CPG Manufacturing

Key Challenges Facing Consumer Packaged Goods Manufacturers and What They Must Do To Survive

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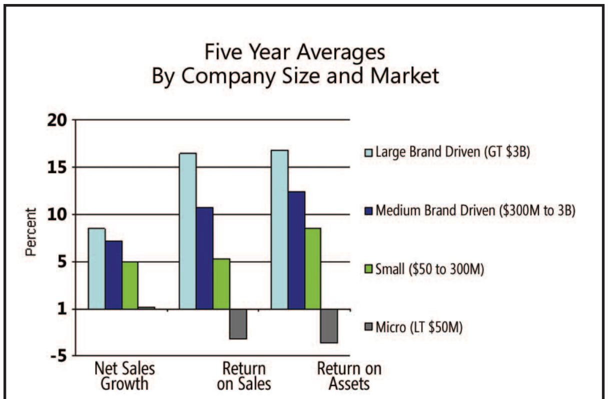
Consumer Packaged Goods (CPG) manufacturers face a lot of pressures: fickle consumers, powerful retailers, globalization, and more. The CPG manufacturing industry is large and thriving; however, margins are slim and competition is furious. There are hundreds of product categories, and to compete, firms must constantly innovate. Even industry giants cannot afford to sit back. How can the small-to-medium CPG manufacturer survive in the face of the same external pressures and fewer resources?

CPG Manufacturers—The Big Get Bigger and Everyone Else Struggles

As an example of what is happening to CPG manufactures, a five-year financial analysis of the small-to-medium food manufacturing enterprise versus larger companies reveals a dim picture. In terms of net sales growth, return on sales, and return on assets, mid-size manufacturers trail their larger counterparts. While the small companies (classified as $50 million to $300 million USD in the study) are at least close, the micro companies (less than $50 million USD) lag far behind.



Source–GMA and Kurt Salmon Associates

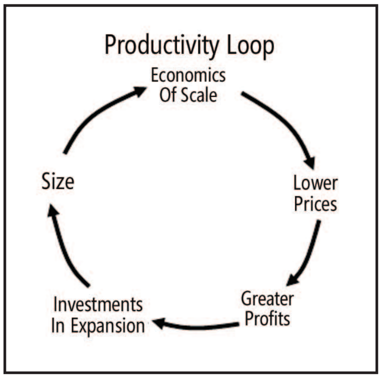
All CPG manufacturers face the same market pressures, but larger companies enjoy some distinct advantages. For example, they have more power with major retailers. Their broad product lines, greater geographic coverage, and typically stronger brands result in customers finding it easier and more effective to deal with them than their mid-sized counterparts.

With the large retailers demanding specific business process and technology investments, the larger manufacturer has the advantage of being able to write off these investments over a larger volume.

With the big manufacturers having many advantages, how does the mid-size CPG manufacturer compete and survive? To answer this question, we will examine the major pressures on CPG manufacturers today, analyze what these pressures mean to the small-to-medium manufacturer and describe the systems that can help meet these challenges.

Retailer Consolidation

From convenience stores to big box specialty stores to warehouse clubs, the big have gotten bigger while smaller retailers—from mid-size regional chains to the mom and pops—have been on a slide. Ten years ago, there were nearly 500 public retail companies in North America; today there are fewer than 300. "Size matters" is the rule that has driven consolidation. Economies of scale lead to greater efficiency and lower prices, generating greater volume at a lower cost per unit sold. This, of course, results in greater profits. And the ability to invest means an increase in size, which means even greater economies of scale. The result is a productivity loop.[1]



Today's typical CPG manufacturers are seeing a greater concentration of demand in their top few customers. Often, the top five customers make up the majority of revenue—sometimes as much as 80%. As one executive told us, "The small customers are getting both fewer and smaller while the large are getting fewer and bigger." With fewer, larger customers, the CPG manufacturer is increasingly reliant on keeping those few customers happy. The effects of having one of the top five go away could be devastating.

Retailer Demands

Consolidation means fewer decision makers with more power. Each controls a greater volume and market coverage. More importantly, a "no-thank-you" from one of the major retailers eliminates the manufacturer from a large segment of the business, with decreasing options to make up the lost opportunity and volume.

[1] Carl Steidtmann, chief economist and director, Consumer Business, Deloitte Research

The term "channel master" describes the developing role of the major retailers and CPG service companies. A channel master controls access to the market, decides which products will make it onto shelves, what the prices will be, and how business will be conducted.

TECHNOLOGY HURDLES

In the business press, we frequently see articles about radio-frequency identification (RFID). Major retailers are increasingly setting technical and business process requirements and deadlines for their suppliers. No one doubts that RFID will be an absolute requirement in the future; in fact, the issue is not if, but when. However, RFID is just one element of a continuing process on the part of the retailers to drive costs out of the supply chain. Other elements have included electronic document interchange (EDI) and, more recently, data synchronization, such as UCCNet and EAN. These technology-driven requirements represent an ever-higher technology hurdle that manufacturers must clear to participate in the retailer's sales success.

For many, these technology demands benefit both the retailer and the manufacturer. For example, AMR Research has reported that data synchronization reduces invoice and purchase order errors by more than 40% while decreasing the time to introduce new items by as much as three weeks.

Wal-Mart's drive toward "everyday low prices" is not new but has clearly helped the retailer become the largest company in the world. Wal-Mart continues this quest by leveraging both its size and technology to drive costs out of its supply chain. If a manufacturer wants to do business with Wal-Mart, it has to provide more than just product. It absolutely must also meet Wal-Mart's technology requirements.

Wal-Mart is not an isolated example; it's just the one we hear about most often. Technology mandates also exist from Home Depot, Marks & Spencer, Target, METRO, CVS, and other major names. Often, a mandate is for the same technology but with individual twists. Meeting Wal-Mart's RFID requirements is not the same as meeting those of Target or Marks & Spencer. The manufacturer needs both the ability to meet the technology requirement and to tailor its response to the demands of the individual retailer.

The retailer's decision to do business with a new supplier is not only about product. Retailers are now quizzing potential suppliers about their ability to meet the retailer's business processes and technology demands. Retailers are looking at the total cost of carrying a manufacturer's product, and that cost includes non-product issues such as supply chain and customer service abilities.

TIGHTER SHIPPING SCHEDULES

Retailers continue to push business practices that cut costs and increase product availability. With those objectives in mind, they insist on tighter shipping schedules. This means lower inventory across the supply chain, which reduces cost and typically results in less stock handled, which reduces labor and damage.

Product availability or the elimination of out-of-stocks has a major financial impact on both retailer and manufacturer. Keith Harrison, Global Product Supply Officer for CPG giant Proctor and Gamble relates the impact of retail out of stocks, "Retailers on average lose the sale 41% of the time, P&G loses 29% of the time." It is therefore not surprising that out of stocks is a key performance indicator for most if not all retailers when evaluating manufacturers.

PRIVATE LABEL

A study by the Gallup Organization found that 75% of consumers believe that store brands have the same quality, guarantee of satisfaction, packaging, value and performance as national brands. More than 90% of all consumers are familiar with store brands, while 85% say that they purchase them frequently.[2] For example, among 53% of top 100 CPG categories, private label volume share has increased.[3]

Store brands continue to be an important growth factor for retailers. In supermarkets and drug chains in particular, private label products now contribute an outsize share of new dollar sales as matched against the performance of national brands. Market share for private label in supermarkets was nearly 21% in terms of units, and the products accounted for more than 16% of total dollar sales. Market shares in drug chains reached a record 13% in units and nearly 12% of total dollar sales.[4]

[2] The Private Label Manufacturers Association

[3] IRI

[4] The Private Label Manufacturers Association

The drive to private labels has many impacts on the industry. Key among them is the market for branded products. With 50% of Wal-Mart's grocery sales coming from private label products, even those manufacturers that sell branded products through Wal-Mart cannot participate in 50% of Wal-Mart's volume. With both large and other retailers growing their private label business, the competition to supply the remaining branded business becomes even more heated.

However, for some manufacturers, providing the private label products represents a major opportunity. The competition to provide these private-label products is primarily driven by price and customer service.

PROMOTIONS

No one doubts that promotions are a driving force in the industry. For example, approximately 50% of all batteries are sold on promotion. The same is true of laundry detergent and facial tissue.

Trade promotion spending constituted 12% of gross dollar sales on average, with health and beauty care companies continuing to spend less on trade promotion than their food and general merchandise/non-food counterparts.[5]

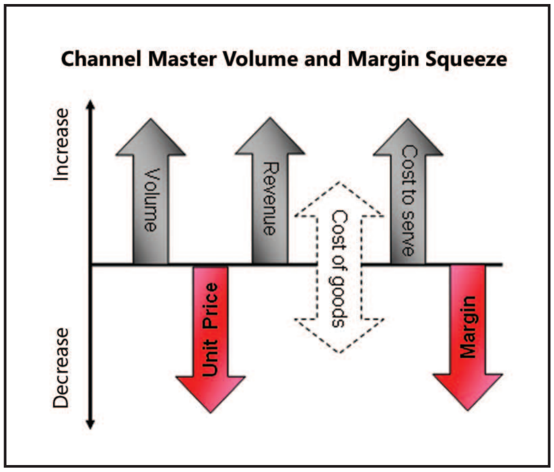
According to Cannondale, trade spending has jumped 33% in the past five years. Bob Hilarides, a consultant for Cannondale, isn't surprised, likening promotional spending to a drug addiction. Manufacturing companies, he says, "report earnings quarterly and need to support sales volume. They are not sure shareholder patience will be there. However, by increasing trade spending, they only raise the bar for next year. It becomes a never-ending cycle."

Nevertheless, industry surveys[6] show that nearly two-thirds of companies believe that the value received for promotion spending is only "fair" to "poor." And 85% percent of respondents feel that inefficient promotions are a "very important" issue.

THE MARGIN SQUEEZE

What does doing business with a channel master mean to the manufacturer's bottom line? For the most part it means increased complexity and cost of customer service. Let us look at the impact of channel master volume on margins.

What can a manufacturer do about the decrease in margin per unit? Sure, the manufacturer can accept it as a cost of doing business. But the continued pressure from the channel master for lower prices and greater service means that margins will eventually go negative. The manufacturer can also attempt to address the margin erosion; however, this effort is hampered by the fact that the manufacturer does not control many of the determinants of the profit margin. The manufacturer can attempt to increase volume with promotions, but only within limits and by sacrificing margins. The final volume decision is made by the channel master, who also controls the unit price, with the manufacturer having limited power to increase or maintain prices.



As we can see, the only real variable the manufacturer does control is the cost side of the equation. As a result, maintaining margins is the result of lowering cost.

WHAT CAN THE MID-SIZE CPG MANUFACTURER DO ABOUT RETAILER DEMANDS?

The consolidation of the retail market means more competition for the channel master's business and fewer places to make up any lost volume. It also means pressure on margins.

Larger and mid-size manufacturers with very strong brands can typically push their way in to gain a share of the channel master's business. Mid-size manufacturers with weaker brands have a larger challenge in gaining the channel master's business. Mid-size manufacturers with weak brands or no brands must rely on smaller retailers and private label.

[5] Cannondale Associates
[6] AC Nielsen Trade Promotion Practices Survey

In all cases, the mid-size CPG manufacturer must compete on many fronts. A major competitive tool is internal operations based upon strong systems. Reducing costs and improving customer service demands operational excellence. And in today's world, that means having in place systems that increase abilities, not hamper them.

Companies with ERP systems that were installed more than 10 years ago often share a similar situation. These systems may have been an excellent choice at the time. However, comparing the impact of these systems on the business can be revealing. In most cases, it has been necessary to augment the systems with extra efforts and side systems. These systems have often become a negative influence on these companies' ability to compete. Even with extraordinary efforts from the staff, gaping holes often exist between what customers expect and what can be delivered.

Any company has one of these older systems needs to ask whether the system is helping the company compete or limiting its ability to provide customers with what they demand.

These older systems often lack business process support for many functions. They were often designed in the mid-to-late 1980s to meet the needs of 1980s-era CPG manufacturers; but those needs have evolved, and the systems could not easily handle the new requirements. The base technology supporting these systems has also evolved, making them difficult to use and lacking flexibility relative to newer systems.

Consumer Demands

As everyone in the CPG industry knows, consumer behavior is ever changing, and new preferences, fads, and fashions dominate many purchasing decisions. For example, sales of air fresheners rose 17% between 2003 and 2004, while weight control product sales fell 12%.[7]

In addition, families account for a very large proportion of total CPG spending. Societal changes and the demands of increasingly busy lifestyles mean that families are no longer a homogeneous group. Different types of families require different products to solve their everyday needs.

As another example, the desire of consumers to look good and the aging of the population mean that cosmeceuticals market will grow quickly over the next five years. Older consumers will drive growth in this area through their adoption of anti-aging products. To capitalize on this trend, manufacturers must understand the specific needs and expectations of increasingly savvy and demanding consumer segment.

RISK OF FAILURE IS HIGH

Shifting consumer demands dictate that CPG manufacturers quickly develop products that meet those demands. Retailers and consumers will not wait, opting instead to switch to products and manufacturers that do meet their needs.

The fact that consumers and retailers will not wait means that time to market is a key to success. Reducing time to market requires that the trend be identified quickly, and, perhaps more important, the reaction time between the decision to develop a new product and the time at which it hits the shelf be as short as possible. Anyone involved in the CPG industry knows too well that most new products fail. Of all the new products proposed, only 2% make their way to the marketplace. And of these, 50% of those do not succeed. The risk is high.

WHAT CAN THE MID-SIZE CPG MANUFACTURER DO TO MEET CONSUMER DEMANDS?

To meet the demands of consumers and retailers for new products, the mid-size CPG manufacturer must invest in new product development. Consumer and retailer demand will not remain at the same level. While investments in new product development are required, the mid-size manufacturer must work harder to leverage these investments into the right product, and getting that product market at the right time. Today, that means having systems in place that allow both development and commercialization of new products.

[7] CPG Institute and IRI

Innovation drove share gains for manufacturer brands within several private label strongholds. Manufacturer brands increased share within 47% of top 100 CPG categories, including many in which private label has held an above-average share. Across several of these categories, successful new branded product introductions resulted in private label share declines.

Will a new product be good for both the market and the manufacturer? One key to that question is setting the right price—one that the consumer sees as good value and the manufacturer sees as having the right margin. Deciding on a price that provides an acceptable margin should be easy, but too many mid-size CPG manufacturers lack the cost information to make informed decisions. Quality costing information means the right pricing decision for new products and the ability to maintain margins on existing products.

ERP systems play a major role in new product introduction. A mid-sized manufacturer reports that the time between producing an acceptable test batch and reaching full production was 30 to 45 days. The delay resulted from the difficulties involved with gathering all the information, securing the appropriate in-house approvals, and establishing the required database (bills of materials, routing, quality, etc.) The combination of work flow systems common to most ERP systems and the improved ease of use of current systems can cut that delay and reduce the overall time to market.

Globalization

The CPG industry long thought it was safe from the impacts of globalization. It reasoned that the barriers of transportation cost, shelf life, and consumer preferences would protect its local markets. These assumptions have proven false. Due to lower labor costs, offshore manufacturers are delivering products to the local market at a lower price than domestic or even local manufacturers can achieve.

Of course, globalization is a two-way street. Products can enter your market, but your products can now enter other markets, a phenomenon once seen as impractical.

OPPORTUNITY AND THREAT

Is globalization an opportunity or a threat? Looking at the entire CPG industry, the answer is "both." Looking at individual product categories, the answer can be yes, no, or a combination of both.

Globalization clearly provides the opportunity to sell to new markets. Any discussion of globalization must begin with the impact of China. As a market for CPG products, the Chinese economy has been doubling in size roughly every six years. In 2003, total consumer spending in China was $1.1 trillion USD. From 1997 to 2003, per capita disposable income of urban Chinese increased 64.2% while total consumer spending in China rose 64.2%. China's huge population base of 1.3 billion consumers represents a very large opportunity. The challenge is to gain access to this very large market and provide products that the Chinese consumer wants. As other countries expand their middle class, the demand for imported products also grows.

Globalization presents the threat of new competitors with cost advantages. Logistics differentials still exist; however, the lower costs of production and processing in other countries more than makes up the difference.

WHAT CAN THE MID-SIZE CPG MANUFACTURER DO ABOUT GLOBALIZATION?

To benefit from globalization or to meet its threat, a mid-size manufacturer must, above all, be ready. To sell into new markets, it need to be a better partner and collaborate with customers who have different needs than its traditional customers. The mid-size manufacturer has to be able to deal with the increased complexity of a global supply chain. Product development must look at non-local issues, such as banned ingredients and local-label statements.

To benefit from and defend against globalization, costing systems become even more important. We find that most mid-size CPG manufacturers fail to have competitive cost tools. Without the right costing tools, pricing and cost-reduction programs are less than effective.

Summary

The pressure is on every CPG manufacturer worldwide. The small-to-medium CPG manufacturer faces the same pressures as the large companies, but has fewer resources to address them. However, the mid-size manufacturer must proactively address these pressures to maintain or grow share.

An important part of the strategy must be systems. Can the mid-size CPG manufacturer keep up without an industry leading ERP system? A manual system, one that is a mix of manual and spreadsheets or an ERP installed for a number of years, does not give the mid-size manufacturer a competitive platform to address these pressures. The lack of a competitive platform means expensive and time-consuming efforts to meet retailer demands, consumer demands, and the growing weight of regulations. The lack of a competitive platform limits a manufacturer's ability to benefit from or protect its markets against globalization.

Larger companies are leveraging large, recent investments in ERP to meet the needs of the major retailers, increase customer service, cut costs, and grow market share. Industry data tells us that these large companies are succeeding while mid-size CPG manufacturers are falling behind. Competing and defending your position means many things, but a key strategy is operational excellence, and that means leveraging ERP investments. Can a mid-size CPG manufacturer find an ERP system that meets both its business needs and its budget? The answer is clearly yes. ERP suppliers that focus on mid-size CPG manufacturers provide the functions required with a full understanding of the constraints of the mid-size company.

ABOUT THE AUTHOR

Olin Thompson is a principal of Process ERP Partners. He has more than 25 years' experience as an executive working with the CPG and software industries. Olin has been called "the Father of Process ERP." He is a frequent author, including a columnist for Food Engineering magazine, and an award-winning speaker on such topics as gaining value from ERP, SCP, e-commerce, and the impact of technology in the CPG industry. He can be reached at Olin@ProcessERP.com.

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