From Conflict to Cash Flow:

Why a Retailer-Supplier Truce on Margin Split Disputes Makes Dollars and Sense

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By Vish Sharma, Vivek Narasimhan, and Shannon Kollasch

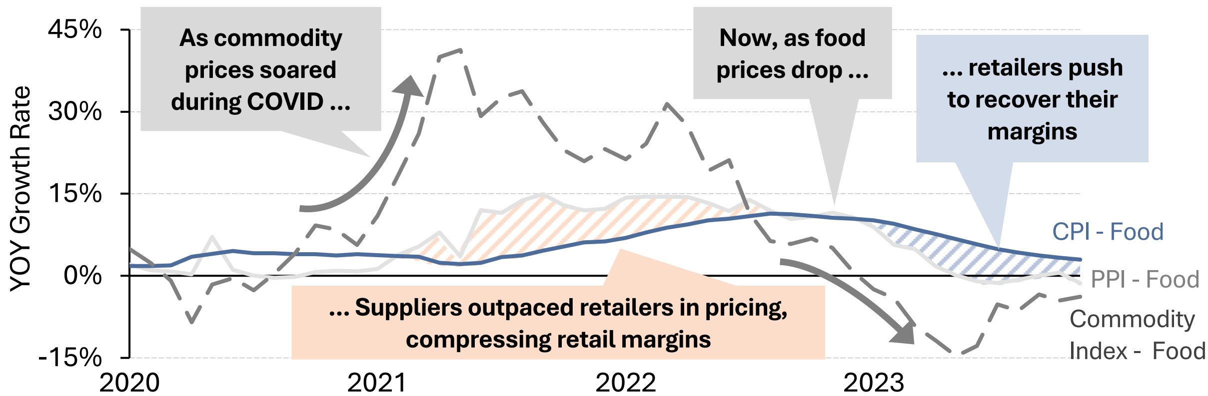
Summary: *After a recent inflationary period, consumers have tightened their belts. This has created upstream tension between retailers and suppliers over margin sharing arrangements. We suggest that while margin splits are an important point of contention, there is a bigger opportunity: suppliers and retailers can collaborate to grow overall consumer spend.*

Inflation is receding, but consumers are still uncertain

As COVID-19 began receding in 2022, inflation scorched U.S. consumers. At its peak, **the U.S. inflation rate soared to 9.1%** - the highest it had been since November 1981. Of late, however, the outlook has improved from a consumer perspective. As of January 2024, the CPI has fallen to 3.1%, inching closer to the Federal Reserve's target of 2%. However, this reduction in inflation has not translated to growth acceleration. Indeed, while the retail spending this holiday season grew 3.1%, this is a slowdown compared to what we saw during the pandemic (5.4% a year ago and 12.7% two years ago)[1,2]. As we detail below, this has adversely impacted the **supplier & retailer relationship.**

Conservative retailers, Vulnerable suppliers

During the pandemic, surging commodity prices and supply chain logjams led to producers taking higher price increases relative to retailers. Meanwhile, retailers were focused on managing surging consumer demand. Now, as we cycle through post-COVID recovery, consumer belt tightening and decreasing commodity prices have opened the gateway for retailers to revisit margin sharing agreements with suppliers, thereby protecting their profit pools.



Source: Federal Reserve Economic Data, BLS, IMF, USDA, SSG Analysis

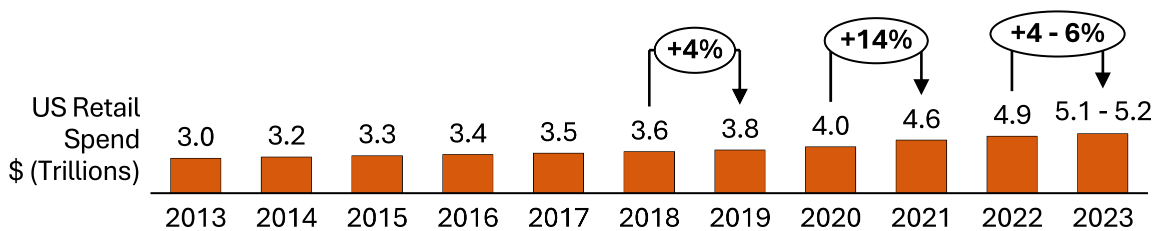
It’s time for suppliers and retailers to work together: The four realities of growing the pie collaboratively

We believe that while revisiting profit-sharing agreements may seem attractive to retailers and inevitable to suppliers, **the greater opportunity lies in growing the pie collaboratively**. Our perspective is informed by **four realities**:

1) Overall retail spend is growing albeit slowly.
2) Consumer demand is significantly underserved.
3) Shelf simplification is here to stay, and
4) Supply chain disruptions are easing, but not going away completely.

Hence, while revisiting profit sharing agreements is a lever for retailers to pull in the light of easing inflationary pressures, it is a distinct secondary lever. There is a greater opportunity for retailers and suppliers to **work together and grow the overall pie**.

Reality #1: Overall retail spend is still growing, albeit slower than during the pandemic. Retail sales for the previous year experienced a favorable 7% increase versus 2021, reaching a total of $4.9 trillion. While lower than the pandemic peak rate of 14%, this growth rate still surpasses the average annual retail sales growth of 3.6% observed pre-pandemic[4]. In our view, focusing excessively on margin adjustment at this stage threatens to disrupt the consumer centric economic growth engine.



Source: NRF (2023) | Note: Figures above exclude automobiles, gas stations and restaurants. 2023 values forecasted

Reality #2: Consumer demand is still largely underserved. Despite the higher spend noted above, our proprietary consumer surveys indicate that majority of consumer demand across categories is underserved, i.e. the products purchased by consumers do not completely address their emotional and functional needs. As such there is a large degree of **consumer compromise**. Addressing these gaps can dramatically change the shape of consumer spending, in favor of brands and retailers that position themselves to better address core consumer demand. However, this requires a significant supplier – retailer partnership to truly unlock growth.

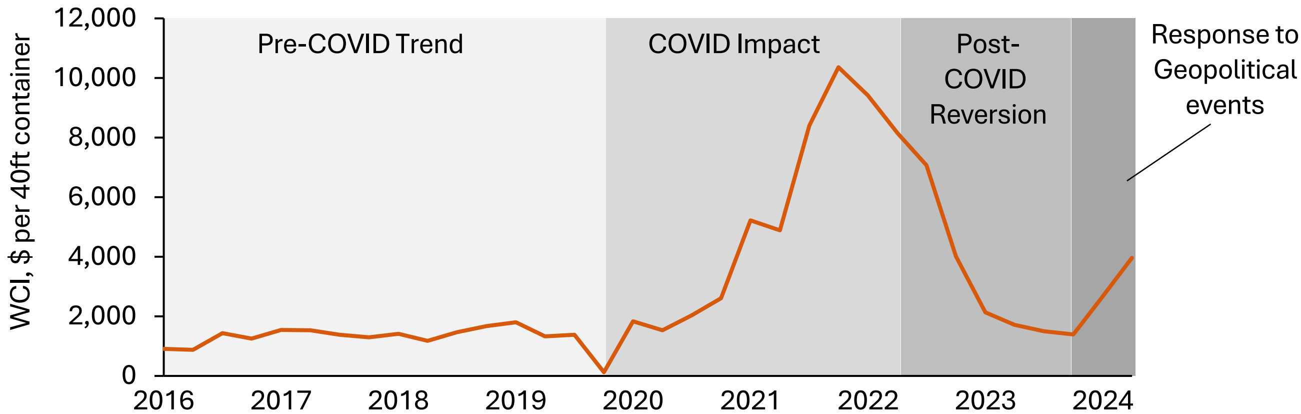
% of Underserved Demand Across Categories

Source: SSG Client experience

Reality #3: Shelf simplification initiatives add to pressure on retailers and brand owners. Despite growing consumer demand and its underserved nature, we have noticed that there is a concerted effort across retailers and brand owners to redirect this demand to a smaller set of SKUs. As an example, the number of new SKUs introduced in stores reduced by 60% between 2019 and 2022[5]. We have also seen brand owners take really hard looks at their portfolios and reduce focus on non-performers. This is partly a coping mechanism for supply chain logjams and high interest rates, but also driven by an inherent realization that improving variety for variety's sake does not result in sustainable incrementality.

Reality #4: Supply chain constraints have eased but have not disappeared. Supply chain disruptions have significantly eased after COVID-19 and shipping container prices have come down by about 90% from their COVID peaks. However as recent price movements illustrate, there is still geo-political risk in the system which might still adversely impact cost of supply[6]. Thus, suppliers still need margin flexibility to mitigate adverse supply chain impacts.

World Container Index, 2016 - 2024



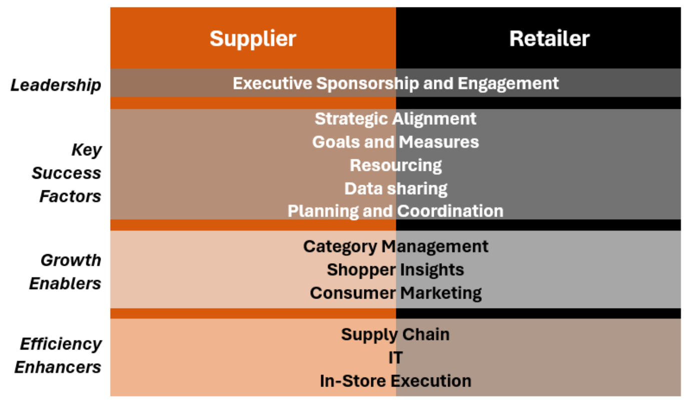
Source: Drewry (2024)

Takeaway: *There are four realities: retail spend is still growing, consumer demand is underserved, shelf simplification pressures are increasing, and supply chain disruptions remain. As these realities illustrate, there is significant opportunity for retailers and suppliers to drive growth collaboratively.*

4 Ways suppliers and retailers can work together

We recommend a **4-step playbook** for suppliers & retailers to play together in a dynamic economy:

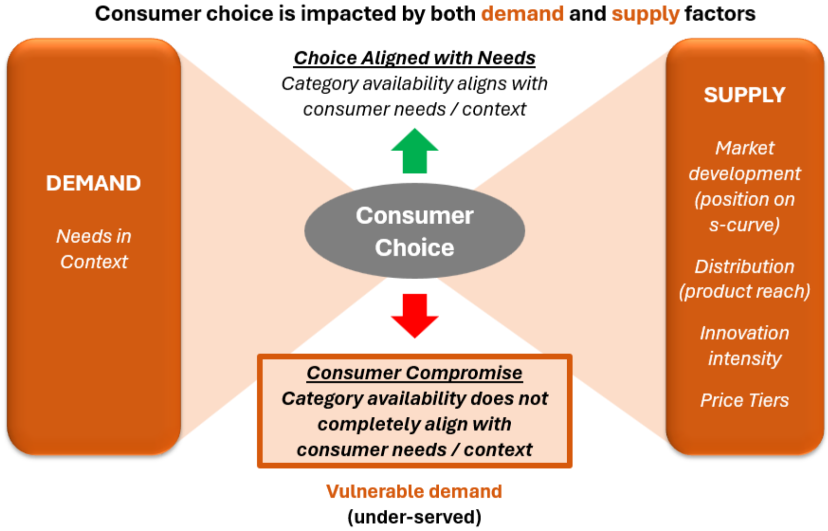
1. **First, put skin in the game.** Growing the overall consumer pie requires joint commitment on the part of retailers and suppliers. In our experience, joint business planning exercises leveraging a collaborative approach acknowledges and actions against the reality of shared interests, ultimately benefiting both parties. Joint business planning, done the right way, fosters stronger supplier retailer relationships and increases cooperation in other areas such as category management.



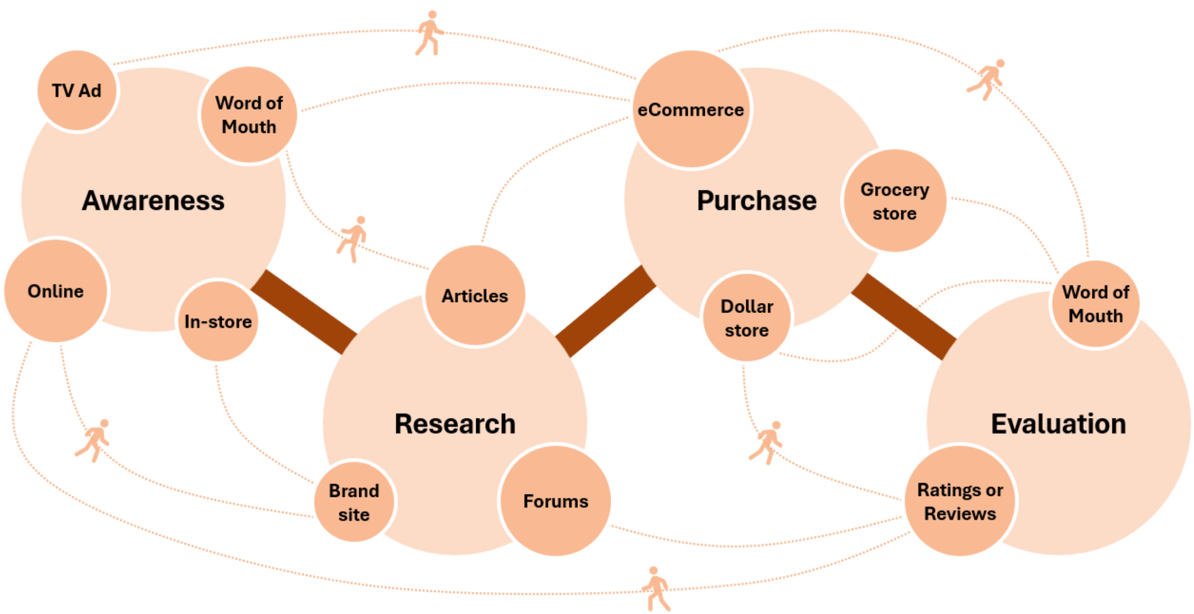
> *Our JBP efforts have driven incremental topline growth of 3 - 5% and resulted in stronger relationship with our customers*
>
> *- VP, Sales for Large Food Service Company*

2. ***Next, focus on understanding the shopper's underserved demand:*** No product is purchased in a vacuum. Across categories, our proprietary research shows that a very small number of shopping trips are for single product purchases. There are high synergies across categories that we can quantify analytically to derive 'power pairs'. Suppliers can leverage retailer specific strategic partnerships within and across categories by understanding how shopping baskets are built, identifying contexts and needs that drive choices at-shelf, and jointly developing programs that target the shopping occasion.

Consumer choice is impacted by both demand and supply factors



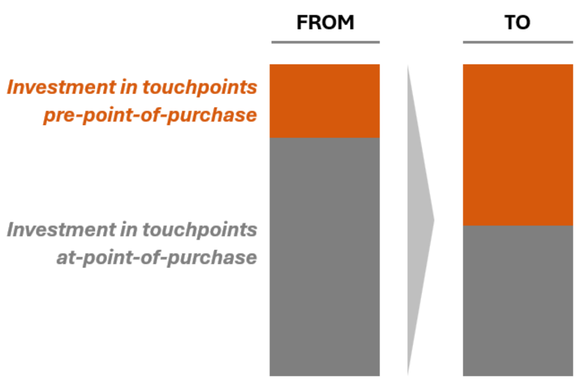
3 ***Then, activate against their path-to-purchase:*** The path to purchase is the journey of a shopper from the first time they are aware of a brand to when they purchase it. This journey spans across manufacturer and retailer websites, ads, in-store, and all other channels as a customer engages with your business and can be modelled comprehensively using large-scale consumer behavior studies and our proprietary performance-predictive algorithms.



At SSG, we have developed analytical models to identify shopper touchpoints that are most predictive of purchase and have developed investment plans aligned to this optimal path to purchase. In one category, our proprietary large scale consumer study revealed 60% of purchase decisions at the brand level were made long before the shopper even set foot in the store. Hence, pre-store touchpoints became very important. We then developed a predictive algorithm to allocate investments across touchpoints, calibrating for brand size, life-stage and growth ambitions. By rebalancing investment choices across touchpoints both before and at the point-of-purchase (POP), we were able to drive significant change in the trajectories of our clients' brands, while increasing ROI of the client's marketing spend.

4 Finally, develop a robust execution platform, tailored to each shopper, occasion & trip:

A. *Communicate where it matters:* Both retailers and brand owners need to first identify the touchpoints that matter to their consumer base and then prioritize these in their media and advertising efforts. The proliferation of Retail Media Networks also offers joint execution opportunities where touchpoints overlap.



> *Aligning our marketing investments to key consumer decision points was key differentiator for us*
>
> *- CEO, A Fortune "World's Most Admired Company"*

B. *Get the shelf right:* Refocusing on shelf management basics is important for retailers and brand owners to combat the post COVID consumer uncertainty and supply side constraints. Understanding the role that different SKUs play in driving both consumer volumes and upstream supply chain complexity is key to informing backend processes such as demand planning and innovation development. Leveraging forecasting tools can also help calibrate the level of innovation / new product launches to the market's ability to bear the innovation.

C. *Price to win demand:* For both suppliers and retailers, getting at-shelf pricing right is key to minimize leakage. While price elasticities and dynamic pricing tools help identify day-to-day opportunities, we believe there is a greater incrementality in aligning pricing strategies to true consumer willingness to pay. This requires articulating the value that the set of products offer to a consumer and then understanding the relative strength of a product vs its peers. This would also go a long way in reducing underserved demand.

D. *Measure, measure, measure:* Most companies have made laudable progress in gathering data to measure performance. For companies who do it well, the key differentiator, is measuring a simple, prioritized set of predictive metrics, tiering them to identify the 'what' and 'why' of performance. A best-in-class performance management system will go further and identify remedial actions to change performance trajectory.

***Conclusion:** The current dynamic of persistent underserved demand and inflation offer opportunity for retailers and suppliers to grow consumer spend through joint planning, addressing underserved consumers, activating along the path-to-purchase, and developing robust execution. Both parties stand to benefit from growing the consumer pie together, choosing cooperation over competition.*

Sources

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Our experts

Vish Sharma
Managing Principal
vish@sharmastrategy.com

Diana Hartford
Managing Principal
diana@sharmastrategy.com

Vivek Narasimhan
Senior Principal
vivek@sharmastrategy.com

Kirsten Myers
Principal
kirsten@sharmastrategy.com