also to transmit the brand value. At the same time, the sector is confronted with workforce challenges such as labour conflicts, absenteeism, and changing work values. All this poses significant challenges for human resource management, which is charged with finding innovative ways to engage people in the company in the interests of attracting and retaining talent and generating brand loyalty.

So what are management's top concerns? The top three workforce issues mentioned by survey respondents are: retaining talent (49%), attracting talent (48%) and managing performance (42%). When the organisations were asked whether they had a defined plan for human resource management, a resounding 91% indicated that they do – and that their top priorities include company values (83%), company mission (79%), and strategic business plan (76%). Human resources efforts are focused on succession planning and other activities primarily related to the company's concerns; however, employee needs, such as work-life balance, only figured into the human resource management plans in 21% of cases. Considering the workforce challenges mentioned earlier – as well as the fact that in many cases the retail employee is the face of the company to the customer – the time may be right to shift focus in the direction of employee satisfaction.

Recruitment methods among our survey respondents are fairly conventional. In almost 65% of cases there was no group interaction; in 39% no assessment center was used and in 35% no personality test conducted. In a sales-oriented job, exposing candidates to real situations and analysing their behaviour would seem most effective;

however, 82% of the organisations surveyed still use internal, individual interviews with candidates. Similarly, companies are not very advanced when it comes to delivery of training. Only 32% of companies have a flexible training programme in place in which employees can select their own content and source.

ROI metrics not common

When it comes to employing human resources metrics, participating companies mentioned budget control (91%), assessing and monitoring employee productivity (58%), and workforce planning (56%) as major motivations. Surprisingly, financial indicators, such as the calculation of the ROI related to human resources, were not seen by many as important (16%). Among most of the companies these metrics are either not used or are restricted to only a few areas of human resource management. The metric most commonly implemented is productivity and value-added (41%) – but only 44% of those companies consider it effective. Even in areas like succession planning, which respondents thought important (51%), only 21% of companies had implemented their metrics.

“There are several approaches to valuing human capital; some focus on qualitative factors and conclusions and others on quantitative measures. A profound and meaningful valuation approach should produce a monetary measure which includes an in-depth analysis of company cash flows and associated opportunities and risks.”

– Jutta Menninger, advisory partner, valuation & strategy practice, PricewaterhouseCoopers Germany

European retail companies are just beginning to understand the important role that employees play in creating competitive and brand advantage, the variety of tools available, and the importance of metrics. The human resource function can play a key role as a strategic partner in providing value to employees and thereby contribute to supporting the business strategy.

Congratulations to the winners of our Olympics trivia quiz in the July 2008 issue. Each winner received an Olympics-themed leather portfolio.

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Mattel
Australia

Daan Koning

PricewaterhouseCoopers
Netherlands

Heikki Kemola

Kesko
Finland

Gilberto Vianna

PricewaterhouseCoopers
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